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Executive Summary

2006 Fall Outlook

Stewart Hunt — Managing Director, Portfolio Advisory Group

In the Summer 2006 edition of IPQ, we focused our attention on when the rising North American interest rate cycle would come to an end, and the magnitude of the correction underway in the North American equity markets. Our direction at that time could be defined as “keep your eyes on the road, your hands upon the wheel”. As we move into the fall of 2006, the interest rate question has turned to if, and when, the Bank of Canada and the U.S. Federal Reserve (Fed) will begin cutting rates. The correction in the equity markets we experienced at the beginning of the summer has now turned around as investors showed their resilience through a sector switch from cyclical stocks to defensive stocks to drive the market higher. Over the next three months, we will be watching whether the North American economy will have a hard or soft landing, depending on the stabilization in oil prices and the decline in the U.S. housing market. With a new Fed Governor at the rudder there is greater concern whether he can guide the U.S. economy through the turbulent waters of inflation and economic growth. As a result, until we gain confidence from Fed Governor Ben Bernanke and Bank of Canada Governor David Dodge, we will follow Lord Baden Powell and the Boy Scouts and “be prepared.” In the commentary that follows, our team of experts provides you with guidance on what to prepare for and where we see investment opportunities.

- If we are to assume recent history has repeated itself, it would be safe to say that interest rates in both Canada and the U.S. peaked in the late spring to, early summer of this year. This would mark the sixth consecutive year North American interest rates peaked in the first half of the year. If we continue on the historical path then we should expect interest rates to decline into the winter months and then creep higher in the spring. However, if the Fed has ended their rate tightening bias, then historically within 100 days the next move by the U.S. Central Bank will be to cut rates. The change from a monetary tightening bias to an easing bias creates a move to a more normal upward sloping yield curve with short term interest rates declining in greater magnitude than long term interest rates. As our Portfolio Strategist Vincent Delisle has advised, in the potentially downward moving interest rate environment he recommends investors move to an overweight position in bonds, neutral in equities and neutral in cash from an asset allocation perspective. From a fixed income perspective, Delisle is recommending investors extend the term to maturities of their bond holdings. From an equity perspective, Delisle prefers being overweight defensive sectors of Financials, Utilities, Telecommunications and Consumers Staples, and underweight Energy and Materials. From a North American perspective, Delisle favours the S&P 500 over the S&P/TSX, where valuations look cheap in comparison to Canada. In addition, the appreciation the Canadian dollar has experienced over the past three years looks to be consolidating, as the currency’s value is having its economic impact.
- As Gareth Watson points out, we believe the Canadian markets will continue to trend into positive territory. However, the attention of the markets has shifted from the resource sector and into the defensive sectors of Financials, Utilities, Consumer Staples and Telecommunications. The proposed conversions into income trusts by TELUS and BCE have already provided an upward lift to the Telecommunication sector. While we do not expect the resource sector to show the double digit returns it displayed last year, we do believe there are some select opportunities in this universe.
- Supporting Portfolio Strategist Vincent Delisle’s U.S. over Canada position for North American equity markets, Paul Danesi highlights the attractive valuations of large cap U.S. stocks, which look cheap from a historical perspective. Edison International (EIX), Caterpillar (CAT), Bank of America (BAC), Wellpoint (WLP) and Eli Lilly (LLY) are names Danesi believes are worth a look.

- From the Income Trust perspective, Joey Mack highlights the underperformance of the Income Trusts to the broader equity market (S&P/TSX) due to the percentage weighting of the Energy sector in the Income Trust space. He supports the move to defensive sectors and recommends trusts in Power and Infrastructure to outperform. Mack also provides investors looking at the Income Trust market to take into account the percentage payout ratio of the trust, with the general rule of focusing of trusts with forecast long-term adjusted payout ratios below 100%.
- In conclusion, the Fall IPQ feature article has Howard Kabot ask “Are You Ready to Retire?” where he provides some interesting insights and guidance for those baby boomers that are beginning to move into their retirement years.

We hope you enjoy reading the Fall 2006 edition of IPQ and our thoughts on the markets. If you require information or wish to discuss further the thoughts and ideas that we have shared, please feel free to contact your ScotiaMcLeod advisor.

Enjoy the colours and beauty of the fall!

Economic Outlook

North American Hard or Soft Landing: Oil vs. Housing?

Andrew Pyle — Vice President & Head of Capital Markets Research, Scotia Economics

At the start of the year, we advanced the view that North America would experience a modest economic slowdown, in response to the cumulative increases in both interest rates and energy prices since 2003. This more temperate pace of growth would be triggered, in the U.S. at least, by a retrenchment in consumer spending; while Canada's overall economic picture would sour as a result of a manufacturing-led erosion in Ontario and Quebec. For both countries, housing demand and construction would fall victim to the upward trend in borrowing costs, producing a hangover for builders and homeowners. Evidence of the slowdown became more prevalent by the end of the second quarter, as the U.S. housing sector begun to buckle and, by the end of the third quarter, economists were re-orienting their collective views on the U.S. from continued malaise to potential recession in 2007. Canada, which had witnessed almost a halving of economic growth in the second quarter to only 2%, entered the second half of the year faced with a myriad of headwinds, from the U.S. housing correction to falling energy prices. Had this commentary been penned a few weeks ago, the view would have been for additional slippage in North American growth, reduced momentum in corporate earnings, continued improvement in bond prices and a sell-off in stocks. As the fourth quarter gets underway, we are still comfortable with that view on a 12-month time horizon, but there are some recent developments that suggest the outlook will not unfold without some turbulence.

Let us begin by examining the housing situation. In early October, U.S. Federal Reserve Chairman Ben Bernanke commented that the U.S. was undergoing a significant correction in this sector, and that assessment was based on several factors, not the least of which was a severe downturn in housing starts and construction. In the case of the second quarter, this drop in homebuilding subtracted roughly a full percent from U.S. GDP growth and a similar impact is estimated for the third quarter. At the same time, home price appreciation has virtually ground to a halt and, in some cases, prices are below year-ago levels. Given that home inventories were still quite high last quarter, the assumption that builders would have to further suspend production over the remainder of the year would appear to be valid. What is not clear is (a) how much further construction will drop before it hits a bottom, and (b) whether the process of supply restraint by builders will be enough to prevent home prices from falling, or at least falling significantly below year-ago levels. The uncertainty surrounding both of these issues comes down to one variable and that is demand or, more generally speaking, the demand environment.

Of the multitude of factors that drive housing demand, the most important ones are incomes and interest rates, as well as consumer confidence. Affordability, which is influenced by incomes, home prices and mortgage rates, has been in decline for more than two years and explains much of the erosion in demand for housing that emerged early this year. During this time, there have been episodes where affordability has temporarily improved and this past August was an example. September affordability data will not be released until early November, however, we can make some inferences about its direction. For one, mortgage rates continued to decline during the month, albeit at a slower pace than in the preceding two months. Employee earnings growth held around 4% on a year-over-year basis, and home prices were likely down more on a month-over-month basis than we typically see in a given September. The average September drop in existing home prices since 1989 is 0.8% and the largest decline was 2.8%, back in 2001. If we were to see the same 2.8% month-over-month decline this September, it would take the year-over-year decline to 2.8% from 1.7%, matching the previous record year-over-year decrease in average home prices set in 1990. If such a "cheapening" of home prices were to reinforce affordability, and cause demand to improve, then the concern expressed by builders over second-half inventory levels could diminish, allowing new home construction to stabilize and perhaps strengthen into 2007. Bulls will contend that this assumption is not as fantastical as it sounds, especially given that wages have firmed and households have more disposable cash on the table thanks to lower energy prices.

Ah, the headline-grabbing plunge in gasoline prices. At the time of writing, triple-A regular gas prices in the U.S. were down to US\$2.25/gallon — not far from the low set in the fourth quarter of 2005. Recall from last year that pump prices had fallen less than 30 cents from their early September peak of US\$3.07/gallon by this time in October. Today, the relief since the August high of US\$3.04/gallon works out to more than 75 cents, and some analysts believe that the slide will continue. In fact, gasoline prices do tend to drift lower into November. Over the past 20 years, the average drop in the unleaded gasoline futures contract from the third quarter peak to the trough in Q4 was roughly 24%. Today, we are off more than 35% already. This relief in prices has combined with a continued decline in unemployment rates and soaring equity market to produce a marked improvement in consumer confidence. The most recent weekly statistics show comfort levels back near the highs of the year, set back in April. If these gains were to be sustained into November, expectations for a strong start to the holiday shopping season would be bolstered. Indeed, when we scan over the most recent Beige Book, there has been an improvement in retail sentiment in recent weeks, alongside a robust manufacturing sector, healthy non-residential construction and further evidence of labour market tightness and even, yes, signs of improvement in some housing segments. So, what does this all mean for the U.S. and Canadian outlook, as well as the respective equity and fixed income markets?

The answer depends on whether we are talking about the next three months or the next 12 months. Near term, the market has been forced to re-think the severity of the housing correction, its impact on growth and, more importantly, the view that monetary policy has to become stimulative very, very soon. It's not that anyone really believed that the U.S. Federal Reserve (Fed) would start cutting rates this quarter, but probabilities were high for multiple cuts beginning in the first quarter. The main risk is that the Fed delays its shift to easing, but there is also an outside chance that the Fed resumes its tightening program. Such a development would obviously cause a more severe correction in U.S. and Canadian bond markets and, in turn, cause equities to slide, given that some of the recent rally in stocks can be attributed to the belief that rates would soon fall and provide a shot in the arm for growth. Some investors may be confused as to how stocks have maintained their composure in October given not only the seasonal tendency for weakness but also the back-up in bond yields. The answer is twofold. First, oil prices have hit their lowest levels of the year. Second, the initial stages of this bond market sell-off have seen a re-allocation of funds out of fixed income products and into equities. Something very similar to this occurred between January 23rd and February 16th of this year, when crude oil futures fell US\$12/barrel and the 10-year U.S. bond yield rose 24 basis points. A couple of weeks prior to this period, the Dow had also just set a new record high, just like this month, before some temporary profit-taking and then a renewed rally that carried all the way to May. And it did this despite a run-up in both oil prices and interest rates. Investors may look at the current situation as being no different.

What is different is the prospect for growth and earnings. Either the recent signs of economic optimism are false and this is just a last breath of life in the economy before the slump, or they are real and growth is going to be sustained at respectable levels for a while longer. As we have already discussed, this scenario would likely herald a rise in bond yields, and therefore mortgage rates, at a time when the housing market is just trying (perhaps) to recover. In other words, the longer-term negative outlook for the U.S. economy does not necessarily have to change simply because of a few weeks of resilience and Fed policy confusion. Indeed, one could argue that a second round of rate hikes would cause an even deeper correction in housing, with collateral damage in consumer spending. Interest rates would still have to fall, and equities would look even more overvalued. For Canada, if developments also nudged rates higher, this would only make the situation worse for central Canada, while the swing factor would be what happens to oil prices. And, before we forget about the supposed benefit that weaker crude has had on the U.S. picture, let us not forget that oil has been shown to work in an asymmetrical manner. That is over-complicated economic talk for saying that higher oil prices tend to negatively impact the economy, but falling oil prices does not always have a long-lasting positive impact. Bottom line, this is a quarter when investor agility is necessary. Time to start stretching.

Economic and Market Outlook — 2006/2007

	2004	2005	2006f	2007f
Canada				
S&P/TSX Composite Index				
Earnings (C\$)	\$531.00	\$602.00	\$745	\$760
Levels	9,247.00	11,272.00	12,250.0	12,250.0
Economic Performance (annual average)				
Real GDP (% change)	3.3	2.9	2.8	2.5
Consumer Prices (% change)	1.8	2.2	2.3	2.0
Motor Vehicle Sales (thousands)	1,534	1,583	1,590	1,510
Unemployment Rate (%)	7.2	6.8	6.4	6.5
Current Account Balance (C\$ bn.)	27.6	31.8	18.0	5.0
Yield Curve (end of period, %)				
Bank of Canada Overnight Target Rate	2.50	3.25	4.25	3.50
2-Year Canada Bond	3.00	3.86	3.80	3.30
10-Year Canada Bond	4.31	3.98	3.95	3.80
United States				
S&P 500 Index				
Earnings (US\$)	\$67.67	\$76.43	\$84.50	\$89.00
Levels	1,212.00	1,248.00	1,400.0	1,400.0
Economic Performance (annual average)				
Real GDP (% change)	3.9	3.2	3.3	2.4
Consumer Prices (% change)	2.7	3.4	3.5	2.2
Motor Vehicle Sales (millions)	16.9	16.9	16.5	15.5
Unemployment Rate (%)	5.5	5.1	4.7	5.0
Current Account Balance (US\$ bn.)	-665	-792	-870	-875
Yield Curve (end of period, %)				
Fed Funds Target Rate	2.25	4.25	5.25	4.25
2-Year Treasury	3.07	4.40	4.60	3.80
10-Year Treasury	4.22	4.39	4.65	4.40
Foreign Exchange (end of period)				
Canadian Dollar (US¢/C\$)	83.0	86.2	87.5	92.5
Canadian Dollar (C\$/US\$)	1.20	1.16	1.14	1.08
Yen (¥/US\$)	103	118	110	100
Euro (US\$/€)	1.36	1.18	1.30	1.35
Sterling (US\$/£)	1.92	1.72	1.92	1.90

f: Forecast (Scotia Economics). Based on October 12, 2006 Forecast Update.

Source: Scotia Economics; Statistics Canada; U.S. Dept. of Commerce; U.S. Bureau of Labor Statistics; Bloomberg.

Portfolio Strategy

Strategy Update — Fall 2006

Vincent Delisle — Director, Equity Research, Scotia Capital

The Big Picture

- U.S. economic activity has moderated since the end of the first quarter of 2006 (Q2/06) and we expect this slowing momentum to prevail in Q4/06 and extend into 2007. Weakness in the housing sector should spill over to construction and consumer spending, two of the main engines of growth since 2002. Leading economic indicators (which include data on employment, manufacturing, housing, money supply, financial markets, and consumer expectations) are now in negative territory (-1.2% six-month annualized basis), and our blended ISM index (the U.S. Institute for Supply Management's monthly survey of production) has backed down from its 60+ peak and could dip below the 50 threshold before it recovers. Considering that current monetary policy is not overly restrictive, any additional weakness in energy prices could be viewed as highly positive for the "soft landing" scenario. Scotia Economics expects U.S. GDP growth to reach 2.4% in 2007.
- In Canada, growth continues to be timid east of Alberta and the overall pace has decelerated since May. In the last three months, employment has been negative (-26,000 jobs) and the trade surplus retreated to \$3.9 billion in August from a peak of \$7.7 billion in December 2005. GDP growth is expected to hit 2.9% this year before moderating to 2.5% in 2007.
- According to the International Monetary Fund (IMF), world GDP growth is set to remain above its 36-year average of 3.7% in both 2006 (5.1%) and 2007 (4.9%). In our opinion, this robust level of economic activity will prove difficult to achieve, as global liquidity declines and U.S. imports level off. With the U.S. outlook uncertain, rising IMF expectations for 2007 appear somewhat at odds, and we believe the IMF forecast will be revised lower in coming quarters.

Monetary Policy & Interest Rates

- The North American interest rate outlook has drastically improved since August as evidence of slowing economic activity surfaces in the United States and inflation fears abate. With the recent retreat in energy prices, the U.S. Federal Reserve appears more inclined to focus on weaker growth than on inflation risks.
- Based on our belief that long-term bond yields have peaked and that benchmark rates will come down 75 to 100 basis points next year, we went to an Overweight bonds/Underweight Canadian equities position at the end of August 2006, and feel this defensive stance will be beneficial in the coming months.
- Scotia Capital expects long-term yields to decline to 3.80% in Canada and 4.40% in the United States in 2007. U.S. benchmark Federal funds rate and the Bank of Canada overnight rate could decline 75 to 100 basis points next year, respectively. Our bond 12 to 18 month total return outlook stands at 8%. We believe the three-year flattening trend in the North American yield curve is coming to an end and we expect visible yield curve steepening in the coming months.

Commodities

- Commodity prices could experience further downside in the following months as financial flows temper and global growth moderates. The behaviour of West Texas Intermediate (WTI) crude oil is of particular importance at this stage, as funds invested in commodity exchange-traded funds (ETFs) are heavily skewed towards energy (energy comprises over 70% of the Goldman Sachs Commodity Index). Should commodity ETF funds flow turn negative for a sustained period of time, the selling pressure would also hit raw materials. Technically, WTI and Commodity Research Board or CRB (Index of Commodity Prices) patterns are not looking supportive at this point, and we would remain cautious.

- According to Scotia Capital Research's Energy team, oil prices should average US\$67.75/bbl in 2006 before moving down to US\$64.50/bbl in 2007. Natural gas prices should average US\$7.35/mmBtu in 2006 and US\$8.00/mmBtu in 2007.
- Scotia Capital Research expects gold prices to average US\$604/oz in 2006 and US\$625/oz in 2007. Scotia Capital's Metals & Mining team expects aluminum prices to average US\$1.12/lb in 2006 and US\$1.13/lb in 2007. Copper prices could decline to US\$1.35/lb in 2007 from US\$2.16/lb in 2006. Zinc should trade at US\$1.36/lb in 2006 and US\$1.48/lb in 2007; Nickel prices are expected to trade at US\$7.51/lb and US\$7.36/lb in 2006 and 2007, respectively.

Equity Outlook

- Since global equity indices and investor optimism peaked back in April, there has been a visible rotation towards lower-risk assets and sectors. These evolving market conditions are having a notable impact on market leadership. Quarter-to-date, bonds (4.8%) have outperformed equities in Canada (TSX -0.3%) and large cap stocks (3%) have outpaced small cap stocks (-0.8%) in the United States. The TSX Financials (8.3%) performance has been well above that of the TSX Resources (-7.5%), and the S&P 500 (3.8% in Canadian dollars) appears to have snapped its five-year losing streak versus the S&P/TSX along with the erosion in cyclical/commodity sentiment. Combined with the retreat in commodity prices, the Canadian dollar has also modestly stepped back to the US\$0.88 level.
- We believe the changing macro environment will continue to favour U.S. large cap equities and TSX sectors that are most sensitive to S&P 500 outperformance. North American monetary policy is reversing from the two-year tightening program initiated by the U.S. Federal Reserve back in June 2004. Scotia Economics has adjusted its forecasts recently, and the conclusion is quite clear: lower growth expectations and lower interest rates. Based on our belief that long-term bond yields peaked in early August, the developing environment is obviously friendlier to bonds/interest sensitive stocks than to the TSX/cyclical stocks.
- We have retained our Overweight stance in U.S. equities (the S&P 500) in light of the potential for Price/Earnings (P/E) expansion and very attractive risk-reward profile. Our S&P 500 valuation model still yields an attractive risk-reward profile, with the U.S. benchmark currently trading at a 9% discount to its fair value (1,450). In contrast, the S&P/TSX is still trading 9% above its fair value of 10,650, indicating more vulnerability to slowing U.S./global growth and softer commodities.
- Based on Scotia Economics' GDP and commodity forecasts, we expect S&P/TSX earnings to increase 24% to \$745 in 2006 and 2% to \$760 in 2007 (bottom-up consensus at \$853). S&P 500 earnings per share (EPS) should increase 10.5% to US\$84.50 in 2006 and 5% to US\$89.00 in 2007. Our 12 to 18 month targets remain unchanged at 12,250 for the S&P/TSX and 1,400 for the S&P 500.
- Based on current commodity spot prices, our 2007 S&P/TSX earnings forecast would fall to \$745, which would obviously have adverse effects on our target. Lower commodity prices actually act as a positive for S&P 500 earnings. Based on our model, every \$1 movement in energy prices (WTI equivalent) has a \$3 impact on our overall TSX EPS.

