AS AT DECEMBER 31, 2006

2006: A year of transition for the U.S. economy

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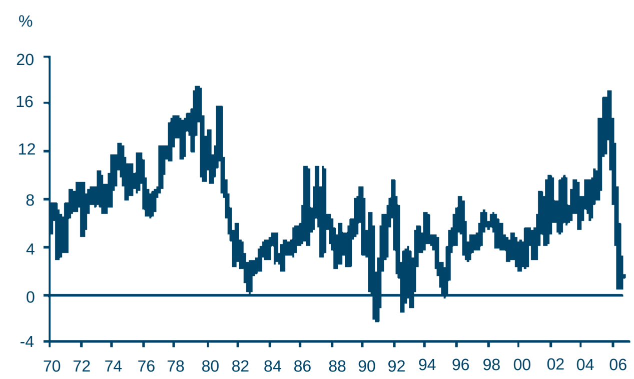
Recent changes in the economy

Economically speaking, 2006 could be described as a year of transition for the United States. The pace of the world's biggest economy has slowed in the last few years, as the numerous stimuli of previous years have gradually become a distant haze.

An analysis of the 2001-2005 period shows that several economic factors fostered U.S. growth. The price of oil was trading at less than $40 per barrel on average, the three major U.S. automobile manufacturers were offering attractive financing, interest rates were at historic lows, housing prices were reasonable and U.S. government spending was massive. In the last two years, the price of oil has gone up considerably, as has the key rate of the U.S. Federal Reserve. How was the cycle of economic growth able to last so much longer than expected?

The secret lies in the real estate sector, through home-equity loans. The drop in long-term rates in the last few years combined with the rise in housing prices enabled consumers to borrow more than $800 billion against the equity accumulated on their real estate assets in 2005. By spending this money, consumers—who account for 70% of economic activity—kept the economy moving beyond a normal cycle. However, economic growth based on asset growth is more vulnerable than growth based on an increase in revenues, because assets are more vulnerable to drops in value.

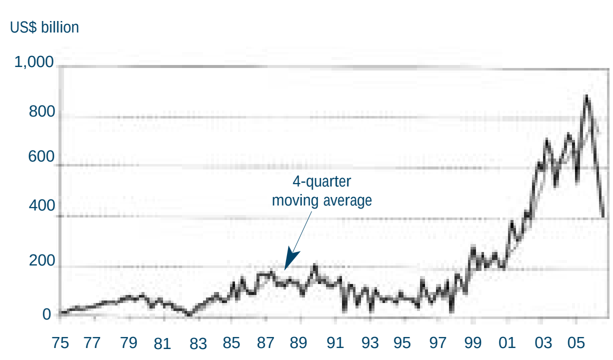
Graph 1 - Median sale price of total existing homes
Variation in %, year/year



Source: National Association of Realtors, Merrill Lynch

In addition, new mortgage products available in the U.S., in particular interest-only payment mortgages and payment-option mortgages (with the option to make a minimum payment), encouraged property ownership and speculation. According to the Mortgage Bankers Association, these new products represent 40% of all mortgages. In fact, they have pushed the property rate (percentage of people who own their home) up to 69%, a record high. Previously, without this easing of credit restrictions, many of these new borrowers would not have been able to acquire a property because of their limited financial capacity. As long as housing prices remain stable and interest rates low, this sector of economic activity is an asset for the U.S. economy. But now interest rates have gone up, and housing prices have plummeted 10% since last year. (Graph 1) As stated above, consumers account for 70% of U.S. economic activity. But now their main source of liquidity of the last few years—the equity accumulated on their real estate assets—is drying up, and the number of loans has fallen to its lowest level in three years (Graph 2). The retreat of the real estate market in 2006 had a direct impact on the country's quarterly gross domestic product (GDP). If we look at the quarterly GDP growth in the U.S. in

Graph 2 - Mortgage Equity Withdrawal
(relative score)



Source: BMO Capital Markets estimate

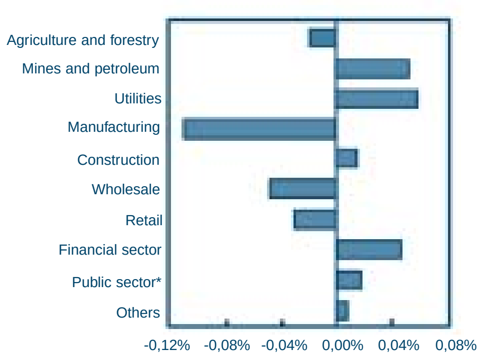
2006—5.6% (Q1), 2.6% (Q2) and 2.2% (Q3)—it is clear that the pace of economic activity has slowed in the last few months.

Everyone agrees that the U.S. economy will be slower in 2007, but the question is just how slow. The impact of the job market will be a determining factor. More than 40% of job creation in the last few years has been directly or indirectly tied to the real estate sector. The decline of the real estate market has already had repercussions on employment, with 5,300 jobs cut by residential construction contractors in the last two months and another 102,000 jobs lost in construction-related products and services.

Even the Federal Reserve recognized, at its last meeting, that U.S. economic growth would be more moderate in 2007 as a result of the slowdown in the real estate sector. By leaving its key rate at 5.25%, the Federal Reserve is seeking to strike a balance between moderate economic growth and controlled inflation. The current risk is that by maintaining its key rate too high for too long, it could push the U.S. economy toward a recession. However, the Fed has stated that inflationary pressures remain, justifying its decision to keep its key rate unchanged for a fourth time this year.

While the U.S. economy has slowed, two of its major suppliers—Canada and Mexico—are feeling the repercussions, as demonstrated by the recent statistics for Canadian GDP in September (-0.4%) and October (0.0%). In particular, automobile manufacturing as well as wholesale and retail trade saw limited growth in October (Graph 3). The export sector continues to deteriorate under the influence of a high dollar and weaker U.S. demand. Like the Federal Reserve, the Bank of Canada opted to maintain its key rate at 4.25%, indicating that some risks of inflation were still present. With the downturn of the last few months, however, the Bank of Canada could begin raising rates in 2007, since inflation does not seem to be a problem.

Graph 3 - Contribution to total growth by the main industrial sectors



* Education, health and public administration.

Source: Statistics Canada

Chart 1 - Market Returns as at December 31, 2006

Index	Returns 3 months	YTD
Canada Treasury bills - 91 Day	1.0%	4.0%
SC - Universe Bond	0.7%	4.1%
S&P/TSX Composite Index	10.4%	17.3%
S&P 500 (Can. $)	11.5%	15.7%
MSCI - EAFE (Can. $)	15.3%	26.8%
MSCI - World (Can. $)	13.3%	20.6%
Exchange Rate (Can. $ / US $)	4.5%	(0.1)%

Changes in the financial markets

The year just ended once again turned out to be excellent for the stock markets. In fact, 2006 saw equity markets posting strong gains worldwide. The S&P/TSX was once again among the top-performing indices. However, unlike previous years, the Canadian index was closely followed by the other stock market indices. The Dow Jones—the U.S. index representing the biggest companies listed on the New York Stock Exchange—even broke records. Several European indices, such as the FTSE (England), the DAX (Germany) and the CAC 40 also generated good performances.

After a spectacular rebound in the third quarter (+4.85%), the Canadian bond market was much less generous towards investors in the last three months, advancing just +0.70% during the period—less than the coupon payment (at December 31, 2006, the return from the coupon payment was hovering around 4.34% annually, and therefore 1.09% quarterly)—following a slight increase in the majority of rates along the yield curve (inverse relationship between interest rates and bond prices). For 2006 as a whole, the return of the Canadian bond market, as measured by the Scotia Capital Universe

Bond Index, climbed +4.06%, which was also less than the coupon payment.

Outlook

With the retreat of the U.S. real estate market and the increase in short-term interest rates, we are expecting a slowdown of the U.S. economy in the coming months. As well, we believe the high costs of energy will translate into a slowing of U.S. economy activity rather than an increase in inflation and prices in the long term. As the largest trading partner of the U.S., Canada will also be affected by this economic downturn.

For the next twelve months, we are forecasting economic growth of 2.0% for the Canadian economy. Interest rates should eventually drop, as we are expecting inflation to remain within the Bank of Canada's target range (between 1% and 3%). On the financial markets, we are forecasting a return of about 5.9% for Canadian equities for the next 12 months ending December 31, 2007. Meanwhile, bonds should generate a return of roughly 7.5% for the same period. The Canadian stock market has offered the best return for several years now, primarily owing to its heavy weighting in the energy sector and the rise of the Canadian dollar. These two components contributed to the solid performance of Canadian equities as compared to foreign equities. However, the current valuation levels of Canadian stocks and the Canadian market's dependence on the energy and materials sectors has prompted us to reallocate some assets toward foreign markets, which offer more opportunities for diversification across sectors. To reflect our more cautious position, we maintained our asset allocation for the last quarter of 2006. We remain overweighted in fixed-income securities, foreign equities and underweighted in Canadian equities. Of course, we remain very attentive to the various developments that are taking place on the economic stage so that we can modify our position, should our forecasts for the economy and financial markets change.

Chart 2 - Economic and financial indicators - Canada

	2001	2002	2003	2004	2005	The most recent data	Trend	Forecast December 2007	
Real gross domestic product (%)	(0.1)	3.4	2.6	2.6	3.3	2.50 [1]	↘	1.75 to 2.25	*
Inflation rate (%)	0.7	3.9	2.0	2.1	2.2	1.40 [2]	↗	1.75 to 2.00	*
Unemployment rate (%)	8.0	7.5	7.3	7.1	6.5	6.10 [3]	↗	6.30 to 6.80	**
Treasury bills (91 days) (%)	1.91	2.66	2.57	2.44	3.39	4.15 [3]	↘	2.75 to 3.00	**
3-year mortgages (%)	5.75	6.00	5.90	5.60	6.00	6.40 [3]	↘	5.25 to 5.75	**
10-year bonds (%)	5.36	4.80	4.66	4.31	3.98	4.08 [3]	↘	3.45 to 3.75	**

[1] As at September 30, 2006 [2] November 2006 [3] As at December 31, 2006
* Annual average ** End of period

Chart 3 - Estimated gross returns for the next twelve months starting December 31, 2006

Market indicators	Interest or dividend	+	capital gains	=	Total estimated gross return
Treasury bills (91 days)	3.50%	+	0.00%	=	3.50%
SC - Universe Bond	4.30%	+	3.20%	=	7.50%
Canadian stocks (S&P/TSX Composite Index)	1.65%	+	4.25%	=	5.90%

A quarter in keeping with 2006 overall

By Pascal Garneau, CFA
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After a spectacular rebound in the third quarter (+4.85%), the Canadian bond market was much less generous towards investors in the last three months, advancing just +0.70% during the period—less than the coupon payment (at December 31, 2006, the return from the coupon payment was hovering around 4.34% annually, and therefore 1.09% quarterly)—following a slight increase in the majority of rates along the yield curve (inverse relationship between interest rates and bond prices). For 2006 as a whole, the return of the Canadian bond market, as measured by the Scotia Capital Universe Bond Index, climbed +4.06%, which was also less than the coupon payment.

The year 2006 was divided into two distinct periods. In the first six months, the world tightening of liquidities created a difficult environment for the bond market; in the second half of the year, the bond market fluctuated to the beat of the economic data published. Thus, in the latter six months, debt instruments benefited from a drop across the yield curve as a whole, sparked by economic statistics pointing toward a slowdown of the North American economy. However, as previously discussed, most of the gains in the second half of the year came between the end of June and the end of September, since the October and December interest rate increases completely erased the November decreases. Several reasons can account for the bond market's more difficult end of the year: "mixed" economic data, inflation (which, although under control, is currently above the U.S. Federal Reserve's and the Bank of Canada's target range), as well as special circumstances related to the end of the year (coupon payments at the beginning of December and the resulting decrease in liquidity; increase in the duration of the index while rates moved upward).

> In the last quarter, as for 2006 as a whole, the return of the Canadian bond market was less than the coupon payment.

Thus, in the fourth quarter, the yield curve moved upward and flattened slightly, as short-term rates climbed more than longer-term rates. The yield curve also flattened compared with December 2005, but the movement was more pronounced. Therefore, at the end of 2006, the yield curve was slightly inverted (3-month rates higher than 10-year rates) (see graph 1). In the United States, the yield curve was also inverted—even a bit more so. Historically, an inverted yield curve has often been a precursor to a slowdown in economic growth.

It is interesting to note that despite these fluctuations up and down, the rate for Government of Canada bonds with 10-year terms to maturity ended the year at almost the same level as the previous year (4.08% at the end of 2006 versus 3.98% at the end of 2005).

As for short-term rates, in the last three months, the North American central banks maintained the status quo of the third quarter. The Fed's key rate remained unchanged at 5.25%, and that of the Bank of Canada is still at 4.25%. The Fed repeated the same caution about inflation and pointed to "mixed" economic signals and a "substantial" slowing of the real estate market. It

Graph 1 - Evolution of the bond rate curve

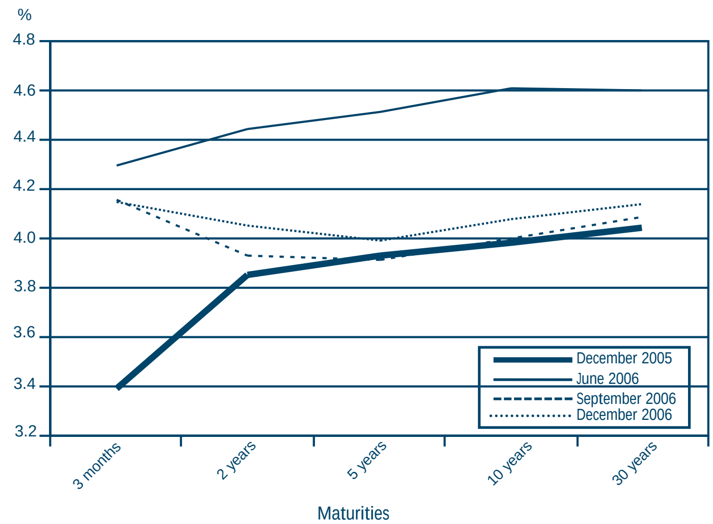

Chart 1 - Returns of the Canadian Bond Market as at December 31, 2006

Index	Returns 3 months	Returns YTD
SC - Universe Bond	0.7%	4.1%
SC - Short Term	0.8%	4.0%
SC - Mid Term	0.6%	4.1%
SC - Long Term	0.7%	4.1%
SC - Canada	0.5%	3.6%
SC - Provincial	0.8%	4.4%
SC - Municipal	0.7%	4.2%
SC - Corporate	0.9%	4.4%

Source: Scotia Capital Debt Market Indices seems, however, that some members are becoming increasingly concerned over the risks facing the U.S. economy.

According to the Bank of Canada, some recent indicators suggest that output growth in Canada and the United States in the fourth quarter of 2006 may be a little weaker than previously expected. It also states that inflation in Canada has evolved broadly in line with the Bank's expectations.

On both sides of the border, monetary policy continues to depend on the economic statistics published. The fact that inflationary fears have not completely dissipated is keeping market players on the alert. This will likely remain the case until a clearer trend emerges as to the future direction of retail prices. However, some market players are beginning to speculate that the North American central banks will soon lower short-term rates in order to sustain economic growth, which is facing major challenges—in particular, the slowing of the real estate sector and its ripple effects on the rest of the economic machine.

As demonstrated in Chart 1, all terms to maturity generated roughly the same return in the last quarter and for 2006 as a whole. The fact that the yield curve is currently flat means that short-term bonds are generating about the same current return as bonds with longer terms.

In terms of issuers, the fourth quarter largely resembled 2006 as a whole as well. Corporate bonds have delivered the best performance since the end of September, and for all of 2006. Despite an increasingly likely slowdown of the North American economy which could cause investors to ask for higher risk premiums to compensate for the higher risk of default) demand for this kind of security remains strong, and the credit spreads between corporate securities and government securities is small. For example, TD Bank had no problem finding buyers for a $2.3 billion issue, the largest debt issue ever by a Canadian company. In terms of the rates of return, corporate securities were closely followed by provincial bonds. Several positive elements worked in this issuer category’s favour. The credit rating of some provinces was revised upward and the fiscal situation of some provinces has improved (notably Ontario, which reported a “surprise” budgetary surplus in the last few months); at the same time, there seems to be some openness on the part of the Harper government to resolve the fiscal imbalance question.

In closing, the year just ended was fertile in emotion. Despite a difficult start to the year for the bond market, the second half of the year was profitable for investors in the Canadian bond market. Some elements could favour fixed-incomes securities in the coming year (expansionist monetary policies, a decrease in inflation, a greater-than-anticipated slowdown of economic growth). However, given that we seem to be in a period of transition, investors should expect a few more shocks in the short term, until a clearer trend emerges with respect to North American economic growth and retail prices.

World stock markets ahead

By Julie Caron, CFA
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The year just ended once again turned out to be excellent for the stock markets. In fact, the year 2006 saw equity markets posting strong gains worldwide. The S&P/TSX was once again among the top-performing indices. However, unlike previous years, the Canadian index was closely followed by the other stock market indices. The Dow Jones—the U.S. index representing the biggest companies listed on the New York Stock Exchange—even broke records. Several European indices, such as the FTSE (England), the DAX (Germany) and the CAC 40 (France) also generated good performances. They posted returns of 10.72%, 21.98% and 17.53% respectively, in local currency, and even more when converted into Canadian dollars. In terms of emerging markets, countries such as the Philippines, Malaysia and Hong Kong did particularly well.

> The concentration of the S&P/TSX Index means that just a few sectors and a few stocks were responsible for the good market performance.

In Canada, the performance was excellent, but once again this year, the concentration of our market means this performance was the result of just a few sectors and a few stocks. We cannot say that all investors enjoyed remarkable returns. As in 2004 and 2005, when the energy sector largely dominated the Canadian market, the year 2006 was characterized by a concentration of returns. The materials and information technology sectors did particularly well this year, with respective returns of 38% and 27.3% (see Chart 1). Within the materials sector, the mergers surrounding Inco and Falconbridge were the driving forces. It was therefore primarily the diversified metals and mining sub-sector that led to the solid performance of the materials sector this year. In information technology, a single stock, Research in Motion, was responsible for the sector's return. RIM accounts for 1.66% of the S&P/TSX, or half its sector. It is therefore of major importance, particularly since its stock delivered a return of 94% in the last year. Among other things, the stock benefited from the court ruling in its favour concerning its famous Blackberry patent, RIM's flagship product. The effect of this stock alone was enormous; if excluded, the return of the S&P/TSX would be lower, as was the case for the materials sector. RIM alone added roughly 1% to the index's return in 2006.

Of course, it is not the first time we have seen the effect of the Canadian market's concentration on stock market returns. And the effect has not always been a positive one. One simply has to recall the year 2000, when the information technology sector—and Nortel in particular—accounted for more than one third of the index. When the tech bubble burst, this lack of diversification caused the entire index to come crashing down. Now, although the situation is quite different, the problem of concentration persists, with just three sectors—materials, energy and financials—representing three quarters of our stock market index. And it is

Chart 2 - Resource companies were popular S&P/TSX targets

Industry Sector	Number of deals by sector	Percentage of deals by sector
Basic Materials	11	35%
Energy	7	23%
Technology	2	6%
Industrial	2	6%
Consumer, Cyclical	3	10%
Financial	2	6%
Consumer, Non-cyclical	1	3%
Utilities	1	3%
Communications	2	6%
Total	31	100%

Source: National Bank Financial

Chart 1 - Market Returns as at December 31, 2006

	Total Return 3 months	Total Return YTD
Sector Allocation S&P/TSX		
Energy	7.7%	6.1%
Materials	20.8%	39.8%
Industrials	9.6%	14.7%
Consumer Discretionary	8.8%	15.7%
Consumer Staples	7.4%	5.5%
Health Care	15.4%	0.7%
Financials	9.7%	19.2%
Information Technology	19.1%	27.3%
Telecommunication Services	(1.1)%	20.1%
Utilities	9.4%	7.0%
S&P/TSX Composite Index	10.4%	17.3%
S&P 500 (Can. $)	11.5%	15.7%
MSCI - EAFE (Can. $)	15.3%	26.8%
MSCI - World (Can. $)	13.3%	20.6%

this concentration that explains the out-performance of the Canadian stock market in the last few years. These sectors have seen phenomenal cumulative returns: 114% for the energy sector, 66% for the materials sector, and 63% for the financial sector, all in the last three years. The other seven sectors made rather weak contributions; the growing size of the top three performing sectors is therefore making our market increasingly vulnerable. It is this aspect that is currently prompting us to diversify our assets and to ensure increasing exposure to foreign markets. In the United States, for example, the more defensive sectors, which are less influenced by economic cycles, are larger and there is a greater choice of securities. For instance, the U.S. market offers attractive opportunities in consumer staples. These companies produce common consumer goods such as baby diapers, toilet paper and toothpaste; they are therefore less susceptible to the effects of economic downturns. The pharmaceutical sector also has a high presence in the U.S. and European indices. Should the scenario of an economic slowdown materialize, these defensive sectors should be less affected than more cyclical sectors such as the materials sector.

The year 2006 was marked by a wave of mergers and acquisitions in the stock markets, especially in Canada. The value of mergers and acquisitions in Canada nearly doubled as compared to the previous year. A total of 31 stocks disappeared from the S&P/TSX last year. This is causing the Canadian stock market to lose investment opportunities, further exacerbating the lack of diversification. Some of the more major stocks that disappeared included Fairmont Hotels, Shell Canada, ATI Technologies, not to mention the Falconbridge and Inco acquisitions that garnered so much media attention (see Chart 2). The most popular targets for acquisitions this year were resource companies: 58% of acquisitions affected companies in either the energy sector (23%) or the materials sector (35%). The appreciation of the stocks targeted by acquisitions was a significant factor in the return of the S&P/TSX this year.

Company profits were solid this year. For the four quarters ending September 30, 2006, earnings per share for the S&P 500 were up 18%. Previous years were also very profitable, with increases of 19% and 20% in 2005 and 2004. The situation in Canada was similar. The question is now whether these companies will be able to maintain this rate of expansion. Current concerns over U.S. economic and world growth are causing us to be cautious. We remain vigilant and favour a solid diversification in equities across sectors and geographic regions.