



Global economies and markets were presented with unprecedented challenges in 2008. As we head into a new year, many of these challenges still exist. While this can be unsettling for investors, it's important to remember that staying committed to a disciplined investment strategy is never more important than in volatile times.

With this recent volatility, many individuals are now beginning to realize – or worse, have yet to realize – that they could benefit from qualified, financial advice. This could be help with a single, specific need or perhaps advice on all aspects of a financial plan. If you have a friend or family member who you feel could benefit from the same level of professional advice that you are receiving, please talk to your ScotiaMcLeod advisor. They would be happy to offer them a complimentary portfolio review and second opinion on their investments and strategy.

All of us at ScotiaMcLeod wish you and your family all the best for 2009.

Uncharted Territory

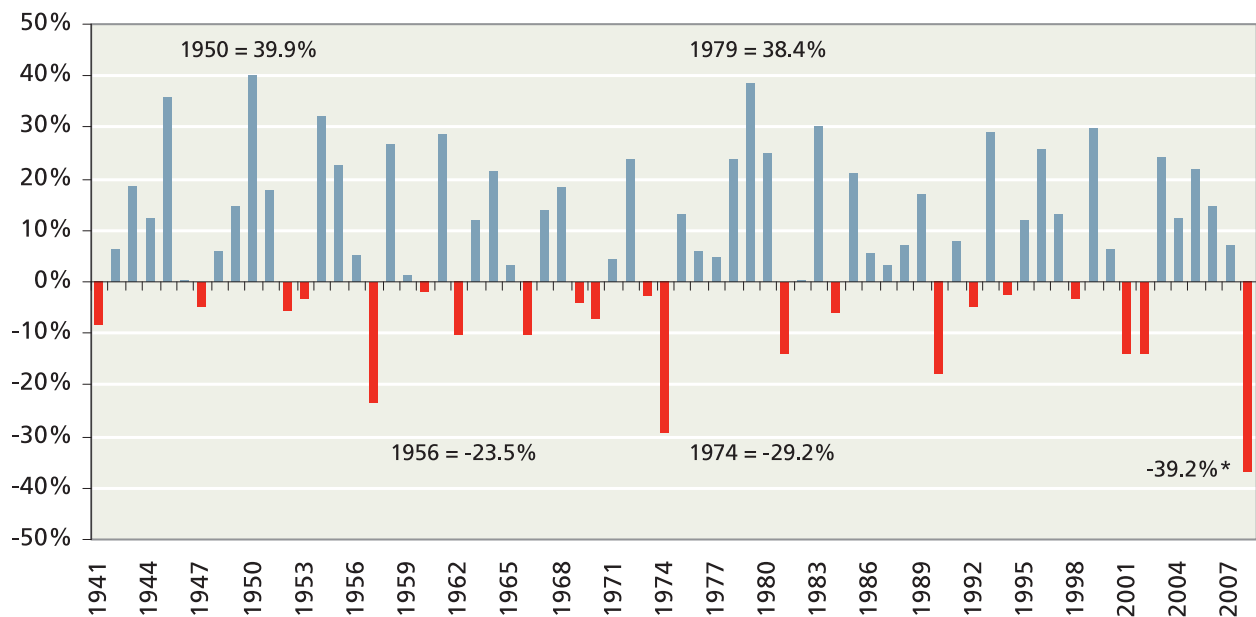
Gareth Watson, CFA, *Director, ScotiaMcLeod Portfolio Advisory Group*

2008 was simply a remarkable year, but unfortunately for the wrong reasons as we have been through 12 months of extreme circumstances and a roller coaster ride which most investors would have rather avoided. What made the performance of the TSX Index and other global indices all the more shocking was the speed and magnitude of declines witnessed in the second half of the year. Traditional fundamental analysis took a back seat

to irrational thought as equity markets found themselves facing a financial and economic crisis not seen since the Great Depression. The severity of the problems faced by economies and markets worldwide was not apparent at first, but became all too clear as capital flows disappeared, investment declined, consumption slowed and wealth was destroyed. Simply put, 2008 will likely be the worst year of performance for many equity markets in over 65 years.

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S&P/TSX Simple Annual Returns



Source: Bloomberg; *Returns as of December 1, 2008.

Before investors can think about the future, it is important to reflect on the past and make sense of what happened and why equity markets find themselves in such a difficult situation. Three main factors contributed to market declines in the second half of 2008.

1. THE CREDIT CRISIS

While we've known that credit markets faced headwinds since the emergence of the "sub prime mortgage" problem in 2007, a lack of transparency amongst global financial institutions hid a credit problem which turned out to be much larger than many investors expected. Predictions of losses in 2007 that were considered too aggressive at the time proved to be too conservative in hindsight. While

an ongoing subject of debate, we view the bankruptcy of Lehman Brothers in September as the catalyst which resulted in a domino effect of illiquidity and failure within the global financial system. Capital is the lifeblood of the financial markets. Without capital there is no investment, and without investment there is no economic growth. If capital is like blood then the financial system is like our circulatory system. Policy makers let Lehman Brothers go bankrupt, but that would be equivalent of removing your heart and expecting the rest of your organs to function efficiently. While I'm not a doctor, I think you'll all agree that such an expectation is not only wishful thinking, but simply impossible. The bankruptcy of Lehman

Brothers had many unintended consequences, but the most notable was the overwhelming decline in capital availability to banks, businesses and consumers like you and me. Without that capital, economic growth disappeared.

2. ECONOMIC CONCERN TURNS TO PANIC

The fact that many economies around the world started to slow in 2008 was not a surprise as many economists had forecasted a reduction in growth expectations. However, few expected a near collapse of the credit markets and the resulting consequences to the global economy. What was once economic concern turned into economic panic as many businesses

have been brought to a standstill resulting in an acceleration of unemployment, a collapse in commodity prices and restraint in consumer spending. Naturally, these three elements are important to our economy and help reinforce the conclusion that the Canadian economy has followed its international peers into recession.

3. FORCED SELLING

We have all been witness to a deleveraging of the global equity markets since September. Very cheap debt made it easy for investors to borrow money to invest. Such a strategy is sound when markets appreciate, but is detrimental when markets fall and lenders ask for their money back. Many institutional investors, notably hedge funds which made great use of leverage, have been forced to sell stocks not because they want to, but because they have to in order to pay back debt and meet redemption requirements. Simply put, thanks to cheap debt we had far too much capital in the equity markets and now we have to get rid of some of that excess capital before markets can stabilize. This is similar to an unfortunate trip to the doctor where you feel sick and ask for antibiotics. The doctor replies that you have a viral infection and there's nothing you can do but let the virus run its course. We face a similar situation as we try to flush the excess debt out of our equity system. While painful to experience, it's a necessary process that must occur before we can reduce volatility and gain a sense of stability. Forced selling has increased the magnitude of equity price declines and destroyed investor confidence. We cannot expect to see sustainable market rallies until that confidence is restored.

Going forward the question remains 'how can we turn things around?' While I certainly don't pretend to have the exact answer, there are two events in particular that need to occur before the global economy, and thus equity markets, have a chance to rebound.

RETURNED STABILITY AND FLUIDITY TO THE CREDIT MARKETS

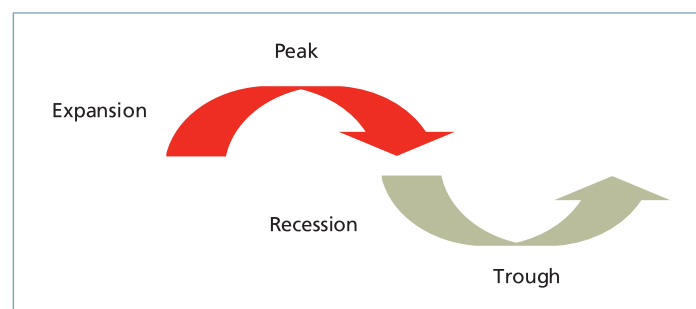
While credit markets have improved since mid-October, they are nowhere near the level of stability we need to see for banks to feel comfortable lending to each other, to corporations and to consumers.

STABILIZATION OF THE U.S. HOUSING MARKET

U.S. housing prices continue to fall, foreclosures continue to rise and inventories of homes continue to increase. These trends need to stop to prevent further wealth destruction for the U.S. consumer who is already showing signs of fiscal restraint. Also, the housing industry makes up a significant portion of the U.S. economy. It's difficult to expect economic growth when such an influential segment is struggling. The U.S. economy will likely lead the rest of the world out of this economic crisis, but the timing of such a recovery is well off into the second half of 2009 at the earliest.

LOOKING FORWARD

Let me state for the record that I believe that recessions and market downturns are inevitable as they are part of an economic cycle which has continuously repeated itself in the past and will continue to repeat itself in the future.



All that governments and policymakers can do is hope to extend expansions and limit the length and severity of recessions. In addition I will also state my belief that with every cycle comes the inevitable favourability or

lack thereof of different asset classes. What we have witnessed in the stock markets over the recent months has not been a “stock specific” issue, but rather a complete aversion to equities in general. Even some of what we consider to be the most defensive or safest companies in Canada have seen their stock price decline, not because they’re bad companies, but because investors simply did not want to own stocks. Equities, bonds, cash, and real estate are all different classes and history will show that one has never always outperformed the other.

This fact is the driving force behind diversification because you’ll never be entirely exposed to the best performing asset class all the time. While diversified or balanced investors do tend to adjust their weightings to such asset classes, they do not avoid an asset class altogether. To put equity performance into perspective, we were actually treated to one of the longest equity market expansions ever recorded in Canada from late 2002 to June of 2008. Unfortunately all good things normally do come to an end at some point in time, which is why regular portfolio reviews are always recommended as investors should not only diversify but also rebalance their portfolios from time

to time. While the most recent bull market was certainly welcome, it is no excuse to ignore the basic investment principles for a disciplined and diversified investment strategy. Every investor has different financial needs and goals and there is no single asset allocation model that works for everyone. To discuss whether your current asset mix is appropriate in meeting your long-term investment objectives, I recommend you speak with your ScotiaMcLeod advisor who can help you through this process.

We’ve just been through a market downturn that even the most experienced of investors will tell you was unlike any other. It was fast and its magnitude was severe. We know the first half of 2009 will be difficult, but the equity markets are already pricing in this expectation. If there is a silver lining to this decline it would be that we could be forming a low enough base that could possibly provide us with positive returns this year. But keep in mind that you should not expect a quick fix to the economic and financial problems we face as one does not exist. Patience and a disciplined investment plan are what you need to get through this difficult economic and financial storm.

Reflections

“Small opportunities are often the beginning of great enterprise.”

*Demosthenes, Greek Statesman
(384-322 BC)*



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