

CAPITAL MARKETS

Review and Outlook

THIRD QUARTER, 2001

THE ECONOMY

The Federal Reserve Board has reduced short-term interest rates by a substantial 2.75% since the beginning of the year. As a result, U.S. manufacturing is showing tentative signs of revival, although the sector continues to operate below capacity. The Bank of Canada lowered short-term rates by 1.25% over the same period. Even though the slowdown in some Euroland economies has accelerated, inflation concerns have prevented the European Central Bank from reducing rates more than a token amount year-to-date. Despite weaker labour market conditions, U.S. auto sales and housing demand remained firm over the quarter, highlighting the persistent divergence between the consumer and industrial sides of the economy. The continued appreciation of the U.S. dollar has made U.S. exports less competitive, compounding the difficulties in the manufacturing sector. Over the past three months the Canadian dollar has resisted the downward trend in most primary currencies. Attractive interest rates and high energy prices allowed the Canadian dollar to advance 3.9% against its U.S. counterpart, and 7.4% and 3.3% against the euro and yen, respectively. Although exports from non-North American regions have been insulated somewhat by weaker currencies, slowing global and domestic demand continues to inhibit the growth and trade outlook for Asia and Europe. As a result, consensus real global GDP growth forecasts for 2001 have been revised down to 2.1% versus the March estimate of 2.5%. Global real GDP is expected to expand 2.9% in 2002.

BOND AND STOCK MARKETS



A Look Ahead

The economic downturn in the United States continues to be concentrated primarily in the manufacturing sector. Although consumer confidence is vulnerable to further deterioration in labour

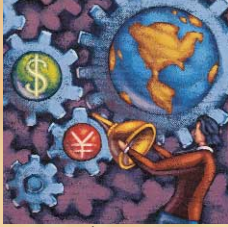
markets, low short-term interest rates and pending tax rebates should support consumer demand in the months ahead. In addition, early indicators, such as durable goods orders, suggest that the U.S. slowdown may be reaching a trough. Old economy sectors will likely continue to benefit from the lagged effects of monetary easing and a gradually improving outlook for the industrial sector and the economy as a whole. However, ongoing retrenchment in capital investment and demand in the technology and telecommunications areas could continue to weigh on index performance. Until the overall earnings outlook stabilizes, our equity allocation remains neutral.

TOTAL RETURNS

Period ended June 30, 2001

	Quarter	12 Months
SC 91 Day T-Bills	1.13%	5.47%
SC Short/Mid-Term Bond Index	-0.43	7.03
TSE 300 Capped (5% max/issue)*	4.10	-0.24
TSE 300	2.09	-23.11
S&P 500 (Cdn\$)	1.85	-12.62
MSCI EAFE (Cdn\$)	-4.61	-21.33

* courtesy BMO Nesbitt Burns



Bonds

Due to higher longer-term interest rates, which generally rise in anticipation of an end to monetary easing, fixed income markets registered the first negative quarterly return since the final quarter of 1999. The increase in longer-term interest rates caused the yield curve to steepen further over the past three months.

Although the Federal Reserve and other central banks are signaling an end to aggressive rate cuts, past central bank behaviour suggests short-term rates could remain low over the medium-term investment horizon, particularly if inflation pressures remain contained. Given moderating energy prices and lower overall demand in the economy, we view the steeper yield curve as an opportunity to increase yield and income. For eligible portfolios, therefore, we continue to recommend a slightly increased exposure to longer-dated Government of Canada and appropriate provincial bonds. Based on early evidence that the economic slowdown is bottoming, we are maintaining a modest overweight in corporate bonds to further enhance income and performance. To limit risk, we continue to emphasize high quality, liquid corporate issues with maturities of ten years or less.



Equities

For the third consecutive quarter, the weakest performing TSE 300 sector was Industrial Products, which declined 7%. The Industrial Products sector has eroded approximately 65% over the last nine months in response to ongoing weakness in the technology hardware area generally, and Nortel Networks specifically. By the end of June, Nortel Network's TSE 300 weighting stood at 6%, compared to its weighting of 10% at the end of March and 18% at the end of 2000. Apart from

Industrial Products, the only other sectors experiencing negative returns for the quarter were Paper & Forest Products and Pipelines. All of the eleven remaining TSE 300 sectors advanced, with Mines & Minerals, Precious Metals and Real Estate posting gains in excess of 10%. The S&P 500 traded higher over the period, gaining 5.85% in U.S. dollar terms. As was the case for the TSE 300 and major international equity markets, most of the advance in the S&P 500 occurred early in the quarter. The rally in equity markets stalled as the period progressed, reflecting renewed concerns about corporate earnings and the potential for a rapid U.S. economic recovery. Outperforming S&P 500 sectors were Technology, Capital Goods, Basic Materials and Financials, while the Utilities, Communication Services and Healthcare sectors posted negative returns for the period. Measured in local currency terms, most major EAFE (Europe, Australasia and the Far East) markets ended the quarter stable to moderately higher.

THE LAST WORD

While bond markets are increasingly discounting a trough in the economic cycle, equity markets could remain range-bound until the corporate profit outlook stabilizes. As noted in our April review, positive fiscal and monetary conditions are in place and return expectations are becoming more realistic. Overall conditions remain supportive of a gradually improving economic and earnings outlook.

SCOTIA CASSELS RESEARCH TEAMJuly 9, 2001