

Review and Outlook

CONTINUED CONUNDRUM IN THE BOND MARKET OR ECONOMIC SLOWDOWN?

The Economy

Last quarter we wrote about Mr. Greenspan's comment on the "conundrum" in the bond market, where long term interest rates continued to decline in the face of rising short term interest rates and relatively good economic growth. This phenomena continues with the U.S. 10 year Treasury bond now yielding around 4.0%, down from the 4.5% we wrote about last quarter. In Mr. Greenspan's latest address to congress, he indicated that the economy continues on a firm footing and it was implied that he will continue to raise short term interest rates on a "measured basis", as required, even if that should result in an inverted yield curve (typically an indication of slowing economic growth).

At the same time, Mr. Greenspan pointed out potential risks to the current situation. The housing market in the U.S. has had excellent appreciation over the last 10 years and is becoming speculative in a few key markets (California, NY, Washington, Boston, Florida). Mr. Greenspan cautioned lenders on the use of "interest only" mortgages and exotic adjustable rate mortgages that let borrowers reduce their

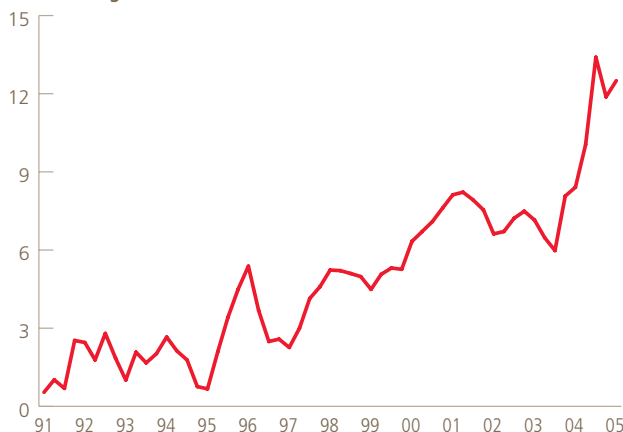
down payment. He essentially is using moral suasion to encourage lenders to be more vigilant in their lending practices to avoid over heating the housing market and creating a bubble. However, he did note that a housing slowdown in overheated markets was not likely to derail the economy generally.

Global growth continues to soften. Europe and the Euro are facing a challenge from countries not wanting to sign the EU Constitution (France and the Netherlands) which questions the pace of gains from a unified Europe. Italy and Germany are on the wrong side of the fiscal guidelines with a budget deficit too high relative to GDP. The western European labor market has been slow to restructure. China is still trying to slow its economy, adding restrictions and taxes on speculative real estate development and restricting lending practices to certain industries. Japan continues to oscillate between positive and negative growth and oil prices remain high. In spite of all of the above, economic growth remains above trend, even for the G-8 countries.

Financial Markets

Fixed income markets were strong as interest rates continued to decline around the world. The U.S. 10 year Treasury bond is hovering around 4.0%, with the Canadian 10 year slightly under that and most European 10 year rates

U.S. Housing Prices – US \$



10-Year Treasury Bond Yield



80-90 basis points lower. This interest rate differential has supported the U.S. dollar for most of the year contrary to expectations by most strategists who were focused on the trade and current account deficits.

Equity markets were up modestly on the quarter as lower longer term interest rates and generally good earnings provided fundamental support. Concerns about forward guidance prevented markets from advancing further resulting in a trading range mentality for most sectors. Energy in Canada, and Health Care and Utilities in the U.S. were exceptions, gaining modestly, as earnings stability and valuations supported these defensive sectors.

Euro vs US \$



Outlook

We continue to believe that economic growth is slowing for a number of reasons: high oil prices, rising short term interest rates and modest job creation in the G-8 countries as outsourcing to lower cost regions continues. The ongoing transfer of jobs to low cost centers will, however, keep inflation in check and interest rates lower than otherwise.

It is our view that equity markets, which have been generally flat year to date (in CAD), will provide low single digit gains by year end. As growth in the U.S. slows from 5% year over year, to 3.5% in 2005, earnings gains should slow as well. After recording 13.8% in the first quarter, we expect earnings gains to slow to the 7 – 8% level in the second half. This is down from current expectations of 12 – 15%. As a result, we have become more defensive in our sector allocation and stock selection and continue to favor high quality blue chip companies at this time. We have also moved more defensively in our fixed income strategy, reducing corporate holdings and shortening the maturity profile. We are now modestly underweight both equities and bonds with the balance in cash.

We will wait out this period of slowing growth and look for opportunities to invest as the tightening cycle comes to an end. Longer term, we are confident that companies are stronger with better balance sheets, more so than the consumers whose balance sheets are a little stretched relative to history. We are underweight consumer discretionary companies as a consequence, but feel that corporations are in good shape overall reflected somewhat in the activity in mergers and acquisitions. Slower growth now should result in more sustainable non-inflationary growth as we go into the coming year.

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