

## Investment Outlook

April 2007

“In all times and in all markets, excess is a leading indicator of peril.”

- James Grant<sup>1</sup>

Despite a modest uptick in the optimism expressed in our last quarterly *Outlook*, readers will recall that we have been articulating a cautious outlook for many quarters. The U.S. has been the particular focus of many of our worries due to the proliferation of consumer debt, obvious excesses in the housing market in certain regions, the twin trade and budget deficits, and the geopolitical quagmire in which the U.S. finds itself in the Middle East.

Over the recent quarter, two of these issues have come into particular focus. First, the unwinding of excesses in the U.S. housing market has continued to gather steam. Prices in the most inflated markets, such as in South Florida, have collapsed. A number of lenders have disclosed the onset of problems with mortgage delinquencies. While credit problems have thus far been concentrated in the so-called “sub-prime” sector of the market (borrowers with weak credit ratings), they have impacted a wide range of financial institutions, including sophisticated global banks like HSBC, as well as specialized mortgage lenders. A few of the weaker players, such as New Century Financial, recently filed for bankruptcy.

Three months ago, pundits were split over whether the worst in housing had passed. The optimist camp, which included former Federal Reserve Chairman Alan Greenspan, has been wrong thus far as conditions with housing and mortgage debt have worsened over the past three months. However, there remain intelligent commentators on both sides of the issue: those that believe we are close to resolving the housing imbalances, and those that believe the peril has hardly begun. All one can say for certain is that there remains a clear risk to the U.S. economy should sub-prime credit woes spread.

The second issue that remains in the spotlight is the risk that excess liquidity poses to financial markets. One manifestation of this liquidity can be seen in the remarkable number of leveraged buyouts led by private equity firms in recent months.<sup>2</sup> In the first nine months of 2006, 25% of all U.S. acquisitions were done by private equity compared to just 5% in 1999.<sup>3</sup> Without doubt, the pace of these deals has increased since September. Deals are happening in every sector: big companies and small, stable ones and cyclical ones, good ones and bad. As we write this *Outlook*, the media is gripped by the prospect that Canada’s venerable BCE might be the next dance partner for some private equity player.

As if this flood of deals was not a bright enough warning beacon, formerly secretive private equity firms ironically are seeking to cash out by going public, and their wealthy principals are treated in the media like rock stars. We refer back to the quote that heads this page. While many of these private equity deals may well be sound, they can’t all be. If the maxim that excess is a leading indicator of peril holds true, this latest attempt at financial alchemy will end in tears – just like many that have gone before it.

### The Unsinkable U.S. Economy

Notwithstanding these particular issues, the U.S. economy soldiers on. It is a tribute to its strength and resiliency that it remains sound in the face of its many challenges. Certainly growth has

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<sup>1</sup> *Grant’s Interest Rate Observer*, June 10, 2002.

<sup>2</sup> A leveraged buyout is the purchase of a public company using mostly debt to finance the purchase price.

<sup>3</sup> From *Barron’s*, September 25, 2006.

slowed from the rapid pace of 2005 and the first half of 2006, but it remains positive and seems likely to stay so. In our opinion, the glue that has held it together is the labour market. Americans have jobs. Unemployment is at record lows, and, so long as people have jobs, they will continue to make payments on their mortgages and patronize the malls.

Some of the most recent U.S. data releases have suggested a slowdown in corporate capital spending, which may portend future weakness in hiring. As well, U.S. Federal Reserve Chairman, Ben Bernanke, has fueled worries of stagflation by noting that inflation has not moderated as much as he hoped and there remains a risk of economic weakness. While both of these situations require close monitoring, in the here and now, growth remains sound and we think it likely will continue that way through the rest of the year.

### **Still Proud to be Canadian**

Perhaps the result of its citizens' more conservative nature, Canada never experienced the excesses in house prices and consumer debt that are prevalent in the U.S. Accordingly, the risks our economy and markets face from an unwinding of these excesses is much more modest. In fact, economic conditions in Canada remain generally strong. While economic growth is slowing from more robust levels, the slowdown in Canada is perhaps not quite as marked as in the U.S. Indeed, the recent strength of the Canadian dollar is an indication that foreign investors seem more optimistic about our own economic prospects than those south of the border.

While the strength of our currency does reflect a vote of confidence in our overall prospects, it also remains a drag on those sectors of the economy oriented to manufacturing exports. However, firm pricing of commodities, particularly energy, which represent approximately 50% of merchandise trade, have kept the currency well supported. Although our close ties to the U.S. economy remain a strong factor in determining Canada's economic fortunes, as one of the most open economies of the G8, Canada continues to benefit from the positive trends in global growth – not only a recovery in Europe and Japan, but also the remarkable secular growth story in China, India and much of the developing world.

### **Our Stocks Remain Attractive**

Investment returns were modest but positive over the last quarter. Bonds paid their interest and bond prices went sideways. Canadian stocks posted a decent quarter and the U.S. equity market drifted on either side of unchanged throughout much of the quarter. Perhaps most notable was the clear increase in volatility. Many will recall a 10% drop in the Chinese market over one night in February that subsequently caused European and North American investors to dump stocks as well. In reality, North American stock markets have enjoyed a period of remarkably low volatility over the last several years. We think increased volatility over the course of the year is quite a sensible expectation.

We continue to believe that equity markets in Canada and the U.S. are reasonably valued and expect market movements to be mostly explained by the path of corporate earnings in the period ahead. Having said that, expectations for earnings growth, particularly in the U.S., have been sharply reduced over recent months. Following several years of double-digit earnings growth for the S&P 500, analyst consensus as we entered 2007 was for yet another year of more than 10% EPS growth. Over the course of the last three months, analysts have come to terms with the reality of slowing economic growth; consensus expectations now call for 6.3% earning growth for all of 2007. It may be that expectations drift lower still.

As you know, however, short-term expectations for index earnings have little impact on the way we manage client portfolios. As we focus on the outlook for each of the companies in our portfolios over the next three to five years, we remain confident that earnings will be much higher in several years than they are today. There are many positive secular trends that we feel present enormous opportunity for investors – the growth of emerging markets and the growth in health care spending are two examples of these. The markets could well be marked by increased volatility over the coming months and quarters, but if we are right about the attractive prospects provided by the specific stocks we own, we are confident that clients will enjoy very satisfactory investment returns over time.

## FINANCIAL MARKET SUMMARY

### Market Levels

<u>Canada</u>	<u>March 31, 2007</u>	<u>December 31, 2006</u>
TSX Composite Index	13,166	12,908
91-Day T-Bill Yield	4.18%	4.15%
30-Year Canada Bond Yield	4.20%	4.14%
Prime Rate	6.00%	6.00%
Exchange Rate (1\$ Cdn. = US\$)	\$0.8674	\$0.8581
<u>United States</u>		
Dow Jones Industrial Average	12,354	12,463
Standard & Poor's 500 Index	1,421	1,418
30-Year U.S. Treasury Yield	4.84%	4.81%

### Market Returns For Periods Ended March 31, 2007 <sup>(1)</sup>

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years <sup>(2)</sup></u>	<u>Last 10 Years <sup>(2)</sup></u>
SC 91-Day Treasury Bills <sup>(3)</sup>	1.0%	4.2%	3.0%	3.7%
SC Universe Bond Index <sup>(3)</sup>	0.9%	5.5%	7.0%	7.0%
TSX Composite Index	2.6%	11.4%	13.1%	10.4%
S&P 500 Index (C\$)	-0.4%	10.5%	-0.4%	6.2%
MSCI EAFE (C\$)	3.0%	18.7%	8.5%	6.3%

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Footnotes:

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

(2) Compound average annual return.

(3) Scotia Capital Inc. index returns.