Economic & Market
Outlook
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Liftoff Achieved, but the Flight Path Will Be Turbulent

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The global recovery has achieved liftoff, led by China and a number of emerging nations. The U.S. and other developed economies also should become fully airborne in the months ahead, fuelled by unprecedented monetary and fiscal stimulus set in motion in 2009, the revival of consumer spending and the re-ignition of production as firms react to improving sales prospects. However, a legacy of high unemployment and structural weakness in key sectors such as housing and financial services points to a bumpy ride during 2010 and a relatively low-altitude global growth trajectory into the next decade.

Domestic economic conditions have been more resilient in Canada than in the U.S., in large part because of the world-class strength of our financial sector and relatively stronger household, corporate and government balance sheets. Canada experienced only about half the rate of job loss recorded south of the border during the downturn and has lead the U.S. in a return to job creation. These factors have supported a rebound in consumer spending and the revival of Canada's housing market, where buyers have been taking advantage of historically low interest rates at a time when U.S. residential activity is still mired in recession.

At the same time, Canadian exporters have faced heavy headwinds, with sales receipts going into the final quarter of 2009 down more than 25% from the previous year. Commodity producers are beginning to benefit from a rebound in global markets but, with three-quarters of external sales going to the U.S., the pace of recovery will be subdued. The rise in the loonie to 95 cents (US) – in part, reflecting the recent rebound in energy and industrial resource prices – also has undercut competitiveness and squeezed earnings. More of the same could be in store if our currency moves to parity or beyond.

The pathways from recession to recovery vary significantly between Canada and the U.S., but both nations will benefit as previously announced public infrastructure projects get fully underway. Canadian and U.S. motor vehicle producers are gearing up to replenish depleted dealer inventories now that sales have begun to recover. The impetus from these temporary factors will help both economies gain altitude during the first half of 2010.

While there is a risk of economic relapse as governments begin unwinding unprecedented monetary and fiscal support, the broadening of global growth across sectors and regions should sustain the recovery through 2010. In Canada and the U.S., however, this year's growth will do little more than backfill the hole created by the steep decline in activity during 2008-09. Even this modest performance will compare favourably with trends in Europe and Japan, where economic retrenchment has been much deeper and the timetable for regaining lost GDP will stretch beyond 2010.

Economic and Market Outlook 2010 - 2011

Canada	2009e	2010f	2011f
Economic Performance (annual average)			
Real GDP (% change)	-2.5	2.7	2.8
Consumer Prices (% change)	0.3	1.7	2.1
Core CPI (% change)	1.8	1.6	2.0
Unemployment Rate (%)	8.3	8.5	8.2
Housing Starts (units, thousands)	143	168	172
Motor Vehicle Sales (units, thousands)	1,461	1,525	1,570
Merchandise Trade Balance (C$ billions)	-7.3	-1.5	8.3
Yield Curve (%, end of period)			
Bank of Canada Overnight Target Rate	0.25	1.25	2.25
2-Year Canada Bond	1.47	2.70	2.45
10-Year Canada Bond	3.61	4.50	4.50
United States			
Economic Performance (annual average)			
Real GDP (% change)	-2.4	3.3	2.5
Consumer Prices (% change)	-0.4	2.1	2.3
Core CPI (% change)	1.6	1.4	2.1
Unemployment Rate (%)	9.2	10.0	9.4
Housing Starts (units, millions)	0.56	0.73	1.08
Motor Vehicle Sales (units, millions)	10.4	11.5	12.2
Merchandise Trade Balance (US$ billions)	-510	-592	-663
Yield Curve (%, end of period)			
Fed Funds Target Rate	0.25	1.25	2.25
2-Year Treasury	1.14	2.70	2.45
10-Year Treasury	3.84	4.80	4.80
Foreign Exchange Forecast (end of period)			
Canadian Dollar (CAD/USD)	0.95	1.03	1.05
Yen (USD/¥)	93	87	92
Euro (€/USD)	1.43	1.53	1.46
Chinese Yuan (USD/CNY)	6.8	6.4	6.0
WTI Oil (US$/bbl) (ann. avg.)	61.8	90.0	92.0
Nymex Natural Gas (US$/mmbtu) (ann. avg.)	4.15	5.50	5.50

f: Forecast - Scotia Economics *Global Forecast Update* (January 8, 2010)

Source: Scotia Economics, Statistics Canada, U.S. Dept. of Commerce, U.S. Bureau of Labor Statistics, Bloomberg

U.S. Equity Strategy

Top 10 U.S. Stock Picks for 2010

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As we enter the New Year, the global economy appears to be on the mend, corporate profits are recovering, and monetary policy remains highly stimulative and supportive of equity markets. Furthermore, cash and fixed income alternatives are unattractive. However, investors should not expect the sort of returns witnessed in 2009 and will need to be more selective when choosing stocks for their portfolios. With this in mind we offer our top U.S. equities ideas for 2010.

While 2009 was a turbulent year, it proved to be a great time to be invested in equities as unprecedented efforts to stimulate financial markets and the economy achieved their intended effect. Equity markets overshot to the downside in the first quarter of 2009 as investors weighed the risks of a financial collapse and economic depression. In hindsight, panic selling created a tremendous opportunity for investors to buy U.S. stocks as the S&P 500 rallied nearly 70% from its March low, ending the year with a 23% gain.

Looking ahead, the largest threat to the U.S. equity market and economy are higher interest rates and an un-orderly decline the U.S. dollar. The U.S. Federal Reserve and Treasury will eventually have to unwind the numerous liquidity programs and other stimulative measures which have been put in place over the last 18 months. It is very possible U.S. economic activity could slump again later in 2010 as ongoing signs of a recovery in the first quarter of 2010 force central bankers to prematurely remove economic stimulus and raise interest rates. Low interest rates have played a critical role in sustaining the recovery so far.

While there are risks, given the alternatives -low bond yields and cash returns near zero - equities look relatively attractive as we begin the New Year. With lower return expectations, investors should be far more selective when choosing stocks for their portfolios as we begin 2010. We admit attractive risk return profiles are much more difficult to find at this juncture.

Our stock picks for 2010 encompass a number of themes including investing in the emerging markets consumer and infrastructure development, as well as an expected resurgence in capital spending, particularly where technology is concerned. With stronger relative growth expected in most emerging economies in 2010, we are biased towards companies with a multinational orientation. Bank of America is a recovery play on domestic banking and one where investors, in our opinion, are under appreciating the earnings recovery potential.

Company	**Ticker**
Bank of America	BAC
EMC Corp.	EMC
Fluor Corp.	FLR
General Electric	GE
Intel Corp.	INTC
McDonald’s	MCD
Mead Johnson	MJN
PepsiCo	PEP
Teva Pharmaceutical Industries	TEVA
Transocean Ltd.	RIG

While there are risks, we are not ready to get overly defensive just yet, so our list offers some beta in names like EMC Corp., General Electric, Transocean, and Intel. EMC Corp. is considered to be one of the best ways to play a recovery in enterprise spending on information technology. General Electric is a play on global economic growth and a recovery in its capital arm. Among defensives industries we emphasized those companies that offer above average growth, in some cases such as Teva Pharmaceuticals, at the expense of dividends. Mead Johnson Nutrition is somewhat unique in that it is considered to be a highly attractive takeover target for Nestle SA or Heinz Foods. All in all, our list for 2010 offers a fairly diverse basket of U.S. blue chips. For more information on any of the securities listed above, please contact your ScotiaMcLeod advisor.

Canadian Equity Strategy

Canada – 2010 Looking Positive

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After a rocky first quarter Canadian equity markets appreciated nicely during the remainder of 2009. Over 90% of these gains have come from the three highest weighted sectors in the TSX Index (Financials, Energy and Materials), thus indicating that investors expect signs of economic recovery already witnessed will only strengthen.

In the past we have provided you with some larger macroeconomic arguments; however, since those arguments really haven't changed much we will instead provide you with some observations as to what we are currently witnessing from an economic and market perspective:

- Equity markets worldwide have rebounded nicely off their lows. Canada is not alone as the emerging BRIC (Brazil, Russia, India and China) markets led major market returns in 2009.
- The worst of the credit crisis is likely behind us, but problems will persist for years. A real estate crisis ballooned into a corporate credit crisis and is now a consumer credit crisis south of the border. While the absolute worst of the credit crisis is likely over, we will feel remnants of it for years to come as governments and central banks continue to provide life support to the global financial system.
- Government intervention/rescue/stimulus appear to have averted a depression. Now we just need to see the global economy get back to a self sustaining level without the need for intervention.
- Canadian interest rates are at all time lows and will remain there for months. While this is good news for individuals that want to borrow and can get access to such credit, it is also remarkably clear that over the next couple of years interest rates have nowhere to go but up.
- The western world consumer, namely U.S. consumers, are saving rather than spending – unemployment is still high and U.S. housing prices are still low. These factors do not create an environment ripe for consumption; therefore the global recovery is not without its challenges.
- The recession is technically over in the United States and Canada, but the recovery could be sluggish if individuals don't pick up their rate of consumption. The specific time the recession ends is irrelevant, how we position ourselves for the recovery is much more important.
- U.S. dollar weakness has pushed commodity prices higher and speculators have returned to markets they briefly abandoned. Fundamental analysis of commodity prices can become meaningless when commodities are used for investment rather than consumption.
- As long as commodity prices rise and Canadian consumers maintain their wealth/equity, the Canadian economy has the potential to outperform the United States over the next year and the loonie will be a "go to" currency for global traders.
- Canada emerged as a winner during a difficult time. Not only has our financial system withstood the blows of the credit crisis, our federal and provincial governments are holding in much better than our counterparts in the United States. While deficits are certainly a reality this year, those deficits in relative terms to our debt are still manageable.

There is no denying the fact that the rebound for the TSX Index has been impressive. While we certainly do not expect the same rate of appreciation for the TSX index in 2010, we are bullish for the Canadian stock market over the long term and believe this country will be a great place to invest as the global economy accelerates this year and beyond.

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