Market Update - Japan

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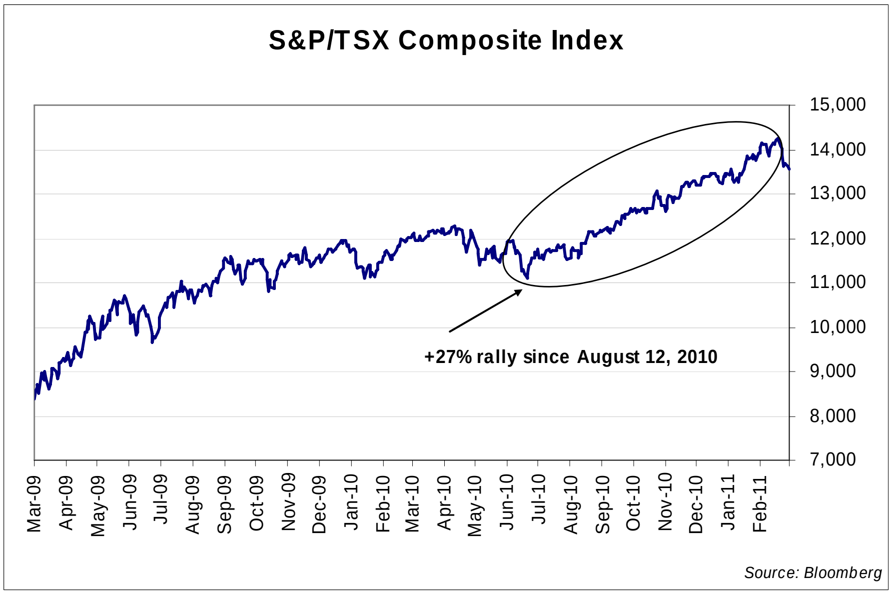
In the aftermath of the devastating earthquake and tsunami that hit Japan last week, investors have many questions regarding market risk, implications for the global economy, and the outlook for equities. In the days following, with news of explosions and potential radiation leaks at nuclear facilities, global equity markets might finally be commencing the pullback many investors have been anticipating for some time. Unlike the unexpected uprisings in the Middle East and North Africa which capital markets shrugged off for the most part, justifiably nervous investors at last are selling equities, in some cases indiscriminately, from their previously overbought levels. Although the specific trigger could not possibly have been predicted, and not to minimize the human tragedy in Japan, this sell-off is healthy for equity markets and investors should be looking to add to positions on this bout of current weakness once market sentiment stabilizes.

The Bank of Japan pledged to ensure financial stability and began injecting cash into the banking system soon after the earthquake struck. Similar to the situation in the U.S., the bank's main interest rate had already been cut to near zero as policy makers last year sought to end the nation's deflationary pressures. Oil prices, which had risen north of US$100 over concerns surrounding potential supply disruptions in the Middle East, sold off as refineries in Japan closed and thus, temporarily, cut demand for oil in the country. In addition to the primary concern for saving lives and basic food and shelter, other immediate issues facing the country include the risk of nuclear contamination, resuming power supply to allow factories to re-start, and opening up supply lines for distribution of basic goods and services. Following that will be the very daunting task of rebuilding the critical infrastructure that suffered wide-spread destruction caused by the earthquake, tsunami, and subsequent aftershocks.

Scotia Capital's Portfolio Strategist Vincent Delisle published a report on March 15, 2011 which provides some insight into recent developments and the implications on North American markets. Essentially, he believes that "**Japan's impact on the world economy and S&P 500 profits appears limited**…the current uncertainty is definitely enough to sustain the flight-to-quality in the near term" and the negative sentiment is likely to continue heading into the second quarter of 2011. However, he does not expect the pullback to exceed the 10% mark and doubts the Japanese situation will trigger a global recession. "Equity damages are limited to Japan, nuclear segments, and oil prices so far. The flight-to-quality has been orderly, and emerging markets and small caps are not getting crushed. Japan accounts for about 8% of world GDP and only 1% of global imports. The WTI [oil] price appears most vulnerable in the near term as Mid-East tensions moderate and Japan hits the demand outlook."

It is important to highlight that up until early March, Canadian and U.S. equity indices were trading at or near multi-year high prices, and had been on an upward trajectory, with only slight deviations, since late August, 2010. While not overvalued, we felt equity markets were extended given their nearly un-interrupted rally, fuelled by liquidity injections from the U.S. Federal Reserve and renewed investor allocations toward equities at the beginning of 2011, and therefore vulnerable to a modest (and much needed) pullback within otherwise positively trending equity markets. In addition to Japan, there are certainly a number of risks in the market place at the moment including instability in the Middle East and sovereign debt issues in Europe. In fact, it is actually remarkable how well the North American indices have held in against this



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backdrop; the S&P 500 is down a mere 6% since the highs reached in February and flat so far in 2011. Many markets worldwide (i.e. Saudi, Japan, even Shanghai) have experienced much worse declines and volatility. We think over the near term, the above risks will be an overhang on the market as these issues will take time to play out.

Generally speaking, and barring a full nuclear meltdown, we are still constructive on the market and would still maintain a 'buy the dip' bias once this volatility eases. A few supporting themes for equity markets are:

- Despite these risks, one has to keep in mind that another key takeaway from these recent developments is that central banks will maintain accommodative policies for a very long time (i.e. low rates and possibly more stimulus measures).
- The U.S. economic picture is stabilizing and it does not appear that progressive, albeit slow, job growth will be impacted by these recent events.
- Investor sentiment was severely impaired over the past few years and our sense is that fear and cautiousness continues to dominate.
- There remains an abundant amount of cash on the sidelines that have been waiting for a modest pullback in the market.

Although there is a legitimate bear case to be made that the Japanese economy will suffer in the short term, leading to negative implications for industrial commodity prices and more economically sensitive sectors, it is also reasonable to predict that after a brief slowdown, the massive rebuilding required in Japan will generate outsized demand for those very same commodities. We are more inclined to be buyers and not sellers of commodity producers and equities in general once market sentiment stabilizes. Although not an exhaustive list, there are several companies we would highlight which had either sold off prior to the earthquake surfacing in Japan and/or are trading at attractive valuations:

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