

Volatile Markets

Winter 2008 Update

Volatility in global financial markets has increased substantially over the past six months, beginning with the equity market downturn at the beginning of the summer of 2007. Equity markets did briefly recover much of their losses, but have since moved lower, and the path appears to remain rocky.

Key Points to Remember

- It is a market of stocks, not a stock market. Although the benchmark indices have posted negative returns over the past twelve months, with sharply negative returns in the last three, sector and individual share price performance has been very mixed.
 - In the S&P/TSX Composite Index, Utilities and Materials have posted positive returns over the past three months even as the index posted a -7.1% return.
 - 68 of the 257 members of the index are in positive territory over this period – 28 of which have provided returns in excess of 10%.
- After a sluggish performance in the first half of 2007, bonds have provided solid returns as equity markets moved lower. Over the past 12 months, the DEX Universe Bond Index has returned 4.9%, after marking a 4.4% gain over the last three months.

Where are things headed?

Our Portfolio Advisory Group continues to hold a constructive view of markets going forward:

- Although the pace is expected to slow, Scotia Economics is forecasting growth will remain in positive territory – in 2008 the Canadian economy is expected to grow 2.2%, while the U.S. is expected to grow by 1.8%, Japan by 1.4%, Western Europe by 2.0%. Softening growth in the industrialized world will temper performance in developing nations, but nonetheless, Scotia Economic believes China's economic expansion will remain robust, especially as they move towards the 2008 Beijing Olympics in August, while India, Russia, and a number of other emerging nations will continue to outperform.
- Scotia Economics is forecasting a 0.5% reduction in the Bank of Canada's overnight target rate to 3.75% by mid 2008, to address tight credit conditions, slowing growth, and the strong Canadian dollar. In the U.S., the Federal Reserve is expected to lower its funds rate a further 1.0% to 3.25% to address risks of a housing recession and associated financial contagion.
- With lower benchmark rates, Scotia Economics is also forecasting short-term bond yields to continue to decline from current levels over the next six months. Longer term bond yields however are forecast to bottom in the first quarter of this year near current levels, and then to rise over the balance of the year. Benchmark 2-year Canada yields are expected to fall towards 3.0%, but 5-year yields are expected to rise back above 3.70% and 10-year yields are forecast to rise back above 4.00% by the third quarter.

- Scotia Capital Portfolio Strategist Vincent Delisle has highlighted that the S&P 500 and the S&P/TSX Composite are in correction territory, with both indices more than 10% below their peaks. He believes those peaks are unlikely to be revisited in the coming months, and hence has recommended lowering equity exposure in favour of cash/money markets. However, he continues to call for positive equity market performance for 2008, based on a recovery in the second half of the year. His forecast level for the S&P/TSX Composite for the end of 2008 is 14,500, and 1575 for the S&P 500.
- After rising 16.8% in 2007, the Canadian dollar is expected to continue to gain versus the U.S. dollar, based on merchandise trade and fiscal surpluses, stronger relative underlying economic fundamentals. The Canadian dollar is also expected to appreciate versus the Pound Sterling; however, it is expected to lose ground versus the Euro, the Japanese Yen, the Australian Dollar, and the Chinese Yuan.

What do you do now?

- In times like these, we remind investors as we did last summer and again last fall that we have been here before. Investors should not panic – **stick with your long-term plan, and maintain a diversified portfolio that meets your risk tolerance.**
- Quality Financials look good for the long term but expect that bank stocks will remain volatile in the short term. Coming out of this pullback, other defensive sectors like Telecommunications, Pipelines/Utilities, Consumer Staples, and Gold will outperform.
- We also recommend greater emphasis on dividends and U.S. multinationals. Dividends provide downside support and become an increasingly significant part of total return calculations when the market is trending lower.
- Given our outlook for longer term yields to rise, we continue to recommend active fixed income investors focus on 2-4 year maturities of high quality corporate issues.
- Although the near term outlook is for the Canadian dollar to appreciate versus the U.S. dollar, the U.S. equity market is home to numerous multinationals and offers Canadian investors many attractive investment alternatives.

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