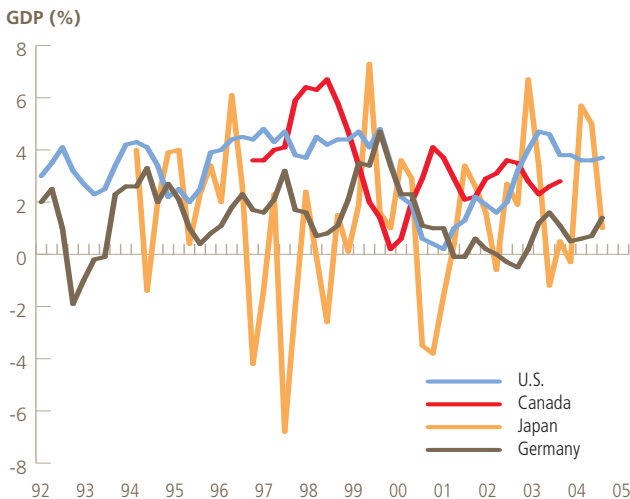


Review and Outlook

RESILIENCE IN THE FACE OF ADVERSITY

The U.S. economy has shown remarkable resilience in 2005 in spite of several shocks, natural and otherwise (Katrina, high oil prices, rising short term interest rates) which acted as a drag on the economy. Preliminary GDP numbers for the third quarter indicate growth of 4.3%, with 5% growth projected for Q4. Recent FOMC minutes suggest concern about the tightening process going too far, but the economic data shows unexpected strength that may not easily be abated. The consumer continues to hold up quite well, showing high confidence levels and a willingness to spend; in spite of the high debt levels. Globally, Japan has been experiencing a domestic recovery as deflation appears to have ended and corporate restructuring improves profit margins and return on equity. Continental Europe remains mixed while the emerging markets are quite robust as they benefit from rising resource prices and foreign direct investment. Canada has also been a large beneficiary of the strength in resources.

It is generally expected that the rebuilding after Katrina and Rita will extend the period of above trend economic growth into 2006. Beyond this, there could be a return to more normalized growth levels as higher interest rates and higher energy prices start to impact the overall economy.



New Face at the Federal Reserve

On February 1, 2006, Ben Bernanke assumes the position of Chairman of the U.S. Federal Reserve from Alan Greenspan who has served with distinction for over 18 years. Already there is much discussion in the investment community as to what this change might mean for monetary policy and its impact on the financial markets in the years to come. Mr. Bernanke is respected for his integrity and intellectual rigor and is generally well received by the financial community. It is expected that he will attempt to bring more transparency to the Federal Reserve. He also favours inflation targeting as a policy tool which, if adopted, could bring a greater emphasis on “inflation watching” as a means of anticipating interest rate shifts. The current core rate of inflation (Consumer Price Index ex food and energy) is 2.1% year over year. If the widely expected target rate for core CPI (between 1 – 2%) is used as a measure, then the Federal Reserve may not be as close to ending rising interest rates as some people think. These developments will be worth watching in the coming months.

CPI – excluding food & energy (%)



Financial Markets

2005 was a year of mixed returns for equities. Some markets were very strong, such as Canada, Mexico and Brazil in USD terms, benefiting from both local returns and strong currencies. Other markets, the U.S. in particular, provided modest returns in spite of a relatively strong currency. Fixed income returns in the major markets were also modest, as interest rates were generally flat to rising slightly.

As we look forward to 2006, we have reason for modest optimism as well as some caution with respect to overall expectations. First the optimism. Economic growth remains robust and above long term trends. Global growth is broadening to include Japan; emerging market growth remains strong. Inflation, while at the upper end of the desirable range, is generally contained through a combination of productivity gains in the major markets and wage costs restraint due to the threat of outsourcing to emerging markets. Earnings growth should continue, although at a lesser rate than in 2005. Equity valuations are within the normal range in most markets, assuming earnings remain somewhat intact. Short term interest rates, which have been rising since June 2004, should level off in 2006. Equity markets will likely greet the end of rising rates with a positive response.

Our caution comes from two sources. First, interest rates may have to rise longer than expected to contain inflation expectations. Secondly, earnings growth may be weakening by the time the Federal Reserve quits tightening. Interest rates are at very low levels across all major markets, the general level of which may have to rise slightly to keep inflation expectations under control.

Conclusions

In 2006, we expect that equities should continue to outperform fixed income and that fixed income should modestly outperform cash. Equity returns will likely be in the mid single digit range with fixed income returning slightly less than coupon. We remain focused on quality companies with reasonable valuations to achieve the best risk adjusted returns possible.

We wish you the best of the holiday season and a prosperous 2006!

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