

# Special Report

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## 2011-12 Economic and Market Outlook

### *Another Year of Recuperation & Repair*










**Warren Jestin, Senior Vice-President & Chief Economist**

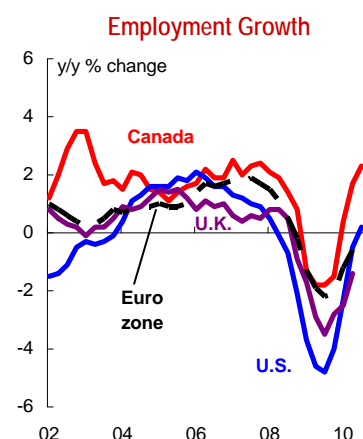
Global economic activity has decelerated in recent months, with next year's growth in North America, Europe and Japan likely to fall short of the average pace set in 2010. The severe financial strains confronting some debt-heavy European nations and the U.S. probably won't trigger a 'double dip'. However, the lengthy process of bringing outsized fiscal deficits under control, withdrawing unprecedented monetary stimulus and restructuring the global financial system will impede growth prospects in many countries through mid-decade.

Canadian output growth is expected to fall below 2½% in 2011 as domestic demand softens and fiscal repair gets under way. The U.S. won't do much better, even with the infusion of additional monetary stimulus and delays in addressing massive fiscal imbalances. Although some improvement is expected in 2012, another year of sub-3% growth is likely in both nations as interest rates begin to rise and fiscal retrenchment gathers force. While subdued by pre-recession standards, these gains compare quite favourably with prospects for Europe and Japan, where the recovery will be both weaker and take much longer than in North America.

In contrast, China is expected to grow by 9.5%, followed by India (8.5%) and Brazil (5.5%). These and other emerging powerhouses have become crucial sources of global locomotion, with their impact on foreign exchange and on commodity and capital markets escalating alongside their financial resources. China's surging domestic demand, already a driving force in many commodity markets, has made it the world's fastest-growing market for motor vehicles. In 2009, China sold and produced more cars and trucks than the U.S., Canada and Mexico combined. With foreign exchange reserves rapidly approaching US\$3 trillion, China's asset allocation decisions have the potential to significantly influence movements in global financial markets.

To date, Canada's economic resilience through the global financial crisis, both during recession and recovery, has been the envy of most developed nations. As was the case elsewhere, monetary and fiscal stimulus offered vital support. However, Canada had the decisive advantage of entering the financial crisis with a world-class banking system and relatively stronger household, corporate and government balance sheets. These

		2000-09	2010e	2011f	2012f
<b>Real GDP (annual % change)</b>					
Canada		2.1	2.9	2.2	2.7
U.S.		1.8	2.8	2.5	2.9
Mexico		1.9	4.8	3.5	4.0
Euro zone		1.2	1.9	1.4	1.6
United Kingdom		1.6	1.8	1.6	1.7
Japan		0.7	3.4	1.6	2.7
China		10.2	10.0	9.5	9.7
India		7.2	8.3	8.5	8.8
Brazil		2.9	7.5	5.5	5.0



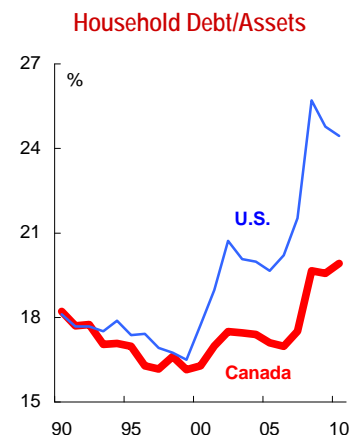
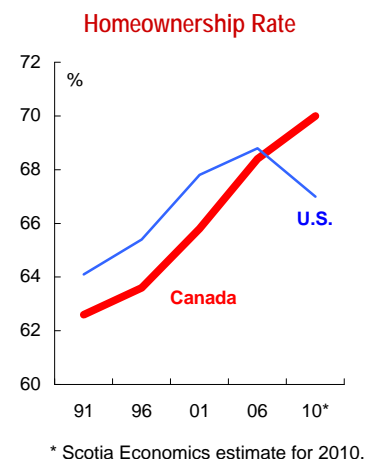
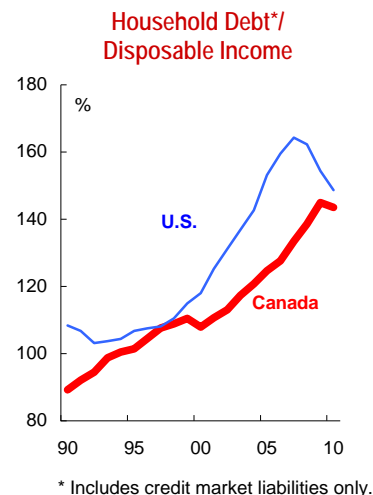
home-grown advantages insulated the economy from the negative fallout from the steep nosedive in U.S.-bound sales and global commodity prices in late 2008 and the first half of 2009.

Because Canada entered the recovery less damaged by the global financial crisis than the U.S., employment rebounded earlier and in the final months of 2010 was back to new records, while the U.S. had regained only 10% of the jobs lost during the recession. With no sub-prime credit crunch on this side of the border, the household sector was able to continue making big-ticket purchases with the benefit of historically low borrowing costs. Home prices in many Canadian markets stayed near record levels at a time when average prices in major U.S. urban centres were more than 25% below their pre-recession peaks.

However, job creation and consumer spending growth have moderated in recent months and housing starts have receded from the highs recorded in the spring. Residential activity may soften further with both home ownership rates and personal debt/disposable income near record levels. The recent run-up in personal debt leverage is unlikely to trigger a substantial relapse in the housing market or the economy, particularly now that the Bank of Canada has moved to the sidelines after nudging rates higher through the spring and summer. However, the consumer can no longer be counted on to lead Canadian economic growth.

Canadian activity also will be tempered in 2011 as the federal and provincial governments curtail fiscal stimulus and step up restraint to re-establish more balanced budget positions by mid-decade. Between 2007 and 2009, Canadian governments collectively moved from an overall budget surplus of 1½% of GDP to a deficit just over 5%. This deterioration was actually much smaller than that experienced by the U.S. — where the overall shortfall widened from 2.7% in 2007 to 13% in 2009 — and compares favourably with the average deterioration among developed nations (where the combined deficit surged from just over 1% of GDP to nearly 9%). Canadian public debt burdens also are more manageable, with interest payments on government net debt equivalent to only 0.4% of GDP compared with an OECD average of 1.8%. The bottom line — while restoring a sounder fiscal balance will temper growth in Canada well into this decade, the drag will be much larger and occur for longer in many other developed nations. The U.S. decision to delay fiscal repairs and continue running trillion dollar-plus deficits beyond 2011 may prove quite costly because today's historically low borrowing costs are unlikely to be a permanent part of the financial landscape.

Canada's export sector is not poised to take over growth leadership as the pace of household and government spending subsides. In fact, the trade sector subtracted roughly two percentage points from national growth over the past year as import gains continue to outpace exports. U.S.-bound sales — which account for three-quarters of Canadian foreign exports — are still running 20% below 2008 levels and will continue to be hampered by lethargic household spending and the high-flying loonie. China has overtaken Japan as Canada's third-largest trading partner, but it currently accounts for only 3% of total sales. While industrial commodity producers will continue to enjoy robust demand



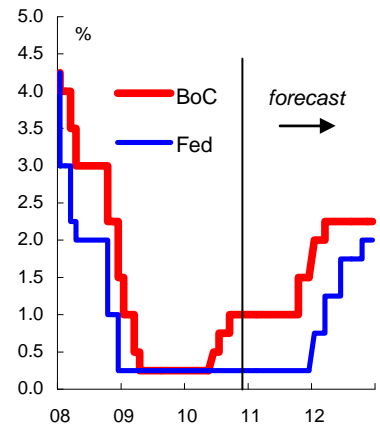
from China and other emerging markets, export earnings in Canada's resource sector will remain well below 2008 levels because neither oil nor natural gas prices will regain their lofty pre-recession peaks soon.

With imports supported by solid gains in domestic demand, our merchandise trade balance has swung dramatically from a pre-recession surplus of nearly \$50 billion to a deficit expected to be more than \$10 billion in 2010. Adding in traditional deficits in tourism and other services, over the same period Canada's current account balance has plunged from a surplus of close to \$10 billion to a deficit of over \$50 billion. With U.S. domestic demand still fragile, export gains are unlikely to make much of a dent in either trade shortfall in 2011.

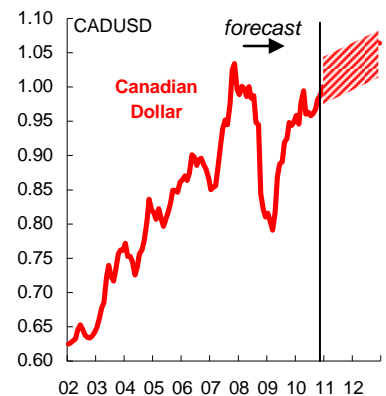
By itself, the abrupt shift from a pre-recession trade surplus to a sizeable post-recession deficit is unlikely to trigger a significant drop in the Canadian dollar. International investors have become increasingly interested in Canada because of its strength and relative stability through the global financial crisis and its position as a commodity-rich country in a commodity-short world. Financial and fiscal challenges are much larger in the U.S. than in Canada. Monetary policy also is more supportive of the exchange rate on this side of the border. While the Bank of Canada will probably refrain from raising interest rates again until the second half of 2011, the Federal Reserve is implementing additional quantitative easing (a.k.a. printing money), which is negative for the greenback in the short term and, by raising inflation concerns beyond 2011, is ultimately negative for the U.S. bond market.

With the loonie likely to continue flying high and our principal external market showing relatively moderate growth, export success for many Canadian businesses increasingly will hinge on adopting a less U.S.-centred focus and identifying niche products and services in rapidly growing emerging markets where our skills and resources provide a unique competitive edge. These markets were not there for us in the early 1990s, but they are a driving force of the global economy today and have the potential to drive improvements in Canada's overall terms of trade and domestic prosperity.

Less Monetary Stimulus Ahead



Commodity Rebound Boosts Loonie



## Portfolio Strategy Outlook — 2011

Vincent Delisle, Director, Portfolio Strategy

### Markets upstaging sentiment

Global equities posted positive returns for a second consecutive year in 2010 amidst a constant barrage of economic and geopolitical uncertainty. In our opinion, the last 2 years have provided investors with further illustration on what drives performance. Markets do not move on good or bad news, they are rather influenced by improving (better) or deteriorating (worse) data. Expectations have been very low since the recession ended in the summer of 2009 and we believe the macro situation, albeit fragile, has been improving. Heading into 2011, U.S. leading indicators are looking positive and we expect equity performance to benefit from sustained profit growth.

### Equities slightly edge Bonds in 2010....

Following blockbuster returns and broad equity gains last year (the MSCI AC World index was up 35% in 2009), 2010 will be remembered as a year of positive performances with geographic divergences. Since the start of 2010, the World index is up 9% with Canada (TSX +21%, in USD), Latin America (+12%) and the S&P 500 (+12%) outpacing China (-10%) and Europe (+2%). Bond performance has been positive with a gain of 6% for the DEX Canadian Bond Universe index (in CAD). Canadian equities (TSX +15% in CAD) are en route to outpace bonds and cash for a second consecutive year. Cyclical sectors have had the upper hand in 2010, outperforming defensives.

### ...but volatility Reigned

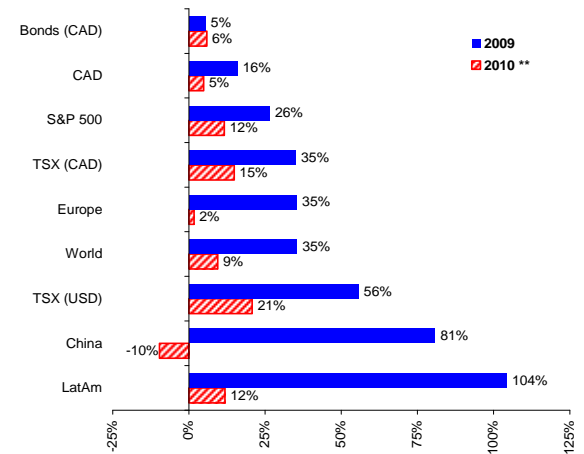
Extreme volatility has also been a trademark in 2010 and investors have been treated to three different leadership cycles since the start of the year. A sub-par recovery in developed economies, the U.S.'s excessive monetary stimulus campaign, China's tightening bias and Europe's debt problems explain recent market volatility. As we head into calendar 2011, these items should continue to challenge investor sentiment and trigger sporadic shifts in the risk-on/risk off mentality.

### Big Picture Outlook

The global recovery is expected to continue in 2011 and world GDP growth should hover near 4% (4.8% in 2010). In developed economies, a slower pace of growth is unlikely to stem inflation fears, but sustained price pressures in Emerging markets (China, India, Brazil) could trigger further tightening measures. In this context, interest rates should stay low in developed countries and rise in most Emerging markets. De-coupling monetary policy points to sustained volatility for currencies and commodities in 2011. Consequently, investment flows should continue to chase higher yielding markets until the Federal Reserve starts raising interest rates, which may not occur before 2012. Although record inflows into Emerging markets represent an element of risk, EM valuations remain attractive. Based on 2011 earnings forecasts, the MSCI EM index forward P/E of 13.2 is at a discount to the MSCI AC World's P/E of 13.7.

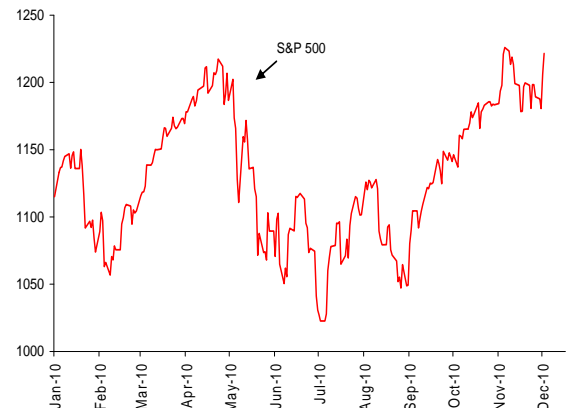
Our outlook for the U.S. economy remains both conservative and constructive and we expect growth in the 2011/2012 time horizon. Although the U.S. recovery stalled in the spring of 2010, recent statistics point to growth picking up since August. Housing data

Exhibit 1  
Market Performance in 2009 & 2010



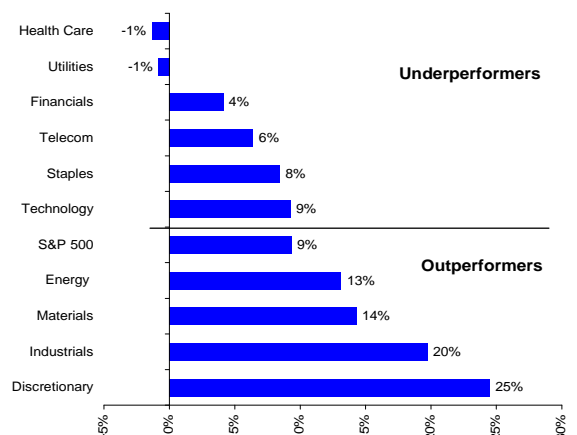
\*Performance in USD, unless otherwise stated \*\* as at December 2  
Source: Scotia Capital, Bloomberg

Exhibit 2  
Extreme equity volatility in 2010



Source: Scotia Capital, Bloomberg

Exhibit 3  
Equity Sector Performance\* (2010 YTD%)



\*Based on S&P 500 Sectors  
Source: Scotia Capital, Bloomberg

appears to be stabilizing and private payrolls are up 1.1M since the start of 2010. As long as the U.S. economy keeps adding jobs, the double-dip recession scenario remains a low probability outcome. And as long as U.S. GDP growth stays positive, corporate profits should improve, leading to positive equity returns. China's growth trajectory could be hampered by tighter policy in 2011, translating into volatility for industrial commodities such as oil and copper. Japan's outlook remains challenged by a stronger Yen, but Germany seems to be successfully weathering the debt storm in Europe.

### Strategy Stance

The Federal Reserve recently launched its QE2 program and stimulative monetary conditions should extend throughout 2011 in the U.S. The Canadian dollar is expected to strengthen as the Bank of Canada resumes rate hikes in the second half of 2011. Shorter term interest rates should stay low, but mean-reverting inflation expectations could push long term yields higher. Bond total returns should hover between 2-4% in 2011 and the risk for bond yields is to the upside. We expect shorter maturities and corporate bonds to outperform.

The outlook for equities is positive and we expect the S&P500 to trade within the 1,125-1,325 range in 2011. However, investor sentiment will remain vulnerable to myriad challenges and a tactical approach should add value again in 2011. Investors have been through bouts of euphoria and despair in recent months and 2010's volatile equity climate could continue in 2011. Spain and Portugal could be the Euro spoilers next year and China's tightening intentions also threaten to dampen fragile risk appetite. In our opinion, the catalyst to sustained improvement in equity sentiment, i.e. a positive reversal in flows that would lift valuations, will materialize when the Fed talks about its exit strategy (rate hikes).

Our global earnings revisions ratio remains high and we are comfortable with a scenario of sustained profit growth in 2011. Furthermore, a steep U.S. yield curve points to low double-digit profit growth next year. Our 2011/2012 earnings estimates stand at \$860/\$925 for the TSX and US\$90/US\$95 for the S&P 500. Our 12-18 month price targets are set at 14,000 for the TSX (15.1x forward P/E) and 1,325 for the S&P 500 (13.9x forward P/E). Based on our revised equity targets, we expect total returns of 10% (TSX +8% in CAD; +12% in USD, S&P500 + 8% in CAD; +12% in USD) in 2011.

From an asset mix perspective, we reiterate our equity over bond preference for 2011. However, the magnitude of our equity overweight recommendation for 2011 is reduced to 58% (was 65% in 2009 and 68% in 2010). Consequently, our Bond suggested weighting increases to 35% (28% in both 2009 and 2010) and Cash settles in at 7%. Globally, Canada and EM (especially LatAm) should be preferred to Japan and Europe. We would market weight the U.S.

In terms of sector strategy, our game plan in 2010 was to orchestrate a shift from early cyclical sectors (Financials, Discretionary, Transport-Rails) into mid-to-late cyclical areas (Technology, Media, Industrials, Energy, Materials). Earnings momentum still favors cyclicals over defensive sectors heading into 2011. In an environment of low nominal interest rates, we expect the "high yield/dividend" theme to reward investors once again in 2011. Risks of additional tightening in China and EUR weakness prompt us to start 2011 with a neutral view on Materials.

**Exhibit 4**  
**Scotia Capital Asset Mix - 2011**

	Asset Mix		Change from EMOC 2010	Total Return Next 12-M
	Benchmark	Recommended		
<b>Equities</b>	<b>50%</b>	<b>58%</b>	<b>-10%</b>	<b>8-10%</b>
Canada (TSX)	10%	13%		
U.S. (S&P500)	15%	17%		
Int'l (Europe, Japan)	15%	15%		
EM-Asia	6%	6%		
EM-LatAm	4%	7%		
<b>Bonds</b>	<b>45%</b>	<b>35%</b>	<b>+7%</b>	<b>3%</b>
Government	35%	23%		2%
Corporate	10%	12%		4%
<b>Cash (91-D Tbills)</b>	<b>5%</b>	<b>7%</b>	<b>+3</b>	<b>1%</b>

Source: Scotia Capital

**Exhibit 5**  
**Scotia Capital Sector Allocation - 2011**

Sector	Recommendation
Energy	Overweight
Materials	Marketweight
Industrials	Overweight
Discretionary	Marketweight
Staples	Underweight
Health Care	Underweight
Financials	Marketweight
Technology	Overweight
Telecom	Underweight
Utilities	Underweight

Source: Scotia Capital

## Still Balancing on a Tightrope

Camilla Sutton, Director, Chief Currency Strategist

As we leave 2010 and move into 2011, the global economy, financial sector and monetary authorities are balancing on a tightrope. The path that lies ahead for Europe is of prime concern, but so too is the strength of the global recovery and US monetary policy. The risks have increased, which will likely encourage investors to pay increasing attention to currency risk.

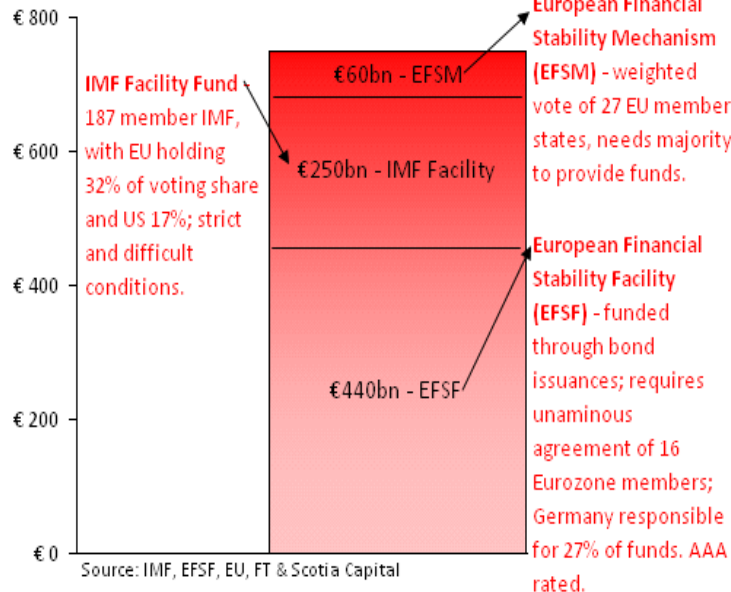
Tensions in the FX space are high. China's currency policy, viewed by many as a peg with limited flexibility, has provided a significant trade advantage and helped to create a staggering \$290bn current account surplus (5.6% of GDP). The reluctance to speed the pace of change has been a highly politicized and criticized policy. However, as many of the advanced economies point fingers at China, the United States is not free of blame. Its current account deficit, running at \$430bn or 3.3% of GDP, combined with loose monetary policy that many believe is a deliberate attempt to weaken the USD have also been highly criticized. Many other nations are directly impacted and their response (capital controls, intervention, etc.) has only escalated global tensions. This will continue to be a major theme in 2011.

However, the world's focus is not just on China and the United States. Europe continues to crumble under the weight of its escalating debt crisis. As this has moved from a sovereign debt issue to a major crisis of confidence, it has become increasingly difficult to quantify and forecast the snowball effect. Our base case remains that Europe has the resources it needs to move through the crisis. The combination of the European Financial Stability Mechanism, the European Financial Stability Facility and the IMF potential aid packages should be sufficient; however the interconnectedness of the European banking system combined with

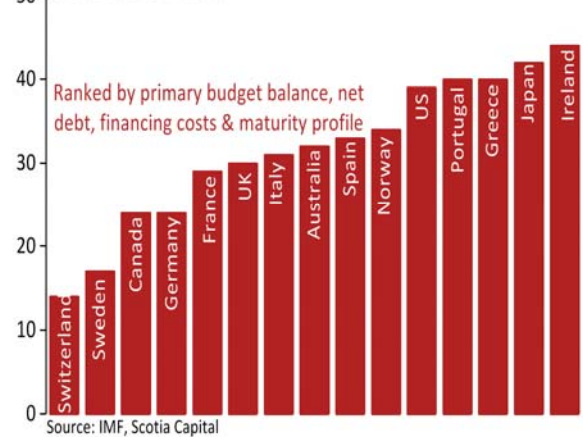
### Scotia's Forecast - USD Continues Its Downward Trend

	Q410	Q411	Q412
<b>USDCAD</b>	1.00	0.96	0.94
<b>CADUSD</b>	1.00	1.04	1.06
<b>EURUSD</b>	1.32	1.37	1.45
<b>GBPUSD</b>	1.57	1.63	1.70
<b>USDJPY</b>	82	84	90
<b>AUDUSD</b>	1.01	1.08	1.10
<b>USDCHF</b>	0.96	0.91	0.86
<b>USDCNY</b>	6.50	6.10	5.70

### THE EUROPEAN AID PACKAGES



### SOVEREIGN RISK

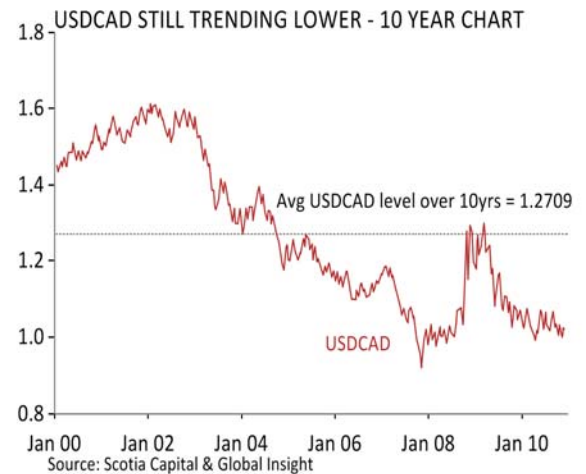


a major loss of confidence complicates matters materially. Still, minimizing emotion and the 'what ifs', the fundamental facts point to this being a recurring theme for Europe, but one that is surmountable. Accordingly, we expect the EUR to maintain a slow appreciating trend in 2011 and 2012.

The USD itself is likely to resume a slowly depreciatory trend. Its fiscal position is weak and, worse, there is only a limited plan in place to improve it. The economic recovery has been slow to materialize and this, combined with loose monetary policy, has not gone unnoticed by global investors. In addition, longer-term structural issues, like the country's massive current account imbalance, and ongoing evidence of reserve diversification are major weights against the USD. In the near-term, investor sentiment is key. Twenty-ten highlighted well how quickly sentiment can shift. However, with its status as reserve currency of choice, the USD gains materially in times of risk aversion. We expect that in both 2011 and 2012 bouts of USD-positive risk aversion will recur, taking some of the downward pressure off the currency. Putting the pieces together, there is significant risk that problems in Europe escalate causing the USD to appreciate; however, this for us is a major risk to pay close attention to. Our base case is that by the close of 2011 and 2012 we will have a weaker USD than we do today.

The Canadian Dollar therefore has an interesting place within the environment that has been laid out above. Relatively strong fundamentals, an important commodity base, widening interest rate spreads, a broadly weaker USD and an enviable sovereign position should leave Canada as an attractive base for international investment flows. However, bouts of risk aversion and political resistance to a materially stronger CAD dampen the outlook. Accordingly, we expect CAD to maintain an appreciating trend, but that the pace will be relatively slow and interrupted by periods of weakness.

As we move towards 2011 the dangers of the balancing act have escalated. In this environment we expect that market sentiment will shift course rapidly, but that a weaker USD, a recovering EUR and a moderately stronger CAD will be the themes we are looking back at this time next year.



## Economic and Market Outlook 2011-2012

	2009	2010e	2011f	2012f
<b>Economic Performance</b>				
<b>Real GDP (annual % change)</b>				
Canada	-2.5	2.9	2.2	2.7
United States	-2.6	2.8	2.5	2.9
Euro zone	-4.1	1.9	1.4	1.6
Japan	-5.2	3.4	1.6	2.7
China	9.1	10.0	9.5	9.7
<b>Consumer Prices (y/y % change)</b>				
Canada	0.3	1.8	2.0	2.0
United States	-0.3	1.6	1.2	1.4
Euro zone	0.9	1.8	1.9	2.0
Japan	-1.7	-0.5	0.7	1.0
China	0.7	3.5	4.5	4.0
<b>Markets</b> ----- (end of period, %) -----				
<b>Yield Curve - Canada</b>				
Bank of Canada Overnight Target Rate	0.25	1.00	1.50	2.25
2-Year Canada Bond	1.47	1.40	2.00	2.50
10-Year Canada Bond	3.61	3.05	3.40	3.70
<b>Yield Curve - U.S.</b>				
Fed Funds Target Rate	0.25	0.25	0.25	2.00
2-Year Treasury	1.14	0.50	1.00	2.20
10-Year Treasury	3.84	2.85	3.40	3.80
<b>Foreign Exchange</b>				
Canadian Dollar (CAD/USD)	0.95	1.00	1.04	1.06
Yen (US\$/¥)	93	82	84	90
Euro (€/US\$)	1.43	1.32	1.37	1.45
Sterling (£/US\$)	1.62	1.57	1.63	1.70
<b>Equities*</b>				
S&P/TSX*	11746	13100	14000	
EPS*	600	700	860	925
S&P 500*	1115	1225	1325	
EPS*	57.03	83	90	95
----- (annual average) -----				
WTI Oil (US\$/bbl)	61.78	79	90	95
Nymex Natural Gas (US\$/mmbtu)	4.15	4.40	4.40	4.60
Copper (US\$/lb) <i>LME Base Metals</i>	2.34	3.40	4.00	4.00
Zinc (US\$/lb) <i>LME Base Metals</i>	0.75	0.98	1.05	1.15
Gold (US\$/oz) <i>London PM Fix</i>	973	1225	1500	1450

f: Forecast (Scotia Economics, December 7, 2010)

Source: Scotia Economics, Statistics Canada, U.S. Department of Commerce, U.S. Bureau of Labor Statistics, Bloomberg

\* Source: Scotia Capital, CPMS, S&P

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