

Outlook- First Quarter 2007

As 2006 drew to a close, U.S. economic indicators suggested that the economy was holding up surprisingly well, even though the housing sector continued to weaken. Conversely, Canada experienced waning growth due to declines in commodity sensitive sectors and manufacturing. These divergent trends in the U.S. and Canadian economies put downward pressure on the Canadian dollar, which finished the year almost 7% below its May 2006 peak level.

Despite the year-end slowdown, we project that the Canadian economy will likely continue to grow at a respectable 2.5% to 3% pace for first half of 2007. Continued job gains have pushed the unemployment rate to a 30 year low of just above 6%, despite losing 200,000 manufacturing jobs over the past two years. Asian economic growth will continue to fuel demand for commodities, while cutbacks in auto production are mostly complete and the export challenges created by the advancing Canadian dollar have now gradually began to ease.

This pace of economic growth will result in the Bank of Canada staying on the sidelines in the first half of 2007, unless an external shock causes domestic and international growth to moderate further than our projection. Short-term interest rates should decline later in the year, but there is not much potential for longer term rates to decline, as 10-year Canada Bond yields are now down to the 4% level from a high of 4.60% seen in July of last year.

During the first two quarters of 2007, US economic growth should be in the 2.0% to 2.5% range, as the economy will struggle to regain momentum. Residential investment expenditures, which lead economic growth, have declined in the U.S. for the last 5 quarters. Even if a trough in the housing sector is at hand, there are still negative ripple effects that will work their way through the economy during the first half of 2007. After peaking at an annualized rate of 14.50% in the second quarter of 2005, growth in homeowner's equity declined to only 0.53% in the third quarter 2006. The absence of growth in homeowner equity will remove important source of consumer spending. Therefore, sub par economic growth combined with reduced inflationary pressures, will allow the Federal Reserve to beginning moving to lower short term interest rates by mid-year.

Despite a weakening housing market, slowing economic growth and a nuclear test in North Korea, equity prices completed their fourth year of advance in 2006. This is the second longest uncorrected advance in the history of the U.S stock market. Investors are betting that the U.S. economy will only experience a mid-cycle slowdown (i.e., something just short of a recession). In addition, strong corporate profits allowed U.S.

corporations to retire a record \$566 billion in stock buy backs or mergers during the third quarter. As a result, equity markets bypassed their traditional fourth quarter correction and rallied higher into year-end.

Bottom Line:

2007 promises to be a transition year, as it will become clear if the US housing sector troughs and allows the U.S. economy to regain positive momentum and whether corporate profit growth will continue to be enough to support equity prices.

We will continue to monitor economic and financial markets as they react to the unfolding economic environment. 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.