Review and Outlook

A NEW YEAR BRINGS NEW CHALLENGES

A tough part of our job is forecasting change, especially trying to predict when that change will occur. What makes it difficult is that at any given time, the odds favour a trend that's in force remaining in force. In its early stages, it's unclear whether a developing trend will last. But once it takes hold and gets used to its surroundings, it's usually reluctant to go away.

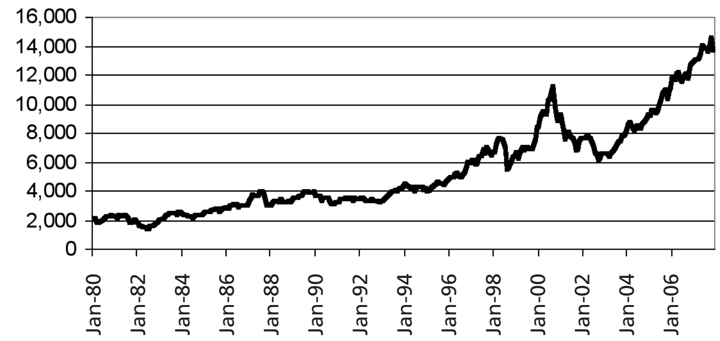
This type of stability is often viewed with skepticism by an investment world in constant flux. It's a world where stocks, groups and styles continually move into and then out of favour. It's a world of shifting currents with a myopic focus on the short term. And it's the kind of world that typically forecasts the demise of any trend that perseveres to multiyear status.

However, an awareness of this concept of major trend durability can be a big help to investors. It can prevent buying or selling too soon but in general, it's seldom discussed. That's in part because human nature likes to deal more with news of the here and now. This need is so intense and all-pervasive that it sometimes blots out what really matters to most investors – what happens over the long term.

Of course, no major trend goes straight up. There are always corrections or countertrends, some quite long, along the way. But in all of these examples, the primary underlying trend prevailed. Once grooved in, major trends often show amazing durability.

The truth is that well-entrenched trends, whether they apply to the overall market, stocks, interest rates, inflation or the economy, are exceedingly difficult to reverse. The stock market went from TSX 1346 in 1982 to TSX 11,388 in mid-2000 (including the 1987 crash), an 18-year bull market. Interest rates on the 10-year Government of Canada bond declined from 17% in 1981 to 3.82% in June 2005. That's a 24-year bull market. Inflation dropped from 12.9% in 1981 to 0.7% in 2006. That's a 25-year downtrend.

S&P/TSX Composite Index



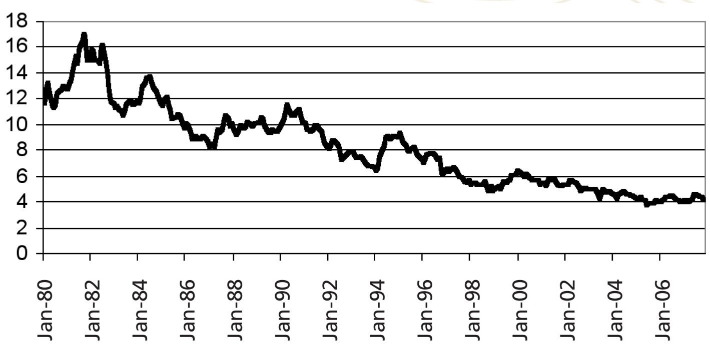
Like everything else in the investment world, there are always exceptions. By definition, a trend is major because it has achieved a certain maturity, but not all major trends last beyond expectations. What we can say is that the longer it endures, the more likely the principle of the durability of major trends will apply. It's similar to the reasoning behind assigning life expectancies. A 60-year-old male with a life expectancy of 80, once he turns 80, is expected to live another eight years and then another five after that.

Occasionally, we are wrong about a trend's perseverance, but more often than not, widespread expectations of the demise of an aging trend prove premature. Part of investing is dealing with extremes as extended markets typically become even more extended.

Therefore, just because you are seeing more news stories about the strained health of the U.S. economy doesn't mean you won't see better equity markets ahead. In fact, the S&P 500 (the benchmark for U.S. equities) climbed in eight of the 10 years the economy grew less than 1% since 1948.

So while we expect that the credit and housing crisis will likely lead the Federal Reserve (the "Fed") to reduce short-term interest rates in the U.S.(they did on December 11th), these lower borrowing costs could spur growth by the end of next year and drive stocks to the longest rally in two decades. Since 1971, the Fed has cut rates at least three successive times on 16 other occasions with higher stock prices (as measured by the S&P 500) being registered one year after the third cut in 15 of them, with an average gain of 18.2%.

Government of Canada 10 Year Bond Yield



Here in Canada, we continue to remain upbeat…more so with equities than bonds, which have rallied significantly on the back of the Bank of Canada's most recent cut. While valuations are now somewhat less compelling than earlier this year, we continue to see more value within the corporate bond market where, in many cases, many issuers have been unfairly tarred with the same brush that are underlying the credit issues facing many financial companies. Global corporate defaults remain low and we fully expect that operating earnings in both Canada and the U.S. are on track for solid growth in 2008. With equities, we are attracted by reasonable valuations, combined with mild interest rates and low inflation – both of which we believe will help the durability of the current business cycle.

At Scotia Cassels, we believe we have developed the patience and discipline to stay with the major trends. By adhering to a system of sound judgment and rational decision-making, we hope investors are likely to be pleased and surprised at just how far these trends can take and benefit them. As an investor, this knowledge can help prevent the disturbance of solid positions and help keep you on the right side of the market. And it will make it easier to put into proper perspective the daily onslaught of short-term news and opinion.

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