

April 2007 Market Outlook

- Slowing earning growth, large sector skew, and a fully priced market raise the probability of a multiple contraction in Canada
- U.S. markets offer a lower risk opportunity and a great offset to Canada
- Highly correlated global markets challenge investors to construct meaningfully diversified portfolios

Equity markets are moving in sync

For the second time in less than a year, global markets engaged in a broad-based and unified swoon only to, once again, stage a quick and vigorous recovery. The February 2007 retreat, precipitated by events in China, follows last year's April-June draw in which global equity markets also fell in tandem. This year's decline was much shallower, with most markets falling less than 10%, while many emerging markets dropped as much as 20% in 2006. This year's sell off has been quickly erased, as almost all of the major markets including developed Europe, UK, Canada, Australia and China, as well as other emerging markets, are again setting new highs. The only notable exceptions are Japan, which is still below its peak, and the U.S., which has just recently completed a rebound to its previous high.

Since the current rally began in the Spring of 2003, this pattern of small but highly correlated global draws has been a consistent one. Markets fell together during the March/April period in 2004 amid terror attacks and concerns over rising interest rates and oil prices, in March/April 2005 over automotive and credit default issues, again during May/June 2006 in tandem with commodities markets retrenching, and most recently in February 2007, instigated by events in China.

5 Year Correlation vs. S&P/TSX Composite

5 year period ended	MSCI EAFE	MSCI EM
1992 (Dec)	50%	31%
1997 (Dec)	52%	49%
2002 (Dec)	76%	75%
2007 (Apr)	79%	84%

Source: Hillsdale Investment Management

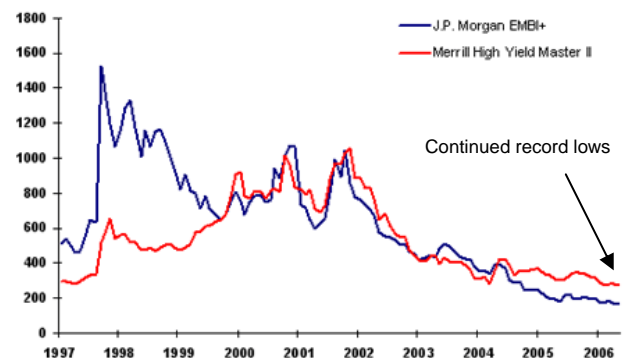
Over the past five years, international markets have displayed one of their highest levels of correlations on record. The rise in correlations between global markets has experienced a pronounced acceleration since the beginning of this decade. Correlations between Canada and both developed and emerging markets are at their highest levels ever. As the above chart shows, these correlations, as measured by the MSCI EAFE (Morgan Stanley Capital International Europe Asia Far East) Index, were near 50% in the early 1990s and have now risen closer to 80%. Likewise, correlations between Canada and emerging markets, as measured by the MSCI EM (Morgan Stanley Capital International Emerging Markets) Index, have climbed above 80% from their level of 30% in the early 1990s. As the world economy has become more interconnected, the relationship between markets has grown. While much of the rise in correlation is driven by a convergence of international policy at all levels - trade, monetary, inflation - the net result for investors is that the benefits from international diversification are actually declining.

Is there any fear?

While there remains an abundance of 'topics of worry', many of the standard risk measures that we follow continue to emit little, if any, readings of fear. Volatility levels, whether for equities or cash, remain at or near all time lows. U.S. equity volatility, as measured by the VIX index, has been at its lowest levels ever and, while it has spiked up with each market draw, its long term trend has continued to move downward over the cycle. Canada and other developed markets are experiencing a similar trend, though the U.S. is now the lowest risk equity market when measured by volatility. Cash volatility, as measured by the Merrill Option Volatility Estimate Index, shows similar readings as implied volatility on the 30 day treasury is at 20 year lows. The years with the lowest level of volatility on record are 2005, 2006 and, so far, 2007.

Credit spreads on all fronts have continued to trend lower. U.S. investment grade spreads, as measured by the difference between Moody's Corporate Long Term AAA Bond Index and 10 year treasuries, are around 70 bps, matching lows reached in the mid 1990s and late 1980s. Higher risk junk spreads, as measured by the difference between the Merrill High Yield Master (MHYM) and 10 year Treasuries, are around 230 bps, which is a 10 year low. Emerging market spreads, as measured by the JP Morgan Emerging Market Bond Index vs. the MHYM, are less than 200 bps and have continued to set record lows. Each time equity markets had a minor draw, credit spreads backed up. Even so, the long term trend has continued to move downwards over the cycle. **This is a notable difference from previous cycles** (see graph below).

Emerging Markets and High Yield Spreads (vs. 10 Year Treasuries)



Source: J.P. Morgan & Merrill Lynch

These measures indicate that there is ample liquidity in the system and little, if any, risk premia priced into markets when measured against historic norms. Accordingly, as risk premiums have fallen,

investors have been emboldened to undertake greater risk either through seeking more leverage or through chasing riskier assets.

Global View: Growth is strong, integration is rising

Behind the backdrop of low risk premia has been the continuing strength of the world economy and the dramatic integration of capital flows. The global economy grew at 5.4% last year, its fastest rate in 25 years and the second highest ever since the IMF began keeping records in 1970. This compares to 4.9% in 2005 and 5.3% in 2004. The forecast for 2007 is 4.9%, as is the forecast for 2008. If accurate, the 5 year period would represent the best 5 year growth period for the world economy ever.

As the global growth continues its torrid pace, international capital flows have grown dramatically. In the early 1980s, capital flows, as measured primarily by debt, equity, foreign direct investment and derivative transactions, represented around 3 to 5% of global GDP. They remained within this level for 15 years until the mid 1990s. Since then, flows have taken off and now represent 15% of the global GDP. Concurrent with the rise in capital flows has been the rise in the value of financial assets. Today, the value of the world's equity and debt markets are now double the level of world GDP.

Given the integration of capital markets, their sheer size and the dramatic rise in cross border flows, it is now clear that the investor base has also changed dramatically. As the IMF has noted,

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“analyzing the changes in the international investor base and their investment allocation behaviour is fundamental to understanding the build-up of strengths and weaknesses in international financial markets.” One obvious

example is that investors see the same level of risk in owning emerging government market bonds as they do in owning U.S. investment grade Baa's (Baa's are the lowest level of investment grade bonds as rated by Moody's Investors Service). This is a heroic change from 10 years ago when, following the 1998 Russian default, emerging market yields were 1000 bps higher than low rung investment grade bonds. Today, both trade at the same level, each 160 bps higher than U.S. treasuries. This means that sovereign and quasi-sovereign entities in countries such as Mexico, Brazil, Russia, the Philippines, Turkey and Venezuela can borrow funds in U.S. dollars at rates that, on average, are only 1.6% more than the U.S. government pays for its borrowings. As a result, with greater global integration and higher cross border investment flows, investors at the local level need to continue to place more weight on global factors when making investment decisions.

Canadian Growth: Driven by commodities

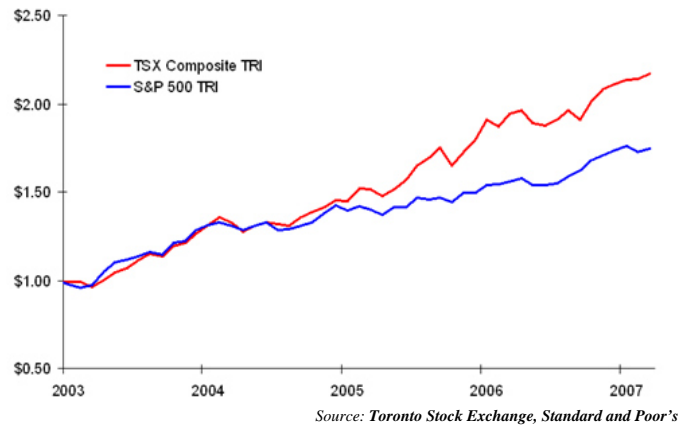
Commodity and energy markets, which rose very strongly during Q4 2005 and Q1 2006 and suffered a large retrenchment in Q2 2006, have slowly regained momentum. Though most commodities such as energy, gold, aluminium, platinum, zinc and copper are still below their May 2006 highs, their price levels remain at multi-decade highs. Two notable exceptions are nickel and uranium, both of which have continued to rise unabated and are ahead more than 100% since

Commodity price levels have reached multi-decade highs

May 2006. As the commodity bull has run, the Canadian markets have continued to benefit, with Canada handily outpacing the U.S. over the past 4 years by a

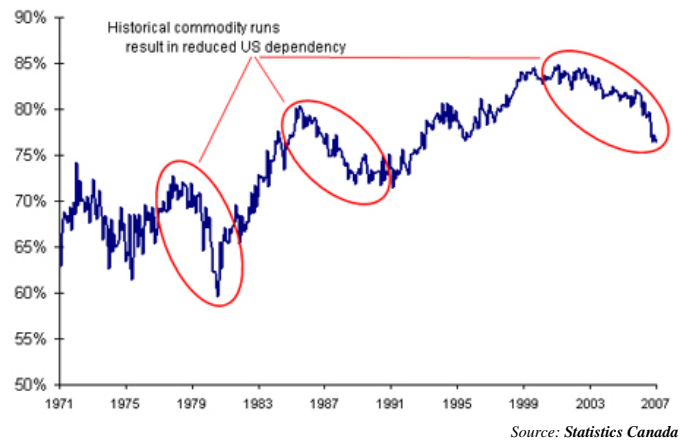
margin of 20%. Its annualized return over this period now stands at 14% (see graph below).

Value of a Dollar Invested
Inception January 2003



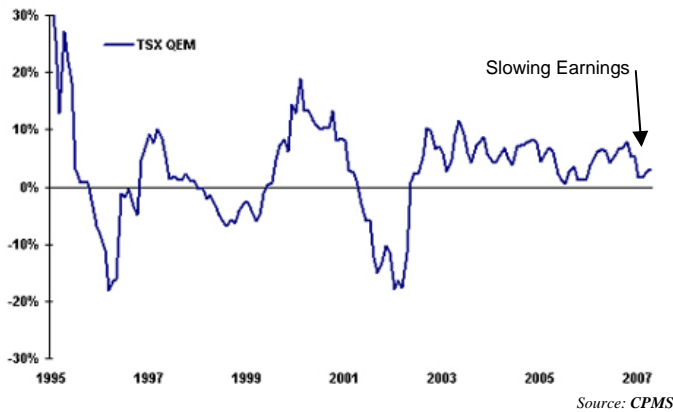
During the 4-year period, Canada's reliance on the U.S. decreased as it shifted more commodity exports to global markets. As the graph below shows, exports to the U.S. have decreased almost 10% in the last four years, falling from 85% in 2003 to nearly 75% today. A similar pattern of behaviour was evident during previous commodity runs, as seen in 1986 to 1989 when the share fell from 80% towards 70%, and in the late 1970s when the share fell from 70% towards 60% (see graph below). This means the growth of Canadian markets, as well as the Canadian dollar, over the past 3 to 4 years has been significantly dependent on global commodity prices. This dependence is not likely to change going forward.

Canadian Exports to U.S.
as a % of Total Exports



Despite the record commodity and energy prices, the problem for the Canadian market is that year over year earnings growth is actually slowing. Growth is currently at 5%, the slowest rate for the composite since this cycle began back in 2002 (see graph below). The largest contributors to the slowdown are the energy sector and the trust sector. Stronger earnings growth is available from the materials, telecom and information technology sectors. For the composite to meet its earnings target, firms now need to reaccelerate to reach this year's forecast of 14%.

Slowing Canadian Market Earnings Growth



During the past two years, the market multiple, as measured by trailing price earnings, has remained relatively stable, averaging 17.5x. If the market maintains this level, this would imply a closing value around 14,500 and a year over year gain of 13%. If the multiple slides back to 16x, this gain drops to 3%. As we noted in our last commentary of September 2006, the long run in energy prices and the past year's preference for all things metal has forced a notable skew into the Canadian marketplace. Given the high levels of volatility associated with both energy and metals stocks and their higher weighting in the index, the price movement of these two sectors now accounts for roughly 70% of the volatility of the index. Given the slowing trend in earnings, and short of rate reductions from central banks, the market appears to be fully priced. With this in mind, the probability of a multiple contraction is much greater than a further expansion.

From a global perspective, many countries offer better fundamental value than Canada. Each of Germany, Netherlands, New Zealand, Italy, Norway, Sweden, South Africa and Switzerland offer stronger earnings growth, lower valuations and a higher dividend yield. From a diversification perspective, countries such as France, Germany and Switzerland have less than 20% of their market price movement originating in the energy and materials sectors.

Neglected U.S. Market: Better fundamentals, greater breadth

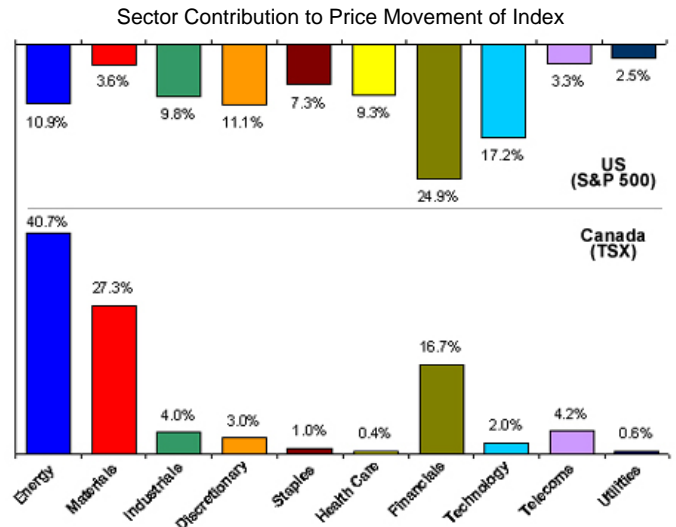
Closer to home, the U.S. market also looks more appealing than Canada. U.S. earnings are running at 10% versus 5% in Canada and trailing profitability is 4% higher in the U.S. than in Canada, running at 21% versus 17%. The U.S. is also favoured from a multiple perspective trading at 16.5x versus 17.5x in Canada. While the market volatility in the two countries is the same, the risk offset at the industry level is dramatically different. Today, the two are almost a

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perfect offset to each other. As the graph below notes, the main drivers of price movements in the U.S. are the technology, financials, health care and consumer discretionary sectors

which, in aggregate, account for 60% of the price movement of the S&P 500. These sectors account for only 20% of the Canadian market returns. Conversely, energy and materials make up 76% of the Canadian index, compared to 13.4% in the U.S. (see graph below).

U.S. vs. Canada



The rapid surge of the global commodity markets, the heightened takeover activity in Canada, and investors' continued focus on energy and materials stocks, has left the TSX with a much narrower composite than four years ago. It is now trading more like a dual sector fund with a disproportionate weight in higher risk energy and materials names. The TSX will continue to be a good investment only as long as commodity prices remain at elevated levels. If prices decline, the resulting exposure will lead to larger drawdowns and higher losses in comparison to other developed markets. With earnings slowing and multiples unlikely to expand, the risk return trade-off is neutral to negative with commodity prices, for better or worse, continuing to be the leading driver.

Conclusion

At the global level, economic growth continues unabated, and commodities markets, though not as frothy as they were one year ago, remain at multi-decade highs. In addition, credit markets remain very buoyant and are providing tremendous liquidity into global markets. The underlying story for Canadian markets is that earnings have been slowing down and future growth appears to be fully priced.

Given the current valuations levels, the commodity/energy exposure is a mixed bag, as the current skew clearly lowers the risk reward trade off. A commodity price pull back and a multiple contraction would be a double blow to the Canadian market. Given the excess returns generated within Canada over the past few years and the natural home country bias that afflicts most investors' portfolios, now is a good time for investors to consider rebalancing a portion of their portfolios by taking profits out of Canada and redeploying across the global equity spectrum. The U.S., which has been a laggard over the past four years, as have many European markets, definitely offers better fundamentals and better risk reward options mainly because their indices are not as tightly skewed and their levels of volatility are comparable, if not lower. Furthermore, since the global markets are now clearly more correlated, it also makes sense for investors to diversify their portfolios by seeking equity strategies that are meaningfully hedged and/or strategies that offer materially different return streams, particularly during the inevitable periods of global equity stress.

Regards,
Chris Guthrie and Arun Kaul