

Review and Outlook

AUGUST WAS THE BEST MONTH IN A DECADE FOR HOUSING STARTS.

The Economy

The consumer continues to carry the North American economies on its shoulders. In Canada, despite a discouraging array of setbacks, from disease to blackouts, summertime retail sales were up, and August was the best month in a decade for housing starts. The U.S. consumer has been even more robust in both discretionary and non-discretionary spending. This includes strong sales of houses and autos. The stimulative power of low interest rates, and the automakers desperation to sell cars, has fueled a torrid pace of consumption. After a weak start the U.S. economy will likely grow 2.7% this year and 3.5% next year, but not before clocking a 5.0% increase in this current quarter. After years of out performance Canada will rebound less and grow just 1.9% this year and 2.7% next.

While monetary stimulus has underpinned the consumer it has been less effective with corporations. Despite some recent evidence of increased capital spending in North America the legacy of excess capacity lingers from the 1990s. In addition, capital spending patterns have changed as China has increasingly become the new location for plant construction and manufacturing jobs. The loss of jobs to China is made worse by the one way nature of trade flows. Wal-Mart imports \$12 billion in goods from China yet 95% of goods sold in their 26 Chinese stores are made in China. The decline in the dollar will improve U.S. trade opportunities but only to the extent that other economies are growing. At this time the U.S. remains the global engine of growth while domestically struggling with the deficit impact of the war in Iraq, a stubborn employment environment, and an expensive energy bill that exacerbates their trade problems.

The Fed, the Bank of Canada and central banks everywhere are on easing mode while the White House is focused on the 2004 elections. The impetus behind improving the economy is very strong. The capital markets have begun to discount a robust and sustainable environment. We are positive but more suspect about the level of growth and its valuation in the market place. We are clearly in the growth camp but believe the long-term range of real GDP expansion is 2.5% to 3.0% not the 4.5% plus we are seeing now. Forecasters have consistently underestimated the consumer but eventually even the incentive driven spending levels that currently prevail will fall back to reflect the low savings rates, the moderate 2.5% rise in incomes and the weak employment situation. The loss of jobs has been part of an extensive cost reduction program in the U.S. The implications are that with further productivity gains and lower wage expenses North American inflation should remain within controllable limits, i.e. below 2.0% in 2004. The improved cost structure augurs well for corporate profits in any positive revenue forecast.

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Financial Markets

The third quarter continued the strength shown by global equity markets that began late in the first quarter and gained momentum in the 2nd. By September 30 the TSX had risen 6.7% in the quarter and 13.9% year to date. This compares to gains by the S&P500 up 2.7% and 14.7% respectively in U.S. dollar terms. In Canadian dollars the quarterly increase is slightly reduced to 2.3%, but the year to date number goes to negative 1.9%. Global markets achieved generally positive returns over parallel periods, but with a marked superiority of Asian results over European markets.

A dominant influence on returns has been the movement of currencies. In general the U.S. dollar has declined against most major currencies, reducing U.S. based returns to Canadians and other countries. Year to date the impact in Canada has been over 17%, as our dollar climbed from 63.31 cents to 74.18 cents.

Markets have gained across most sectors but it has been the Information Technology sector that has been the strongest. This group and other high 'beta', high multiple growth stocks have been the strongest components in the market. Joining the top performers in the most recent period were the more typical early market leaders such as cyclical metals and basic material sectors. The more defensive groups such as Utilities, Consumer Staples and Health Care have fallen behind the more aggressive elements in the market.

Canadian government bond yields were relatively unchanged over the quarter. Yields on maturities under three years trended lower, whereas on maturities above five years yields drifted higher. Globally interest rates tended to move in a uniform manner, with short rates lower as central banks eased, and longer rates bouncing off June lows to respond to an improved economic and capital market outlook. The impact on quarterly returns was positive with the 91 Canada T-Bill Index earning 0.8 %, while the SCM Universe Index gained 1.3%. Yield spreads between Canada and Provincial bonds were unchanged, but spreads to Corporate bonds narrowed as investors gained confidence in lower credits and sought higher yielding investments.

Investment Strategy

We are optimistic but cautious. We agree that the global economies are improving and that current U.S. growth will moderate but remain healthy. The U.S. job picture must turn around and while interest rates are rising they can only do so modestly if the current personal debt burden is to remain affordable.

Interest rates are expected to respond to an improving economy but should be tempered by a favourable inflation scenario. The yield curve should flatten as the need to ease gives way to a more neutral or tightening response.

Equity markets have responded to the more positive forecasts with an aggressive salvo. The key drivers have been excess liquidity, low interest rates and a momentum, or follow the leader trend. Led by the Technology based groups that ballooned in the 1990s, the market is now, from a valuation standpoint, waiting for earnings to catch up. To date, earnings have been just adequate, but not strong, and have reflected gains achieved through cost control as opposed to strong top line growth. As investors discriminate on valuations the broad market should progress on a path that reflects normalized earnings growth between 7% to 9%. We do not expect the current leaders to remain out front, but should see a rotation to the better valuations on stocks with a strong secular theme, such as Health Care, Financials and select Industrial and Material companies.

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