



Investment Outlook

October 2006

Will the Landing be Soft or Hard?

There is broad agreement among observers that, after a number of years of robust growth, the U.S. economy is slowing. There is further agreement that the slowdown in the economy is being led by a decline in the U.S. housing market. The point of debate arises over whether this slowdown will end in a much-hoped-for soft landing for the economy, where growth slows, but remains positive. Of course, the other possible outcome is a harder landing, and the possibility of recession.

Often, financial markets provide a reliable forecast of future economic activity. Markets are discounting mechanisms, meaning the value of securities today is based on expectations about the future¹. Countless investment decisions are made every day by millions of investors, and while no one individually possesses a magical crystal ball, on average the market reflects a pretty accurate forecast of future economic activity. It is a bit troublesome, therefore, that stock and bond markets in the U.S. currently are sending conflicting signals.

On one hand, stocks seem to portray a fairly cheery outlook. The Standard and Poor's 500 Index, for example, rose 5.7% in the past quarter, the best third quarter result in many years. No doubt analyst forecasts of a 14% year-over-year gain in Q3 S&P 500 earnings, together with confidence of further strong earnings gains ahead, played an important role in emboldening equity investors. Even the stodgy old Dow Jones Industrial Average drew attention (and shrieks of excitement from cable news broadcasters) when it made a new all-time high in early October, finally surpassing its previous high water mark set on January 14, 2000.

On the other hand, an inverted yield curve in the U.S. bond market points to troubled economic times ahead. Normally, investors in bonds with longer maturity demand a higher interest rate to compensate them for the risk of tying up their money for longer periods of time. When the curve "inverts", the yields on longer-dated bonds become lower than shorter-dated ones. Since the level of long-term interest rates is generally set by the market, and the level of short-term rates is administered by the U.S. Federal Reserve, the message implied by an inverted curve is that policy-makers will soon need to be reducing short-term rates to stimulate lagging demand. In other words, the market is simply ahead of policy makers in re-setting rates to lower levels. Over time, an inverted yield curve has been a pretty good forecaster of economic trouble ahead.

Time will tell which of the stock market or bond market has it right, or whether they are both right in some way. The prevailing view at Nexus is that a soft landing in the U.S. should be achievable, notwithstanding the worrisome decline of the housing market. We have repeatedly expressed concern about a bubble in U.S. housing, and the expected correction clearly has begun. In August, the median sale price of existing homes fell by 1.7% from the previous year, the first such outright decline in more than a decade. Other scary housing statistics abound.² The inventory of unsold homes has ballooned to almost 4 million units at the same time that the University of Michigan consumer sentiment survey showed house purchase intentions to be at their lowest level since 1991. Housing affordability is at its worst level in 20 years. Household debt to income, which stood at 40% in 1953, and climbed to 70% in 1986, has now mushroomed to an all-time high of 134%.

¹ In fact, stock and bond movements are key components of the Conference Board's closely-followed Index of Leading Economic Indicators.

² Housing statistics from "The Hard Landing Scenario", David Rosenberg, Merrill Lynch, October 2006.

While housing itself is a fairly small part of the economy, it has a powerful secondary effect on consumer behaviour, particularly since real estate equity seems to have replaced savings as a store of wealth on consumer balance sheets. Why, then, our sanguine outlook for economic growth? Mitigating the impact of the housing correction is the windfall consumers have enjoyed from sharply reduced energy prices. U.S. gasoline prices have dropped more than 70¢ per gallon from their highs, and one estimate we have seen suggests that a penny decline in gasoline prices unleashes \$1 billion of incremental consumer spending. As we approach the winter heating season it is also important to remember that natural gas prices have also moderated significantly.

While our expectation may be for a soft landing in the U.S., one must not rule out the potential for a more disruptive outcome. Simply put, no one really knows how bad the housing correction might get, and a number of sensible and insightful commentators fear for the worst. For example, one recently wrote that: "The deflation of the housing market is sure to wreak far more havoc than its dot-com predecessor, shaking the very foundation upon which the U.S. consumer and financial system (with its record real estate exposure) now rest."³ As highly leveraged consumer balance sheets deteriorate, the only solution will be to re-build savings from its current negative run-rate, and that will have adverse consequences for consumer spending and economic growth. It may be that declining energy prices are not the antidote to the weak consumer but in fact a symptom of the economy sliding into recession. As mentioned above, this is not our forecast, but it is a risk we are monitoring carefully.

As always, the Canadian experience will be strongly influenced by how the U.S. slowdown plays out. Conditions in Canada today are distinctly less ebullient than they were three and six months ago, and this should be unsurprising given developments south of the border. The competitiveness of Canadian manufacturers remains severely hampered by our strong currency. Sadly, the state of North American auto manufacturing, on which so many Canadian jobs depend, continues to deteriorate. While economic conditions remain strong in the Western provinces, the recent pullback in commodity prices provides reason to question the sustainability of the West's torrid growth. With Canadian growth moderating, the Bank of Canada looks to have been very wise in stepping to the sidelines in early July to watch how the economy will adjust to the effects of previous interest rate hikes.

Our Bridge Over Troubled Waters

Despite our optimism that the U.S. slowdown will end with a soft landing, we harbour concern regarding the outlook for corporate earnings in both Canada and the U.S. Quite simply, we worry that expectations are too high and that disappointment looms. As mentioned above, analyst expectations call for 14% annual growth in S&P 500 Q3 earnings as companies report over the coming weeks. Looking to 2007 and beyond, it seems to us that the consensus believes double digit earnings growth will continue forever. This is implausible in the best of times and, with the slowdown we have described, earnings growth will almost certainly moderate in the period ahead. A period of slowing economic growth and potentially disappointing earnings is not a time when economically sensitive stocks typically do well. As a result, we continue to emphasize investments in companies that can grow their earnings in challenging times – so-called defensive stocks such as those providing health care services or consumer staples.

At the same time, there have been several corporate takeovers in recent months where traditional measures of valuation seem to have been set aside. On more than one occasion, sophisticated institutional investors have stepped up to pay prices that stretch the imagination. It is possible that they have lost their minds, but it is also possible that they have concluded we are in an extended period of very low interest rates as well as low equity returns. Accordingly, stable, low risk cash generators such as pipelines and real estate may be more valuable in this environment than they were heretofore. If this interpretation is correct, it could be a favourable environment for a number of our holdings.

While the period ahead contains many risks and uncertainties, there is always opportunity. Carefully chosen investments, combined with the diligent management of risk, will continue to offer clients the opportunity to earn good investment returns over the years ahead.

³ Stephanie Pomboy, MacroMavens, quoted in *Barron's* October 2, 2006.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>September 30, 2006</u>	<u>December 31, 2005</u>
TSX Composite Index	11,777	11,272
91-Day T-Bill Yield	4.14%	3.46%
30-Year Canada Bond Yield	4.08%	4.03%
Prime Rate	6.00%	5.00%
Exchange Rate (1\$ Cdn. = US\$)	\$0.8943	\$0.8598

United States

Dow Jones Industrial Average	11,679	10,717
Standard & Poor's 500 Index	1,336	1,248
30-Year U.S. Treasury Yield	4.76%	4.53%

Market Returns For Periods Ended September 30, 2006 ⁽¹⁾

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years ⁽²⁾</u>	<u>Last 10 Years ⁽²⁾</u>
SC 91-Day Treasury Bills ⁽³⁾	1.1%	3.7%	2.8%	3.7%
SC Universe Bond Index ⁽³⁾	4.9%	4.0%	6.9%	7.3%
TSX Composite Index	1.9%	9.2%	13.6%	10.2%
S&P 500 Index (C\$)	5.7%	6.4%	-0.2%	6.4%
MSCI EAFE (C\$)	4.0%	14.5%	6.6%	4.7%

Footnotes:

(1) Represent total returns, including income and capital appreciation (or depreciation).

(2) Compound average annual return.

(3) Scotia Capital Inc. index returns.