

CAPITAL MARKETS Review and Outlook

FIRST QUARTER, 2001

THE ECONOMY

The pronounced deceleration in the United States economy over the fourth quarter increased the risk that the world's largest economy might be heading for a harder-than-anticipated landing in 2001. With faltering consumer confidence, a much weaker manufacturing sector and lower equity prices signaling that the economic slowdown was gathering momentum, the Federal Reserve's Open Market Committee moved to an easing bias in mid-December. This dramatic shift in Federal Reserve policy was quickly confirmed by a lowering of short-term interest rates to 6.00% (from 6.50%) on January 3. Although Canadian and European real GDP growth rates also eased over the fourth quarter, the slowdown was not as dramatic as in the United States. Over the near-term, the Canadian and European economies have the potential to outperform the United States, a trend underlined by the fact that neither the Bank of Canada nor the European Central Bank moved to immediately match the Federal Reserve in lowering rates. However, with overall global growth moderating significantly from the high levels experienced in the first half of 2000, the medium-term prospects for significant growth differentials are less certain. Current consensus forecasts are for real global GDP growth to slow to approximately 3.0% in 2001, down from an estimated 4.1% in 2000.

BOND AND STOCK MARKETS

A Look Ahead



Factors supporting a soft landing outcome for the United States economy in 2001 are lower interest rates, the Federal Reserve's bias towards easing and the probability that the new Bush administration will quickly apply fiscal stimulus via tax cuts. However, for the first time in five years, technology production and investment are slowing at the same time as the rest of the economy, suggesting that a rapid economic re-acceleration is unlikely. Lower estimates for personal consumption, business investment and industrial production also imply a much weaker outlook for pre-tax profits, particularly for the first half of the year. With lower interest rates typically taking from nine to twelve months to positively impact profits, we believe the earnings outlook needs to stabilize before we significantly increase our asset allocation in equities. However, we do expect to gradually increase our equity exposure over the next several quarters, at a pace consistent with market conditions and opportunities.

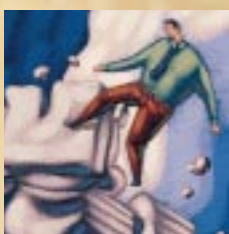
Bonds



Short and mid-term bonds performed well during the fourth quarter in anticipation of central bank rate cuts. With oil prices off their highs and a more stable inflation outlook, long bonds also rallied, but to a lesser extent than shorter maturities. As a result, the yield curve steepened, particularly between the two- and twenty-year term. We expect the Government of Canada yield curve to continue to moderately steepen in the months ahead, assuming a more normal positive slope as economic conditions stabilize and improve. Corporate spreads, particularly those of lower-

rated issuers, widened over the quarter, reflecting business cycle concerns, increased supply and modestly tighter lending conditions. As fiscal stimulus and interest rate cuts help to prime the recovery, we expect corporate spreads to narrow from current levels. For these reasons, we continue to emphasize higher-quality, liquid corporate bonds to enhance yield and performance. We recommend maintaining a lower-than-index duration in fixed income portfolios in anticipation of higher real rates and moderately higher long-term bond yields.

Equities



The weakest performing TSE 300 sector in the fourth quarter was Industrial Products, which declined 38.3%. Index returns continued to reflect the large Nortel Networks' weighting, which represented 18% of the TSE 300 at the end of December (down significantly from its 28% weighting at September 30). Excluding Nortel Networks, the "TSE 299" declined 0.3% over the period, reflecting the strong performance of traditionally defensive and less richly valued sectors such as Pipelines, Financial Services and Utilities. Overall, the fourth quarter was characterized by

downward earnings guidance from companies and earnings disappointments as slower economic growth began to affect corporate results. Measured in Canadian dollars, the S&P 500 finished the period down 8.24% (down 7.82% in US\$). Although eight of the eleven sectors that comprise the S&P 500 posted positive returns over the quarter, the negative index impact came from declines in the Technology, Communication Services and Capital Goods sectors. As with the Canadian market, sectors posting positive returns over the quarter were those providing more predictable and stable earnings. On the international side, equity market preoccupations mirrored the North American experience, with the earnings and economic outlook the primary concern. EAFE (Europe, Australasia and the Far East) markets traded lower over the quarter, with the weakest performance coming from the Asian region, particularly Japan. Within the context of the EAFE markets, we expect Europe to continue to outperform Asia due to improving prospects for the Euro and more stable European economic conditions.

THE LAST WORD

The current global economic slowdown has precipitated a rapid reassessment of security valuations. With sector and regional valuations now converging to a degree not seen for several years, we believe that stock selection will be key to superior equity performance in the months ahead.

SCOTIA CASSELS RESEARCH TEAM January 5, 2001