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AROUND THE WORLD**The first simultaneous global slowdown, in seven years**

World economic growth is losing support from more and more countries. The three largest economies of the euro zone—Germany, France and Italy—posted contractions in the second quarter. Scarcely better is the news from the U.K., where increasingly severe home-price deflation has observers fearing the worst for the coming quarters. Japan has also joined the club of shrinking economies. In short, the richest countries, accounting for about 55% of world GDP, are slowing in sync for the first time in almost a decade. The weakness is no longer confined to the U.S. and spillover effects from the advanced economies to the rest of the world are beginning to appear. As world trade volume declines sharply, no country seems to have real shelter from this phase of global slowdown.

This also includes emerging Asia. In 2001, the year China joined the World Trade Organization, it exported only 20% of its GDP. Today the proportion is 40%. With the doubling of its exposure to the rest of the world, it is hard to see how China can decouple from the simultaneous slowing of advanced economies. The new giant now accounts for almost a quarter of

world manufacturing output and exports 80% of this output. We see Chinese growth decelerating to 7% next year. Many other emerging economies have also staked their development on manufacturing for export, and in 2009, will be especially vulnerable to global economic cooling.

With no player immune to the effects of global slowdown, we expect world growth to slip next year to the neighbourhood of 3%, the weakest since 2002.

The manifest worldwide deceleration of activity has pulled the magic carpet out from under commodity prices—good news for consumers of resources, bad news for those who invest in them. The price of crude is now down more than 35% from its July peak and the International Energy Agency projects a 1.2% contraction in demand from OECD countries next year. Even Chinese consumption could decelerate, since 25% of this consumption is for industrial use. As a result, the price of oil is falling faster than expected to our target range of US\$75-\$80 a barrel.

UNITED STATES**A serious financial crisis that is unlikely to become an economic crisis**

These are extraordinary times for the U.S. economy. As these lines are written—about 10 quarters after the housing bubble sprung its first leaks—the Treasury Department has taken control of insurance giant AIG and of the government-sponsored mortgage-finance companies Fannie Mae and Freddie Mac. This salvage operation could end up costing U.S. taxpayers, but the Treasury and the Federal Reserve judged that the failure of any of the three entities could have even worse consequences for the economy. It should be noted that, contrary to perception, the conservatorship formula in no way bails out the shareholders of

these companies. Their equity holders lose virtually everything and their managements now report to the government. Moreover, the Lehman Brothers story, in which Washington chose to stand aside as a 150-year-old investment bank went under, made it clear that Wall Street cannot automatically count on public powers to make good the consequences of poor judgement. Since there are more than 8,500 financial institutions in the U.S., 90% of them with assets of less than \$1 billion, the current liquidity crisis can be expected to trigger a wave of industry consolidation. With time, the purge

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Much of the bad news now priced in?

If the economic backdrop described above is hardly cheerful, our forecast for capital markets behaviour going forward is considerably more upbeat, despite the fears aroused by the disappearance of large Wall Street actors. It is important to remember that, in contrast to the Canadian system where most large brokerage firms are owned by commercial banks, the assets of the large U.S. investment banks have grown rapidly over the last seven years without a corresponding increase in their capital base.

The marked widening of risk premiums on corporate bonds and the significant decline of the world's leading equity markets (including, finally, our S&P/TSX) lead us to conclude that much of the actual and potential bad news has now been priced in. It should be kept in mind in this regard that volatility and downside risk, which together define risk, are two different concepts. At

this point, equity investors should distinguish between volatility, which will continue for a while, and downside risk, which has greatly decreased since last summer with the decline of stock indices. Bear markets (declines of 20% or more from peak) are not that frequent—by our count the S&P 500 has been through 11 in the last 50 years. The current one has created a good opportunity for long-term investors to add quality securities to their portfolios at bargain-basement prices.

Consider recent developments favouring a gradual return of investor confidence. First, U.S. 30-year mortgage rates have fallen almost half a point since the government takeover of Fannie Mae and Freddie Mac—a plus for faster stabilization of the housing market. Second, the recent sharp drop of oil prices will give U.S. consumers respite and will probably prevent the recession from lasting past next spring. Third,

the model of action adopted by the Federal Reserve and the U.S. government seems increasingly clear. In cases where a financial company is indeed "too big to fail"—where its distress is perceived as a risk to the financial system as a whole—the Fed will intervene. The company will be taken over, it will continue in business and its assets will be liquidated as and when market conditions permit. In other cases, like that of Lehman Brothers, the firm will be left to its own devices and will go under if it finds no competitor or commercial bank willing to buy it. This line of conduct will prevent a recession of 9 or 12 months from becoming a depression lasting 5 or 10 years.

If a depression is not in the cards and the recession lasts only three or four quarters, what is the right investment strategy for today's conditions? Here it is important

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CANADA

Slowed, but well-positioned to ride out heavy weather

The Canadian economy is feeling an increasing drag from the U.S. slowdown. Growth has stagnated since the beginning of the year. With U.S. *demand* in decline, exports fell in Q2 for the fourth straight quarter. Not all is gloom, however. Though manufacturing has shed 39,000 jobs since January, the labour market as a whole has gained 87,000 jobs. The Canadian unemployment rate, adjusted for comparability, is a full percentage point lower than that of the U.S.—the widest spread in Canada's favour since 1975. With the economy slackening, Canadian unemployment can be expected to rise somewhat but its rate is unlikely to exceed that of other G 7 countries.

Since the relative strength of the Canadian economy is reflected in rising real disposable income (in contrast to the U.S.), it is hardly surprising that

consumer spending has kept domestic demand growing at 2% annually. This trend is likely to continue because corporate profits, also on the rise, suggest that massive job losses are unlikely on this side of the border. Canadians also continue to enjoy a housing wealth effect with no imminent threat of home-price deflation, since the housing market is on the whole in equilibrium. Domestic demand is likely to continue growing over the coming quarters, especially as the decline of energy prices adds lift to household purchasing power.

Less favourable are the prospects for the Canadian dollar, which faces strong cyclical headwinds. After trading in a narrow range close to par since the beginning of the year, the loonie has dropped to the neighbourhood of 93 or 94 cents US, the lowest in more than 12 months. Since

cyclical currencies always move with commodity prices when a clear trend emerges, we see the loonie falling to a little below 90 cents in the first half of next year.

As for monetary policy, the Bank of Canada has been obliged to cut its policy rate a total of one and a half points since last fall, to 3%, because of the degree to which export weakness has offset the strength of domestic demand. Further easing could be in store if the decline of commodity prices begins to weigh heavily on Western Canadian growth. That eventuality could bring a fiscal as well as a monetary response, since the federal government still has some budgetary option room.

In sum, we expect Canadian real growth of about 1% in 2008. A slow U.S. recovery is likely to bring a slight improvement for 2009, to about 1.8%.

Fighting volatility with a plan

The last few weeks have seen some unprecedented levels of volatility. However, as we mentioned earlier, volatility is not the same thing as downside risk. As we have also seen of late, the moves to the upside can be just as violent as the moves to the bottom. The best way we know on how to keep a level head as an investor is take a step back from the daily noise and ensure that long term investment plans are being followed. Despite the recent frenzied markets, we are not changing our recommended asset mix for the time being. This does not mean that you should not check your own individual portfolio. Chances are that market moves may have altered your personal asset mix

and a rebalancing may be required. Now is a perfect time to ensure that you continue to follow your long term plan, perhaps guided by one of our model portfolios.

Following our move last quarter, we are now neutral U.S. equities across all of our models. This means that we are relatively more positive on U.S. stocks as compared to either Canadian or foreign stocks, where we recommend marginal underweight positions in both cases. This may seem counter-intuitive given that all the negative headlines appear to be emanating from south of the border. Remember, however, that markets are forward looking. In many cases, the U.S. is leading the race to find solutions, just as other

regions are only beginning to realize the extent of their own problems. We still believe that as we enter a period of more moderate growth in the global economy, markets with a more cyclical natural resource orientation like Canada's will tend to lag.

On the fixed-income front, we remain neutral across our various models. Here we are balancing their positive attributes as a haven in these times of uncertainty with the fact that overall yields are still very low on a historical basis. The net result of our equity and fixed-income call is that our models are still overweight cash as compared to their benchmark levels. As of this writing, the U.S. Congress is debating whether to pass a major bail-out plan to help finalize a resolution to the ongoing financial turmoil. If enacted, such a plan could provide a major boost to the confidence of the markets, and might entice us to revisit our current recommendations. As always, your Investment Advisor is your best source to provide you with our latest thinking.

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to remember that equity prices tend to rebound before the economy does—typically about two-thirds of the way through a recession. And the rebound is typically

very steep. In the last seven recessions, the S&P 500 has gained an average 17.5% within three months of the market bottom and 28.4% within six months.

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of 2008 may well come to be seen as a historic turning point leading ultimately to a more stable financial system.

As for the state of the real economy, the time has come to categorize it as in recession. The U.S. unemployment rate is now up 1.5 percentage points from its cyclical low. Each of the seven rises of that magnitude in the last 50 years has been associated with recession. Though the contraction will be appreciable, given continuing excesses in housing inventories and the need of U.S. households to rebuild savings, we see no justification for brandishing the spectre of a depression with its implications of 20% unemployment.

Easing by the Federal Reserve, a policy transmission belt that was to a large extent severed by the financial crisis, will now have more effect on the real economy as mortgage risk premiums abate. In the period since Fannie Mae and Freddie Mac went into conservatorship, mortgage rates have fallen for the first time since the beginning of the crisis. Also, the fiscal stimulus deployed since April, together

with ongoing oil price relief, can be expected to finally boost household purchasing power, an essential condition for lasting economic recovery.

Declining imports—a normal effect of recession—have been rapidly narrowing the U.S. trade deficit. The currency has been appreciating as a result, with additional help from the attractiveness of certain U.S. financial assets as havens from the current global slowdown. The rise of the greenback and the slide of energy prices are likely to keep the Federal Reserve's policy rate at 2% in the quarters ahead, although the Fed has yet to be fully persuaded that inflation is no longer much of a threat. As job losses dampen inflationary pressures in the labour market, the Fed will have the room it needs to hold off tightening, thus giving the economy a chance to recover.

In short, the U.S. economy has probably not yet bottomed out, but encouraging recent developments in the mortgage market are likely to put it on track for recovery late next year. Four-quarter U.S. growth is likely to accelerate to about 2.5% toward the end of 2009.

OUR FORECAST

	2006	2007	2008	FORECAST 2009
Gross Domestic Product (%)				
Canada	3.1	2.7	0.7	1.8
U.S.	2.8	2.0	1.5	1.5
Inflation (%)				
Canada	2.0	2.2	2.5	1.5
U.S.	3.2	2.9	4.3	2.1
Sept. 22, 08 Sept. 09				
Short-term rates (T-Bills, 91-Day) (%)				
Canada	2.19		3.08	
U.S.	0.92		2.55	
10-year bond yields (%)				
Canada	3.71		4.27	
U.S.	3.88		4.50	
30-year bond yields (%)				
Canada	4.14		4.70	
U.S.	4.45		5.10	
Canadian dollar	U.S.\$0.96		U.S.\$0.89	
S&P / TSX Sector Rotation				
Overweight			Underweight	
Financials			Energy	
Consumer Discretionary			Materials	

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: 5.5 years) ¹	60% to 100%	70%	70%	—
	Canadian equities	0% to 30%	10%	8%	—
	U.S. equities		5%	5%	—
	Foreign equities		5%	3%	—

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%	—
	Fixed-income (duration: 5.5 years) ¹	50% to 80%	60%	60%	—
	Canadian equities	20% to 45%	10%	8%	—
	U.S. equities		10%	10%	—
	Foreign equities		10%	8%	—
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%	—
	Fixed-income (duration: 5.5 years) ¹	30% to 65%	50%	50%	—
	Canadian equities	30% to 65%	15%	12%	—
	U.S. equities		15%	15%	—
	Foreign equities		10%	8%	—
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%	—
	Fixed-income (duration: 5.5 years) ¹	25% to 45%	35%	35%	—
	Canadian equities	40% to 75%	20%	16%	—
	U.S. equities		15%	15%	—
	Foreign equities		15%	13%	—
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%	11%	—
	Fixed-income (duration: 5.5 years) ¹	0% to 30%	20%	20%	—
	Canadian equities	55% to 100%	20%	16%	—
	U.S. equities		20%	20%	—
	Foreign equities		20%	17%	—
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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