December 17, 2008

Warren Jestin (416) 866-6136
warren_jestin@scotiacapital.com

Vincent Delisle (514) 287-3628
vincent_delisle@scotiacapital.com

2009-10 Economic and Market Outlook

Heading South For The Winter

Warren Jestin, Senior Vice-President & Chief Economist

Global economic activity is receding rapidly, despite unprecedented government actions to support credit markets and inject big doses of monetary and fiscal stimulus to revive consumer, business and investor confidence. The seismic shock delivered by the U.S. sub-prime fiasco to world financial markets has now triggered retrenchments in North America, Europe and Japan and has substantially undermined economic prospects in emerging economies. Global growth is unlikely to exceed 1½% in 2009, the weakest performance since the early 1980s.

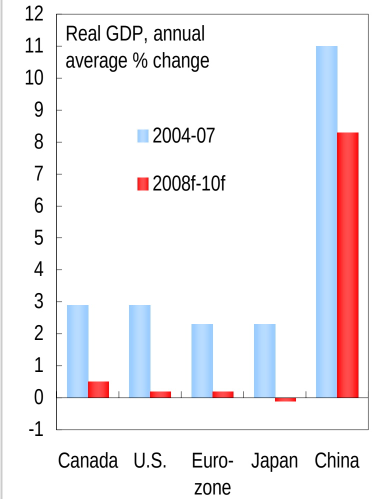
The U.S. economy contracted in the third quarter and will likely continue losing ground through much of 2009 before embarking on a protracted period of convalescence extending through 2010. The stabilization of the housing market and home valuations — an essential precursor to U.S. recovery — will be impeded by accelerating job losses and an overhang of unsold inventories equivalent to 10 months' sales. Export gains, until recently one of the few bright spots for Corporate America, are being circumscribed by weakening global activity. Reduced offshore earnings will also add to the squeeze on profits from falling domestic sales, triggering further big layoffs and cutbacks in business investment.

While high inventories have greatly exacerbated the U.S. downturn, the fundamental impediments to economic revitalization are structural, not cyclical. The powerful 'borrow-to-buy' driver of consumer spending over the past three years, fuelled by home equity withdrawals and financial innovation that allowed marginal borrowers to ramp up leverage, has been disengaged. It is being replaced by an 'earn-and-save-before-you-buy' dynamic that points to a prolonged period of deleveraging and subdued consumer spending.

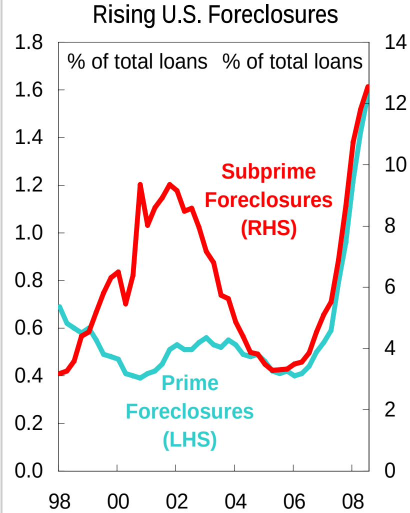
Washington is poised to deliver another huge dose of fiscal stimulus, this time focused on job-creating infrastructure projects and, in the case of the auto industry, on job-preserving support packages. While such action will help support U.S. domestic demand, it will take considerable time — and more than fiscal stimulus — to resolve the imbalances underlying depressed housing activity and the longer-term global market challenges confronting the Detroit Three. Pedal-to-the-metal U.S. government spending also will not reverse the broad-based slide in business profitability tied to a loss of growth momentum abroad.

The Federal Reserve also is in uncharted waters, dramatically expanding its balance sheet, accepting a broadening array of collateral and soon, moving its bellwether rate on overnight Fed funds even closer to zero. There are increasing signs that aggressive purchases of longer-term securities may be used to bring interest rates down across the yield curve. To date, the impact of this unprecedented monetary stimulus has been severely constrained by broad-based financial deleveraging and the deteriorating credit-worthiness of marginal borrowers. More generally, households and businesses will be very cautious about ramping up borrowing or spending in today's highly uncertain economic environment.

G7 Growth Stalls



Rising U.S. Foreclosures



Policymakers in other major developed nations also have moved aggressively to cushion the slide in their economies. In Europe, the Bank of England and European Central Bank have cut their policy rates to historic lows. The Bank of Japan has moved back towards a zero interest rate policy. Mounting job losses also have underlined the need for immediate, aggressive fiscal action even as government deficits widen sharply. With economic retrenchment becoming more pervasive across sectors and more synchronized across nations, there is bound to be an escalation of pro-growth initiatives in the months ahead. However, as these actions begin to gain traction in stabilizing global financial and economic conditions, probably during the second half of 2009, policymakers will confront a new set of challenges.

This is particularly the case in the United States, where the Fed will need to move quickly to drain the flood of excess liquidity that has been pumped into the system before it drives inflationary expectations and bond yields sharply higher — a politically difficult task if the recovery is weak and uneven. Washington's current acquiescence to running deficits that will average at least one trillion dollars this year and next will limit future fiscal flexibility and, unless pared back, will ultimately pose clear risks to the U.S. dollar and the bond market. As global investors regain confidence and begin to diversify their portfolios, the current vast appetite for Treasury securities will subside, undercutting the U.S. dollar and giving renewed support to various currencies, including the loonie. The bottom line — the U.S. road to recovery is likely to stretch beyond 2010, with plenty of volatility in currency and bond markets along the way.

While economic conditions also have deteriorated in growth leaders such as China, India and Brazil, these nations appear to have enough resilience in domestic demand to continue outperforming the traditional developed nations by a wide margin. For example, China is still expected to generate growth approaching 8% in 2009 at a time when the G7 nations collectively will record declining output. A more pronounced deceleration in emerging nations would have serious consequences for commodity producers and exporters of high-tech and infrastructural products, primarily headquartered in North America, Europe and Japan.

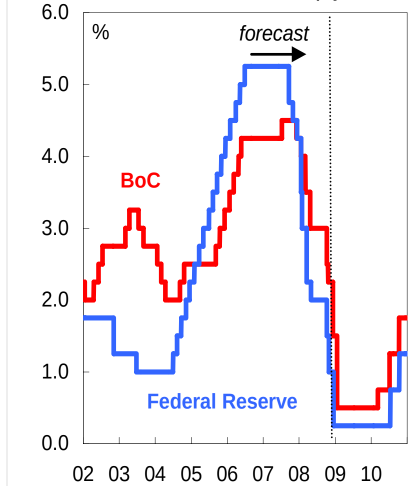
While the home-grown risks to the outlook vary across nations, the process of rejuvenating global growth and re-establishing confidence in financial markets requires policy co-ordination among both developed and emerging nations. Agreement among G7 nations, often hard to achieve, is not enough because the new growth leaders are providing much of the world's locomotion and control enormous pools of financial assets. President Bush's decision to invite the heads of state of all G20 nations to meet in Washington during November to discuss ways of dealing with the global crisis reflects that reality.

Canada's Prospects — Caught In The Global Downdraft

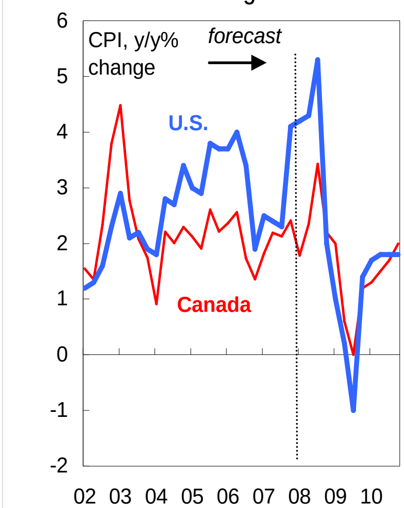
The Canadian economy lost considerable momentum over the summer, with output in the third quarter up only half a per cent from a year earlier. Prospects for resource-rich provinces have deteriorated as faltering demand from emerging markets triggered a sharp fall in prices for oil and most industrial commodities. By November, Canadian motor vehicle sales were running 10% below the previous year. Housing starts and sales also have fallen to the lowest levels in more than half a decade.

In explaining its latest three-quarter percentage point rate cut, bringing the Bank Rate to a fifty-year low of 1.5%, the Bank of Canada indicated that our economy is in the process of joining other major industrial nations in recession.

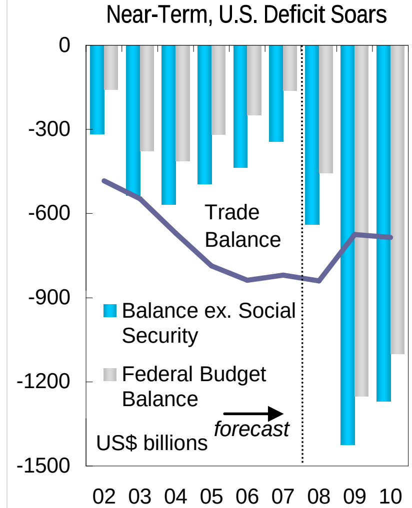
Central Bank Rates Sharply Lower



Inflation Is Going Nowhere Fast



Near-Term, U.S. Deficit Soars



We expect output to contract 1.2% next year, with much of the weakness concentrated in Central Canada. Overall, next year's retrenchment is likely to be about half the setback recorded in the U.S., with the prospect of a slightly stronger recovery in 2010.

The greater resilience of the Canadian economy reflects a number of positive fundamentals. Canadian financial institutions are rated among the strongest in the world. Canadian households have tended to build equity in their homes over the past decade, unlike their U.S. counterparts that relied on home equity withdrawals to underwrite spending. The levering up of higher-risk U.S. households that eventually precipitated the sub-prime mortgage crisis and credit crunch was not replicated in Canada. As a result, the drop in Canadian residential activity will be much less severe and extensive than south of the border.

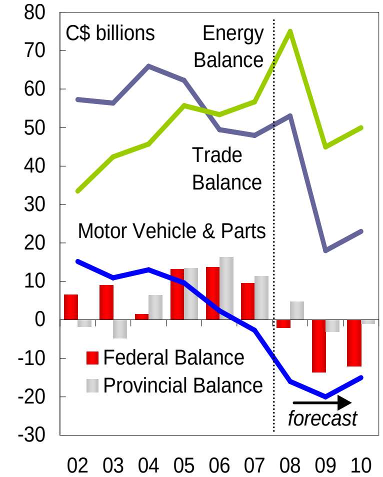
The longer-term, broad-based commitment of Canadian governments to balanced budgets also will prove to be an important national strategic advantage. Over the past decade, Ottawa has halved its net debt relative to GDP, and the Provinces' debt service has dropped to less than 10% of their revenues. Previously enacted fiscal stimulus — in the form of tax cuts and spending increases — is already working to support our economy. Additionally, several Provinces have brought scheduled tax cuts forward as well as implementing new tax relief. Unlike the *ad hoc*, deficit-financed U.S. initiatives that have been escalating in recent months, Canadian governments have focused on longer-term, productivity-enhancing investments. Federal, provincial and municipal investment in Canada's transportation, education and health care infrastructure will offer important support to our job market and domestic demand.

Declining revenue flows and multiple demands for economic stimulus may end up pushing Ottawa's budget gap to double-digit levels. Several provinces, including Ontario, are confronting similar fiscal issues. Even in the resource-rich Western Provinces, the big setback in commodity prices coupled with initiatives to support domestic demand, will sharply reduce their surpluses. Taken together, this year's Provincial balances are likely to total less than half the $11 billion-plus balance in FY2007-08. Further erosion is anticipated in FY2009-10. The litmus test for sound policy, however, will be whether fiscal recovery plans are geared to improving long-term productivity and restoring balanced budgets once economic growth resumes on a durable basis.

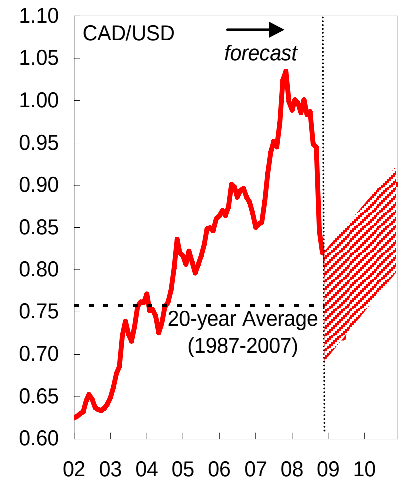
That said, Canadian consumers inevitably will become even more cautious spenders in the coming months. Consumer confidence has already fallen to levels not seen since the recessions of 1981-82 and 1990-91 alongside record-low employment expectations. Canada's labour market has been much stronger than its U.S. counterpart in 2008, but employment has started to decline, with job cuts likely to accelerate over the winter as the U.S. recession deepens and the global retrenchment in commodity demand hits Canadian exporters. Even here, however, declines in the Canadian dollar and prices for gas and other commodity inputs should provide some temporary relief for many Canadian industries — temporary because a return to stronger growth in emerging and developed economies will likely coincide with a rebound in both commodity prices and the loonie.

On a regional basis, stronger fiscal fundamentals and momentum from existing infrastructural projects will provide support in Western Canada. As the global economy rebounds beyond 2009, stronger resource prices will once again boost growth in the major resource-producing regions. The net result – Western Canada and parts of Atlantic Canada will continue to outperform Central Canada.

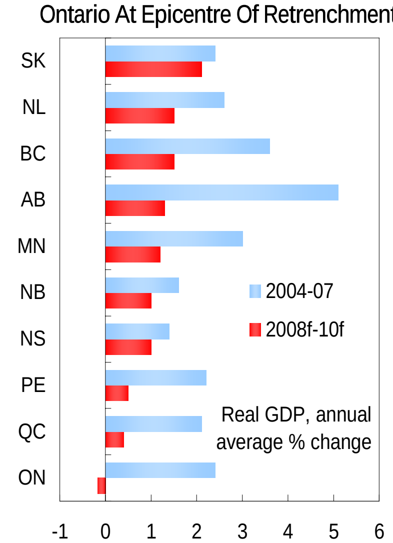
Canada Tops G7 In Fiscal & Trade Trends



Commodity Drop & Liquidity Flight Hit C$



Ontario At Epicentre Of Retrenchment



Looking To Add Offence Throughout 2009

Vincent Delisle, Director, Portfolio Strategy

Nowhere To Hide In 2008

As the global economy weathers through its most challenging period in a generation, 2009 world GDP growth should be the weakest since 1982. The U.S. recession, which started in December 2007, ended 2008 with severity based on employment and retail sales data. With most developed and developing countries on the brink of recession, investors who bet heavily on the decoupling fantasy theory are the ones suffering the most. As of December 11, 2008, the MSCI-World index's year-to-date losses tally 44.8%. The Dow Jones Industrial average is off 34% so far in 2008 versus -54.8% for the MSCI Emerging index. In today's globalized financial markets and increased trade, we were always dubious about the concept of decoupling. The 2008 equity downturn has been broad and there has been nowhere to hide in equity-land.

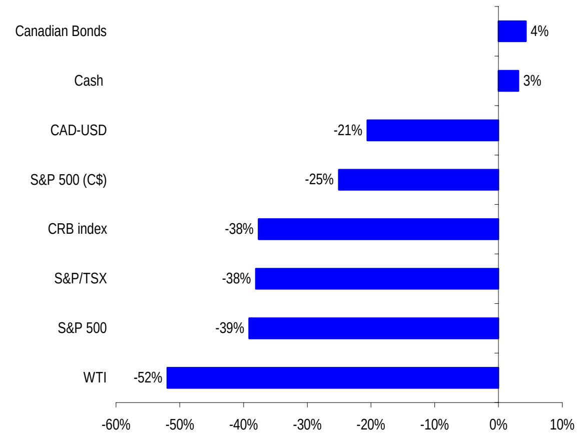
A rebounding U.S. dollar and eroding demand has also sent oil and other commodities on a precipitous fall. As a word of caution, commodities prices are not likely to stage a sustained rebound until the global recession is over, which could be very late in 2009 in the U.S., and not until 2010 for the rest of the world. Although the decline in input costs will take care of inflation expectations in the near term, the 53% slide in the CRB index will severely dampen the earnings outlook in Canada. Government bonds and Cash have been the dominant assets in 2008 as they overly benefitted from the growing sense of investor panic. As soon as confidence comes back, however, investors are likely to leave the over-priced comfort of safety (U.S. 3 Months T-Bills are yielding 0.01%) and rotate into corporate bonds and equities. From a risk-reward standpoint, we believe investors will have the opportunity to move up the risk curve in 2009 by adding to their equity exposure and reducing cash. Our recommended asset mix is biased towards equities as we expect greater returns from that asset class both in the short (1-year) and long (3-5 years) term.

Scotia Capital Asset Mix

	Min	Weights	Max	Recommended Weight
Equities		**60**		**65**
TSX	*10*		*30*	***20***
S&P 500	*10*		*30*	***23***
MSCI EAFE	*10*		*30*	***22***
Bonds	20	**38**	70	**28**
Govt.	*10*		*50*	***15***
Corp.	*0*		*20*	***13***
Cash	0	**2**	20	**7**

Source: Scotia Capital

2008 Market Performance (As at December 10, 2008)



Source: Scotia Capital, Bloomberg

Pro-Growth Measures Should Pay Off For 2010

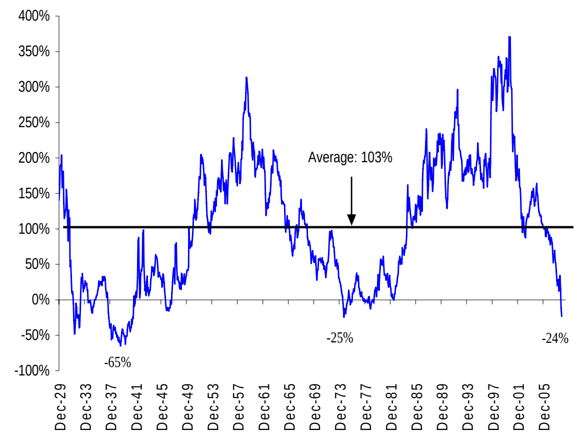
From a macroeconomic standpoint, the silver lining in these uncertain times has been the adoption of concerted monetary and fiscal stimulus measures. Deflation has replaced inflation as enemy number one and we expect global central banks to sustain their pro-growth actions throughout 2009. Although we expect weak economic data, profits recession, budget deficits, and interest rate cuts to dominate headlines for most of 2009, financial markets will focus on how long the ongoing recession lasts, and look for signs of activity picking up by 2010. In our opinion, the unprecedented amount of stimulus decisively raises the odds of witnessing an improvement in the U.S. economy by the end of 2009. If such is the case, equity markets will move higher. From a strategy perspective, the challenge is to determine what scenarios equities and bonds are pricing. Since the start of December, the S&P 500 has managed to survive a series of gloom & doom data on manufacturing (lowest ISM index since 1982), retail sales (worst same- store-sales decline since 1969), and employment (worst monthly job losses since 1974). As we write this note, the S&P 500 index is hovering roughly 10% above its November intra-day low of 741. The string of negative economic data will extend through the first half of 2009 but the bottoming process should start before the data improves.

Long-Term Equity Return Outlook Improves

Although the timing of any pending rebound is debatable, we believe the longer-term risk-reward outlook has dramatically shifted in favor of equities. In addition, we believe the end of this cyclical bear market may coincide with the end of the decade-long secular bear market. The S&P 500's 10-year return stood at -23% at the end of November, well below its historical average of 103%. Such an attractive long-term entry point has only occurred two other times in the last 80 years. In the short term, however, any bottoming process will remain fragile and investors should remember that retesting the lows is very common in bear markets. Consequently, we will be waiting for the following catalysts before raising our equity exposure and reallocating money from outright defensive sectors (golds, utilities, healthcare, staples) to more cyclical areas (financials, discretionary, industrials, technology). Key catalysts would be a trough in U.S. housing prices and S&P500 moving averages (50-day and 200-day) convincingly moving north.

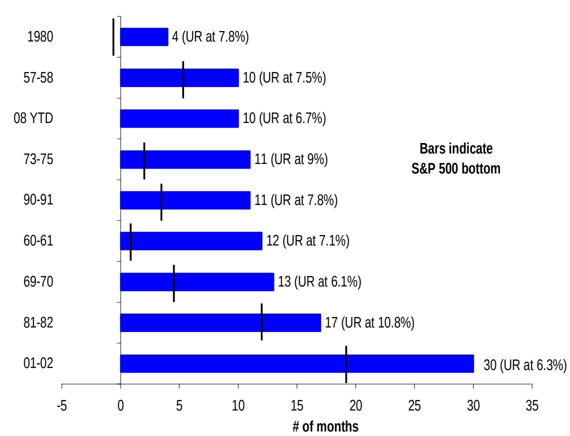
Since Equities will likely bottom just when the recession appears to be at its nadir, it will be important to monitor when the rate of deterioration in key data starts to moderate. As an example, S&P500 bear markets typically end eight months before employment losses reverse. Moreover, spikes in job losses, as we are witnessing right now, tend to coincide with latter stages of recessions, not the beginning. Employment is lagging, not leading.

S&P 500 10-Yr Rolling Return (1929-2008)



Source: Scotia Capital

U.S. Jobs Recessions & S&P 500 Rebounds

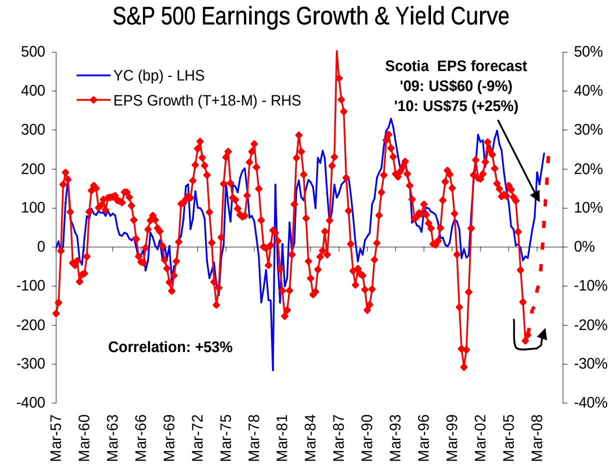


Source: Scotia Capital, Bloomberg

The Scotia Strategy View: TSX Earnings Heading For A Slide In 2009

Since Canada's economy and equity market lag the U.S. by approximately 12-18 months, 2009 will be the year where Canada's numbers visibly deteriorate. Our 2009 TSX EPS forecast is set at $650, pointing to a 32% decline in TSX earnings. TSX earnings could rebound to $700 in 2010 if commodities prices collaborate. In the U.S., we expect a 9% decline in S&P 500 EPS to US$60 in 2009 followed by a 25% rebound in 2010 to US$75. If the U.S. recession remains contained to 2009, positive (albeit mild) GDP growth in 2010 will trigger a positive uptick in profits. Moreover, our 25% EPS turnaround would be in line with the massive yield curve steepening and the 18-month lag with earnings. S&P 500 earnings should rebound before the TSX, thus providing superior earnings momentum to the U.S. benchmark throughout the recession. This is the main reason why we believe the S&P 500 will continue to outperform the TSX in 2009.

P/E expansion should make a strong comeback when the constant barrage of negative news flow moderates. By applying a 15x forward P/E multiple to our 2010 earnings estimates, we derive 12-18 month targets of 1,125 for the S&P 500 and 10,500 for the S&P/TSX. In the current low interest rate environment, a 15x P/E multiple appears reasonable. Following the September to November rout in financial markets, equity valuations have fallen to generational-lows and forward P/E's now hover in single-digits. P/E compression has been extremely severe in the last six months alongside earnings revisions. Attractive valuations alone will not put an end to the ongoing equity bear market; the outlook for earnings will have to stabilize first. In other words, it's not about the P, it's all about the E. When the macro outlook stabilizes (setting a floor to 2010 EPS forecasts), however, we are confident investors will look back at today's valuations with nostalgia.



*Yield Curve based on U.S. 10-Yr Yield minus 1-Yr Yield (bp)
Source: Scotia Capital, Bloomberg

Glass Half-Full Approach For 2009

A year ago, our belief that the decoupling fantasy camp would abruptly come to an end, and impact economic activity in Europe, Asia, and in Emerging markets, prompted us to adopt a defensive equity strategy (underweight Resource sectors) and caution investors on Emerging markets. As we look forward to throwing away our 2008 calendar, we are more inclined to enter 2009 with an open mind. If a glass half-empty bias paid off in 2008, a glass half-full strategy should become increasingly appropriate in the coming months. As such, we do not expect to stick to our defensive bias all year. Our recommended asset mix is still tilted towards above-average cash weighting, but we plan to reallocate cash into equities when data deterioration moderates and/or we get heightened bottom confirmation. From a sector standpoint, our bias is to stick with the S&P 500 as our index of choice and focus on defensive and early cyclical sectors for now. We continue to prefer Financials, Discretionary, Consumer Staples, and Utilities. Telecom, Industrials and Technology are rated market-weight; Energy and Materials should still be underweight. We are likely to reduce our presence in Staples, Utilities and Gold when the macroeconomic outlook clears up, raising our weighting in Industrials, Technology, and Resources. Bottom line: if all the pro-growth measures kick in by the end of 2009, portfolios should not look as defensive as they do today by the end of next year.

Scotia Strategy Sector Recommendation

Sector	Canada	U.S.
Energy	Under	Under
Materials	Under	Under
Divers. Metals/Mining	*Under*	*Under*
Golds	*Market*	*Market*
Fertilizers	*Market*	*Market*
Industrials	Under	Under
Consumer Discretionary	Over	Market
Consumer Staples	Over	Over
Health Care	Under	Over
Financials	Over	Market
Technology	Market	Market
Telecom	Market	Market
Utilities	Over	Over

Source: Scotia Capital

Economic and Market Outlook - 2009-2010

	2007	2008	2009f	2010f
Economic Performance		------------ *(annual average)* ------------		
Real GDP (% change)				
Canada	2.7	0.7	-1.2	1.9
United States	2.0	1.2	-2.1	1.7
Euro zone	2.6	0.9	-0.9	0.7
Japan	2.0	0.0	-1.0	0.8
China	11.9	9.5	7.0	8.5
Consumer Prices (% change)				
Canada	2.1	2.4	0.9	1.6
United States	2.9	3.9	0.4	1.8
Euro zone	2.1	3.2	1.2	1.4
Japan	0.1	1.5	0.4	0.0
China	4.8	6.2	1.4	1.5
Markets		------------ *(end of period, %)* ------------		
Yield Curve - Canada				
Bank of Canada Overnight Target Rate	4.25	1.50	0.50	1.75
2-Year Canada Bond	3.75	1.25	1.60	2.50
10-Year Canada Bond	3.99	2.90	3.00	3.60
Yield Curve - U.S.				
Fed Funds Target Rate	4.25	0.25	0.25	1.25
2-Year Treasury	3.05	0.50	0.90	1.80
10-Year Treasury	4.02	2.20	2.40	3.00
Foreign Exchange				
Canadian Dollar (C$/US$)	1.00	0.82	0.78	0.90
Yen (US$/¥)	112	88	83	85
Euro (€/US$)	1.46	1.38	1.40	1.50
Sterling (£/US$)	1.98	1.52	1.50	1.70
Equities*				
S&P/TSX*	13834	8462	10500	
EPS*	802	950	650	700
S&P 500*	1468	869	1125	
EPS*	82.67	66.00	60.00	75
		------------ *(average price)* ------------		
WTI Oil (US$/bbl)	72.32	100	55	70
Nymex Natural Gas (US$/mmbtu)	7.12	8.90	6.25	7.00
Copper (US$/lb) *LME Base Metals*	3.23	3.16	1.30	1.30
Aluminium (US$/lb) *LME Base Metals*	1.20	1.17	0.65	0.70
Gold (US$/oz) *London PM Fix*	697	870	850	750

f: Forecast (Scotia Economics, December 17, 2008

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

* Source: Scotia Capital, CPMS, S&P