Review and Outlook

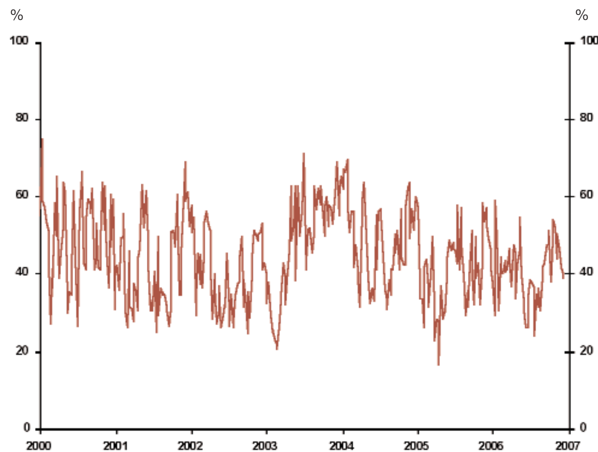
MARKETS CLIMB WALL OF WORRY

There has been plenty to worry about this year including: the slowing U.S. economy led by housing, geopolitical risks – North Korea, Iraq, the middle east, and oil prices…you get the picture. Yet, in spite of many real concerns, global equity markets had a good year (see table, page 2).

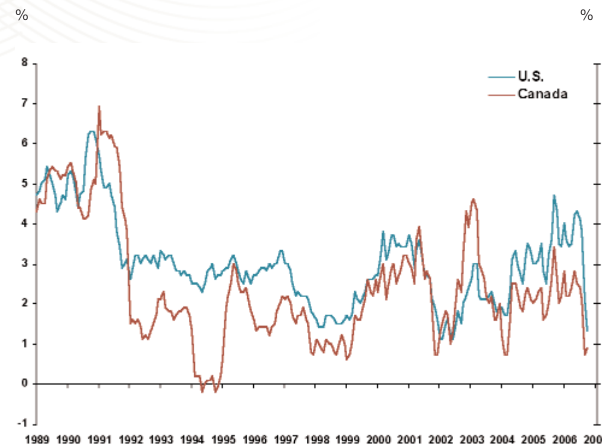
In the long run, earnings and interest rates are what fundamentally drive financial markets. Financial markets tend to lead the real world, discounting both good and bad news. The result is that financial markets do not necessarily reflect current conditions and can go up in the face of bad news, as "it was already reflected in the price."

In the shorter term, liquidity (excess cash) and sentiment, can move markets above or below their equilibrium levels. We monitor investor sentiment to determine how much good or bad news is being reflected in the market. This data (provided by the American Association of Individual Investors) shows that while the market keeps rising, investors' bullishness has moved up from the lows of the summer but is not yet at extreme levels. This suggests that investors are, in fact, being rational, presumably reducing risk as markets rise, which is constructive for markets.

U.S. Investor Sentiment



Consumer Price Index



The Enemy of Financial Markets – Inflation

Amongst all of the issues affecting financial markets, inflation is probably of the greatest concern to central bankers. On November 28th, U.S. Federal Reserve Chairman, Ben Bernanke, commented on "the risks of inflation in the latter stages of an economic cycle, as labour markets tighten, if economic growth is not moderated." While recent declines in energy prices have moderated inflationary expectations, recent core inflation (+2.7% excluding Food and Energy) remains above the FOMC's targeted range of 1-2%, suggesting that monetary policy (short term U.S. interest rates) will remain tight for the near term. The most recent non-farm payroll numbers rose 132,000 which was above consensus of 100,000, suggesting that employment remains reasonably strong in spite of a slowing economy with weak housing and automotive sectors.

Labour costs are rising while productivity is declining and this could put pressure on company margins. The Fed is anticipating further declines in inflation but does not feel that we are out of the woods yet. Therefore, while we expect U.S. short term interest rates to decline in 2007, it could be later, rather than earlier, in the year.

Corporate Earnings

Earnings growth for S&P 500 companies is expected to be 10.7% in 2006 after rising 14.4% in 2005. Consensus estimates for 2007 are for 12.1% earnings growth. This appears to be a bit of a stretch if we have a slowing economy. The S&P 500 is trading at 16.0 times 2007 earnings expectations. If inflation does ease, interest rates should decline, allowing for a modest multiple expansion and thus enabling a continuation of the rally in financial markets.

Conclusions

In the last quarter of 2006, the decline in oil prices and the strength of the employment market have been constructive for inflation and financial markets. Corporate earnings growth should continue in 2007, although at a slower pace. Corporate balance sheets are strong driving consolidation and synergies in even the weakest sectors (e.g. airlines). Emerging market growth remains robust even though developed markets are mixed. Strong overall employment appears to be offsetting weakness in the housing sector. On balance, while economic and geopolitical risks remain, we expect that in 2007 a "soft landing" for the economy is the most likely scenario, enabling lower interest rates without higher inflation. This combination should be constructive for financial markets, although we anticipate volatility and some consolidation as earnings growth slows.

The equity and bond markets have rallied materially off their lows in June. There is substantial liquidity in the market and risk premiums are being lowered, reflecting a positive sentiment shift on improving fundamentals. We are now entering the fifth year of strength in equity markets and are moderately cautious on equity markets as they make the transition to slower earnings gains in 2007. Therefore, we continue to balance our portfolio's with both economically sensitive stocks and defensive holdings, maintaining a slightly defensive asset mix to optimize risk adjusted returns.

Equity Markets	**2006 % Return**
S&P / TSX Composite	17.3%
S&P 500 (Cdn $)	15.7%
MSCI EAFE* (Cdn $)	26.3%
PC Bond Analytics (Universe Bond)	4.1%

* Morgan Stanley Capital Index, Europe, Asia, Far East

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