Economic & Market
Outlook Q2 2008

Global Economic Overview

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United States

U.S. output growth will likely average only 1.2% in 2008. The problem remains the implosion in U.S. housing. The sustained downturn in sales, the continuing build-up in inventories reinforced by mounting sub-prime-related foreclosures, and the collapse in construction, are reinforcing a generational slide in home prices, a contraction in household wealth, and a consolidation in lending by the beleaguered financial sector.

The knock-down effect on the U.S. economy has already begun to materialize. Reduced purchasing power has cut deeply into retail sales and business operations, and triggered private sector job losses. With inflation boosted by rising food and energy costs and the weaker U.S. dollar, the Fed has put its easing on hold after aggressively lowering borrowing costs 325 bps in this cycle. However, look for monetary officials to trim the bellwether funds rate another 75 bps in Q4 if the U.S economy remains soft.

The period of U.S. dollar depreciation has not yet ended. Intensifying economic weakness, compounded by the persistent strains in the financial sector, suggests that the greenback will remain under intermittent downward pressure.

Canada

Canadian real GDP growth is expected to average just 1.3% in 2008. Domestic spending has remained quite robust, a function of firm labour markets, lower retail prices stemming from the strong loonie, solid construction activity, and continued gains in service sector activity across the country. At the same time, the erosion in net trade has accelerated due to the steepening downturn in U.S. demand, the ongoing slowdown in domestic manufacturing activity, and lingering competitive issues, including the persistent strength of the Canadian dollar.

Looking ahead, we expect a scaling back in employment growth and a cooling off in housing activity will temper consumer enthusiasm. Business sentiment has weakened, reflecting heightened concern over the continuing credit market turmoil, the high Canadian dollar and soaring oil prices.

Low consumer inflation trends are giving the Bank of Canada considerable policy flexibility. Look for the central bank to cut the overnight rate another 50 bps by the end of Q2. We expect the Canadian dollar will continue to have a strengthening bias against the greenback, given Canada's less aggressive monetary easing and persistently high commodity prices.

International

With the United States still accounting for more than 20% of world GDP, and with both Europe and Asia not immune to the financial turmoil sparked by the U.S. sub-prime crisis, a deceleration in global growth is unavoidable. As is the case in the United States, economic growth in Western Europe is poised to drop in 2008 to less than 2%. Japan, too, is facing a slowdown, as it wrestles with the impact of a declining population and a rising yen. China, the world's third-largest importing nation, will again be a major driver of global economic activity.

Led by Asia, emerging economies will continue to outpace the developed economies by a substantial margin. In Latin America, Mexico will feel the shocks of the slump in U.S. demand this year. High commodity prices will continue to give a boost to Brazil and Russia.

Economic and Market Outlook 2008 - 2009

Canada	**2007**	**2008f**	**2009f**
Economic Performance (annual average)			
Real GDP (% change)	2.7	1.3	1.9
Consumer Prices (% change)	2.1	1.8	1.9
Core CPI (% change)	2.1	1.4	1.8
Unemployment Rate (%)	6.0	6.1	6.2
Housing Starts (units, thousands)	228	212	192
Motor Vehicle Sales (units, thousands)	1,654	1,610	1,625
Merchandise Trade Balance (C$ billions)	49.6	32.0	24.0
Yield Curve (%, end of period)			
Bank of Canada Overnight Target Rate	3.50	2.50	3.50
2-Year Canada Bond	2.62	2.60	3.70
10-Year Canada Bond	3.44	3.60	4.30
United States			
Economic Performance (annual average)			
Real GDP (% change)	2.2	1.2	1.5
Consumer Prices (% change)	2.9	3.5	2.3
Core CPI (% change)	2.3	2.2	1.8
Unemployment Rate (%)	4.6	5.3	5.6
Housing Starts (units, millions)	1.35	0.95	1.01
Motor Vehicle Sales (units, millions)	16.1	15.0	15.5
Merchandise Trade Balance (US$ billions)	-815	-835	-780
Yield Curve (%, end of period)			
Fed Funds Target Rate	2.25	1.25	2.25
2-Year Treasury	1.58	1.50	3.45
10-Year Treasury	3.41	3.60	4.50
Foreign Exchange Forecast (end of period)			
Canadian Dollar (USD/CAD)	1.03	0.99	0.94
Canadian Dollar (CAD/USD)	0.98	1.01	1.06
Yen (USD/¥)	100	98	100
Euro (/USD)	1.58	1.61	1.53
Chinese Yuan (USD/CNY)	7.0	6.5	5.9
WTI Oil (US$/bbl) (ann. avg.)	72.3	107.0	107.0
Nymex Natural Gas (US$/mmbtu) (ann. avg.)	7.12	9.75	9.60

f: Forecast (Scotia Economics Forecast Update report (May 2, 2008)
Source: Scotia Economics, Statistics Canada, U.S. Dept. of Commerce, U.S. Bureau of Labor Statistics, Bloomberg

Canadian Strategy

2008 Canadian Outlook – Q1 As Expected

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The first quarter was difficult for stock exchanges worldwide. The fallout from last summer's "credit crunch" continued to hit the global financial sector and what was once a "financial" problem has clearly developed into an "economic" problem for North America.

Three months ago we outlined focus themes we thought would emerge during the first half of 2008 if not the entire year. We provide our updated thoughts below:

1. Defence may be the best offence

We were concerned the uncertainty we were seeing in the U.S. at the end of 2007 was going to continue in 2008 and spread north of the border. For that reason we recommended investors stay defensive, or invest in sectors which would remain steady as economic growth declined. Most defensive stocks managed to beat the TSX Index during the first quarter.

2. Balanced portfolios should continue to hold gold

As was the case in 2007, gold prices soared to start the year. However, what differentiated 2008 from last year was a continued decline in the U.S. dollar and the actions of the Federal Reserve, which cut interest rates by 200 basis points within 60 days. While gold prices could pull back in the near term, our long-term call of holding gold still remains in tact. Further rate cuts in the U.S. are coming, inflation has become a concern, and the supply/demand fundamentals for gold are strong.

3. Canadian banks look attractive, and may outperform in the second half of the year following first half underperformance

The operating environment for the Canadian banks was very difficult during the first fiscal quarter of the year and was equally, if not more difficult during the second quarter. Although Canadian banks may not be taking massive write downs like their U.S. counterparts, they are being indirectly impacted by the slowdown in business activity across North America. Therefore, we will likely see the Canadian banks unable to post sustainable share gains in the immediate future.

4. Base metals may lose some shine, but the Materials sector will likely move higher

We will admit that our call for base metals to "lose some shine" has proven incorrect. Nevertheless, our prediction that the Materials sector would move higher has held true thanks to contributions from precious mineral and fertilizer stocks, which should continue to show strength during the year. The key point to remember with commodities is that investors should stay focused on the long-term outlook and not daily price changes.

5. The days of sky rocketing energy prices are long over, but the sector still offers value

Most of the strength from oil prices in Q1 came from U.S. dollar weakness and speculators, as commodities were a place to escape financial weakness. Seasonality may see volatility continue during the second quarter. At the corporate level, companies continue to see costs increase and margins squeezed. However, value does exist as energy equities are currently being valued using a US$65.00 barrel of oil while Scotia Capital believes prices will average US$95.00 per barrel in 2008.

Our outlook has not changed. Although it is regrettable the first quarter provided most investors with negative returns, we must continue to face the reality that financial problems have turned into economic problems and the "credit crunch" will take time to correct. We must emphasize that clarity will be the key for 2008 as it has been lacking for the past nine months. If economic and financial clarity is achieved, then single-digit returns for the TSX are possible.

U.S. Equity Strategy

Defending Against Housing and Financial Problems

PAUL DANESI, CIM - DIRECTOR, PORTFOLIO ADVISORY GROUP

A difficult start to what will likely to be a challenging year for the U.S. equity market. Expectations for a V-shaped recovery for U.S. economic activity and the financial services sector are a best case scenario and in our opinion not the most likely outcome. The downturn in the U.S. housing sector and credit crisis are having a material impact on economic activity that could persist and likely worsen. The current financial and economic turmoil began with U.S. housing and will likely end when stability returns. Unfortunately U.S. housing inventories are still twice their historical average and will correct only as affordability improves, which itself is a function of lower mortgage rates and lower home prices. U.S. mortgage rates have fallen little since last fall while housing prices have corrected by 12% from their peak levels based on the S&P Case Shiller Index. Economists forecast U.S. home prices could fall 20% to 25% peak to trough. This has further implications for related asset values, consumer spending, and financial markets. Typically a credit crisis occurs near the end of an economic/business cycle but rarely does it proceed, suggesting the downturn could otherwise be greater than expected.

Earnings expectations remain too high and will be adjusted to reflect a weakening U.S. and global economic outlook. The current consensus of analysts' estimates for 2008 implies earnings growth of 17% for the S&P 500. Cyclical industrial products, transportation, and information technology sectors are looking more vulnerable to earnings downgrades, with ongoing weakness in consumer discretionary and financial services widely anticipated. We have already witnessed negative earnings surprises from General Electric, UPS Inc, and Alcoa.

It is still too early to call a bottom on U.S. financials given the risk imposed by deterioration in credit quality, the extent of which will depend on the duration and magnitude of the downturn in housing and the economy. Provisions against mortgages, home equity loans, auto loans, and credit card debt are the next threat to earnings, balance sheets, and dividends. Wachovia, the fourth largest bank in the U.S., recently joined the growing list of U.S. financials that have reduced quarterly payouts to shareholders.

The huge hit to commodity prices late in the quarter was largely a function of hedge fund deleveraging to meet investor redemptions and margin calls by the banks' prime brokerage units. Ongoing volatility in financial markets combined with IMF forecasts for decelerating global growth could lead to further selling pressure. In our opinion, any weakness in commodities and related resource stocks is an opportunity to accumulate positions for the long haul. Structural shortages in grains, base and precious metals are likely to persist as demand from emerging markets continues to grow.

Canadian investors should take advantage of our strong currency and add U.S. multinationals and ADRs with global franchises to their portfolios. Outside of the resource sector, few Canadian companies are poised to benefit from the strong economic growth in developing markets. Colgate, Proctor & Gamble, Pepsi, Telefonica, FreePort McMoRan Copper & Gold, Diageo, United Technologies, Nike, Altria, Transcoean, Becton Dickinson, Bristol-Myers, Eli Lilly, Microsoft, Cisco, Total, and Caterpillar all have large geographic footprints. Exchange traded funds such as Claymore's BRIC ETF and iShares MSCI Emerging Market Index Fund also provide exposure to the world's fast growing economies.

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