2006 Economic and Market Outlook

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After The First Waves

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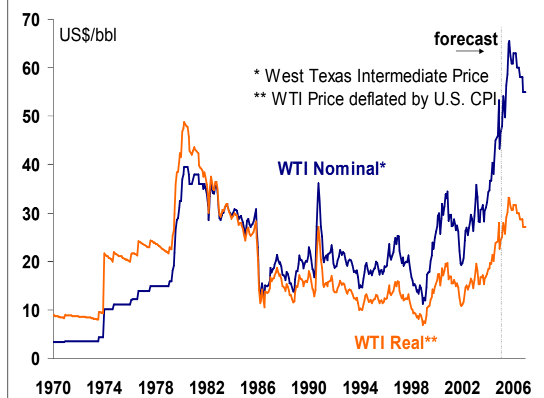
Almost one year ago, the world was shaken by the devastating effects of the tsunami that hit Asia's coastal regions. From a global economic perspective, however, there have been two more relevant waves over the past few years, with both leaving their mark on growth, inflation and employment — the correction in the value of the US dollar and an escalation in oil prices since the start of 2002. Measured against the Canadian Loonie, the US dollar has fallen by 38% during the past four years, while oil prices have risen by almost 230% over the same period. In fact, at its peak in late-August, oil was up almost 290%, even though inflation-adjusted prices remain well below the highs of the late-1970s and early-1980s. These two developments are related.

A storm surge of globalization has seen many of the emerging world economies — particularly China and India — accelerate their growth in production which, coupled with extremely low relative labour costs, has created disinflationary conditions among the G7 members in terms of discretionary goods. With production ramping up, the appetite for energy and input materials has become almost insatiable which has led to higher prices for oil, refined fuels and natural gas, not to mention base metals like copper and aluminum. American consumers have reaped the benefits of increased global competition and, up until recently, the ultra-low level of interest rates, channeling the lion's share of their disposable incomes into higher spending on everything from clothing to cars. The strength in domestic demand has been reflected in the massive import bill the U.S. has rung up, resulting in record high trade deficits, and a weaker dollar.

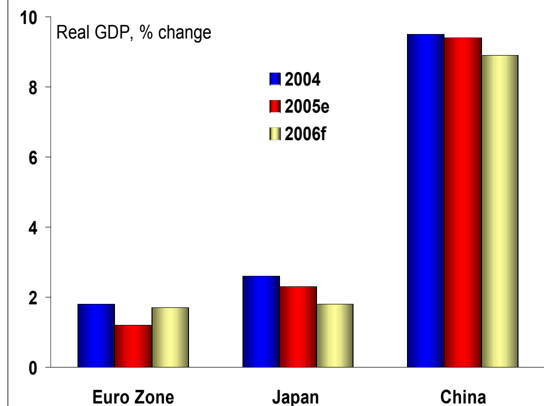
Intensity of both waves has at least settled back this year, with oil prices cresting in the last several weeks and most major currencies ebbing against the dollar, the exception being the Canadian dollar. With the pressures diminished somewhat, economic growth outside of the U.S. has responded positively. In Europe, economic growth remains anemic, although German GDP expanded by close to 1.5% in the third quarter, compared to growth of only 0.5% this time last year. French GDP fell sharply, to 1.1% in the second quarter from 2.8% in the year-ago period, but bounced back to just under 2% in the third quarter. Similar to Europe, Japanese economic conditions eroded in 2004 as the Yen rose in value against the US dollar, with GDP growth slipping from a high of 4.5% in early 2004 to only 0.6% this time last year. Over the last three quarters, however, growth has recovered back to 3% alongside a weaker Yen and continued strength in demand from the major Asian economies. Exports to China, in particular, have more than doubled since 2001, while exports to the U.S. have declined. After seeing average annual growth of 10% during the past quarter of a century, China's economy is expected to cool over the course of 2006, though only slightly.

Exhibit 1 - The Oil Factor



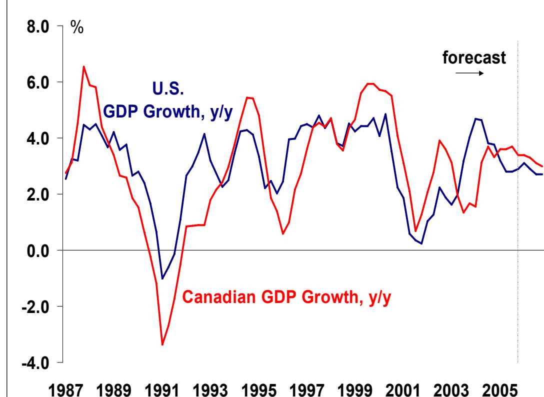
Source: Bloomberg, Scotia Economics

Exhibit 2 - Global Growth



Source: Global Insight, Scotia Economics

Exhibit 3 - Canada & U.S. GDP Growth



Source: Statistics Canada, Scotia Economics

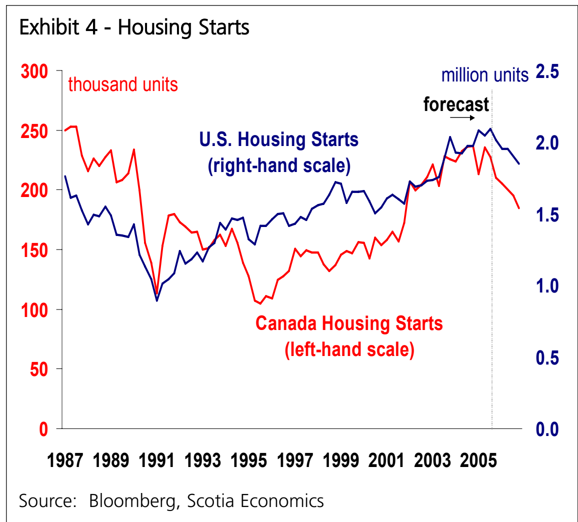
Growth rates in both Canada and the U.S. have been on a gradual downward path since 2004 as a result of higher energy prices and the negative effects of weaker global growth. For the U.S., the combination of a spike in gasoline prices and the two hurricanes shook consumer confidence from the buoyant levels seen earlier in the summer. This coincided with a reversal in discretionary spending at the end of the third quarter and into October, punctuated by a steep drop in auto sales once incentives were reined in. Job creation and personal income growth south of the border have also been sub-par during 2005, and wage increases have been unable to keep up with inflation. In order to maintain consumption growth, U.S. households have been forced to dip into their home equity and take on added debt, at a time when rates are rising. As personal expenditures and housing activity cool, the overall U.S. economic expansion is forecast to decelerate from an estimated 3.6% in 2005 to 3.2% in 2006.

Canada's situation was helped by the modest depreciation in the Canadian dollar during the first half of 2005, but the real driving factor this year has been energy. Currency-sensitive firms have achieved a greater degree of success in transitioning to the higher exchange-rate environment, even though manufacturers continue to shed jobs. Amazingly, overall GDP growth has held relatively constant at just under 3% during 2004 and 2005, and we forecast only a minor erosion to 2.8% in 2006. Beneath this steady picture for Canada's expansion, the regional rotation in growth from central Canada to the west continues. Even with oil prices anticipated to slide next year, the momentum in Alberta and B.C. will be considerable. Meanwhile, Ontario now faces another wave of significant auto-sector restructuring. Households will get a modest boost from the recently announced tax cuts package, but these measures will hardly cover the increase in home heating costs, let alone create an over-heated economy overall.

The Federal Reserve and Bank of Canada are still focused on preventing a resurgence in core inflation, which means we are in for a further 75 basis points in tightening by the Fed and another 100 basis points from the Bank of Canada. Assuming that neither bank takes a pause, the forecast implies that the Fed will end its tightening program at the end of the first quarter next year, while the Bank of Canada extends its program into the second quarter. Whether longer-term borrowing costs match these administered rate increases will depend on the degree to which fixed income markets are concerned about the core inflation outlook, in addition to the direction the U.S. fiscal deficit takes. When monetary policy turns neutral, many will expect that the slowdown in domestic demand growth in Canada and the U.S. will be short-lived, with the worst of the waves' effects behind us.

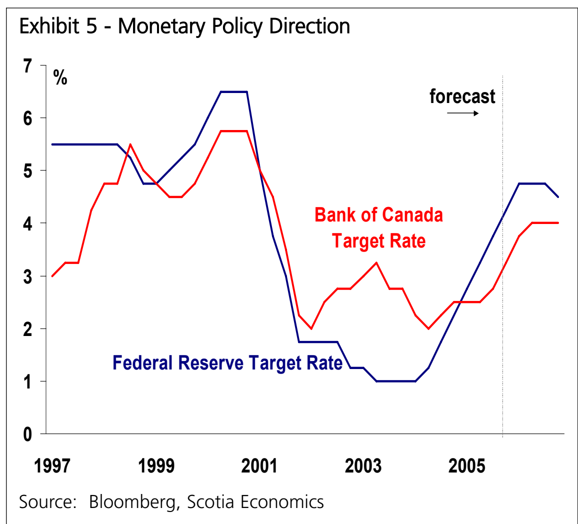
This ignores the very real possibility that a recurrence of these two waves could hit the global economy in the coming quarters, either in terms of another spike in energy prices or a renewed correction in the value of the US dollar, or both. Of the two, a fall in the dollar is more probable. This year's recovery in the greenback can be traced to relatively stronger U.S. economic growth and relatively higher interest rates. A more significant contribution came from the repatriation of foreign profits as firms took advantage of the one-year preferential tax treatment offered under the American Jobs Creation Act. As this treatment extends only into the first quarter, the effects on the US dollar will soon start to fade, forcing foreign exchange markets to re-focus their attention on the mammoth current account deficit. Our forecast calls for sizable improvements in the major currencies against the dollar, and for the Canadian dollar to reach 90 US cents by the end of 2006.

Exhibit 4 - Housing Starts



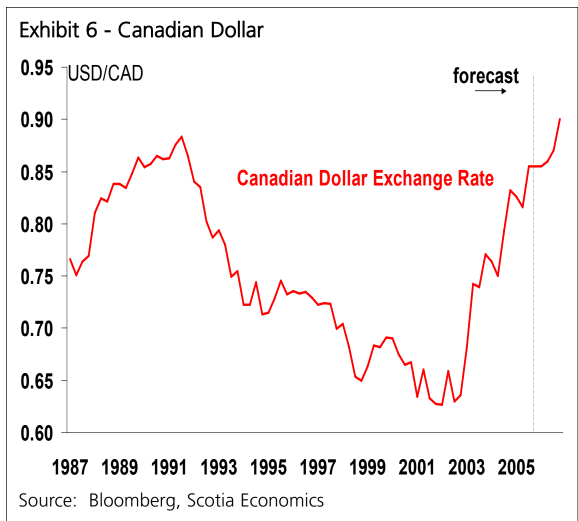
Source: Bloomberg, Scotia Economics

Exhibit 5 - Monetary Policy Direction



Source: Bloomberg, Scotia Economics

Exhibit 6 - Canadian Dollar



Source: Bloomberg, Scotia Economics

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The North American bond markets have had a pretty good year in terms of total return performance but returns are expected to be weaker in 2006 as interest rate levels rise through the early part of the year. In particular, we have begun to see the beginnings of a trending bear market in North American bonds. For this to continue though, we will need to see a series of higher yield highs as market yields back up further in coming months, as well as higher yield lows into any near term rallies. Note that longer term (once through 2006) we see rates declining again as the North American economies slow.

From a strategy standpoint, we see several good opportunities surfacing over the coming year. At the top of the list is the expectation of still further improvement for the C$ as continued tightening Bank of Canada credit policy, high commodity prices, solid fiscal performance and a generally weakening US$ all combine to drive the C$ stronger. As a result, any pullback in the C$ towards the 1.2000 area (83.3 cents) as a result of election uncertainty should be used as a buying opportunity.

With the Fed and Bank of Canada likely to raise rates further in coming months and the spread between longer term and shorter term yields approaching flat in each country, we would look for longer term yields to move up at a similar pace to shorter maturities in Q1. These moves imply that the shorter end of the yield curve will produce the best total return performance in coming months. As such, we would not recommend moving into maturities longer than 5-years at this time. From a borrower's perspective, while rates will rise, given that they are unlikely to rise dramatically means that we do not expect that lending rates will become a major burden for borrowers over the coming year.

Opportunities to make money in curve flatteners are expected to diminish as we go through the New Year, as the Treasury curve is now approaching zero and running out of room to flatten further (without inverting) and the Canadian curve has been showing a steady march to a flatter curve and will likely see curve spreads trough in Q1. Given the implications for the economy of an inverted curve (precursor to a slowdown), we believe that longer term yields will begin to move up at a similar pace to shorter term yields in the New Year. These factors suggest that institutional investors should be using flattening moves in coming months to gradually begin to take off flattening trades.

Taking advantage of Canada-US spreads moving more negative has been a great institutional investor strategy primarily used by foreign investors to enhance their return performance over the US market in recent years. But while the longer term trend continues to suggest that Canadian yields should continue to remain below their US counterparts, we believe that institutional investors should be looking to sell Canada against the US should the yield spread between the two countries attempt to move more negative. Against this background, we could easily see the 2-year spread become less negative and move out towards the minus 40-50 bp area, while the 10-year spread will likely widen back towards the low -20s in the months ahead.

Finally, credit spreads remain on the tighter side of historical ranges and could easily stall out in the expected rising rate environment. We would recommend beginning to lighten up on credit product into any further spread narrowing over the coming quarter.

Exhibit 1 - Recommended Weightings

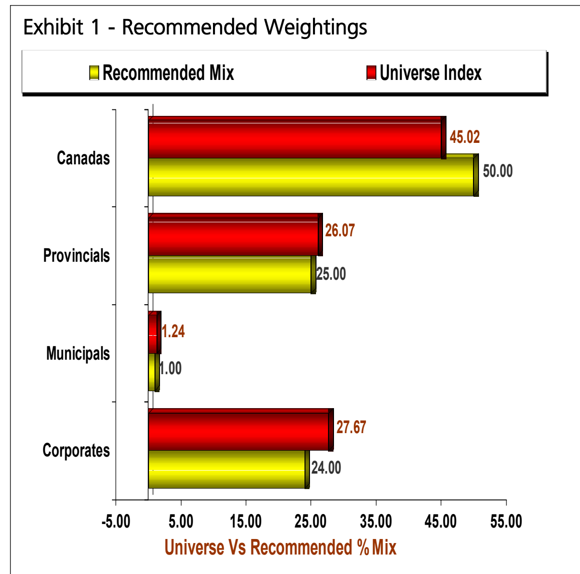


Exhibit 2 - Recommended Term Allocation

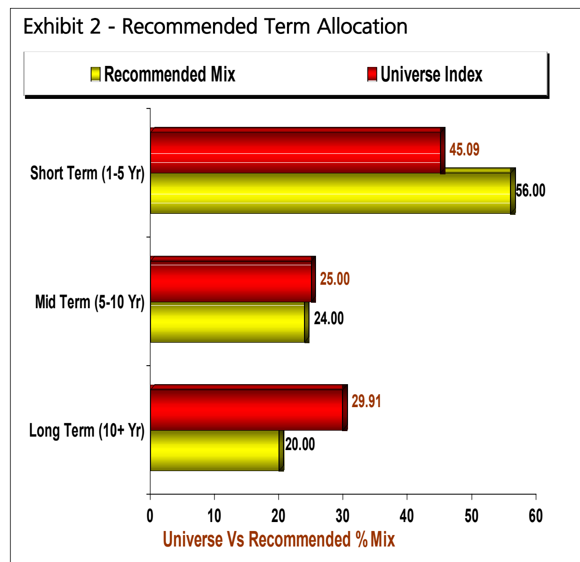
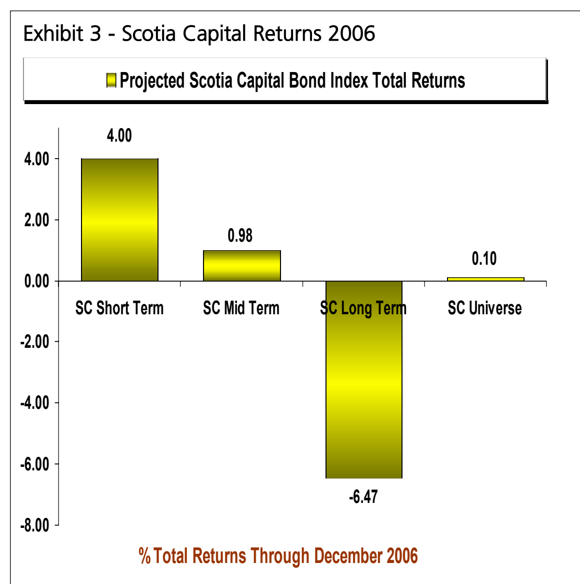


Exhibit 3 - Scotia Capital Returns 2006



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Equity Gains Expected as U.S. GDP Grows Above 3%

We believe a friendlier Fed post Q1-06 and a new tax ruling on dividends in Canada represent positive catalysts for Equities heading into 2006. Strong U.S. vital signs and lower Energy prices could also extend the ongoing year-end equity rally into the first half of 2006. When the Fed does put an end to its rate hikes, the extent of any slowdown will have to be monitored. At some point, the bond market will signal its "economic discomfort" and investors should monitor the shape of the yield curve closely, especially if it inverts.

New Dividend Tax Ruling Equates to Higher Multiple for Interest Sensitives

For over 40% of the S&P/TSX composite index (Financials, Telecom, Utilities), the Federal government's recent proposal on dividends will result in enhanced investor attention and higher valuations. It could also translate into flow of funds moving out of deeper cyclicals and into dividend plays. Sector leadership has visibly switched from Energy (25% of TSX weight) to Financials (32% weighting) since September 2005 and we believe this trend will continue in 2006.

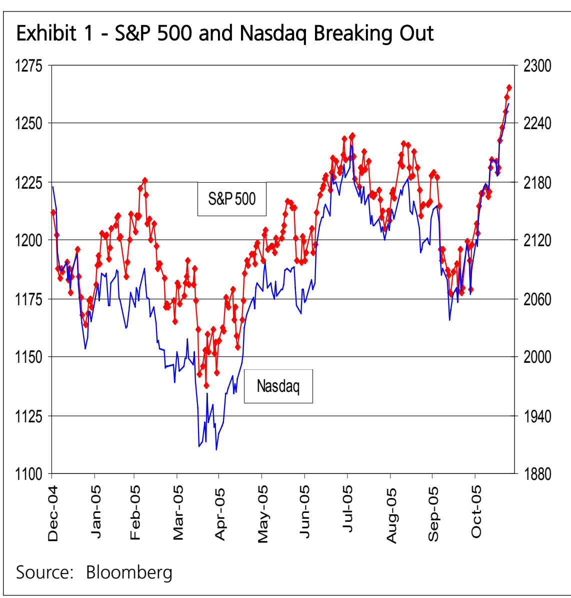
Wall Street Signals are Bullish

U.S. stocks have spent most of the last 12 months in a narrow trading range and have behaved in "Fed rate hike fashion", i.e., going nowhere (Exhibit 1). Lower Energy prices and the end of Fed rate hikes could stimulate the S&P 500 next year and help it outperform the S&P/TSX.

2006 Earnings Outlook and Targets

We are raising our 2006 earnings estimates to $675 for the TSX ($615 in 2005) and US$82.50 for the S&P 500 (US$76.50). Our 2006 targets are set at 11500 for the S&P/TSX and 1400 for the S&P 500, which translates into 5-10% potential returns for North American equities (Exhibit 2). Our price targets are based on 17X PE multiples to our 2006 earnings estimates. From a valuation perspective, we believe the S&P/TSX will be able to sustain its premium to fair value of 10000 as long as U.S./global economic activity grows at a brisk pace. From a risk-reward standpoint, however, we believe the TSX would be more vulnerable to a sharper U.S./global slowdown as commodities prices (Energy) could weaken. Scotiabank Group energy research teams are forecasting oil prices around US$60 for 2006.) The trend in oil prices will be especially key for the Canadian index and lower prices would have a negative impact on our S&P/TSX earnings and target. In terms of sector strategy, Financials, Telecom, Health Care and Golds would remain our focus, with upbeat views on Utilities and Industrials-Rails (Exhibit 3). U.S. Technology gains could eventually translate into positive returns for the TSX-Technology sector as well.

Exhibit 1 - S&P 500 and Nasdaq Breaking Out



Source: Bloomberg

Exhibit 2 - Scotia Capital Equity Forecasts

	2002	2003	2004	2005 E	2006 E
S&P/TSX	6615	8221	9247	11000 (+19%)	11500 (+5%)
EPS (C$)	306 (-19%)	419 (+37%)	531 (+27%)	615 (+15.5%)	675 (10%)
S&P 500	880	1112	1212	1260 (+4%)	1400 (+11%)
EPS (US$)	46.04 (+18%)	54.69 (+19%)	67.67 (+24%)	76.50 (+13.5%)	82.50 (+8%)

Source: Scotia Capital

Exhibit 3 - Scotia Capital Sector Allocation

Sectors	TSX Weight %	Scotia Capital Recommendation
Defensive & Interest sensitive		
Financials	31.4%	Overweight
Utilities	1.6%	Market weight
Consumer Staples	3.7%	Market weight
Telecommunication	4.7%	Overweight
Health Care	1.3%	Overweight
Resources		
Energy	25.8%	Underweight
Materials	14.4%	Underweight
Economic sensitive		
Industrials	5.7%	Market weight
Information technology	5.0%	Market weight
Consumer Discretionary	6.4%	Market weight

Source: Scotia Capital, Bloomberg

Note: All references to data on pages 1-4 are as at December 1, 2005.

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