Review and Outlook

In one of the most dramatic days in Wall Street's history, Merrill Lynch agreed to sell itself on Sunday, September 14th to Bank of America for roughly $50 billion to avert a deepening financial crisis, while another prominent securities firm, Lehman Brothers, said it would seek bankruptcy protection and hurtled toward liquidation after it failed to find a buyer.

The humbling moves, which reshape the landscape of American finance, mark the latest chapter in a tumultuous year in which once-proud financial institutions have been brought to their knees as a result of hundreds of billions of dollars in losses because of bad mortgage finance and real estate investments.

Few things prepare us for the kind of extraordinary developments that have taken place. It is tempting at times like this for people to think of developments like the Crash of '29 and to panic.

But the reality is that the banking sector is not representative of the overall market. Things may turn down for a while and times may get tougher. But life, work and the economy will go on – even without Lehman Brothers. In reality, this is not so new after all.

We have seen the collapse of Barings in 1994, Long Term Capital Management in 1998, 9/11, and the WorldCom panic of 2002: believe it or not, these things happen quite often. And when you are slap bang in the middle of them, they always feel terrifying.

There are a few things we know and they are material now. First, the people who stay at the table and don't make emotional decisions here are going to be the ones who make the money in the years ahead.

Second, trying to get rich quick is one of the surest ways to get poor quick, and the only way to win this game is to keep investing often and broadly.

Third, most great investors made their money buying in a panic. And if this isn't a panic, we don't know what is. The late great, Sir John Templeton, made his fortune, buying a portfolio of all the shares he could find priced under a $1.00 in the 1930s. One of his maxims was "buy during periods of pessimism." It works.

Fourth, there are a lot of good stocks out there that are reasonably valued. Even long-standing bears, skeptics and curmudgeons are starting to say this. These stocks may not be dirt cheap. Times may get worse before they get better. But if history is any guide, buying good stocks when they are reasonably priced and hanging on for five years or more has tended to be the best thing you can do with money.

And finally, at some point this will end and when the market turns it will be rocket powered. There will be no easy chance to get back in. So invest often, and don't panic.

Outlook

In Canada, the impact to the banking sector will probably be manageable but the indirect impacts are material as any announcements that impact the health of financial markets and drive the share prices of global banks down are likely to drive Canadian bank shares down as well. Irrespective of their more favourable fundamental outlook, the ongoing weakness of large global financial services firms will likely continue to put downward pressure on Canadian bank shares.

With Europe in recession and Japan and the U.S. economy in borderline status, the world growth outlook is the weakest in years. But it is still nowhere near as weak as plunging resource stocks would suggest. As was the case in the 2001 recession, China has hardly noticed the U.S. downturn and we shouldn't expect other emerging giants like Russia, India and Brazil to notice that much either. Global growth should still be in excess of 3 percent next year, a good percentage point higher than what, in the past, has signaled bear markets for commodities.

We continue to believe that the secular bull market in commodities, driven by infrastructure and socio-economic advancements in emerging markets, will continue to be positive for our resource-based Canadian market in the long-term. Whilst our current equity strategy is more defensively postured and we are maintaining a healthy weighting in cash, we believe this positioning will provide us with the ability to add selectively to our equity exposure as we gain increased clarity in the marketplace.

On the fixed income side, the recent 'flight to quality' has provided gains in the Canadian bond market but at the same time, has reduced the potential return for the coming months. There appears to be little value left in government securities as prices have been largely supported and propped up by risk aversion. Our preference continues to remain overweight high-quality corporate bonds, which offer superior yields (income) in today's low rate environment as well an opportunity for capital gains as the credit risk moderates.

Keep in mind that big rallies follow big sell offs. We have already seen this in mid-March and mid-July. This time around is unlikely to prove any different. And while bear markets have always been temporary (as have bull markets), we believe our approach, based on solid economic principles that feeds into our systematic and disciplined process, is essential to achieve long-term success in all markets for our clients.

* All opinions contained in this document constitute our judgement as of September 15, 2008, and are subject to change without notice.

™ Trademark of The Bank of Nova Scotia.
Scotia Private Client Group consists of private client services from The Bank of Nova Scotia, The Bank of Nova Scotia Trust Company, Scotia Cassels Investment Counsel Limited, Scotia Cassels U.S. Investment Counsel Inc., and ScotiaMcLeod, a division of Scotia Capital Inc., all members of the Scotiabank Group. Scotia Capital Inc. is a member of CIPF.