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Capital Points

— A weekly look ahead at Canadian and U.S. financial markets

Did Canadians Learn Much From the Global Crisis?

Sure, Canada deleveraged on public and corporate balance sheets in the 1990s before just about anyone else did, such that serendipity played a role in the country being able to outperform the rest of the G7 over the past decade. But did that earlier experience, combined with the lessons of the current ongoing global crisis, impart greater wisdom onto Canadian businesses and households to stand them in good stead under current circumstances? Or did the out-performance of the Canadian economy over the past decade facilitate a certain insouciance that resulted in the creation of current imbalances that could expose the country to risks going forward?

Three sets of metrics merit a closer look in generally suggesting that the answer may well be in favour of the complacency angle. The first one speaks to how business inventories are being managed. The recession hit Canada not just through imported forces that rocked a perfect world, but also because some measures of domestic imbalances were utterly neglected to the point of exposing the country to instability. Going into the crisis, the inflation-adjusted outstanding stock of business inventories relative to sales was high at about 70% by 2008Q2 and well above its average of the period following the US recession earlier in the decade. That left Canada negatively exposed to the events of later that year and early 2009 because the hit to sales emanating from the shocks to US supply chains required even greater cuts to production and employment than would have been necessary had inventories been kept leaner before the crisis. This was a key reason why we were the first forecast shop to move to a Canadian recession call after speaking to an economy that went nowhere throughout the first half of 2008 as domestic imbalances would aggravate the external shocks. We didn't buy the story that Canada was perfect. By 2009Q2, the inventory to sales ratio had indeed risen further to 77.5% and both production and jobs had to be taken down to work off the inventory excess. So what has happened since?

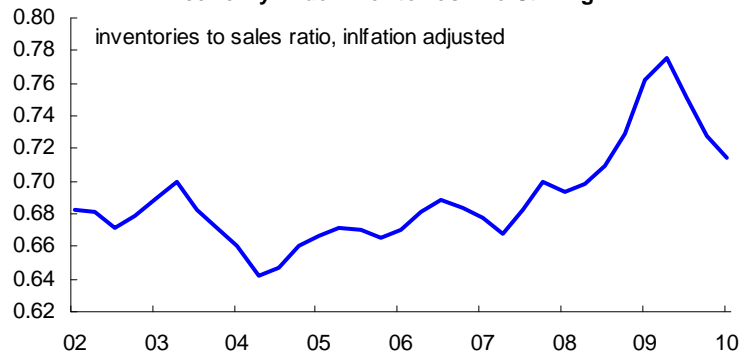
The economy-wide inventory position has indeed been brought lower, but not by much. More importantly, any perception that inventories are lean and the shelves are bare is simply false. At 71.4% as of 2010Q1 (we'll get Q2 figures with the GDP accounts next Tuesday at which point we'll update our analysis), it still stood a touch higher than it was in the summer of 2008 and above its long-run average. Instead of paring inventories further and holding off on the temptation to heap on the payrolls all over again while driving production gains, the necessary inventory adjustment process was slowed and inventories remain high. Thus, we expect inventories to remain fairly high in the Q2 data. The inventory to sales ratio may well continue to point to Canadian businesses being ill prepared for further shocks particularly if the US is indeed stumbling again.

The results, of course, vary according to sectors as shown in charts 2-5 on the next page. Auto dealer inventories are indeed lean, although probably more so across some brands and models than others. So are wholesale inventories. But the problem resides at manufacturers that have pulled down their inventory positions but not enough to classify them as lean, and retailers excluding auto dealers haven't really done much at all to curtail their inventory positions.

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Economy Wide Inventories Are Still High



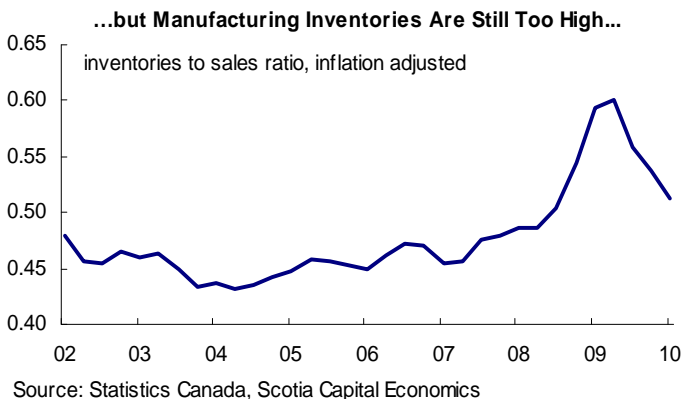
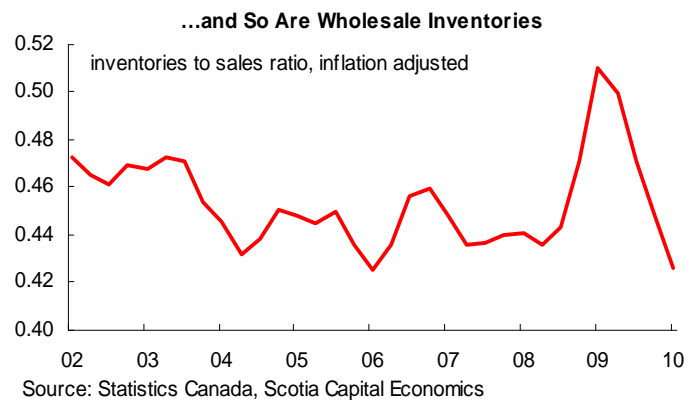
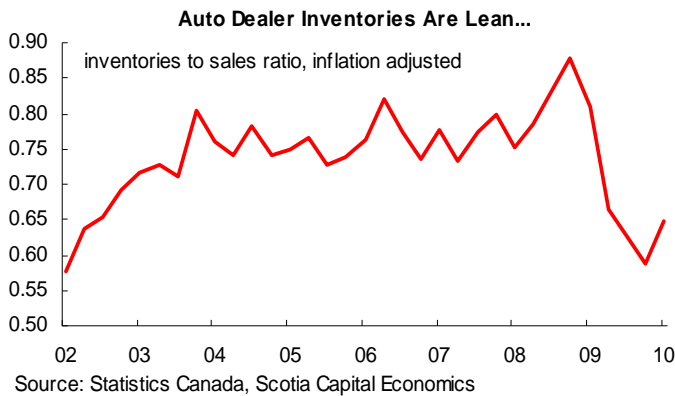
Source: Statistics Canada, Scotia Capital Economics



There are two related implications to this inventory picture. One is that if inventories are hardly lean, then it's unlikely that Canadian GDP growth will get much of a sustained boost from inventory investment in this cycle in contrast to some past recessions after which inventories had been aggressively pared. Second, what are the implications of domestic imbalances from the BoC's standpoint? This latter question we explore on page 9.

As for the other two sets of metrics, we explore them in separate articles this week. On page 6, we compare Canadian and US house prices to one another, and compare different measures of Canadian house prices themselves. To say Canadian housing has become dear is an understatement. Further, on pages 7-8, we provide several perspectives on the health of Canadian household finances and conclude that they are indeed stretched with debt-service payments at late-1980s and early-1990s levels as a share of incomes, and unprecedented heights for overall leverage. By combining the two measures, we're left with the observation that comparisons to past household cycles on sensitivities to the consumer cycle are to be done with great care in the context of historically stretched indicators of asset values and finances.

Overall, it is indeed possible that Canadian firms and households did not learn much of anything from many of the lessons imposed on firms and households elsewhere. The insulating factors remain very strong nonfinancial corporate balance sheets, a well-capitalized banking system, and a so far better-than-expected fiscal picture that remains the envy of much of the western world. Stressed corporate and public sector balance sheets were what sparked the problems of the 1990s, but perhaps the challenges on the household balance sheet are today's risk with inventory management hinting at susceptibility.





Next Week's Key Market Risks

A handful of central banks are scheduled to hold monetary policy meetings next week, including those in Brazil, Bulgaria, the E.U., Indonesia, Malaysia and Sweden. All are expected to remain on hold save the Swedish central bank, where the officials are predicted to hike the overnight rate by 25bps to 0.75%. While the ECB is expected to keep their ultra-low rates on hold, President Trichet's speech is likely to garner the most attention. In Canada, the limelight will be on June GDP numbers, which will round out the second quarter. South of the border, alongside the FOMC minutes from the August 10th meeting, a handful of the FOMC members are lined up to give speeches. The US economic calendar is heavy, populated with August nonfarm payrolls and ISMs, July personal income & expenditure and pending home sales as well as June house prices. Internationally, the euro-zone region is set to release updates on CPI, employment and retail sales.

CANADA

The June report on **real GDP** is due out next Tuesday. We predict headline growth will pick up to 0.3% m/m, from 0.2% in May. Strong gains in price-adjusted retail and manufacturing sales volumes will be only partly offset by declines in housing starts, wholesale trade volumes, aggregate hours worked as well as a wider real trade deficit. We expect growth of 2.6% q/q annualized for the second quarter as a whole, down from 3.2% in the previous quarter and below the BoC forecast of 3.0%.

We expect that headline **producer prices** advanced 0.2% m/m in July, and that the raw materials price index retreated 0.1%. After sharp declines in May and June, commodity prices rose in July. A modestly higher risk appetite and a significant drop in the US dollar lifted dollar-denominated commodity prices. A stronger Canadian dollar (relative to the greenback) reduced the cost of imports. Over the course of the month, the Thomson Reuters/Jefferies Commodity Research Bureau (CRB) Index was broadly stronger, up 6.1% m/m, the most since May 2009. The Canadian dollar gained 3.33% m/m against its US counterpart, the most since March.

Canadian bank earnings continue with Bank of Nova Scotia and Toronto Dominion.

The **Bank of Canada** will auction 30-year bonds at noon on Wednesday.

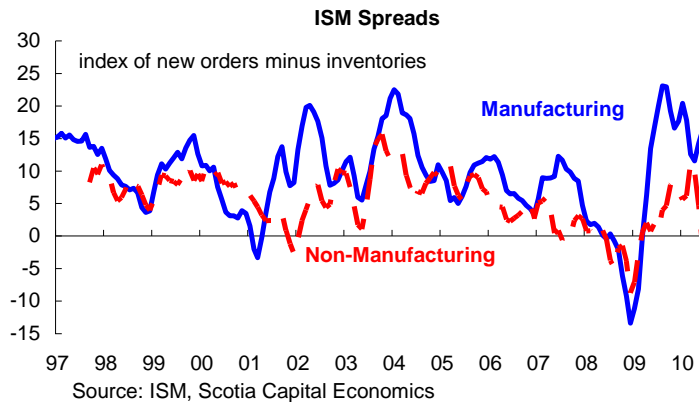
UNITED STATES

The **nonfarm payrolls** report for August is going to be the main event next week, as the market looks for further insight on the state of the economic outlook for America and the report is likely to spur further debate on the risk of a 'double dip' and the possible need for additional stimulus. The headline employment print is likely to remain distorted, as temporary Census hiring started to unwind in June, and will continue to do so until September. We estimate the top print to post a contraction of 90,000 in August, the third straight month of declining payrolls. The weekly report on the number of temporary census workers paid by week showed that related payrolls declined by 33,000 in the first half of the month. However, the Census guidance and weekly numbers have not lined up well with the Census non-farm payrolls report for a number of reasons, including ones we flagged in a prior nonfarm *Flash Points* preview. Private-sector payrolls are forecast to ink a modest gain of about 20,000, slightly below the average monthly gain over the past three months. Furthermore, we expect that state and local government hiring was reduced by another 30,000, on the dwindling state of finances. Regional manufacturing surveys have been mixed. Construction employment could remain a drag following the expiry of the first-time homebuyers' tax credit. While the Conference Board's Employment Trends Index (ETI) — which aggregates eight leading, labour-market indicators — increased again in July for the twelfth successive month, individual leading indicators have been mixed. The number of layoffs continues to moderate and the latest one-month employment diffusion index points to a better August print, but the latest figures on temporary hiring and the average workweek have been less encouraging, suggesting uncertainty and a still-cautious sentiment on behalf of companies. Following another batch of disappointing macro data, renewed fears of a 'double dip' are weighing on the economy, a development likely to be reflected with a lag on the labour market.

Personal income is likely to have picked up pace in July. Corresponding non-farm payroll data support this view. Average weekly earnings have come in flat for two straight months now. Aggregate weekly hours worked improved 0.4% m/m in July, erasing the prior month's decline of 0.3%. Hours are now back to their March 2009 levels. This estimates a 0.28% monthly increase in the proxy for labour income. We expect growth in **household spending** to accelerate to 0.4% m/m, as headline retail sales — which account for 40% of consumer spending, but capture goods only — broke the two-month string of declines. However, strength was concentrated in the motor vehicle & parts sales and gasoline categories. Remaining components registered an uninspiring performance, consistent with the prevailing cautious sentiment and ongoing deleveraging of household balance sheets.

ISM Manufacturing is expected to have ticked lower in August, but should remain in the expansionary territory. Three of the four regional manufacturing indices released to date — Kansas, Philadelphia and Richmond — deteriorated in July, with producers turning more pessimistic about future activity.

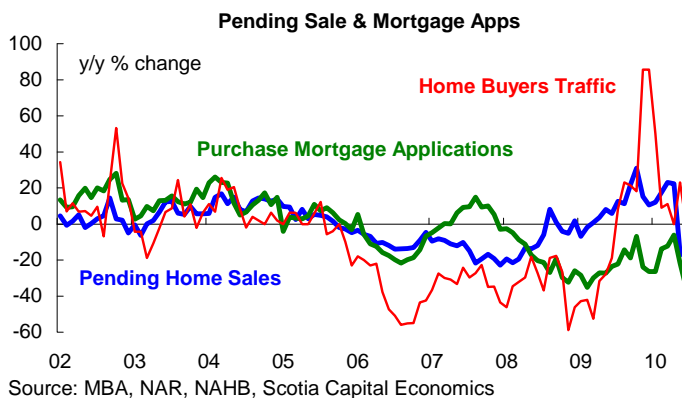
The **ISM's non-manufacturing index** is expected to have reversed gains registered in July. We are looking for a decline to 53.2 from 54.3 in July, consistent with an overall slower growth picture for the service sector, which accounts for 80% of the US economy. The orders to inventories spread has been in negative territory — and widening — for the second straight month, hinting at deteriorating demand-supply dynamics. The housing sector is a key factor for the survey. The expiry of the first-time homebuyers' tax credit is underscoring structural issues in the housing market, where very high inventories of unsold homes and lackluster job growth are keeping prices depressed and potential buyers sidelined. The results of the Richmond Fed services survey were broadly lower. Revenues at retail and non-retail services firms continued to moderate for the second straight month in August.



Factory orders are anticipated to have advanced by 0.4% m/m in July. While data on the durable goods orders has already been released — showing a gain of 0.3%, on higher aircraft orders — this report will provide more insight on the developments in the non-durable segment. Given a 4.4% m/m rise in crude oil prices last month, the refinery component is likely to lift the nominal print for non-durable goods.

Pending home sales are forecast to have pulled back 2.3% m/m in July — their third straight month of retreat — as demand slackens following the expiry of the first-time homebuyers' tax credit. Lower traffic of prospective buyers and depressed levels of purchase mortgage applications, despite record-low interest rates, point to further weakness ahead.

In this environment of unusually high supply of listed and off-the-market properties and increasingly cautious demand, house prices are expected to remain flat to lower through 2011. We expect that the **S&P/Case-Shiller 20-City Composite Index** continued to post decelerating growth for the second straight month in June, climbing 0.2% /m as compared to 0.5% registered in May. The latest survey of cumulative five-year home price expectations from Robert Shiller's firm MacroMarkets LLC shows a broad range of forecasts from a low of -20.7% to a high of 35%, with a median of 9.2%, a standard deviation of 9.4%, and gains concentrated in the later years. These results show the level of uncertainty governing the outlook. Our five year cumulative estimate is roughly flat (-2%), with the view that shadow housing inventories will pose additional downward pressure on house prices and keep them flat for some time thereafter.



The Fed will publish **minutes from its latest FOMC meeting**, which took place on August 10. Aside from reinforcing previous statements that rate hikes will be put on hold for an 'extended period' of time, the report will provide insight into voter sentiment and the general economic outlook. Notes are likely to contain more in-depth discussion behind the reinvestment option announced in August and talk of further easing should the outlook worsen appreciably.

There is a flurry of Fed speeches next week. **St. Louis Fed President Bullard** — a voting member — will kick off the line up on Monday, with a speech at a conference on regulatory reform. Fed **Governor Duke** and the **Chicago, Boston and Cleveland Fed Presidents** — all voters — will give remarks at a Washington summit examining the impact of foreclosed and vacant properties on neighbourhoods. **Dallas Fed President Fisher** — an alternate voter — will talk about the current economic climate at the Greater Houston Partnership Thought Leader Series Luncheon on Wednesday. **Atlanta Fed President Lockhart** — a non-voting member — will finish off the week, with a speech on the economy at East Tennessee State University on Friday.



According to the Tentative Outright Treasury Operation Schedule Table, the **Fed** will complete more purchases of Treasury coupons, using the principal payments from agency debt and agency MBS. The purchase of TIPS is lined up for 11amET on Monday and that of notes and bonds for the same time on Wednesday.

The **reopening of 10-year TIPS** is scheduled for 1pmET on Thursday.

INTERNATIONAL

A handful of **central banks** are scheduled to hold monetary policy meetings next week, including those in **Brazil, Bulgaria, the E.U., Indonesia, Malaysia** and **Sweden**. All the central banks are expected to remain on the sidelines, with exception of Sweden's Sveriges Riksbank. Consensus is looking for a 25bp hike to 0.75%. In July, the country's policymakers raised the repo rate by 25bps to 0.5%, as part of the rate normalization process, but the officials noted that, "at the same time, economic growth abroad is expected to be lower, which means that the repo rate in the longer term will not need to be raised as much as was previously assumed." Nevertheless, the **European Central Bank (ECB)** is likely to draw the most attention next week. Although the ECB is not expected to start tightening monetary policy until the second half of next year, the markets await Governor Trichet's comments on the economic outlook and signs that the ECB may be considering additional measures should the economy deteriorate. The second quarter was kind to the euro-zone region — in part supported by robust export receipts — but it also highlighted increasing divergence in growth rates among member countries. This raised concerns that the recovery in the region is all too dependent upon the performance of the two economic powerhouses, Germany and France, as a number of the region's economies are dealing with the bite of the austerity measures. Even at that, German growth will be challenged by soft world growth.

Against the backdrop of mixed news and increased talk that the global 'V' may be running out of steam, eyes are now turned firmly back on the economic data front. We get a steady flow of releases all through next week. The **euro zone** will release July updates on individual-country and pan-regional statistics, including CPI, unemployment rate and retail sales. Second-quarter GDP will undergo a second round of revisions; the market is not expecting any major changes.

Out of Asia, **China** and **India** will provide an update on the state of the manufacturing and services sectors via August PMIs. For **Japan**, it will be another busy week, flooded with top-tier macro reports, including July industrial production, retail trade, vehicle production, housing starts, construction orders and vehicles sales. **South Korea** will circulate the latest prints on trade, industrial production, consumer prices and the services sector.

In Oceania, it will be a busy week for **Australia**, where statistical agencies will publish the country's second-quarter GDP and update new home sales, private sector credit, retail sales, building approvals and trade data with July numbers.



Canadian Macro Comment

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Canadian House Prices are Rich

Canadian house prices are indeed loftily valued, and we thought we'd though some of the measures that are popularly requested. Prices lie at record highs by a variety of measures and using different metrics. Chart 1 shows average resale house prices in Canada versus the US in local currency terms. Converting to a common currency via the spot rate of exchange would yield not much difference, while converting using purchasing power parity rates of exchange would come nowhere close to bringing Canada back into line with the US. It is a myth that price increases were concentrated in a few select markets even if that is truer in very recent times, since prices were up at the provincial level over the full decade by between about 65% in PEI at the low end, to over 150% in Manitoba and Saskatchewan at the upper end. Ontario was up over 80%, and Quebec climbed by about 120% , just slightly behind BC.

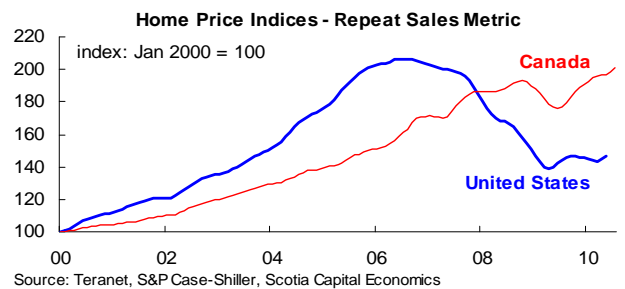
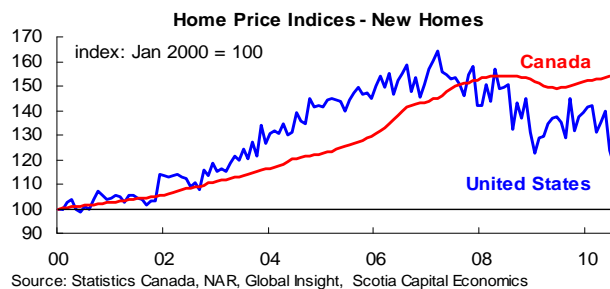
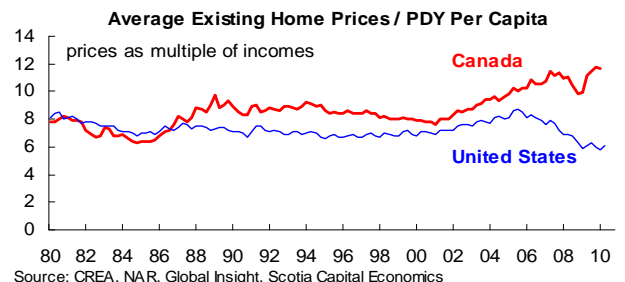
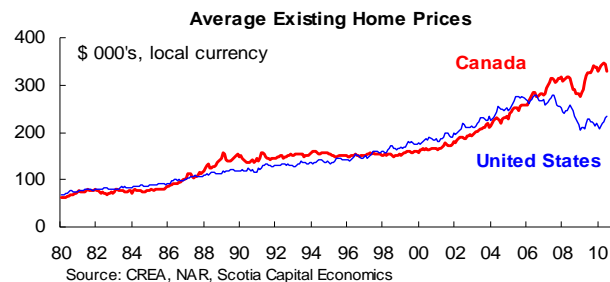
Chart 2 expresses the same nationwide price measures in relation to personal disposable income per capita. Here too, Canada sits well above the US.

Chart 3 switches to repeat-sales measures of house prices by comparing the Canadian Teranet measure against the US S&P Case-Shiller metric. Note that US house prices doubled over the 2000-2006 period, compared to the same performance in Canada over the past full decade.

Chart 4 compares new home prices in the two countries to an indexed starting point at the beginning of the decade (since Canada's measure is an index, versus the US measure that is a price). Here too, Canada is currently tied with its record and well above the US whether converted at spot or PPP rates of currency exchange.

The home ownership rate for Canada stood at a record high of 68.3% in 2006, the last year for which it is available from the Census that is done every five years. We would surmise that it presently stands around 70% after the housing strengths that followed, and is thus further into all-time record territory. This poses the risk of entering a much softer environment for housing demand in ensuing years compared to the long bull run Canada has experienced.

We continue to believe that house prices face further correction risk. This is already evident in the average resale figures available from the Canadian Real Estate Association. It is not yet evident in the Teranet gauge because the latter measure lags behind resales data by about four months in our view. Teranet is reported on a three month moving average basis, versus the spot reports produced by CREA. Further, Teranet is based on land registry figures and there may be between a one- and two-month lag in reporting sales transactions to public land registry offices. Indeed, when we correlate monthly percentage changes in the Teranet and CREA measures, the best correlation arises from comparing current Teranet readings to CREA from four months prior. That said, the correlation is modest, and thus leaves open the possibility that CREA has begun to show price declines since May because it is impacted by compositional shifts that do not affect Teranet since the latter is based on repeat sales data.





Canadian Macro Comment

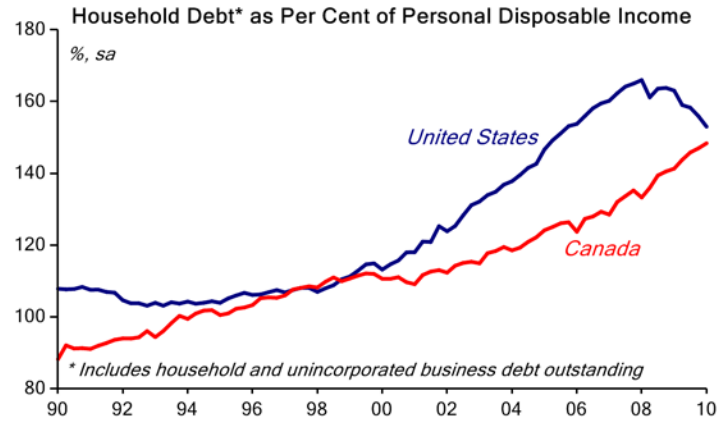
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Canadian Household Finances — Better than the US, but Progressively More Leveraged

We offer a mixed take on Canadian household finances that points to insulating factors behind clear stress points. The analysis is complementary to our focus upon Canadian imbalances and elevated house prices.

Chart 1 shows that the gap is closing on debt-to-income ratios as the US deleverages, while Canada leverages higher. We have used the US Federal Reserve’s flow of funds accounts and compared that to Statistics Canada’s balance sheet figures for persons and unincorporated businesses. To make the figures definitionally comparable, we’ve combined households and unincorporated businesses in the US accounts, since Canada does not separate them. This makes eminent sense to us, since households are ultimately on the hook for the debts of unincorporated businesses lacking limited liability protection, and also lay claim to the residual value of the assets associated with such businesses net of their debts. At recent relative rates of growth, Canadians will be more heavily indebted than Americans by this measure.



Source: U.S. Federal Reserve, Statistics Canada, Scotia Economics.

Chart 2 shows what has happened to mortgage principal payments as a share of income over time. Canadians are currently spending about 12% of after-tax incomes on repaying borrowed principal. This has floated around a record high in recent years, and does not include principal payments on other lending products nor interest payment components to mortgages and all other consumer lending products. The figure may have flattened in recent years because of the arrival of long amortization mortgages beyond the standard 25-year cookie cutter products of the past. Such products began to arrive in 2007 and allow principal to be spread out over a longer period of time, thus flattening this ratio but stretching the payment period. Note that the chart also shows the split between principal payments on insured mortgages with less than 25% down now (20% in the past), and uninsured mortgages with more than 25% down. Almost all of the growth in the total principal payment ratio relative to incomes has come through the insured component over the past two decades, and therefore brought into the housing market buyers who wouldn’t have been able to afford higher downpayment requirements in the past.

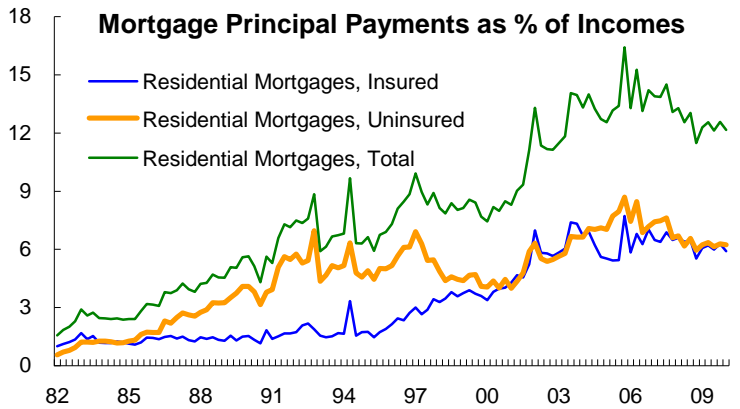
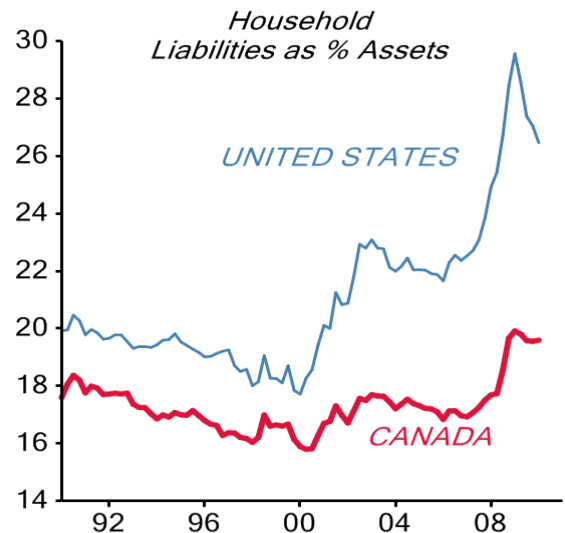


Chart 3 shows an alternate definition that compares debt as a fraction of assets. Canadians use about 20 cents in debt per dollar of assets in aggregate, versus the US that used 30 cents at the peak and has since deleveraged to about 26 cents. Canada, by this measure, remains considerably less leveraged than the US but somewhat more leveraged compared to its own past.



Source: Global Insight

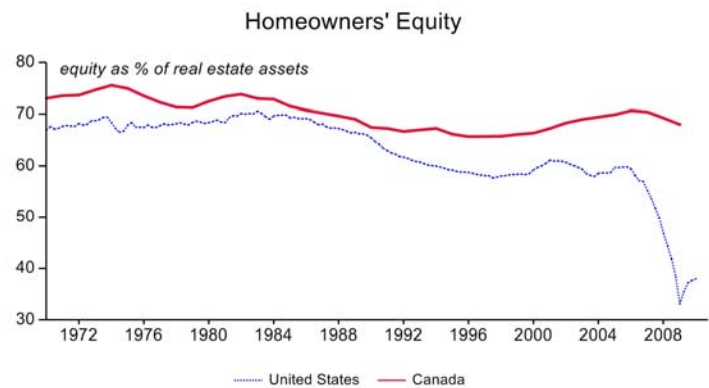
Additionally, Canadians continue to sit atop a far stronger home equity position than Americans (chart 4, next page).

Canadian Macro Comment (continued)Gorica Djerić (416) 862-3080
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What's more is that cash balances on Canadian household balance sheets are high, and rising further. In fact, retail risk aversion has cash balances climbing more aggressively of late. High cash balances can serve as a credit quality buffer. What further supports this picture is that Canadian job growth over the full period of the past year has outpaced most other countries.

Finally, it bears mentioning that the mortgage markets in the two countries are on very different microeconomic foundations:

- Canada is also far less leveraged than the US by other measures. Banks are better capitalized in Canada, and dealer gearing ratios didn't push as high as in the US. More importantly, the mortgage securities were not placed in off-balance sheet SIV and CDO conduits and then leveraged to a much greater degree as they were in the US. So economy-wide leverage creation is far less significant in Canada, and thus downside risks to asset prices would not get leveraged across the economy to the same extent.
- Canada offers an explicit guarantee to the GSEs that have back-stopped the lower downpayment mortgages. Such mortgages represent risks to the sovereign, not the banking sector, and are priced in terms of premiums paid by borrowers.
- Outside of Alberta and Saskatchewan, strategic defaults are not an option in Canada.
- The products are very different in that teaser mortgages like option ARMs and their reset problems are not the same issue in Canada as they were in the US.



Canadian Monetary Policy CommentGorica Djerić (416) 862-3080
gorica_djeric@scotiacapital.comDerek Holt (416) 863-7707
derek_holt@scotiacapital.com**How Will the Bank of Canada React to Recent US and Canadian Data?**

We still believe the BoC will hike 25bps on September 8th. Clearly a key issue for the Bank of Canada is how it will react to faltering US data. It has two choices:

One is obvious in that it can hit the panic button, pass on another rate hike, and tilt the bias toward global downsides.

The other, however, is to see through it by saying that it is natural to go through a period of consolidation across several indicators after the temporary surge in growth late last year, and that demand was temporarily brought forward into earlier in the year via stimulus efforts that had, for instance, US housing peak in early Spring. If the BoC adopts this line of reasoning, it would argue that the US picture remains one of modest growth on the other side of a potential renewed dip, acknowledge that the near-term prospects have been weaker than expected, but flag that it remains faithful to its year ahead views. In that case, the BoC would remain committed to rate hikes at a cautious pace especially since European growth has surprised higher as a partial offset to US worries. We remain concerned about the 2011-12 growth prospects for major developed economies that are likely to remain very muted, but a return to truly emergency conditions requiring still near-zero rates in the Canadian context is unlikely versus the more compelling logic of gently lifting rates to a still low 2-ish zone on the overnight that also connotes greater flexibility to the BoC in addressing future risks than operating at the lower bound.

Further, the BoC could easily deliver a hike but take it back on the bias by sounding more concerned about near-term growth and thus signal that it has more aggressively shifted into data-watching mode until the next statement. Hiking 25bps would cost nothing to growth, in no small part because it can be totally offset by households in the suite of new lending products available today by extending amortization or substituting even further away from principal repayment through interest-only lines. More importantly, longer-term rates have fallen and CAD has depreciated such that markets have eased monetary conditions in Canada. But a small hike would send a signal of confidence that the BoC isn't totally reversing course in its core forecasts to the point to which it is worried enough about growth in Canada to pull the plug on exits. If we were at RBA-style rates then it would be a different matter, but we're still near zero. A hike would also say the BoC is on the ball insofar as countering the risks of mounting levels of household debt is concerned. That would fit the tone of recent signals from the BoC that it is increasingly entertaining the use of monetary policy to address such imbalances.

As a final point, we think one of the major reasons why markets have backed so far away from pricing in a September 8th hike is that markets have totally misread the latest stream of Canadian indicators. Yes nominal retail sales were weak, but real sales were up a solid 0.9% m/m. Jobs fell in July, but largely due to a mythical loss of 65,000 jobs in the education sector that created nary a cry of protest across the well-organized land of labour. Also, CPI fell in seasonally unadjusted terms, but rose slightly in seasonally adjusted terms and is performing generally in accordance with BoC guidelines for what to expect by way of the indirect influence of the HST on core inflation through refunded tax credits.

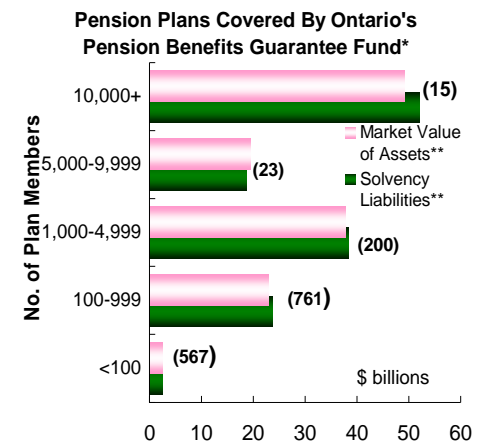
Fiscal Policy**Addressing the Pension Benefits Guarantee Fund — Ontario's Proposals**

Ontario's latest round of proposed pension reforms includes substantial changes to its Pension Benefits Guarantee Fund (PBGF). Unique to Canada, Ontario's PBGF provides some protection to Ontario members and beneficiaries of privately sponsored, single-employer defined benefit (DB) pension plans in the event of the plan sponsor's insolvency. Generally the PBGF guarantees a maximum benefit "top-up" to \$1,000 per month for members meeting certain age and service in Ontario requirements. For most DB plans registered in Ontario and largely outside the public sector, participation in the PBGF is mandatory. The Fund is intended to be self-financing, with each plan member paying annual premiums consisting of a per-member fee as low as \$1 and, for underfunded plans, a risk-based fee calculated as a rising percentage of the funding deficiency up to 1.5%. Presently there is no minimum assessment per pension plan. There is a \$100 per member fee maximum and a \$4 million maximum plan assessment, enabling some plans with sizeable solvency deficits to benefit from PBGF coverage at reduced rates.

An actuarial study for the Ontario government indicated that as of March 31, 2009, the PBGF had assets of \$146 million on a cash basis and a \$47 million deficit on an accrual basis¹. Since the last premium rate setting in 1993 to March 2009, the PBGF's revenues have totaled \$724 million, while claims (net of recovery) and expenses were \$832 million. In fiscal 2009-10 (FY10), Ontario provided a \$500 million grant to

stabilize the PBGF and address the funding pressures from recent plan wind-ups. Yet even with the assumption of external funding to cover anticipated 2010 claims, the actuarial study concluded that overall assessments on plans would have to rise by approximately 450% to cover future claims and expenses on a longer-term sustainable basis, maintaining the current guarantee of maximum benefit top-ups to \$1,000 per month. To increase the maximum top-up under the PBGF from \$1,000 to \$2,500 per month as the Expert Commission on Pensions recommended, the study calculated that a 650% increase in plan assessments would be required.

Thus Ontario faces the challenges inherent in the PBGF as it grapples with an FY11 budget deficit that it currently forecasts at \$19.7 billion. Though the final FY10 deficit was a better-than-expected \$19.3 billion, the outstanding risk of slower U.S. growth would both hamper Ontario's fiscal repair efforts and heighten the probability of plan sponsor insolvencies. Typically, the latter is closely related to the unemployment rate and inversely related to real GDP growth. The actuarial study highlights a number of the risks in the PBGF. The Fund covers 1,580 plans with a large percentage remaining open to new members. The concentration of significant deficits among a few large plans underlines the low-frequency, high-severity claims that have hindered the PBGF. Of the 164 claims that the PBGF has paid since its inception, two claims represent 63% of the net cost. By sector, manufacturing sources the largest number of plans presently covered, and their aggregate deficit stands in contrast to the aggregate surplus for the plans across the majority of other sectors. Ontario's response to the PBGF's documented difficulties is a four-pronged proposal. With the first prong, the \$500 million grant to PBGF, already accomplished, this leaves adopting stronger funding rules for DB plans, extending from three to five years the exclusion period from PBGF coverage for benefit improvements or new plans and adopting more consistent and higher plan assessments. The proposed new premium structure, if it had been adopted in 2009, would have raised total assessments by about \$30 million. It includes a minimum \$250 assessment for each plan, eliminates the overall assessment cap for underfunded plans, raises the base fee per plan member from \$1 to \$5 and the maximum fee per plan member in underfunded plans from \$100 to \$300. Given the significantly higher plan assessments deemed necessary for the PBGF's longer-term stability, the Province is leaving unchanged the maximum top-up under the PBGF at \$1000 per month.

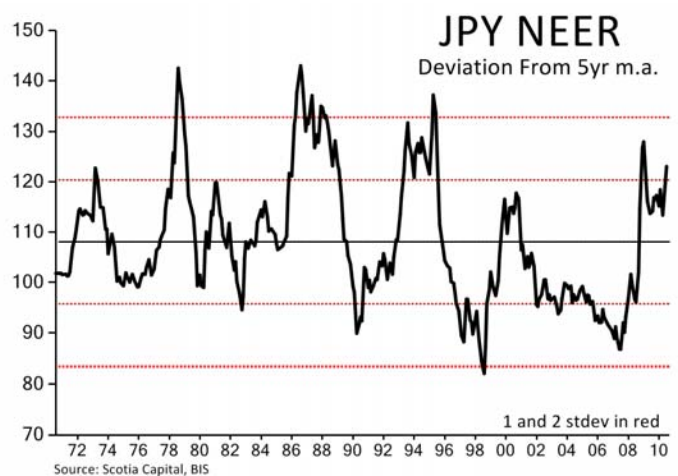
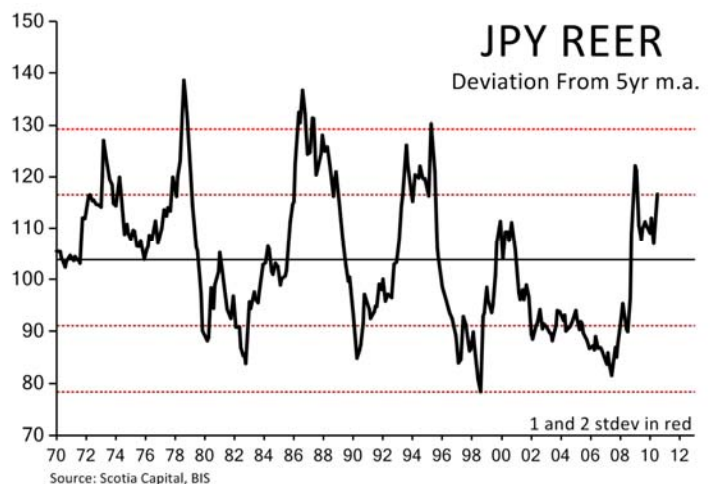


Foreign Exchange MarketsCamilla Sutton (416) 866-5470
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Much has been made over the past two weeks of the potential for Japanese policymakers to enact some measure of policy response to the rapid pace of JPY appreciation. Our forecasts for USDJPY stand in sharp contrast to the 4-month downtrend in the pair. There are a variety of reasons why we hold a bearish outlook on JPY including very low bond yields, a deflationary price environment, weak longer term growth prospects and an unsupportive fiscal picture given the government's extremely high debt burden. However, with the rapid deterioration evident in the higher frequency US economic data, yield spreads between the US and Japan have ground lower and undermined USDJPY. Speculation abounds as to if and just how far Japanese policy makers are willing to go in order counter JPY strength, particularly as the rhetoric continues to intensify, with price action in JPY now being described as "clearly one-sided" by Finance Minister Noda.

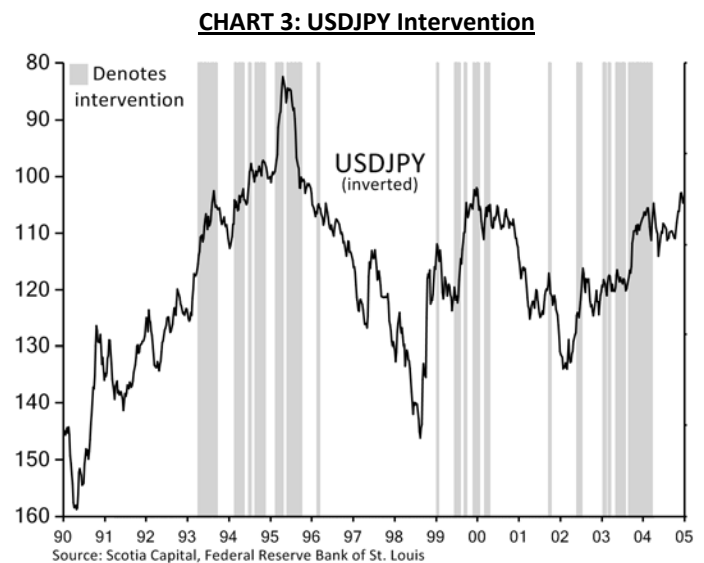
We currently do not see a strong case for direct physical intervention in the currency market. To begin with, G20 communiqués have suggested greater exchange rate flexibility in "some" emerging market economies (read: China), which would be hard to sell if a country with as large a trade presence as Japan intervened in order to weaken off its currency. Additionally, while JPY is currently trading around 15 year highs against the USD and in nominal effective terms against its trading partners, the valuation does not seem "obscenely" out of line considering recent history. JPY has appreciated significantly from a nominal effective point of view since the early 70's, but has for the most part range traded since the mid nineties. If we consider 5-years to constitute the "medium term" and the evolution of the 5-year moving average in the yen's nominal effective level as an approximation of medium term equilibrium, we see that in this way the yen has been rather stable. Looking at the yen's current trading level relative to its medium term "equilibrium" average (see chart 1), it becomes obvious that despite the recent bout of strength, the yen only remains a touch over one standard deviation from its 5-year moving average. This is certainly not enough to be considered extremely out of line relative to average five year nominal effective exchange rate developments.

The picture becomes even clearer when looking at the same metric from a real effective exchange rate basis, an important measure of Japan's trade competitiveness (chart 2). The real effective value of the yen has actually trended lower since the mid-nineties, reflecting the combination of a flat trend in the nominal effective rate and Japan's absolutely anemic long term rate of inflation (y/y inflation has actually averaged -0.5% since the mid nineties). Looking at the near term deviations of the real effective JPY level from the medium term trend, JPY is only about one standard deviation above our simple measure of medium term equilibrium. Taken together, these trends suggest that the Japanese yen could actually face appreciatory pressure over a five-year horizon, looking past factors that we expect to weigh on the currency over the course of the next two years such as world-beating low yields and a deflationary environment that calls for further monetary expansion and/or fiscal action.

CHART 1: JPY Nominal Effective Exchange Rate**CHART 2: JPY Real Effective Exchange Rate**

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Japanese authorities last intervened to weaken the yen against the USD in March of 2004 as the yen had been gaining against the USD since early 2002. Chart 3 shows that USDJPY interventions executed in order to resist JPY strength (buying USD against JPY) in the early to mid nineties were generally unsuccessful in reversing this trend. USDJPY buying intervention was also utilized in the late 1990's/early 2000's, and once again and more heavily in the period of early 2003 to April 2004. Looking at relative currency performance against the USD we can see just how futile intervention was. During the February 1993 to late April 1995 peak in JPY strength against the USD, JPY gained around 50% versus the USD, while the next best performers, CHF and NZD, gained a good degree less at 33% and 32% respectively. Over the March 2002 through March 2004 period, interventions seem on the surface to have been relatively more successful as JPY gained around 28% against the USD, a fair degree less than currencies like NZD, AUD and EUR (which gained 58%, 49% and 43% respectively). However, this is still a relatively large gain, particularly considering the fact that Japanese authorities sold nearly four times as much JPY over this period than during the 1992 to 1995 timeframe in order resist appreciatory pressure. This shows the difficulties that countries face in successfully trying to unilaterally temper currency strength in the face of large current account surpluses, open capital accounts and well developed financial markets.



If it seems somewhat futile to successfully weaken one's currency, particularly when acting unilaterally, why would the authorities wish to engage in such a fruitless struggle that has no sustained medium term impact? Resisting an appreciatory trend in JPY is obviously going to ease the strain on the economically important export sector, however it is the deflation issue that is just as crucial from the point of view of monetary and fiscal policy. A cross-correlation analysis of the monthly changes in Japan's nominal effective exchange rate against monthly changes in CPI show that monthly appreciations in the yen are correlated with monthly deflation at the 1 through 3 month ahead periods, suggesting that an appreciating currency has at least a somewhat persistent and negative impact on domestic price developments. This may not be an issue for a country facing more normal inflation dynamics, but tolerating nominal JPY appreciation during a period of entrenched deflation complicates the issue, even if a currency is not overvalued on a real basis. Ultimately the deflation dynamic serves to increase the likelihood of policy action on the part of Japanese authorities to address JPY strength.

Having established that active physical intervention is likely to be the least favoured choice of Japanese policymakers, as it is somewhat futile and can be costly as the Swiss case has shown us, policymakers seem to be much more likely to counter JPY strength via an expansion in monetary and/or fiscal policies. There is growing political pressure on the Bank of Japan to undertake expansionary monetary initiatives, particularly in light of continuing deflationary price developments. On the monetary front, the Bank of Japan could expand the money supply or ease of credit conditions via some form of quantitative easing in order to offset JPY strength and provide an upside impetus for inflation. This would also send a message to the market that policymakers are serious in their displeasure over the impact of JPY strength on output and inflation, instead of simply playing lip service to it as they have been doing. Fiscally, lawmakers could opt to undertake additional stimulatory measures, which ultimately would result in a worsening in the country's debt burden, in contrast with the longer term fiscal goal set out by Prime Minister Kan to reduce bond issuance and balance the budget by 2020. Though the European fiscal crisis seems to have settled down in the wake of budget cuts, fiscal risk still holds prominence in the market's mind and a reversal of course in Japanese intentions of fiscal consolidation could lead speculators to take aim at the yen in expectation of a sovereign credit rating downgrade. Next week could bring very relevant JPY developments as it is expected that Prime Minister Kan will hold discussions with Bank of Japan Governor Shirakawa following Mr. Shirakawa's return from this week's Jackson Hole symposium. We have already seen pre-weekend rumours of meetings of this nature lead to very little in the way actual action after the fact. Should there not be any material currency-relevant monetary or fiscal policy action, the yen will likely not react in the way policymakers would prefer.

International Markets

Record Yen Strength To Remain Driver Of Japanese Economic Rebalancing

Export volumes out of Japan have yet to show the effects of record-high JPY. The Bank of Japan's real trade balance report displayed a significant pickup in export volumes for July. The index reached 123.8 last month; a pickup from the 120.8 and 110.3 three-month averages for the first and second quarters, respectively. The data is derived from export receipts and export/import price indexes, and is not seasonally adjusted. Barring seasonal effects, the trend in Japanese foreign shipments remains in stark contrast with yen strength. Looking more closely at recent JPY fluctuations, we note that during April-June the currency strengthened vis-à-vis the Euro (6.6% in average quarterly values), while weakening against the US dollar (-1.4%). Japanese exports to both China and the US have therefore benefited from a higher average USDJPY, while foreign sales to Europe were hurt by a lower EURJPY. International Monetary Fund direction of trade statistics for 2009 indicate Japanese shipments to China and the US accounting for 18.8% and 16.4%, respectively; while exports to Europe represent 9.2% of total foreign sales. This explains in part the lagged response from exports to the rise in the value of the yen, while also opening a window into what to expect in coming months. So far in the third quarter, average currency trends have USDJPY and EURJPY lowering in unison. A further exchange rate impact on the country's exports thus remains only a matter of time.

GDP growth in Japan registered a meager 0.1% q/q gain in the second quarter which was in part pay-back from the 1.1% previous three-month gain. A fall in the contribution of net exports was instrumental to the slowdown. However, as explained above, export volumes only slowed slightly, while imports increased significantly. As a logical result of strengthening currency trends that prevail so far, import volumes continued to trend higher in July, rising to an estimated 104.7, from the 99.3 average index level for the first half of 2010. A pickup in the demand for foreign goods speaks of an enhanced outlook for consumer spending which remains supported by confidence indicators, growing labour market participation and rising bank credit flows to individuals. The number of jobs created during July increased more than the size of the labour force — which continued to accelerate — resulting in a small reduction in Japanese unemployment to 5.2%. Real household spending fell (0.4% m/m) in July, following June's strong pickup (2.9%). In our view this indicates that the still-favourable external outlook continues to trickle down to the domestic market. Private consumption represents 57% of Japanese GDP, while exports stand at 15.4%. This figure stands in contrast with Germany and China where the export/output share reaches 41% and 37%, respectively.

U.S. Monetary Policy CommentGorica Djerić (416) 862-3080
gorica_djeric@scotiacapital.comDerek Holt (416) 863-7707
derek_holt@scotiacapital.com***Bernanke Deflects Focus on the Federal Reserve***

In a well crafted speech at the Federal Reserve's annual symposium at Jackson Hole, Wyoming, Federal Reserve Chairman Ben Bernanke noted that the Fed will "do all that it can" to ensure a continued recovery and that the Fed "retains a number of tools and strategies for providing additional stimulus." He flagged downsides to near-term growth as a concern, but remained hopeful that policy supports will add to trend growth. That said, he tossed the ball back into the court of other policymakers and the private sector with the frank admission "Central bankers alone cannot solve the world's economic problems."

The most useful part of the speech came when he addressed the pros and cons of further easing by explicitly rejecting two of four possible tools, and he expanded on the litmus test that would have to apply to require invoking the other two. On balance, this is a Fed that remains some time away from additional measures being taken as it watches the data particularly in terms of inflation expectations, if it ever arrives there.

On the option to purchase additional longer-term securities, Bernanke sounds less than convinced. The benefit of perhaps serving to ease financial conditions was weighed against the uncertainty associated with what impact further purchases would have in a non-crisis market environment. Purchases work best in a period of great stress to the economy and markets "when markets are less liquid and term premiums are unusually high." The other uncertainty is the market's perception with respect to additional purchases serving to complicate longer-run exit strategies and the impact that could have on inflation expectations.

Bernanke dismisses lowering the interest on excess reserves as representing greater risks to the liquidity of short-term markets than are worth it in terms of a tiny 10-15bps reduction in the fed funds rate.

Altering communication in FOMC statements particularly with respect to rate expectations was addressed as an option that is subject to continual review.

Finally, Bernanke entirely dismissed suggestions that the Fed move to create higher inflation expectations in the US economy and noted "I see no support for this option on the FOMC."

So what's the trigger point for further action that Bernanke states the Fed is prepared to take if needed? Bernanke noted that the Committee has not reached agreement on triggers for further action, but strongly signaled that the Fed will do all it can. That said, he set a high bar. This is a Fed in data-watching mode insofar as price readings are concerned in particular, and one that is acutely sensitive to measures of inflation expectations. The Fed would need much more convincing evidence of deflationary pressures to persist versus its base case assumption of a temporary period of weak readings. Perhaps the most important line in the whole speech is that "the risk of either an undesirable rise in inflation or of significant further disinflation seems low." It would take a lot to budge the Fed from that assessment at this juncture, so the focus on what to do regarding additional measures to support growth is indeed back upon fiscal and regulatory policy combined with private sector action.

Insofar as Bernanke's specific comments on growth are concerned, he indicated that despite disappointing prints seen recently, "the preconditions for a pickup in growth in 2011 appear to remain in place." These preconditions include an accommodative monetary policy, steadily improving bank and household balance sheets and some easing in credit conditions. He also noted that he expects business investment in equipment and software, sales and business confidence to continue to improve, which should trigger further payroll gains. That said, companies remain hesitant to invest in new facilities. He noted that state and local finances — and thus state and local employment — remain 'under pressure,' but tax revenues are showing signs of stabilization. As far as speaking directly to the Fed's two main objectives of price stability and full employment, Bernanke noted that "the prospect of a high unemployment rate for a long period of time remains a central concern of policy," as it threatens sustainability of the recovery through income and confidence channels, and that consumer prices have moved "slightly below" levels seen as favourable for long-term economic health. That said, price expectations remain well anchored, and the risks of either deflation or inflation subdued.

In that context, the Fed is likely on hold for a very long time yet, and in our view, the long-run growth outlook remains confronted by the substantial headwinds forthcoming via fiscal drag throughout 2011-13 and ongoing housing sector imbalances.

* The full speech is available at: <http://www.federalreserve.gov/newsevents/speech/bernanke20100827a.htm>

Estimates for the week of August 30 – September 3

 Canada

Date	ET	Indicator	Period	BNS	Consensus	Latest
08/30	(08:30)	IPPI (m/m)	Jul	0.2	0.4	-0.9
08/30	(08:30)	Raw Materials Price Index (m/m)	Jul	-0.1	0.5	-0.3
08/30	(08:30)	Current Account (C\$ bn a.r.)	Q2	--	-10.5	-7.8
08/31	(08:30)	Real GDP (m/m)	Jun	0.3	0.2	0.1
08/31	(08:30)	Real GDP (q/q a.r.)	Q2	2.6	2.5	6.1

 United States

Date	ET	Indicator	Period	BNS	Consensus	Latest
08/30	(08:30)	Personal Income (m/m)	Jul	0.3	0.3	0.0
08/30	(08:30)	Personal Consumption (m/m)	Jul	0.4	0.3	0.0
08/30	(08:30)	PCE Deflator (y/y)	Jul	--	1.4	1.4
08/30	(08:30)	PCE ex. Food & Energy (y/y)	Jul	--	1.4	1.4
08/31	(07:45)	ICSC Chain Store Sales - Weekly (w/w)	Aug. 28	--	--	--
08/31	(09:00)	S&P/Case-Shiller Home Price Index (m/m)	Jun	0.2	0.2	0.5
08/31	(09:45)	Chicago PMI (index)	Aug	--	57.5	62.3
08/31	(10:00)	Consumer Confidence (index)	Aug	--	51.0	50.4
08/31	(14:00)	FOMC Minutes – Meeting of August 10				
09/01	(07:00)	MBA Mortgage Applications (w/w)	Aug. 27	--	--	4.9
09/01	(08:15)	ADP Employment Report	Aug	10.0	20.0	42.0
09/01	(10:00)	ISM Manufacturing Index	Aug	52.0	53.0	55.5
09/01	(10:00)	Construction Spending (m/m)	Jul	--	-0.5	0.1
09/01	(17:00)	Total Vehicle Sales (mn a.r.)	Aug	11.8	11.6	11.6
09/01	(17:00)	Domestic Vehicle Sales (mn a.r.)	Aug	8.9	8.8	9.1
09/02	(08:30)	Initial Jobless Claims (000s)	Aug. 28	465	478	473
09/02	(08:30)	Continuing Claims (mn)	Aug. 21	4.43	4.44	4.46
09/02	(08:30)	Unit Labor Costs (q/q a.r.)	Q2-P	--	1.4	0.2
09/02	(08:30)	Productivity (q/q a.r.)	Q2-P	--	-2.0	-0.9
09/02	(10:00)	Factory Orders (m/m)	Jul	0.4	0.5	-1.2
09/02	(10:00)	Pending Home Sales (m/m)	Jul	-2.3	-1.5	-2.6
09/02	(10:30)	ICSC Chain Store Sales - Monthly (y/y)	Aug	--	--	2.8
09/03	(08:30)	Employment Report (000s m/m)	Aug	-90	-105	-131
09/03	(08:30)	Unemployment Rate (%)	Aug	9.6	9.6	9.5
09/03	(08:30)	Average Hourly Earnings (m/m)	Aug	--	0.1	0.2
09/03	(08:30)	Average Weekly Hours	Aug	--	34.2	34.2
09/03	(10:00)	ISM Non-Manufacturing Composite	Aug	53.2	53.5	54.3
09/03		Fed's Lockhart Gives Speech on Economy in Tennessee (10:00)				

Estimates for the week of August 30 – September 3

Europe

<u>Date</u>	<u>ET</u>	<u>Indicator</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
08/30	(05:00)	EC Economic Confidence	Aug	--	101.6	101.3
08/30	(05:00)	EC Business Climate Indicator	Aug	--	0.7	0.7
08/30	(05:00)	EC Industrial Confidence	Aug	--	-4.0	-4.0
08/30	(19:01)	UK GfK Consumer Confidence (index)	Aug	--	-24.0	-22.0
08/30		Speech by RBA Assistant Governor Guy Debelle in Sydney (19:00)				
08/31	(03:55)	GE Unemployment (000s)	Jul	--	-20.0	-20.0
08/31	(03:55)	GE Unemployment Rate (%)	Jun	--	7.6	7.6
08/31	(04:30)	UK M4 Money Supply (m/m)	Jul	--	--	0.4
08/31	(04:30)	UK Net Consumer Credit (GBP bn)	Jul	--	0.0	-0.1
08/31	(05:00)	IT CPI (y/y)	Jul	--	1.6	1.7
08/31	(05:00)	EC Unemployment Rate (%)	Jul	--	10.0	10.0
09/01	(03:45)	IT Manufacturing PMI (index)	Aug	--	53.5	54.4
09/01	(04:30)	UK Manufacturing PMI (index)	Aug	--	57.0	57.3
09/02	(05:00)	EC PPI (m/m)	Jul	--	0.3	0.3
09/02	(05:00)	EC GDP (q/q)	Q2-A	--	1.0	1.00
09/02	(07:45)	ECB Announces Interest Rates (%)		1.00	1.00	1.00
09/03	(03:45)	IT Services PMI (index)	Aug	--	50.0	49.6
09/03	(04:30)	UK Official Reserves (GBP bn)	Aug	--	--	-24.0
09/03	(04:30)	UK Services PMI (index)	Aug	--	52.9	53.1
09/03	(05:00)	EC Retail Trade (m/m)	Jul	--	--	0.0

Asia/Oceania

<u>Date</u>	<u>ET</u>	<u>Indicator</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
08/30	(19:50)	JN Industrial Production (m/m)	Jun	--	-0.2	-1.1
08/30	(19:50)	JN Large Retailers' Sales (y/y)	Jul	--	-1.3	-3.1
08/30	(19:50)	JN Retail Trade (m/m)	Jul	--	0.5	0.4
08/30	(19:50)	JN Retail Trade (y/y)	Jul	--	3.5	3.3
08/30	(21:30)	AU Building Approvals (m/m)	Jun	--	-0.7	-3.3
08/30	(21:30)	AU Retail Sales (m/m)	Jun	--	0.4	0.2
08/30	(21:30)	AU Current Account (AUD bn)	Q2	--	-6.5	-16.6
08/31	(n/a)	JN Foreign Reserves (US\$ bn)	Jun	--	--	1064
08/31	(n/a)	KOR Imports (y/y)	Aug	--	31.2	28.1
08/31	(n/a)	KOR Trade Balance (US\$ mn)	Aug	--	3133.0	5674.0
08/31	(n/a)	KOR Exports (y/y)	Aug	--	34.2	28.3
08/31	(01:00)	JN Housing Starts (y/y)	Jul	--	2.0	0.6
08/31	(03:30)	TH Imports (y/y)	Jul	--	--	38.3
08/31	(03:30)	TH Trade Balance (US\$ mn)	Jul	--	--	2536.0
08/31	(03:30)	TH Exports (y/y)	Jul	--	--	47.1
08/31	(21:00)	CH Manufacturing PMI (index)	Aug	--	51.2	51.2
08/31	(21:30)	AU GDP (q/q)	Q2	--	0.9	0.5
09/01	(n/a)	IN Imports (%)	Jul	--	--	23.0
09/01	(n/a)	IN Exports (%)	Jul	--	--	30.4
09/01	(n/a)	IND Exports (y/y)	Jul	--	28.3	31.0
09/01	(n/a)	IND Imports (y/y)	Jul	--	35.0	47.6
09/01	(n/a)	IND Trade Balance (US\$ mn)	Jul	--	815.0	580.3
09/01	(01:00)	JN Vehicle Sales (y/y)	Aug	--	--	15.0
09/01	(19:50)	JN Monetary Base (y/y)	Aug	--	--	6.1
09/01	(21:30)	AU Trade Balance (AUD bn)	Aug	--	3.1	3.5
09/02	(06:01)	MAL Exports (y/y)	Jul	--	11.6	17.2
09/02	(06:01)	MAL Imports (y/y)	Jul	--	18.7	30.1
09/02	(06:01)	MAL Trade Balance (MYR bn)	Jul	--	6.1	6.0



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