CAPITAL MARKETS REVIEW

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The Hard Road to Mideast Peace

The defeat of Saddam Hussein proved to be swift and relatively bloodless but it did not win the war on terrorism or secure a more peaceful Middle East. The scene is now set for Mr. Bush to address these enormous challenges. The road map to peace, including resolution of its most enduring conflict – the Israeli Palestinian impasse – will likely take years of dedicated and costly effort.

On the positive side, it must be admitted, even by those who opposed the war, that the removal of Saddam Hussein has had useful consequences. On the global front, the collateral impact has been to cool down tensions in several parts of the world, including less aggressive posturing from North Korea, a reduction in tensions between the U.S. President and Western European leaders (the G8 Summit was a triumph for Mr. Bush in that regard) and constructive overtures between India and Pakistan are in play. However, the positive effects of the military victory on the Middle East situation are most critical. First it has left America in a position to bring new pressure on potential "spoilers" such as Syria and Iran and the revolutionary guerillas they harbor by removing a source of support for the "Intifada". Secondly, it has made it safer for Israelis to compromise and more difficult for Palestinians to believe that they will achieve their aims by violence. Thirdly, it has given America a new opportunity to signal to Arabs and to Muslims everywhere that its war against terrorism is not a war against Islam. Delivering an independent Palestine from Israeli occupation would be an important confirmation of that fact if it could be achieved. More broadly, with Saddam Hussein out of the way, the Middle East is theoretically poised for more enlightened leadership and less oppression. Of course there is the underlying recognition that it could go disastrously wrong. Accordingly, America's resolve is more crucial than ever.

In meetings with key leaders, at Sharm el-Sheikh and at Aqaba in early June, Mr. Bush made some progress towards a "just peace". At Sharm el-Sheikh on, June 3rd,five Arab leaders, including Crown Prince Abdullah of Saudi Arabia and President Mubarak of Egypt, pledged that they would cut aid to Palestinian terrorist groups and reject the culture of extremism and violence, "regardless of justifications and motives". These last few words could mark an important ideological shift. Arab political leaders have always drawn a distinction between true acts of terrorism such as September 11th and acts of national resistance perpetrated by such groups as Hamas. Now Arabs seem prepared to disavow the distinction. Then on June 4th Palestinian authority Prime Minister Mahmoud Abbas met with Mr. Bush and Israeli Prime Minister Ariel Sharon in the "neutral" Jordanian town of Aqaba. Mr. Abbas declared the armed Intifada must end and pledged a denunciation and renunciation of terrorism against the Israelis. While there is a serious question as to whether Mr. Abbas can convince terrorist groups to cooperate, his public stance against terrorism sets him apart from Yasser Arafat who has been sidelined for now. At the same meeting, Mr. Sharon showed his support of the peace plan by giving explicit support for the creation of a Palestinian state.

The most forceful voice for peace in early June was that of Mr. Bush himself. The U.S. President gave his commitment to Arab leaders in private to move the peace process

forward. Of course, in spite of the best intentions of all concerned, the road ahead is guaranteed to be rocky, as evidenced by the incidents of terrorism immediately following these meetings. On June 11th in Jerusalem, a Hamas suicide bomber blew up an Israeli bus killing at least 16, apparently as payback for Israeli's missile attack on June 10th on a car carrying Abdul Aziz Rantisi, a Hamas leader. The peace process may not survive these continued outbreaks of violence, particularly if they escalate.

The main force for peace is America bringing its might to the endeavor, although all sides could abandon hopes "that cannot be satisfied". U.S. pressure has been a factor in the success of the National Security Advisor, Condoleezza Rice, negotiating a temporary ceasefire on condition that Israel cease its practice of targeted killings and begin withdrawing its forces from the Gaza strip. Mahmoud Abbas and Ariel Sharon have now met face to face four times and the ceasefire marks the first tenuous steps along the road to peace. Of course, the road map, even though backed by America, the European Union, the U.N. and Russia, is in fact a "vision" and not a detailed plan. The trickiest stages, deciding on borders, refugees and Jerusalem remain unmapped. But at least by accepting the road map and agreeing to a ceasefire, Palestinians and Israelis have clearly undertaken to bring violence to an end. The responsibility for keeping them on track has to be America's and it appears that Mr. Bush genuinely intends to invest the time and political capital required to untangle a conflict that has defeated peace makers for more than half a century.

The task is Herculean but Mr. Bush believes it cannot be avoided. The downside risk is that the effort disintegrates into a "Vietnam Era" which costs Mr. Bush his presidency and drains the U.S. politically and economically to the point of a crisis. This risk is compounded by ongoing violence in Iraq, which has led to 63 U.S. soldiers being killed since major combat ended. The American occupation is not popular with many Iraqis. There is a risk that widespread rebellion could disintegrate into anarchy. At the moment Americans are being blamed for all the country's problems and could face an intifada.

On the other hand, the upside is enormous. If Mr. Bush can bring about a new order in the Middle East a new era of world peace and prosperity (for example an investment boom in the Middle East) could be had. America's approach to the Middle East may be self-serving in that it is aimed at gaining more control over those forces of globalization that pose a threat to its society. On the geopolitical front it is globalization that has put the U.S. in a position of having to protect its citizens from international security risks. In the area of trade and commerce, it is globalization which has allowed the U.S. to extend capitalism across national boundaries. In the financial world it is the globalization of capital markets that has made possible the relatively free flow of capital around the world.

On that subject, investors must be aware that the U.S. economy is currently very dependent on global capital. As discussed later, it is likely that the U.S. will run twin current account and budget deficits approaching 5% of GDP by year end. Much of this debt is funded from international sources. In itself that is not a current problem provided the U.S. can continue to attract foreign capital. But therein lies the problem. In the past, capital has eagerly sought a home in the U.S. to fund private sector business opportunities such as the technology inspired investment surge of the 1990's. Today, international

suppliers of capital are being asked to finance Mr. Bush's war, his tax cuts and America's other spending needs. The reality is that America's economic and military might is directly tied to the willingness of the rest of the world, particularly Asian banks, to provide the required funds.

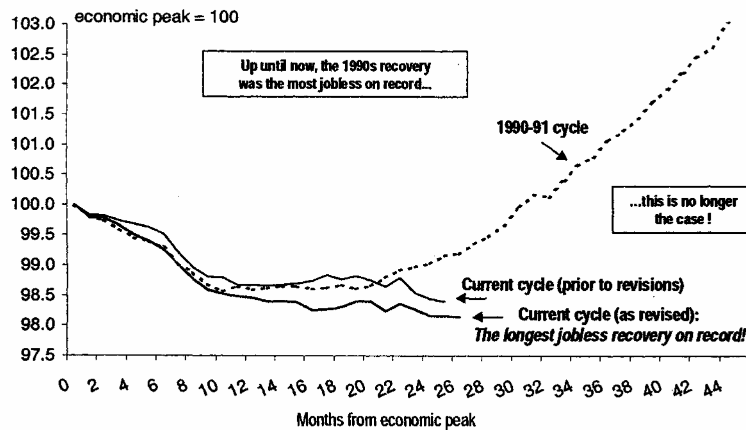
In the final analysis, regional transformation in the Middle East is important to the U.S. not only in geopolitical terms, but also for the health of its economy, i.e. protecting the supply of capital to its programs. For many reasons, therefore, it is critical that America cannot simply win the war and then proceed to lose the peace. In future commentaries we will continue to follow closely the U.S. role in the Middle East now that the real battle - the fight for peace - is underway.

The North American Economy

America's Slow Growth Path

For the past three years the consensus of Wall Street analysts has persistently predicted a vigorous recovery starting one or two quarters ahead. A similar refrain is heard today. Early in 2003 prominent economists including Alan Greenspan were adamant that the major impediment to a vigorous U.S. expansion was uncertainty over the war in Iraq. The Iraq military effort went well, but the economic recovery is not vigorous. In fact since late 2000, annual U.S. economic growth has averaged a meager 1.5%, a rate of expansion which barely exceeds the rate of population growth. America remains in the grip of a somewhat baffling twilight zone in which the economy is recovering but unemployment is still rising. The overall climate reflects insecurity over jobs, a squeeze on government social spending and intense pressure on corporations to grow profits. By one U.S. government survey some 2.5 million jobs have vanished and unemployment is still inching up having risen from 5.6% at the beginning of 2002 to 6.4% at present.

U.S. Labour Market: A Recovery for the Record Books
Payroll employment: A comparison between the current and previous cycle



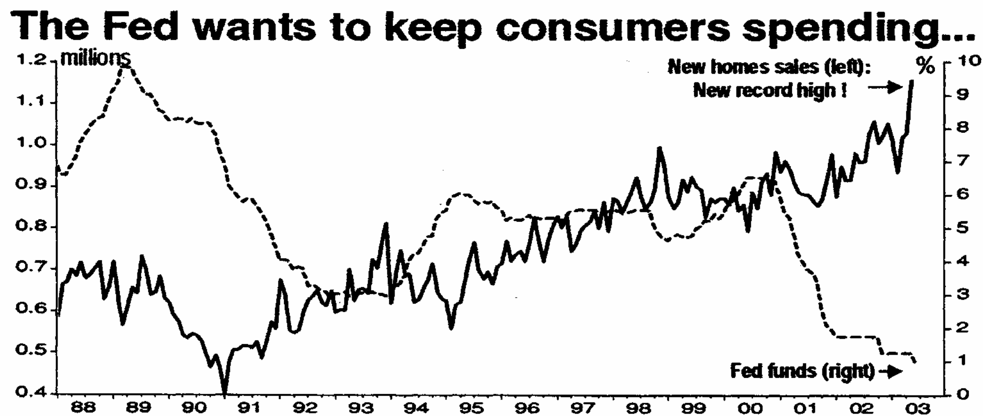
Source: National Bank Financial

Nevertheless, many Americans are prospering – there are still 130 million non-farm jobs, and the median price of existing homes, most Americans' biggest financial asset, rose 7.1% last year.

The official recession appears to have ended during late 2001 when the economy resumed growth, but the rate of recovery so far does not compare favourably to that of previous recessions. Statistically, the U.S. economy needs to grow by about 3% to 3.5% per year to keep the unemployment rate from rising – 2% to 2.5% to offset labor productivity gains and another 1% to provide jobs for new workers. Anything less than 3% to 3.5 % represents the twilight zone between a true expansion and continued stagnation.

Conventional wisdom suggests the setbacks the economy suffered over the last two and a half years were temporary and that the economy will shake off its malaise and embark on a more robust expansion in the second half of 2003. But it is possible that the standard analysis does not adequately account for deeper weaknesses which will condemn the U.S. economy to a long period of constrained growth.

First, in the aftermath of the 1990's boom, consumers continued on a spending spree and never experienced much of a recession. In fact, the main reason the U.S. recession was so mild was that low interest rates spurred spending on housing and autos throughout the downturn.



Source: National Bank Financial

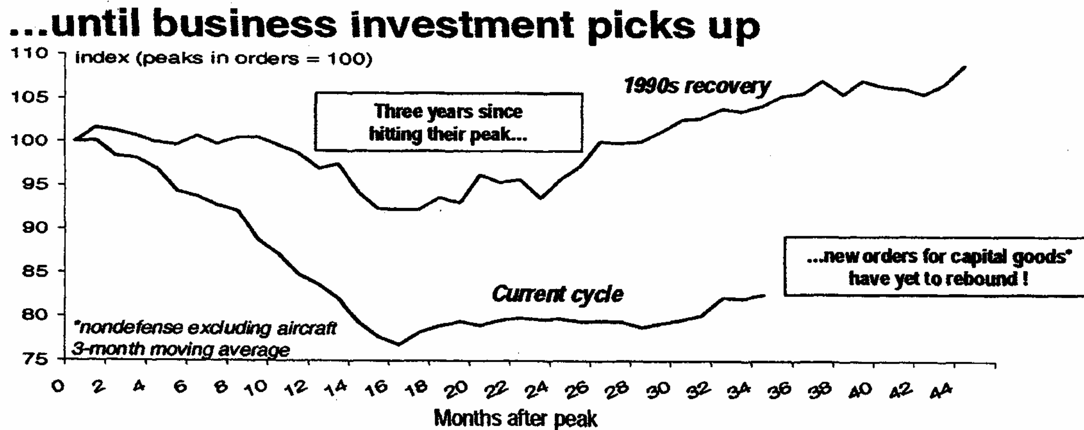
Accordingly there may not be much pent up demand in these interest rate sensitive sectors. Moreover, consumers still have a long-run problem to address, i.e. not enough savings. The personal savings rate, now running about 4% of income, needs to rise substantially if Americans can no longer depend on hefty stock market gains to boost their wealth. American consumers have been improving their balance sheets but they have more work to do.

Secondly, foreign economies cannot be relied upon to help the U.S. economy. A year ago many economists forecast that Europe would take over as the engine of global growth as the U.S. economy retrenched, but that has not occurred. A host of problems are holding Europe back including over-regulation of labor markets, over-dependence on manufacturing jobs which are moving to countries with cheaper labor, restrictive effects of the Growth Stability Pact and finally, the rise of the Euro. Europe will be fortunate to register 1% growth for 2003, let alone provide a stimulus for the rest of the world. For example, Germany, Europe's largest economy is in a recession, with unemployment at almost 9%. Turning to Asia, Japan is in no position to contribute to global growth either. In spite of some recovery earlier in the year, structural issues are holding back a recovery and Japan remains mired in a no-growth mode.

It is evident the rest of the world needs the U.S. to play the role it did during the 1990's as the primary driver of global growth. To get the U.S. economy to expand at an optimal

pace a source of extra spending must develop. If North American consumers and or foreign economies cannot be relied upon, then capital spending by U.S. business is the only real salvation. Of course, skeptics abound as to whether U.S. capital spending will in fact rebound, pointing to lackluster final demand, capacity utilization at only 73% (80% plus is required for expansion), and weak corporate profits (although improving).

It is true that businesses are starting to use up productive capital faster than they are replacing it but actual spending for new business equipment is still being deferred. It is also true that profits have turned around, a precursor to a pick up in capital spending, but shareholders are exerting pressure on management to pay down debt or pay dividends. Moreover, much of the improved profit so far reflects cost cutting initiatives rather than new sales. All this says that corporations have reason to restrain from committing to new projects and that capital spending may only recover slowly.



Source: National Bank Financial

In summary, the U.S. economy is giving mixed signals at present and there is no obvious immediate catalyst for accelerated growth. It is therefore conceivable that 2003 may well turn out to be another year of subpar economic growth in relation to the 3% to 3.5% rate of growth representative of a true cyclical expansion.

Recovery Could Accelerate into 2004

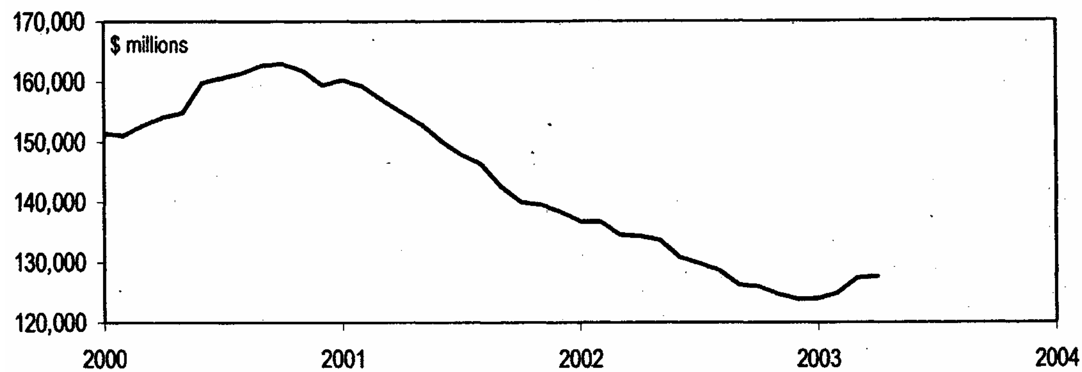
To avoid being overly pessimistic it should be pointed out that the U.S. economy has faced strong headwinds in the past three years including the bursting of the technology bubble, the 9/11 terrorist attacks, a wave of corporate scandals, a spike in oil prices and two wars (Afghanistan and Iraq). Nevertheless the recession in 2001 was brief and mild and the U.S. economy has staged a recovery against the background of the above mentioned constraints.

Furthermore the possibility is very real that economic recovery will surprise on the upside into 2004. In an unusual display of unity, the White House, the Congress, the

Treasury and the Federal Reserve Board are all acting in concert to reinvigorate the economy, bolster competitiveness and encourage spending. Bear in mind as well that 2004 is a Presidential election year. To his credit, President Bush has convinced both the Congress, through fiscal spending, and the Fed, through monetary ease, to step on the gas. Since early 2001 the U.S. Federal Reserve has cut overnight interest rates from 6.5% to 0.75%, the latest rate cut being 0.25% on June 25th. At the same time the Bush tax cuts have shifted the federal budget towards stimulus. A budget surplus of U.S. $236 billion in 2000 became a deficit of U.S. $157 billion in 2002. The deficit is now headed much higher perhaps to the $500 billion level by mid 2004 representing about 5% of gross domestic product. Over the long term big deficits will likely exert upward pressure on interest rates and dampen economic growth. But these concerns are secondary for now to the expected stimulative impact of the Bush tax package which focuses immediately on amended tax withholding schedules promised for July 1st and cheques for an increase in the child tax credit this summer. Of course, the short-term boost from personal income tax reductions partially depends upon the percentage that is spent by households rather than saved, an ongoing source of debate. On the corporate front, however, the bonus depreciation component of the tax package may encourage capital spending. Many economists expect the tax package will boost real GDP growth by somewhere between 0.5% and 1% in its first year.

Apart from monetary and fiscal stimulus, U.S. economic data recently have been somewhat encouraging. The Institute for Supply Management (ISM) Manufacturing index has risen to near break-even, and early data for June (unfilled orders) suggests that manufacturing is poised for an upturn.

Exhibit 11: U.S. Manufacturers' Unfilled Orders (Non-defence Capital Goods ex. Aircraft)



Source: RBC Capital Markets

While labour markets remain a source of concern with the U.S. jobless rate at 6.4%, net job losses have slowed in the past two months. Moreover the previously reported 525,000 net job loss during the February-April period has been revised down to a drop of about 272,000. Thirdly, U.S. housing activity remains strong with new home sales at record levels and new home construction still rising. On the consumer front overall, retail sales were up modestly in May. Excluding autos and gasoline, sales rose 0.6% with solid gains in clothing, furniture, and general merchandise. Offsetting some of this

consumer optimism however, was the early June decline in the University of Michigan consumer sentiment index.

Finally, it appears that the risk of deflation, a new policy focus of the Fed, may have been overstated. A 0.3% jump in core CPI in May created significant doubt that the U.S. is actually facing deflation. Furthermore, much of the deflationary force in the economy is the direct result of rising productivity growth and technological advance not the corrosive deflation Greenspan has referred to from time to time. Corrosive deflation is evident in sectors with chronic excess supply (airlines, autos, and steel) but it is not pervasive throughout the economy. In any event, the Fed is determined to buy insurance against deflation as evidenced by its easing of interest rates on June 25th.

Another positive is that the **dollar's decline is providing an important boost to profits for many companies.** About one-third of the net income of U.S. multinationals is generated overseas and of this two-thirds come from Europe and Canada.

In summary, the economy has faced a series of headwinds in the past three years but the resulting recession was the mildest on record and the economy is on a growth path. A period of fierce retrenchment by the corporate sector has pushed both the inventory to sales ratio and the ratio of net investment to GDP down to record low levels. Meanwhile, corporate balance sheets are being restructured and profits have turned up (this explains the narrowing of corporate bond spreads). The scene is set for a rebound in spending although persistent caution on the part of corporate executives could lead to postponement of capital commitments.

On balance, **weighing all the data available at this time, we would not be surprised if the U.S. economy were to outperform consensus estimates as the year progresses.** This would be a refreshing change from the disappointing experience of the last three years.

Canada's Changing Outlook

Canada's domestic economy has been strong for several years reflecting gains from restructuring in the early 1990's and the spillover impact of the strong U.S. economy. Now there are three important forces operating on the Canadian economy that have the potential to undermine its strong performance. First, weakness in the U.S. and global economies has cut demand for Canadian exports and this trend has begun to be felt in the domestic economy. So far, a breakdown of economic growth demonstrates that the domestic economy is still sufficiently robust, even with the slowdown coming from the external sector, to continue to grow in 2003.

Secondly several one-time shocks have hit the Canadian economy such as SARS and Mad Cow Disease. While these problems will fade over time, the immediate question is the magnitude of their impact on the economy. Economists estimate that SARS may take up to one-half a percentage point off of the annualized second quarter growth rate. Mad

Cow disease is more difficult to quantify. While the cattle industry makes up just 0.7% of GDP its linkages to the rest of the economy would result in larger spillover effects.

Thirdly the repricing of the Canadian dollar in foreign exchange markets will cause exports to shrink as a share of GDP. This may be the most critical issue facing the economy. As a result of the dollar's rise, (over 17% this year against the U.S. dollar) Canadian manufacturers face some serious challenges ahead. To mitigate the tougher environment for exporters, Canadian businesses will undoubtedly resort to cutting costs and increasing efficiencies. Over the long term the recovery in the U.S. and global economy will increase demand for Canadian goods and services but in the meantime the domestic economy will be more critical relative to the economy as a whole.

On the domestic front, both consumption and investment will be supported by historically low interest rates. Barely two months ago, the Canadian central bank warned that inflationary pressures were building and the country needed monetary tightening. Moreover the Bank took action with a quarter point rate rise in March and April. But in recent statements the Bank has done an about face. Mr. Dodge recently stated that inflation was slowing and could reach the central bank's target 2% rate sooner than it had predicted earlier in the year. Canadian inflationary pressures seem to be subsiding just as the appreciation of the dollar is tightening monetary conditions dramatically. The loonie's rise since the beginning of the year is the equivalent of a sharp rise in the Bank's policy rate. The combination of a slowing economy and the rising dollar is a key factor in causing a rethink of interest rate policy by the Bank of Canada. On this basis the financial markets are also beginning to incorporate the prospect of a rate cut by fall. Although, in an environment of slowly emerging cyclical recovery, scope for much lower Canadian official rates is likely limited.

The rise in the currency in part can be explained by the out-performance of Canada relative to its major trading partners and its relatively high interest rate structure. According to the Bank of Canada's equation for the equilibrium value of the Canadian dollar, the loonie has risen too high for Canada's fundamentals suggesting that the dollar's rise also reflects a positive foreign investor attitude towards Canadian assets. A renewal of foreign interest in Canadian assets is positive. It helps the economy reduce its cost of capital but without a U.S. economic acceleration there is a risk that excessive appreciation of the loonie will slow exports to the point of a reversal of overall economic growth. Recently, Bank of Canada Governor David Dodge, forecast very weak second quarter growth of less than 2.5% for the year. Then in a speech to the Economic Club of Toronto on June 25th, Deputy Prime Minister John Manley conceded that the economy is growing slower than originally expected, forecasting 2.2% growth this year versus 3.2% in the budget. If Canadian growth slows and the U.S. economy accelerates as 2003 progresses, Canada's out-performance of the U.S. may well come to an end.

Equity Markets Outlook

First Half Performance

The following tabulation of returns across North American markets reveals the extent of the significant recovery in equity markets that has occurred to the end of June:

	S & P 500	Dow Jones	Nasdaq	S&P/TSX
2002 Returns	-23.37%	-16.76%	-31.53%	-13.97%
2003 Returns				
1st Quarter	-9.72%	-10.69%	0.42%	-3.52%
2nd Quarter	7.0%	3.07%	21.00%	10.62%
1st Half	6.96%	-7.95%	21.51%	6.73%

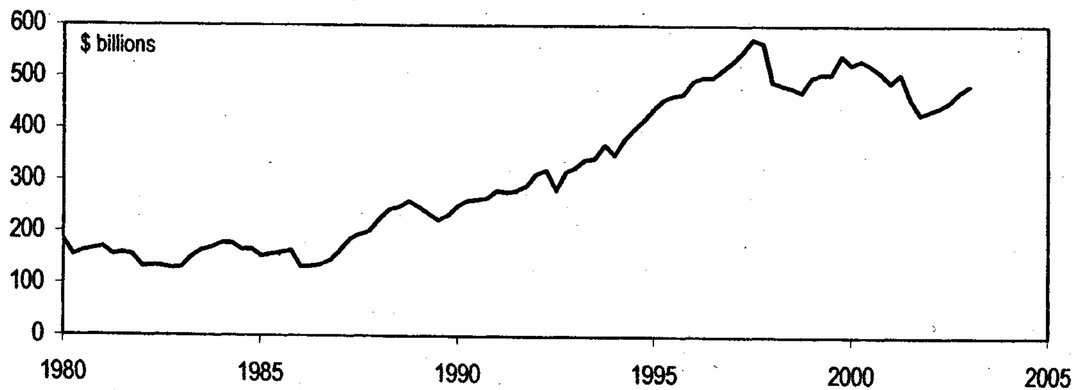
*In Canadian Dollar Terms

It appears that equity markets have finally shaken off the malaise that has plagued them ever since their peak in late 2000. It is useful to summarize the wall of worry that investors have had to climb from 2001 to fully appreciate the significance of the rebound. Back in 2001, the major concern was the recession in the wake of the excesses of the late 1990's. The collapse of the new economy paradigm left many companies laden with debt and grasping for a realistic business model. Consumers also had too much debt and were buying nevertheless against high real estate values that secured inflation. The story changed somewhat after the September 11 tragedy as arguments circulated that the new war on terrorism would undermine American interests and that the spectre of terrorism justified a much higher risk premium, particularly in light of the war in Afghanistan. In 2002, the story worsened. Unemployment climbed, accounting scandals and corporate malfeasance deepened, and a crisis of confidence developed as equity markets eroded and consumers experienced a negative wealth effect. By early 2003, there were new reasons for caution: the build up to the war in Iraq, a spike in energy prices, the war itself, tensions between the Western world leaders, SARS, the fall of the U.S. dollar and overly optimistic earnings estimates. In the last few weeks negative thinkers have picked up on the Fed's concern with deflation. The constant onslaught of worries over the last two and a half years might well have discouraged investors from ever returning to equity markets. As indicated by the markets' rise over the past quarter, investors were not permanently turned off and skepticism is giving way to optimism as the overriding sentiment.

Investors continue to worry about the strength of the economic recovery, earnings forecasts, debt levels etc., but the market is obviously telegraphing a level of confidence not seen in three years. As stated later, we believe a new positive equity cycle is underway.

Corporate Profits

According to the U.S. Commerce Department, U.S. corporate profits made modest gains in the first quarter rising 1% over the fourth quarter after a 3.2% quarterly increase during the final three months of 2002. These data reflect the government's broadest measure of economy-wide profits based on corporate performance before taxes and with adjustments for changes in the valuation of inventory and equipment. Economists also look at after-tax profits but those figures have been skewed by tax law changes related to depreciation of capital equipment. Nevertheless, the after-tax figures were better in the first quarter than the pretax figures.



Source: RBC Capital Markets

At a seasonally adjusted annual rate of $804 billion, profits now are well above their 2001 bottom of $687 billion but they are also well below the peak of $858 billion in 1997. In previous commentaries we have commented upon the various factors restraining profit growth including weakness in the economy, lack of pricing power, excess capacity and higher oil prices. The positive, of course, has been the sharp weakening of the U.S. dollar in recent months which allows corporations to export on more favorable terms.

Profit figures from Business Week's corporate scoreboard showed much more dramatic profit improvement in the first quarter. Based on the 900 companies in its database, profits climbed 33% from the first quarter last year while revenues rose a better than expected 11%. Meanwhile profit margins widened to 6.4% up from 5.3% a year ago. One reason for the better results reported by Business Week is that companies took $14.8 billion worth of special charges in the first quarter of 2002. Total Scoreboard profits, calculated on the basis of income from continuing operations, were $118.2 billion in the first quarter, up from $89 billion last year. As in the case of the government figures, the profits are still well below the record set in the first quarter of 2000 ($127.2 billion).

While first quarter earnings exceeded many analysts' forecasts, much of the buoyant picture for the first quarter was the result of big gains by oil companies and car makers, which are likely not sustainable through the next phase of the economy. One of the unexpected surprises of the quarter was the improved operating results of beleaguered technology and telecom companies. Cost cutting, debt reduction, plus some help from new accounting rules, facilitated profit recovery in these sectors, despite lower revenues.

For many companies, however, the environment for profit growth remains difficult. Tracking revenues for the S&P 500 from 1990, it is apparent that sales have not recovered much from their trough in 2002 even though earnings have risen over 35% since the spring of that year. After a year and a half of economic recovery, pricing power remains almost non-existent in many industries. By implication the profit recovery to date is largely tied to cost cutting and productivity improvement.

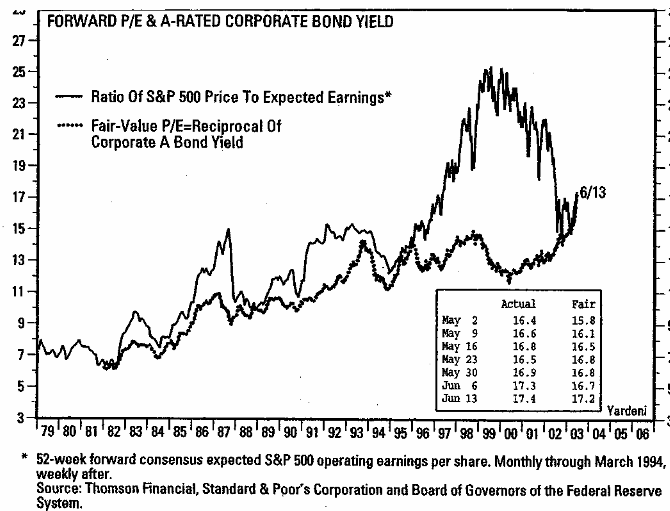
Pricing power isn't likely to recover any time soon in the current cycle. The tight relationship between capacity utilization and earnings growth suggests that the legacy of over-investment through the late 1990's will remain a depressant on earnings for some time. Even many well known large companies are still struggling to grow earnings. For example, the industry bellwether General Electric recorded a drop in earnings of 9% in the latest quarter partly because of a severe slump in its power systems unit.

On balance in spite of the difficult environment, margins are recovering and therefore, the profit picture is improving for an increasingly wider range of companies across different industries. While industry analysts continue to refine their estimates, the consensus calls for considerable improvement in profits over the remainder of 2003. At the micro level we are able to identify companies where profits are in a sustainable up trend and should be sufficient to propel the market price of their stocks higher as the business cycle progresses.

Valuation Factors

Given the strong rise in equity markets this year the valuation question has become even more critical in making investment decisions. Investors in the bullish camp have definitely taken over in financial markets as evidenced by a narrowing of corporate credit quality spreads in the quarter. At this stage, equity prices are a leading indicator of the underlying fundamentals, and the fundamentals are improving steadily.

Turning to price earnings (P/E) considerations, the forward P/E of the S&P 500 is currently around 17 times which is a reasonable valuation level in relation to a 10-year Treasury bond yield of 3.2%, the reciprocal of which is 31 times. This simple analysis suggests that either bonds are grossly over valued or stocks are grossly under-valued. We believe that the answer is probably somewhere between these two extremes.



Source: Prudential Financial

Conservative investment strategists claim that it makes more sense to use a corporate bond yield than the treasury yield when valuing companies. The yield of A-rated U.S. corporate bonds is currently 5.7% which translates to a P/E of 17.2 times. Accordingly, the P/E implicit in the price of corporate bonds is about the same as the equity market's valuation multiple suggesting that companies are fairly valued. However, when an adjustment for long-term expected earnings is incorporated into the model, companies still appear to be undervalued in relation to corporate bond yields.

One of the most popular and straightforward tools for gauging valuation is to simply compare the market's current multiple to its historical average. As pointed out in previous commentaries, these statistics are worth tracking but ignore how changes in interest rates, inflation and technologies might impact valuation. Nevertheless, this model indicates that equity prices have reverted to the mean as long as the mean since 1960 includes the over-valued markets of the bubble years.

The most highly priced stocks at present are in the information technology sector; the forward P/E for the S&P 500 Tech Index is around 30 times. Apart from Tech, there still seem to be a number of relatively cheap high quality companies having multiples of less than 15, such as the financials. Looking beyond overall measures of valuation we are able to find reasonably valued companies which conform to our equity selection process applying our bottom up approach to selecting investments.

Investment Strategy

As discussed earlier, America's actions in the Middle East could have profound implications down the road. In the meantime it is likely that the peak period of negative impact of geopolitics on market behavior probably occurred in late 2002 and early 2003 in the build up to and conduct of the war in Iraq. Equity markets have been in strong

recovery for several months reflecting a return of investor confidence. **As a general comment, we have noticed that bad news, whether it applies to economic releases, to the SARS outbreak, or the continued uncovering of questionable corporate practices, has had only marginal negative impact on investor behavior and equity market direction.**

While the major economies of the world are not performing in a typical post-war / post-recession manner, the all important U.S. economy has withstood incredible stresses and strains and is on a growth plane. Internationally, economic growth is generally weak but interest rates in most parts of the world remain low. The U.S. consumer continues to be a great source of support for global economic recovery. Admittedly, sustained economic recovery may require support from productivity enhancing corporate investment and improving economic fundamentals in Europe and Japan. With international politics exerting less influence on capital market behavior, we expect fundamental developments such as corporate earnings to become the focus of investor attention.

Certainly profits will be a key issue in determining equity market direction and, as indicated above, corporate profits continue to recover and the recovery is more widespread than a few months ago. In addition, it appears that capital markets activity has started to increase in such areas as corporate and high yield markets in the U.S., restructuring in global telecom, spin-offs and reorganizations in various sectors or secondary equity offerings. Other positives include the fact that U.S. tax cuts are in place, the Bank of Japan has become proactive in financial institution reform, and the European Central Bank has used the period of Euro recovery to cut rates by 50 basis points. Finally, greater currency market stability may well lie ahead.

Condensing our strategy thoughts as formulated over the past several weeks, our outlook may be summarized as follows:

1. It is probable that we are in the early phases of a new equity cycle as the real economy and key equity markets appear to be on the mend.
2. So far the environment is not supportive of a vigorous economic recovery but growth is occurring in the all-important U.S. economy. In fact the U.S. economy may be on the verge of accelerating growth. Over the long term, growth may be constrained by efforts to contain individual and government debt.
3. Confidence has certainly received a boost from the significant climb in equity markets. Investor confidence is important to a sustained rally in equity markets.
4. The currency market is playing a dominant role in the realignment of global economies this year and the U.S. economy stands to benefit the most from the substantial decline in the value of its dollar.
5. Corporate earnings have rebounded significantly but will likely grow at a much lower rate than experienced in previous profit recoveries. An earnings growth phase based on top line growth rather than margin improvement has yet to materialize. As well, there are laggards with deep-rooted problems to avoid.
6. After a massive collapse in P/E multiples during the 2000-2003 period, we expect multiples to stabilize. We would expect any ratio decline to result from the P rising at a slower rate than the E although the latter will also grow more slowly than in the past.

7. Equity market leadership is now much more diverse with a broad range of companies. The market rally has been broad-based as traditional defensive sectors like telephone utilities, pipelines, and energy have out-performed over the past three months. The under-performers in Canada are sectors hurt by a rising Canadian dollar and weak global demand including integrated mines, paper and chemicals.
8. Although geopolitical factors may recede into the background in the future, global markets will remain at risk to periodic shocks and restructuring.

Over the longer term we expect that S&P 500 returns should fall in the range of 8% – 10% annually. Although such returns are reasonable in relation to long-term averages they are not what investors regarded as normal in the 1980's and 1990's. Nevertheless, high single digit returns from the equity markets may well surpass the returns to be gained from bond markets over the next few years. The powerful fiscal and monetary stimulants at work today may lead to inflation down the road and higher interest rates.

In our stock selection process we continue to stress the importance of focusing on companies where pricing power already exists, or has the potential to be restored. Pricing power is usually found in businesses that dominate their markets or where capacity is constrained or demand is robust perhaps as a result of innovation. We also favour companies where cost control is visible and capital constraints in the past have forced a tight focus on core businesses operated efficiently.

We also believe that dividend-paying stocks currently play an important role. In the U.S. the reduced tax on dividends as part of the Bush administration's tax package will increase the relative attractiveness of dividend stocks. More fundamentally, dividend-paying companies look attractive in relation to the bond market which seems stretched at the moment. We believe equities are poised to out-perform bonds and fixed income investors should consider dividend paying companies for a combination of income and capital protection. For example, the bank dividend yield is currently a very attractive ratio of the ten-year bond yield in Canada – 64% compared to a historic average of 50%. In the U.S. the ratio is even more appealing.

In summary, while equity markets may have come too far too fast in the short run and will likely experience some unwinding, the fundamentals appear to be in place for further equity market gains following the longest and most painful bear markets since the 1930's. According to RBC Dominion Securities the minimum gain off the bottom in the previous nine bear markets of the past century was 24% after one year and 42% after two years. If history has some relevance then the market has much more appreciation potential ahead. Although volatility will be disconcerting from time to time, we are confident that a higher weighting in equities is warranted at this time than earlier in the year. Our asset allocation is under constant review and adjustments have been made to accounts as appropriate. For the first time in two years we expect that equities will out-perform bonds over the medium term. Of course, buying stocks at the right price will continue to be critical, particularly with stock prices higher today than a few months ago.

Investment Opportunities Reviewed

The remaining commentary provides an update on some of the companies on our focus list grouped by the sectors in which they operate. Several of the companies mentioned are in client portfolios and others are being considered for addition to client accounts subject to valuation considerations and other factors implicit in our disciplined investment process.

Financial Services

We continue to focus on the Canadian banks which, as stated before, have the potential to generate excess capital which will likely be used to increase dividends and repurchase shares. The combination of attractive dividend yields and recovery in earnings leads us to overweight the banks in many accounts. While we worry that the banks are vulnerable to stalling growth in consumer and corporate lending and weak capital market revenues, we believe cost and risk controls will ensure profitability improves.

Healthcare

Healthcare companies including pharmaceuticals, healthcare equipment and services, and biotechnology remain a focus group in our investment thinking. Industry-specific issues continue to give the pharmaceutical industry a negative tone including generic risk, manufacturing issues, and a slow drug approval process by a conservative Food and Drug Administration. However, many of these issues are already priced into the stocks and there is evidence that new drug pipelines are improving and operating issues are being addressed. High quality companies such as Merck, trading at a low price/earnings multiple relative to the S&P average, represent sound value. Performance of healthcare companies has improved recently and we believe that trend will continue as the capacity of leading companies to record steady earnings growth becomes recognized.

Consumer Related

We have maintained a cautious approach to consumer discretionary goods companies (autos, consumer durables, hotels, media and retailing). From a macro viewpoint U.S. consumption growth may well be slowing, as consumers react to weak job markets and the need to bolster savings. Nevertheless, in analyzing consumer trends we see value in merchandising companies with dominant franchises such as Shoppers Drug Mart. Shoppers Drug Mart in Canada has a strong and growing national presence and has consistently delivered solid operating results.

Industrials

The industrial sector (capital goods, electrical equipment, etc.) is closely tied to global economic performance and industrial production in particular. On that score, based on continuing weakness in industrial output, we are cautious on the group in general. In Canada we accumulated Bombardier, which we believe is an exception in an otherwise

troubled industry. Bombardier is undergoing a complete overhaul under Mr. Tellier (a skilled executive who turned CN around). The company has performed well and we are currently assessing the risk/reward trade-off in holding the company for further price appreciation.

Energy

We will not accumulate a higher weighting in energy companies until we are satisfied that oil prices are no longer in a downtrend. Canadian Oil Sands Trust and Petro-Canada are two companies on our focus list. We remain strong proponents, as we have been over the past two years, of natural gas which has experienced very high prices throughout the winter but some weakness into the summer. Typically, when natural gas prices exceed the cost of other energy forms (oil) "demand destruction" occurs and that is occurring to some extent. Nevertheless, U.S. and Canadian gas supply is failing to keep up with demand. While natural gas producers as a group are experiencing a market pullback this summer, after a steep run up earlier in the year, we will continue to add selected gas producers to equity accounts with above average risk tolerance.

Basic Materials

In the basic material group (construction materials, chemicals, metals and forest products) we have a positive long-term bias toward the lowest cost commodity producers in sectors that haven't experienced recent capital expansion. In metals and mining, despite gloomy economic data in the U.S. and Europe, the outlook is improving and many metals producers have healthy cash flow profiles and balance sheet strength.

In basic materials, Inco, the Western world's largest nickel producer, is on our watch list. Despite a mixed operating outlook for 2003, we believe Inco, and other metal producers (Teck Cominco included) will benefit from stronger prices and operational improvements in 2003/2004.

Technology

Our approach to the tech area is to screen for companies with superior business models and dominant positions, with free cash-flow. These companies can launch new products and gain market share at the expense of less capable competitors. Recently we have been accumulating ATI Technologies, a leader in semiconductor products, which has a suite of new products and is overtaking key competitors.

Fixed Income Markets

Lower Returns Inevitable

In the U.S., the Euro zone and Japan, bond yields have declined to levels not seen since the 1950's. The current 45-year low yield of about 3.5 % on a 10-year treasury does not appear attractive on a fundamental basis, but compares favourably to a Fed funds target rate of 0.75% which may not rise for some time. The bias of global monetary policy towards low interest rates, as discussed below, suggests the period of rock bottom yields will continue for some time into the future. The Fed's new concerns about the risk of deflation, however remote that risk is, means that this is not a normal interest rate environment. If it were not for the deflation concern, we would be worried about the sustainability of high U.S. bond prices (low yields). However, short-term interest rates in the U.S. are likely to remain at current levels until the spectre of deflation disappears (i.e. inflation reasserts itself). In Europe the ECB now seems to have finally adopted an easing bias after a period of resistance. In Canada, as discussed below, a period of monetary ease may be expected.

To fully understand the unusual character of today's bond market (record low yields) it is useful to reflect upon how yields got to these low levels.

First, with the economy stalling out in the spring of last year whatever concerns for inflation that arose out of the late 2001 recovery in growth and ease of monetary policy were eliminated. The ongoing saga of the war on terrorism, a steady flow of revelations of corporate malfeasance and a growing sense that the economy was locked in a no growth period (the jobless recovery), eroded confidence and dictated monetary ease. In financial markets, that translated into a rise in risk premiums and investors shifted funds to the bond market in search of a safe haven. The flow of funds into bonds also contributed to lower rates (higher bond prices). Accordingly, Treasury bond yields plunged through 2002 (and bond prices rose) although riskier fixed income products experienced a much more limited increase in value. Late in 2002 and through early 2003, the bond market reversed direction somewhat, reflecting a sufficient restoration in confidence to allow risk premiums and real interest rates to rise. Treasury bond yields for example rose earlier in the year from a low of 3.57% to 4.25% as economic recovery briefly became a more widely accepted view. All of this is consistent with a typical environment in which bond yields finally rise as the pressures of a business cycle contraction abate. At the point of writing the rally has stalled somewhat as investors contemplate the economic outlook.

The complicating factor in this environment is that the U.S. economy is not experiencing a "normal" rebound. In fact the U.S. economy is virtually stagnant in some important respects (notably employment and industrial output). The consumer continues to carry the economy forward but requires the support of low rates and low prices to keep spending. The Federal Reserve has used loose monetary policy to bring down mortgage rates and encourage the refinancing of homeowner's debt. This has in turn placed immense liquidity in consumers hands. Thus even as consumer confidence slipped, the consumer continued to spend, particularly on autos and housing. The international

economy requires low rates to keep it from deteriorating further. More deeply, it is the Federal Reserve's concern over perceived deflation risks that is behind the low rates. The economic slack resulting from weak growth puts downward pressure on inflation. Core inflation currently stands at a 37 year low 1.5%. The possibility of declining inflation from such an already low level has raised the concern that deflation is the greater issue. While destructive deflation in the U.S. economy is a low risk scenario, it is such a negative (and unfamiliar) outcome that the Fed is strongly focused on eliminating it as a possibility. Consequently, short-term interest rates in the U.S. are now almost certain to remain at current levels for the near term. With the risk of higher short-term interest rates postponed for the foreseeable future U.S. bond yields should remain range bound at least until early 2004. Assuming that Fed funds and T-bill rates remain at current levels, the gap between short-term and long-term rates at about 320 basis points would approach the steepest slope of the past 35 years. Such a wide spread encourages traders to establish positions in longer-term bonds financing those positions in some cases with short-term borrowings.

At some point, perhaps as early as the spring of 2004, the policy decisions of the world's central bankers will revert back to the normal policy approach taken in a period of improving economic fundamentals. At that time short-term interest rates will have to rise from historic lows. In the meantime the longer that the current aggressive ease is maintained, the more investors will view these low levels as appropriate. Eventually as the economy gains momentum the Fed will move to raise short-term interest rates and investors could be caught off guard, although they are more likely to anticipate a possible rate increase. In the short term we are comfortable that growth and inflation will be sufficiently weak to ensure no rise in U.S. short-term interest rates. Accordingly, the risk of a bear market in the U.S. bond market is not high at present. However conditions can change rapidly and as the year progresses we will be very watchful of the risks in purchasing bonds towards the end of an easing cycle. The bond and equity markets themselves are leading indicators.

We continue to see superior opportunities in fixed income markets. It must be recognized, however, that corporate, non-investment grade and Canadian bonds have all rallied strongly since last fall. The move began with their yields nearing the highest levels in a generation relative to T-bond yields. Spreads between T-bond yields and similar maturity Canada bonds are about 95 basis points down from a high of 130 basis points in September 2002, but still far above levels near parity through the late 1990's. The Canadian economy is almost sure to slow over the coming months, as discussed earlier, and some narrowing of the spreads between Canada bonds and U.S. Treasuries can be expected.

As with Treasuries, corporate bonds will continue to benefit from ultra low short-term borrowing costs as long as they remain in place. Spreads remain wide even after their significant decline and a combination of rising corporate profits and balance sheet repair will likely permit the compression in spreads (i.e. a decline in corporate yields relative to treasuries) to continue for a while. That said, we are growing somewhat concerned about the speed at which the rally in these bonds has progressed. Furthermore, a firming economy will eliminate the need for aggressive monetary ease. At that stage,

government and corporate bonds may be especially vulnerable to a correction recognizing that their prices may be "artificially" buoyed by deflation concerns.

Investment Strategy

With U.S. interest rates at such low levels and further monetary ease likely to be only marginally effective, the U.S. treasury market does not offer much scope for reasonable returns. An added risk for accounts managed in Canadian dollars is that the strengthening trend of the Canadian dollar against the U.S. dollar is an offset to gains otherwise achieved.

The situation is somewhat different in Canada where rates are higher and there is more scope for monetary ease. With the Canadian economy feeling the pressure of the high dollar and the sluggish U.S. economy, we see a strong possibility of Canadian interest rates falling later this year. In particular, administered short-term rates are likely to fall as the Bank of Canada reverses its course and reacts to economic reality by easing rates. **Consequently, we are keeping our duration relatively short on the basis that fixed income portfolios should benefit more from the decline at the short end of the curve. In addition, this also helps to preserve our clients' capital in uncertain times**. During the quarter we have made selective adjustments to the fixed income portfolios to maintain credit quality and cash flow levels.

With corporate earnings and balance sheets improving slowly, there is likely to be further narrowing of corporate bond spreads over time. Our focus on uncovering value opportunities among corporate bonds by means of our internal research process means that our fixed income portfolios should also benefit from this trend.

Over the next few months we will be carefully monitoring economic developments and central bank policies to detect a time when the ultra-low interest rate environment appears likely to end and the bond market responds with rising yields and falling prices.

Income Trust Update

The high prices of many trust units have continued to moderate in the quarter reflecting declining oil prices (affecting the oil and gas trusts), weaker real estate fundamentals (affecting REITS) and the impact on the asset class of a number of disappointing performers. Over time we expect differentiation between the best managed trusts in the most stable businesses and the laggards which cannot live up to original expectations. In the latter part of 2002 we reduced our exposure to income trusts, particularly in the oil and gas and real estate sectors. As stated previously, we have conducted extensive internal research on the income trusts as an asset class, and have identified a small number of them across different businesses which meet our investment criteria. We will rely on these vehicles to supplement cash returns in portfolios requiring regular income and to diversify returns generally.