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AROUND THE WORLD

A risk factor in global growth

The sudden turn to risk aversion prompted by the U.S. housing bust triggered the biggest credit crisis in a decade. The major central banks injected volumes of liquidity into their banking systems to keep them operational. Can overseas economies dodge the bullet of the U.S. housing crisis? The global expansion continues undaunted so far, but the risks have increased as a spillover from a U.S. consumer slowdown becomes more likely.

It is true that the U.S. is no longer the main driver of global growth and that China and India are leading actors. Yet U.S. consumers are still heavyweights in the world economy. The rapid expansion of international trade in recent years has made economies much more interdependent than before, and the U.S. is the world's largest market for other countries' exports, buying almost 20% of them. In other words, a U.S. consumer slowdown will ripple up the chain of production, including its Asian links. China is at particular risk of overcapacity from its exposure to swings in U.S. import demand. The Asian growth powerhouses are not immune to a U.S. recession.

In Europe, consumer confidence has been eroding in step with a marked cooling of the economy. Growth fell in the second quarter to a quarterly rate of just 0.3%. In the current tense climate, many observers think the European Central Bank has just about finished tightening. A question mark also looms over the Japanese recovery, which is still largely export-driven.

In sum, the global economy will continue to be fuelled by Asian strength in 2008, but Asia is not invulnerable to a U.S. downturn. The global expansion is likely to cool to about 4% next year.

UNITED STATES

A downturn is now more likely

Though as yet there is little sign of a spillover to the economy as a whole, the U.S. housing slump and subprime mortgage defaults have knocked the financial markets for a loop. The reality check presented by these developments has shifted the mood of many investors from excessive risk appetite to caution. The result has been a great deal of volatility in financial markets and a sharp rise in the risk premium on many types of corporate securities.

By all appearances, the U.S. housing bust will take months to play out. Though homebuilding has slowed sharply, the glut on the market is still growing. At this writing the ratio of inventory to monthly sales is 9.2 months for existing homes and as much as 11.9 months for the condo segment. One implication is a further decline of home prices, already down 9% in real terms from the peak of late 2005. Meanwhile, the U.S. Federal Reserve has begun to worry publicly about the consequences of the slump for the rest of the economy.

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CAPITAL MARKETS

Central banks to the rescue?

Investors were much encouraged in the first half of 2007 by profits well above expectations, by a wave of mergers and acquisitions and by a prospect of prolonged economic expansion undeterred by the U.S. housing slump. Then in June came a warning shot: the collapse of two hedge funds due to losses in subprime mortgage lending. Investors suddenly began to see the prevailing returns on debt securities as inadequate to the risk, and risk premiums have been widening ever since. In August the credit turmoil spread to North American stock markets. The Dow Jones Industrial Average ended a record bull run on August 16 when it closed more than 10% down from its July 19 peak. It had gone 1662 trading days without such a correction.

Global stock prices rebounded when the Fed cut its discount rate half a point on August 17 and promised to "act as needed" to calm the financial markets. The prompt response of central banks in pumping liquidity into the conventional banking and brokerage system – in greater volume than at any time since 9/11 – was a step in the right direction and helped stabilize the markets at least temporarily. Following in this course, on September 18th, the Fed cut its discount rate a further half a percent, and took the opportunity to reduce the Fed Funds rate by an equal amount.

Is the worst behind us? At this writing we cannot exclude the possibility that financial markets will remain volatile for some time, not least because hedge-fund positions, and therefore hedge-fund leverage, are not public knowledge. Central bank interventions targeted the daily liquidity needs of regulated financial institutions – bankers and brokers – but did not oblige them to help out financial players that had taken on too much credit risk and market risk when the good times were rolling.

Wall Street is hoping the Fed will rescue financial markets with substantial rate cuts. That would create its own problem – a temptation to act recklessly on the assurance that someone else will clean up the mess. If the past is a guide, investors should avoid putting too much faith in the ability of central banks to manage the business cycle, even through rate cuts, especially when a housing bubble is bursting as in the U.S. at present. That lead time of 6 to 18 months for a shift in monetary stance to take full effect on the economy means that the monetary tool is not sophisticated enough to offset a shift in mood from risk appetite to risk aversion.

CANADA

Still robust, but for how long?

The Canadian economy has been doing very well this year. The unemployment rate is close to a record low, household incomes are growing nicely, consumer spending is way up and, in contrast to the U.S., home prices are still rising.

The country's very healthy fundamentals have not prevented a sharp tightening of its financial conditions in recent weeks due to the global crunch in asset-backed money market securities and other forms of liquidity. No one can say for sure how long the bloodletting will last in asset-backed commercial paper, a market that supplies 51% of short-term corporate borrowing.

On the plus side, Canada's terms of trade remain favourable and the absence of home-price deflation on this side of the border makes consumers more resilient. In addition, the health of federal public finances and the tameness of inflation give the central bank and the federal government ample leeway to intervene in support of the economy. Once again this year Ottawa is running a fiscal surplus in excess of budget, even after last year's $5-billion cut in the goods and services tax.

Yet it would be naive to think Canada can sail untouched through a severe U.S. consumer slowdown. About one-third of all Canadian production goes to the United States. The International Monetary Fund (IMF) estimates that a one-percentage-point difference in the U.S. growth rate generally translates into a half-point difference in Canadian growth. We think net exports are likely to weigh on growth more than we previously expected.

The tightening of financial conditions due to the world credit squeeze, combined with lower expectations for the U.S. economy, has tipped the balance of risk in Canada from inflation to economic slowdown. We accordingly think the Bank of Canada is likely to cut its policy rate about half a point in the coming quarters as the economy slows to a pace below its capacity. We now expect real GDP growth of about 2.2% in 2008, down from our previous outlook of 2.8%.

ASSET MIX

A little more prudence is in order

In light of the rather turbulent markets we witnessed over the summer, and given that our near-term outlook suggests that we could be in for more of the same, we have made some adjustments to our model portfolios. In times of uncertainty, cash is king, as the old saying goes. With this in mind, we have decided to modestly decrease our fixed-income and equity weightings in order to add to our cash position. Although fixed-income securities have performed well over the last few months, interest rates are still quite low, dampening our enthusiasm for this asset class somewhat. For this reason, we have trimmed our modest overweight recommendation for fixed income back to neutral across our different models.

With regards to equities, we had already adopted a cautious stance, having reduced total equity exposure to an underweight position some months ago. However, until now, our modest underweight recommendation has been solely focused on the Canadian market. We are now extending the recommendation to be slightly underweight to both U.S. and foreign equities as well. As is the case with what we have taken out of fixed-income, the proceeds of all our equity reductions are going into cash.

In terms of specifics for our Balanced Portfolio profile, we are reducing our fixed-income exposure by 2%, thereby bringing our recommended weighting down to a neutral 50%. Likewise, U.S. and foreign equities are each being cut back by 1% to recommended weightings of 14% and 9% respectively. The 4% taken out of equities and fixed income is directed towards cash, pushing up our recommended weighting for this asset class to 7%. Proportional changes are also made to our Income and Conservative Portfolios which are more focused on capital protection, as well as our Growth and Maximum Growth Portfolios at the other end of the spectrum.

A more prudent stance is also reflected in our sector recommendations. We think defensive sectors like Consumer Staples and Utilities will out-perform in today's environment. Even Consumer Discretionary sub-sectors that are arguably more "essential" in terms of day-to-day living could do well. This would include broadcasting, cable and publishing. On the flip side, we currently recommend reduced exposures to more cyclical areas like Energy and Materials. Within the latter, we make an exception for Golds, as they could very well play their traditional role as a safe-haven refuge.

As always, a well-diversified portfolio within the particular confines of your own personal risk tolerance will go a long way in allowing you to navigate these more troubled waters.

(CONTINUED FROM PAGE 1 "United States")

With good reason, in our view. The uncertainty originating in the housing market is a risk to the economy as a whole. What kind of landing is in store? The experience of recent decades in many different countries shows that the implosion of a housing bubble tends to be followed by a severe economic downturn. A housing bust tends to have twice the effect on the economy as the bursting of a stock market bubble, because it deals a heavier blow to consumer spending, the dominant component of GDP. One major reason for this is the tendency of financial institutions to respond by restricting credit, a response that typically amplifies the downswing. It seems almost inevitable that U.S. consumers will tighten their purse strings in the quarters ahead.

At this writing the financial markets are looking to the central banks to set things right. They anticipate a series of interest-rate cuts to keep the economy expanding. While it is true that the Fed cannot remain inactive and a new phase of U.S. monetary easing is probably imminent, such action is less effective when a bubble is popping. Not only do rate cuts take 6 to 18 months to work through the economy – a long time in a crisis – but their expansionary effect will be mitigated this time around by a higher rate of saving as U.S. households rebuild their nest eggs.

For this reason we will not be surprised if the U.S. economy slows sharply over the remainder of this year and in 2008. The threat is such that we have raised our odds of a U.S. recession to 50%. Our baseline scenario for U.S. growth in 2008 is only 1.6%.

OUR FORECAST

	2005	2006	2007	FORECAST 2008
Gross Domestic Product (%)				
Canada	3.1	2.8	2.5	2.2
U.S.	3.2	3.3	1.8	1.6
Inflation (%)				
Canada	2.2	2.0	2.3	1.7
U.S.	3.4	3.1	2.8	2.0

	Sept. 19, 07	Sept. 2008
Short-term rates (T-Bills, 91-Day) (%)		
Canada	4.11	3.80
U.S.	3.91	3.65
10-year bond yields (%)		
Canada	4.40	4.27
U.S.	4.55	4.14
30-year bond yields (%)		
Canada	4.47	4.37
U.S.	4.84	4.58
Canadian dollar	U.S.$0.99	U.S.$1.00

S&P / TSX Sector Rotation

Overweight	Underweight
Consumer Discretionary	Energy
Consumer Staples	Materials (Except Golds)
Utilities	Financials

MODEL PORTFOLIOS

Income Portfolio

Investor Profile : You want to preserve your capital or establish a source of periodic income to finance ongoing expenses. You do not find the stock market very attractive because of its volatility, but you are not against the idea of investing a small part of your portfolio in stocks, mainly to counteract the effects of inflation. Your tolerance for risk is very low.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 20%	10%	14%	+5
Fixed-income (duration: 6.0 years) [1]	60% to 100%	70%	70%	-3
Canadian equities		10%	8%	–
U.S. equities	0% to 30%	5%	4%	-1
Foreign equities		5%	4%	-1

Conservative Portfolio

Investor Profile : On the whole, you want your portfolio invested in fixed-income securities. Although you can tolerate limited volatility to ensure that your assets will grow, you prefer having a portfolio consisting mainly of fixed-income investments for reasons of stability. Your tolerance for risk is low.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 15%	5%	10%	+5
Fixed-income (duration: 6.0 years) [1]	50% to 80%	60%	60%	-3
Canadian equities		10%	8%	–
U.S. equities	20% to 45%	10%	9%	-1
Foreign equities		10%	9%	-1
Alternative investments [2]	0% to 10%	5%	4%	–

Balanced Portfolio

Investor Profile : You give equal weight to income and capital growth. You can tolerate moderate volatility to ensure the growth of your capital, but you prefer having a portfolio with a significant exposure to fixed-income securities for reasons of stability. Your tolerance for risk is average.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 20%	0%	7%	+4
Fixed-income (duration: 6.0 years) [1]	30% to 65%	50%	50%	-2
Canadian equities		15%	12%	–
U.S. equities	30% to 65%	15%	14%	-1
Foreign equities		10%	9%	-1
Alternative investments [2]	0% to 15%	10%	8%	–

Growth Portfolio

Investor Profile : Your main goal is capital growth. Although you can tolerate greater volatility in order to increase the value of your assets, you are not prepared to invest your entire portfolio in stocks. Your tolerance for risk is high.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 25%	0%	9%	+4
Fixed-income (duration: 6.0 years) [1]	25% to 45%	35%	35%	-2
Canadian equities		20%	16%	–
U.S. equities	40% to 75%	15%	14%	-1
Foreign equities		15%	14%	-1
Alternative investments [2]	0% to 20%	15%	12%	–

Maximum Growth

Investor Profile : You want to maximize the eventual return on your capital by investing all or most of your portfolio in the stock market. In doing so, you accept higher volatility of your investment returns in the hope that these returns will ultimately be higher. Your tolerance for risk is very high.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 30%	0%	12%	+6
Fixed-income (duration: 6.0 years) [1]	0% to 30%	20%	20%	-2
Canadian equities		20%	16%	–
U.S. equities	55% to 100%	20%	18%	-2
Foreign equities		20%	18%	-2
Alternative investments [2]	0% to 25%	20%	16%	–

1) Includes conventional and real return bonds. Benchmark = 75% SC Universe Index, 25% SC RRB Index
2) Includes hedge funds and real estate. Benchmark = 50% Tremont Hedge Fund Index, 50% S&P TSX Cap REIT Index

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