NEXUS

Portfolio Management & Financial Counsel

Investment Outlook

January 2006

Up, Up and Away

2006 has started with a bang. U.S. and Canadian stock markets have risen steadily in the first trading days of the year. With breathless fervour, U.S. television commentators cheered the Dow Jones as it closed above the 11,000 threshold on January 9th. As always happens when such excitement is in the air, statistics are quickly conjured that provide even more fuel for the fire. For example, it was observed in *Barron's* on the weekend after the first four days of trading in 2006, that the Standard & Poor's 500 has risen on each of the first four days of a year only six other times in the last 50 years![1] In each of these years, stocks finished higher in January and posted gains for the full year. With the S&P posting such a strong start to 2006, the implication must be that 2006 is virtually guaranteed to be a banner year!

On a more serious note, it is interesting to note that a key event driving U.S. stocks higher in the first days of 2006 was also what helped guide them lower in the first days of 2005. In each case, investors reacted to the release of minutes from the December meeting of the U.S. Federal Reserve. In early 2005, these minutes reflected a belief among Fed governors that monetary policy remained too accommodative (i.e., interest rates remained too low), and that the forces of speculation across a variety of asset classes were worrisome. Stocks retreated on the prospect of a continued trend of rising interest rates through 2005. Early in 2006, by contrast, the minutes suggested that Fed governors believed they were close to policy neutrality after 13 consecutive interest rate hikes over the past 18 months. Investors concluded that there will be perhaps only one additional hike before the Fed calls it quits. With this light at the end of the tunnel, stocks were off to the races.

While investors' minds currently are captivated by the prospect of the Fed completing its program of increasing short-term interest rates, it is, of course, only one element of a complex array of trends and issues with which investors will have to grapple over the course of the year. But before looking out to the months ahead, allow us to recap the year that has passed.

Worries Beneath a Calm Façade

Economic conditions in the U.S. were largely favourable through 2005. Overall economic growth remained strong, although it decelerated measurably late in the year. Inflation remained low, the housing market was robust through most of the year, and the unemployment rate continued to fall. The U.S. dollar defied most predictions for continued weakness and was strong against most other currencies in 2005. In this supportive economic environment, corporate profitability was outstanding; corporate balance sheets have never been better. Yet in the face of this good news, U.S. stock market returns were lackluster. In US$ terms, the S&P 500 provided a 4.9% total return. The Dow Jones finished slightly lower on the year.

Clearly, U.S. investors didn't buy into the good news. They were worried. In our view, stock market returns reflect concern among investors that the reign of the U.S. consumer is seriously threatened. As we have discussed many times, relentless growth in U.S. consumer spending has been the major driver of U.S. economic growth over the last five years. An important catalyst for this strong consumer spending has been sharply rising housing prices. As 2005 came to a close, the reality of a weakening housing market finally seemed at hand. This, combined with unprecedented personal debt levels, and the impact of higher interest rates and higher energy prices working their way through the system, caused concern over the risk of consumer retrenchment.

[1] From Michael Panzner of Rabo Securities quoted in *Barron's*, January 9, 2006. The years were 1964, 1967, 1976, 1979, 1987 and 1988.

In Canada, by contrast, stock market returns were excellent. The TSX Composite provided a 24.1% total return in 2005. Fueled by the remarkable strength of many commodity prices, most particularly energy, our currency and our stock market attracted investors from around the world.

Despite the success of the Canadian stock market, there remain a number of worries in our economy as well. While conditions in western Canada remain buoyant, conditions for manufacturing companies in Ontario and Quebec remain challenging and, in some cases, grim. CIBC economist, Jeff Rubin, estimates that if the Canadian dollar rises to 90¢ as he predicts, the average Canadian manufacturer will have 25% higher unit labour costs than his U.S. competitors.[2]

This dichotomy in the Canadian experience is actually reflected in a more detailed look at stock returns. Two sectors, energy and financials, accounted for 84% of the TSX return in 2005. The sharp rise in the energy sector is a well-documented result of the ongoing strength in oil and gas prices as well as increased international interest in our energy companies, most particularly those involved in the Alberta oil sands. The success of financials can at least partly be attributed to the fact that longer-term bond yields declined quite significantly over the year, thereby making the generous dividends offered by financial companies that much more attractive. Outside of the these two sectors, the TSX generated only a 3.5% return – very much in line with the lackluster returns we described in the U.S.

An Interesting Year Ahead

Positive momentum in U.S. equity markets early in 2006 seems to reflect a consensus view that a big rally will take hold once the Fed finally completes its monetary tightening program. Virtually all economists expect the Fed to raise rates one additional time as Alan Greenspan chairs his final meeting later in January. There is increasing hope that as Ben Bernanke assumes the role of Chairman, the Fed's work is done. While this is clearly a positive development for financial markets, it is only one of many complex factors at work.

Indeed, many of the challenges faced by the U.S. economy and financial markets remain. In addition to the risk of a consumer slowdown described above, there also remain unprecedented trade and budget deficits, Iraq, terrorism, the risk of avian flu, and a renewed nuclear threat from Iran. Yet even if the U.S. meets its challenges (as it seems remarkably adept at doing), and continues to post solid growth, the upside in financial markets may be modest. With corporate profits at record levels relative to GDP, the possibility that these would surge further is limited. With long-term interest rates at generational low levels, the possibility that these would fall significantly is also low. Accordingly, we see a major rally in U.S. stock prices as perhaps a little optimistic. Overall equity valuations may be reasonable, but they are not cheap. Without a major catalyst from either unexpectedly robust earnings growth, or a significant upward revision in valuation multiples, we are left with the sense that it is likely to be another year of modest returns from U.S. stock market indexes.

Canadians face many of these same risks and challenges. As well, by the end of January, we will have elected a new federal government. While current polls point to the likelihood of a Conservative victory, in truth, it probably doesn't matter much for investments in the near term who wins the race. Compared to the U.S., our national well-being depends more on the strength in oil prices and in many other commodities. At the moment, the outlook for these sectors is excellent and our financial markets remain strong. On the back of continued strength in these sectors, there is a real chance that the Canadian economy will post solid growth, that our currency will remain strong, and that the TSX will post another year of attractive returns. However, commodity markets are fickle, and our current prosperity may quickly ebb. It is also important to remember, as we have discussed above, that not all sectors of our economy will benefit equally.

In summary, 2006 is shaping up to be an interesting year. While the environment we see ahead seems unlikely to promote robust investment returns across all market sectors, we believe it will continue to support our investment approach. It is likely to be a "stock picker's market." With discipline and hard work, we're confident that we will find a range of profitable investments.

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[2] Jeffrey Rubin, *Canadian Portfolio Strategy Outlook*, January 4, 2006.

FINANCIAL MARKET SUMMARY

Market Levels

Canada	December 31, 2005	December 31, 2004
TSX Composite Index	11,272	9,247
91-Day T-Bill Yield	3.46%	2.50%
30-Year Canada Bond Yield	4.03%	4.84%
Prime Rate	5.0%	4.25%
Exchange Rate (1$ Cdn. = US$)	$0.8598	$0.8319
United States		
Dow Jones Industrial Average	10,717	10,783
Standard & Poor's 500 Index	1,248	1,212
30-Year U.S. Bond Yield	4.53%	4.83%

Market Returns For Periods Ended December 31, 2005 [1]

	Last Quarter	Last 12 Months	Last 5 Years [2]	Last 10 Years [2]
SC 91-Day Treasury Bills [3]	0.7%	2.6%	3.0%	3.8%
SC Universe Bond Index [3]	0.7%	6.5%	7.4%	7.7%
TSX Composite Index	2.9%	24.1%	6.6%	11.0%
S&P 500 Index (C$)	2.5%	1.6%	-4.4%	7.4%
MSCI EAFE (C$)	4.5%	10.0%	-0.6%	4.2%

Footnotes:
(1) Represent total returns, including income and capital appreciation (or depreciation).
(2) Compound average annual return.
(3) Scotia Capital Inc. index returns.