ScotiaMcLeod exchange

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Q4

UNDERSTANDING THE FINANCIAL LANDSCAPE

All of us at ScotiaMcLeod hope that you have enjoyed your holiday break and were able to relax with family and friends. As we embark on another new year, we would also like to thank you for your trust and the opportunity to work together to help you achieve your financial goals. Our focus is on helping you 'stay the course' over a variety of economic and market conditions. This means providing you with a clearly defined, long-term strategy that reflects your level of risk and regular portfolio reviews.

The Leapin' Loonie

Warren Jestin, *Senior Vice-President & Chief Economist, Scotiabank*

The unprecedented 17%-plus jump in the Loonie since last spring highlights both the extraordinary volatility of exchange markets and the inherent vulnerability of the U.S. dollar to shifts in global investor sentiment. While recent currency adjustments may have gone too far, too fast, the underlying economic fundamentals remain broadly negative for the greenback and supportive for the Loonie.

In the United States, the credit crunch triggered by the sub-prime mortgage crisis and associated big setback in residential sales and construction foreshadows a retrenchment in consumer spending and a slower pace of business investment in the months ahead. Weaker growth and aggressive price discounting should also dampen U.S. inflation, providing room for the Federal Reserve to cut interest rates by at least three-quarters of a percentage point over the winter. As the Fed moves further out of sync with other more cautious central banks, the U.S. dollar will be prone to further slippage against global currencies.

Softening U.S. demand has tempered import growth at a time when currency depreciation and robust sales to emerging nations have underpinned double-digit export gains. However, with import costs nearly 70% above export earnings, a prolonged export out-performance is needed to allow a big reversal of the US$800 billion trade shortfall. About 70% of the overall shortfall reflects energy imports and the bilateral deficit with China, so rapid adjustment requires a big downdraft in commodity prices and reining-in of the consumer's proclivity to buy low cost imports -- both unlikely in the near future. Since the trade deficit must be financed by massive capital inflows, the U.S. dollar is vulnerable as long as efforts to reduce the imbalance

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lag actions by nervous foreign investors to cap or diversify heavily overweight U.S. dollar positions.

The Canadian dollar's meteoric rise against the U.S. currency has coincided with smaller but significant gains against the Euro and Japanese yen. In part, this reflects Canada's newfound attraction as a resource-rich economy in a resource-short world -- a positive for the currency that will be sustained by continued buoyancy in commodity markets through 2008. Our twin trade and fiscal surpluses, a more cautious monetary policy and the tendency for global investors to diversify their portfolios across currencies and asset classes also favours the Loonie. Even if, as we expect, an emerging trend to slower growth and lower inflation encourages the Bank of Canada to cut domestic interest rates by a further quarter of a percentage point in the first half of 2008, underlying economic fundamentals will probably keep the Loonie flying high.

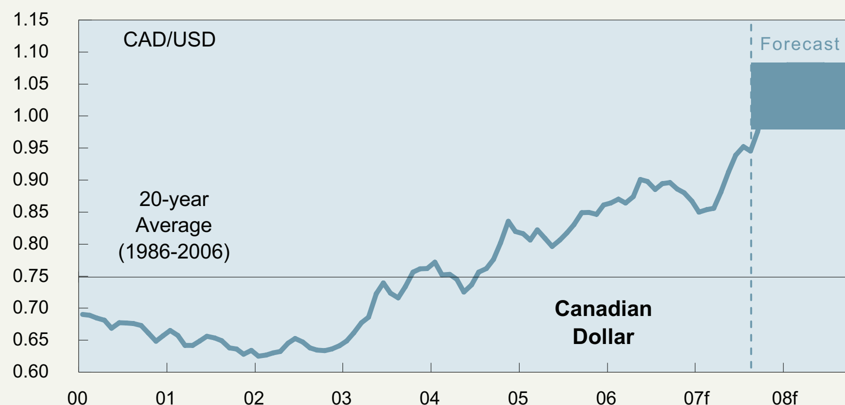
While the one-two punch from currency appreciation and weakening U.S. activity is dampening Canadian growth, we expect output to expand by just over 2.2% in 2008, roughly in line with our giant southern neighbour. China and other emerging nations will continue to expand rapidly, underpinning commodity markets and growth in our western resource-based provinces. Even in Ontario, weaker exports and job losses in manufacturing have been mitigated by solid growth in services and construction. At the national level, more construction jobs have been created over the past year than have been lost in the manufacturing sector, with the overall employment growth rate running at roughly twice the pace recorded in the U.S.

In some important respects, Canadian personal balance sheets also are in better shape than their U.S. counterparts. Unlike U.S. households, who reduced home equity to finance consumer spending, the average Canadian family has more equity invested in their home than a decade ago. The levering up of higher risk households that continued to fuel the U.S. housing boom, but ultimately set the stage for the U.S. sub-prime mortgage crisis and crunch in residential activity, has not been replicated here. Residential activity will be much less of a drag on growth on this side of the border.

The same holds true for non-residential construction, with major commodity-related projects providing important support. The commitment of Canadian governments to balancing budgets and reducing debt leverage also is a strategic competitive advantage and will be a key factor insulating our economy from setbacks in the U.S. economy. With combined federal and provincial black ink surpassing $30 billion last year, recent federal and provincial initiatives to boost spending and cut taxes will add significant stimulus. Government spending on Canada's transportation, education and health care infrastructure is boosting job creation – just over half of the employment growth this past year has been in the public sector.

The Leapin' Loonie

Underlying economic fundamentals will probably keep the Loonie trading between US$0.97 - US$1.07 in 2008.



Source: Scotia Economics

Sailing in Choppy Waters

Katie Tabesh, CA, *Associate, Canadian Equity Advisor, Portfolio Advisory Group*

Looking back on 2007, investors will likely find the second half of the year to be most memorable. Unfortunately, the past few months will not be remembered for returns, but for the heightened volatility in global financial markets. After paying little attention to risk for the past few years, during the third quarter of 2007 risk was re-priced and reassessed by investors globally. The underlying culprit was the cumulative effect of the availability of cheap capital that led to inflated asset values and ultimately volatility. The U.S. housing market was the first casualty contributing to the collapse of the sub-prime mortgage market which then spilled over into the financial markets. The re-pricing of risk was evident by the widening of credit spreads (the difference in yield between corporate and Government of Canada bonds) which was the result of investors moving to the sidelines which caused liquidity to dry up. As it currently stands, volatility and negative investor sentiment have not yet dissipated as concerns over the U.S. economy and consumer spending has only heightened.

Interest rates in Canada gravitated higher in the spring/early summer of 2007 as the central bank continued to battle the threat of rising inflation. However, concerns over price stability were soon replaced with apprehensions about economic growth as losses related to the downturn in the U.S. housing sector stole the spotlight. As a result, the Bank of Canada placed its tightening bias on hold while the Federal Reserve cut the overnight target rate by 75 basis points. Against this backdrop, bond yields in Canada rose during the first half of the year, but experienced significant volatility in late summer after credit concerns hit the marketplace. In the midst of the volatility, investors sought the safety of Government-backed securities in lieu of higher risk, corporate fixed income and equity securities.

Aside from the market turbulence, the currency was another hurdle investors faced in 2007 as the Loonie gained more than 17 percent against the U.S. dollar. The sharp rally of the Canadian dollar in the latter half of the year worked against investors that were internationally diversified, and in some instances erasing returns on U.S. securities. The strength in the Canadian dollar was largely driven by record prices of key Canadian exports such as oil, gold, and wheat. Earlier in the year, another influencing factor was the increased pace of takeover activity with Canadian companies targeted by foreigners. However, as the pace of global merger and acquisition activity took a back seat to credit issues in the second half of the year, the appreciation of the Canadian dollar relative to the U.S. dollar was largely due to interest rate differentials. The Federal Reserve cutting interest rates in the U.S. while most other central banks remained neutral, worked to push the U.S. currency lower against all global currencies. The continued strength in the Canadian economy combined with easing U.S. monetary policy could see the Loonie remain closer to par in 2008.

Longer-Term View Remains Positive

Looking forward, 2008 may touch on some of the themes discussed in late 2006/early 2007, but with a far more negative tone. Our initial view for 2007 was that the moderating U.S. activity in the latter half of 2006 would spill over into the new year and in response, the potential for Federal Reserve monetary easing would support the "soft landing" scenario which would lend support to equity valuations and ultimately send equity markets higher in the latter half of 2007. The U.S. housing sector began showing signs of weakness in 2006 which led to concerns surrounding construction and consumer spending in 2007. However, the slowdown in the U.S. housing market has taken longer than expected to work its way through the system and has adversely impact economic growth. Accordingly, we expect volatility in the equity markets to persist in the

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first half of 2008, but the recent actions of the Federal Reserve should continue to support consumer and business spending which defends our longer-term positive outlook for equity markets.

Building Positions in Foreign Securities

We have been encouraging clients to invest internationally for some time now, and considering the strength of the Canadian dollar, this investment strategy has become even more compelling. We give you four good reasons to look south of the border: 1) In the months ahead, if the Canadian dollar depreciates against the U.S. dollar (some analyst estimates call for the Canadian dollar to trade at US$0.96 in 2008) you will enjoy a foreign currency gain by purchasing U.S. securities at the current foreign exchange rate; 2) With the depreciation of the U.S. dollar, U.S. exports become cheaper in relation to imports, which ultimately translates into higher earnings for U.S. companies; 3) Considering the U.S. dollar has depreciated against major global currencies, U.S. companies with a large portion of sales from international markets benefit from the repatriation of foreign currency earnings; and 4) Considering the large weighting towards commodities in the S&P/TSX Composite Index, to attain portfolio diversification, investors are encouraged to look towards the U.S. for exposure to sectors where Canada is deficient (i.e. Healthcare, Technology, Consumer Discretionary, and Consumer Staples).

Maintaining Exposure to Commodities

Prices for base metals, gold and crude oil remained firm in 2007 thanks to a strong global economic outlook and a weaker U.S. dollar. Specifically, gold traded above $830 per ounce in November supported by the precious metal's correlation to a falling U.S. dollar, low sensitivity to economic cycles, and favourable supply/demand fundamentals. If commodity prices remain at current levels, which we expect, and as the global growth story remains intact for 2008, Materials and Energy related stocks should perform well, which in turn could support the TSX in the new year.

As we begin the new year, investors should take the time to review their asset allocation, as it is one of the most important investment decisions an investor can make. As noted, 2008 is likely to be a challenging year with strong headwinds as the fallout effects from the credit issues may prove to be a significant drag on economic growth and equity valuations. As such, reducing allocations to economically sensitive securities and increasing defensive equities exposure would be advised. We are also maintaining our asset allocation recommendation of overweight equities versus bonds. On average, equities have generated positive returns 12 months after the first rate cut. Your ScotiaMcLeod Advisor can help you establish and maintain the optimal asset allocation, investment selection and diversification to provide the best return possible for your level of risk.

Reflections

"Our greatest glory is not in never falling, but in rising every time we fall"

Confucius

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