

Outlook-First Quarter 2005

US economic growth accelerated in the final half of 2004 and should average over 4% for the year. As oil prices declined from a historic peak, consumer spending finished the year strongly with gains in both durable goods and retail sales in October and November. The US consumer will face stronger headwinds this year due to rising interest rates and the end of President Bush's tax cuts package. Income and employment growth will have to be the key drivers of consumer spending in 2005.

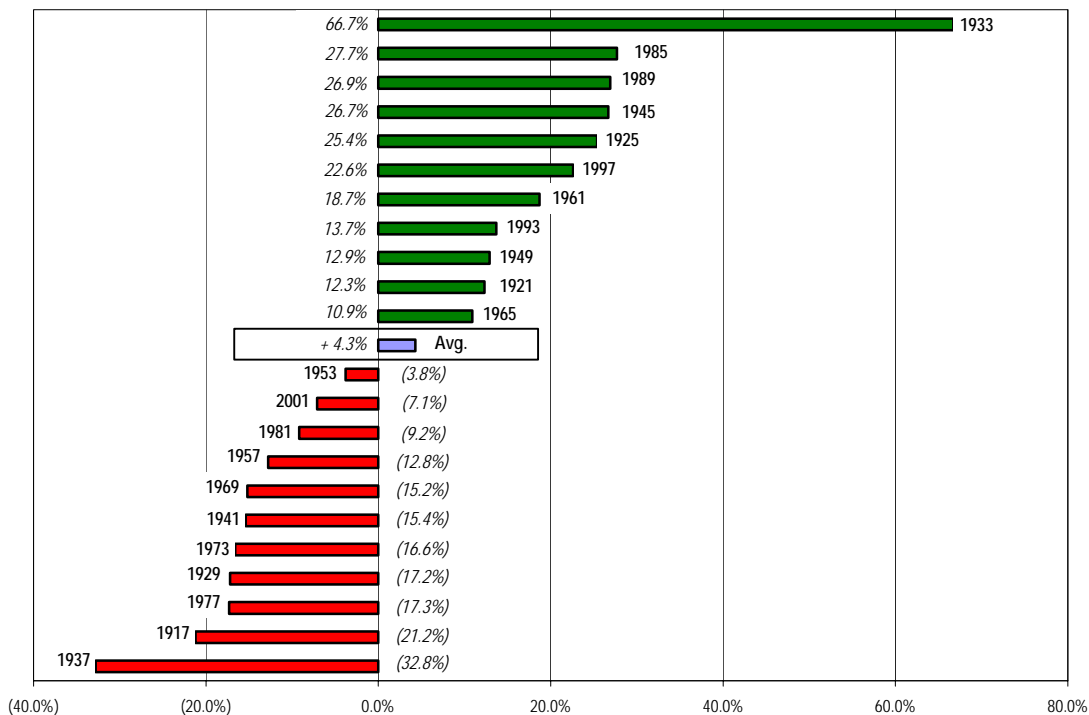
Unlike the US, Canadian economic growth decelerated as the year drew to a close and will likely average under 3% for 2004. As the New Year begins, consumer confidence is near a 14 year high and will likely continue to support spending in housing and retail sales. The Canadian dollar finished the year at 83.20US up 4.71% for the quarter. The strong rise in the Canadian dollar is now having a negative effect on our economy as industrial production and factory employment declined in November and the trade surplus has declined 42% from its peak. A further significant rise in the dollar will have further negative implications for economic growth.

The US Federal Reserve raised interest rates 125 bps in 2004. The Bank of Canada raised rates by 50bps in the last half of the year, but paused its tightening cycle in December and signaled its intention not to raise rates further as the strong Canadian dollar was negatively affecting economic growth. The differential between Canadian 2 year and 10 year bonds is now the lowest it has been in several years.

For 2005 the Canadian and US economies are likely to experience moderately slower growth, slightly higher inflation, and a decline in the pace of corporate profit growth. As a result, many forecasters are predicting another year of single digit equity market returns combined with low volatility. We disagree and believe that it is likely that 2005 will be a challenging year for investors.

This year is the first year in a new US presidential election cycle. The four-year election cycle usually encourages tough policy decisions to be conducted in the first two years. The chart below shows the range of returns in the Dow Jones Industrial Average from 1917 to 2001. Although the financial press is highlighting the average return in the first year of the cycle has been 4.3%, we believe this statistic is misleading. Although the average is comforting, it is the range of returns that is stunning!

DOW JONES ANNUAL RETURNS - 1st YEAR OF PRESIDENTIAL CYCLE



As we have mentioned in our previous commentaries, the volatility of returns of most asset classes has been declining over the past two years to reach multi decade lows. These levels of volatility combined with the historic range of returns for the first year of a presidential cycle, make it likely that many investors will be surprised in 2005!

Bottom Line:

In the latter part of 2004, we were correct in our forecast of a decline in oil prices combined with a favourable seasonal pattern for equities would produce a late year rally. However, this year's investment environment is likely to be much more challenging than most investors expect. Our focus will continue to be on preserving the value of our clients' investment assets by opportunistically adjusting equity allocations, utilizing hedging strategies, reducing corporate bond holdings and maintaining below average duration in bond portfolios.