



Investment Outlook

January 2007

Let the Good Times Roll

2006 was a great year for stock market investors. In Canada, the TSX Composite offered investors a total return of 17.3%. In the U.S., the Standard & Poor's 500 returned 15.8% (in US\$ terms). Outside of North America, things were even better. For example, the Morgan Stanley EAFE Index¹ provided a total return of 26.3% in Canadian dollar terms. To most commentators, Nexus included, the extent of the gains came as a bit of a surprise. The consensus expected a much more modest year.

The happy events of 2006 have been described as a "melt-up." While equity markets were a little rocky in the first half, they were strong in the second half. The explanation is simple. After mid-year, oil prices quit making new highs, the U.S. Federal Reserve ceased raising short-term interest rates, and inflation worries cooled. As well, corporate earnings were surprisingly strong, interest rates remained low, and there were huge pools of liquidity (i.e., cash) in hedge funds, private equity firms and on corporate balance sheets that had to be invested somewhere.

As we look to 2007, it is hard not to be optimistic based on the solid outlook for global growth in front of us. Cautious optimism may be the defining mood of these early weeks. While growth clearly is cooling in both Canada and the U.S., growth in other parts of the developed world remains sound, and it remains robust in many of the emerging economies, especially China and India. Those who attended our client presentations in November will recall that we devoted considerable time to the notion that growth outside North America was starting to provide meaningful support to North American economies and opportunity to North American companies. Demand from developing markets is not just a one-quarter or one-year phenomenon. Fuelled by increasing living standards and demographics, this growth should be sustained for years to come.

Too Good to be True?

Perhaps it is the very fact that our situation seems so stable and comfortable that makes us uneasy. As the U.S. and Canadian economies slow, virtually every economic forecaster is promoting some version of a soft landing. The lack of dissent is worrisome, and this complacency is evident at the same time that the U.S. stock market is setting records for the longest bull market run in history, without a significant correction. Stated another way, the 8% correction in the spring of 2006 was the mildest correction in any four-year U.S. bull market since 1934.² Historically, it has paid to be skeptical during the fifth year of a bull market when the outlook seems most promising.

What could go wrong? In the U.S., the greatest vulnerability is in housing, an area we have discussed frequently in the past. Many will be aware that after five years of rapid house price appreciation, the housing market in the U.S. is correcting significantly. While many intelligent observers, including Alan Greenspan, believe that the housing correction has largely run its course, there are an equal number of intelligent observers that believe the worst is yet to come. Certainly growth in the U.S. could be significantly impacted, and even turn negative, if, in the face of falling house values, consumers decide to forego consumption in order to re-build savings.

In Canada, domestic demand may be healthier than in the U.S., but a build-up in inventories over the last several months could well lead to increased slack in the economy. The Bank of Canada will be

¹ The EAFE Index is an index of stock market returns from 21 developed country stock markets other than Canada and the U.S. EAFE stands for "Europe, Australasia and the Far East".

² *Barron's*, January 8, 2007.

keenly attuned to this. Should there be any further weakness in the economy, the Bank could consider interest rate reductions to mitigate the softness. However, at this time, it is mostly likely that the Bank will not be in a hurry to make any decision. More likely, it will take advantage of the effect of the recent weakness in the Canadian dollar. This weakness is providing a timely and natural stimulus to the manufacturing and export-oriented sectors of the economy, without the headline-creating issues of interest rate cuts. As a solution, it is not without its own problems, for there is some risk that a further reduction in commodity prices begets a reduction in capital investment in this country, which creates further currency weakness in a negative interaction that becomes self-reinforcing.

Money Can be a Two-Edged Sword

The particular risks to continued economic growth that we have highlighted are typical of the sorts of risks investors must always confront and evaluate. What may be different at this juncture in our history is a different sort of risk: the risk of excess liquidity. For those who aren't familiar with this term, we mean there is simply too much money sloshing around. After an extended period of abnormally low interest rates, investors have too much money looking to be put to work.

For years, excess liquidity has caused the price of many assets to hit new highs: stocks, bonds, real estate, commodities, and art are all affected. While we have no particular concern with rising asset prices in and of themselves, we believe investors ought to be vigilant in a world of excess liquidity to be sure that price does not deviate too far from intrinsic value. It is when such deviations or imbalances occur that financial accidents arise.

It is clear that Canada has been a destination for much of this liquidity in recent years due to the commodity-orientation of our economy. While we have benefited in many ways, we must also be aware of the risks. An example of the risk can be seen in a financial crisis that hit Thailand in the week before Christmas. Such is the magnitude of the liquidity in Asia (think of U.S. dollars resulting from the trade deficit) that the Thai currency had been bid up to levels that was undermining the economy. In a botched attempt to protect itself with capital controls, the Thai government further exacerbated the situation and the stock market collapsed. While Thailand is far away and its situation very different from that of Canada, it does highlight one of the consequences of being an open economy in a globalizing world filled with excess liquidity. Marc Faber, a well-known investment commentator, believes the Thai crisis contains lessons for us all: "Excess liquidity has created huge imbalances and economic distortions that one day will have to be corrected, and I am afraid not in a pleasant way."³

More Modest Returns Ahead

In a world of decent global growth such as we expect, it is reasonable to forecast positive investment returns. Despite being too conservative with our expectations for modest returns over the last several years, we repeat it again for 2007. Interest rates on bonds ended 2006 almost precisely where they began. While there is the possibility that the Bank of Canada may lower short-term interest rates in response to growing slack in the economy over the coming months, we think it likely that 10-year Canadian bond yields will look pretty much the same in 12 months as they do now. Not very exciting.

Stock valuations in both Canada and the U.S. are neither cheap nor dear; they are reasonable. Our expectation is that they will remain reasonable so we look primarily to earnings growth to propel stock prices over the next year. Given slowing, but positive economic growth in each country it appears likely that earnings growth will be solid, although not as robust as it was in 2006.

As always, we believe the best results will come from a bottom-up approach of investing in sound businesses at reasonable prices. Investments such as these should benefit from the solid global economic growth we believe lies ahead, but offer some defensive characteristics should some negative development occur in 2007. Stocks won't go up each and every year, but carefully chosen ones will continue to serve investors well over time.

³ *Barron's*, December 25, 2006.

FINANCIAL MARKET SUMMARY

Market Levels

<u>Canada</u>	<u>December 31, 2006</u>	<u>December 31, 2005</u>
TSX Composite Index	12,908	11,272
91-Day T-Bill Yield	4.15%	3.46%
30-Year Canada Bond Yield	4.14%	4.03%
Prime Rate	6.00%	5.00%
Exchange Rate (1\$ Cdn. = US\$)	\$0.8581	\$0.8598
<u>United States</u>		
Dow Jones Industrial Average	12,463	10,717
Standard & Poor's 500 Index	1,418	1,248
30-Year U.S. Treasury Yield	4.81%	4.53%

Market Returns For Periods Ended December 31, 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⁾	1.0%	4.0%	2.9%	3.7%
SC Universe Bond Index ⁽³⁾	0.7%	4.1%	6.6%	6.9%
TSX Composite Index	10.4%	17.3%	13.1%	10.0%
S&P 500 Index (C\$)	11.5%	15.7%	-0.2%	6.7%
MSCI EAFE (C\$)	15.3%	26.3%	8.0%	6.0%

Footnotes:

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

(2) Compound average annual return.

(3) Scotia Capital Inc. index returns.