

## 2008 Canadian Outlook – Cautious Optimism

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At the beginning of last year we correctly predicted that the TSX Index would post a fifth consecutive year of gains; however, we never expected to see the large increase in volatility nor the pronounced performance split where first half returns were positive and second half returns were cautiously negative. The TSX Index posted a simple price return of 7.2% in 2007, which differed from the 14.5% return posted in 2006 for two main reasons. First, Financial stocks were negative contributors to the TSX Index after providing the largest positive contribution in 2006 and second, we saw larger gains out of Telecommunications and Technology stocks (most notably Research in Motion). This year's gains were misleading compared to years past as the top 5 point contributing stocks (Research in Motion, Potash Corporation, Alcan, Encana, and Suncor) within the 258 stock index were responsible for 90% of the TSX's gains. In fact, more stocks within the index declined last year than advanced. Below, we provide a table showing the point contributions from each sector for 2006 and 2007 returns and the weighting of each sector within the TSX index as of December 31, 2007.

2006 & 2007 TSX Performance Breakdown & Current Sector Weightings			
	Contribution to 2007 7.2% TSX Return	Contribution to 2006 14.5% TSX Return	Current Weighting Within TSX Index
Financials	-2%	34%	29.61%
Energy	27%	32%	27.88%
Materials	28%	23%	16.88%
Telecommunications	13%	3%	5.50%
Industrials	7%	4%	5.39%
Information Technology	26%	0%	5.19%
Consumer Discretionary	2%	5%	4.97%
Consumer Staples	1%	-1%	2.49%
Utilities	2%	2%	1.57%
Health Care	-4%	-1%	0.52%

} Top 3 Sectors = 74.37%  
} Bottom 7 Sectors = 25.63%

*Source: Scotia Quantitative Research, Bloomberg.*

As we look ahead to 2008, we predict the performance of the TSX this year will demonstrate that:

- Fallout from credit markets will continue into the second quarter of 2008 and possibly the second half of the year, restraining financial performance and possibly the TSX Index
- Leveraged buyouts may have come and gone and merger and acquisition (M&A) activity in general may slow, but M&A amongst companies in the Materials sector should continue
- The TSX Index should move higher in 2008 with single digit returns; however, this does not mean that an overwhelming majority of stocks will finish the year in positive territory

### **Fallout from credit markets will continue into the second quarter of 2008 and possibly the second half of the year, restraining financial performance and possibly the TSX Index**

The second half of 2007 became synonymous not only for equity price declines but also for words and phrases such as sub-prime, the consumer, asset backed commercial paper, and mortgage backed securities. In hindsight, we can conclude that the market was caught off guard by the severity of what has been labelled as the “credit crunch.” We do not believe the market was surprised by the decline in the U.S. housing market, as this trend has been in place since 2006. However, we do believe the surprise and resulting selling action was a result of the depth and magnitude of financial engineering which has resulted in investors and financial institutions sitting on credit related products which to this day are difficult to explain and value. A lack of clarity leads to nervousness and nervousness leads to selling, which we saw not only in July and August but also again in November and December as the extent of the credit crunch became more apparent. We could write numerous pages on the credit fallout but will summarize by saying that a lack of clarity amongst financial companies led to a broad market sell off and raised a number of questions about the direction of the U.S. economy. We do not believe investors will rush to put capital back into Financials until the full impact of the credit crunch becomes clear.

The only problem is the fallout from the credit market continues to evolve and there is no return to normalcy expected in the near future. Many U.S. and global banks took substantial write-downs in the fourth quarter of 2007. However, most investors expect more write-downs are forthcoming as credit markets have deteriorated further, leading us to conclude that Financial stocks will continue to come under pressure during the first quarter of 2008 and almost certainly beyond. Canadian banks have shown that their exposure to riskier assets is not as severe as what has been revealed at U.S. and global financial institutions. However, the financial industry is a global industry, so investors tend to stay away from the sector as a whole regardless of geography. Therefore, whether justified or not, Canadian bank stocks will likely be restrained by the credit markets until confidence is restored. Since Financials tend to make up a large percentage of many indices including the TSX, it is possible that some major exchanges worldwide will see little upward momentum in the first half of 2008.

### **Leveraged buyouts may have come and gone and merger and acquisition (M&A) activity in general may slow, but M&A amongst companies in the Materials sector should continue**

One problem that became apparent from the credit crunch was individuals and investors should not have received loans at such cheap rates. We need not worry about this problem any more as lending practices have been improved and lending rates have moved higher, thus putting an end to the recent wave of leveraged buyouts. Also, since some merger and acquisition activity has relied upon debt financing, the growth in M&A activity we’ve seen for some time now has declined. However, continued M&A activity can’t be ruled out in areas of the market where companies are sitting on large amounts of cash or will see cash balances increase in the future. We believe the Materials sector falls into this category. Although base metal prices declined in 2007, they still remain well above recent historical averages and base metal companies continue to generate strong levels of cash flow. However, due to the incredible wave of M&A activity amongst base metal companies, we may not see a lot in 2008 simply because few Canadian large capitalization companies remain. One area of the market where we expect M&A activity to continue is the gold sector. With gold prices continuing to climb and the desire for companies to grow production through acquisition rather than through exploration, we believe this sector is still ripe for more M&A activity in 2008. We would also not rule out global M&A activity amongst fertilizer companies as grain prices continue to rise and global food inventories continue to decline. In Canada we would expect the majors such as Potash Corporation and Agrium be acquirers rather than be acquired, although the opposite scenario can’t be dismissed either.

### **The TSX Index should move higher in 2008 with single digit returns, however, this does not mean that an overwhelming majority of stocks will finish the year in positive territory**

Even after the declines of the banks, Financials, Energy and Materials continue to comprise close to three quarters of the TSX Index. If you want to know where the index is going this year, then you really only need to focus on these three sectors. In our discussion, you will see that we believe banks may underperform in the first half of the year, but could see some momentum in the second half of 2008. We also believe gold and fertilizers may offset any potential weakness amongst base metals thus supporting Materials and that in a high oil price environment, Canadian energy stocks should be able to post positive returns. However, you'll also note that our enthusiasm for positive returns is somewhat restrained due to current credit markets and the related effects that may emerge not only in the U.S. economy, but worldwide. Therefore, we believe there is a good chance for the TSX to post a positive simple return in 2008, but that return will likely not reach double-digits. We would also caution investors that market capitalization indices such as the TSX can be misleading due to the weighting of individual stocks within that index. For example, even though the TSX posted a simple price return of 7.16% in 2007, 155 stocks within the index declined whereas only 146 advanced and 2 were unchanged. In other words, the TSX only advanced because most of the higher weighted stocks appreciated while more of the lower weighted stocks declined. Our expectation for single digit returns again this year opens the possibility that we could see a repeat of what happened in 2007.

In Canada, we believe there are a few focus themes that should emerge during the first half of 2007 if not the entire year:

- Defence may be the best offense
- Portfolios should continue to hold gold
- Canadian banks look attractive, but may outperform in the second half of the year following first half underperformance
- Base metals may lose some shine, but the Materials sector will likely move higher
- The days of sky rocketing energy equity prices are long over, but the sector still offers value
- Opportunities still exist amongst select telecommunications and technology stocks

#### **Defence may be the best offence**

Considering what happened during the second half of last year, it should come as no surprise when we conclude that investors remain very cautious. The difficult credit environment has thrown the financial market into a period of uncertainty while many market participants are starting to question how resilient the U.S. and global economy may be in the face of a declining U.S. housing market and the prospect that spending by the U.S. consumer may decline. In Canada, we must remain concerned about the U.S. because any slowdown south of the border will have an impact on our economy. Not only are investors faced with the financial uncertainty of the market place, they are also faced with economic uncertainty. During times such as these, we recommend that investors increase or establish defensive positions within their portfolios. Sometimes the best offence in the face of uncertainty is a solid defence. By "defensive" we mean investments in companies that tend to perform well no matter what the economy is doing. Utilities such as TransCanada Corporation, Enbridge and Fortis; pharmacies such as Shoppers Drug Mart. Health care companies and gold are also examples of such investments. We are quite confident that effects from the credit crunch are likely to persist for months to come. Therefore, investors may want to take more of a defensive stance for at least the first half of 2008. We also recommend that with the higher loonie, investors look to the U.S. for defensive investment opportunities as the selection of equity names is far greater south of the border.

### **Portfolios should continue to hold gold**

This was one of our focus themes last year, which has rewarded investors nicely. We were bullish on gold in 2007 and we remain bullish on gold in 2008. The outlook for gold remains strong as the U.S. dollar may continue to decline if economic pressures persist and the Federal Reserve continues to cut interest rates, as forecast by Scotia Economics. Rising oil and food prices also help gold as investors look for a way to hedge against inflation. Although U.S. dollar weakness and rising inflation help our gold argument, the main reason why we've been bullish on gold this year and last is predominantly due to the supply/demand fundamentals of this precious metal. Demand for gold continues to rise, particularly from China and India. However, gold supplies have been flat for the past two years, and may actually start to decline going forward. Our gold research team notes that the gold sector has been ineffective at discovering new world-class deposits or at replacing global reserves in a meaningful way. This fact also supports our conclusion that merger and acquisition activity within the gold sector will likely continue.

### **Canadian banks look attractive, but may outperform in the second half of the year following first half underperformance**

As noted earlier, Financials, in general, are out of favour globally with investors due to the continued uncertainty surrounding the credit market. Although investors may have painted all financials with the same brush, it is unfair to do so as some are far more exposed to U.S. subprime mortgages and questionable financially engineered products than others. Canadian bank's exposure to high-risk assets is low with some exceptions such as National Bank's exposure to non-bank sponsored asset backed commercial paper, Bank of Montreal's structured investment vehicles, and CIBC's exposure to the U.S. sub-prime market and collateralized debt obligations. However, Scotia Capital bank analyst Kevin Choquette believes the exposure amongst these banks is manageable. We'd also note that TD Bank, Royal Bank and the Bank of Nova Scotia have either minimal or no exposure at all to these risky assets classes and thus should not be penalized to the same extent as their U.S. or global counterparts. Nevertheless, it is quite likely that Canadian banks will have little opportunity to rally until the credit market returns to some state of normalcy, which may not occur until the second half of the year. Investors holding those banks with little or no exposure to risky assets should continue to hold as the market will eventually differentiate the high quality Canadian banks from other financial institutions. As Scotia Capital's bank analyst notes, Canadian bank profitability and capital levels are at all time highs, with low relative exposure to high-risk assets, diversified revenue mix, reasonable earnings growth outlook, low earnings volatility, ability to increase dividends and attractive valuation including high dividend yields, low price/earnings multiples, and low relative risk. Patience with Canadian banks should be rewarded later in 2008.

### **Base metals may lose some shine, but the Materials sector will likely move higher**

The days of soaring base metal prices are likely over. However, we'd still note that current base metal prices for metals such as copper, nickel, zinc, and aluminum are still well above historical averages as well as the prices witnessed at the beginning of the base metals boom in 2003. Nevertheless, it is metal pricing going forward that will drive equity valuations and Scotia Capital's base metals team sees prices trending sideways to downwards driven by market fundamentals. They forecast copper prices will remain on par with those prices in 2007; metallurgical coal and molybdenum prices should rise, while average annual prices of aluminum, zinc and nickel are expected to fall. Some Canadian base metal companies are also seeing headwinds from increasing capital costs, production costs and the higher Canadian dollar. This is not to say that all base metal companies are going to post negative returns this year. However, posting positive returns may be more of a challenge. So should we forget the Materials subsector altogether? We believe the answer is no, as we should see positive contributions to the sector by gold and fertilizer stocks as the fundamentals for precious metals, grains and fertilizers look strong for 2008. This is not to say that positive returns will come without volatility as we expect underlying commodity prices and thus equity prices will fluctuate due to factors such as seasonality, weather, market expectations and monetary policy; however, the overall long term outlook for precious metals and fertilizers/soft commodities is one with an upward bias.

### **The days of sky rocketing energy equity prices are over, but the sector still offers value**

It's interesting to note that in a year that saw oil prices almost reach US\$100 per barrel, energy equity prices underperformed relative to their underlying commodities. Of course weakness in natural gas markets did not help a lot of junior exploration companies in Canada, while the senior explorers and integrators were held back later in the year by increasing capital costs and a higher Canadian dollar. The sector also faced a new royalty regime in Alberta which our senior Energy analyst Nick Rontogiannis believes has taken away the upside torque once expected from oil-sands investments, thus impacting almost all of the large capitalization energy equity space. The energy sector faced a number of headwinds in 2007, which should continue into 2008 and reduce expectations for material and sustainable rallies in equity prices in the absence of materially higher energy prices. But all is not lost. Not all production comes from Alberta. Therefore investors will have to be more selective amongst the energy equities as we recommended at the beginning of 2007. Although oil prices hover around US\$100 per barrel, the market is only valuing the energy space with an average price of US\$60 to US\$65 per barrel. Our oil and gas research team is currently forecasting average WTI oil prices of US\$82 per barrel in 2008, thus implying that upside amongst senior energy names still remains. However, the upside will likely not be of the same magnitude seen over the past 5 years. We look favourably on oil in 2008 compared to historical averages as we expect demand from developing economies such as China will remain strong even in the face of an economic slowdown in the United States and perhaps more broadly amongst G7 nations. Natural gas prices tend to be a wildcard based on weather. However, there is a possibility interest in natural gas may pick up later in 2008 as the market may start to see the impacts of lower North American drilling activity, particularly in Canada.

### **Opportunities still exist amongst select Telecommunications and Technology stocks**

With the TSX Index dominated by Financials and Resources, it's easy to forget that investment opportunities exist elsewhere in Canada. One of our predictions last year was that wireless stocks should outperform the market which was true for names such as Rogers Communications and BCE Inc., but less so for Telus. Our belief that wireless fundamentals remain strong in Canada still holds true in 2008. However, we believe that Rogers Communications will outperform its competitors due to its GSM network and strong free cash flow which could see its way back to shareholders either through dividend increases or share buybacks. Telecom stocks came under pressure late in the year following the release of spectrum auction rules by the Federal Government which opened the door for more competitors to enter the Canadian wireless marketplace. We believe the sell off witnessed was well overdone and has created a buying opportunity for Rogers in particular, as any new entrant will have little impact on the market until 2010 at the earliest. In fact, Scotia Capital Telecom analyst John Henderson believes the impacts of a new competitor will be indiscernible until 2010 and will take until 2015 to capture 5% market share.

When someone speaks of technology in Canada, they really only speak of Research in Motion which is now the third largest weighted stock in the TSX Index. RIM has had two years of outstanding performance, and if recent earnings results and forecasts are any indication, there is further room to grow for the maker of the Blackberry. Although it's unlikely the stock price will double like it did in 2007, subscriber growth remains strong not only amongst the business enterprise market but now amongst consumers. In fact, Scotia Capital is forecasting that RIM could almost double its subscriber base in the coming fiscal year. Competition is always a threat to Research in Motion, however, it has illustrated over several years that it can compete by expanding to new markets and providing new product/device offerings.

Overall, we believe 2008 will present a challenge for the Canadian equity market, particularly during the first six months of the year, due to ongoing concerns in the credit market and the economic fall out that may result. However, current attractive valuations amongst financials, a supportive outlook for energy prices and a positive outlook for gold and soft commodities may help the TSX overcome initial weakness. Clarity will be the key for 2008 as it has been lacking for the past six months. If economic and financial clarity is achieved, then a single-digit return for the TSX is possible.

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