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Spring 2011

The road ahead: Where is the global economy headed next?

Economies are growing and stock markets are rebounding as corporate profitability improves. Our experts talk about the global recovery and themes that could drive financial markets in the months ahead.

EQUITIES

The credit crisis and global recession drove many investors to the relative safety of cash and other ultra-conservative investments. But in the past two years, most stock markets have enjoyed impressive double-digit gains, making investors feel more confident about prospects for the economy and their longer-term investments.* As a result, investors are gravitating back to equities for greater long-term growth potential and purchasing power protection.

What are the prospects for stocks in 2011?

"Our longer-term outlook for equities remains optimistic. Strong growth in company earnings in both Canada and the U.S. should continue to provide support to stock prices, although some of this growth is already factored into valuations, particularly in Canada. We continue to monitor broader macro economic themes such as those in European debt markets, the strength of the U.S. economy and rising inflation in emerging markets as they could influence market activity."

*John Varao, Portfolio Manager,
Goodman & Company,
Scotia Canadian Balanced Fund*

BONDS

Bonds have enjoyed strong returns over the last decade, thanks to a steady decline in interest rates. But with limited room for rates to move lower, the current interest rate environment in Canada could be a challenge for investors. Yet, bonds remain an essential component of any balanced portfolio. Diversified exposure to fixed income investments such as government and corporate bonds and GICs of varying maturities can effectively decrease the overall volatility of a portfolio while adding regular income.

Where are interest rates headed and what is the potential impact on fixed income investments?

"We expect The Bank of Canada to hold interest rates steady in 2011, given our forecast for a slower-than-consensus recovery. The corporate sector and yield curve positioning will be the focus for 2011, while income generation rather than capital appreciation will be the general theme."

*Romas Budd, Portfolio Manager,
Goodman & Company, Scotia Bond Fund*

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* Scotiabank® Consumer Insights study

GLOBAL EQUITIES

Growth in emerging markets has been so rapid that inflation has become a concern. In contrast, the debt crisis in Europe has stalled growth as many countries implement harsh tax measures and spending cuts.

What opportunities and risks face global markets in the coming months?

"Although short-term performance will ebb and flow, we think that global growth will continue, with emerging economies leading the way, aided by monetary policy in mature economies remaining accommodative. The biggest threat to continued improvement is probably inflation. However, a lack of credit growth, together with modest wage growth suggest this will not immediately become a major problem."

Charles Plowden, Portfolio Manager,
Baillie Gifford, Scotia Global Growth Fund

COMMODITIES

Natural resource-related companies account for more than 50% of the Canadian stock market. As a result of rising commodity prices, Canada was the best performing G7 market in 2010 and has been among the top performing equity markets for most of the past decade.

What's the outlook for the resource sector and what's likely to drive returns in 2011?

"The outlook for the resource sector remains positive for 2011. The prime driver in the energy sector will be the price of oil, which should remain attractive due to growing demand from China. While the materials sector also remains attractive, driven by soaring demand for base metals such as copper as well as precious metals including gold, prices are now so high that investors might begin to question how much upside is left."

Shane Jones, Portfolio Manager,
Goodman & Company,
Scotia Canadian Dividend Income Fund

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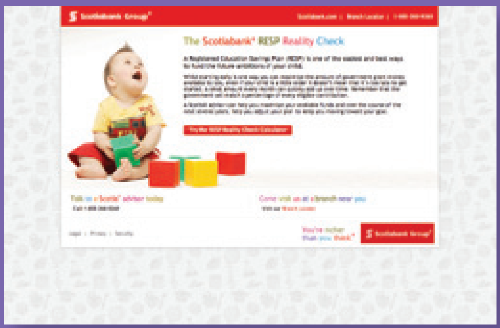

U.S. STOCKS

Home to over 40% of world's stocks and many of the world's largest multinational companies, the U.S. market is a critical component of any balanced portfolio. While the Canadian market is highly dependent on the performance of the Financial and Resource sectors, the U.S. offers more varied exposure to the growth potential of companies in the Technology, Health Care, Industrial and Consumer sectors.

With the U.S. consumer and their weakened balanced sheet, what are the prospects for U.S. markets?

"We are bullish on the U.S. and believe now is the time to invest in U.S. equities. The U.S. market has underperformed many of its global peers – most notably Canada – for a number of years and U.S. stocks remain very attractively valued. Multinationals and exporters stand to profit enormously as businesses and consumers around the world start spending again. And with a weak US dollar, U.S.-produced goods are even more attractive."

David F. Fingold, Portfolio Manager,
Goodman & Company, Scotia U.S. Value Fund

Before investing, talk to your *Scotia* advisor about which investment opportunities are best suited to your goals and personal risk tolerance.

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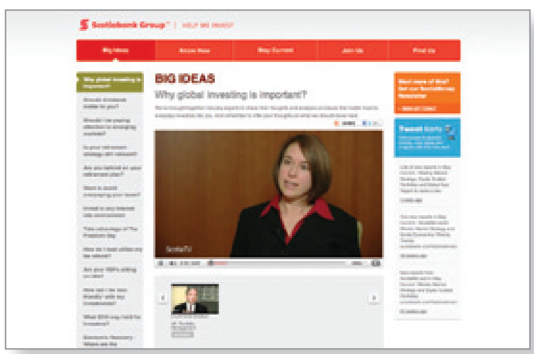

Warren Jestin,
Senior Vice-President and Chief Economist, Scotiabank Group

New world realities

In the U.S., economic growth is expected to be around 3% in 2011, supported by the extension of federal tax cuts through 2012 and other stimulus initiatives. Canada has outperformed most other industrial nations through the recession and recovery, and will probably match the U.S. this year, even as domestic demand softens and fiscal repair gets under way. While subdued by pre-recession standards, growth in the U.S. and Canada will compare quite favourably with prospects for the U.K., the euro zone and Japan.

The new economic powerhouses

At a time when major developed nations are destined for another year of recuperation and repair, China is expected to grow by nearly 10%, followed by India with an 8.5% gain. Growth of 5% or more is also likely in Brazil and a number of other Latin American and Asian nations, including Chile, Peru, Colombia, Korea, Thailand and Indonesia. These and other emerging powerhouses have become crucial sources of global locomotion, with their impact on foreign exchange and on commodity and capital markets escalating alongside their financial resources, and these nations are destined to become much more important to Canadian businesses over the next decade.

China, in particular, has become the driving force in many commodity markets. With foreign exchange reserves approaching US$3 trillion, its direct investments span the globe and its asset allocation decisions can have a powerful impact on global financial markets.

Inflation outlook

Robust growth in China has coincided with an acceleration in inflationary pressures. While inflationary hot spots have also flared up in Canada, the U.S. and other developed economies, the persistence of high unemployment rates limits the potential for a broad-based heating up of wage and price pressures.

Inflation prospects are less reassuring beyond 2011 as intensifying skill shortages begin putting upward pressure on labour costs. The cost of imports from emerging nations will escalate as their incomes rise and their currencies appreciate. The net effect — G7 central bankers will likely have a harder time achieving low inflation targets beyond 2012 than they have had over the past two decades.

Currency outlook

Concerns about the longer-term impact of unprecedented monetary and fiscal stimulus and sovereign credit risk are likely to push bond yields higher and will add to currency volatility through 2011 and beyond. While the U.S. dollar and euro may periodically display sudden bouts of currency strength and weakness, both currencies are likely to lose ground over time against commodity-based currencies — such as the Canadian and Australian dollars — and emerging market currencies such as the Chinese renminbi. The loonie will probably average above parity with the US dollar in 2011 and gain further altitude in 2012.

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