Review and Outlook

RISK IS BACK IN PEOPLES INVESTMENT THINKING

After nearly eight months of advances, global equity markets corrected 5-10% in late February, precipitated by China's Shanghai Exchange, which lost 9.5% on February 27. The net effect of these corrections has been to remind investors of the risks inherent in capital markets and to raise the "risk premium" in some of the more volatile and less liquid markets. It has also prompted much commentary and speculation as to whether this is the beginning of a major correction, or merely a pullback in a bull market. The table below shows the historical record of extended advances and corrections on the S&P 500.

The most prominent of the "experts" speaking on the markets has been Alan Greenspan, the former Chairman of the U.S. Federal Reserve, who indicated that a U.S. recession was "possible but not probable" and later quantified the risk of a recession as 33%. Weak U.S. durable goods data (-7.8%) preceded a sharp sell-off in U.S. markets, on the fear that the U.S. economy would slow more than expected.

S&P 500 Index after a big one-day decline

Day of decline of at least 2%	# of days since last decline of at least 2%	# of days in next 12 mos. when S&P fell at least 2%
02/27/07	949	?
03/07/96	526	16
02/12/93	314	2
01/07/86	746	6
10/30/78	807	2
05/11/73	728	8
07/25/69	678	5
08/25/66	694	3
08/07/59	428	0
Average	652	5

Mr. Bernanke Calms the Markets

Mr. Bernanke, the current Federal Reserve Chairman, in a congressional testimony on March 1, commented that markets were "working well" and that "there's a reasonable possibility that we'll see some strengthening of the economy sometime during the middle of the year." With respect to delinquencies in the sub-prime mortgage market, he indicated that it is "a concern, but at this point we don't see it as being a broad financial concern or a major factor in assessing the course of the economy." U.S. sub-prime delinquencies rose in the third quarter to the highest level since March 2003, causing at least 20 lenders to go under, scale back or sell themselves in the last five months.

Globalization and Liquidity

Economic globalization through trade, investment and the free movement of capital, has supported positive development in all regions. Liquidity, or the cash available for investment, has increased dramatically as hedge funds and private equity pools have provided material funding. Hedge funds, in particular, have been cited as culprits in this recent correction as they unwind the "Yen carry' trade (which involves borrowing cheap yen and investing in higher yield return instruments in North America). While movements in the Yen may make this thesis partially correct, the total value of the Yen carry trade is about $150 billion, small relative to the $43 trillion in global equity market capitalization.

Equity Valuations and Earnings Growth

Equity valuations are fair to attractive, depending on your expectations for earnings. Earnings are slowing, particularly in North American where expectations are for 5-6% earnings growth for 2007. The duration of the latest economic recovery and high profit margins has prompted questions as to whether we are at "peak margins," with earnings reliability now suspect. Expectations for lower energy and some materials prices have constrained the aggregate data. If demand for resources from emerging markets remains robust, positive surprises could emerge from these sectors.

Equity Valuation Metrics

	Price/Earnings Multiple		Expected Earnings growth 07/06 (%)
	Current	Forward 07/06	
Canada	16.5	15.3	5
U.S.	17.0	15.2	6
Europe	12.6	12.4	8
Japan	23.4	23.0	12

Outlook

Corrections are rarely two week events. We expect further consolidation and probably another downside test before the upward trend in equities resumes. During the recent market correction, the bond market rallied. The yield on 10 year Government of Canada bonds declined from 4.2% to under 4.0% resulting in a capital gain in bonds. Going into the market correction, we were overweight short-term and mid-term bonds, and underweight equities. We remain constructive on the 2007 economic and financial market outlook as employment remains strong, inflation contained and emerging markets growth, robust. We used this correction to add to equities (primarily in EAFE markets), but remain modestly defensive. We expect market volatility to continue as economic growth slows throughout the year and will use any market pullbacks to further add to equity positions. We remain focused on high quality companies with strong fundamentals, seeking to optimize risk adjusted returns over a business cycle.

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