



# INVESTMENT REVIEW AND ECONOMIC OUTLOOK

## First Quarter 2008

### Overview

Global equity markets moved decidedly lower in the first quarter triggered by an escalation in the U.S. sub-prime mortgage market crisis, higher commodity prices, weaker than expected economic data, rising U.S. jobless figures and higher than expected inflation readings.

Volatility in equities subsided late in the quarter, after the Federal Reserve implemented a number of liquidity initiatives that were aimed at alleviating strains in the credit markets. Continued credit market uncertainties fuelled a “flight to quality” into less riskier and above average quality fixed income products, causing bonds to outperform in the quarter. Commodity prices remained firm on the back of weakness in the U.S. dollar and a continued surge in Asian demand.

Markets have recognized that a North American earnings recession has begun, even though not all of the data and indicators have contracted. The main question that investors are now grappling with is whether the earnings downturn will be followed by a recovery later in this year and most importantly, the strength of such a recovery. The probability of a slowdown abroad has also increased as the strength in foreign currencies (i.e. Euro and Yen) together with tighter financial conditions has created weaker earnings prospects in overseas and export oriented economies. Given such an outlook, we believe U.S. growth will slow significantly and the economy will experience a technical recession. Most importantly however, a deep and prolonged downturn will now be avoided due to the aggressive pre-emptive moves of the Federal Reserve in slashing interest rates. Economic growth in Canada will certainly not be spared as U.S. headwinds slow real Canadian GDP growth towards the 2% or lower level.

### Canada

At the beginning of the year it appeared that the downturn in the U.S. would not have a major impact on the Canadian economy, outside of the financial sector.

As expected, the Canadian banks were not immune from the contagion in global financial markets, as they all took significant write downs. And like the Fed, the Bank of Canada did begin on a path of accommodation as well, albeit far less aggressively, cutting the Bank Rate Rate from 4.25% to 3.50% in early 2008. The Bank of Canada will continue on its path of accommodation and will likely cut the Bank Rate by a further 50 – 100 basis points over the balance of 2008, although this will certainly be governed by the relative strength of the resource-dependent Canadian economy.



## INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

Canadian real GDP growth in late 2007 registered a solid 2.5%, powered by strong consumption and also vibrant corporate spending. This is particularly significant given the loonie reaching parity with the greenback, but it truly highlights that the currency-dependent Canadian manufacturing sector is less important to the overall economy than it was ten years ago. In fact, manufacturing's share of real Canadian GDP has fallen to only 10%, versus 19% in 2001. Even though central Canada has seen some 300,000 factory jobs lost, this has been more than made up by job growth in other parts of the economy, including resources, construction, trade and services. In fact, the first two months of 2008 saw some 85,000 new jobs created, with the unemployment rate dropping to a generation-low of 5.8%.

Some economists believe that "when the U.S. sneezes, Canada catches a cold", implying that Canada will slow in 2008. Clearly there is some truth to that and as a result, we are decreasing our estimate for Canadian 2008 real GDP growth from 2% to 1.5 – 2%.

Strength in resource prices, including energy, metals and agricultural prices continues to be a boon for the Western Canadian economy. Nowhere is this more pronounced than in the price of gold, which hit \$1000 an ounce in the first quarter and is up over 60% in the last two years. Part of this move is clearly a result of the weak U.S. economy and greenback, as gold is perceived as a safe haven during times of crisis.

While it is still early in 2008, the Canadian consumer continues to spend at a healthy rate. Canadian retail sales increased a sizeable 7.5% year-over-year in January, versus a sharply deteriorating consumer spending environment in the United States.

So far in 2008, the high Canadian dollar has kept a lid on inflation in Canada, offsetting some of the inflationary factors described above. The Core Consumer Price Index rose only 1.5% in February.

Materials (+7.3%), Energy (+1.2%) and Technology (-1.6%) sectors led the overall S&P/TSX this quarter. Four of the top five portfolio performers were from the Energy and Materials sectors and were propelled by higher commodities. Are these commodity prices sustainable? With respect to oil, we think the uptrend that started in 2002-03 was based on tight fundamentals. In our opinion, the price of oil will probably remain at a relatively high level as long as the supply/demand balance remains reasonably tight and global growth does not collapse. With respect to gold we remain bullish over the longer term as we believe the liquidity being pumped into the world's economies will eventually bring higher inflation. We also remain cognizant of the possibility that part of the move higher in some commodity prices may have been driven by speculation on the part of some financial institutions. Consumer Discretionary (-14.3%), Telecommunications (-12.0%) and Financials (-8.6%) sectors were the performance laggards this quarter. Shaw Communications (-20.6%) and Rogers Communications (-17.9%) were lower on concerns about possible new competition after the spectrum auction, pricing pressures from U.S. competitors on wireless rates, slowing wireless demand and concerns over the possible impact of a weakening economy.

### Debt Markets

Investors' experiences in the bond market in the first quarter of 2008 as well as in the last six months of 2007 varied dramatically between the government bond market and that of the credit market, whether investment-grade corporate, high-yield, asset-backed, mortgage-backed – any component of the market that was not a government issue.



## INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

The first quarter of 2008 was highlighted by a sharp decrease in bond yields in Canada and the United States, particularly at the short end of the yield curve. The DEX Universe Bond Index had a strong positive return of 3.0% in the quarter. The corporate bond market underperformed the Government of Canada market in the quarter, returning 2.1% versus 3.8% respectively.

As mentioned earlier, the credit crunch intensified in the first quarter of 2008, which led the U.S. Federal Reserve, and to a lesser extent the Bank of Canada, to accelerate their path of easing. With the credit crunch in full force, the U.S. and Canadian government bond markets rallied sharply in the first quarter. While longer-term issues rallied substantially, the big move was in short-term T-bills and bonds, which continue to price in more central bank easing. Although there could be a further down leg in yields, value in the government bond markets has diminished appreciably given the already sizable rally – real rates are once again negative in the U.S.

When one studies previous economic/financial crises over the last few decades and the policy actions taken to combat these crises and their results, it is very clear that the way to succeed is to take direct and significant action, both through rate cuts and other policy initiatives. Japan in the 1990's is an example of a failure of monetary policy and proof that doing nothing is not the way to proceed. The property and stock market bubble in Japan burst in 1989. Unfortunately, the Bank of Japan, worried more about stoking inflation rather than a slowdown, continued to hike rates rather than cut them. The result – a crash of both the property and equity markets, depression-style deflation and the subsequent cutting of rates to essentially zero, and a subsequent ten-year workout. The Federal Reserve, specifically Ben Bernanke, a student of the Great Depression, does not want to make the same mistake. As a result, the Fed has been willing to take very rapid and dramatic action, not just with regard to rate cuts but other moves as well. The Fed's engineering of the takeover of Bear Stearns was criticized by many pundits as a "bailout of Wall Street". But this was not why they did it - Bear Stearns was one of the largest players globally in the now gigantic \$45 trillion credit default swap market. The Fed was worried about the domino-effect repercussions globally of a Bear Stearns bankruptcy – in short, the Fed was trying to maintain the integrity of the entire global banking system!

What else might the Fed do? It is very likely possible that there will be two other policy actions in the next few months: 1) a federal guarantee of some portion of residential mortgages, in order to keep more people in their homes, 2) a federal body that would begin buying distressed mortgage-backed and asset-backed securities. This is along the lines of the Resolution Trust Corporation, the government entity that was set up in the early 1990's to buy up the distressed assets of bankrupt U.S. Savings & Loan corporations.

With the substantial rally in government bond yields over the last nine months, value has diminished significantly, but given our view that the global financial workout will continue for another couple of quarters and that North American economies are slowing sharply, we are still slightly bullish on the Canadian bond market. As this workout continues into 2008, credit markets will continue to be very volatile – default rates will likely rise and liquidity will continue to be challenging. However, there is now excellent value in the credit markets, both in high-yield and particularly in investment-grade corporates, where credit spreads are as attractive as they have been in almost twenty years and where historical default rates are at less than 1%.

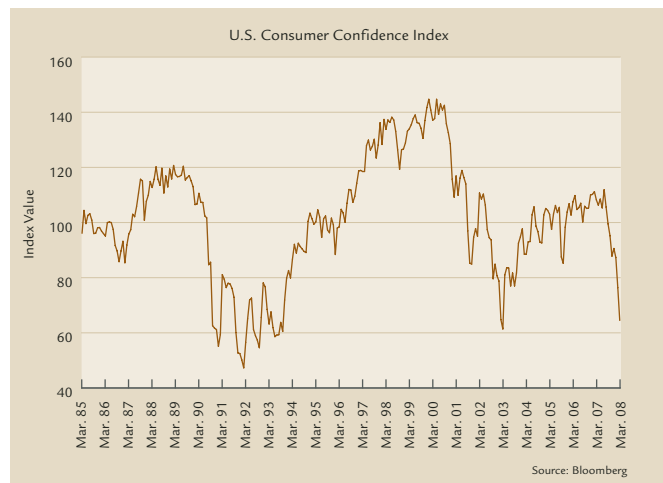
## INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

Given our view that economies are slowing sharply and the global financial system will continue to be under stress, we believe the bias for interest rates is stable or slightly lower, and value in the bond market is attractive. Thus, we are maintaining portfolio duration modestly longer than that of the market. We are also in the process of adding substantially to the corporate bond component of the fixed income portfolio and will continue to do so over the next few quarters.

### United States

So far in 2008, the anticipated severity of pain in the financial markets has surpassed expectations.

The housing market has continued to be a major drag on the U.S. economy. Not only is the deterioration of this market having a negative effect on financial markets, it is leaving consumer confidence at recession-like levels. With the inventory of both new and used homes still at very high levels, the housing market may be some time from bottoming.



Capital spending is decelerating as corporations' cost of borrowed capital has risen. Even more significant, the U.S. labour market has now cracked. The economy experienced negative job growth in January of 22,000 jobs – this is the first negative job growth month since mid 2003 and was followed by a further loss of jobs of 43,000 in February.

As a result, retail sales have also begun to trend lower. The recent earnings reports and guidance from such retail bellwethers as JC Penney suggest this trend will be more negative than we had anticipated just a short three months ago, and may be negative for the first two quarters of 2008. We had always believed that the U.S. economy could escape a recession if the labour market did not significantly deteriorate, however, this does not appear to be possible now. It is now quite likely that the U.S. economy will experience a technical recession, and 2008 GDP growth will be close to 0%, versus the positive 1 – 1.5% we initially estimated.

With the U.S. economy and financial markets in such difficulty, the U.S. dollar has been trending significantly lower versus all major currencies, particularly the Japanese Yen. As a result, the export market has become the one bright spot in an otherwise moribund economy.



## INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

The Federal Reserve has been extremely active in the first three months of the year – it has become abundantly clear that the Fed is very worried about both the credit crunch and a potential recession. As previously mentioned, the central bank cut the Fed Funds rate by an incredible 200 basis points in the quarter, to 2.25%, far lower than most economists expected. Furthermore, it introduced other non-traditional forms of monetary stimulus, including increasing the size of its lending window, extending its “lender of last resort” to include not just commercial banks but also broker/dealers and investment banks and expanding the array of allowable collateral to include not only Treasuries but also investment-grade corporate bonds and certain mortgage-backed securities. Lastly, the Fed assumed direct credit risk by directly engineering and backstopping the dramatic takeover of troubled investment bank Bear Stearns by JP Morgan. We anticipate that the Fed will continue to maintain an accommodative stance and will likely cut the Fed Funds rate another 50 – 100 basis points over the balance of 2008.

Consumer Staples (+1.2%), Materials (+0.3%) and Industrials (-0.7%) were the best performing sectors over the past quarter in the S&P 500 Index. The top five performers in the portfolio were from the Industrials, Consumer Discretionary, Consumer Staples and Healthcare sectors. The two top performers in the quarter Navigant Consulting (+43.4%) and Starwood Hotels & Resorts (+21.4%), were both up after reporting Q4 earnings results that were significantly better than analysts’ consensus estimates.

Technology (-12.0%), Financials (-11.4%) and Telecommunications (-11.2%) were the worst performing sectors for the quarter. The bottom five performers in the portfolio were from the Financials, Consumer Discretionary, Technology and Energy sectors. Tempur-Pedic (-56.3%), was the worst performing name in the portfolio for the quarter. The stock moved lower after pre-announcing a weak Q1 earnings outlook that fell short of analysts’ consensus estimates. Another underperformer in the quarter was Alliance Data Systems (-34.6%). Alliance stock fell early in the quarter on news that Blackstone was unlikely to complete its buy-out agreement for the company at \$81.75/share due to what the company indicated were onerous conditions from the regulator. However, the stock pared losses late in the quarter after positive regulatory developments and a mutual willingness on the part of both companies to work together to get the deal done.

### Global

International equity markets have had a weak and volatile start to 2008. The Morgan Stanley EAFE, Europe and Asia Pacific indices returned -5.2%, -4.9% and -5.8% in Canadian dollar terms, respectively. The reversal in economic news flow and sentiment since the summer of last year has been remarkable. Economic growth expectations and corporate earnings continue to be revised down in Asia and particularly in Europe, albeit not as sharply as in the United States. Estimates of losses in credit markets continue to escalate with the International Monetary Fund (IMF) projecting potential losses approaching U.S. \$1 trillion related to residential mortgages, commercial real estate and other business and personal loans. The IMF has also recently reduced its estimate for global growth to 3.7% for 2008.

In March, 2008 the euro zone reported a year over year CPI increase of 3.5%, well above its comfort level of 2% and yet GDP is expected to grow by just 1.7% this year. The European Central Bank’s (ECB) primary policy objective is the control of inflation and inflationary



## INVESTMENT REVIEW AND ECONOMIC OUTLOOK (CONT'D)

expectations. It is therefore difficult to imagine rate cuts in the region in the near term with inflation so far above their targets. Recent data shows a slowdown in both manufacturing and service sector activity across Europe. Areas of acute stress include the property markets in the U.K., Ireland and Spain and the banking system in the U.K. The 18% appreciation of the Euro relative to the U.S. dollar over the past year, will also impact on growth prospects while hopefully providing some relief on the inflation outlook.

China has continued to show strong growth with factory spending, for example, rising at 24.3% during the first two months of the year. However, concern does exist that China will not be immune to the deteriorating health of its major global customers. Inflation also remains a very significant issue running at over 8% as we enter 2008. The government has implemented a range of price controls and taken various administrative actions to prevent further overheating. The outlook for domestic consumer spending looks to be very robust and should support continued exceptional growth for China. The outlook for Japan, however, continues to be for softening growth with weak business and consumer confidence data being released this quarter.

Decoupling proved a myth with emerging market indices generally falling materially on concerns of a severe U.S. slowdown. The worst performing indices were those linked to countries with unsustainable dynamics such as large current account imbalances or accelerating inflation. Most notable was the fall in past darlings China mainland and India, through valuation concerns also played a part. The banking crisis remained at the forefront with financial stocks suffering the sharpest falls. Generally, the strong demand for materials and energy combined to limited supply responses continued to push resource stocks higher.

### Forecast

Although we continue to have serious reservations as to the health of the U.S. economy and in particular the U.S. consumer, we are somewhat more optimistic on equity markets. The basis for our optimism is rooted in the fact that global equity markets are trading at reasonable valuations. Developed markets are trading at price/earnings multiples in the 12 to 16 times earnings, which, in a historical context, is not expensive especially considering the current level of interest rates. Additionally, unlike the market correction of 2000, corporate balance sheets are in good shape, underpinning current dividend payments and corporate equity buy back programs. Our expectations are that the markets in the near term will continue to be choppy and experience a high degree of volatility. There will be more bad news on the economic front, bank write downs will continue, and earnings expectations will be revised down. However, with the Fed aggressively easing, and the U.S. Administration about to implement a \$162 billion economic stimulus package, the economy will emerge from the slowdown.