

## In this issue ...

### Page 1

- Around the world: The U.S. no longer the global growth driver
- United States: Continuing expansion, rising headwinds

### Page 2

- Capital Markets: A return of volatility
- Canada: Well-positioned to brave headwinds from the south
- What to expect in 2008

### Page 3

- Asset Mix: Moving forward by taking a step back
- Our Forecast

### Page 4

- Model Portfolios: asset mix, geographic diversification and duration for five individual investor profiles

## AROUND THE WORLD

# The U.S. no longer the global growth driver

The U.S. economy is still the world's largest, but emerging Asia is expanding so rapidly that this year, for the first time on record, China and India combined will make a larger contribution to global growth. The two Asian giants together account for 21% of the world's economy but 45% of its expansion.

Despite China's many efforts to rein in its boom, it has grown faster in 2007 than in 2006 and at last report its economy was more than 11% larger than a year earlier. India's boom, meanwhile, is beginning to react to past tightening by its central bank but is unlikely to slacken much in 2008. With the OECD economies expected to decelerate, emerging Asia will largely dominate world growth next year.

Yet while global expansion has been very robust so far, it faces increasing risks. The G 7 countries seem on the verge of slowdown, with the U.S. an especially large cloud on the horizon. The financial market turmoil that began in August has forced central banks to pump liquidity into money markets to stabilize the supply of short-term credit. The U.S. Federal Reserve has been easing since September. The Bank of England has eased for the

first time in two years, the European Central Bank has ceased its tightening, and in mid-December, these three central banks and two others announced they would work together to restore liquidity to the markets, in their first major joint effort since 9/11.

In Europe, the prospects for 2008 are shaded by a combination of past rate rises, a stronger euro, an expected slowdown in global demand and a rise in the cost of credit due to the liquidity crisis. The ECB will at the same time need to keep an eye on inflation expectations, currently on the rise. The risk of a second round in wages as the labour market tightens further - with inflation running over the 2% target - will require attention from the continental monetary authority if it is to preserve its inflation-fighting credibility.

As for the accumulating risk to the world economy as a whole, leading indicators show increasing signs of weakness, oil is close to \$100 a barrel, financial turbulence has yet to subside fully and the world's largest economy is downshifting. The global economy, coming off its best run in more than 30 years, is likely to grow very respectably but less spectacularly in 2008 - about 4%, or one percentage point less than in 2007.

## UNITED STATES

# Continuing expansion, rising headwinds

The U.S. housing market began its descent to earth in 2007, after several years of euphoria in which some households found themselves trading their real property as if it were highly liquid paper. The number of unoccupied homes for sale is a record 3 million. The median sale price is down almost 10% in nominal terms from its recent peak - the largest drop in almost 50 years.

This slump has so far had few ill effects on the rest of the U.S. economy, as attested by the low unemployment rate. Yet an IMF study of 20 housing bubble in 14 countries since 1970 finds that real estate busts are very hard on consumer spending growth. Given the anti-wealth effect of home-price deflation, combined with the

(CONTINUED ON PAGE 3)

## What to expect in 2008

The shock waves radiating from the collapse of the U.S. housing bubble have spilled a great deal of ink. They are likely to spill more in the months ahead, and market participants are more than ever divided about the future.

At this writing, Wall Street is hoping the Federal Reserve will continue riding to its rescue with a panoply of tools including drastic cuts in interest rates. This would amount to a moral hazard - a temptation to act recklessly on the understanding that someone else will clean up the mess. Moreover, repeated injections of liquidity by central banks, including Fed rate cuts totaling one percentage point to date, have already got the stock indexes mostly back on their feet.

If the past is a guide, investors should avoid overestimating the ability of central banks to bring about a soft landing (especially when a real estate bubble is bursting) or their ability to eliminate the inherent risks of holding financial assets. As Fed chairman Ben Bernanke recently noted, the role of a monetary authority is to maintain the conditions for a non-inflationary expansion, not to limit the losses of participants who have (knowingly or otherwise) taken too many risks.

At this point the main threat to the U.S. economy is that the housing bust will spread to consumer spending and other sectors through a tightening of the conditions on which households and businesses can borrow. Meanwhile, in spite of the U.S. bond market and an increasing number of economists seeing significant odds of recession south of the border, Wall Street analysts have remained unshakably optimistic. Large writedowns and major earnings disappointments have made no dent in their expectations for 2008 profits. Since earnings stumbled in the second half of 2007, that means they are now expecting S&P 500 earnings growth of almost 15% next year! In Canada, despite the exposure of our economy to U.S. demand, the earnings growth expectation is on the order of 12%. It is true, however, that the earnings of resource producers (almost 40% of Canadian market capitalization) depend more on developments in China and other emerging economies than on the path of the U.S. economy.

## A return of volatility

For financial markets, the year has been rich in emotion and plot turns. It began with an extension of the rally under way since early in the decade, with corporate earnings continuing to grow at double-digit rates. Abundant liquidity and cheap capital led to an unprecedented wave of mergers and acquisitions in Canada and abroad.

Then during the summer, a crisis in U.S. mortgage credit scrambled the cards. Risk premiums rose sharply as financial institutions, doubting the quality of their competitors' assets, became reluctant to lend to each other. Home-price deflation forced a series of write-down announcements by financial institutions. One consequence was a return in force of volatility, largely absent since 2003. Another was the first S&P 500 correction (10% or more) in 1,154 days. The U.S. stock market benchmark has seen 43 such corrections since the Second World War, and about a quarter of them have deepened to a decline of 20% or more.

Investors have been reassured to some extent by the repeated interventions of the U.S. Federal Reserve. At this writing, after the three Fed rate cuts of September, October and December, U.S. stock indexes have regained much of their lost ground. The story is similar in Canada, whose stock market is headed for a fifth straight year of positive returns in 2007, the first such run in almost 20 years. Moreover, the rise of the loonie means that the domestic market has been providing Canadian investors with better returns than the U.S. market. Over the last five years, for instance, the return of the Canadian market has averaged 17.9% annually. Over the same period, the return of the S&P 500 has averaged 11.8% annually in U.S. dollars but only 2.5% in Canadian dollar terms. For a Canadian investor, loonie appreciation has almost wiped out the very respectable U.S.-dollar returns of the U.S. market over the last 12 months, three years, five years and ten years.

### CANADA

## Well-positioned to brave headwinds from the south

Canada's domestic demand has been very strong, the mainstay of its economy. The country has gained no fewer than 226,000 new jobs in the last six months, leaving the unemployment rate at a 30-year low and full-time employment at an all-time high. The Canadian economy is now operating slightly above capacity.

Over the next 12 to 18 months Canada is likely to ride out a U.S. slowdown more successfully than in previous cycles. In contrast to the U.S., its housing market is doing well. The nationwide average home price is still rising 10% or more annually, buoying consumption. Also, Canada remains a net exporter of resource commodities, whose prices are at historic highs. Business is especially good in the western provinces, which are likely to maintain their lead over the two

central provinces in the coming year. Public finances are in very good shape, leaving Ottawa with considerable fiscal room to cushion the shock of a U.S. downturn.

Of course, Canada is still highly exposed to the U.S. business cycle. Canadian manufacturers will once again face stiff challenges in the year ahead, since the loonie will continue to trade in the neighbourhood of par and U.S. consumers will be running out of gas. Canada is likely to remain among the G 7 frontrunners, but its economy will probably decelerate in 2008. We anticipate growth of about 2.0%, accompanied by some monetary easing – about half a point – as the Bank of Canada uses option room created by the disinflationary effect of currency appreciation.

# Moving forward by taking a step back

With many things in life, it is often better to take one step back in order to fully understand the entire picture. This can be true for appreciating a work of art as well as attempting to solve a complex engineering problem. This is where the expression "seeing the forest beyond the trees" comes from, and its common sense implication applies to portfolio management just as well. If you are the type of investor that closely follows your portfolio, thoroughly reads the financial press, or religiously follows the TV business news, the last few months could easily have caused an upset stomach or worse. Often, the best prescription for feeling better is taking a large step back.

Yes it is true, as we described in our economic outlook, that markets have been volatile. It is also true that a 1% daily market decline in the stock market will almost certainly make the front page of the financial section, if not the entire newspaper. The corresponding 1% rebound will almost certainly be buried in a small back-page article. The editors know that bad news sells, and if you have been following the headlines too closely, you may have missed the fact that both the Canadian stock and bond markets are in positive territory this year. Now we will admit that overall portfolio

returns are currently very modest, as U.S. and foreign market gains have been completely erased by the strong Canadian dollar. However, even on this point, things can change quickly. A month ago, the Canadian dollar was touching \$1.10 against the U.S. dollar, and now we are back close to par.

The lesson we would like to impart is that investor anxiety can be controlled for the large part by focusing on the more important matters like long-term portfolio asset allocation. In the "benchmark" column of our various model portfolios, you see the strategic (i.e. long-term) allocations we believe are appropriate for our different models based on individual tolerances of risk. In the "recommended weighting" column, you can also see our current tactical (i.e. shorter-term) calls. Here you will notice that despite the market volatility, we have not changed any of our recommendations from the previous quarter. Three months ago we raised the level of cash equivalents in all our models. Currently, we are neutral in our fixed-income allocation and slightly underweight the equity allocations, including alternative investments. This means that we have extra cash equivalents in all our models, which could still come in handy if volatility

continues to be high as we expect.

With regards to specific strategies within the asset classes, we are somewhat split when it comes to the financial services sector. On the one hand, we still think it is too early to start buying financial services stocks aggressively, given the potential for further credit market disruptions. We are therefore recommending an underweight position to the sector. On the other hand, we think the risk premiums are becoming attractive with regards to certain financial sector bonds, for example short-term bank debentures. Here, the 1% - 1.25% spread we can pick up by buying Canadian banks versus federal bonds appears reasonable when applied in moderation. We had also previously mentioned our equity preference for larger companies that are financially sound with good dividend histories. We would start our hunt in the consumer sectors, both consumer staples and consumer discretionary.

## OUR FORECAST

	2005	2006	FORECAST	
			2007	2008
<b>Gross Domestic Product (%)</b>				
Canada	3.1	2.8	2.5	2.0
U.S.	3.1	2.9	2.1	1.1
<b>Inflation (%)</b>				
Canada	2.2	2.0	2.2	1.0
U.S.	3.4	3.1	2.7	1.9
		<b>Dec. 18, 07</b>	<b>Dec. 2008</b>	
<b>Short-term rates (T-Bills, 91-Day) (%)</b>				
Canada	3.84		3.55	
U.S.	2.99		2.92	
<b>10-year bond yields (%)</b>				
Canada	4.01		3.91	
U.S.	4.10		3.96	
<b>30-year bond yields (%)</b>				
Canada	4.13		4.19	
U.S.	4.53		4.49	
Canadian dollar	U.S.\$1.00		U.S.\$1.03	
<b>S&amp;P / TSX Sector Rotation</b>				
<b>Overweight</b>		<b>Underweight</b>		
Consumer Discretionary		Energy		
Consumer Staples		Materials (Except Golds)		
Utilities		Financials		

(CONTINUED FROM PAGE 1 "United States")

bite taken out of spending power by surging food and energy prices, we cannot exclude a very real possibility of contraction in U.S. consumption over the coming quarters. Former Fed chairman Alan Greenspan recently described the odds of recession as "clearly rising" with the liquidity crisis (now a credit crisis) rampant since August. Despite a cumulative one-percentage-point cut in the Fed's key policy rate this fall, households are suddenly faced with tightening of credit standards by lenders, who have lost their eagerness to grant loans on the conditions they offered before the securitization trade dried up. This trade, which transferred credit risk from the original lenders to holders of mort-

gage-backed securities, had been in increasing vogue since 2002 as a risk management tool. The housing bust and its effect on delinquency rates has torpedoed the interest of institutional clients in such instruments.

There is nevertheless a chance - we put it at about 50% - that the U.S. will dodge the bullet. It is likely to gain lift from strong exports, government spending (especially on infrastructure) and business investment. In the circumstances, we see the most probable U.S. scenario as two years of weak expansion. For 2008 we anticipate real GDP growth of 1.1%. That would be the softest in the G 7, a first for the U.S. since the recession of 2001.

## 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%	–
Fixed-income (duration: 6.0 years) <sup>1</sup>	60% to 100%	70%	70%	–
Canadian equities	0% to 30%	10%	8%	–
U.S. equities		5%	4%	–
Foreign equities		5%	4%	–

### 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.

Cash equivalents	0% to 15%	5%	10%	–
Fixed-income (duration: 6.0 years) <sup>1</sup>	50% to 80%	60%	60%	–
Canadian equities	20% to 45%	10%	8%	–
U.S. equities		10%	9%	–
Foreign equities		10%	9%	–
Alternative investments <sup>2</sup>	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.

Cash equivalents	0% to 20%	0%	7%	–
Fixed-income (duration: 6.0 years) <sup>1</sup>	30% to 65%	50%	50%	–
Canadian equities	30% to 65%	15%	12%	–
U.S. equities		15%	14%	–
Foreign equities		10%	9%	–
Alternative investments <sup>2</sup>	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.

Cash equivalents	0% to 25%	0%	9%	–
Fixed-income (duration: 6.0 years) <sup>1</sup>	25% to 45%	35%	35%	–
Canadian equities	40% to 75%	20%	16%	–
U.S. equities		15%	14%	–
Foreign equities		15%	14%	–
Alternative investments <sup>2</sup>	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.

Cash equivalents	0% to 30%	0%	12%	–
Fixed-income (duration: 6.0 years) <sup>1</sup>	0% to 30%	20%	20%	–
Canadian equities	55% to 100%	20%	16%	–
U.S. equities		20%	18%	–
Foreign equities		20%	18%	–
Alternative investments <sup>2</sup>	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