



TO OUR CLIENTS

While the TSX Composite index has wrapped up another year of strong returns, a mix of rising interest rates, strong dollar and higher costs for raw materials and energy will likely challenge corporate profits and share prices over the next 12 months. In this environment, investors will need the right overall investment strategy in order to maintain positive returns in 2006. Your ScotiaMcLeod advisor is committed to keeping you on track and can select and maintain the optimal asset mix to provide you with the best possible return for your level of risk.

As we embark on another year, we would like to take this opportunity to wish you and your family the very best for 2006.

Sincerely,
ScotiaMcLeod

Lowering the Landing Gear

Andrew Pyle, *Vice-President, Capital Market Research, Scotia Economics*

Global economic growth has been underpinned by the twin-engine thrust of strong U.S. household spending and the high-octane expansion in China and India. Yet despite the accelerated rise in world energy prices, the pace of global growth has not slowed down by a significant degree. While one of the main reasons behind the climb in gasoline and home fuel prices has been the severe lack of spare refinery capacity (made worse by the hurricanes that hit the American Gulf), China's insatiable appetite for energy has also played a strong role in the four-year uptrend in crude oil prices, with imports up roughly 100% versus levels five years ago. As a result of these issues, weaker global economic growth may not produce as significant a drop in oil prices as we've been accustomed to in previous economic cycles.

INFLATION REMAINS STABLE

The combination of high energy costs and tight capacity has led to heightened concerns by the world's central banks over

the outlook for inflation, even in those countries and regions where domestic growth has been sub-par. Leadership in the pre-emptive strike against inflation has come from the U.S. Federal Reserve, which is now 1-1/2 years into a tightening program that has sent official rates up by three percentage points. Debate as to how much further the Fed should push rates is expected to intensify into 2006 as economic signals become more ambiguous. Inflation in the U.S., excluding energy, has remained fairly well behaved despite the surge in pipeline pressures and healthy consumer demand. That said, there have been more recent signs of firms being able to pass along cost increases to the end buyer. At the same time, the increasing strain on households from high levels of debt and rising interest rates has caused retail sales growth to weaken from the peak witnessed during the summer. Some U.S. retailers were already discounting before the traditional Thanksgiving Day start of the holiday shopping season, suggesting

that underlying inflation will remain calm. We anticipate that the Fed will continue to tighten monetary policy into the New Year but take its foot off the brake pedal by the end of the first quarter.

RESILIENT US DOLLAR LIKELY TO LOSE GROUND

Foreign exchange developments also featured prominently in 2005, from the decision by Chinese authorities to revalue the Yuan to the sustained recovery in the US dollar from its late-2004 lows. The dollar's improvement surprised most analysts, considering that the U.S. saw new record-high trade and current account deficits in 2005. However, the greenback's strength can be explained, in part, by the repatriation of U.S. foreign corporate profits, under the one-year tax relief program offered under the America Jobs Creation Act. The positive influence on the US dollar generated by the Act is expected to diminish early in 2006, leading to a substantial decline in the value of the dollar. For Canada, this means a further rise in the Loonie's

value even though a gradual slide in energy prices might otherwise point to a weaker Canadian dollar.

For the most part, exporters, manufacturers, and other currency-sensitive sectors have made good progress in adjusting to the Loonie's flight from its all-time low of under

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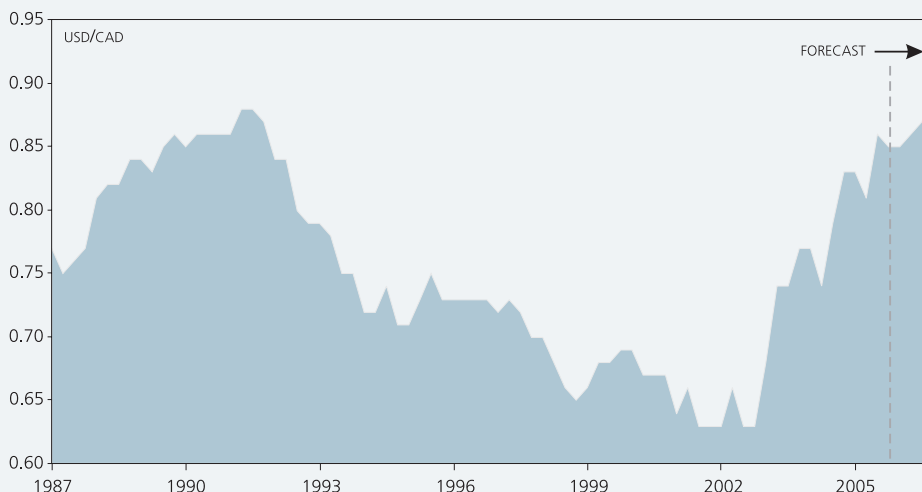
62 US cents back in 2002 to 86 US cents this past September. Pressures will build, however, if the currency flies towards 90 US cents next year. Europe and Japan benefited from seeing their own currencies fall against the US dollar this past year,

although the improvement in competitiveness was dampened by the fact that energy inflation in local currency terms was even worse than in North America. In the event that the Euro and Japanese Yen strengthen in 2006, the direction of energy prices will be extremely important in terms of growth and profitability for those regions.

HOUSING EXPECTED TO COOL

A soft-landing scenario for global economic growth in 2006 does carry with it some very plausible risks. In this scenario, we assume that housing market conditions in most of the western markets cool down. However, if a more extensive correction in sales, prices and construction were to emerge, this would have a major impact on consumer spending. So far, longer-term mortgage rates have not increased to the same extent as variable-rate loans and have therefore helped keep housing airborne. Fixed income investors remained confident that central bank policy would prevent inflation from becoming a problem over the medium-term, which has translated into a flatter yield curve and relatively stable longer-dated bond yields. If that confidence were shaken, then the resulting jump in mortgage costs could cause home demand to erode. Finally, protectionism is a persistent threat that investors deal with, especially as we head into a congressional election year south of the border. With the U.S. trade deficit at a record high, pressure on members of Congress by their local constituents could translate into a tougher trade stance against countries which enjoy a burgeoning surplus with the U.S.

Loonar Eclipse: Canadian Dollar Exchange Rate



SOURCE: BLOOMBERG, SCOTIA ECONOMICS

Further pressure on the US dollar may lead the Canadian dollar to reach the 90 cent threshold for the first time in 25 years.

Data as December 1, 2005

Caught in the Cross Currents

Paul Danesi, *Director, ScotiaMcLeod Portfolio Advisory Group*

Looking back on 2005, the Canadian equity market surprised to the upside. Our initial view was that the year was likely to be challenging for investors with an end to easier monetary policy and a stronger Loonie. However, strong demand for commodities in particular energy and base metals along with solid gains for many defensive sectors of the economy helped lift the TSX Composite.

Canada wasn't the only success story in 2005 as Europe and Japan also delivered strong returns for investors while the U.S. lagged.

Bond yields, in a downward trend through the first half of the year, began to work their way higher late in the summer. In an effort to maintain the balance between aggregate supply and demand and keep inflationary targets in line, the Bank of Canada and U.S. Federal Reserve continued to ratchet interest rates higher.

Commodity prices were a major story in 2005 with Scotiabank's Commodity Price Index establishing a new record high. Hurricanes Katrina and Rita delivered a supply shock to the energy market sending the price of oil to a new record of US\$70 a barrel and natural gas to US\$15/mcf. The price of natural gas is now up almost six fold in the last three years. Metal prices also soared on supply disruptions in what were already tight market conditions.

In Canada, income trusts stumbled late in the third quarter after the Federal Government temporarily halted advance tax rulings on trust conversion while it was undertaking

an extensive review of the sector. In late November, the Federal Government announced that it had completed its review. Responding to investor concerns, the government chose to leave the tax treatment of income trusts unchanged. The income trust market quickly recovered lost ground with the Scotia Capital Income Trust Index finishing the year in record territory.

Commodity prices may lose some of their momentum in 2006 if U.S. growth eases, but are expected to remain strong relative to historical long-term averages.

As we look ahead, the catalysts that propelled the market higher over the last year, strong economic and corporate profit growth, along with historically low interest rates have begun to reverse themselves. Both the Bank of Canada and U.S. Federal Reserve have their feet on the brakes in an effort to tame inflationary pressures. The removal of monetary stimulus is expected slow economic growth in 2006.

CORPORATE PROFIT GROWTH EXPECTED TO SLOW

The pace of corporate profit growth will also be challenged over the next

12 months as profit margins are squeezed by a higher dollar, as well as the high cost of raw materials, energy and transportation. A mix of slower economic growth, higher interest rates and lower profits generally doesn't support higher share price valuations. To position for the year ahead, investors should reduce exposure to cyclical industrial product and resource positions and increase their weighting in the defensive consumer staples, financials, utilities and telecommunications sectors. The strong and rapid recovery in the income trust market has driven valuations for many trusts back to unappealing levels. Investors are urged to review their income trust exposure with their advisors. Emphasis should be placed on those trusts which offer the best stability ratings, distribution growth potential, and lowest payout ratios.

MORE MOVEMENT IN THE CANADIAN DOLLAR

On the surface, Canadian real GDP growth has remained surprisingly resilient despite the headwinds created by a stronger Loonie. A closer look at our trade surplus with the U.S. shows an increasing reliance on energy and mining exports as auto parts, forestry and other goods lose ground. If the Canadian dollar appreciates to the \$0.90 US cent level as forecast by Scotia Economics, then challenges will grow for many cyclical industrial and materials companies in 2006. Conversely, a stronger dollar benefits Canadian retailers and broadcasters that source their products from the U.S.

While profit margins may be challenged in 2006, corporate balance sheets are the strongest they've been in many years. The current foreign exchange rate makes investment in productivity enhancing software and machinery sourced south of the border an attractive proposition for Canadian companies intent on remaining competitive in an increasingly global economy.

COMMODITY STORY REMAINS INTACT

The past two years have seen a massive cyclical upswing in commodities that appears to have some staying power. Looking back over the last decade, low prices depressed the development of new metals and mining resources. This lack of new supply has been met by the urbanization/industrialization of major Asian economies, most notably China, and their insatiable demand for raw materials. This evolution is nowhere near its end. Scotia Economics forecast that Chinese real GDP and industrial production will continue to grow at double digit rates in 2006. If the

U.S. growth eases over the next 12 months as expected, it is possible that commodity prices may lose some of their momentum. Nevertheless, the price of oil, natural gas, base metals and chemicals should remain well above their long-term historical averages. In this environment, investors should maintain some, albeit reduced exposure to energy and the broader commodities group.

INVESTING ABROAD

Foreign currency risk is a common reason for not investing abroad. Nevertheless, investing internationally offers the benefits of increased portfolio diversification and exposure to higher growth regions of the world. Few economists will argue that there are simply too many variables to accurately forecast foreign exchange rates over very long periods of time. Given the multi-year or in some cases multi-decade investment horizons for many registered accounts, and the elimination of foreign content limits, investors are encouraged to

consider adding international exposure to their portfolios. As we enter 2006, the U.S., Asian, and Japanese equity markets appear attractive.

As we begin this New Year investors should take the time to review their asset allocation, it is often one of the most important investment decisions an investor can make. As noted, 2006 is likely to be a challenging year with headwinds, cross currents and increasing volatility. As such, reducing allocations to equity and increasing fixed income exposure would be prudent. Your ScotiaMcLeod advisor can help you establish and maintain the optimal asset allocation, investment selection and diversification to provide the best return possible for your level of risk.

Reflections

"Though no one can go back and make a brand new start, anyone can start from now and make a brand new ending."

Anonymous



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