

# Review and Outlook

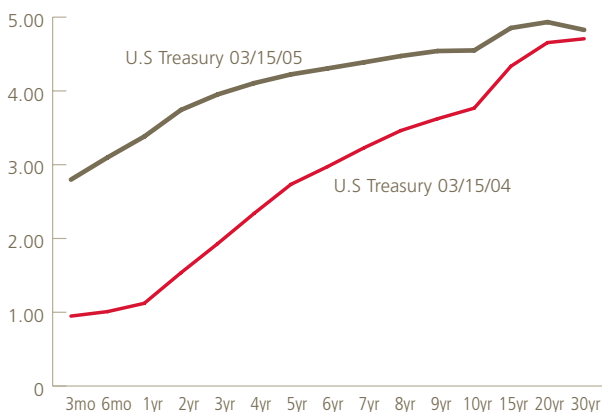
## EQUITY MARKETS CONTINUE TO GET LEADERSHIP FROM RESOURCE STOCKS.

### The Economy

In a recent hearing before the U.S. Senate, the Chairman of the U.S. Federal Reserve referred to the U.S. bond market as being a "conundrum". The Chairman's comments were directed to the fact that bond yields had not moved in line with the increases in short-term yields. Last June 30th the Fed reversed a policy of maintaining 40 year lows on overnight interest rates and began, with regular increments, to raise overnight yields. Since then, 90 day T-Bill yields have moved from 0.90% to 2.90% in less than a year. However, the focus of his "conundrum" is represented by the 10 year Treasury bond. Last June it yielded 4.55% and today yields about 4.50%, having dipped as low as 3.80% last fall. The failure of bond, and importantly mortgage yields, to move higher has impeded the Fed's goal to slow growth and prevent higher inflation, and to return the U.S. yield curve to a more historically neutral level.

Of particular concern to the Fed has been the rapid rise or "bubble" in residential real estate. Recent data shows that the U.S. housing market continues to have record strength and that the U.S. economy, after growing 4.4% last year, is in line to produce a robust 3.5% gain this year.

U.S. Yield Curve – Cdn \$



There is an axiom in the bond market that says, "don't fight the Fed", but bonds are doing just that. Bond yields, after some early concerns last spring about inflation, have interpreted higher oil prices, now threatening \$60 a barrel, as a relative rather than generalized rise in the price level. The economic impact of the dramatic rise in energy costs is expected to inhibit economic activity in the latter stages of 2005 to such an extent that generalized inflation would remain in check. Inflation forecasts for 2005 indicate that the U.S. CPI will rise about 2.5% versus an average annual rise of 2.9% dating back to 1990.

In Canada, as a resource based economy, our exports and GDP should benefit. However, these gains will be regionally felt, with industrialized regions like Ontario contracting, not just from higher energy costs but also from the lost competitive advantage caused by a higher Canadian dollar. GDP growth in Canada should fall from 2.8% in 2004 to 2.5% this year. Inflation should grow close to 2.0% as wage gains soften in a more difficult labour market.

### Financial Markets

Equity markets continue to get leadership from the Energy sector. Energy stocks in North America are up over 13% year to date. These gains mask an otherwise mediocre stock market performance. The S&P TSX now up some 2% would be down without this sector. The S&P 500, already moderately negative, would be even further in the hole. The TSX's superior results reflect the larger weighting, 21%, that this group represents of our market. Stocks, like bonds are forward looking and are measuring the potential for \$60 oil. While earnings for 2004 year-end and in 2005 thus far, have been exceeding expectations, up over 20%, forecasts are that higher borrowing and energy costs will soon take their toll on non-resource company margins. Manufacturers globally face increased difficulty in flowing higher costs

through in the form of higher prices because the competition from nations with substantially lower labour costs is so great. Consumers benefit from cheaper goods and lower inflation, but workers find jobs outsourced and companies earn lower profits. Investors have been pushing the price of Oil and Mining stocks to record levels, but as this positive market cycle approaches 30 months and matures, some investors have begun to rotate from the more cyclical commodity stocks to more defensive names.

In Fixed Income markets, the yield curve has taken on a flatter structure as short yields have climbed higher and longer bond yields have remained static. Returns this quarter were best in longer-term bonds where steady prices and higher yields prevailed.

**Outlook**

U.S. short-term interest rates are forecast to move higher. The market is anticipating an increase of 150 basis points to 4.00% by the fall of 2005. We expect short-term rates to plateau at 3.00 – 3.25% as the economy slows in the second half of 2005. Rates could move higher beyond this, depending on the degree of the economic slow down.

We expect Canadian short rates to remain around the current level of 2.50% and anticipate that the Bank of Canada will lower rates in the second half of 2005.

We expect that bond yields in both countries are “range bound”, trading either side of current levels, with a bias to moving lower if, as we anticipate, inflation remains moderate in 2005. Equity markets will continue to respond to commodity prices, interest rates and earnings. A cyclical retreat in oil and metal prices is likely, and with it, a consolidation in resource stock prices. Other sectors will be impacted by margin pressures and are forecast to produce 5.0% to 8.0% earnings gains with commensurate stock price performance. We have reduced exposure to Financial and Consumer Discretionary stocks as both groups are negatively impacted by higher short-term interest rates. We are now neutral Energy but remain underweight Technology.

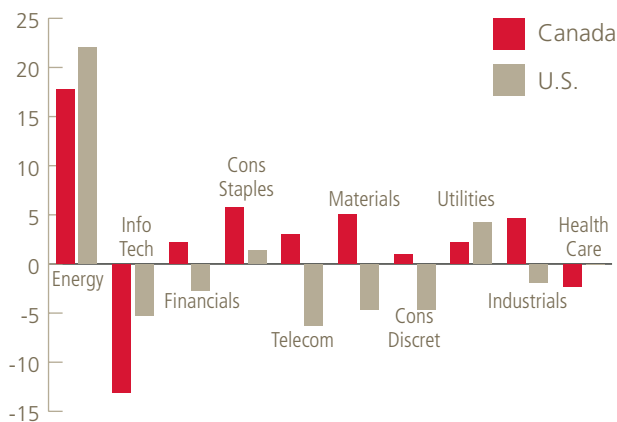
An important variable in the market place has been the U.S. dollar. After being under enormous pressure the last few years we see some respite this year. The U.S. dollar will likely move sideways in 2005 supported by a relatively strong economy (versus the rest of the G-7) and higher interest rates. On a more secular basis, the direction of U.S. Trade and Fiscal balances, along with productivity and inflation rates, will determine whether the U.S. dollar returns to its declining trend.

**Foreign Property Rules Eliminated**

In the most recent Federal Budget, the Government of Canada proposed the elimination of the Foreign Property Rules (FPR) which impact RRSP and Pension related portfolios. This is a positive market initiative that has been lobbied for by the investment community and the Pension Association of Canada since the early 1990’s, when the limit restricted foreign content to 10% of the book value of non-taxable assets (most recently 30%).

The removal of FPR will create a level playing field with respect to the purchase of domestic versus non-domestic assets. It will affect the operations of some RRSP eligible mutual funds that used structured products and derivatives to circumvent (legally) the exposure limits imposed by the

TSX & S&P 500 Sector Performance - YTD



Income Tax Act. These funds obtained exposure to U.S. or International equities through derivatives while maintaining their "Canadian" property status.

Our private clients will not be affected by this change at this time, as we have not been using structured products or derivatives to increase the foreign content beyond the 30% limit. Our clients have a variety of mandates but in general would have no more than 25% of foreign content at this time, most of which would be in the U.S.

Going forward we view this as positive nonetheless as we seek to buy the best companies around the world for our clients. At the present time we like many Canadian companies because they are benefiting from the growing global demand for resources, in addition to the leading financials, and select staples, industrial and other companies in Canada that offer an attractive risk/reward at this time. Nonetheless Canadian equity markets represent only 3% of the world market capitalization. We are therefore small on the world stage making it important that we continue to monitor the world for leading companies.

In this regard we have substantially strengthened our in-house research capability over the last couple of years, adding analysts in many sectors. We have focused our efforts on North American markets (the U.S. represents 52.2% of world market cap) as we can add the most value

in terms of bottom up research. We also follow international companies in industries where the leaders are outside of North America. More generally we use external advisors and managers to assist us in the management of our non-North American assets. Given our proximity to the U.S. we feel that this is the best use of our people and resources.

There has been some discussion as to the impact of this change on the flows of funds. We do not think that it will be material as Canadian investors were generally not at their limit. This is a positive step towards educating Canadian investors about opportunities in world markets. The removal of limits encourages a full assessment of global opportunities reducing the "home country bias" (favour your own market) in investment decisions. Exchange rate fluctuations and client needs will tend to continue to encourage investment in our own market. The removal of the FPR will simply open up the universe of opportunities!

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