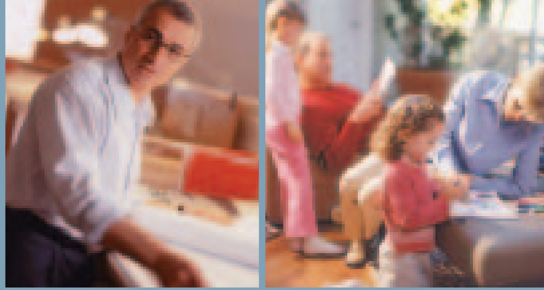


ScotiaMcLeod

exchange

SUMMER 2006

Q2

UNDERSTANDING THE FINANCIAL LANDSCAPE

With interest rates in both the U.S. and Canada continuing to climb in the first half of 2006, it's important to review investment holdings to make sure portfolios remain on track. This issue of *exchange* discusses why rates have risen over the past 2 years and provides some recommendations based on the current outlook in Canada and the U.S.

If you have any questions about the impact of interest rates on your portfolio, speak to your ScotiaMcLeod advisor. Your advisor can recommend a mix of asset classes and investments that are consistent with your goals and are appropriate for the market conditions.

March of the Interest Rates

Gareth Watson, CFA, *Associate, Portfolio Advisory Group*
Kevin Martin, CFA, *Associate Director, Portfolio Advisory Group*
Joey Mack, CFA, *Associate Director, Portfolio Advisory Group*

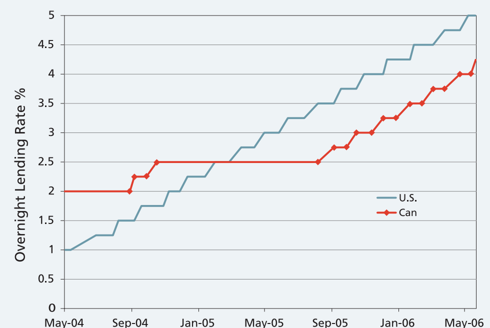
Interest rates have moved higher in 2006 as both the U.S. Federal Reserve and the Bank of Canada continue to raise their respective benchmark lending rates. The Bank of Canada has increased its overnight lending rate by 225 basis points (2.25%) and the U.S. Federal Reserve has raised its Fed Funds rate by 400 basis points (4%) over the last two years in an effort to tighten monetary policy from historically low levels.

The low interest rate environment seen over the past few years has had the desired effect of stimulating economic growth and consumer spending in both Canada and the U.S. to the point where both economies are currently operating at full production capacity. The Bank of Canada and the Fed are now concerned with controlling inflation pressures that are typically associated with this stage of the economic growth cycle and are increasing their benchmark interest rates in order to keep inflation in check.

Outlook on Rates

After the seventh straight 25 basis point interest rate hike at the end of May, the Bank of Canada signaled that it will pause its monetary policy tightening campaign. We believe the Bank is likely to remain on hold over the near term as it assesses the impact of the previous interest rate increases. South of the border, we believe there is still room for interest rates to move higher over the near term as the U.S. Federal Reserve

Interest Rate Increases by Canadian and U.S. Central Banks Since 2004



Source: Bank of Canada, U.S. Federal Reserve Bank

continues to assess the need to tighten monetary policy further. A pause by the Fed is not likely to occur until the central bank is convinced that economic growth is slowing and inflation is under control. Both U.S. and Canadian central bankers are in data watching mode as they continue to monitor the economic indicators for signs of the overall strength of the economy.

Fixed Income Recommendation

Analysis from the Scotia Capital Fixed Income Research department indicates that U.S. and Canadian bond yields typically move down (prices up) coming out of the final Fed tightening move in the rate cycle. With this in mind, active fixed income investors who believe that the Fed and the Bank of Canada are close to the end of their tightening program should consider positioning their bond portfolio for the end of the rate cycle by increasing portfolio duration during market pull-backs over the coming months. For passive fixed income investors, we recommend using a five or ten year laddered bond strategy depending on the required time horizon of the portfolio.

U.S. Equity Recommendation

We believe that U.S. equity market optimism should grow as soon as the U.S. Federal Reserve reaches the end of the tightening cycle. The S&P 500 index has still failed to reach new-all time highs, remaining 17% below the peak reached in 2000, despite strong earnings growth, as the market has been unwilling to assign higher price-earnings multiple overall. Large Caps, Golds, Technology, and Industrials would be among the biggest beneficiaries of the move to a neutral policy stance, and therefore we continue to recommend investors overweight these sectors within their U.S. equity portfolios.

Canadian Equity Recommendation

Considering our outlook, we would encourage investors to revisit interest sensitive stocks in Canada. These equities have declined in price due to the recent rise in interest rates and sector rotation into resource-based equities. Although there is no guarantee that money will stop flowing into energy or materials stocks, or that interest sensitive stocks will continue to weaken if interest rates continue to rise, we cannot ignore the fact that fundamentals have not changed to a great extent and that valuations for stocks such as banks, life insurance companies, pipeline companies, and power income trusts have become more attractive. We would treat the coming months as a period of accumulation for these stocks, encouraging investors to selectively add positions to their portfolios, especially with the Bank of Canada indicating that the current tightening cycle may be at an end.

Your ScotiaMcLeod advisor, with the support from a team of experts, have the resources and knowledge to help you determine the right mix of investments for any market conditions.

Reflections

"A goal without a plan is just a wish."

Antoine de Saint-Exupery

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