

Review and Outlook

THE FEDERAL RESERVE HAS ORCHESTRATED INTEREST RATES TO 45 YEAR LOWS.

The Economy

The U.S. economy is attempting to recover from the mildest recession in history, where economic activity only declined 0.6%. The lack of job creation and concerns about deflation make the recovery prospects uncertain, prompting aggressive policy response in the form of fiscal and monetary stimulus. This has been aided by a weakening in the U.S. dollar, which has been tacitly supported by the administration.

In monetary policy, the Federal Reserve has orchestrated interest rates to 45 year lows. The result has been to stimulate successive years of near-record auto and housing sales; possibly leaving little if any gas in the tank to stimulate incremental buying power. On the corporate side there was a significant build up of capacity and technology in the 1990s that has largely remained under utilized. Therefore, the ability to access cheaper capital, other than to refinance existing debt, has been ineffective in stimulating expansion. Over capacity remains a significant problem for the economy. Cost containment, inventory management and labour reductions have enabled corporations to minimize the impact of slower growth in the economy. It is this latter issue, i.e. employment, that remains a serious impediment to growth. An increase to a 6.0% unemployment rate and an intransigent 400,000 weekly jobless claims number mean no new pay checks to buy products.

On the fiscal front, Mr. Bush's tax plan has been modified from its original scope, but should still have sufficient teeth to promote spending. One concern remains that the individual States may dampen the effects of a cut by instituting tax/fee increases to fund their regional deficits.

The U.S. dollar has long been expected to reverse course from its near two decade appreciation against most currencies. If surprise, or discontent exists, it is that the reversal has been rapid and severe. Washington is determined to redress the poor state of their trade, current and capital account balances. A weak dollar will go a long way towards assisting U.S. companies in being more competitive and reducing imports of foreign goods.

The Federal Reserve Board in the United States reduced rates by 25 basis points (0.25%) at the last Federal Open Market Committee (FOMC) meeting on June 24, 2003. The question lingers as to whether this move will be enough to stimulate the economy on a sustained basis. Despite some reservations, with regard to employment and the demand side of the economy, we are confident that by the 2004 election year, economic growth will be on solid ground. It will be an uneven process but in 2003 we see growth averaging about 2.0% and increasing to over 3.0% in 2004. In Canada, growth will be hurt by the rise of our dollar but there is sufficient momentum to keep pace with the U.S. this year, then slightly lag in 2004.

THIS MARKS JUST ONE OF TWO QUARTERS IN WHICH STOCKS HAVE OUTPERFORMED SINCE EARLY 2000.

Financial Markets

The performance of the equity markets in the second quarter has been the strongest since the post 9/11 rebound. The Canadian stock market (TSX) advanced 10.6%, a return that lags the U.S. but represents a median return for most European, Asian and Far East (EAFE) markets. In the quarter, the U.S. stock market, as represented by the S&P 500 Index, advanced 15.4%, while the offshore markets rose by 19.6%. One very significant factor for investors outside of the U.S. was the decline in the U.S. dollar over the quarter. This resulted in a Canadian dollar return of only 6.5% for the S&P 500 and 10.0% for the offshore markets index (MSCI EAFE).

Bonds markets were not idle either. The Canadian bond market, as represented by the Scotia Capital Universe Index, returned 5.1% in the quarter. This marks just one of two quarters in which stocks have outperformed since early 2000. Corporate bonds advanced even more as investors narrowed spreads in their quest for higher yields. The flattening of the yield curve continued as 90/91 day to 10 year spreads narrowed by 70 and 40 basis points (0.70% and 0.40%) in Canada and the U.S. respectively.

Indicators on economic performance have been mixed, and seemingly not strong enough to fuel such a significant rally. Most observers conclude that after years of sitting on the sidelines and with money market and even bond funds earning next to nothing, the opportunity cost of being in the equity market was greatly reduced. Dividend yields for many stocks are in excess of a large portion of the fixed income curve. Further, with stock prices down, many areas of the equity markets have become more attractive. The rally has been lead by Technology stocks. Investors have shown an increased risk tolerance by once again pushing these stocks to excessive valuations.

Investment Strategy

A review of most economic news in recent months provides a mixed and uncertain picture. The equity markets, however, have adopted a very certain and positive tone. The rally has been based upon three elements: excess capital market liquidity, a post war revival, and a spate of positive corporate earnings reports. A fourth contributing factor has been record low interest rates. However, we see

this rally being unsustainable based upon the fundamentals. Earnings growth has been tentative (gained primarily through cost cutting) while valuations are high assuming a traditional robust recovery.

Our concern is not with the long-term outlook, in fact, we are constructive about many areas of the market now and the market as a whole in the years ahead. The recent rally seems premature and overdone, though certainly a pleasant relief from the back-to-back negative quarters experienced in recent years. Our expectation is that in the months ahead the market will consolidate, but stage a recovery as we approach and enter 2004. U.S. election years, orchestrated or not, have a propensity to be positive for stocks. Leadership in stocks is not clear but areas like Health Care and Financials offer good long-term prospects.

Our equity investment strategy is to use recent market strength to sell over valued, higher volatility positions and reinvest the proceeds in more defensive stocks with good earnings prospects. We anticipate a consolidation in equity markets which should provide a good opportunity to raise equity exposure in anticipation of a more sustained market advance in 2004.

On the fixed income side, with interest rates at historical lows, bonds have become somewhat expensive. This is not to say yields can't go lower, but we believe we are very close to the bottom. As the lag effect of the rate cut takes hold, bond and money market yields should begin to rise. Under a moderate recovery scenario the yield curve should flatten, as the curve shifts higher but short yields rise more than long yields. Structurally, we are looking to shorten term, lighten up slightly on credit and hold to a more defensive posture.

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