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Economic & Market Outlook 2005

Dollar Daze

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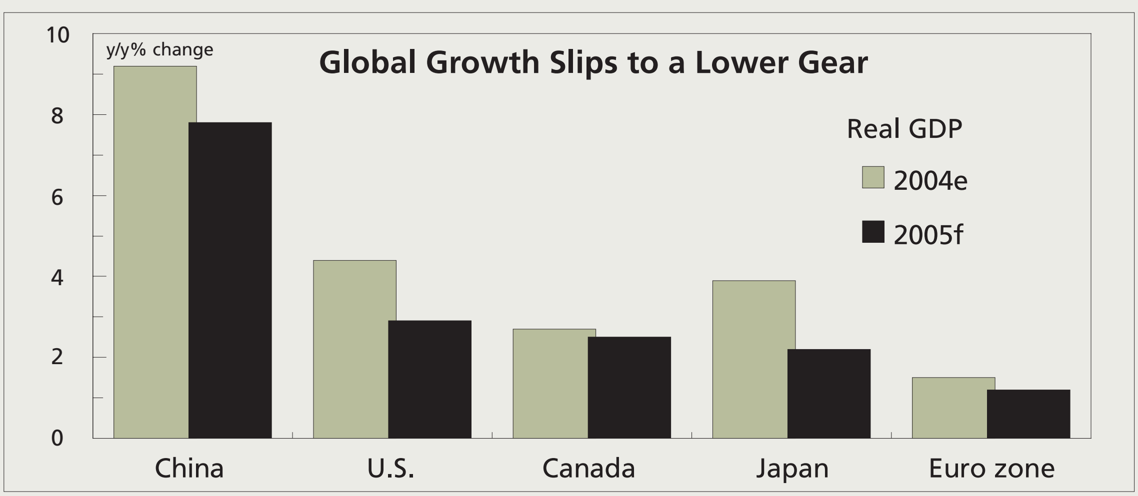
The global economic landscape is being reshaped by the rise of China and the fall of the U.S. dollar. During 2005, we expect economic activity to downshift across Europe, Japan and the NAFTA zone. The U.S. should slow from roughly 4½% growth in 2004 to about 3% this year—still almost twice the probable outcome in the Euro zone. Canadian growth also will moderate to about 2½% as currency appreciation aggravates competitive challenges in a number of sectors.

While China is moving out of overdrive, growth should still be over 8% because of enormous investment, further gains in global industrial market share and the ramping up of local consumer demand. China is already the world's third largest exporter and importer and accounts for 20% of global demand for industrial metals. Even with softer activity among G7 nations, buoyant Asian demand should bolster commodity prices. With Asia accounting for 27% of world oil consumption, a strong regional profile also will limit the reversal in energy prices.

Higher energy prices have nudged up global inflation, though a further increase is unlikely because global growth is moderating and cross-border competition for a share of the consumer's wallet is intense. In strong currency areas such as Europe, Japan, Canada and Australia, U.S. dollar depreciation will temper import prices. Even in the U.S., where a weaker currency and higher energy costs have pushed import costs up nearly 10% over the past year, headline consumer inflation shouldn't move much above 2½%.

Financial market developments in 2005 will be shaped by the expectations of slower growth, low inflation and further U.S. dollar depreciation. The U.S.



government has little room for further tax cuts or spending stimulus with its fiscal deficit stuck above $350 billion. However, the Federal Reserve will move away from a gradual tightening bias and step to the sidelines once growth slips onto a 3% glide path.

U.S. dollar prospects are heavily clouded by the government's enormous borrowing requirements and a US$600 billion-plus trade deficit. The U.S. does not have an export problem—revenues have risen by 17% over the past year. The problem is that U.S. imports are now over 50% higher than exports and are growing at double-digit rates, fueled by consumer spending and hefty energy import requirements. A major shift won't happen as long as domestic demand in the U.S. is growing faster than markets in many of its trading partners.

The unrelenting U.S. trade deficit must be financed by a huge infusion of foreign savings. According to a report from the New York Fed, "the United States is now absorbing more than the recorded net saving of the rest of the world combined." This would not be possible without massive, sustained purchases of U.S. dollar assets by foreign central banks, primarily in Asia. Reversing this trend requires a longer-term rebalancing of trade through a big step-up in imports by Asia and a substantial downshifting of U.S. domestic demand.

From a Canadian perspective, the appreciation of our currency has major implications for growth, inflation and policy settings. The move into the 80–85 cent (US) range has dampened exports, production and job creation in the manufacturing sector. The higher exchange rate alongside the run-up in oil, gas and other commodity prices also is causing economic momentum to shift from Central to Western Canada. The trend will continue if the currency tests 90 cents (US) and energy prices are supported by strong Asian demand.

In this environment, Canadian growth will do well to exceed 2½% this year, lagging a relatively lukewarm U.S. performance by half a percentage point. Resource-rich B.C. and Alberta will be top performers while our most U.S.-focused, manufacturing intensive province—Ontario—will lag as industries adjust to the substantial shift in competitive realities. Our hefty trade surplus will be supported by buoyant commodity revenues, but the balance on manufacturing, tourism and other dollar-sensitive areas will continue to erode. Even in the resource sector, currency appreciation will constrain profitability.

On the domestic front, competitive pressures should support investment in productivity-enhancing technology but a focus on cutting costs to restore profitability will dampen hirings. The housing sector and big-ticket consumer sales may stay buoyant, but growth will be subdued, particularly now that the household savings rate has fallen to record lows.

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A sub-par domestic performance will trigger more fiscal stimulus, with pressure on the minority federal government for tax cuts and new infrastructure spending on top of recent big commitments in health care and equalization. Slower growth also implies softer government receipts, pushing debt repayment into the back seat until economic activity recuperates. However, broad-based popular support for balanced budgets rules out any attempt at U.S.-style 'pedal-to-the-metal' fiscal stimulus.

The Bank of Canada's decision not to raise interest rates on December 7th reflects concern about the implications of a skyrocketing currency at a time when world growth is moderating. Renewed easing becomes increasingly likely as the currency moves above 85 cents (US).

Canada will not be alone in facing further currency appreciation. The Euro should break above 1.40 against the U.S. dollar, with the yen moving below 95 (¥/US). A move by China to allow modest currency appreciation against the U.S. dollar will do little to mitigate upward pressure on world currencies at a time when global investors are becoming increasingly concerned about the sustainability of U.S. financial imbalances.

Economic and Market Outlook - 2005

SCOTIA ECONOMICS, DECEMBER 2004

Canada	2003	2004e	05Q1f	05Q2f	05Q3f	05Q4f
Real GDP (q/q, ann. % change)	2.0	2.7	2.0	2.8	2.7	2.5
Consumer Prices (y/y, % change)	2.8	1.9	2.4	1.8	2.1	2.1
Unemployment Rate (%)	7.6	7.2	7.1	7.1	7.1	7.1
	----------------------------End of Period----------------------------					
BoC Overnight Rate	2.75	2.50	2.50	2.50	2.50	2.25
10-Year Canada (%)	4.70	4.31	4.45	4.75	4.90	4.85
United States						
Real GDP (q/q, ann. % change)	3.0	4.4	2.4	2.4	2.8	3.3
Consumer Prices (y/y % change)	2.3	2.6	2.7	2.2	2.3	2.3
Unemployment Rate (%)	6.0	5.5	5.4	5.3	5.2	5.1
	----------------------------End of Period----------------------------					
Fed Funds Rate	1.00	2.25	2.50	2.75	2.75	2.75
10-Year Treasury (%)	4.20	4.22	4.40	4.75	5.05	5.20
Foreign Exchange						
	----------------------------End of Period----------------------------					
Canadian Dollar (US$/C$)	76.3	83.2	84.7	87.0	90.1	90.1
Canadian Dollar (C$/US$)	1.31	1.20	1.18	1.15	1.11	1.11
Yen (¥/US$)	108	103	98	96	94	92
Euro (US$/EUR)	1.22	1.36	1.35	1.37	1.40	1.42

Notes: e = estimate (Scotia Economics, based on available data); f = forecast (Scotia Economics)
Source: Scotia Economics, Statistics Canada, U.S. Department of Commerce, U.S Bureau of Labor Statistics, Bloomberg

Driving to Neutral

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For investors, looking back whether to yesterday, last year, last cycle or many previous cycles, an historical review can put today in a clearer light and provide guidance for the future. Indeed, the outlook for 2005 could be a replay of the activity in 2004—with a few differences. Global investors entered 2004 enthusiastically (similar to the start of this year) although equity markets spent a good portion of the last year underwater as concerns we highlighted escalated in importance (namely a slower economy and a rising interest rate environment) and were complicated by currency volatility and a rapid increase in the price of energy. This rise and then fall into the summer lows was followed by a strong rally that accelerated following the re-election of George W. Bush in the U.S. In Canada, the dynamics of the market changed (as energy and other commodity prices eased into year-end), but the market put in a strong showing right into the calendar's close.

Our 2005 outlook is less optimistic than what we offered in the autumn of 2004, especially for Canadian equities. Specifically, the impact of the strong Canadian dollar on the economic landscape should, in our opinion, translate into a less robust profitability outlook than is generally expected. This risk, combined with stocks that on average are trading above our calculation of fair value, provides a lackluster total return expectation from Canadian equities of less than 5%. Based on this forecast, we have reduced our weighting in equities to a neutral 50%. On the other hand, U.S. equities, which are still trading on average below fair value and still carry a decent profitability outlook, are positioned to provide a relatively more attractive total return close to 10%. With respect to bonds we remain cautious anticipating higher longer term yields in both the U.S. and Canada one year from now. However, the outlook for Canadian bonds is somewhat more sanguine than U.S. fixed income and we have adjusted our allocation accordingly to 40% (up from 35% previously). Cash remains an important component of our asset allocation recommendation and we currently suggest a 10% weighting. We wouldn't be surprised to see this recommendation rise as the year unfolds and sustainability of this economic cycle and the length of this bull market (more than 800 days versus an average length of 716 days) begin to weigh on riskier investments.

Finally, when looking at how we would position portfolios through 2005, we are adjusting our sector and duration recommendations to be somewhat more defensive. We'd focus on a shorter overall term in our bond portfolios while increasing our exposure to utilities, consumer staples and telecommunications in stocks. While we maintain our aggressive bias to the technology and materials (ex-energy) sectors, we would stick with the highest quality companies. We also believe that quality and larger companies will take precedence over lower risk and smaller firms. And we wouldn't be surprised to see volatility pick up as the year progresses.

Overall, 2005 is likely to be a challenging year and therefore remind investors that their ScotiaMcLeod advisor can help establish and maintain the optimal asset allocation, investment selection and diversification to provide the best return possible for your level of risk.

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