INVESTMENT REVIEW AND ECONOMIC OUTLOOK

September 2007

Overview

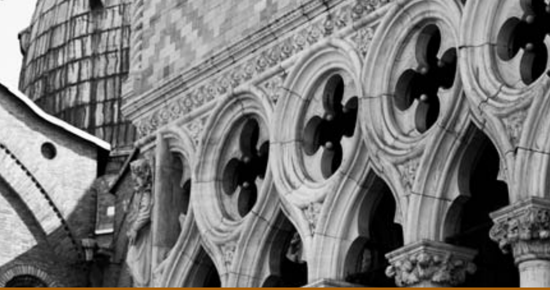
Global equity markets were volatile in the third quarter as a re-pricing of credit risk due to the sub-prime mortgage meltdown in the United States spooked investors. Bonds benefited from this uncertainty and rallied early in the quarter as fears of a slowing economy surfaced on the back of very weak job market data south of the border. After the pullback in equity markets, stocks rebounded strongly when the U.S. Federal Reserve slashed interest rates by 50 basis points stating that "tightening credit conditions had the potential to intensify the housing correction and restrain economic growth". Furthermore, the Federal Reserve indicated that additional rate cuts might be necessary given the prospects of a further weakening in the U.S. housing market and concerns about financial entity failures.

The slower earnings growth that we had been forecasting is now clearly on the horizon. Our view remains that equities are slightly undervalued, given the low relative real interest rates available in fixed income, our expectations of a soft economic landing for the economies of North America and a prolonged overseas expansion. As long as the damage from the credit crunch remains contained and the housing downturn does not broaden into a full-blown economic recession, then equity prices within North America should stabilize and eventually move higher into year end. Going forward, overseas earnings will provide a positive offset to the deceleration in North American profit growth and we expect this growth to remain strong, especially within the Asian region. As such, we continue to be positive on International equities compared to domestic names.

Canada

The Canadian economy continues to surprise to the upside with real GDP increasing 2.5% year-over-year in July, up from its 2.1% pace earlier in the year. Canadian growth continues to be powered by strong consumer demand and tremendous capital spending, particularly in the resource sector. The job market remains robust, with a substantial 51,000 new jobs created in September and a generational low unemployment rate of 5.9%.

The manufacturing sector remains under pressure with Ontario's manufacturing shipments down year-over-year. However, as mentioned in our last issue, manufacturing's share of total growth and employment in the Canadian context has diminished over the last 5 years and manufacturing employment now represents barely 10% of total Canadian employment.

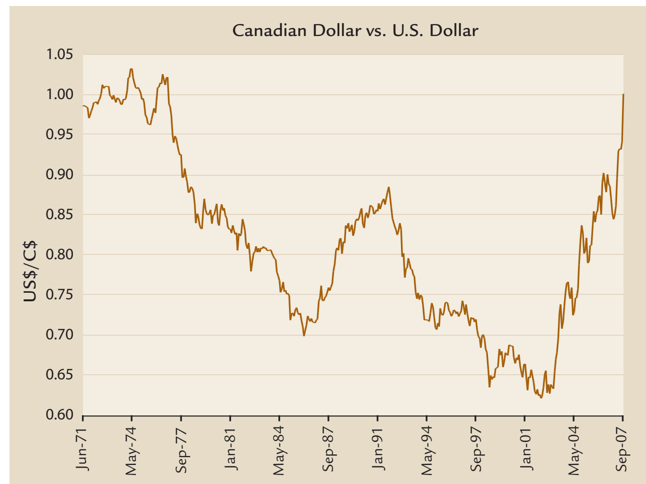


INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

The regional disparity in economic growth in Canada shows no signs of correcting. Ontario remains mired in a manufacturing-driven slump, with its 2007 GDP estimated to be less than 2% and an unemployment rate of over 6.5%. In addition to Alberta's high growth rate and low unemployment, many of the other provinces are also performing extremely well, including Newfoundland & Labrador. Newfoundland, with its three major offshore oil projects reaching various stages of completion, should experience growth of close to 6% in 2007.

Canada was not immune to the previously discussed credit crunch, however, the effect on the Canadian economy has been much more muted than in the U.S. The Canadian home sector did not reach bubble-like levels like in the U.S., nor is it slowing with the same momentum. Furthermore, there is no sub-prime mortgage crisis in this country. As a result, home equity will not decline to the same degree and thus consumer spending will be less imperiled.

The Canadian dollar continued to take flight in the third quarter, reaching parity with the U.S. dollar for the first time since the mid 1970's. There are many factors driving this strength: 1) the continued upward surge of oil and other commodities, 2) the strong fiscal position of all the Canadian provinces and the federal government, which reported a higher than expected budget surplus of $13 billion, 3) continued foreign capital investment. In addition to these factors, the Canadian dollar is caught up in general malaise for the U.S. greenback, which is down sharply versus almost every major currency.



Source: Bloomberg

With respect to our Canadian equity investments, the technology (+14.4%), materials (+12.5%) and utilities (+6.9%) sectors led the overall market this quarter. Two of the top five portfolio performers were in these sectors and included Research in Motion (+36.8%) and Goldcorp (+20.2%). RIM shares have witnessed a considerable appreciation aided by several catalysts, including new device launches, new carrier pricing plans and a 3-for-1 stock split. Goldcorp (+20.2%) was up strongly, on the back of a positive global supply/demand outlook for gold and a very weak U.S. currency. We remain positive on Goldcorp as it has improving production and cost profiles, gold reserve upside, active exploration programs and a strong management team.

INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

The healthcare (-14.7%), energy (-2.5%) and telecommunications (-2.0%) sectors were the performance laggards this quarter. Opti Canada (-18.0%) was weak this quarter after the company indicated that it had encountered further operational challenges at its Long Lake in-situ oil sands project and as a result the project would be delayed and require a capital cost hike of a further 10% to 15%. Cameco (-15.0%) underperformed after the company lowered its realized forward price guidance suggesting that margin estimates and earnings would need to be revised lower.

After rising appreciably in Q2, bond yields in both the U.S. and Canada ended the quarter sharply lower versus June levels. The bellwether 10-year U.S. Treasury bond yield began the quarter at 5.00% and as of September 30th was down 40 basis points to 4.60%. 10-year Canada bonds were also down 20 basis points in the quarter, from 4.55% to 4.35%. Even more impressive however, was the rally in treasury bills with 3-month U.S. Treasury Bills dropping 100 basis points in Q3 to 3.80%. Yield curves the world over steepened sharply and this will help to reliquify the global lending system going forward. With the rally in bond yields over the quarter, value has diminished somewhat, but given our view that the North American economies are slowing, we are still modestly bullish on the Canadian bond market.

One theme over the last couple of years has been the huge supply of liquidity which led investors to buy risky assets everywhere in the world, including emerging market debt, high-yield bonds, investment-grade bonds and equities. Credit markets were therefore expensive and a correction was warranted. In short, risk was not being priced appropriately. All that was needed was a catalyst to sell off, and it came in the 3rd quarter. The sub-prime mortgage difficulties in the U.S. led to a genuine credit crunch, to a degree not experienced since 1998. Lending essentially seized up, including bank lending, high-yield lending, investment-grade lending or emerging market lending. Even short-term money markets became extremely illiquid, with 3-month bankers' acceptances widening to a huge 100 basis points over T-Bills versus the normal 10 basis point spread.

Some degree of normalcy has begun to return to credit markets late in the 3rd quarter and early in the 4th with some debt placements getting done, both in the investment-grade and the high-yield markets. We believe that at these new and substantially improved credit spreads, there is now value in credit markets.

United States

Early in the 3rd quarter, the U.S. economy registered a surprisingly strong 3.8% Q2 GDP figure. But that resiliency was all in the rear-view mirror. The escalating housing recession and sub-prime mortgage crisis in the U.S. led to one of the worst credit and liquidity crunches seen on a global basis in ten years. Not since 1998 when the Asian flu, Russian default and Long Term Capital Management dominated the headlines, has the global financial system been so tight. The sub-prime crisis punched significant holes in the balance sheets of financial institutions and funds the world over – from Countrywide to Northern Rock to Coventry – every major country and market had its story. Even some of

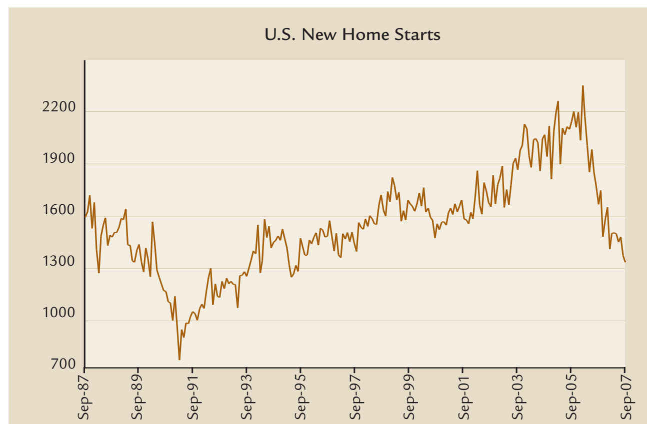
the world's largest institutions, such as Bear Stearns and Merrill Lynch were forced to take significant write downs as a result of this phenomenon.

As a result of all this, central banks around the globe were forced to step in and provide liquidity through a variety of mechanisms, including cutting their administered rates. This provided the appropriate medicine for global markets, as equities and lower grade bonds began to rally later in the quarter. As well, banks began to lend to each other again, and it appears that the crisis has been averted.

Fortunately, labour markets in the U.S. continue to be reasonable, with 110,000 new jobs being created in September and a positive revision to the job figures in July and August. However, the trend in the labour market is definitely toward deceleration, with average monthly job growth falling to 120,000 in 2007 versus 190,000 in 2006. As long as the labour market does not deteriorate too sharply, we continue to believe that a modest slowdown in consumption is the most likely scenario for the next few quarters. With consumer spending comprising 70% of GDP, it is clear that this is the key to a "soft landing".

The U.S. housing recession does not appear to be letting up, in fact, it may even be accelerating. New and existing home sales continue to decline. The National Association of Home Builders Index is now at its lowest level ever, even below the levels seen in the recession of 1991. Home prices are now down close to 5% year-over-year. At the end of the day, there are simply far too many homes and far too many homeowners that could not afford them. The inventory of new homes in the U.S. is still at an 18-year high with many housing industry analysts believe that a 10% decline in average home prices will be needed to have the market clear. Furthermore, many adjustable rate mortgage borrowers will face mortgage resets early in 2008, which will significantly increase their monthly mortgage payments. We continue to believe that housing will decline and damper consumer spending into 2008.

In June, we believed that the Federal Reserve would likely maintain the Fed Funds rate at 5.25%, recognizing that the economy was slowing but that potential future inflation risk existed. As a result, we believed it was unlikely that they would switch to accommodation mode before year-end. Clearly the



Source: Bloomberg

events of the summer that we have described have changed all this. In mid-August the Federal Reserve decided that it had to act. While it is not in their mandate to bail out individual financial institutions, it most certainly is in their mandate to help keep the U.S. financial markets running smoothly. As a result, the Fed cut its discount rate, which is the rate that they lend directly to banks, by 50 basis points. Along with other central banks, the Fed also injected a substantial amount of liquidity into the system through open market purchases of government securities, to a magnitude not seen since the credit crunch of 1998. At its September meeting, the Fed further lowered the discount rate another 50 basis points. It then also lowered the Federal Funds rate 50 basis points, ending any skeptism that it was not sensitive to the negative economic effects of the credit crunch.

While the US market posted a seemingly quiet 2% return in US dollars, the summer months were anything but sleepy. The virtually unabated rise in the US equity markets were brashly interrupted by the credit markets on the back of worries in the sub-prime mortgage market.

While Canadians are busy planning their next trip to Florida to spend their Canadian dollars at par, they are also looking at the exchange rate impact on U.S. equity performance, which has turned 9.1% gain on the S&P 500 for the year into a 6.7% loss in Canadian dollars.

Expressed in Canadian dollars, energy was the top performing sector for the 3rd quarter (+2.4%), followed by technology (-0.4%) and industrials (-.3%). The top five performers in the U.S. portfolio were spread across the consumer discretionary, telecommunications, technology, consumer staples and industrials sectors. Tempur-Pedic (+29.3%) was up strongly this quarter after the company reported better than expected quarterly earnings for the second quarter of 2007 and revised 2007 EPS guidance higher for the full fiscal year. Consumer discretionary was the worst performing sector overall (-12.4%), followed by financials (-10.8%) and healthcare (-5.7%). Pool Corporation (-40.1%), was weak this quarter after the company issued a pre-release in July materially lowering 2007 earnings guidance.

Global

Our recent trip to Hong Kong provided a stark contrast to the financial woes afflicting Western markets. We note of course that western markets enigmatically rest at close to record levels after their recent rally. While increased market volatility and financial strains reached acute levels around the globe during the quarter, sentiment in Asian markets and China in particular remained remarkably robust. China reported growth in fixed asset investment of 27% for the first seven months of the year, retail sales grew 17.1% in August (year-over-year) and money supply expanded 18.1% over the same period.

Conditions are not uniformly buoyant across the Far East with Japan the notable exception. Economic data continued to be lackluster and the exit of Prime Minister Shinzo Abe highlighted the current political turmoil.

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In Europe, the European Central Bank has abruptly changed its attention to the potential fallout from stresses in financial markets, keeping rates on hold, together with the Bank of England, as they wait for evidence of the impact on the broader economy. The outlook for growth in Europe is moderating while forecasts for the UK have remained more resilient. The 50 basis point rate cut in the U.S., and concerns over prospects for consumer spending, contributed to a weaker dollar relative to the euro and sterling during the quarter.

The International portfolio enjoyed strong relative performance during the quarter benefiting from the emphasis on Asian companies that are exposed to the dynamic growth in the Far East. While recent exceptional performance has caused us to take profits, we continue to feel that investors are likely to attach a scarcity premium to the exceptional growth on offer in Asian and Chinese markets

Forecast

The new Bank of Canada governor, Mark Carney, takes the helm in February 2008 and he will be faced with a difficult dilemma. Strong home prices, a pickup in Western Canadian inflation and a strong labour market would argue for the Bank to maintain its administered rate at 4.50% and not follow the U.S. Federal Reserve into accommodation mode. However, he must balance this with the global credit crunch, a potential sharp U.S. economic slowdown and a very weak Ontario economy, all of which suggest that accommodation would be the best course of action.

We believe the Bank of Canada will be far less willing than the Fed to cut rates late in 2007, however, as GDP growth moderates into 2008, they will look to begin easing.

We continue to believe that the Canadian economy will outperform the U.S. economy in 2007 and into 2008. Consumer spending will moderate somewhat and the high Canadian dollar will continue to slow exports. As a result, GDP growth will slow to 2.5% in 2007 and just above 2% in 2008.

Looking forward, we continue to emphasize holdings in late cycle (e.g. infrastructure construction) or defensive sectors (utilities). While the consumer sector in Canada appears to be strong we are gradually reducing our exposure to this sector as we expect an eventual slowdown in Canada over the medium-term as well. The energy and material weights will continue at their current levels.

Also we would not be adding appreciably to the financials sector based on their rapid price appreciation in the past month combined with the fact that credit conditions are still tighter compared to the beginning of the quarter.

Given our view that economies are slowing, the bias for interest rates is stable or lower, and value in the bond market has improved, we continue to look for opportunities to extend duration in the fixed income portfolios. Since credit spreads are appreciably wider than earlier this year, we have begun to substantially add to the corporate bond component and will continue to do so over the next quarter.