



As the global economy shows signs of turning the corner investors may be wondering where opportunities exist. With the support from a team of investment specialists, your ScotiaMcLeod advisor can help ensure that your portfolio is positioned to benefit from an improving economy with investment recommendations that are tailored for your personal situation and risk tolerance.

## What the Global Recovery Means for Canada

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

Canada was initially insulated from the deepening retrenchment in the U.S. and other developed nations by the resilience of its banking system, the relative financial strength of the government and household sectors, and by a huge revenue infusion from booming commodity markets. Our nation was dragged fully into the global recession only when faltering demand from emerging economies triggered a collapse in resource prices and export earnings in the final months of 2008. Even then, the erosion in employment, housing activity and car sales has been less severe than south of the border. Canada's headline jobless rate remains roughly a percentage point below U.S. levels — a rare occurrence — and the

\$50 billion deficit Ottawa projects for FY 2009-10, is less than one-third the comparable U.S. level when measured as a share of GDP.

As in the U.S., Canadian domestic activity will revive in the months ahead as consumers begin to return to the malls in greater numbers and a myriad of government-funded *shovel ready* projects actually get into the ground. The Bank of Canada will likely nudge up interest rates as the economy recovers in 2010, but borrowing costs will not be an impediment to the revival of domestic demand. However, with foreign sales one-third of Canadian GDP, the strength of the rebound will be tied to commodity markets and reversing the recent slide in U.S. sales.

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Canada is already benefitting from higher commodity prices in response to demand from China and other nations, but global growth through 2010 will be too tepid to reverse last year's unprecedented slide. The U.S. rebound will help bolster south-bound exports, but gains will be tempered if, as we expect, the loonie moves towards parity vis-à-vis the U.S. dollar as commodity markets strengthen further and the greenback comes under pressure on global currency markets. Prices for oil and most minerals are expected to move higher as global growth gets into gear, although sales of natural gas

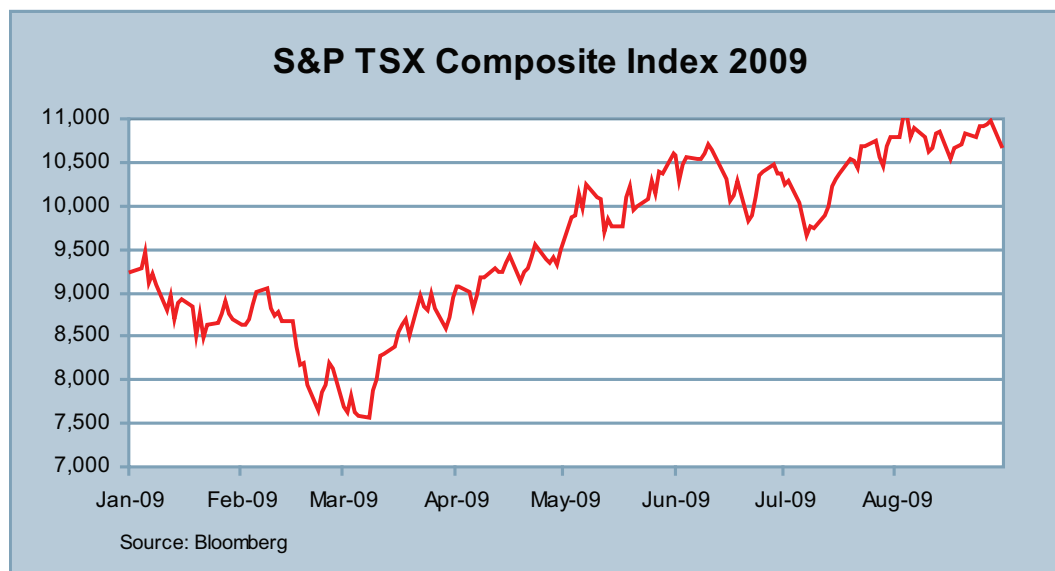
and forest products to the U.S. will be constrained both by that country's slow pace of expansion and competition from alternative sources. Auto exports also will be disrupted as the industry enters a prolonged restructuring.

The bottom line — we will soon begin moving away from one of the most difficult economic setbacks experienced in our lives, but patience will be required because the road to recovery will be a long and winding one.

## Canadian Market Update

Gareth Watson, CFA – Director, Portfolio Advisory Group

The year to date return of the S&P / TSX Index has been impressive thus far considering expectations going into 2009. As we head into the final months of the year, the Portfolio Advisory Group at ScotiaMcLeod provides some updated commentary on key Canadian sectors.



## FINANCIALS

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We have always been of the belief that:

1) Canadian banks were not going to cut their dividends; and 2) Canadian banks were well capitalized. We feel that the performance of Canadian banks since March only serves to justify and vindicate the statements above as share price performance has been impressive since March. At the end of August we could have argued financials were performing ahead of where they should be in the short term, but we believe such arguments are not that relevant for investors with a buy and hold strategy. Recent earnings out of the banks provided further evidence that Canadian banks are in better financial position than their international peers, that dividend policies were not in jeopardy, that risk was managed more appropriately in Canada, and that Canadian banks were profitable in a difficult economic and financial environment. While we still recognize that earnings growth will be difficult to accomplish in 2009, Canadian banks are still executing well.

## ENERGY

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Our expectations for the Canadian Energy sector were thrown completely out of whack since March because the U.S. dollar depreciated by a larger magnitude in a much shorter period of time than expected. We do not believe such a move was justified, but there is no doubt that a falling U.S. dollar put upward pressure on oil prices simply due to currency translation. Combine that effect with overly optimistic economic expectations and you saw the speculative premium in oil prices

expand. Strictly speaking from a fundamental perspective, focusing purely on supply and demand, we never thought oil should have reached US\$70.00 per barrel and as such we have been very cautious on buying the Energy sector in the short term.

## MATERIALS

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We continue to believe that the same arguments we make for the Energy sector apply to Base Metals due to their economic sensitivity. While we recognize that base metal commodity and equity prices did get a lift since March from U.S. dollar weakness and speculative premiums, fundamentally speaking we are not convinced that supply/demand fundamentals are strong enough to maintain such increases in the short term. Therefore we are cautious going forward, but admit there could be some additional strength to this area towards the end of the year if the economic recovery shows signs of accelerating into 2010.

Gold prices weakened towards the end of the second quarter in a seasonally weak period for the commodity and we couldn't be happier as we believe such weakness gives investors another opportunity to get exposure to this area of the market before we enter the seasonally strong demand period of the fall. While increased demand will help gold prices, our positive view on gold this year still hangs predominantly on our belief that the U.S. dollar will continue to depreciate further in 2009 and possibly 2010. While the depreciation may not happen in the immediate future, we believe this longer-term thesis will bring positive returns.

## DEFENSIVES

We continue to recommend that investors maintain defensive positions in a well balanced and diversified portfolio because the financial and economic headwinds we face are not going to disappear in the immediate future.

Furthermore, many defensive companies in Canada also have strong balance sheets, good management teams and offer a sustainable and high relative dividend yield. However, we could continue to see some “sector rotation” as investors that bought defensive stocks last year will actually start to sell them and buy more economically sensitive cyclical stocks to position their portfolios for an economic recovery. Such a move can provide temporary weakness for defensives, but just because their share prices may fall does not mean they are bad companies and in most cases we see value investors step in and buy them if share prices

fall too far. So while we recommend investors maintain exposure to these sectors of the market we do not recommend that investors overweight defensive industries as sector rotation will have an ongoing influence in the market for the next few quarters.

## OVERALL CONCLUSION

We remain cautious in the immediate term on cyclical stocks namely Energy and Base Metals and are comfortable with defensive industries and Financials. As we progress through the remainder of this year and into next, we may see more evidence of improved availability of credit, marginal improvements to the U.S. housing market and a possible economic trough. As such, we believe we will see strong financials, higher commodity prices and a weaker U.S. dollar along with positive (but modest) TSX returns.

### Reflections

*“Always remember that  
the future comes  
one day at a time.”*

*Dean Acheson  
American Statesman*



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