

# Review and Outlook

**THE MOST PROMINENT CONCERN, EVEN AS THE ECONOMY EXPANDED, WAS THE ABSENCE OF JOB CREATION AND CORPORATE CAPITAL SPENDING.**

## The Economy

The issues and attitudes that govern the direction of the capital markets can alter rapidly. In June 2003, interest rates dropped to secular lows on the belief that the economy was possibly headed into a deflationary spiral. The potential source of deflation was to be found in weak economic performance and the employment and pricing impact of low cost offshore manufacturing. Just 12 months later the U.S. economy is growing at a prodigious 4.5% rate and employment is increasing. As attitudes shifted from deflation to growth, equity markets rose significantly. As growth took hold, so did inflation. Bond yields rose on the expectation that inflation will exceed the 3.0% level this year. The yield on 10-year U.S. Treasury bonds climbed by 1.75%, to where they are currently yielding 4.75%. The deflation arguments have, for the most part, moved to the back burner. The most prominent concern, even as the economy expanded, was the absence of job creation and corporate capital spending. Recent data seems to point to a recovery in both of these areas, leading to a rise in disposable income levels and a spate of machinery and technology purchases. Canada's economy is producing more modest growth, of approximately 2.8%, with inflation closer to 2.0%. Canada's 10-year bond yields have followed the U.S., but on a more restrained path, rising 70 basis points off last years lows, to 5.05%. Beyond North America, economies are mixed. Asia is strong, with China and India both growing in the high single digits. This strength has dragged even the somnambulant Japanese economy to a 2.5% rise in GDP, after virtually a decade of being in and out of recession. Europe remains the laggard, with the exception of Spain and the U.K. High unemployment and large deficits will mean the Eurozone will struggle to achieve 1.0% to 2.0% growth this year.

Despite modest growth, Europe is also facing rising inflation, due in large part to the global issue of higher energy costs.

## Financial Markets

Equity markets began to anticipate the 2003 shift to a growth focus well before the bottoming of yields last June. Equities began to rally in mid-March, paused in late spring, then posted further impressive gains through to year-end. For all of 2003 the S&P 500 rose 28.7% while the S&P TSX gained 26.7%. In 2004, after a positive beginning, the markets have accomplished very little. Despite a still buoyant economic and corporate environment, the capital markets thus far in 2004 have been disappointing. The cause would appear to be concern over inflation that has led to the rapid rise in bond yields. Higher yields have raised investors' doubts about the sustainability of economic strength and the lowering of expectations of gains in revenues and profits. After remaining virtually unchanged for almost 18 months, money market rates are also expected to head higher. The most recent 25 basis point increase, from 1.0%, in the Fed Funds rate, is the first in what is likely to be a U.S. Federal Reserve program that could add another 75 basis points this year and as much as 150 basis points next year. The Bank of Canada is likely to follow suit, but to a more moderate degree.

The actual results for the second quarter illustrate investor wariness to a rising inflationary environment. Money market yields have remained static for the entire three months, only moving higher with the June 29 Federal Reserve increase. Bond prices moved sharply lower over the quarter, as yields in the U.S. and Canada rose 90 and 60 basis points respectively. Corporate bonds followed the trends of the market but neither widened nor narrowed the gap between themselves and government bonds. With the

more dramatic moves occurring in the bond market, stocks seemed to adopt a wait and see approach. On much lighter than normal volumes, equity markets traded in a narrow range. The S&P 500 traded in a range of 70 points between 1080 and 1150 while the TSX maintained a larger range, moving between 8100 and 8800. By the end of the quarter North American equity markets were flat to slightly down. Global trends, with the exception of a strong move by the Nikkei, followed a similar pattern.

Currently the centerpiece of most forecasts is the direction of interest rates. Consensus outlooks point to higher inflation and a commensurate rise in yields. The Scotia Cassels outlook agrees with the general trend in rates, but not with the degree. The U.S. 10-year Treasury yield, the most common bond benchmark, has been forecast to reach 5.75% over the next six to 12 months. Scotia Cassels is expecting a 5.25% yield, up from the current 4.65%, over that period. A moderation in energy prices and more subdued wage demands, should cap inflation at 3.0%, providing a real return of 2.25%. On shorter-term instruments the general expectation is that the Fed will double yields by year-end. This tightening phase should last into the end of 2005, over which we see rates rising 150 basis points to 2.50%, well below consensus.

The equity markets are unlikely to make a major move while interest rates are moving higher, or until the nature of any economic slowdown can be determined. The Federal Reserve would like to moderate growth, not extinguish it, thus avoiding the boom-bust scenarios of the pre 1990s. If the Fed is successful, the equity markets will evaluate the new levels of growth and begin to advance accordingly. We anticipate that markets will rise about the same rate as the nominal economy and earnings, or a rate between 5.0% and 10.0%. The strong and increasing global presence of China, and Asia, puts a favorable outlook on Energy and Material stocks. These more cyclical areas will be supported by a core of stable Health Care, Financial and Consumer Staples companies. We continue to be cautious about Technology, not so much because of the prospects for product demand, but due to rich market valuations.

## Investment Strategy

For the remainder of 2004 we expect equities to outperform short-term investments and bonds. Short-term interest rates should rise more than long rates resulting in a balance between less than two-year and 10-year bonds outperforming the market. Corporate bonds will maintain their higher yield attractiveness and should be better absolute performers even in a slower growth economy.

Stock market returns will be driven by stock selection. Some sectors, like Energy still exhibit strong industry wide fundamentals. The rest of the portfolio will benefit from investing in companies with strong fiscal potential, with fair valuations across all areas of the market.

Globally, the U.S. will remain the dominant economy and the market with the best prospects. Canada, with our abundance of natural resources, should not be far behind. Europe will continue to struggle should the U.S. dollar continue to depreciate, (a scenario we think is highly likely). Companies that export to Asia or North America and rely less on domestic European demand should fair better. The Asian markets are tied to China, with growth rates that will be volatile over the short term. Japan remains the more conservative way to invest in the Asian growth story.

The greatest risk to our strategy is higher inflation and thus much higher levels for interest rates. Finally, our current outlook focuses on the fundamental economic factors impacting markets. Terrorist events and other geo-political risks have not been factored into our forecast. These factors are clearly a risk, especially in a U.S. presidential election year, and could have a profound impact on capital markets. However, since such events are impossible to predict, we will adjust our forecasts as they occur.

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