

Finding Direction in Uncharted Territory

Gareth Watson, CFA

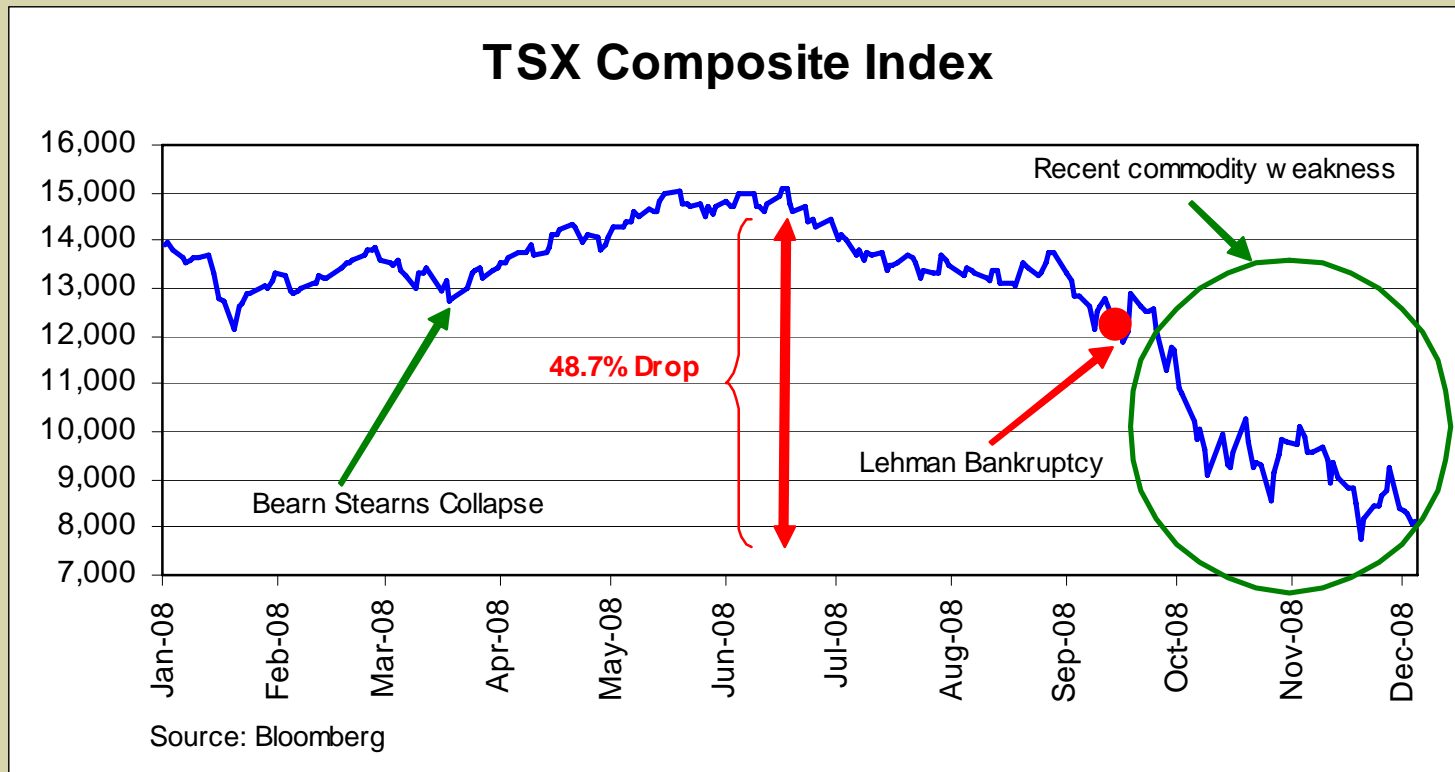
Director, Portfolio Advisory Group

ScotiaMcLeod

December 2008



2008 – Quick Review

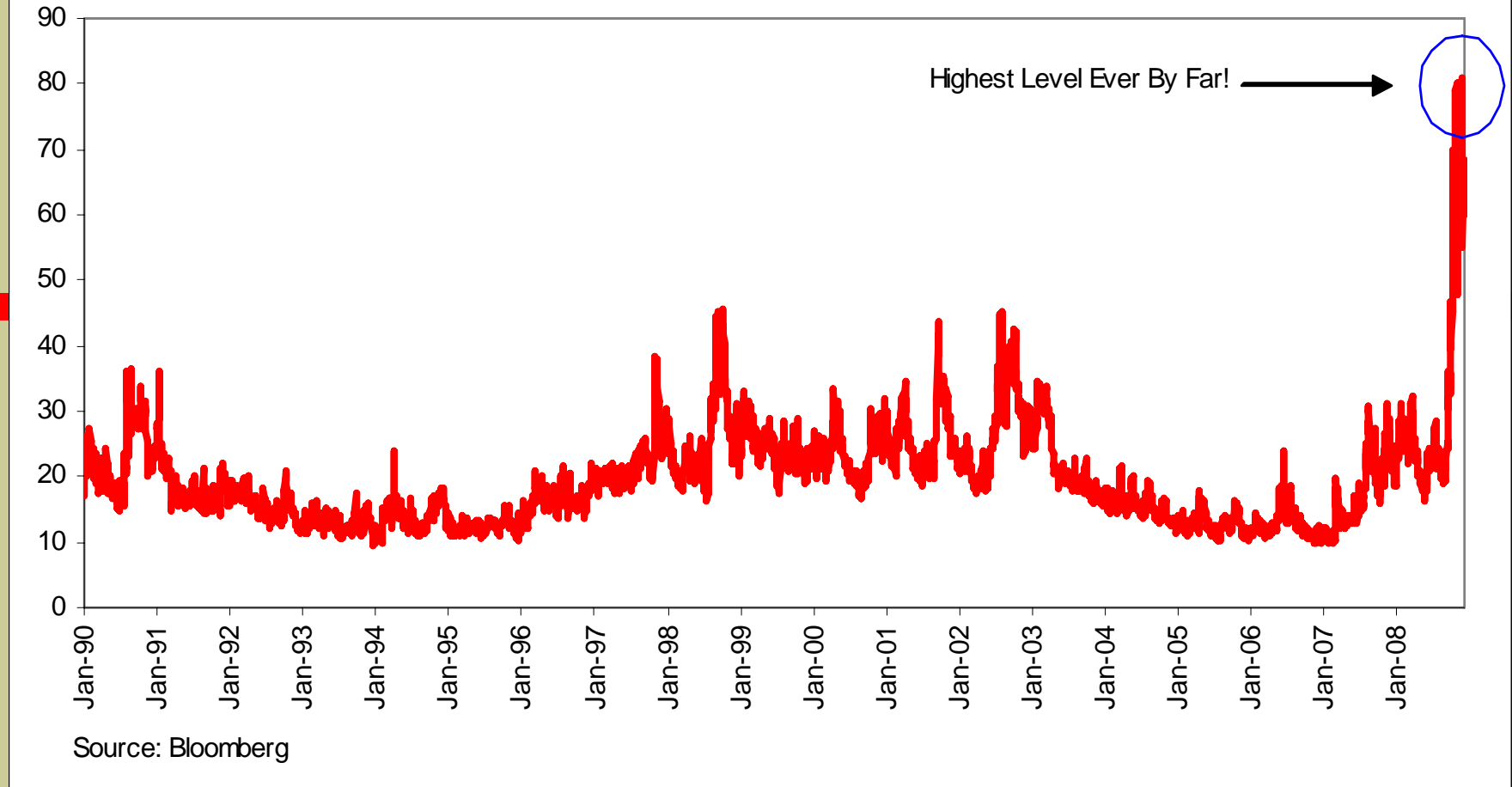


An underestimated credit problem eventually exploded resulting in a deep economic crisis.

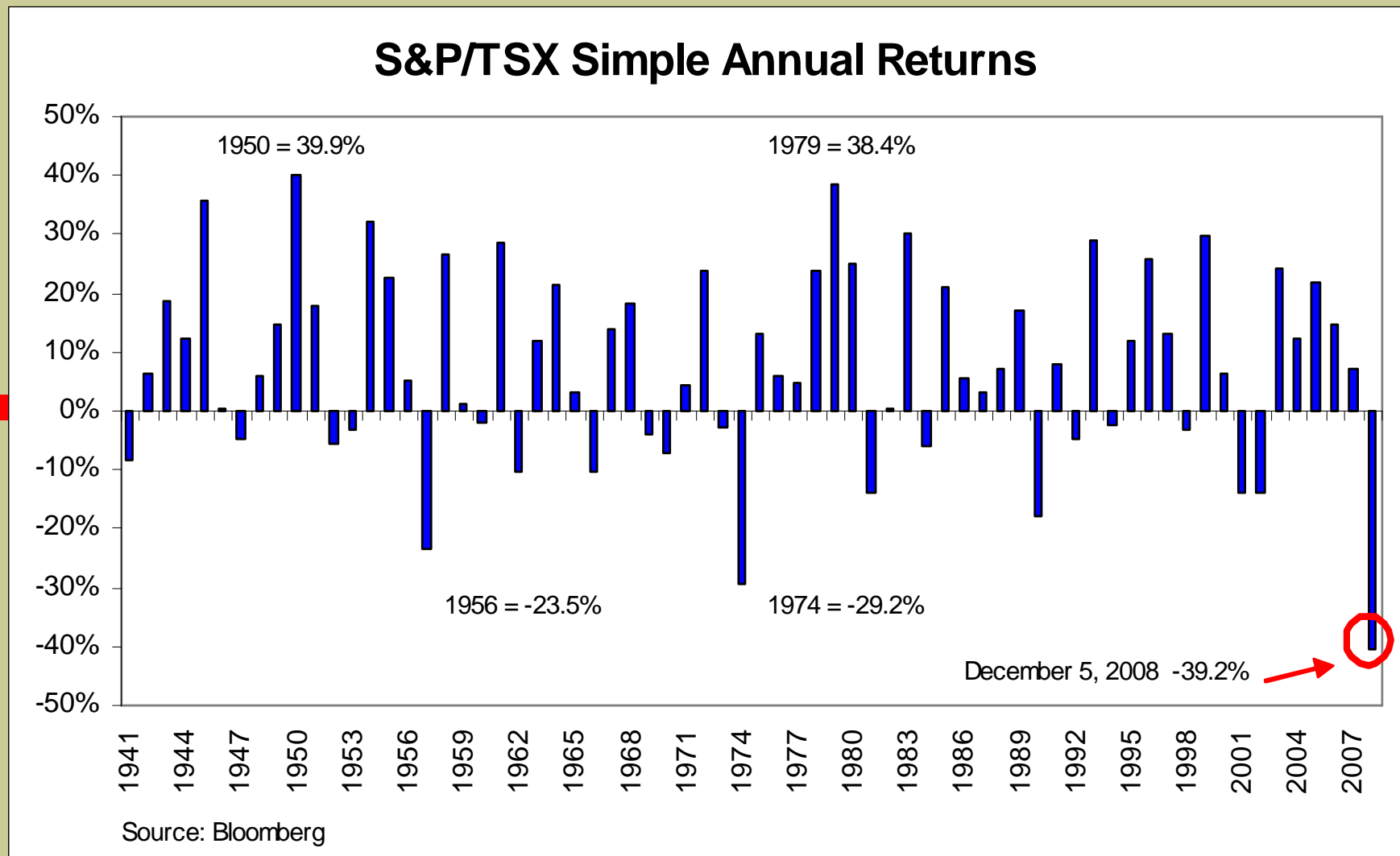
- The failure of Lehman Brothers had many consequences
- When credit markets dried up, economic concerns multiplied and commodity prices fell rapidly
- The volatility (magnitude and speed of decline) is like nothing we've seen in recent memory

Volatility Like We've Never Seen Before

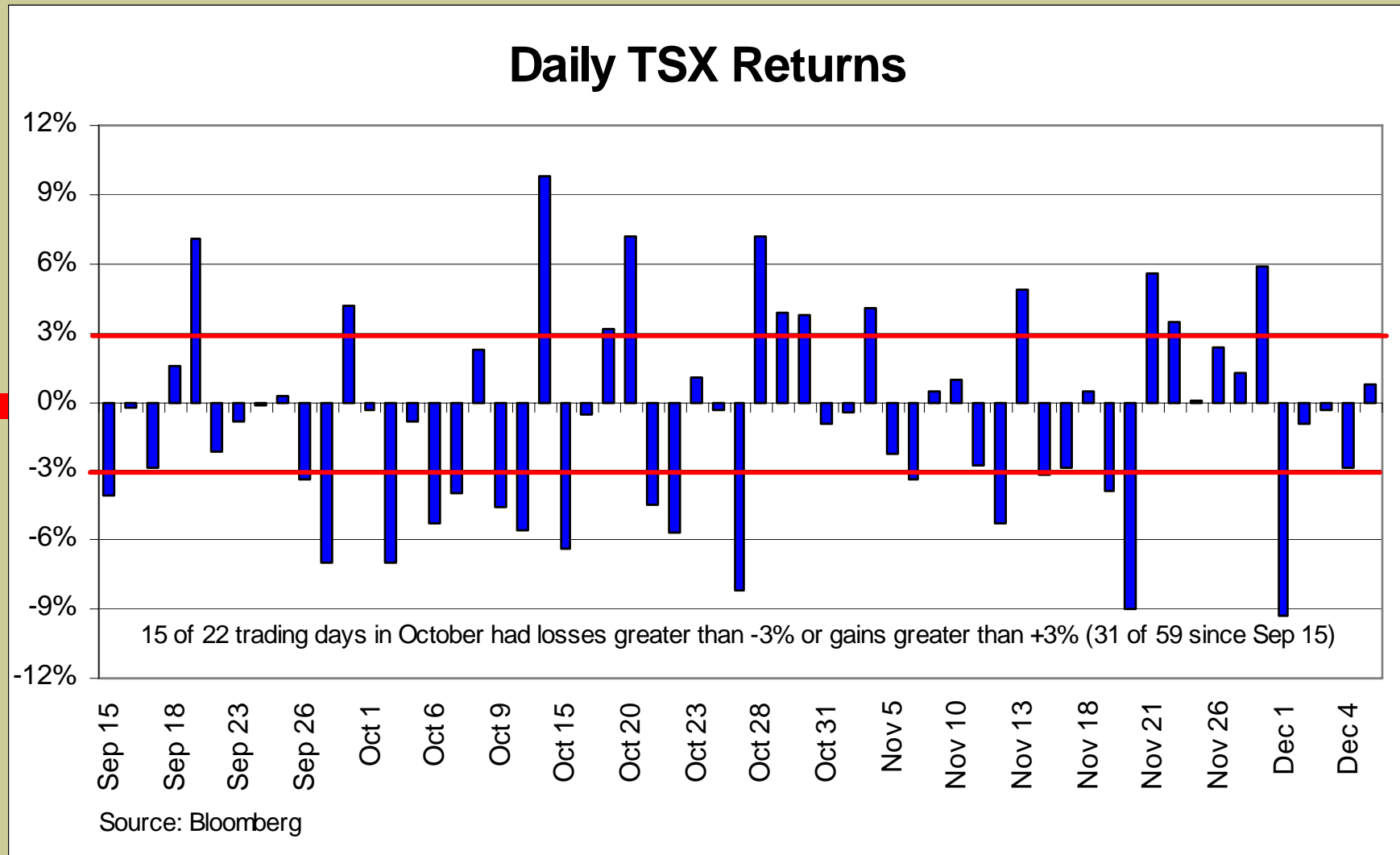
CBOE SPX Volatility Index



2008 – Worst Performance In Decades



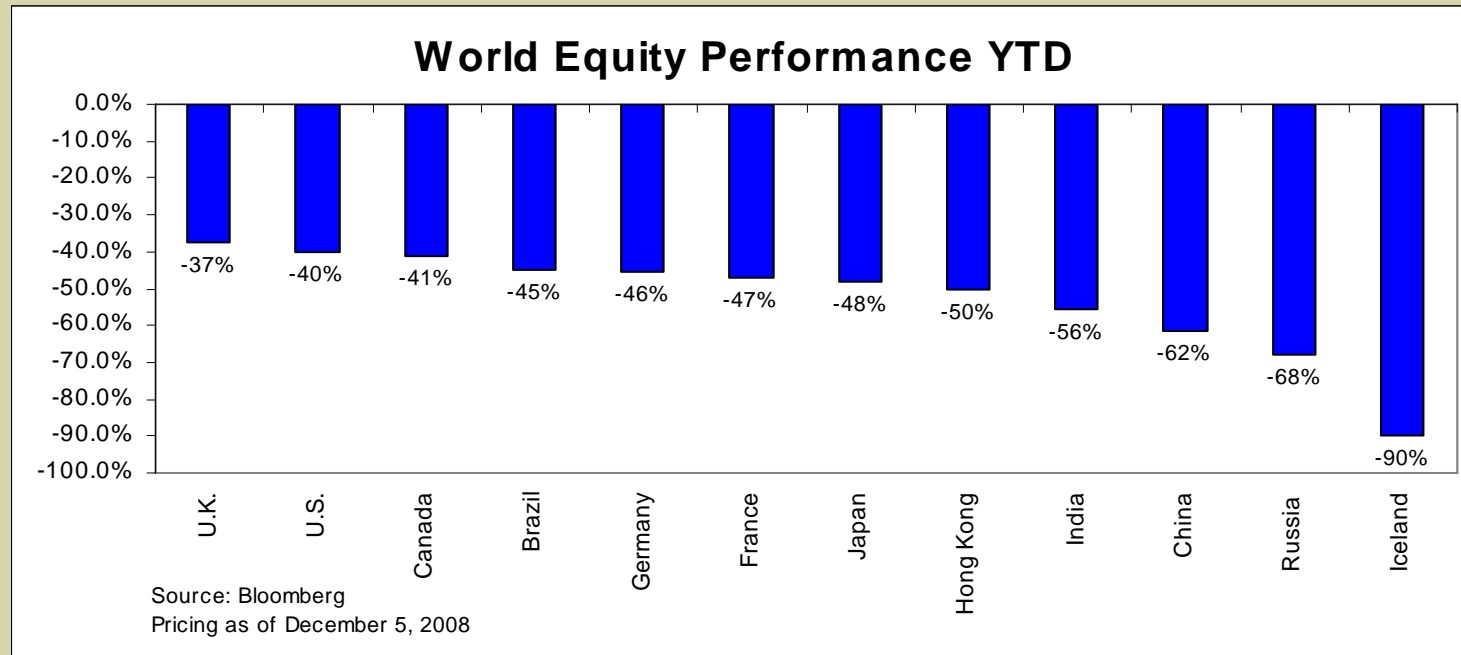
2008 – Daily Returns Have Been Staggering



It's Been A Difficult Year for Stocks

Nowhere to Hide for the TSX, and the rest of the world for that matter

- Approximately 26 TSX stocks out of 270 have posted gains so far this year
- Approximately 16 out of 252 TSX stocks have posted gains since September 15
- Believe it or not, on a relative basis, Canada is outperforming its peers
- Only 8 of the S&P 500 stocks in the U.S. are higher since September 15.



So What Happened?

The Credit Crisis

- A lack of transparency hid a credit problem which turned out to be much larger than many expected
- Consequences from the domino effect of financial failure (i.e. Lehman)

From Economic Concern to Panic

- A frozen credit market dried up liquidity and access to capital, thus increasing the rate and magnitude of the economic slowdown
- Investors now expecting a deep recession and avoiding cyclical stocks at all costs (i.e. energy, materials, industrials, consumer discretionary)

Forced Selling

- Even professional investors “got it wrong” as hedge funds and mutual fund companies have been forced to sell stocks to meet redemption requests or have shut down all together. Individual investors have faced margin calls. These two effects combined have increased volatility and the magnitude of the declines seen thus far.

What Has Been Done to Solve the Problem?

Governments

- Capital injections/equity investments in financial institutions
- Backstopping or guaranteeing certain debt issues
- Guaranteeing deposits

Central Banks

- Injecting liquidity into the financial system
- Cutting interest rates

	January		December
Bank of Canada	4.25%	↓	2.25%
U.S. Federal Reserve	4.25%	↓	1.00%
Bank of England	5.50%	↓	2.00%
European Central Bank	4.00%	↓	2.75%
Central Bank of China	7.47%	↓	5.58%
Bank of Japan	0.50%	↓	0.30%

How Can We Turn Things Around?

1. Return Stability and Fluidity to the Credit Crisis

- While credit markets have improved since mid-October, they are no where near the level of stability we need to see for banks to feel more comfortable in lending to each other, to corporations and to individuals like you and me

2. Stabilize the U.S. Housing Market

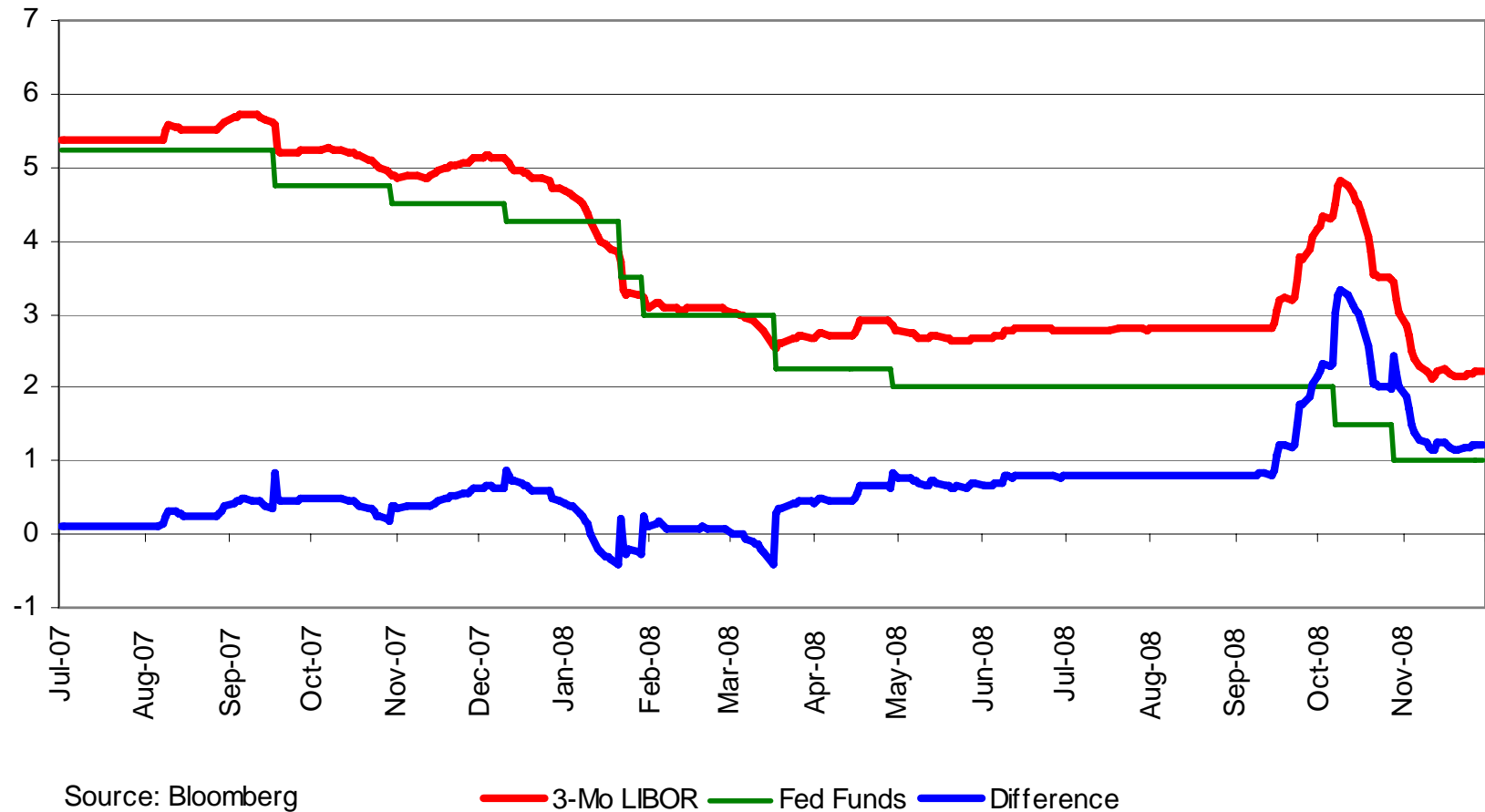
- U.S. housing prices continue to fall, foreclosures continue to rise and inventories continue to increase. This has to stop to prevent further wealth destruction for the U.S. consumer.

3. Turn the Economy Around

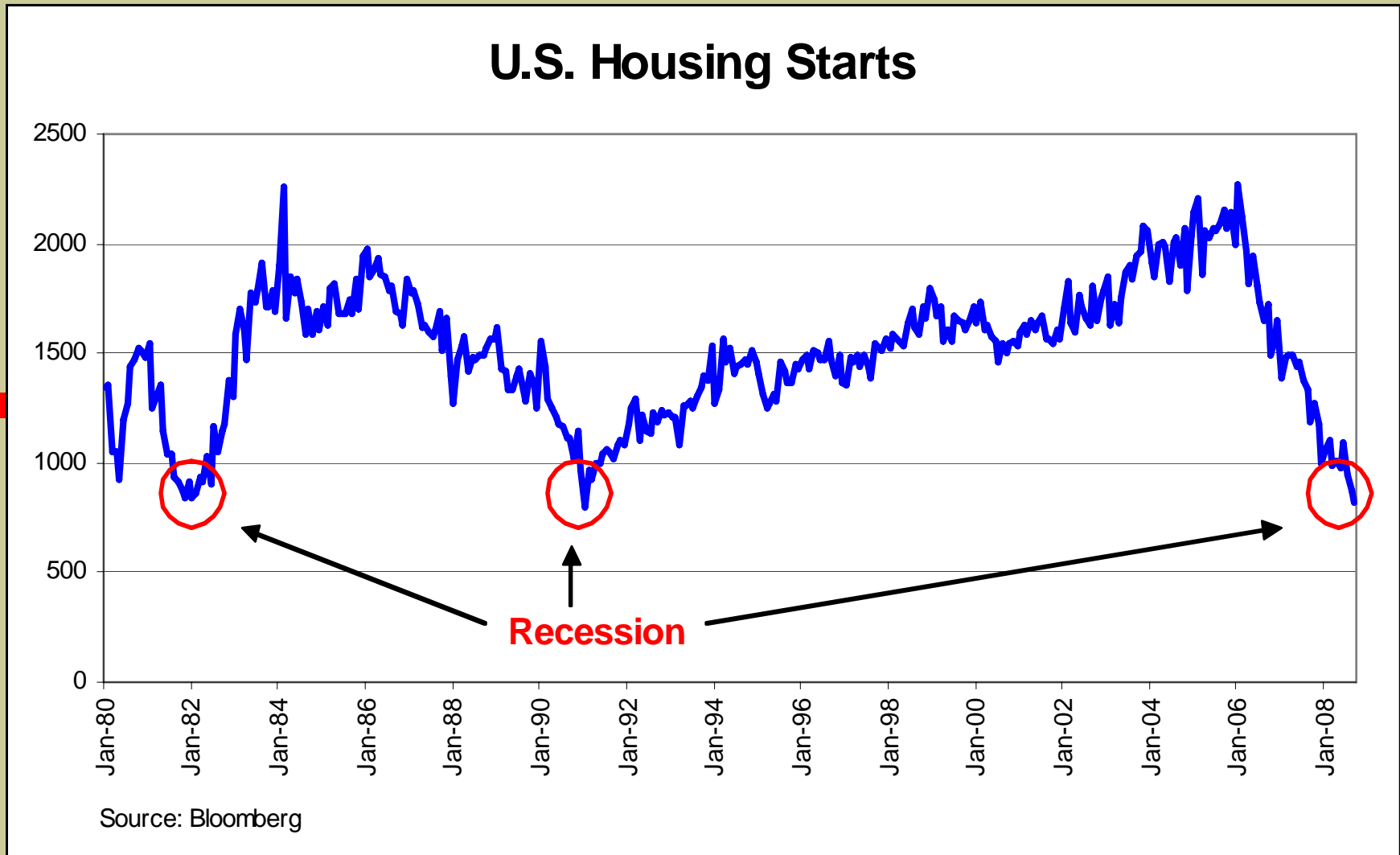
- If we can get credit markets back on track and stability in the U.S. Housing market then we can try and create the environment required to get the U.S. economy back on track. If the U.S. starts to move in the right direction then the rest of the world could follow. The problem is that it will take some time to fix the credit markets and we likely won't see some stability in the U.S. housing market until mid 2009.

Credit Markets – Not Back to Normal Yet

Measuring the U.S. Credit Markets

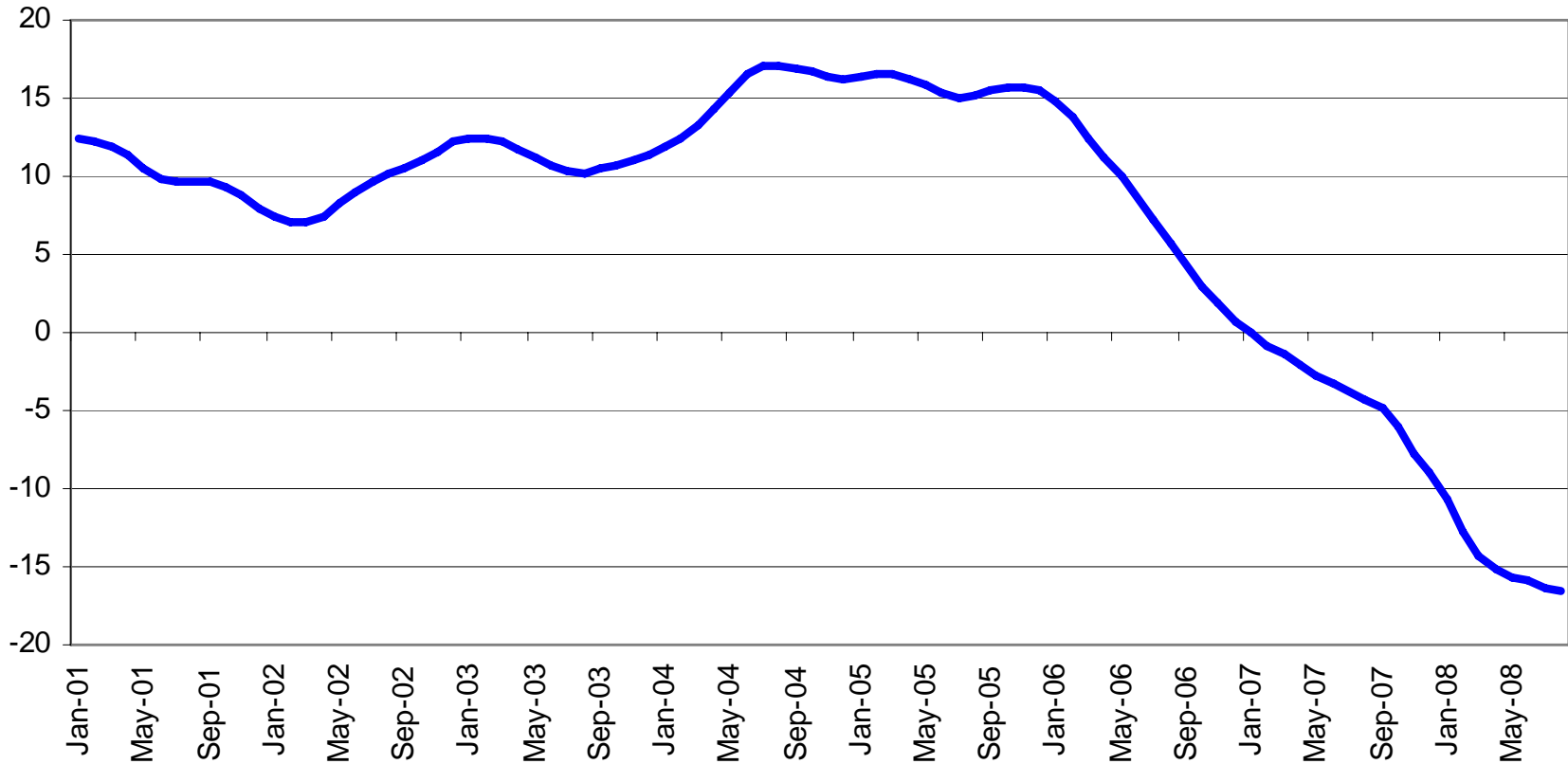


Housing Starts < 1M = Recession?



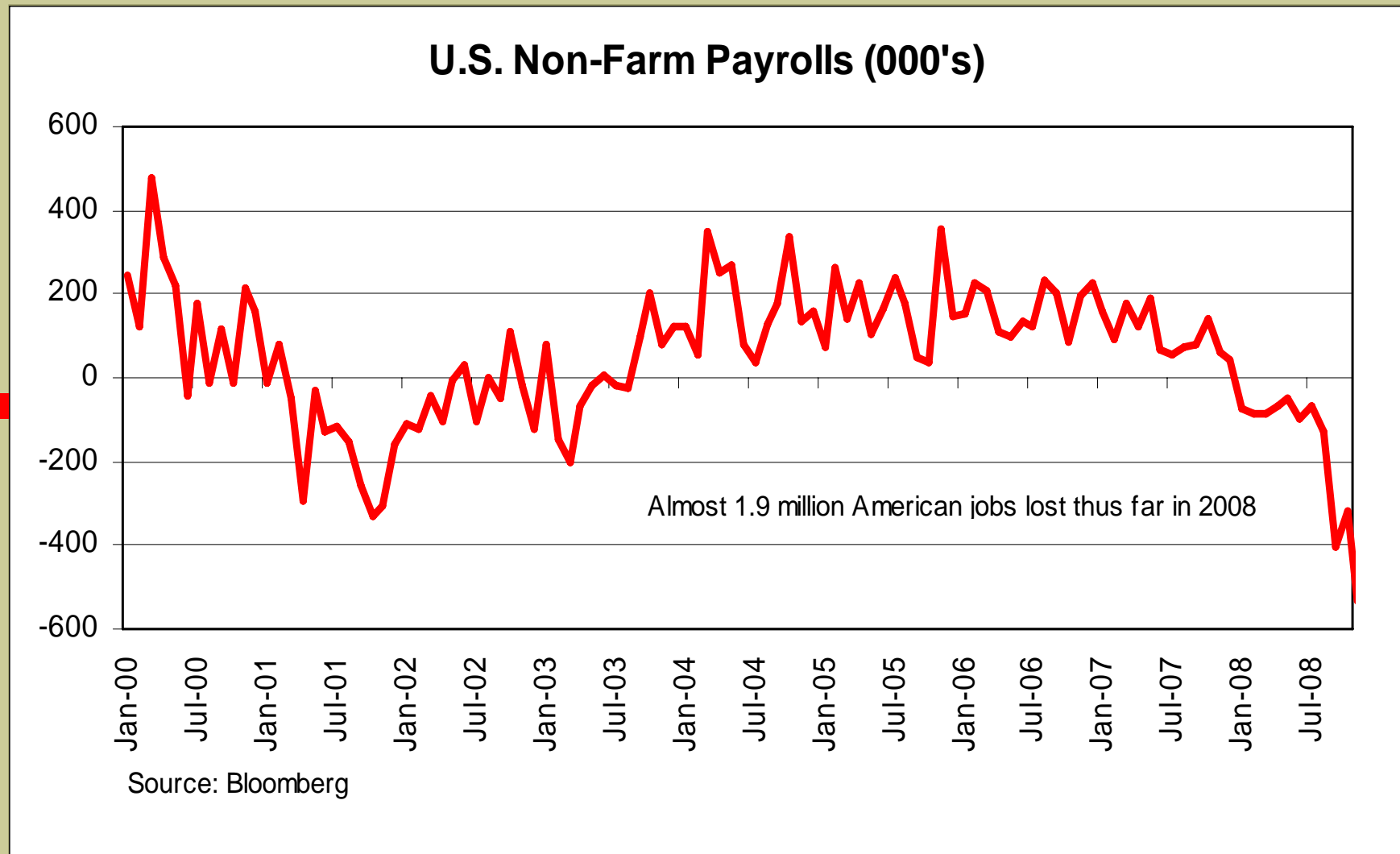
Price Declines = Wealth Destruction

Case-Shiller Home Pricing Index (% Change YOY)



Source: Bloomberg

Job Creation Tough in this Environment



Scotia Economics Outlook

Scotia Economics Forecasts as of December 1, 2008

Real GDP (% change)	2007	2008f	2009f		
Canada	2.7	0.7	-0.8		
United States	2.0	1.2	-1.8		
Japan	2.0	0.2	-0.6		
United Kingdom	3.1	0.8	-1.5		
Euro Zone	2.6	0.9	-0.9		
China	11.9	9.5	8.0		
India	9.0	7.0	6.0		
Brazil	5.4	5.0	3.0		
	Q4/2008	Q1/2009	Q2/2009	Q3/2009	Q4/2009
Bank of Canada Rate	1.75	1.00	1.00	1.00	1.00
Federal Reserve Rate	0.50	0.50	0.50	0.50	0.50
Canadian Dollar (USD/CAD)	\$1.22	\$1.27	\$1.33	\$1.29	\$1.25
Canadian Dollar (CAD/USD)	\$0.82	\$0.79	\$0.75	\$0.78	\$0.80

The Loonie – More Like the Looney



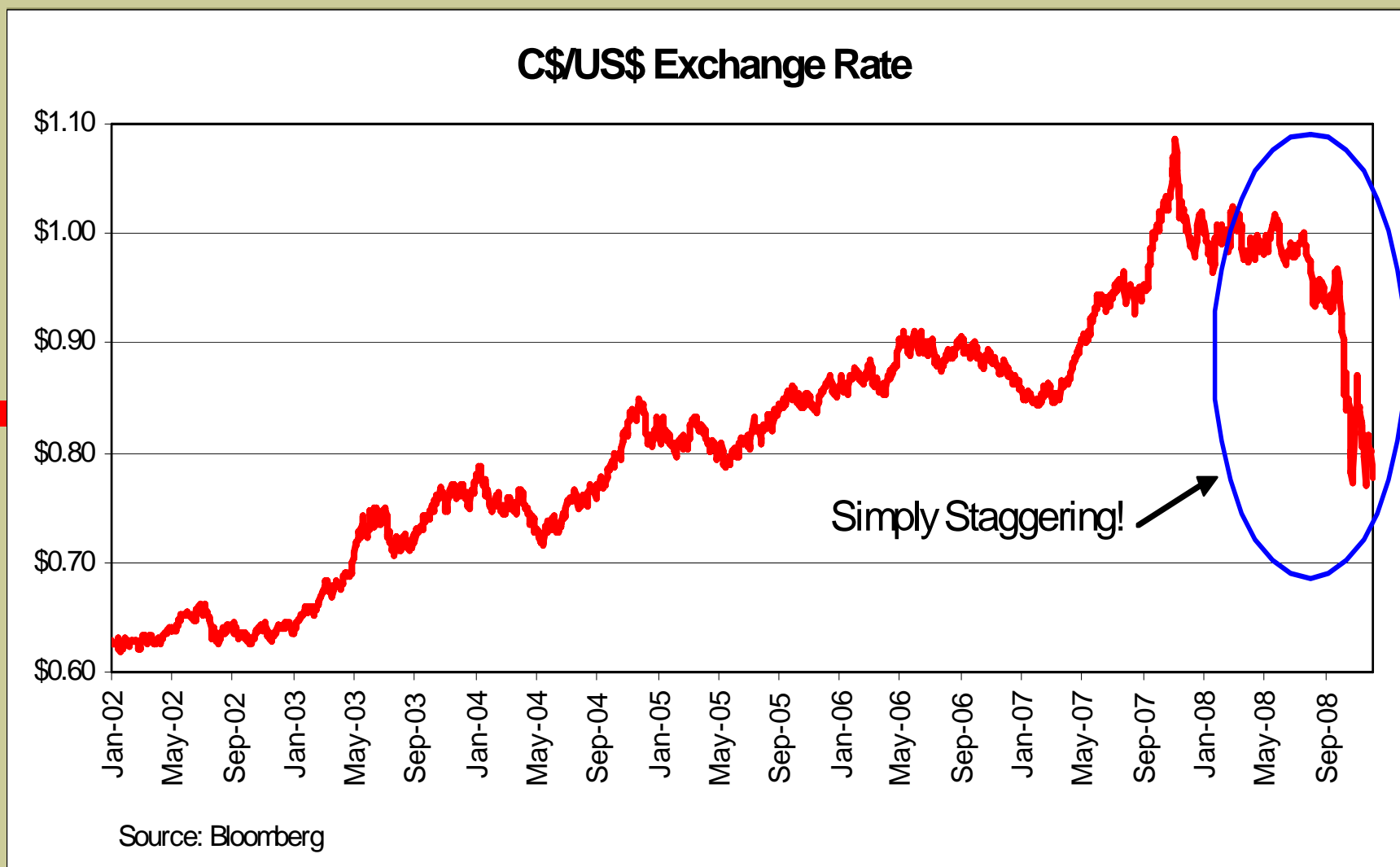
The Canadian dollar has been remarkably erratic recently thanks to the volatility seen in the financial markets. The loonie weakened thanks to:

- A decline in resource prices (oil, natural gas, base metals, etc)
- The expectation of further interest rate cuts
- Investors flocking to U.S. treasuries for safety thus propping up the US\$

The loonie rebounded off its recent lows when the equity markets managed to post a few days of positive returns, but will likely remain range bound (US\$0.75 to US\$0.85) for the foreseeable future as:

- Resource prices are not expected to have a quick rebound in the near future
- Rates will likely continue to fall in Canada (maybe more than the US)
- Equity market volatility will still guide investors to safety in U.S. denominated bonds

Canadian Dollar – Staggering Volatility



Equity Markets – What to do?

1. Consider Increasing Bond Exposure

- Equities are simply out of favour as an asset class. Even the most defensive of companies has not escaped the weakness. Check your asset mix and ask yourself if increasing your bond exposure may be prudent.

2. Conservative Investors Stay Defensive

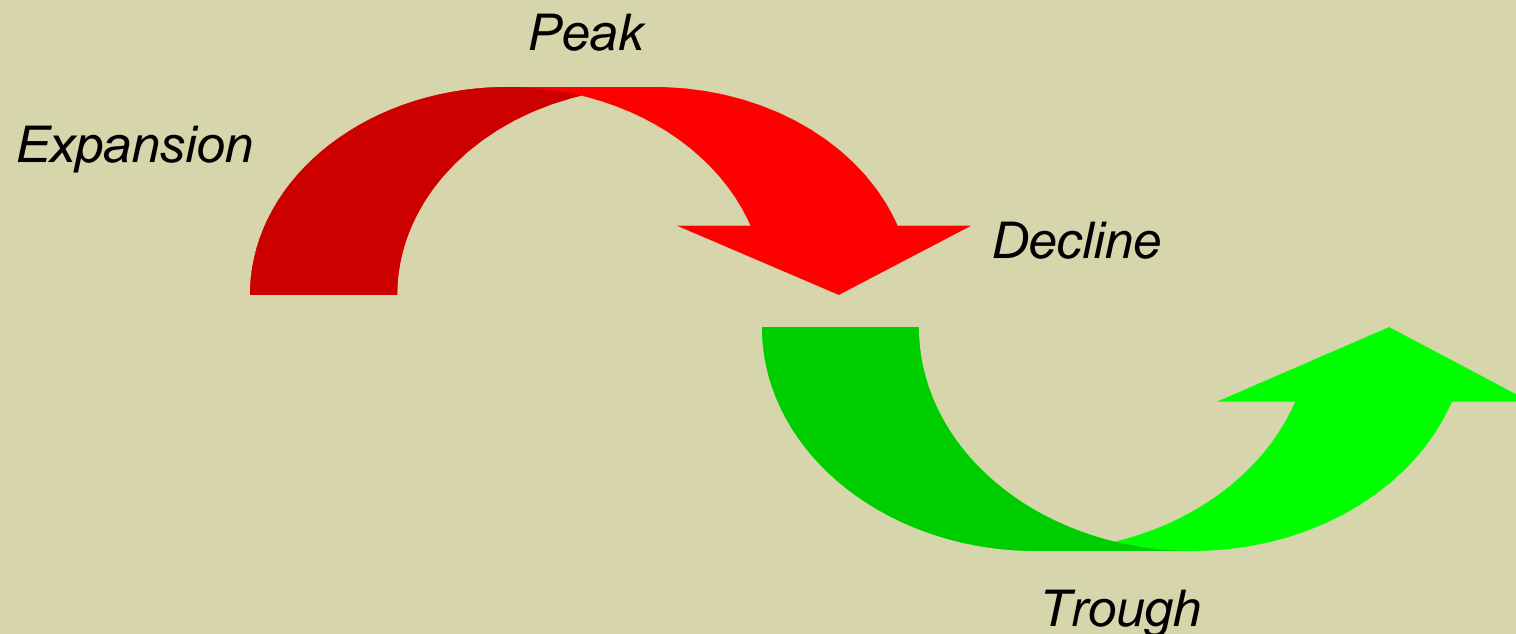
- Defensive areas of the economy are the place to be during an economic downturn such as Utilities, Telecommunications, Consumer Staples
- Most defensive stocks also happen to offer decent dividends, so they pay you while you wait out the slowdown

3. Value Investors Look at Cyclical?

- Higher risk investors that are willing to accept more short term downside might actually consider looking at economically sensitive stocks if they have a time frame greater than 2 years. It is likely still too early for this approach, but value investors like to sniff around when these stocks are significantly off their highs

What You Do Depends on the Cycle

- Recessions and market downturns are inevitable as they are part of a cycle which has continuously repeated itself in the past and will continue to repeat itself in the future.
- The good news here is that if we're at or close to a bottom, then the only way to go is up. What we don't know is how long it will take for the economy to get moving again.



TSX Outlook – Sector Breakdown

	Weighting in the TSX Index	Negative Point Contribution to the TSX Index Jan 1 to Nov 30	
S&P/TSX		-4562.44	
Financials	31.2%	-1248.79	27.4%
Energy	27.7%	-1129.96	24.8%
Materials	14.2%	-944.73	20.7%
Telecommunications	6.3%	-206.71	4.5%
Industrials	6.0%	-236.71	5.2%
Consumer Discretionary	5.0%	-263.32	5.8%
Technology	3.7%	-391.35	8.6%
Consumer Staples	3.5%	-59.47	1.3%
Utilities	2.0%	-47.46	1.0%
Health Care	0.4%	-33.94	0.7%

Financials

Canadian Banks:

- 6 Major Canadian banks vs. approximately 8000 U.S. financial institutions, our industry structure is different.
- Capital levels are strong. Minimum Tier 1 Capital ratio is 7.0%

BMO at 9.77%

BNS at 9.3%

CM at 10.5%

NA at 9.4%

RY at 9.0%

TD at 9.8%

All ratios above are as of October 31, 2008

- Canadian banks were still very profitable in fiscal 2008 as other global financial institutions lost money.
- Canadian banks have not cut their dividends, nor do we expect they will.
- Canadian banks have diversified revenue streams.
- A consolidated industry in Canada leads to greater efficiency.

Financials Continued

Canadian Banks:

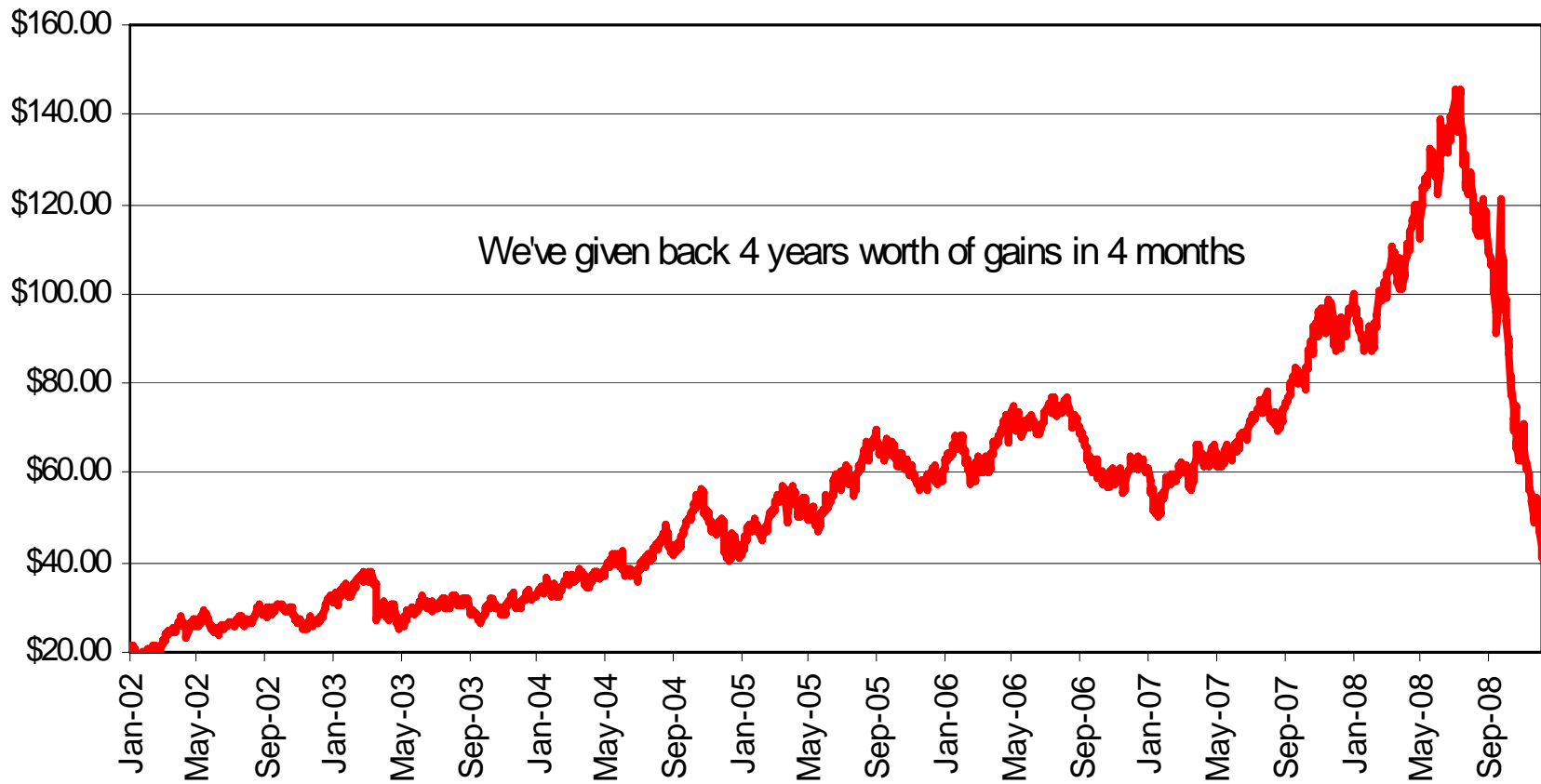
- But banks do face a number of challenges in 2009 as the operating environment will be difficult. Remember, banks are economically sensitive.
- The credit crisis has expanded beyond sub-prime mortgages.
- Overall we would conclude that Canadian banks find themselves in a better operating and capital position, but 2009 will be challenging depending on the length of the global recession. We do not expect Canadian banks to rally sustainably during the next one or two quarters; however, long term investors may consider the Canadian banks now as they are positioned well for an economic recovery.

Life Insurance Industry:

- In a recession, life insurance premiums are still paid, group insurance plans continue and investors still contribute to their RRSPs.
- Even when the economy is struggling, revenues tend to be consistent.

Energy

WTI Crude Oil Prices (US\$ per barrel)



Source: Bloomberg

Energy Continued

- 2008 was a year of extremes
- The market was too focused on supply during the first six months of 2008 when it should have been paying more attention to demand.
- However, we now believe the market is too focused on demand when it should also be thinking about supply.
- Production cuts are already underway and investment is being deferred. So what happens when the economy turns around?
- Energy prices will find support if our call for a weaker U.S. dollar materializes.
- Due to the economic challenges that lie before us, we do not expect energy stocks to rally sustainably in the near future and possibly not until later in 2009. Short term downside is still a distinct possibility.
- However, longer term investors may consider energy investments at this time to position themselves for an economic recovery.

Materials

Base Metals:

- Supply balances were emerging at the beginning of 2008. While commodity prices tend to overshoot the downside as they decline, we don't think a possible rebound in base metal prices is going to be significant over the next 12 months.

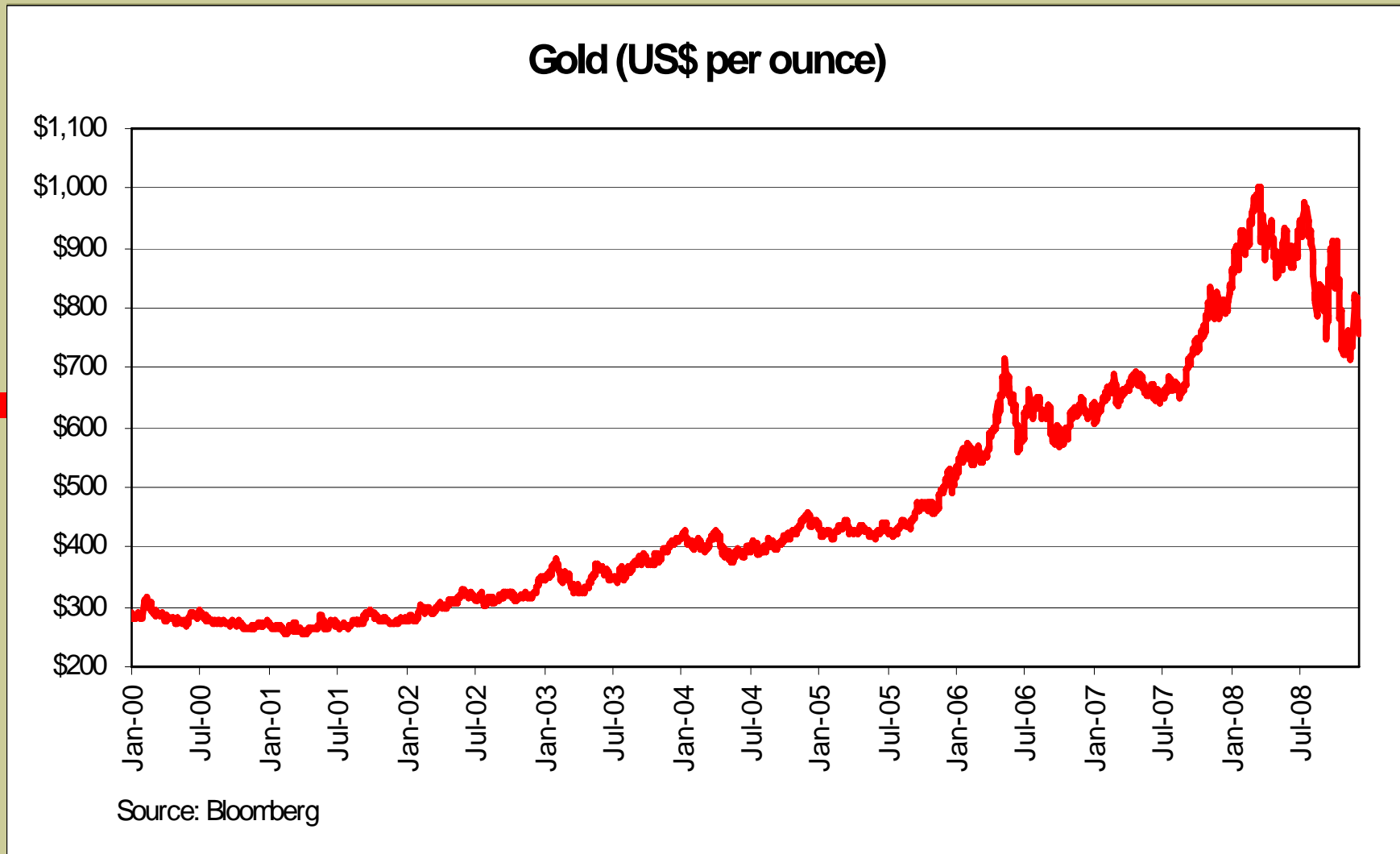
Precious Metals:

- We're still bullish on gold as we believe the U.S. dollar will weaken again. While it may take some time for this assumption to materialize, we believe precious metal prices can still move higher.

Fertilizers:

- While grain and fertilizer prices have declined, we believe the sell off in fertilizer equities has been overdone as food supply/demand fundamentals remain strong. This sector will benefit from a weaker U.S. dollar. We may not be proven correct until Q1/09 results are reported in May.

Materials Continued



Defensives

Consumer Staples:

- The drug store industry, namely Shoppers Drug Mart should continue its strong performance. Food store valuations may have been pushed too high in the near term.

Utilities and Pipelines:

- Utilities and Pipelines should be part of a well diversified portfolio in 2009 as these companies provide consistency during times of economic uncertainty. Most stocks in this sector also usually pay a decent dividend.

Telecommunications:

- In a wireless world, consumers are hesitant to part with phone, cable or internet services. The Canadian telecommunications industry is in decent shape. Cash flows and balance sheets are relatively strong.

Technology and Consumer Discretionary

Technology:

- It's all about Research In Motion in Canada and we still like the name due to its strong balance sheet (no net debt), attractive product pipeline, more diversified subscriber mix and valuation.

Consumer Discretionary:

- **Media companies** may find the near term difficult as advertising spending could come under pressure.
- **Cable companies** may act in a similar fashion to telecommunications companies as cable services are fairly recession proof, unless the recession is deep and prolonged.
- **Retailers** should be avoided in the near term as the consumer is showing fiscal restraint this holiday season. However, investors should keep their eyes on retailers if we happen to see signs of economic recovery during the second half of 2009.

Industrials

Like the name suggests, Industrials tend to do well when industry does well

- **Railroads** in Canada are efficient, well run companies and while they still tend to have some pricing power, a slower global economy could reduce shipment volumes. While the short term will not see a sustainable rally, these stocks are well positioned for an economic recovery.
- **Airlines** are likely the most economically sensitive amongst the industrials as lower fuel costs could now be offset by lower demand as economic growth and discretionary spending declines. We wouldn't be buying airline stocks at this time.
- **Aerospace and industrial equipment** stocks aren't impacted by a slowing economy as quickly as other areas of this sector as long term purchasing commitments are normally required. While order backlogs could potentially decline during a recession, they tend not to disappear.
- **Engineering services** stocks, such as SNC Lavalin, do tend to be sensitive to commodity prices; however, they also tend to be beneficiaries from government stimulus investment. These stocks could show signs of strength before any economic recovery materializes.

Individual Stocks to Highlight

Instead of giving you a list of stocks to own throughout the year I will provide you with two lists:

- 1) Stocks to highlight as the economy continues to struggle and
- 2) Stocks to highlight to position yourself for the economic recovery

While these lists are not exhaustive, our intention here is to highlight higher quality names with relatively strong balance sheets, good management teams and a decent track record of past performance. We are not saying these companies will be the top performers of the year, but we do believe they should be considered core holdings for a well balanced portfolio depending on what you're trying to achieve.

Individual Stocks to Highlight Continued

Stocks to Highlight as the Economy Continues to Struggle

Agrium
Barrick Gold
Cogeco Cable
Enbridge
Potash Corporation
Rogers Communications
Shoppers Drug Mart
SNC Lavalin
TransCanada Corporation

Individual Stocks to Highlight Continued

Stocks to Highlight for Economic Recovery

Bombardier
Brookfield Asset Management
Canadian National Railway
Canadian Natural Resources
Canadian Tire
Finning International
Research in Motion
Suncor Energy
TD Bank
Westjet Airlines

Final Thoughts

- We've just been through a market downturn which even the most experienced of investor will tell you was unlike any other. It was fast and it's magnitude was severe.
- While difficult to experience, such a downturn reminds investors of the importance of diversification as you'll never own the best performing asset class all the time.
- We know the next few quarters are going to be difficult, but the market is already pricing that into the market. If there is a silver lining to this decline it would be that we could be forming a base which could possibly provide us with positive returns in 2009.
- Don't expect a quick fix because it does not exist. Patience and a disciplined investment plan are what you need to get through this difficult economic and financial storm.

Disclaimers

The author(s) of the report own(s) securities of the following companies.

Bank of Nova Scotia, Potash Corporation of Saskatchewan, Inc., Rogers Communications Inc., Research In Motion Limited,

The supervisors of the Portfolio Advisory Group own securities of the following companies.

Bank of Nova Scotia, Canadian National Railway Company,

Scotia Capital Restriction -- U.S. (American) **Bank of Nova Scotia, Royal Bank of Canada**

Scotia Capital Restriction -- Canada **Bank of Nova Scotia, Royal Bank of Canada**

The Fundamental Research Analyst/Associate, in his/her own account or in a related account, owns securities of the following issuer(s) under his/her coverage: **Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Royal Bank of Canada, Toronto-Dominion Bank**

The Head of Equity Research/Supervisory Analyst, in his/her own account or in a related account, owns securities of the following issuer(s): **Agrium Inc., Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Canadian National Railway Company, Canadian Tire Corporation Limited, Enbridge Inc., EnCana Corporation, Finning International Inc., Research In Motion Limited, Rogers Communications Inc., Royal Bank of Canada, Shoppers Drug Mart Corporation, SNC-Lavalin Group Inc., Suncor Energy Inc., Toronto-Dominion Bank, TransCanada Corporation**

The Portfolio Strategist/Associate, in his/her own account or in a related account, owns securities of the following issuer(s): **Agrium Inc., National Bank, Toronto-Dominion Bank**

The Quantitative Analyst/Associate, in his/her own account or in a related account, owns securities of the following issuer(s): **Royal Bank of Canada**

Portfolio Advisory Group



Disclaimers

The issuer paid a portion of the travel-related expenses incurred by the Fundamental Research Analyst/Associate to visit material operations of the following issuer(s): **Barrick Gold Corporation, Bombardier Inc., Finning International Inc.**

Scotia Capital Restriction **Bank of Nova Scotia**

Scotia Capital Inc. and its affiliates collectively beneficially own in excess of 1% of one or more classes of the issued and outstanding equity securities of the following issuer(s): **Bank of Montreal, Bombardier Inc., Canadian Imperial Bank of Commerce, Canadian Tire Corporation Limited, Enbridge Inc., EnCana Corporation, Finning International Inc., Great-West Lifeco Inc., National Bank, Potash Corporation of Saskatchewan, Inc., Rogers Communications Inc., Royal Bank of Canada, SNC-Lavalin Group Inc., Toronto-Dominion Bank, TransCanada Corporation**

The Bank of Nova Scotia (“the Bank”) is the parent company of Scotia Capital Inc. (“SCI”). This Report includes comparative information regarding a substantial number of competitors of the Bank where such comparable information is known or ascertainable by SCI and in equal prominence to the information in respect of the Bank. **Bank of Nova Scotia**

The Fundamental Research Analyst/Associate has visited material operations of the following issuer(s): **Barrick Gold Corporation, Canadian National Railway Company, Potash Corporation of Saskatchewan, Inc., Research In Motion Limited, WestJet Airlines Ltd.**

Within the last 12 months, Scotia Capital Inc. has undertaken an underwriting liability with respect to equity securities of, or has provided advice for a fee with respect to, the following issuer(s): **Agrium Inc., Bank of Montreal, Bank of Nova Scotia, Barrick Gold Corporation, Canadian Imperial Bank of Commerce, Canadian National Railway Company, Enbridge Inc., EnCana Corporation, Finning International Inc., Great-West Lifeco Inc., National Bank, Rogers Communications Inc., Royal Bank of Canada, Shoppers Drug Mart Corporation, Suncor Energy Inc., Toronto-Dominion Bank, TransCanada Corporation**

Disclaimers

RATINGS: 1-Sector Outperform; 2-Sector Perform; 3-Sector Underperform RISK RANKINGS: Low; Medium; High; Caution Warranted; Venture . For Scotia Capital Research Analyst standards and disclosure policies, please visit: <http://www.scotiacapital.com/disclosures>.

Each research analyst named in this report or any subsection of this report certifies that (1) the views expressed in this report in connection with securities or issuers that they analyze accurately reflect their personal views; and (2) no part of their compensation was, is, or will be directly or indirectly, related to the specific recommendations or views expressed by them in this report.. Scotia Capital Inc. and/or its affiliates expects to receive or intends to seek compensation for investment banking services from issuers covered in this report within the next three months. Scotia Capital Inc. and/or an affiliate has or seeks a business relationship with the issuers referred to herein which involves providing services, other than securities underwriting or advisory services, for which compensation is or may be received. These may include services relating to lending, cash management, foreign exchange, securities trading, derivatives, structured finance or precious metals.

SCOTIA CAPITAL INC. (SCI) is a member of the Canadian Investor Protection Fund (CIPF). Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither SCI nor its affiliates accepts any liability whatsoever for any loss arising from any use of this report or its contents. This report is not, and is not to be construed as, an offer to sell or solicitation of an offer to buy any securities and/or commodity futures contracts. SCI, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities and/or commodities and/or commodity futures contracts mentioned herein as principal or agent. Directors, officers or employees of SCI may serve as directors of corporations referred to herein. SCI and/or its affiliates may have acted as financial advisor and/or underwriter for certain of the corporations mentioned herein and may have received and may receive remuneration for same. This research and all the information opinions and conclusions contained in it are protected by copyright. This report may not be reproduced in whole or in part, or referred to in any manner whatsoever, nor may the information, opinions, and conclusions contained in it be referred to without in each case the prior express consent of SCI. SCI is a wholly owned subsidiary of a Canadian chartered bank. SCI is regulated by FSA for conduct of investment business in the UK. U.S. Residents: Scotia Capital (USA) Inc., a wholly owned subsidiary of SCI, accepts responsibility for the contents herein, subject to the terms and limitations set out above. Any U.S. person wishing further information or to effect transactions in any security discussed herein should contact Scotia Capital (USA) Inc. at 212- 225-6500.