

Finding Direction in Uncharted Territory



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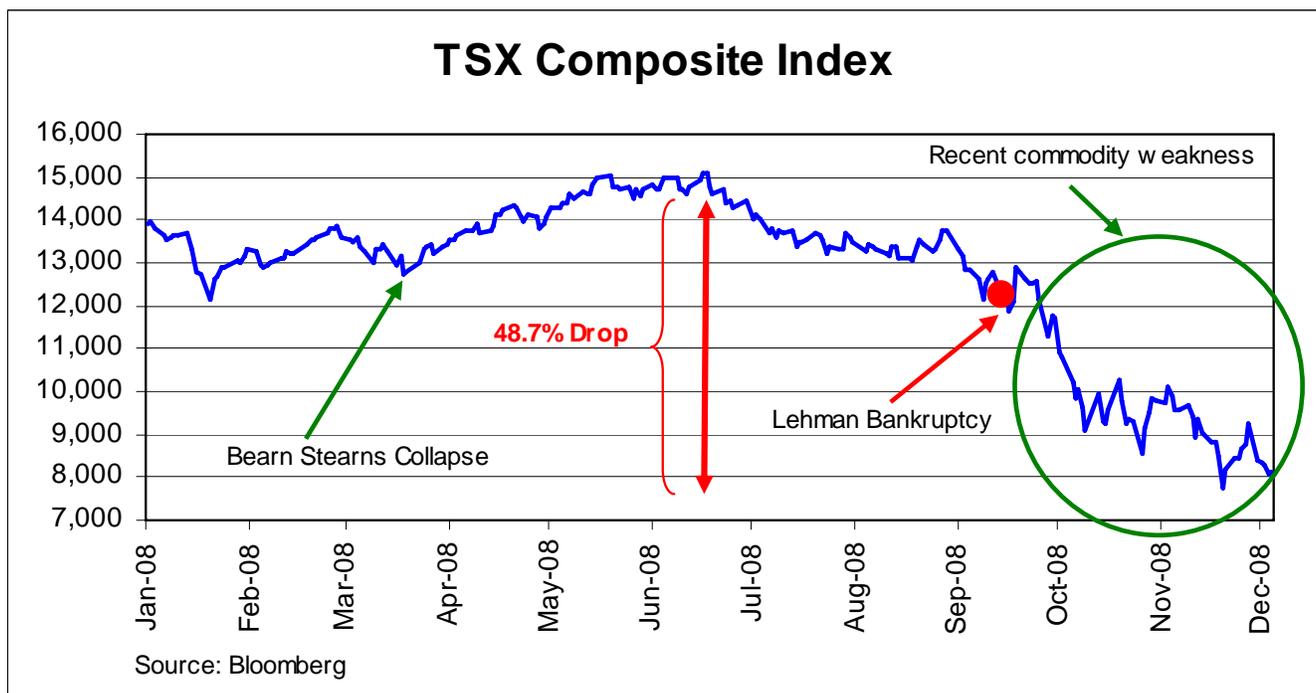
Contents

	Page
2008 – A Review	3
What Happened?	7
The Credit Crisis	7
Economic Concern turns to Panic	8
Forced Selling	8
What Has Been Done?	9
How Can We Turn Things Around?	10
Return Stability and Fluidity to the Credit Markets	10
Stabilize the U.S. Housing Market	10
What Happened to the Canadian Dollar?	13
Looking Forward	14
Economic Outlook	16
Where is the Canadian Dollar Headed in 2009?	16
Canadian Equity Market Outlook	17
Financials	18
Energy	20
Materials	22
Consumer Staples	24
Utilities & Pipelines	24
Telecommunications	25
Technology	25
Industrials	26
Consumer Discretionary	27
Individual Stocks to Highlight	28
Silver Linings	29
Overall Conclusion	29

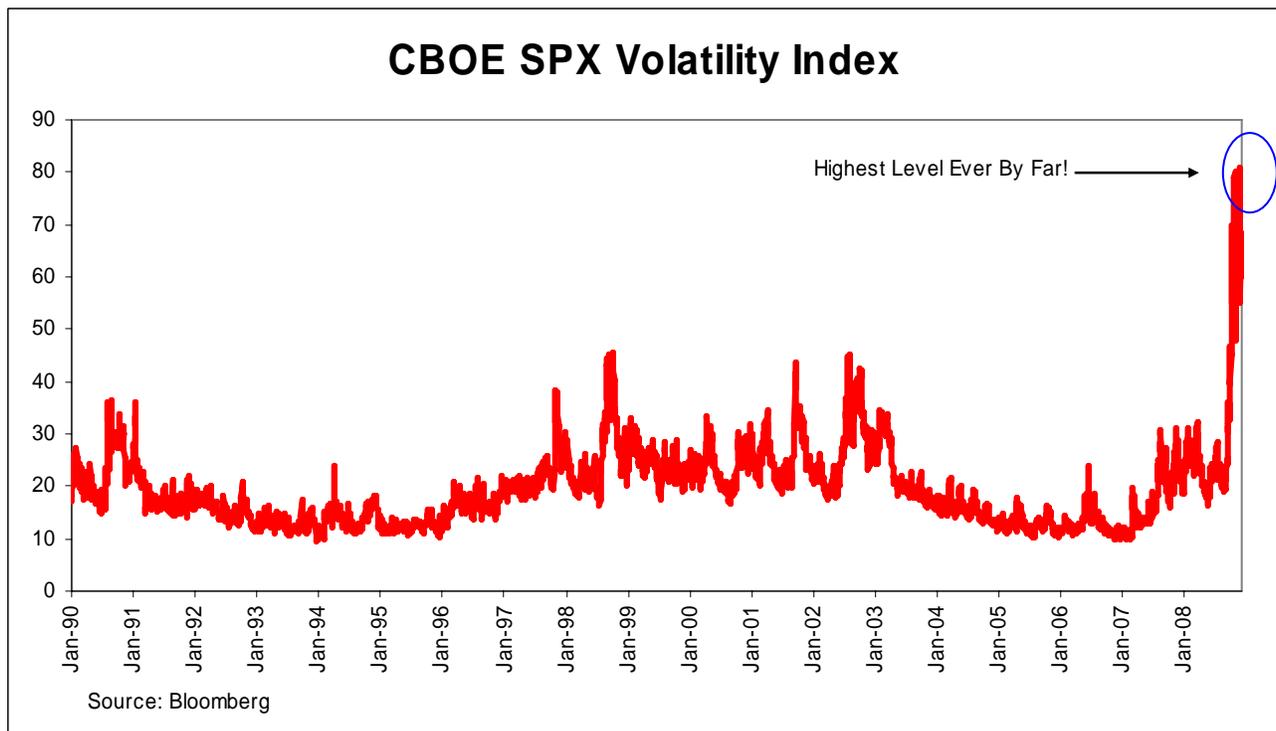
2008 was simply a remarkable year, but unfortunately for the wrong reasons as we have been through 12 months of extreme circumstances and a roller coaster ride which most investors would have rather avoided. What made the performance of the TSX Index and other global indices all the more shocking was the speed and magnitude of declines witnessed in the second half of the year. Traditional fundamental analysis took a back seat to irrational thought as equity markets found themselves facing a financial and economic crisis not seen since the Great Depression. The severity of the problems faced by economies and markets worldwide was not apparent at first, but became all too clear as capital flows disappeared, investment declined, consumption slowed and wealth was destroyed. Simply put, 2008 is shaping up to be the worst year of performance for many equity markets in over 65 years.

2008 – A Review

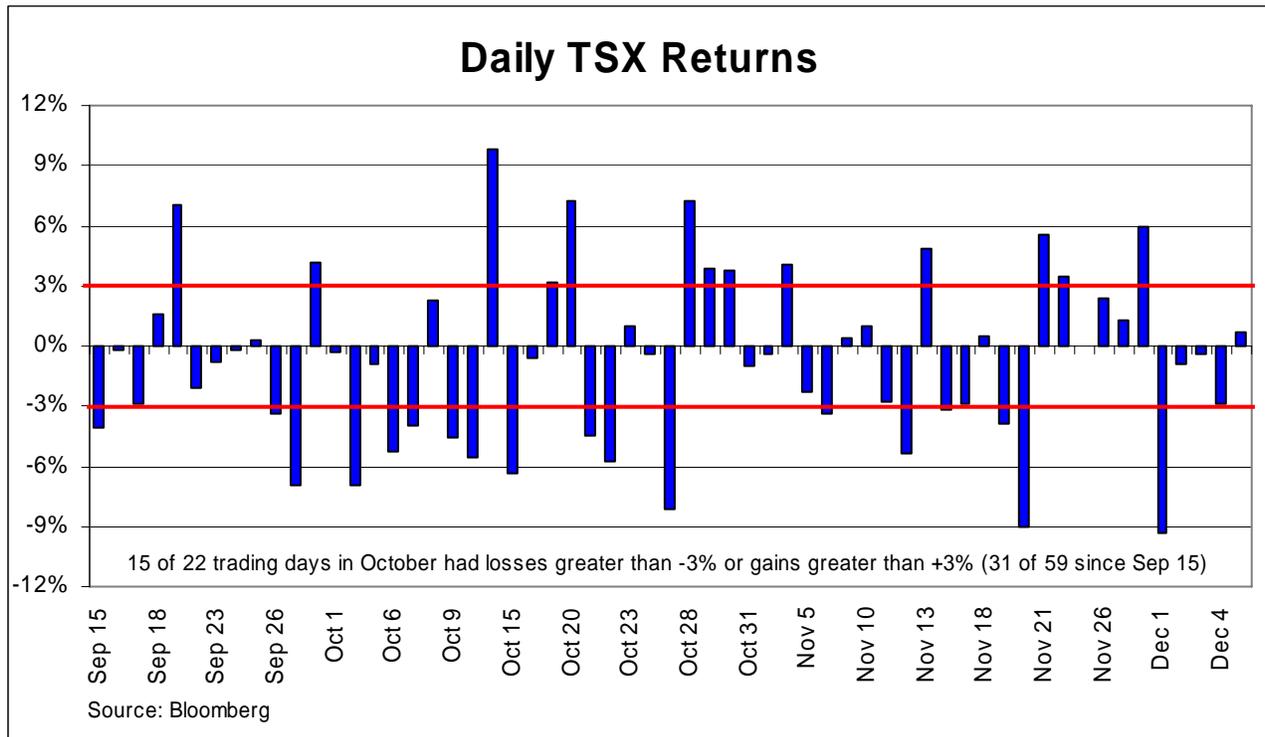
Looking at a 2008 performance chart for the TSX Index you can certainly see that the first half of the year told a different story than the second. Even with the collapse of Bear Stearns in March, Canadian markets continued their historic bull run thanks to continuing strength in resource prices. However, financial concerns in the U.S. escalated again in June and commodity prices saw material declines in the month of August thanks to growing credit/economic concerns and selling by levered investors such as hedge funds. Losses were compounded by the uncertainty and lack of confidence created by the failure of Lehman Brothers in September. This failure started a chain reaction of events which resulted in some of the most dramatic losses seen in recent memory. We will touch on the impact of the Lehman failure later in this report.



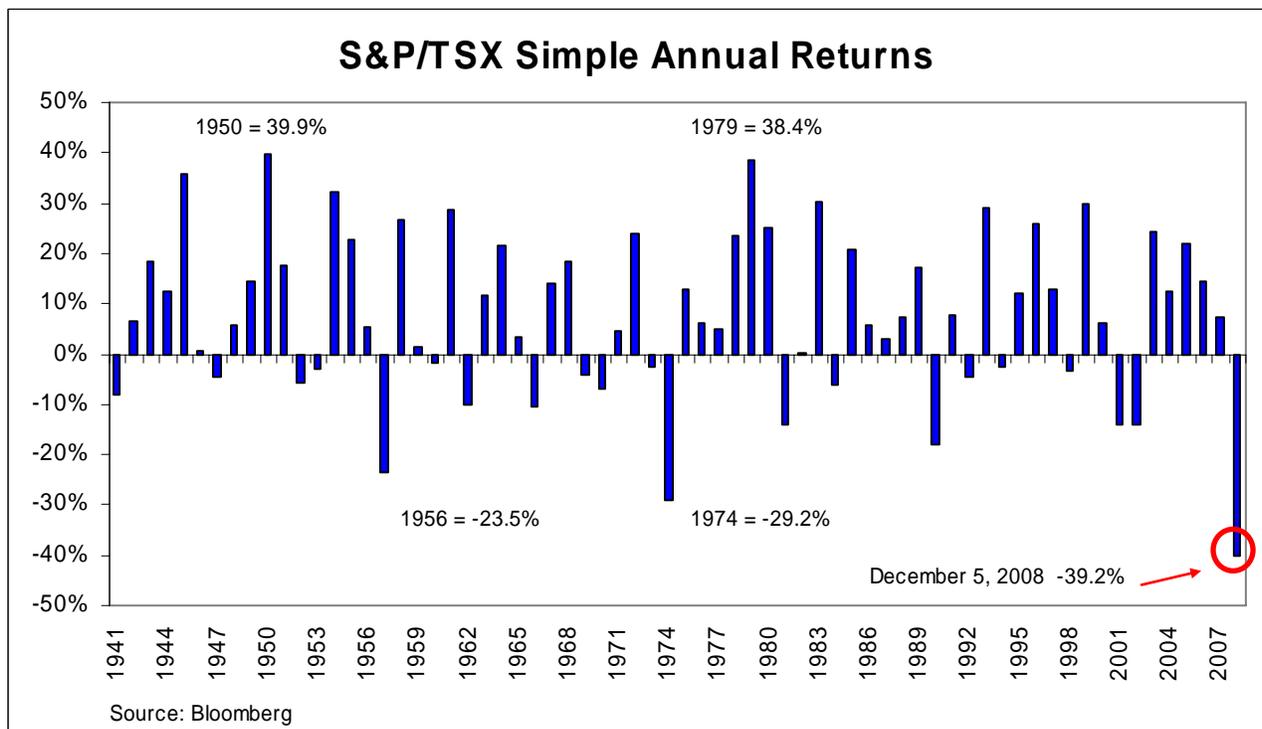
Not only were stock market losses material, but the volatility was like nothing we've seen for at least a couple of decades. Below we show a graphical illustration of the Chicago Board Options Exchange SPX Volatility Index which was created in 1993 (data has been backdated to 1990). Naturally a low number is desired by investors who enjoy steady performance; however, as you can see the index reached an inter-year high of 89.53 on October 24. You'll also note that the sharp spike in volatility, caused by increasing credit, liquidity and economic concerns, makes the volatility seen during the 1990 recession, 1997 Asia crisis, 1998 Russian crisis, 2000 tech bubble, and September 11, 2001 seem minor.



Another way to illustrate how volatile markets have been is to look at daily returns for the TSX which have simply been staggering. It was only a few months ago that investors considered a gain or loss of 3% or more to be a “big deal”. Unfortunately, since the failure of Lehman Brothers it has become all too commonplace. As you can see in the chart that follows, 15 of 22 trading days in October had losses greater than -3% or gains greater +3%. If we go back to the bankruptcy of Lehman Brothers until December 5th, 31 of 59 trading days have posted similar excessive returns. Seeing so many returns of such a high magnitude over a short period of time is not normal or rational for that matter.



When I mentioned that 2008 is shaping up to be the worst year of performance for many equity markets, unfortunately the TSX Index in Canada cannot be excluded from that group. The following chart shows the performance of the TSX Index going back to 1941 and if December 5th of this year had actually been December 31st, then the TSX would have posted its worst return over that time period. 2008 would exceed the losses seen in 1974 (-29.2%) and 1956 (-23.5%).

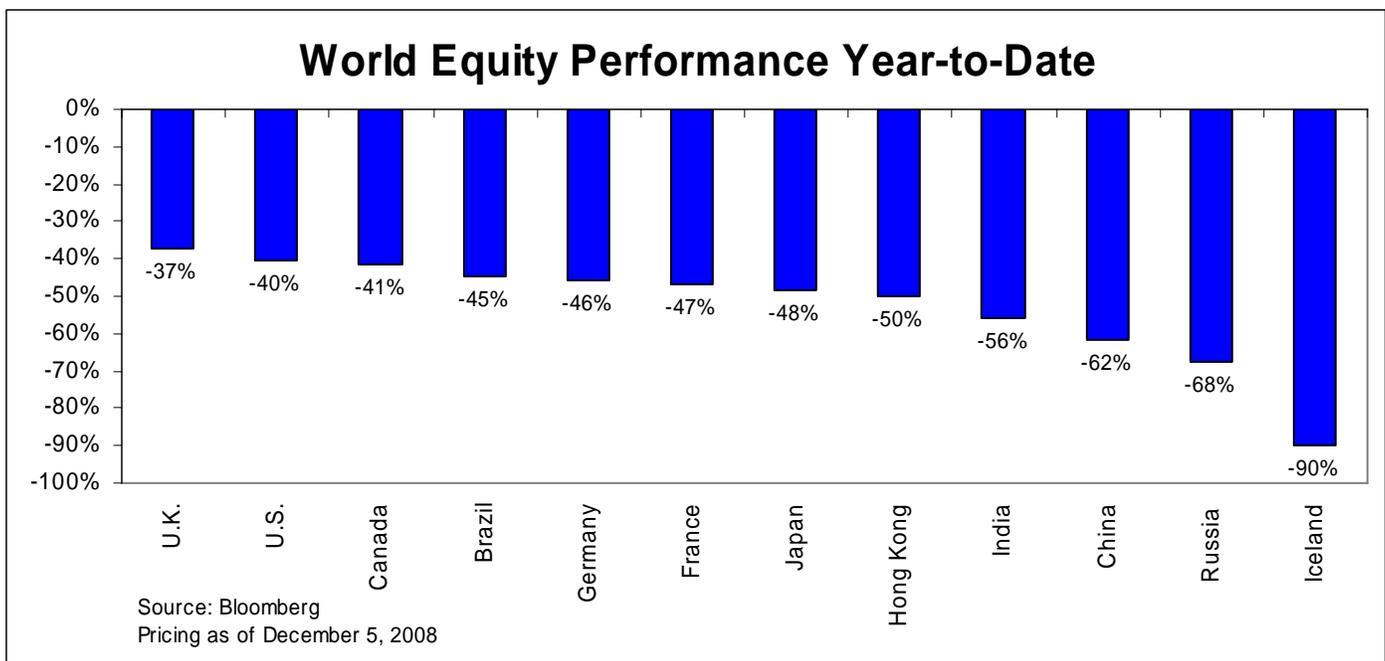


2009 Outlook

Investors should also be aware that losses this year were widespread as even some of the most defensive stocks in Canada experienced share price declines. We will discuss why this happened in greater detail later, our point at this time is that there were few places for Canadian equity investors to hide. To illustrate our point, we make the following observations for both the U.S. and Canada as of December 5th:

- 24 TSX stocks out of 270 have posted gains so far this year
- 16 TSX stocks out of 252 have posted gains since September 15 (Lehman bankruptcy)
- 18 S&P 500 stocks have posted gains so far this year (index comprises 500 stocks)
- Only 12 of the S&P 500 stocks in the U.S. are higher since September 15 (Lehman bankruptcy)

If there is one positive takeaway on a relative basis it would be that Canada is outperforming many of its international peers in 2008 as illustrated in the following graph. This may surprise investors since the TSX was approximately 45% weighted to resources prior to the market downturn; however, financial collapses in other countries have wreaked havoc on international returns. While this relative performance is a positive way of looking at a bad thing, it should encourage Canadian equity investors to know that when considering international returns, our performance could have been a lot worse.



What Happened?

Before investors can think about the future, it is important to reflect on the past and make sense of what happened and why equity markets find themselves in such a difficult situation. We believe three main factors contributed to market declines in the second half of 2008:

1. The Credit Crisis

While we knew credit markets faced headwinds since the emergence of the “sub-prime mortgage” problem in 2007, a lack of transparency amongst global financial institutions hid a credit problem which turned out to be much larger than many investors expected. Predictions of losses in 2007 that were considered too aggressive at the time proved to be too conservative in hindsight. We were lead to believe that credit losses, while disappointing, were manageable and that many banks had sufficient capital when they did not. While an ongoing subject of debate, we view the bankruptcy of Lehman Brothers in September as the catalyst which resulted in a domino effect of illiquidity and failure within the global financial system. Capital is the lifeblood of the financial markets. Without capital there is no investment, and without investment there is no economic growth. If capital is like blood then the financial system is like our circulatory system. Policy makers let Lehman Brothers go bankrupt, but that would be the equivalent of removing your heart and expecting the rest of your organs to function efficiently. While I’m not a doctor, I think you’ll all agree that such an expectation is not only wishful thinking, but simply impossible. The bankruptcy of Lehman Brothers had many unintended consequences, but the most notable was the overwhelming decline in capital availability to banks, businesses and consumers like you and me.

It’s one thing for banks to refuse to lend to consumers, but something completely different when banks refuse to lend to one another out of fear they won’t get their money back. However, when you consider that Lehman, one of the world’s largest investment banks and an institution that has been in existence for over 150 years, went bankrupt you can’t necessarily blame banks for being skeptical of one another or at least charge a very high premium to borrow. The uncertainty of capital availability amongst banks worldwide led to many deposit holders withdrawing their funds out of fear that their bank would collapse. Such an act only complicated matters as withdrawing deposits left banks with even less capital thus accentuating credit concerns that existed in the first place. The lack of liquidity and capital availability even went as far as to make investors skeptical about money market funds, which in normal times are viewed as one of the safer investments available. Not only were banks and investment banks impacted by the credit crunch, so too were insurance companies such as AIG which offered insurance on certain credit related investments which were being brought into disrepute. We as consumers know that it is a good thing to have insurance, but not when our insurers go bankrupt. For that reason, and considering the wider ramifications for the financial industry, the U.S. Government refused to let AIG fail like Lehman. Unfortunately the damage caused from the Lehman failure was already done. Only a few months prior we lived in a world that had too much cheap capital available and now we find ourselves living in a world with little capital available at all. Without that needed capital, economic growth has disappeared.

2. Economic Concern turns to Panic

The fact that many economies around the world started to slow in 2008 was not a surprise as many economists had forecast a reduction in growth expectations. However, few expected a near collapse of the credit markets and the resulting global economic consequences. What was once economic concern turned into economic panic as many businesses were brought to a standstill resulting in an acceleration of unemployment, a collapse in commodity prices and restraint in consumer spending. Naturally these three elements are important to the Canadian economy and help reinforce the observation that our economy has followed its international peers into recession. With investors expecting and now experiencing a recession, they avoided economically sensitive (cyclical) stocks at all costs. Stock prices in the Energy, Materials, Industrials, Financials, and Consumer Discretionary sectors have been hit hardest, while less economically sensitive (defensive) stocks outperformed on a relative basis, yet still declined.

If there is one lesson that investors learned from the recent stock market and economic downturn it was that the U.S. economy is still the main driving force for the global economy. With the growth of many emerging markets and even the growth seen in Canada due to resource price appreciation, some investors wondered if the U.S. economy was still as relevant as it once was. This question also resulted from the material decline we've witnessed in the U.S. dollar for a number of years. However, it has become clear that when the U.S. economy struggles, the rest of the world follows. It is for that reason we expect the U.S. will be the driving force to lead us out of this economic decline; however, gaining any visibility as to when that will be is very difficult. Usually during times of economic slowdown the U.S. consumer, who is responsible for about 60 % to 70% of GDP growth, comes to the rescue. However, with wealth destroyed by a falling U.S. housing market, personal consumer credit levels disappointingly high, unemployment accelerating, and abrupt fiscal restraint prior to the busiest shopping season of the year, it's very difficult to see how the U.S. consumer can help lift the U.S. economy from recession any time soon. So much has happened so quickly in the credit and economic environment that investors are finding it difficult to gauge the severity of the macroeconomic picture and the consequences of the various events that have happened in only a few short months.

3. Forced Selling

We have all been witness to a deleveraging of the global equity markets since September. Very cheap debt made it easy for investors to borrow money to invest. Such a strategy is sound when markets appreciate, but is detrimental when markets fall and lenders ask for their money back. Many levered institutional investors, notably hedge funds, have been forced to sell stocks not because they want to, but because they have to in order to pay back debt and meet the redemption requirements of their investors. Individual investors have also been leveraged and have unfortunately faced margin calls as markets declined. Simply put, thanks to cheap debt we had far too much capital in the equity markets and now we have to get rid of some of that excess capital before markets can stabilize. This is similar to an unfortunate trip to the doctor where you feel sick and ask for antibiotics. The doctor replies that you have a viral infection and there's nothing you can do but let the virus run its course. We face a similar situation as we try to flush the excess debt out of our equity system. While painful to experience, it's a necessary process that must occur before we can reduce volatility and gain a sense of stability. Forced selling has increased the magnitude of equity price declines and destroyed investor

confidence. We cannot expect to see sustainable market rallies until that confidence is restored. One of the biggest problems faced by investors since the sell off began was trying to determine when the forced selling was over. Unfortunately, due to a lack of publicly available information on the billions and billions of dollars in hedge funds in terms of how much leverage was used and what stocks were bought, we have no reliable way to know when the forced selling will come to an end, if it hasn't ended already. This is yet another unknown variable that investors have to contend with and therefore, volatility levels will likely remain high.

What Has Been Done?

While there certainly is no “play book” of steps to solve the greatest financial crisis since the Great Depression, governments and central banks have tried a number of measures to stabilize credit markets and stimulate the global economy. On the fiscal policy side of the equation, many governments have provided capital injections/equity investments in financial institutions, backstopped or guaranteed certain issues of debt so that struggling companies could raise capital, guaranteed bank deposits so that “runs” on banks (excessive withdrawals) declined, and provided fiscal stimulus packages so that investment could stimulate the economy. Some of these measures have not been used in Canada, or at least to the same extent as other countries, as our financial institutions have found themselves in a much better capital position during the credit crunch.

Central bankers have also tried to improve conditions by making capital available to financial institutions (liquidity injections) and cutting interest rates. Interest rate cuts in some cases have been large in a number of developed countries; however, their intended consequences have not been as forthcoming. The whole purpose behind cutting central bank rates, or the rate charged by central banks to financial institutions is so that those financial institutions will then cut their lending rates to consumers. Hopefully consumers will then borrow more money and either spend it or invest it in the economy, thus paving the way for economic growth. However, this time around interest rates cuts by central banks have not necessarily been met with similar cuts as global banks have reduced their willingness to lend and some consumers are already so levered that cheaper debt may not be attractive enough to convince them to add more debt for consumption. Below we show how much central bank rates have changed in 2008 in various influential countries or regions.

Various Central Bank Interest Rate Cuts in 2008

	Rate as of Jan 1/08	Rate as of Dec 9/08		Difference
Bank of Canada	4.25%	1.50%	↓	275 bps
U.S. Federal Reserve ¹	4.25%	1.00%	↓	325 bps
Bank of England	5.50%	2.00%	↓	350 bps
European Central Bank	4.00%	2.75%	↓	125 bps
Central Bank of China	7.47%	5.58%	↓	189 bps
Bank of Japan	0.50%	0.30%	↓	20 bps

¹ Federal Reserve forecast to cut rates to 0.5% on December 16

There is no specific recipe for governments and central bankers to get us out of this crisis and for that reason investors and stock markets are going to have to be patient until they figure out the correct approach.

How Can We Turn Things Around?

Going forward the question remains ‘how can we turn things around?’ While I certainly don’t pretend to have the exact answer, there are two events in particular that need to occur before the global economy, and thus equity markets, have a chance to rebound.

1. Return Stability and Fluidity to the Credit Markets

While credit markets have improved since mid-October, they are no where near the level of stability we need to see for banks to feel comfortable enough to lend to each other, to corporations and to consumers. I’ve mentioned a number of methods taken by governments and central banks above, but I’ve also noted that we’re not sure if these measures are good enough because we’ve never been in this situation before. While the Great Depression was likely worse than what we’re experiencing now, you cannot take solutions used in 1929 and expect them to work in 2008. We live in a different world, a world of globalization and greater connectivity. Furthermore, there is not just one answer to all of our problems, as this credit and economic crisis is going to require a number of concerted measures to get us back on track.

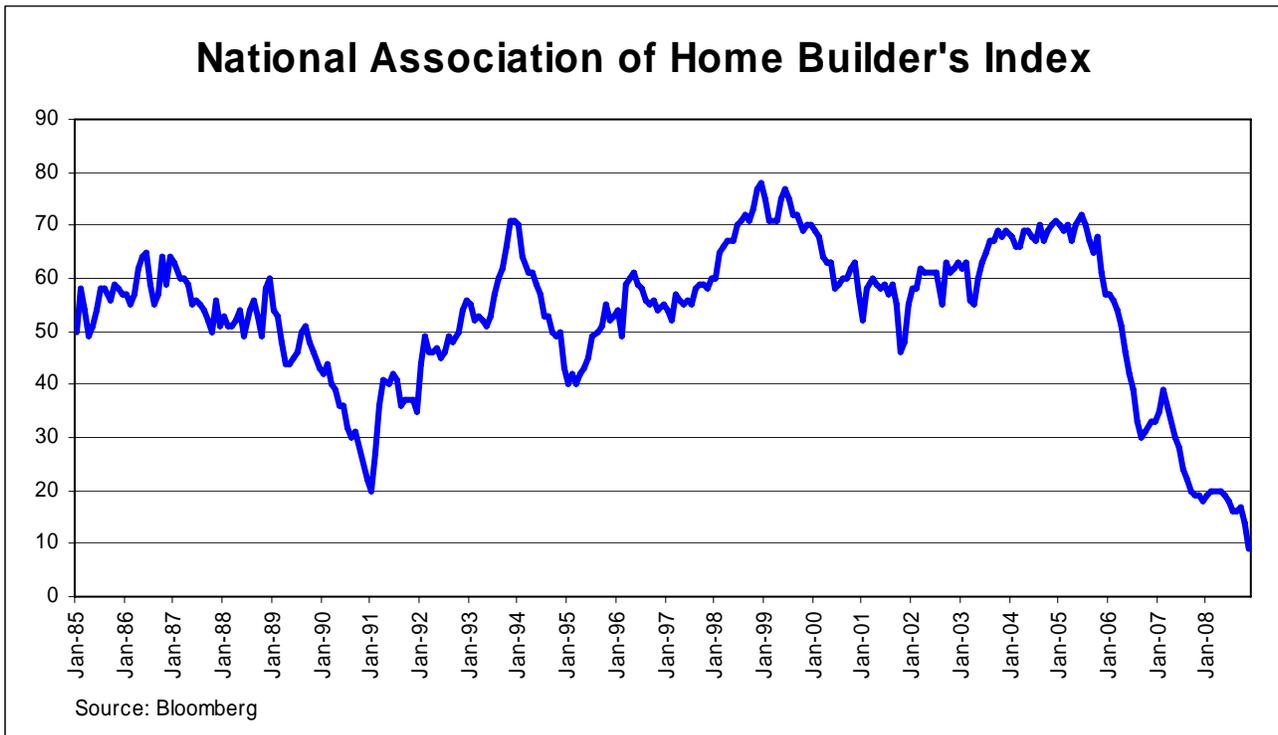
2. Stabilize the U.S. Housing Market

U.S. housing prices continue to fall, foreclosures continue to rise and inventories of unsold homes continue to increase. These trends need to stop to prevent further wealth destruction for the U.S. consumer who is already showing signs of fiscal restraint. We are not saying that we need to see a significant rebound, but we definitely need to stop “the bleeding”. You can’t expect to grow an economy if wealth is being destroyed, it’s that simple. Unfortunately there are U.S. homeowners now that have negative equity in their homes as their mortgage is greater than the market value of their house. It’s for this reason that foreclosures continue to rise.

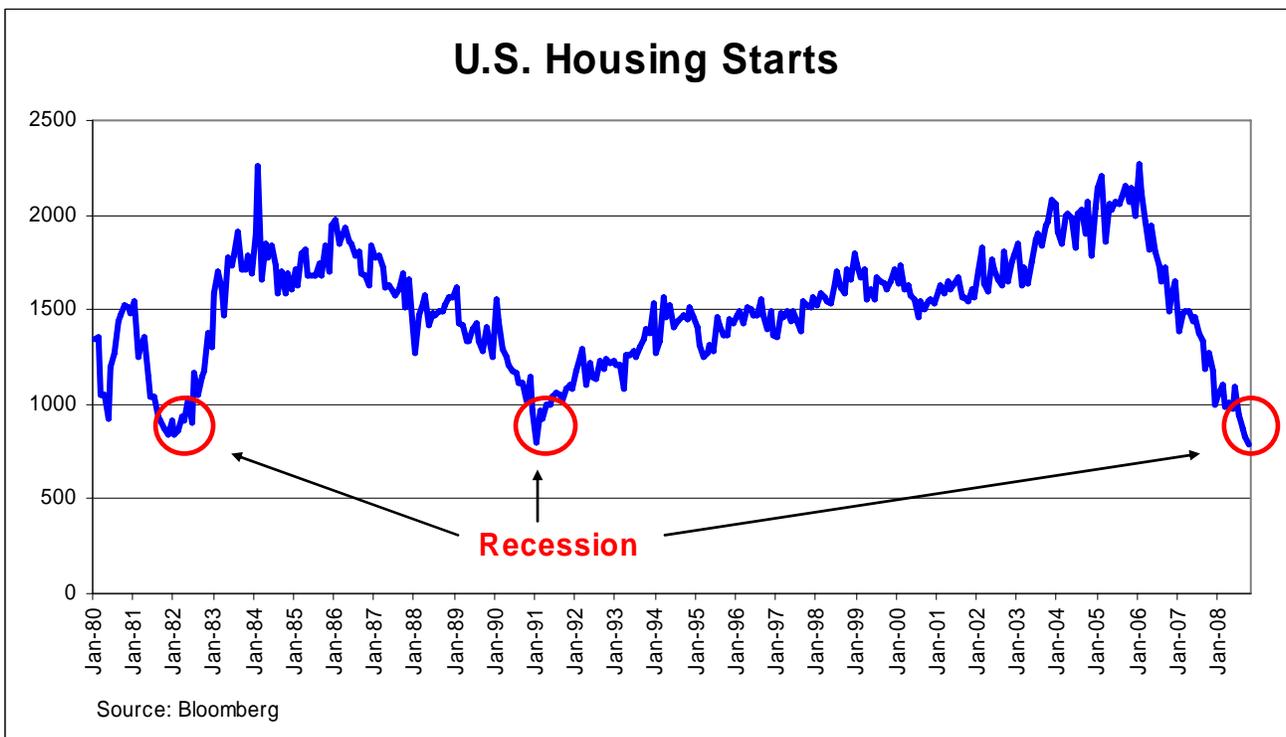
It’s also important to note that the housing industry makes up a significant portion of the U.S. economy. It’s difficult to expect the U.S. economy to grow when such an influential segment is struggling. The U.S. economy will likely lead the rest of the world out of this economic crisis, but the timing of such a recovery is likely well off into the second half of 2009 at the earliest.

To illustrate how bad the U.S. housing market is from a historical perspective, we provide the following charts:

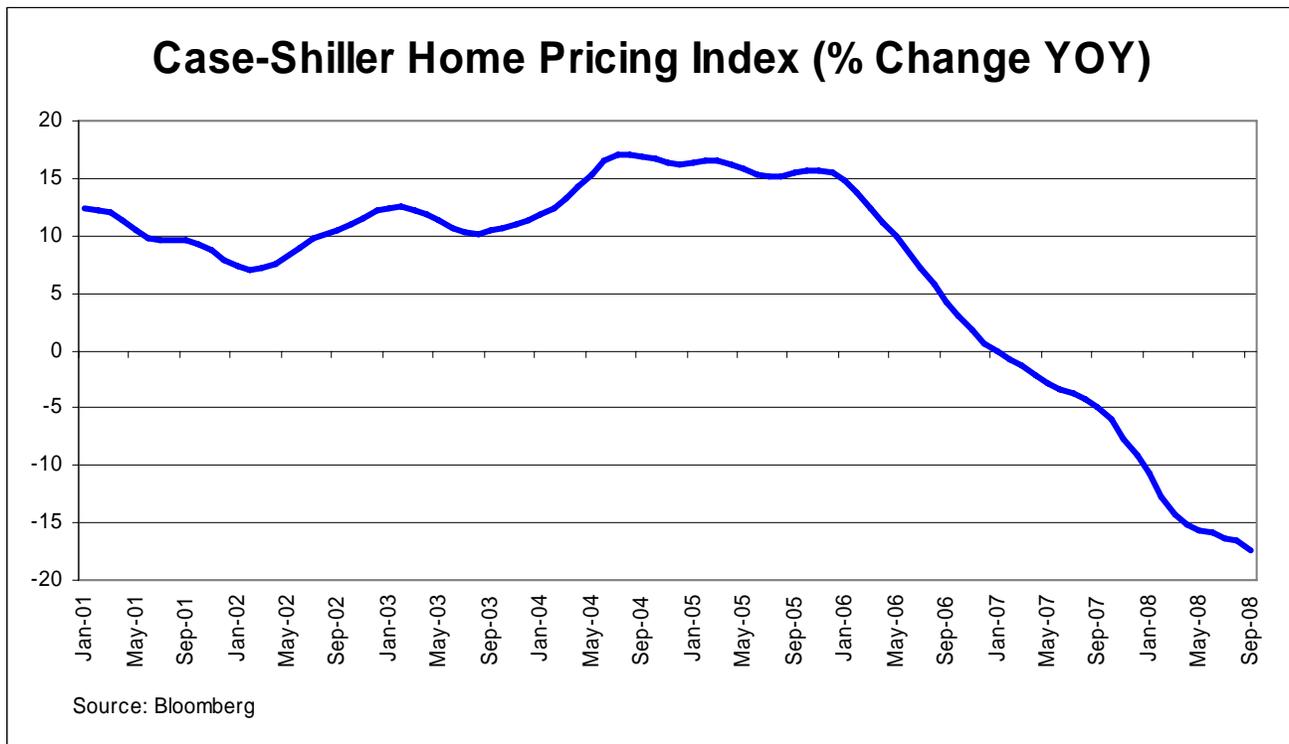
The National Association of Homebuilders Index is essentially a sentiment index that depicts sales expectations. A level of 100 is good, and 0 is bad. As you can see we’re currently at the lowest levels ever since the Index was created in 1985.



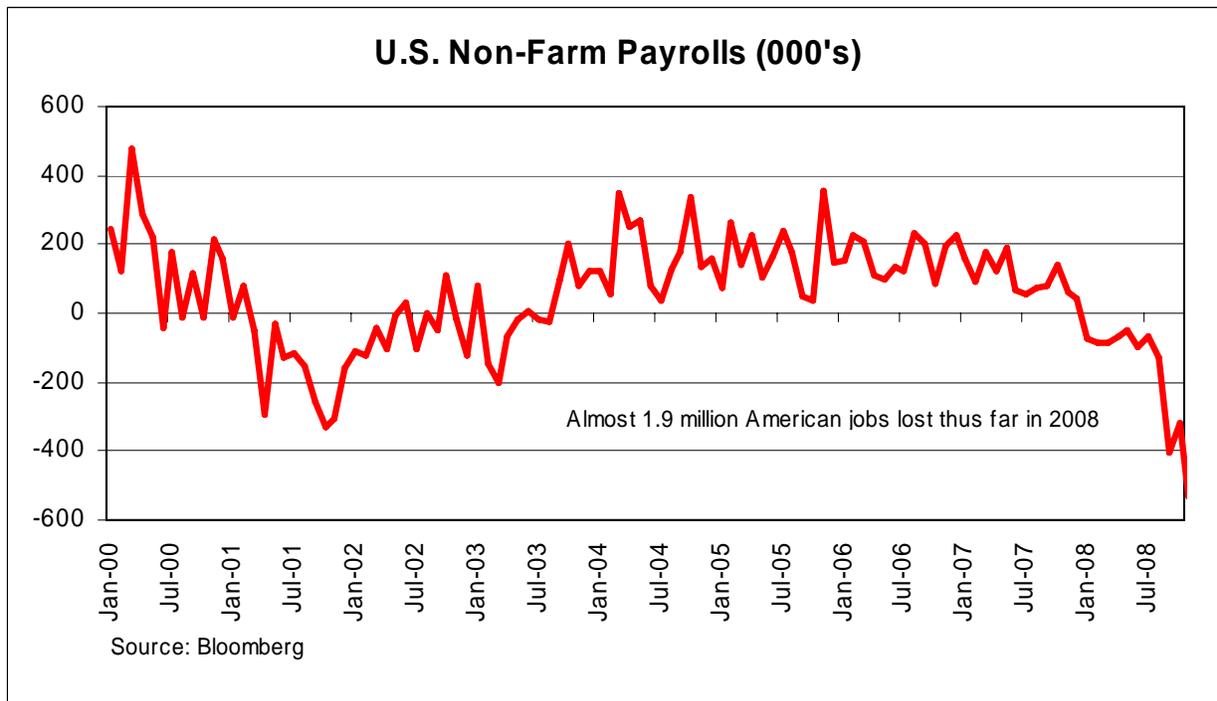
Growth in housing can be easily gauged by looking at housing starts, or the number of new houses constructed on an annualized basis. As the following chart illustrates, any time U.S. housing starts have fallen below 1 million, the U.S. economy has fallen into recession. We are now seeing some of the lowest housing starts figures in 30 years, which is not good considering how much the U.S. population has grown.



The Case-Shiller Home Pricing Index, as its title suggests, illustrates changes in housing prices. The following chart indicates that housing prices actually started to decline at the beginning of 2007, even before the emergence of the sub-prime mortgage crisis.



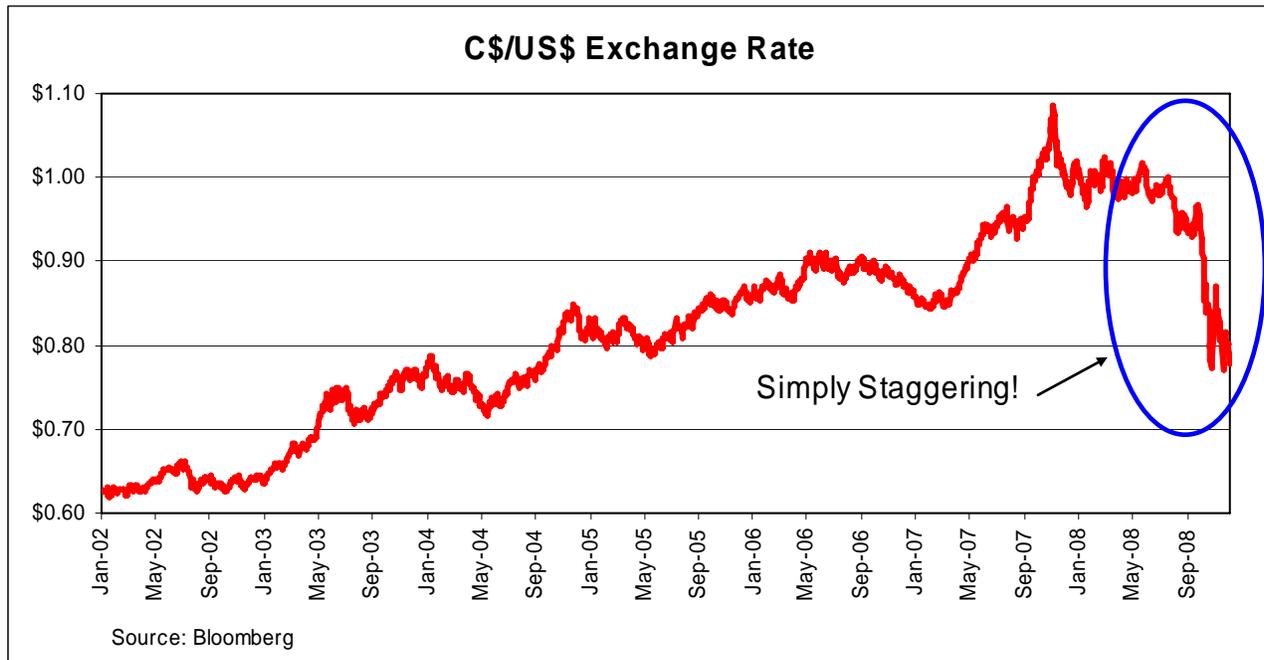
Finally, while not a housing chart per se, we show you the U.S. employment picture and how influential the housing sector can be. While recent layoffs can be chalked up to layoffs in other sectors, investors might be surprised to know that the U.S. economy has actually lost jobs in every month this year and 1.9 million jobs so far in 2008. Some of those layoffs earlier in the year can likely be attributed to a slowing housing market.



What Happened to the Canadian Dollar?

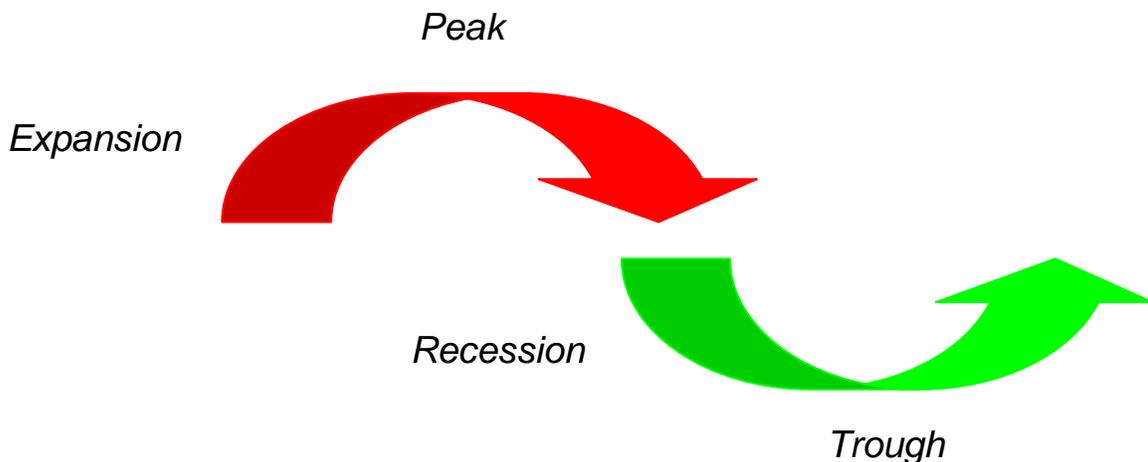
Not only were equity returns dramatically impacted by the credit crunch and global economic slowdown, so too was the Canadian dollar. The month of October was particularly bad for the loonie as it started off the month at US\$0.94 only to reach an intra-month low of US\$0.7682 on October 28. Just like the volatility we've seen in stocks has not been normal, neither is such a dramatic decline in our currency. A number of factors contributed to loonie weakness including:

- A decline in resource prices and oil prices in particular which fell from US\$147 per barrel to US\$40+ in only a matter of months. The Canadian dollar has also been referred to as the petro-dollar due to its recent strong relationship to movements in West Texas Intermediate oil prices.
- The expectation of further interest rate cuts in Canada. The lower your interest rates the less attractive your currency becomes as returns in that currency are lower on a relative basis when you could be getting higher returns in another country. While further rate cuts are also likely in the U.S., the idea of rates going lower in Canada in general still weighs on our dollar.
- Investors flocking to U.S. treasuries for safety thus propping up the U.S. dollar and weakening currencies throughout the world. This factor likely explains the magnitude of the recent loonie decline. Even though the United States is in a terrible position when it comes to its national debt, its annual deficit/spending, its very low interest rates, and its financial system, investors around the world still turn to U.S. dollar denominated debt during times of uncertainty as they believe the backing of the U.S. Government behind those investments is still the most reliable on the planet. When international investors buy U.S. treasuries they need to convert their local currency into U.S. dollars first which creates increased demand for the U.S. dollar and sends it higher. By sending the U.S. dollar higher, most other currencies tend to fall on a relative basis.



Looking Forward

Let me state for the record that I believe that recessions and market downturns are inevitable as they are part of an economic cycle which has continuously repeated itself in the past and will continue to repeat itself in the future. All that governments and policymakers can do is hope to extend expansions and limit the length and severity of recessions. While it would be wonderful if we could time peaks and troughs of cycles perfectly, we simply cannot. The perfect investment strategy would involve buying defensive stocks at the peak and buying cyclical stocks at the trough, but even the most professional and experienced of investor cannot time a cycle perfectly.



In addition I will also state my belief that with every cycle comes the inevitable favourability or lack thereof of different asset classes. What we have witnessed in the stock markets over the past 4 months has not been a “stock specific” issue, but rather a complete aversion to equities in general. Even some of what we consider to be the most defensive or safest companies in Canada have seen their stock prices decline, not because they’re bad companies, but because investors simply did not want to own stocks. Equities, bonds, cash, and real estate are all different asset classes and history will show that one has never always outperformed the other.

This fact is the driving force supporting the principle of diversification because you’ll never be entirely exposed to the best performing asset class all the time. While diversified or balanced investors do tend to adjust their weightings to different asset classes, they do not avoid an asset class altogether. To put equity performance into perspective this century, we were actually treated to the longest equity market expansion ever recorded in Canada from late 2002 to June of 2008. Unfortunately all good things normally come to an end at some point in time, which is why regular portfolio reviews are always recommended as investors should not only diversify but also rebalance their portfolios on a regular basis.

While the most recent bull market was certainly welcome, it is no excuse to ignore the basic investment principles for a disciplined and diversified investment strategy. Every investor has different financial needs and goals and there is no single asset allocation model that works for everyone. To discuss whether your current asset mix is appropriate in meeting your long term investment objectives, I recommend you speak with a ScotiaMcLeod Wealth Advisor who can help you through this process.

In the context of the current market environment, investors may consider one of the following approaches:

1. Consider Increasing Bond Exposure

Equities are simply out of favour as an asset class as are some corporate bond issues. Check your asset mix and ask yourself if increasing your bond exposure may be prudent.

2. Conservative Investors Stay Defensive Within the Equity Component of your Portfolio

Defensive, or less economically sensitive, areas of the economy are the place to be during an economic downturn such as Utilities, Telecommunications and Consumer Staples. Most defensive stocks also happen to offer decent dividends, so they pay you while you wait for the economy to improve.

3. Value Investors (those that like to buy cheap stocks) Look at Cyclical

Higher risk investors who are willing to accept more short term downside might actually consider looking at economically sensitive stocks if they have a time horizon greater than two years. Value investors love to sniff around the market when high quality stock prices are significantly off their highs.

While this list is not exhaustive, it does provide some insight as to how investors can approach the current market depending on their risk tolerance and investment requirements. Again, a ScotiaMcLeod Wealth Advisor can help you with this process.

Economic Outlook

The economic outlook for 2009 isn't exactly full of lollipops and rainbows, but I'm sure that doesn't surprise many investors considering what we've been through since September. It's been a struggle and it's hard to imagine that economic conditions can recover quickly. In the table that follows we provide a summary of forecasts from Scotia Economics. As you can see real GDP is expected to decline in most major industrialized nations and while the growth is still positive in China, India and Brazil, those growth rates have been lowered. Interest rates are expected to decline further.

Scotia Economics Forecasts as of December 1, 2008

Real GDP (% change)	2007	2008f	2009f		
Canada	2.7	0.7	-0.8		
United States	2.0	1.2	-1.8		
Japan	2.0	0.2	-0.6		
United Kingdom	3.1	0.8	-1.5		
Euro Zone	2.6	0.9	-0.9		
China	11.9	9.5	8.0		
India	9.0	7.0	6.0		
Brazil	5.4	5.0	3.0		
	Q4/2008	Q1/2009	Q2/2009	Q3/2009	Q4/2009
Bank of Canada Rate	1.75	1.00	1.00	1.00	1.00
Federal Reserve Rate	0.50	0.50	0.50	0.50	0.50
Canadian Dollar (USD/CAD)	\$1.22	\$1.27	\$1.33	\$1.29	\$1.25
Canadian Dollar (CAD/USD)	\$0.82	\$0.79	\$0.75	\$0.78	\$0.80

Where is the Canadian Dollar Headed in 2009?

Considering the current economic and financial environment, it is exceptionally difficult to forecast out 3 months let alone a full year; however, we believe the following events may occur in the coming 12 months:

- After possible further weakness and if the global economy starts to show some signs of improvement by the second half of 2009, then we believe oil prices will find some support and regain lost ground as investors focus again on supply rather solely on demand destruction
- Canada will likely still have a higher relative central bank interest rate relative to the U.S. even though more rates cuts are likely on the way for both countries
- Equity market volatility will eventually subside which will likely either stop or slow the flow of capital into U.S. treasuries, thus relieving some of the upward pressure on the U.S. dollar
- If the U.S. housing market finally stabilizes and the financial and economic outlook starts to improve by the second half of 2009, then investors may actually look at the U.S. not as a safe haven, but as a country that needs to get its fiscal house in order. As such we believe the U.S. dollar will eventually weaken again as Canada will continue to look better on a relative basis.

2009 Outlook

If all of these events actually occur then we believe the Canadian dollar will make up lost ground in 2009. The loonie will likely remain range bound between US\$0.75 and US\$0.85 for the foreseeable future, but we may manage to sneak above US\$0.85 in the second half of the year if the economic outlook is actually better than expected. Then again if economic problems persist or we face other unforeseen hurdles in the next six months, then the loonie will struggle to reach the US\$0.85 level. We do not believe that we will reach parity again in 2009.

Canadian Equity Market Outlook

In order to properly examine where the TSX may lead us in 2009, we must first understand its composition. As of December 5th, the TSX is weighted to the following sectors of the economy. We also show each sector's contribution to this year's weakness as of November 30, 2008.

S&P/TSX Index Breakdown by Sector

	Weighting in the TSX Index	Negative Point Contribution to the TSX Index Jan 1 to Nov 30	
S&P/TSX Index		-4562.44	
Financials	31.2%	-1248.79	27.4%
Energy	27.7%	-1129.96	24.8%
Materials	14.2%	-944.73	20.7%
Telecommunications	6.3%	-206.71	4.5%
Industrials	6.0%	-236.71	5.2%
Consumer Discretionary	5.0%	-263.32	5.8%
Technology	3.7%	-391.35	8.6%
Consumer Staples	3.5%	-59.47	1.3%
Utilities	2.0%	-47.46	1.0%
Health Care	0.4%	-33.94	0.7%

Source: Scotia Capital, Bloomberg

Even with the decline in commodity prices, you'll still notice that Financials, Energy and Materials together still make up a substantial portion of the TSX Index. For that reason most of our forward looking commentary will focus on those sectors, but we will touch on others as we look forward to 2009.

Financials

When we speak of Financials in Canada, banks and life insurance companies are the first things to come to mind as they make up a significant portion of the Financials subindex. Another thing that comes to mind is the credit crisis, as it was Financials that led the global equity retreat this year. Let us first address Canadian banks and then I will follow with the life insurance companies.

Banks

Let me first state that the financial makeup of our planet has changed considerably compared to a few decades ago. The advancement of globalization has taken individual national banking systems and turned them into one network. When some countries may have found themselves immune to problems outside of their borders in the past, they now find themselves confronted with problems occurring on a global scale. Considering that the United States contributes about 25% to the world's economy, it should come as no surprise that U.S. financial problems can quickly expand. For evidence of this fact, look no further than the sub-prime mortgage problem which emerged in mid-2007. Not only did U.S. banks struggle, but international banks that bought packages of mortgages found themselves writing down these assets as their values were impaired. When the U.S. catches a cold, the rest of the world has a very good chance of getting sick. The second half of 2008 has illustrated this point well and has also highlighted that instead of a cold, the U.S. and global financial systems may be dealing with a pretty awful stomach flu.

So where does this leave us in Canada? Well there are a number of different issues I could discuss here, but I will try and generalize those thoughts into broader issues. Many investors wonder whether Canadian banks should follow the lead of U.S. banks since our two countries share such a close economic and financial relationship. While it is true that our two countries are closely connected, the actual structure of our financial systems is quite different. In Canada, we have 6 major national banks with a few regional banks spread across the country; however, the United States has about 8,000 financial institutions including national, regional and municipal banks. The U.S. system is much more fragmented than Canada, which naturally leads to the observation that there is a greater chance of a U.S. bank failing than one north of the border as assets and capital are much more concentrated in Canada. Recall that I mentioned earlier in this report that capital is the lifeblood of any financial system. The more fragmented your capital base is, the more difficult it is to make sure that capital is proportionately distributed amongst your financial institutions at any given time. This is one of the reasons why you've seen Canadian banking capital levels remain strong while the U.S. Treasury Department has had to come to the rescue with capital injections in the United States. The minimum Tier 1 Capital ratio for Canadian banks, as determined by the regulator OSFI, is 7.0%. As of October 31st, all 6 major Canadian banks easily exceeded such levels with the Bank of Montreal at 9.77%, Bank of Nova Scotia at 9.3%, CIBC at 10.5%, National Bank at 9.4%, Royal Bank at 9.0% and TD Bank at 9.8%. No major financial institution on this planet has been immune to the credit crisis, but Canadian banks have certainly weathered the storm better than others. We are restricted on Bank of Nova Scotia and Royal Bank.

I'd like to highlight a few other points that support the view that Canadian banks are better positioned than their international peers:

2009 Outlook

- Bluntly put, Canadian banks were still very profitable in fiscal 2008 (year-end October 31). Even including writedowns, Canadian banks still made money. This is in contrast to a number of global financial institutions that not only lost money this year but have wiped out profitability going back a number of years.
- Canadian banks have not cut their dividends, nor do we expect they will. The same cannot be said for what were some of the largest financial institutions on the planet such as Citigroup and Bank of America. While payout ratios for the Canadian banks may increase in the short term as earnings growth will be challenging, we still believe these payout ratios are manageable. None of the major Canadian banks, with the exception of National Bank in 1992, have ever cut their dividend.
- Because our financial system tends to be highly concentrated and Canadian banks have expanded into other businesses (i.e. brokerage, investment banking, etc) with acquisitions over the past few decades, the overall revenue mix of Canadian banks tends to be well diversified. As such, when one business line struggles, risk is minimized through the performance of other business units.
- Having a more consolidated financial industry in Canada also leads to efficiency over time. Canadian banks have illustrated this point well with consistent operating profit, dividend growth and impressive returns on equity.

While there are a number of positive things to say about our banks in the past, we must also take a look at the future and recognize that Canadian banks face a number of challenges. Considering how well Canadian banks performed from 2002 to 2007, it's easy for investors to forget that banks are economically sensitive entities. When the economy does well profit growth is easier to achieve, but when the economy struggles profit growth is harder to come by. Fiscal 2008 earnings showed declines from 2007 levels for the most part, but certainly not the magnitude or elimination of returns seen from other global banks. However, this emphasizes the point that if the economy faces headwinds, so too does bank revenue growth. It's for this reason that we have seen Canadian banks analyzing their cost structure in an attempt to maintain profitability going forward.

And let us also emphasize that the credit crisis is not just a subprime mortgage problem. While subprime mortgages were the catalyst of this crisis, credit problems have spread from mortgages to corporations and now to consumers. Not only have equity markets been forced to deleverage, so too have corporations and individuals that have been living beyond their means. Canadian banks, just like any other bank in major industrialized or even emerging markets will face a challenging economic environment in 2009 and as such we cannot expect remarkable returns. While profit growth is still possible for some banks next year, depending on the length and magnitude of the global recession, earnings growth will certainly not exceed single-digits.

So our overall conclusion on Canadian banks is that while they find themselves in a better operating and capital position than their international peers, economic headwinds will provide many challenges in 2009 depending on the length and magnitude of the current U.S., Canadian and global recessions. For that reason we do not expect Canadian banks to rally sustainably during the next one or two quarters. However, longer term investors with a time horizon greater than one year may consider investments in this sector as Canadian banks are positioned well on a relative basis for an eventual economic recovery.

Life Insurance Companies

ScotiaMcLeod is restricted on Manulife Financial, Sun Life Financial and Great West Lifeco. As such, this prevents me from discussing Canada's three largest life insurance companies. However, I will share some thoughts on the industry in general which may provide you with some insight for 2009. One of the most topical issues in this industry from a global perspective is capital, which of course has been a topic of discussion for any financial related sector thanks to the credit crisis. However, the research department at Scotia Capital has highlighted in the past that the Canadian life insurance industry is well capitalized and capital levels would still be appropriate even if we were to see the S&P 500 fall to 600. Furthermore, liabilities for the industry are longer term in nature looking out 15 to 20 years from now. The life insurance industry has largely avoided investing in asset backed commercial paper, collateralized debt obligations and structured investment vehicles which have impacted other financials; however, they still face some risk with equity investment guarantees if markets fall and stay at low levels for a very long time (i.e. 15 years).

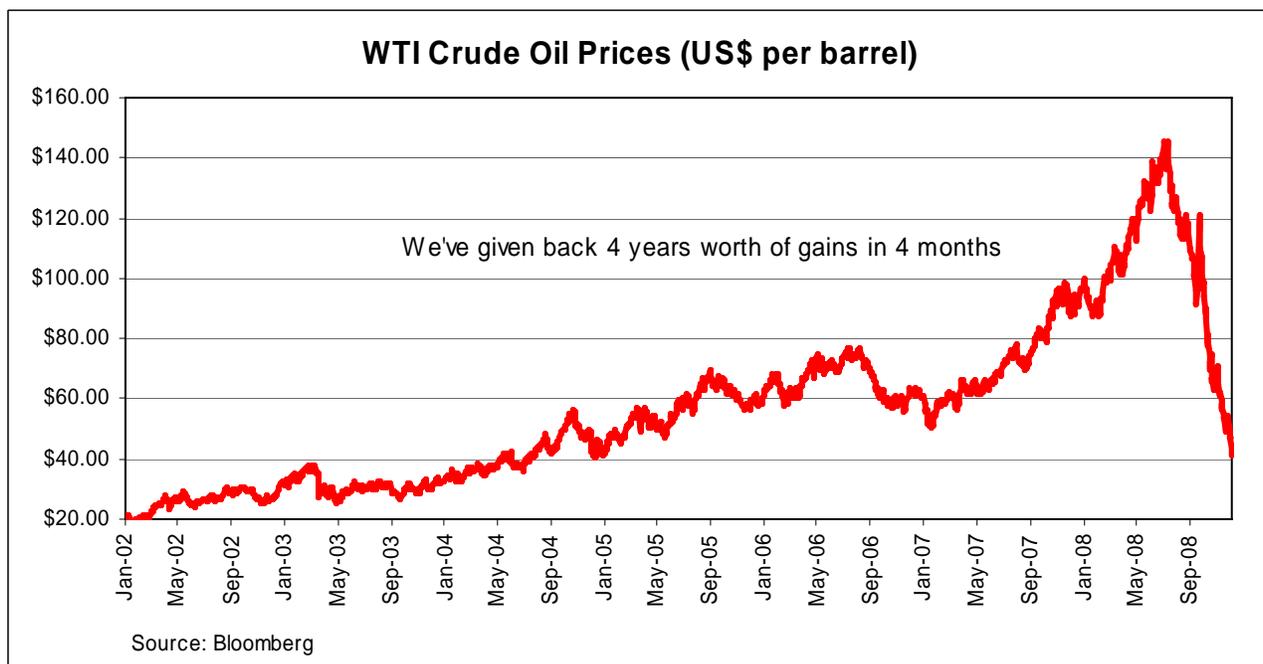
But we must also look at the nature of this industry and the products that are sold to realize that the life insurance industry is fairly recession proof. Life insurance is not really discretionary in nature, and as such policy holders will continue to pay their premiums whether we are in a recession or economic expansion. Also, investors will continue to contribute to their retirement savings plans and also contribute to any group insurance plans they may have through their employer. The point here is that even when the economy is struggling, revenues coming into the industry tend to be consistent. While premium growth during a recession may not be as great as during an expansion, it still has the potential to grow, thus making it easier in some cases for the life insurance industry to grow revenues during a downturn compared to other financial related sectors such as banking or the mutual fund industry.

Energy

Before I can talk about our outlook on oil and gas, I must first touch on our thoughts of what happened in 2008. At the beginning of this year, with oil below US\$100.00 a barrel we noted in our 2008 Outlook that while the days of sky rocketing oil prices were over, oil equities still offered investors value. When oil prices reached US\$120 per barrel by April we were a little concerned, not only because of the speed and magnitude of the price increase but also because we were hearing calls on Bay and Wall Street for oil prices to exceed US\$200 per barrel. Our reason for concern stemmed from our belief that higher energy prices would eventually curb demand, otherwise known as "demand destruction". At this stage we were wary of the energy markets as we believed prices were moving too high, too quickly. By the time July rolled around oil prices were quickly approaching US\$150 and we were starting to wonder if our demand destruction argument was simply incorrect; however, eventually the market started to see economic growth slow and this slowdown was dramatically exacerbated by the financial crisis of September/October. As oil prices were falling from their peak, we thought that a price range between US\$95 to US\$105 was more appropriate; however, we never expected that we would see both a domino effect of financial failure and oil prices in the US\$40 to US\$50 range. I certainly won't even suggest for a moment that I saw such a complete economic collapse coming, but then again few people did; however, what has been made very clear by the market is that we cannot expect energy prices to find support when economic growth no longer exists.

2009 Outlook

So why do I bring up our thoughts over the past year? I do so to emphasize how 2008 was a year of extremes for both the upside and downside for equities and commodities. I also do so to emphasize how the market got ahead of itself when it comes to supply/demand fundamentals. The market was too focused on supply during the first six months of 2008 when it should have been paying more attention to demand. However, and this is the crux of our upcoming investment argument, we now believe the market is too focused on demand when it should also be thinking about supply. Let's not fool ourselves, the short term outlook (6 months) for energy prices is not good. As I've just mentioned above, you can't expect energy prices to sustainably rally when economic growth is declining. However, as prices fall, new additional supply becomes uneconomical as the cost to produce new sources of supply exceeds the revenues generated from it. As such, energy companies have been announcing supply reductions on a global scale and have cancelled a number of future projects including some in Alberta's oil sands. In fact, Canadian oil production could fall by about 20% in 2009. The more oil prices fall, the more dramatic the supply cuts will become, which begs the question "what will happen when the economy eventually recovers?" With economic recovery comes increased demand; however, if supply has been reduced and investment in future supply has been eliminated then we could certainly see upward pressure on oil prices once again. Of course this all depends on when the economy will recover and as we've noted earlier in this report, few investors expect such a recovery until the second half of 2009 at the earliest as we wait for credit conditions to improve and the U.S. housing market to stabilize. We'd also highlight that energy prices could be helped by an eventual weakening of the U.S. dollar.



Similar to our conclusion for the Canadian banks, economic headwinds will provide many challenges in 2009 depending on the length and magnitude of the current U.S., Canadian and global recessions. For that reason we do not expect energy stocks to rally sustainably in the near future and possibly not until later in 2009. Short term downside in this sector is still a distinct possibility. However, longer term investors with a time horizon greater than one year may consider investments in this sector as energy companies will likely benefit from upward pressure on oil prices from an eventual economic recovery. With energy equities currently discounting lower energy prices, there will be good opportunity for leverage in equities if underlying commodity prices rebound.

Materials

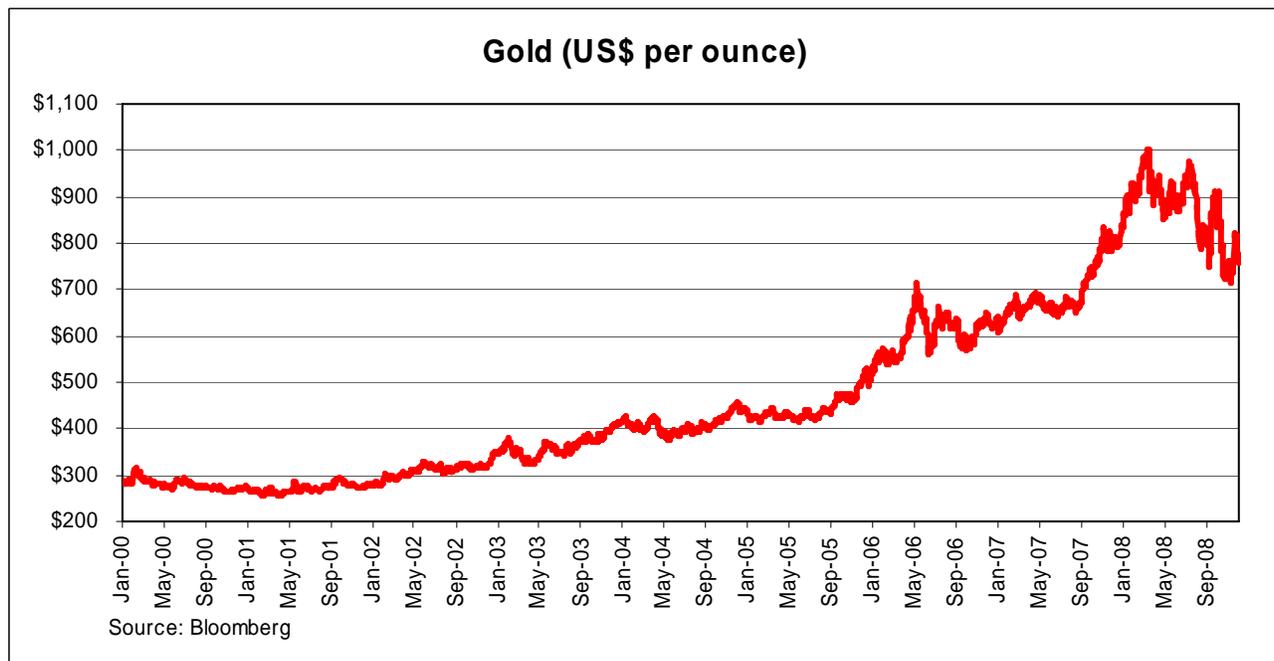
The Materials sector includes commodities such as base metals, precious metals and fertilizers. It has behaved in a similar fashion to the energy sector as both fall under the “Resources” banner which has been completely out of favour during the second half of 2008. Base metals in particular have been hit hard due to the market’s focus on “demand destruction”. In our Outlook 2008, we noted that base metals “could lose some shine”. Little did we know how much shine would be lost. Our rationale at that time was that analysts were starting to come out with forecasts showing supply surpluses for a number of metals either in 2008 or into 2009 even with strong economic growth rates projected at that time. We had also seen some remarkable price gains in base metals over the previous 4 years. While we didn’t expect base metal prices to plummet, we also didn’t see an overwhelming reason to conclude they could continue on their current upward trajectory. Many of you may wonder whether our arguments made in the Energy section of this report will apply equally to base metals in that supply is now being cut on a global scale and pricing may have room to move higher when the economy eventually recovers. While the dynamics of such a relationship are the same, we believe the energy sector will likely move more than base metals as base metals had already started to see supply balances at the beginning of 2008, while the future supply balance for energy was not as strong. However, base metal stocks will continue to behave like energy stocks in the near future due to the difficult macroeconomic environment. While it is true that commodity prices do tend to overshoot to the downside as they decline, we don’t think a possible rebound in base metal prices is going to be significant over the next 12 months to get us excited about this sector. While longer term investors may see opportunity looking out to 2010 and beyond if further supply cuts emerge and investment is restrained, we don’t believe that 2009 will prove to be a banner year for base metals.

But all is not lost in the Materials sector as we believe precious metals and fertilizers were excessively punished in 2008 simply due to their “guilt by association” with commodities and hedge fund selling. Relative to energy and base metals, we believe the fundamentals for the precious metals and fertilizer sectors remain strong and as such represent opportunities for 2009. First, let me touch on precious metals.

In our Outlook 2008 report we were bullish on gold not because of the prospect of falling interest rates or a falling U.S. dollar, but due to favourable supply/demand fundamentals. However, this thesis was turned upside down due to the unforeseen events of September and October which caused investors to flock to U.S. treasuries, push the U.S. dollar higher and thus push gold and other precious metal prices lower. It would be easy for investors to think, like we did, that during the greatest financial instability since the Great Depression that gold prices would certainly get support from the market, but the capital flows into treasuries overwhelmed that argument. However, our view for 2009 is similar to that of 2008 in that we’re bullish on precious metals;

2009 Outlook

but, we believe eventual weakness in the U.S. dollar will be the driving force this year instead of supply/demand fundamentals. Eventually the volatility of today's market will subside which we believe will reduce the capital flows to treasuries and take some of the upward pressure off of the greenback. We also believe that investors will eventually take a look at the U.S. and its current financial situation, including its \$10 trillion + of debt and recognize that the U.S. dollar is not a currency worthy of high opinion. While it will take some time for such a thesis to take effect, we believe that precious metal prices do have room to move higher next year and thus believe that precious metal equities should remain a component of a well diversified portfolio.



Finally I'll touch on fertilizers, namely Agrium and Potash Corporation, two of the world's leading producers in this space. In addition to fertilizer cost input declines in 2008 such as oil and natural gas, we also saw grain prices (corn, wheat and soybeans) participate in the resource sell off. As such, fertilizer prices, namely nitrogen and phosphate based fertilizers fell quickly; however, potash prices have held in well for the time being. But, throughout the economic and financial crisis of 2008, we question whether anything materially changed when it comes to food demand or the need for farmers to fertilize their crops as the global food demand/supply balance remains tight. While we recognize that falling fertilizer prices lead to lower revenues for Agrium and Potash Corporation and that seasonality has likely had a significant impact on demand during the last four months of 2008, we believe the stock price declines for these two companies have been excessive. While evidence of our argument may not show up until Q1 results are reported in April, we still believe that the longer term fundamentals for this sector are very strong, and a falling U.S. dollar would only emphasize our argument further. Just like other commodity related stocks we've discussed in this report, the short term performance for fertilizer equities remains uncertain; however, in the absence of a deep and harsh global recession, we feel strongly that fertilizer stock prices should be higher one year from now.

Defensives

If there is one theme we highlighted in our 2008 Outlook that is still exceptionally relevant today it is that “defense may be the best offence”. By that we meant that portfolios should have decent exposure to defensive, or economically insensitive sectors especially since many economists had ratcheted down some of their forecasts at the beginning of last year. Little did we know that the financial and economic crisis of September and October would make this our best investment theme of the year. As we’ve already highlighted earlier, conservative investors should already have decent exposure to defensive stocks at this time and we don’t see ourselves changing this recommendation for at least the first half of 2009. Economic data released during the next couple of quarters will continue to be poor and stability in the U.S. housing market is not immediately forthcoming, so investors have every right to be cautious by assigning higher weights to defensive industries such as Consumer Staples, Utilities & Pipelines, and Telecommunications.

Consumer Staples

In Canada there are really only two types of staples that make up the Consumer Staples sector and those are drug stores and food stores. As logic would conclude, the economy may struggle but you still have to eat and you still need prescription drugs. Last year we thought that food stores such as Metro Inc and Loblaw Companies faced a number of headwinds due to increasing competition from Wal-Mart and thus preferred drug stores, namely Shoppers Drug Mart. We still favour drug stores over food stores as we believe the industry fundamentals are still more attractive for the drug store industry and Shoppers’ competitive position. We also now favour the drug stores as investors have likely pushed the valuations of the food stores too high in the near term. Shoppers Drug Mart is Canada’s only national publicly traded drug store and has continued to produce consistent earnings growth and cash flow over a number of years. We believe Shoppers remains the stock to own in this sector in 2009.

Utilities & Pipelines

Will you never turn on the lights again until the economy recovers? I’m sure everyone would respond “no” to this question which is one of the reasons that investors turn to utilities and pipelines during times of economic weakness. Companies in this sector tend to have regulated assets and thus consistent revenue streams and as such have had impressive dividend growth track records over the past number of decades. In fact a company like Fortis Inc. has increased its dividend every year for the past 30 years. This type of consistency is what investors like to see during times of uncertainty. While the global economy continues to struggle during the first half of the year, we expect utilities and pipelines will outperform the market. However, we must also note that if the recession is not as bad as some economists believe it will be and we start to show some signs of improvement in the second half of 2009, then it’s possible that some investors might start moving some of their defensive positions into more cyclical or economically sensitive areas to position themselves for a recovery.

But I must emphasize that utilities and pipelines should be components of a well diversified portfolio next year. In particular we like stocks such as TransCanada Corporation and Enbridge. We are Restricted on Fortis Inc.

Telecommunications

Could you imagine a world without cellphones or smartphones in 2009? Neither can I, and for that reason we expect that telecommunications companies should continue to hold up well during this recession. I'm not a tech wiz in any way, shape or form as I still use my VCR even though I actually do own a DVD player; but if there's one thing I have observed over the past few years it's that handheld devices are more a staple than a discretionary item. Whether we want to talk about the Blackberry or the iPhone or any cell phone in general, they have become so important (or annoying depending on how you look at it) that there are many people out there that wouldn't know what to do without one. There are many consumers that have now eliminated their land line phones and replaced them with wireless devices. While handheld device upgrades may slow during a recession, their usage likely will not and that's where telco companies such as Rogers Communications, TELUS, and BCE will benefit. They benefit not only because the use of such devices will continue but also because the wireless business is more profitable than the old traditional land line business.

But wireless is not the only chapter to this defensive story as we must not forget about the internet and cable services that these companies offer. Again, these are services which consumers would be very reluctant to cancel even during a recession. Our lifestyles in Canada and around the world for that matter have changed significantly over the past decade as we've changed to a world where immediate data flow is demanded and where wireless services are the norm. While a very deep and long recession would eventually have some impact on demand, we believe the Canadian telecommunications industry is in decent shape. But the future is not completely without risk as competition amongst the incumbents could put downward pressure on pricing and we could see that accentuated if new entrants to the industry are successful in attracting subscribers. However, difficult credit markets could make financing for new entrants expensive and the economic environment could make stealing subscribers from the incumbents difficult. Our preference last year was for Rogers Communications due to its technology advantage, strong balance sheet and strong cash flow. While TELUS and BCE plan to work together on upgrading their network, we still prefer Rogers Communications in this sector for at least the first 6 months of 2009.

Technology

It's remarkable to think that the Technology sector was such a huge influential force back during the tech boom 8 years ago and now it is only comprised of 6 companies. Research in Motion has a largest influence with a 78% weighting within that subindex while former heavyweight Nortel only represents 1.089% of the Technology index and a marginal 0.041% of the TSX Index (remember when it was almost a third of the TSX?). My point here is simple, when we think of Technology in Canada we really only think about Research in Motion (RIM). We were very bullish on RIM in our Outlook 2008 report as we thought it's competitive positioning was strong, its product pipeline was attractive and its virtual debt free balance sheet gave the company a great deal of financial flexibility. However, I will admit when I'm wrong and as the stock price performance will show, this was not a stock to own this year, but then again only a few were. The economic

and financial fallout of the fall spooked investors and put downward pressure on any company that relied on discretionary spending which had broader implications for the technology sector in general. Investors simply concluded that with an economic slowdown, few people would want to buy new devices or renew old ones. However, I'd refer you to my earlier comment in the Telecommunications section where I highlighted my belief that handheld devices have become more staples than discretionary and as such we are not willing to give up on our RIM thesis yet.

The past 6 months have seen a number of new Blackberry devices come through the company's product pipeline and while some may have been delayed, the portfolio of devices which provide a number of options for the consumer is quite impressive. Another reason for negative sentiment towards RIM is that it has traditionally been known as a company that served the enterprise (business) market while having a small presence in the consumer market. Therefore, if businesses are laying off employees then it was only safe to assume that RIM was going to lose subscribers from its enterprise base. However, not only has RIM transformed its product offering to provide more device choice, it now has more "consumer" subscribers than "enterprise" subscribers, thus mitigating the enterprise concentration risk that was once present. While we recognize that a recession will certainly dampen growth expectations for this company and the sector as a whole, we believe the stock price of RIM has fallen to such a degree that any signs of an eventual recovery in 2009 will propel this stock higher. A deeper than expected recession would certainly hold back this name, but we believe that RIM's stock price will be higher 12 months from now.

Industrials

Like its name suggests, Industrials tend to do well when industry does well. In Canada, our Industrials sector is made up of the rails, aerospace, airlines, engineering and industrial equipment providers. All of these components are economically sensitive, but some are more sensitive than the others. The first logical conclusion that an investor may come to is that during a recession these stocks should struggle as business opportunities decline. While this may be correct to a degree, the situation is not so black and white. First off the Canadian railroads, CN Rail and CP Rail, are efficiently run companies that still have some pricing power, but could be impacted by lower volumes if the recession continues to worsen. Evidence of this would likely show up in their intermodal traffic if fewer shipments are coming from overseas. Nevertheless, these two stocks (CN Rail in particular) are still solid companies that should be core components of a well balanced portfolio. Airlines are likely the most economically sensitive of the bunch as lower fuel costs could now be offset by lower demand as economic growth and discretionary spending declines. We wouldn't be buying airline stocks at this time, but would lean towards Westjet over Air Canada due to its better operating and financial position. Aerospace and industrial equipment stocks aren't impacted by a slowing economy as quickly as other areas of this sector as long term purchasing commitments are normally required. While order backlogs could potentially decline during a recession, they tend not to disappear entirely. Engineering services stocks such as SNC Lavalin do tend to have high sensitivities to commodity prices which would probably scare some investors away at this stage of the cycle; however, they also tend to be beneficiaries from investment as governments try and get their economies back on track. It's for this reason that we believe engineering services stocks could be well positioned to show signs of strength even before any economic recovery is well under way. While the overall near term outlook for Industrials will likely remain negative as investors shy away from any stock that is economically sensitive, some Industrials may actually do better than expected next year if economic activity shows signs of renewal.

Consumer Discretionary

If we had to generalize this sector we would say that it is comprised of media companies, retailers and cable stocks. Simple logic would indicate that the first two (media and retailers) face difficult economic headwinds in the near future as advertising spending could fall and it would appear that the consumer is not spending as much during the 2008 holiday season and will probably continue to show fiscal restraint going into 2009. For that reason we are not recommending any purchases in these areas of the market at this time. If we see signs of economic recovery in the second half of the year we may warm up to them, but the near term outlook remains challenging. However, the cable sector shares similar characteristics to our discussion of the Telecommunications sector as consumers will likely sacrifice other expenses during a recession before cutting their cable service. While a deeper than expected recession could prove this conclusion wrong, we would still prefer to own a cable stock over a retailer at this moment in time. Cogeco Cable remains our favourite name in this particular area of the Consumer Discretionary sector due to the fundamental strength it has shown relative to its peers.

Individual Stocks to Highlight

Let me first say that I don't know when the market will hit its bottom nor do I know the exact date when the global economy will start to recover. As such, I cannot provide you a perfectly timed portfolio of stocks to own in 2009, especially since every investor has different investment goals and needs that will influence what is in his/her portfolio. However, instead of giving you a list of stocks to own throughout the year I will provide you with two lists: 1) Stocks to own as the economy continues to struggle and 2) Stocks to own to position yourself for the economic recovery. From this list, with the assistance of your ScotiaMcLeod Wealth Advisor you can identify opportunities for your portfolio now or in the future. If you own a stock that is on the "position for recovery list" now, do not interpret its place on this list as an indication that you should sell it today and repurchase it later. We believe that a lot of downside has been priced into these stocks and would encourage you to hold.

Stocks to Highlight as the Economy Continues to Struggle

Agrium
Barrick Gold
Cogeco Cable
Enbridge
Potash Corporation
Rogers Communications
Shoppers Drug Mart
SNC Lavalin
TransCanada Corporation

Stocks to Highlight to Position Yourself for the Economic Recovery

Bombardier
Brookfield Asset Management
Canadian National Railway
Canadian Natural Resources
Canadian Tire
Finning International
Research in Motion
Suncor Energy
TD Bank
Westjet Airlines

While these lists are not exhaustive, our intention here is to highlight higher quality names with relatively strong balance sheets, good management teams and a decent track record of past performance. We are not saying these companies will be the top performers of the year, but we do believe they should be considered core holdings for a balanced portfolio depending on what you're trying to achieve. We believe our sector commentary from earlier in this report will help explain why you see these particular names in their respective lists.

Silver Linings

While it is very easy to be negative looking forward to 2009, we believe there are some silver linings to the poor performance from 2008 that may not be getting a lot of attention, but are worth mentioning.

1. While we are not believers that just because something happens in the past that it must occur in the future, since 1941 every time the TSX declined over 10% in a given year it almost always posted a positive return the following year. The one exception to this pattern is the 2000 – 2001 time frame and that was because we had two significant events in each year. The bursting of the tech bubble and significant price decline in Nortel was followed in 2001 by the events of September 11.
2. Someone's pain may be someone else's gain. As such, lower equity valuations could actually lead to consolidation in a number of sectors of the economy. We have already seen some signs of consolidation/opportunism during the past year as stock prices fell and we believe it is far from over, especially if there are some industry heavyweights out there with strong balance sheets looking to grow through acquisition. With a number of junior resource companies struggling to finance themselves during this economic downturn, you could see a number of large cap companies pick up high quality assets from the juniors at a reasonable price. The same goes for the global financial industry as the "survivors" look to consolidate deposits and capital.

Overall Conclusion

We've just been through a market downturn that even the most experienced of investor will tell you was unlike any other. It was fast and its magnitude was severe. We know the first few quarters of 2009 are going to be difficult, but the equity markets are already pricing in those expectations. If there is a silver lining to this decline it would be that we could be forming a low enough base to provide us with positive returns next year. But keep in mind that you should not expect a quick fix to the economic and financial problems we face as one does not exist. Patience and a disciplined investment plan are what you need to get through this difficult economic and financial storm. Seasons Greetings and Best Wishes for a Prosperous New Year.

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Bank of Nova Scotia, Manulife Financial Corporation, TELUS Corporation, BCE Inc., Canadian National Railway Company,

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2009 Outlook

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