



# INVESTMENT REVIEW AND ECONOMIC OUTLOOK

## Fourth Quarter 2007

### Overview

The positive bounce in global equity markets in the third quarter was short lived as the U.S. housing debacle and the ensuing credit crunch triggered renewed fears of economic recession and worries over the health of the U.S. economy. Volatility in equity markets escalated further due to disappointing earnings, renewed tightness in credit markets and massive write-offs at major banks and investment firms worldwide. These wild market gyrations caused a “flight to quality”, driving fixed income instruments higher and equities lower. Commodity prices were firm and continued to trade near multi-year highs as Asian demand for these materials continued unabated.

Tightening bank lending standards and the credit crunch have clearly increased economic risks to the downside. We remain of the opinion that the U.S. may avoid an outright recession as corporate balance sheets remain in reasonable shape and the Federal Reserve has already embarked on an easing campaign. Furthermore, somewhat stable inflation readings suggest that the Federal Reserve has the latitude to continue cutting rates if conditions weaken. Given that corporate earnings growth has peaked for this cycle and that North American economic output will slow to sub-par levels for 2008, the main risk, in our opinion, is that the recent turmoil in credit markets broadens and spreads into business activity. If this does occur and the corporate sector retrenches significantly, then employment and income growth will be negatively affected and consumers may not be able to weather this double whammy on top of a downturn from the housing sector.

In the near term, we maintain neutral to cautiously positive on equities for 2008, given both the low relative real interest rates available in fixed income securities and our expectations of a soft economic landing for the U.S. and a prolonged overseas expansion. However, if the U.S. housing market downturn creates a spill over effect into the corporate sector causing employment and income growth to fall, then a significant retrenchment in consumer spending could take place. If this occurs, the odds will certainly tilt towards an economic recession and we will have to revise our outlook for equity markets lower.

For the time being though, we are sticking with our base case scenario that North America will experience very slow growth in 2008 while overseas earnings will provide an offset to this deceleration in domestic profit growth. Given this environment, we expect equity prices to bottom out mid-year, stabilize and eventually move higher through the course of 2008.



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

With respect to the fixed income markets, yields moved decidedly lower in the quarter as a result of both a flight to quality caused by the continued meltdown in the subprime mortgage market and weak corporate earnings forecasts for next year. The subprime liquidity panic and continued strength of the Loonie have increased the probability that the Bank of Canada will continue on its easing campaign, while the Federal Reserve, remains tilted towards further interest rate cuts over the next few meetings. As such, our bond portfolio maintains a longer than benchmark duration and an overweight in corporate bonds relative to the benchmark. Going forward, we feel that fixed income will perform in line with cash as the strong Canadian dollar and an economic slowdown in the U.S. tempers economic growth within Canada.

### Canada

Earlier in the year we presented the view that the Canadian economy would slow toward a yearly growth rate of 2 – 2.5%. We believed that the sluggish Canadian manufacturing sector would take the core Canadian inflation index down below 2% in 2007, allowing the Bank of Canada to turn accommodative. Lastly, we believed the Canadian dollar strength was overdone and the loonie would end the year at, or near, parity with the US\$.

In fact, the Canadian economy did not slow as much as we thought. Canadian real GDP was actually up a solid 2.8% year-over-year in October, powered by strong consumer spending. This was partly due to the resilience of the Canadian labour market, which added close to 400,000 jobs in 2007, leading to an unemployment rate of 5.9%. However, manufacturing in Ontario and Quebec, has been under siege due to the high Canadian dollar. Ontario's unemployment rate was at 6.2% in November while Quebec's was a disappointing 7.0%.

The Canadian dollar has been the economic story of 2007, rising an incredible 20 cents to 110 in the fall, before pulling back to finish the year just under par with the U.S. dollar. This factor, along with the surprising strength of the Canadian economy, left the Bank of Canada less dovish than the U.S. Federal Reserve, although it did decrease the Bank Rate 25 basis points in the fourth quarter to 4.25%. The strong Canadian dollar kept a lid on inflation through the balance of 2007, with core CPI down to an annual rate of only 1.6% in November.

Canada was also not immune to the credit crunch as several banks took significant write downs and credit markets also experienced a complete freeze in the asset-backed commercial paper area. However, as the mortgage and subprime bubbles were not as pronounced in Canada as they were in the U.S., the resulting downturn has not been as extreme.

### *2008 – What Lies Ahead?*

We believe that the Canadian economy will be negatively affected by the U.S. slowdown, slowing its yearly real GDP rate from 2.5% to 2% or just below. Our expectations for the Canadian economy in 2008 are as follows:



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

- 1) The Canadian consumer will slow somewhat in 2008, but nowhere near the levels in the U.S. Unlike in the U.S., Canadian households continue to have a very high level of home equity and have not levered their household balance sheets to the same degree – this will allow spending to remain solidly in positive territory. Job growth may decelerate in 2008, but is likely to remain positive. Lastly, the 1% cut in the Goods & Services Tax will be stimulative to the consumer in the early part of the year.
- 2) Exports will be a drag on growth in Canada in 2008, as the 100-cent dollar makes the manufacturing sector a difficult place to operate.
- 3) Strength in resource prices, the outperformance of the Canadian economy and higher relative interest rates to the U.S. should maintain the loonie at elevated levels in 2008.
- 4) Real Canadian GDP growth in 2008 will decelerate to 2% or just below.
- 5) Inflation in Canada will continue to be very benign in 2008, tamed by a high Canadian dollar.
- 6) The Bank of Canada under new Governor Carney will continue to be accommodative, however, the situation will be much more data dependent than in the U.S. The Bank will continue to balance economic strength and inflation in Western Canada with economic malaise and job losses in Ontario/Quebec. We believe the Bank Rate will finish 2008 lower than today, in the range of 3 - 4%.

With respect to Canadian equity investments, Technology (+11.8%), Utilities (+4.6%) and Materials (+3.4%) sectors led the overall market this quarter. Two of the top five portfolio performers were in these sectors and included Research in Motion (+15.2%) and Suncor Energy (+14.2%). RIM shares rose again this quarter after earnings for fiscal Q3 2008 exceeded analysts' consensus estimates and guidance for Q4 2008 was also above analysts' estimates. Suncor Energy was strong on the back of a continued positive global supply/demand outlook for energy. Healthcare (-9.7%), Industrials (-7.6%) and Consumer Staples (-7.3%) sectors were the performance laggards this quarter. CIBC (-29.0%) remained under pressure this quarter because of its structured credit exposure. We believe the stock will be range-bound until the amount of additional markdowns becomes clearer.

### Debt Markets

In the debt markets, even short-term money markets became extremely illiquid in the latter part of 2007, with 3-month bankers' acceptances widening to a huge 100 basis points over T-Bills versus the normal 10 basis point spread. High-grade corporate bonds widened out well over 100 basis points since June, while high yield bonds suffered even more, with credit spreads some 300 basis points wider than their May 2007 tights. Low-grade triple-C paper is now trading at a staggering 900 basis points over treasuries, or a yield of over 12%!



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

We believed at the end of June that Canadian bond yields offered reasonable value at these levels – yields were as high as they had been since 2004 and real rates were approaching 2.5%, which has been the average level since 1999. With the substantial rally in bond yields over the last six months, value has diminished somewhat, but given our view that the global financial workout will continue into 2008 and that North American economies are slowing, we are still modestly 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 very significant 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.

The DEX Universe Bond Index (formerly the Scotia Capital Universe Bond Index) had one of its best quarterly returns in several years, returning 2.7% for the 4<sup>th</sup> quarter. The corporate bond market again significantly underperformed governments in the quarter, returning 1.9%. Given our comments on credit spreads, we are adding substantially to the corporate bond component of the portfolio and will continue to do so over the next few quarters as we believe that this will add significant value over the longer-term. As we are adding positions into market weakness one must expect some short period of under-performance when building positions in this area as it is impossible to time bottoms or tops of markets.

Given our view that economies are slowing and the global financial system will continue to be under stress, we believe the bias for interest rates is stable or lower, and value in the bond market is somewhat attractive. Thus, we are maintaining a portfolio duration modestly longer than that of the market.

### United States

We predicted that US GDP growth was going to slow appreciably to a yearly rate of 2–2.5%, dragged lower by negative residential construction activity and slowing personal consumption. We believed that this slowing economy would lessen inflationary pressures in the U.S. and we believed that the Federal Reserve would begin on a path of accommodation, resulting in a classic “soft landing”.

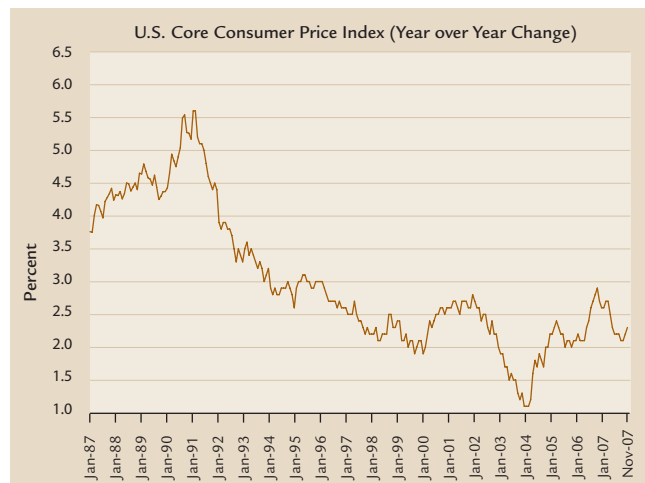
Our forecasting 2007 was reasonable, but it was not perfect. The housing recession accelerated, leading to terrible performance for residential construction, which was down 20% in the 3<sup>rd</sup> quarter. However, personal consumption continued to be resilient having risen 2.8% in the 3<sup>rd</sup> quarter for a strong 4.9% 3<sup>rd</sup> quarter showing for real GDP. Real GDP will likely finish the year up about 2.2%.

Outside of the food and gasoline components, inflation did slow in 2007, with Core CPI down to 2.1% before trending somewhat higher to 2.3% year-over-year in November. What we did not anticipate however, was the tremendously negative impact that the housing recession would have on credit and the



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banking system. The sub-prime mortgage crisis in the U.S. has resulted in one of the worst credit and liquidity crunches seen on a global basis in ten years. Substantial asset value write downs were taken at almost all major financial institutions worldwide, as CEO's and Chief Risk Officers attempted to value mortgage-backed securities and collateralized debt obligations (CDO's). Fear became the operative word in the fall as banks were wary of lending to one another. This prompted the Federal Reserve to make a series of rate cuts for both the discount rate and also the Federal Funds rate, which now sits at 4.25%. The Fed and other central banks also took other action to take the stress out of the global financial system, including adding billions of dollars of liquidity to the system and expanding the types of securities that they accept as collateral to include not only Treasuries, but also certain types of mortgage-backed securities.



Source: Bloomberg

### *2008 – What Lies Ahead?*

So what is in store for 2008? Well, unfortunately, a slowdown – how severe that slowdown is depends on a number of factors, including action taken by the Federal Reserve. Our expectations for the U.S. economy in 2008 are as follows:

- 1) The housing market will continue to be a significant drag on economic growth in 2008. With home inventories at levels not seen since the severe recession of 1981-82, it is likely that home prices will have to come down another 10% to clear the market – this represents a shocking \$2 trillion loss in home equity.
- 2) With the on-going credit crunch, corporations will decelerate their hiring plans and the unemployment rate will move higher in 2008. We have always said that consumption depends ultimately on the labour market, not on home equity. If you have a job, you will spend. With both of these forces acting on the downside in 2008, it is likely that the consumer will finally retrench.



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- 3) With the U.S. dollar having declined so significantly against the world's currencies, the U.S. export market will finally get a break. As a result, the trade and current account deficits will begin correcting.
- 4) We are not forecasting a technical recession, although the risk of such an event has clearly increased. With consumer spending finally decelerating, it will be difficult for 2008 real GDP growth not to decelerate sharply to a yearly rate of 1 – 1.5%. Whether an actual recession occurs depends on how much the labour market deteriorates and also on the Fed.
- 5) Inflation remains benign for the early part of 2008, as the economy slows down. However, inflation will likely rear its head again late in 2008 and into 2009, as food, energy and Chinese import inflation make their way through the domestic price complex.
- 6) Banks and other financial services companies will continue to grapple with write downs as they try and value their mortgage and CDO books. This will continue to make the lending environment very difficult. Thus, the Federal Reserve will continue on its path of accommodation, taking the Fed Funds rate down toward 3 – 3.25%, as it works to ensure that the financial and banking system continues to operate in an orderly fashion.

### Global

Europe continued to offer attractive valuations in the fourth quarter, but faces the challenges of higher recent readings for inflation and slowing economic growth. Recent data from Japan also points to slower growth ahead. Certainly all markets globally will feel the impact of a challenged U.S. consumer. Growth in Emerging Markets, with China being a prime example, should offset to some extent slower growth in the world's major economies.

In Europe, the central bank continues to express concerns over inflationary pressures, however we believe that forward looking data which point toward a slowdown in growth will ultimately dictate reductions in interest rates during 2008. The European Commission for example, recently reduced its GDP forecast for the Euro zone to 2.2% for 2008. The Bank of England lowered rates in December to 5.5%, citing concerns relating to credit markets and the risks of slower economic activity.

Emerging markets are mitigating to some extent the global slowdown. The prime example is China where growth continues at an extraordinary pace. GDP grew at a rate of 11.5% in the third quarter. Data for November showed fixed asset investment growth of 26%, retail sales growth of 18.8% and company profit growth of 36.7% over the previous year. However, policy initiatives are now clearly geared to restraining what the government fears is an overheating economy. China raised interest rates several times through 2007 and also applied various other measures intended to restrain lending growth.

The International component of the portfolios enjoyed positive performance for the fourth quarter and generated positive returns of approximately 1.1%, outperforming the -2.5% return for the MSCI EAFE Index. Stock selection was



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the primary contributor, with equities outperforming in Asia, Europe and Emerging Markets. Small caps underperformed in the quarter, giving up a small portion of very strong third quarter performance.

The top five performers in the quarter were from the Telecommunications, Energy, Consumer Discretionary and Industrials sectors, while the five bottom performers were from three sectors; Industrials, Consumer Discretionary and Technology.

We have become more cautious as a result of the financial stresses and general slowdown being experienced by the global economy. We have taken decisive action to protect capital by first reducing weights in financial stocks most exposed to these deteriorating conditions and additionally we have reduced weightings in economically sensitive stocks. We continue to also invest in niche sectors where we feel industry and company dynamics are solid.