

Review and Outlook

CANADA IS FORECAST TO FOLLOW A...MODEST GDP PATH, GAINING JUST OVER 2.0%...FROM SUBDUED INCREASES IN BOTH THE CONSUMER AND CORPORATE ENVIRONS.

The Economy

The recent U.S. economic environment has been characterized as a 'jobless recovery'. It is this issue that seems to be the pivotal variable in forecasting the direction of the U.S. economy, and will be forefront in the coming Presidential election. While most elements of the economic landscape are performing well, U.S. employment levels have been declining since the early part of 2001. In contrast, Canada has experienced unprecedented levels of growth over most of this same period. However, in the last 12 months, job creation has slowed noticeably, as Canada relinquished its role as the strongest G7 economy. Ironically the mantle of strongest economy has shifted back to the U.S, without the commensurate job strength one might expect. As stated, the general levels of U.S. economic activity can be defined as healthy. The consumer continues to buy cars and homes at a torrid pace, while corporations are reporting both stronger earnings and increased levels of capital spending on machinery and equipment. The U.S. economy appears on course for a 4.8% gain for 2004, without any significant increase in inflation, despite the soaring costs of energy. The only problem on the horizon is the growing and troublesome twin U.S. deficits, being Trade and Budget. While the current economic strength is generally accepted, its sustainability is questioned without resurgence in job creation. Canada is forecast to follow a much more modest GDP path, gaining just over 2.0%, derived from subdued increases in both the consumer and corporate environs. Joining Canada in the slow growth camp will be the Eurozone, dragged down by notable weaknesses in the larger players, being Germany and France. In addition, in May, the Eurozone will be adding

10 new members, mostly former members of the Soviet bloc, and this will cause some digestion problems in the short term. In all, the economic table in 2004 appears to be set to serve up disparate, but still synchronous growth for the capital markets. Once again leadership is back with the U.S., but forging ahead in Asia are the remarkable gains of China and India.

Japan seems to be experiencing a both a domestic revival as well as the benefits of the surrounding robust, Asian expansion. But even still, Japanese growth will only be about 2.0%.

Financial Markets

Growing economies, low inflation and rising corporate profits are the usual elements that foster healthy financial markets. To that extent, we have seen over the last 12 months, a rise of 37.7% in the TSX, a 20.7% rise by the S&P 500 (CDN\$) and a 10.8% return by the Scotia Capital Universe Bond Index. The rewards going ahead, through December 31, 2004, will be smaller and more difficult to earn. As of March 31, 10-year Canada and U.S. Treasuries yielded 4.35% and 3.90%, respectively. Both yield significantly more than their equivalent T-Bills, implying that the "curve" is very steep. It is our expectation that this difference will begin to narrow as we approach year-end.

Policy makers will become increasingly concerned about moderating the rate of consumption and spending, through higher short-term rates, so as to mitigate any serious threats of excess growth leading to inflation. Presently, no such concern exists and 10-year and longer bonds, which see inflation as a negative, should remain in their current general yield range. Corporate bonds will follow the general trend in rates while also moving their yields moderately closer to their government counterparts.

Investors are still hungry for higher yields and have, in recent years, chased corporate bond prices relatively higher. Given the historically low level of interest rates, we have modest expectations for fixed income assets. Treasury Bills, yielding about 2.07% currently, should earn about 2.40% for 12 months ended December 31, while 10-year bonds should return the coupon yield of close to 4.0%. Equity markets, after a strong 2003, rallied early on in 2004, but have reversed course as the quarter progressed.

Presently, the U.S. markets are close to breakeven, and the TSX is ahead just 4.4%. Overseas markets have followed a similar pattern with only the Nikkei showing strong year-to-date gains. North American equities have benefited from an improved corporate participation in the economy, a more favourable tax regime, a resilient consumer, and some strong evidence that believable profits are finally being made. Ironically, leading the gains in many markets have been Technology stocks – the group that, while demonstrating some fundamental improvements, still represent some of the poorest valuations. Preventing a repeat of the 1990s Tech bubble has been the strong performances, price and earnings, of Financial and Energy stocks to name just two. The market rally, which began last March with Technology stocks, has broadened its base to include gains in virtually all major sectors, with only a surprising weakness in Health Care stocks. Health Care is one of several sectors we favour demographically going ahead. Portions of the equity markets should benefit from increased Asian demand for raw materials, and thus cyclicals like Energy and Material stocks will play a strategic role in a volatile environment. Consumer Staple and Discretionary sectors will benefit from a still strong, if not more cautious, consumer. Capital spending improvements on software and machinery point to a select group of Industrial stocks as having merit. The degree to which equity markets will reward investors in the year ahead is difficult to forecast. The markets correctly anticipated the economic strength that occurred in the second half of 2003. The abrupt reversal of gains and the inherent volatility, suggests the markets are uncertain about the next 6 to 12 months. We would frame our expectations as optimistic, but cautious. Currently we feel we have a solid

fundamental base to predict rising markets. In aggregate, based on earnings potential and continued low levels for interest rates, we see North American markets up by some 8.0% to 12.0% by year end.

Investment Strategy

Equities in 2004 should outperform both bonds and cash. The price for outperformance will be volatility. Our bond outlook favours 10 year and very short bonds. The areas in between could be vulnerable to a change in Central Bank policy, if inflation becomes a problem. Corporate bonds should be better absolute value than governments in 2004. While we expect that the economic leadership by the U.S. will translate into a stronger equity market, this is not a certainty, and strategically we are remaining well diversified. A mitigating factor on U.S. performance could be further weakness in the U.S. dollar, which would impair U.S. returns for foreign investors, as occurred in 2003. Sectorally valuations point away from Technology, to a diversified mixture of Financials and cyclicals, i.e. metals and oils. Some Industrial stocks will benefit from the rise in capital spending, specifically those that build productivity enhancing goods such as sophisticated machine tools. Health Care is a theme that is not going away and should be a large part of any long-term portfolio. The greatest risks to our outlook would be, 1) an even more prolonged failure of U.S. job creation, 2) a reversal of the strong offshore support for the U.S. Treasury market, which would adversely impact interest rates, and 3) the impact of escalating terrorism on individuals, countries and capital markets.

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