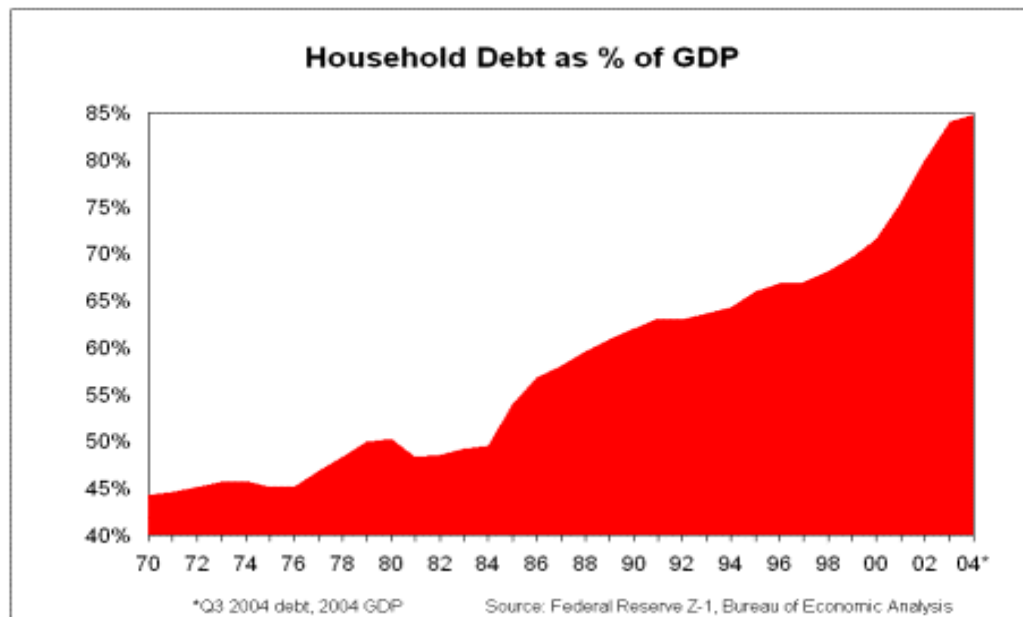


## Outlook- Second Quarter 2005

The US economy supported by solid business and consumer spending grew in the final quarter of 2004 at an annual rate of 3.8%. This brought GDP growth last year to 4.4%, the best performance since 1999.

Growth has moderated from this pace in the early part of 2005, as February industrial production advanced just .3% and retail sales were up only .5%. It is noteworthy, that because of weak job creation and income gains, economic growth has had to come at the expense of savings. The personal saving rate was only 0.6% in February. Consumers continue to fund their consumption by drawing down savings and home equity. This trend has resulted in increasing levels of debt. The household sector debt-to-GDP ratio is holding in record territory around 85%.



Canadian GDP grew .2% in January, which brings the 3 month annualized trend to 3.2%. Retail sales increased 2% in January and February industrial production was up 1.1%. However, the February trade report heightened concern over the impact of trade on economic growth as the surplus narrowed to \$4B. Export related manufacturing continues to be a drag on growth, as it is being slowed by the rise in Canadian dollar and higher energy costs.

The Federal Reserve raised interest rates in March by 25 basis points. This was the seventh straight hike, lifting the fed funds target to 2.75%. Since the Fed started to raise rates in June 2004, longer-term bond yields had been largely moving lower, even as signs of an inflation pickup were emerging. However, after the Fed's most recent move, 10-year yields jumped to over 4.60% from the 4.00% level in early February.

Inflation pressures are building as the February Producer Price Index was up 4.7%, while CPI was up .4%, its strongest monthly gain since last October. Bond yields will likely be more sensitive to any future inflationary pressures.

The Federal Reserve target rate is now 25 basis points above the Bank of Canada's overnight target rate of 2.5%. However, it is clear that inflation is more of a pressing problem in the US than in Canada, suggesting that the Bank of Canada will hike rates at a more moderate pace than the Fed.

As we highlighted 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. We believed that this trend was likely not sustainable for 2005 and the first three months of this year have shown signs of a reversal: oil prices hit a record high of \$57, bonds prices had their largest decline since the spring of 2004, the CRB Commodity index reached its highest level since 1981 and stocks hit multi-year highs early in March and then retreated at quarter end.

**Bottom Line:**

Increasing volatility in many financial markets will make this year's investment environment more challenging. Our focus will continue to be on preserving the value of our clients' investment assets by opportunistically adjusting equity and bond allocations and utilizing hedging strategies.