

Review and Outlook

IN 2002, CANADA HAD STRONG CONSUMER SPENDING, A ROBUST HOUSING MARKET AND THE BEST JOB GROWTH OF THE G7 COUNTRIES

The Economy

In 2003, economic growth in Canada and the United States should converge around the 2.8-3.0% level. After a more modest slowdown in 2001 (1.5% versus 0.3% in the U.S.), Canada continued its out performance in 2002 propelled by a 14 year high in consumer confidence, a four year swing of record auto sales in the U.S. and a competitive exchange rate. As a result, Canada had strong consumer spending, a robust housing market and the best job growth of the G7 countries (close to 500,000 new jobs created). The U.S. also benefited from strong consumer spending, supported by record mortgage refinancing driven by exceptionally low interest rates. The difference in growth rates between the two countries (3.3% versus 2.5%) however, was due primarily to the drag on economic growth created by the sharp decline in capital spending in the U.S. Business investment dropped close to 30% from its peak in 2001, but provided a modest contribution to growth in Canada over the same period. The U.S. is now suffering from the overbuilding and excesses that took place in the latter half of the past decade.

In 2003, economic growth in Canada should trend moderately lower from the 3.3% rate recorded in 2002. It is unlikely that auto sales will remain at peak levels in the U.S., consumer spending already started to ease in the fourth quarter of 2002, and the leading indicators are flattening. Conversely, in the U.S., growth could move moderately higher (from the 2.5% rate in 2002). Although consumer spending is not expected to be as strong in 2003, due to high debt levels and low savings rates, there will be offsetting factors contributing to economic growth. The Bush administration is planning to pass a stimulus package, which will include tax cuts and government

spending, and we could see some improvement in business investment. The risk to growth in 2003 is clearly the level of capital spending. Normally at this stage in the economic cycle, capital spending is one of the main drivers of growth. However, given the excesses of the late 1990s, corporate debt levels are high and capacity is abundant. In addition, weak profit growth, the focus on expense control and the uncertainty surrounding geopolitical risk, all combine to limit significant spending increases.

AS WE LOOK OUT TO 2003, WE EXPECT THE YEAR WILL BE ANOTHER VOLATILE AND CHALLENGING ONE FOR EQUITY MARKETS BUT THE PROSPECTS ARE GOOD FOR A RESUMPTION OF POSITIVE RETURNS.

Financial Markets

Given the tumultuous year in 2002, marked by accounting scandals, disappointing profit growth and renewed geopolitical risk, it is no wonder that equity markets (in the U.S.) declined for a third straight year. The year was marked by significant volatility with interim lows on July 9th and October 9th, followed by powerful rallies which proved to be unsustainable. As we look out to 2003, we expect the year will be another volatile and challenging one for equity markets but the prospects are good for a resumption of positive returns.

Economic growth, although moderate, will still be up nicely from the recession lows of 2001. The first part of the year will likely be the most constrained due to the Iraqi situation and high energy prices. Assuming a favourable resolution by mid year, lower oil prices should follow, and this should set the stage for a stronger second half.

In contrast to the equity markets in 2002, the bond market completed its third straight year of positive returns. Less than robust economic growth in North America, low inflation, and worries with respect to potential deflation, all combined to take the 10-year Government of Canada bond yield to a low of 4.8% at the end of 2002. This was close to the all time low of 4.7% recorded in 1998. As longer term rates were trending lower, the Bank of Canada raised short term rates (three times in 2002) to 2.75%. This caused a flattening of the yield curve as rates shorter than two years rose and longer-term yields fell. Provincial spreads narrowed over the year while corporate spreads finished the year relatively unchanged after large gyrations that ebbed and flowed with economic expectations. In the U.S., government bonds performed even better, due to the slower economic growth and lower inflation. Given the weaker economic conditions, the U.S. Federal Reserve lowered interest rates to the very low rate of 1.25% on November 6th. As with equity markets, the first half of 2003 will be particularly challenging for fixed income markets due to geopolitical uncertainty. In the latter half of the year, tax cuts and deficit spending should put upward pressure on interest rates.

Investment Strategy

Our equity strategy for 2003 will be governed by a stock picking focus and a valuation discipline. In a modest growth economic environment, where corporations have marginal pricing power, our challenge will be to find well-positioned companies with strong management and trading at reasonable valuations. We will focus on companies with strong cash flow and solid dividends. From a sector perspective, we remain concerned by the high valuations still present in the technology sector and as a result will underweight this group. We are emphasizing cyclical areas of the market as opposed to consumer related. In the consumer area, we are de-emphasizing the housing and auto sectors as these groups have benefited inordinately through the downturn leaving little pent-up demand.

The fixed income strategy in 2003 is to maintain a slightly short average duration and to overweight good quality corporate bonds. The emphasis will be on a 'barbell' yield

curve strategy, which takes advantage of a flattening yield curve. This strategy avoids mid term bonds in favor of shorter term bonds, which can be reinvested at higher rates, and longer term bonds for the higher yield.

THIS TYPE OF MARKET ACTIVITY...PROVIDES AN EXCELLENT OPPORTUNITY FOR PORTFOLIO MANAGERS TO GENERATE SOLID RETURNS FOR INVESTORS.

Unlike the 1990s, when it was difficult for investment managers to beat the indexers and day traders (as traditional equity analysis fell to the wayside and companies without earnings or even the prospect thereof, out performed), the next few years will provide the opportunity for fund managers to provide significant added value. In a post-bubble environment, it can take years before the stock market resumes a sustained upward trend and breaks through its previous highs. This period is usually marked by extended cyclical advances (and declines), as the market trades within a wide range. This type of market activity however, provides an excellent opportunity for portfolio managers to generate solid returns for investors. Tactical asset mix changes and security selection will be the main focus of our investment strategy in 2003. We are currently modestly underweight both bonds and equities anticipating better buying opportunities later in the first quarter. Given the anxious geopolitical outlook, we expect to be able to take advantage of expected volatility. Total returns on equities will likely exceed bonds on the year, but will be subject to considerable volatility making timing and execution more important. On balance we look forward to a better year for capital markets in 2003!

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