

# ECONOMIC AND CAPITAL MARKETS MONTHLY UPDATE

## THE ECONOMY

Manufacturing activity in the United States has slowed considerably impacted by the depressed housing market. New home sales continue to slide despite improving affordability, a reflection of tightening credit standards and fears of further price declines. Although the U.S. economy has slowed inflation remains a concern due to the high cost of food, energy and other commodities. In January, import prices registered the largest year over year on record on continued weakness of the U.S. dollar.

Slowing U.S. growth, the strong Canadian dollar and completion from emerging markets continue to put downward pressure on the Canadian economy. In the fourth quarter Canada recorded its first current account deficit in almost a decade with only energy products reporting higher foreign sales. Canada's housing market remains buoyant. However reduced affordability due to the pace of housing price appreciation over the past few years and a lack of pent-up-demand will slow house sales this year.

In the Canadian Federal Budget on February 26<sup>th</sup> fiscal stimulus was relatively modest as the government had already introduced tax cuts in its Economic Statement last October. The centerpiece of the Budget was the Tax-Free Savings Account (TFSA) which provides an additional choice for savings, adds flexibility and can be an effective complement to RRSP's.

## FIXED INCOME MARKETS

The Canadian bond market continued to perform strongly in February as faltering global stock markets, concerns of a U.S. recession and illiquid credit markets provided an excellent bid for high quality bond investments. On March 4, the Bank of Canada lowered its overnight rate 50 basis points to 3.5%, the largest reduction in over 6 years. In its commentary, the Bank was concerned with "the downside risks from a weakening U.S. economy" and stated "further monetary stimulus is likely to be required in the near term". In fact, 4<sup>th</sup> Quarter GDP growth for Canada, released on March 3, was only 0.8%, substantially lower than the Bank's forecast of 1.5%. In this environment, the yield curve steepened as 2 year yields fell 38 basis points to 2.78% in February while 30 year yields only fell 9 basis points to 4.09%. Corporate credit spreads widened as investors reacted to the global liquidity crunch.

### Canadian Economic Indicators

Annual % change	2006	2007	2008
Unless otherwise indicated		Forecast	Projected
G.D.P. (real)	2.5%	2.5%	2.5%
Exports	3.0	3.0	2.0
Consumer spending	3.5	3.0	2.5
Capital spending	8.0	7.0	6.0
Corporate Profits (S&P/TSX) (after tax)	17.0	9.0	7.0
Unemployment rate (%)	6.3	6.1	6.1
Inflation Rate Core	2.3	2.4	2.3
Wage increases	2.5	2.5	2.5

### Interest Rate Trends

	Feb. 2008	Dec. 2007	Dec. 2006
Canadian Bank Prime	5.75%	6.00%	6.00%
U.S. Bank Prime	6.00	7.25	8.25
30-Day Commercial Paper			
Canada	4.03	5.23	4.37
U.S.	3.13	4.78	5.23
5-Year Bonds			
Canada	3.14	3.87	3.99
U.S.	2.47	3.44	4.69
30-Year Bonds			
Canada	4.09	4.10	4.14
U.S.	4.40	4.45	4.81
Cdn./U.S. dollar	101.22¢	100.17¢	85.77¢

### Market Index Returns

	February	YTD	2007
S&P/TSX Composite Index	3.45%	-1.43%	9.83%
S&P 500 Composite	-5.41	-9.82	-10.55
MS EAFE (net)	-0.83	-8.71	-5.74
MS Japan	-1.56	-4.72	-18.72
MS Pacific (ex Japan)	-0.33	-9.16	11.69
MS Europe	-0.64	-9.73	-3.00
MS Emerging Markets	5.02	-6.75	18.52
DEX Universe Bond	1.34	1.97	3.68

All returns are in Canadian dollars and include income.

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## EQUITY MARKETS

### Canada

The Canadian equity market moved higher during February – a continuation of the rally begun in late January. For the month, the S&P/TSX Composite posted a 3.45% total return to bring the year-to-date return for the Index to -1.4%, a reasonably good result compared to where we sat in mid-January. The market was led higher during February by many of the same sectors that have been our leaders over the past year – Materials +9%, Energy +8.6% and Industrials +5%. Weakness continued to be focused within the Consumer and Financial sectors. Looking forward, we believe volatility will remain high as investors grapple with the prospects of slowing economic growth, on-going difficulties within global credit markets and efforts by the Federal Reserve to reflate the system.

### United States

US equity markets remained volatile in February, caused by investor concerns over slowing economic growth and a tight credit environment. The S&P 500 Index was range bound between 1316 and 1396 during the month, and closed near the low-end of the range for a total monthly return of -3.3%. While US economic growth is clearly slowing, there are a number of mitigating factors. Relatively better economic growth overseas combined with aggressive easing by the Federal Reserve, suggests that an economic recession, should one occur, would likely be relatively shallow and short-lived. Although market volatility is likely to remain at an elevated state over the near-term, we believe that the current market weakness provides an excellent opportunity to increase exposure to US equities.

### International

Most European and Asian markets stabilized in February following sharp declines in January. The Energy and Materials sectors continued to lead the market as commodities performed strongly on renewed investment by the market. In a more uncertain environment for profits, stocks with consistent earnings should perform better, particularly from a low valuation base.

**S&P/TSX COMPOSITE INDEX**



**STANDARD & POOR'S 500 INDEX**



**MS EAFE INDEX**

