

# Review and Outlook

**THE OUTLOOK FOR 2003 IS FOR STILL POSITIVE NORTH AMERICAN GROWTH, BUT GROWTH AT HALF THE PACE OF THE LATE 1990s.**

## The Economy

Economic and capital market matters have taken a back seat to events in Iraq. These events, while distracting, are also creating uncertainty amongst consumers and investors, exacerbating an already tentative economic recovery. The uncertainty has led to a shift in behaviour as evidenced by a change in spending patterns and enhanced financial market volatility.

The global economy has been overly reliant on consumer spending to sustain growth in the past few years. Business investment has been a poor contributor, as companies deal with over-capacity and falling profits. The U.S. remains the locomotive, but the potential retrenchment of a debt burdened, war weary, weather challenged consumer in such key areas as housing and autos, could significantly moderate the growth prospects for North America and the world. New car sales in the U.S. are forecast to fall from 17 million units to 15.5 million. Housing starts were 1.7 million in 2002; this is predicted to fall to 1.5 million this year.

The outlook for 2003 is for still positive North American growth, but growth at half the pace of the late 1990s. We have been revising downward our prospects for 2003 to the point that we now see real growth at 2.0% to 2.5%. In 2004, growth should be stronger approaching 3.0%. Canada should slightly outperform the U.S. in 2003, as the benefits of superior job creation continue to work through the economy. Canadian growth will begin to lag slightly in 2004, as weaker U.S. growth impacts the demand for our exports.

Inflation pressures are likely peaking with energy costs. However, a prolonged Mid-East disruption could push oil prices back to, or through, recent highs. High energy prices act like a debilitating tax on businesses and individuals. A critical component in inflation is wages, but with global competition and rising unemployment, we see little reason for sustained high inflation. The U.S. CPI should be below 2.4% by year end, with a more energy dependent Canada running closer to 3.0%.

Capital spending will be an important variable in the nature and strength of the future economic recovery. Today the excesses of the 1990s point to restrained investment in plant and technology. Corporate profits are also constrained with softening domestic demand, weak export markets, and limited price flexibility. Looking ahead, business reinvestment is expected to be modest and to be sub par versus previous cycles.

Outside the fiscal arena, central banks are struggling to find the balance between stimulus and inflation. The Bank of Canada, with perhaps the strongest economy, chose to tighten slightly, fearful of inflation but mindful that their major trading partner is considering easing to stimulate their flagging economy. Japan is fighting secular deflation, while the European Central Bank seems to have been slow to recognize slowdowns in Germany and France.

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## Financial Markets

After rallying, in hopes of a brief and victorious war, equities continued their downward path, with the S&P 500 Index falling 3.3% in the first quarter and the TSX declining 3.5%. Concerns about the war, and more recently SARS, helped to push stocks close to record lows. In major North American markets, Healthcare, Energy and Technology were relatively strong performers. Underperforming sectors were Telecommunications and Consumer Staples, as well as Industrials and Materials in Canada. While the focus has been on the war, revenue and earnings prospects are the real issue in light of weaker employment and consumer spending trends.

Canada, despite some weakening, has to some degree bucked the global trend with an economy that, while heavily U.S. dependent, was still relatively strong. The Bank of Canada raised rates by 25 basis points in an effort to curtail growth and rising inflation. As worried investors sought quality, Canadian 10-year government bond yields flirted with 4-year lows before backing off to 5.25%, the high-end of a 7-month 40 basis point range. Bond markets overall were slightly negative in the quarter as oil driven inflation fears outweighed a flight to quality. The U.S. Federal Reserve remained on the sidelines; more inclined to ease than tighten. This divergence resulted in wider yield differentials and a flatter Canadian yield curve. An ancillary effect has been a 7.5% rise in the Canadian dollar to \$0.68.

## Investment Strategy

We are unconvinced that the end of the war will bring a newly invigorated economy. Equity markets may temporarily surge, but the reality of a weakened consumer, poor earnings prospects and fiscal deficits, will soon become evident. In addition, many individual stocks are still overvalued on traditional measures. Our equity strategy remains defensive, with a focus on companies with good cash flow and the ability to sustain and raise dividends.

Our fixed income strategy emphasizes a barbell structure, in the anticipation that the yield curve will flatten. Short rates should rise while long rates will remain relatively unchanged. However modest the recovery, tax cuts, government spending and higher levels of inflation, could put upward pressure on short-term rates. The barbell will avoid mid curve price declines, while earning the higher yields on long bonds and providing for reinvestment opportunities from the short bonds. We are overweight in high quality corporate bonds, as the higher running yields and potential narrowing of spreads are attractive. Finally, our duration call is neutral to slightly defensive, as we expect concerns on inflation to linger.

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Our recommended asset mix is also somewhat defensive. Given the forecast volatility in financial markets, we are maintaining relatively high cash and short-term reserves. We are using market strength to reduce or sell stocks that are not expected to perform in a slow growth economic environment and using market weakness to add positions that will gain market share and perform well.

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