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Capital Points

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

A US\$6.5 Trillion Headache

In judging pressures on the Treasury curve and corporate finances into 2011-12, a key consideration involves gauging the competition for global capital. Massive global corporate bond rollover during 2011-12 will intensify the competition for capital at the same time as a surge in global sovereign issuance and a gradual recovery in private lending occurs. Large maturing corporate debts may also be a reason why companies are hoarding abnormally high cash balances and thereby resisting pressure to hire, invest, lend, and hand cash back to shareholders versus a preference to guard against refinancing risks and/or retire some issues.

We use Bloomberg data on the amount of corporate bonds that mature over 2011-12 in a search confined to maturing issues of over US\$100 million for companies across the globe. Thus, our estimates will understate the full volume of maturing debt but we had to draw the line somewhere on a list that already has almost 2,000 entries. Our full tally for this sample is US\$6.5 trillion in maturing global corporate bond issues. Charts 1 & 2 (next page) show that the countries with the highest volumes of maturing corporate bonds are the US, Germany, UK, and Italy but the first key point entails

acknowledging whether these volumes are out of line with global market weights. They are not terribly so for the US or UK. But German corporations have about 12% of the global total for maturing bonds which is about four times Germany's share of world equity market capitalization. Italy's share of maturing issues is almost 6% which far surpasses its just over 1% share of world equity capitalization. By comparison, the Canadian share (US\$177 billion or 2.7% of the total) is lower than Canada's 3.9% weighting in world equity market capitalization and thus suggests that rollover risk is less material in aggregate than elsewhere.

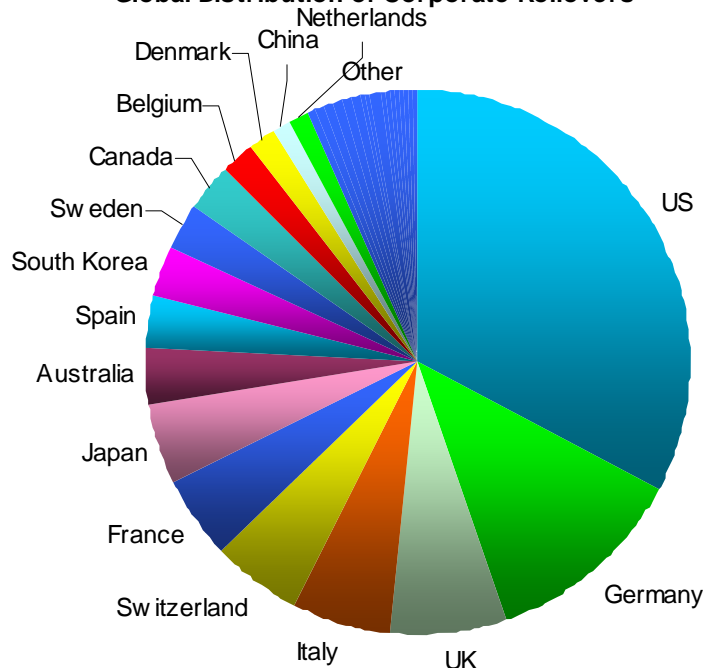
The story changes with chart 3 (page 3) that shows the volume of debt that has to be rolled over relative to the market capitalization of the affected companies, and summed by country. We have highlighted the PIIGS economies (Portugal, Ireland, Italy, Greece and Spain) in dark blue to emphasize that they face among the heaviest volumes of rollover pressure. But it's not just the peripheral European economies that lead the pack as even Germany faces among the greatest degrees of corporate debt rollover among countries. Thus, Europe faces the greatest corporate bond rollover risk as well as the greatest sovereign rollover risk into 2011-12 (see "Can the EU Absorb Problems in Peripheral Economies?", *Capital Points*, November 26, 2010).

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Chart 1

Global Distribution of Corporate Rollovers



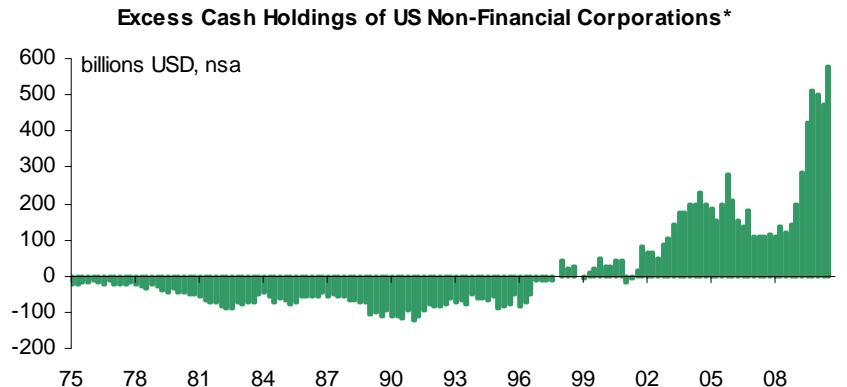
Source: Bloomberg, Scotia Capital Economics



By comparison, however, the United States and Canada are relatively well situated by the measure shown in chart 3. Insofar as US companies themselves are concerned, the US\$2.1 trillion in maturing corporate bonds over 2011-12 compares to our estimate of almost US\$600 billion in excess cash holdings beyond what the long-run average ratio of cash balances to total assets would prescribe (chart 4). Record-high cash balances could well be in place to help cushion the impact of refinancings.

This analysis extends the points we made in our pieces last week, (see “a Turning Point for Treasury Market Appetite?” and “Is Obama’s Stimulus Proposal a Game Changer?”, *Capital Points*, December 10, 2010). Stiffer competition for capital will pose a materially different challenge to both the US Treasury and the Fed’s QE efforts over the next two years. While next year is likely to extend the subdued global economic recovery, a flood of global issuance could well keep fixed income markets under the pressure of rising yields with adverse implications for growth. So could growing deficit worries that began when the White House first signaled its willingness to compromise on tax cut extensions that we do not believe will be allowed to expire again come the 2012 Presidential election.

Chart 4



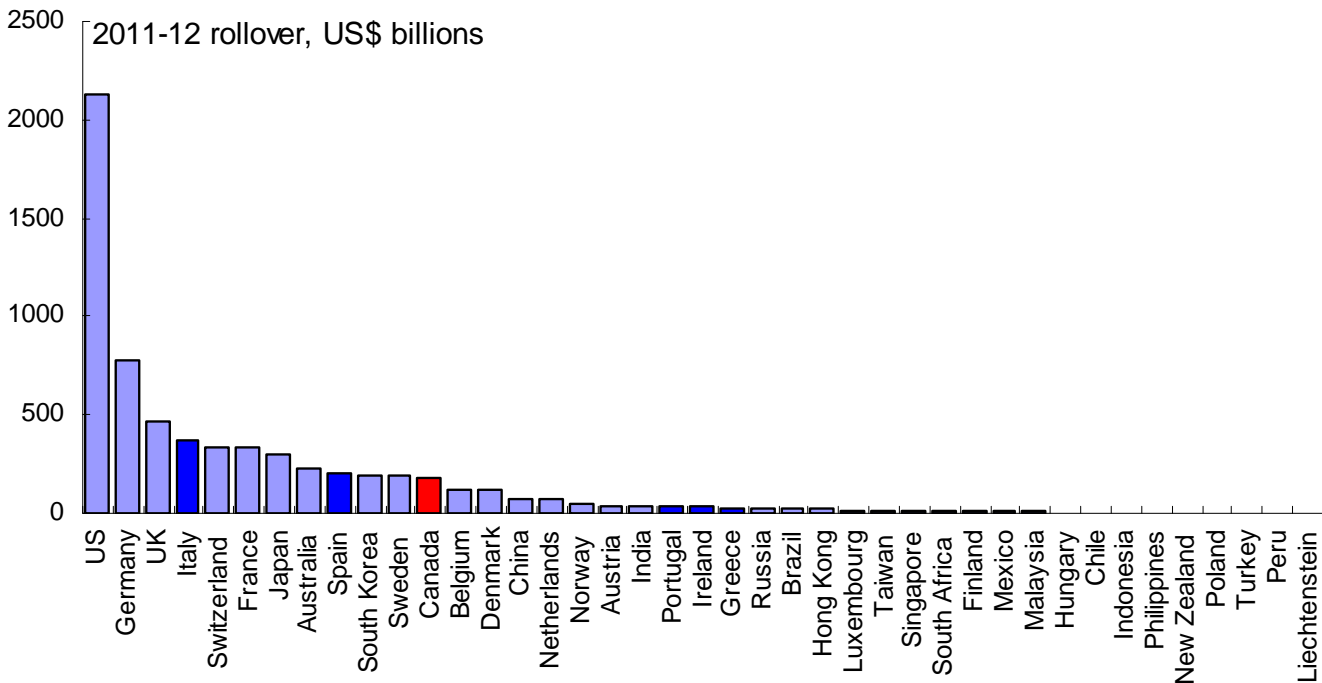
* US non-financial corporations, cash and cash-equivalent holdings, spread between cash-to-asset ratio and the long-term average, expressed in US\$ terms.

Source: FRB, Scotia Capital Economics.

Thus, while banks may be more willing to put balance sheets to work in buying Treasuries into the new year, the longer-term trend points toward a more pressured environment for yields. This has yet to show up by way of impairing growth prospects for the US and global economies but may begin to do so in 2011Q1.

Chart 2

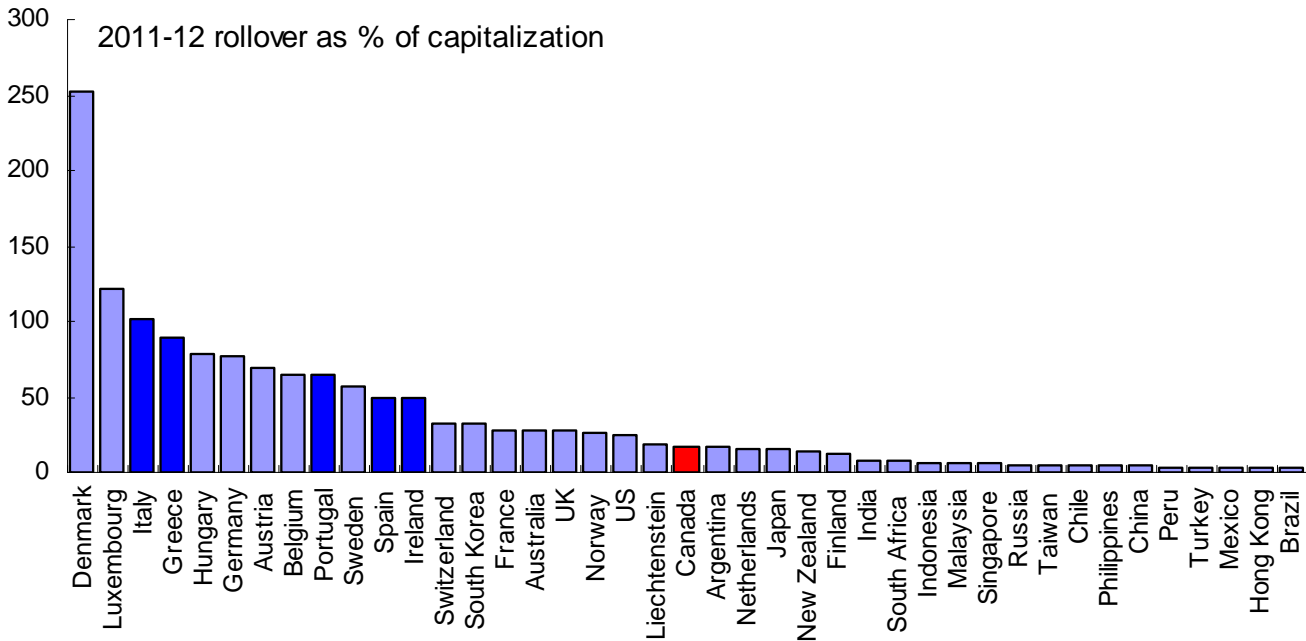
Corporate Bond Rollovers in USD



Source: Bloomberg, Scotia Capital Economics

Chart 3

Corporate Bond Rollovers Relative to Capitalization



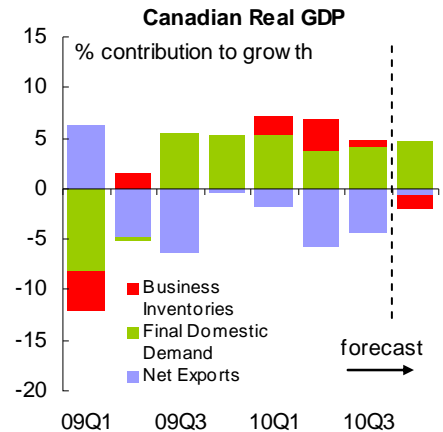
Source: Bloomberg, Scotia Capital Economics

Next Week's Key Market Risks

The key release schedule can be found on pages 14-15. While — aside from the Bank of Japan — no top-tier central banks will hold rate meetings, data risk will be high in Canada and the United States. In the lead-up to the October GDP release on Thursday, Canada will release the latest reports on retail sales and wholesale trade. US statistical agencies publish data on household income and spending, durable goods orders and the housing market, all back-loaded to the second half of the week. Internationally, the economic docket will be light, focusing on European sovereign auctions, BoE and RBA minutes and updates on European consumer spending, employment and prices.

CANADA

So far we have four pieces of data to help us approximate October GDP, due out next Thursday. We know that higher hours worked, a narrower trade deficit and stronger manufacturing sales will contribute positively to the economy, while lower housing starts weigh on the headline. Next week, we get two more reports: **wholesale trade** (Monday) and **retail sales** (Tuesday). We think that headline prints will post gains of 0.5% and 0.4% m/m, respectively. The boost from higher gasoline prices will be partly offset by new vehicle sales, estimated to have edged down 0.3% in October. Higher vehicle prices — the transportation component of CPI rose 1.3% m/m in October — suggest that sales volumes may have been hit harder. Should our forecasts materialize, **October GDP** is expected to advance 0.3% m/m, reversing the prior month's contraction of 0.1% m/m that poses a soft base effect. Upside risk may lie in the broad cross-sections of the services, utilities and resource sectors — and the retail and wholesale trade data that have yet to be released — which are largely unobservable, but likely performing better than the manufacturing and housing sectors. For the quarter as a whole — assuming flat November and December prints to focus on what we know thus far — the fourth quarter would track annualized growth of 0.8% q/q, the



Source: Statistics Canada, Scotia Capital Economics.

weakest since the third quarter of 2009. Domestic demand (see chart #1) — modest growth in household spending and accelerating business investment in machinery & equipment in particular — are expected to be the key drivers of growth not only in the final quarter of 2010, but also through next year.

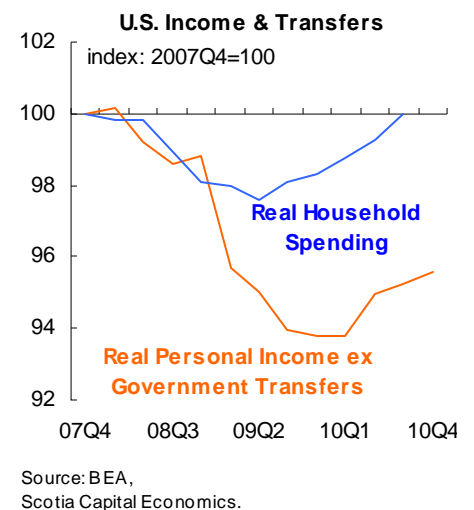
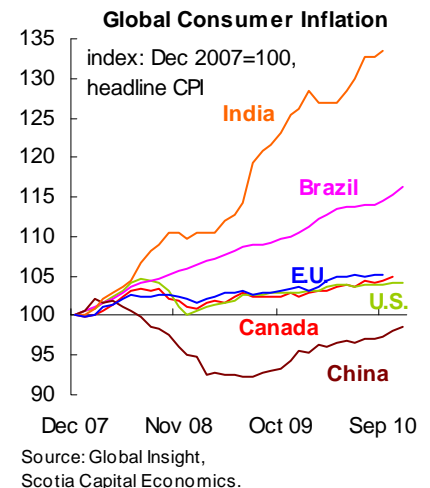
The headline **CPI** (Tuesday) figure for the month of October popped to 2.4% y/y, but a single inflation report — distorted by three components — is not likely to sway the Bank of Canada off course. The higher cost of transportation led the way (1.3% m/m, weight of 19.9%), followed by apparel (1.2% m/m, weight of 5.4%) and shelter (0.6% m/m, weight of 26.6%). Other components were only mildly higher, registering advances in the range of 0.1-0.2%. Our view was echoed by BoC Governor Carney in his latest speech on the Canadian economy, where he highlighted that the current global economic environment, will likely warrant ‘living with low [interest rates] for long[er].’ We expect that the headline **CPI** (Tuesday) will advance at a more moderate clip of 0.2% m/m in November, partly on a strong base effect, and that the core index will climb 0.1%. Gasoline and agricultural prices moved up in November, but at a more modest pace than in the prior month. The upward trend in commodity prices — the cost of food in particular — has been stoking inflation in a number of countries, and particularly in the latter half of the year. Canada has not been left unscathed, with its food component of the consumer basket up 1.3% since June, nearly twice the long-term average. That said, underlying pressures remain muted in the OECD economies, for the most part well below the central bank targets, and not expected to reach these for still some time (see chart #2).

UNITED STATES

The results of the third round of revisions for the **third-quarter GDP** will be published on Wednesday. We are forecasting an upward revision of 0.3 percentage points to 2.8% q/q annualized, on revisions to business investment and household spending, partly offset by a wider trade deficit. Views of nearly 50 economists polled by Bloomberg range widely from 2.5% to 3.3%. Should the upper end of that spread materialize, US GDP could easily turn to be next week’s marquee release.

Our call is for **personal income** (Thursday) to post a modest gain of 0.3% m/m in November, led by higher labour income, as corresponding non-farm payroll data suggest that wage & salary disbursements rose by about 0.2%. Outside of wages, limited data are available, particularly on aggregate monthly dividend and interest payouts, but we do know that while a number of the major equity indices retreated modestly for the month as a whole, companies paid out more in dividends (on a per share basis) than in the prior month. Government unemployment benefits (see chart #3) are also expected to have declined in November, as jobless claims — across categories (initial, continuing, extended, emergency) — moved lower. We expect growth of 0.5% m/m in nominal **personal consumption expenditure**, as headline retail sales — which account for 40% of consumer spending — advanced for the fifth straight month in November, up 0.8% m/m. Volume gains are likely to provide the most support, led by stronger demand for goods. While real household spending is back to its pre-recession levels, earnings excluding government stimulus remain depressed. So where are the funds coming from? Americans are using their savings to finance their spending needs. The personal savings rate has been trending lower, retreating from 6.3% in June to 5.7% in October.

Durable goods orders (Thursday) are expected to have contracted modestly in November, with our forecast looking for a decline of 0.7% m/m, and a gain of 1.2% at the core level (excluding transportation), partly supported by a strong negative base effect from the prior month. The top print is likely to be misleading, distorted by the sizeable and volatile transportation segment. Industry data suggest that the demand for both commercial aircraft and vehicles was lower in November, with Boeing booking only 17 new orders as compared to 108 in October (non-seasonally adjusted). That said, stronger defense procurement and higher commodity prices may provide some offset. According to the September ISM manufacturing index, growth in orders moderated in domestic and export markets, but still continued to advance at a reasonable clip.





And the heavy flow of housing data continues for another week. We are forecasting a gain in both **new** and **existing home sales** of 5.0% to 297,150 annualized units and 6.0% m/m to 4.70 million annualized units, respectively, in part supported by a strong negative base effect. Leading indicators — including pending home sales, purchase mortgage applications, traffic of prospective buyers — reaffirm this view. That said, both series remain depressed by historical standards, and buying activity is unlikely to improve substantially until hiring activity picks up and Americans have a stronger sense of job security. The bigger question marks concerns regarding the lagged effect of the 63bps increase in the 30-year mortgage rate since early October. It currently sits at 4.84%, its highest since early May.

Initial jobless claims (Thursday) have been retreating for 10 of the past 15 weeks, last week included. The less volatile 4-week moving average has been trending lower since mid-August, and currently sits at 422.8k, its lowest level since early August 2008. Moving below the 400k line would be consistent with a pick-up in hiring activity. President Obama's negotiated US tax package — approved by the Congress on Friday — includes a 13-month extension of unemployment benefits for the long-term unemployed, programs which expired on November 30th. In terms of its implications for the December payroll report, initial jobless claims averaged 17.5k lower in the first half of December — consistent with the reference period for nonfarm payrolls — which points to a mild upside bias. Looking ahead, we think that the week-to-week volatility will remain a major feature, but that the more stable four-week moving average will, on balance, extend the downward trend.

INTERNATIONAL

The only top-tier bank to hold a monetary policy meeting next week will be the **Bank of Japan** (Tuesday). It is widely expected that officials will keep the key lending rate steady at virtually zero and hold off on easing policy further through unconventional means. A strong yen — currently at a fifteen-year high — and the end of a number of government stimulus programs are putting pressure on Japan's economy, with 11 of 18 economists on Bloomberg expecting GDP to shrink in the fourth quarter for the first time since late 2009. The latest economic releases reveal that the mood of Japanese businesses and households is weakening. In response, the BoJ implemented a US\$60 billion asset buying program back in October. And, just days ago, the country's Prime Minister announced a 5 percentage point cut in the corporate tax rate effective next April, as "a first step" towards boosting economic recovery, hinting at the possibility of more measures to come.

The **Bank of England** (Wednesday) and the **Reserve Bank of Australia** (Monday) will publish minutes from their respective December 9 and December 6 meetings. For the former, the overall tone is expected to be little changed from the most recent minutes. While views differed across members — in what is likely to have been once again a 7-1-1 vote to hold the overnight rate and keep the bond purchase program unchanged — the minutes are expected to show that further QE is still off the BoE's agenda. In Oceania, only a month after a surprise (and controversial) rate hike, the RBA decided to stay on the sidelines in early December, with its Governor no longer hinting at any imminent rate hikes, but still maintaining a hawkish bias. Concerns over the uncertain global economic outlook and sovereign debt issues in Europe will likely be key sources of concern listed in next week's minutes, as will the expectation that mining investment, job growth and overseas demand — from China in particular — will provide the most economic support in 2011.

It will be a relatively light week on the data front, with the brunt of the releases coming from Europe. We look forward to updates on **household spending** (France, Italy), **employment** (France, Italy) and **producer prices** (Germany, Spain). A number of countries — including Japan, the Philippines, Spain and Thailand — will publish the latest **trade** figures.

Emerging Markets

The following article was first published on December 16, 2010.

Belize Update: Idiosyncratic Risks Continue

Fair economic performance is overshadowed by unusual idiosyncratic risks in Belize. If Belize is able to resolve these issues over the next year, we could see bond yields compress further.

Beka Lamb, the classic novel about life in the Caribbean, describes the struggle for modernity in Belize City, a struggle often thwarted by old ways and shaped by foreign influence. How things were “Befo’ time,” as Beka’s Grandmother likes to put it, is a constant theme throughout the book. We wonder if the current government feels the same way, as they continue to toil against a bad situation, which, in their view, they inherited when they took office.

Dominating the credit analysis behind Belize bonds are not issues like fiscal performance or tourism flows, both of which are doing fine, but rather two related idiosyncratic risks characterized by myriad international lawsuits and the possibility, however unlikely, of large costs to the government.

Idiosyncratic risks

First, the problems with BTL/Telemedia continue. As we explained in our note earlier this year, the government nationalized the country’s largest telecommunications company in order to obtain relief from various concessions made to the owners by the previous administration. Those previous owners, in turn, are suing the government in both local and international forums in a disagreement over the appropriate amount of compensation. The latest development is that the government is attempting to quickly auction a portion of the company to the public. We can only guess that the purpose of the auction is to find a quick solution to an issue that has been plaguing the government for a couple of years. Presumably, once ownership is transferred away from the government, it would become much more difficult for a court to order the government to return the company to its original owners; that subsequently weakens the bargaining position of those owners in any negotiations over compensation. For obvious reasons, those owners are suing to stop the auction. In a related story, the government will refuse to pay a loan contracted by the previous owners of BTL because that loan was used entirely to pay dividends; the government alleges that directors of the company were not allowed to authorize such a loan.

A second, but perhaps connected problem is the loan portfolio at Belize Bank, with 31% of loans adversely classified as of June 30th. Belize Bank is the largest bank in the country, with 679mn BZ\$ of loans outstanding (\$339mn USD). With total capital of 150mn Bz, the bank probably still has a positive net value, although perhaps only barely so. We note that the owners of Belize Bank are believed to be the same group that is currently pursuing litigation against the government with regards to Telemedia, and there are some worries locally that Belize Bank has made bad loans to related parties. Recently, new bank management was brought in from Trinidad; judging by the complaints lodged against them in the local press, these managers have started to pursue bank debtors more aggressively.

Belize Bank is the second of Belize’s locally owned banks to have problems. Heritage Bank, the smallest of Belize’s five banks, has had problems for quite some time, but with a loan portfolio of only 113mn BZ, it poses a much smaller risk to the local financial system. Belize also has three foreign owned banks whose loan portfolios are performing.

Compounding these problems is the lack of good information about developments in the country. A country with a population of only 300,000 would tend to have limited press coverage anyway, and the fact that the local press is highly politicized doesn’t help. Last week, citizens were worried about news that Bank of America had closed the foreign exchange account of Belize’s Central Bank. What actually happened did not affect Central Bank reserve accounts but rather was related to cash couriers services used for one of Belize’s free trade zones and processed through the Central Bank. Our understanding is that this action has nothing to do with Belize in particular, but is rather a reflection of the increased compliance and anti-money laundering burdens that such accounts pose for US banks. (See, for example, “Banks exit from embassy business,” Wall Street Journal, November 20, 2010). Nevertheless, lacking an official explanation, some people may have assumed the worst, since Belizeans place significant importance on a stable exchange rate.

Emerging Markets (continued)Joe Kogan (212) 225-6541
joe_kogan@scotiacapital.com***Solid economic indicators***

The above discussion reflects how large idiosyncratic factors could potentially overwhelm what would otherwise be reasonable economic performance. In the first half of 2010, the Belizean economy overall grew at 2.4% relative to the same period in the previous year. Notable sources of growth were the implementation of the 2010 Census, the 9% increase in cruise ship passengers, and a 6% increase in hotel room revenue. On the negative side, manufacturing output fell, caused by a considerable decrease in the production of citrus concentrates, and compensated in part by a large increase in sugar cane production.

Stay-over tourism arrivals increased by 3% in the first nine months of 2010. That compares poorly with the Caribbean median of 8% growth for the 15 countries that have reported data for this period to the CTO. Nevertheless, it fares better when we consider that Belize tourism also fell less than other Caribbean countries in the previous year, and is in line with the slow but steady growth rates in Belize tourism we saw throughout the past decade. Basically, Belize does not specialize in the large, resort-style tourism found in some of the larger Caribbean destinations which can permit rapid growth during good times but also lead to intense price competition during economic downturns.

Government revenues are doing well, with official projections showing an increase in revenue of 7% over the previous year, stemming mostly from an increase in general sales tax receipts. The government is projecting a 1.5% primary surplus for 2010 and a 2.0% overall deficit, which should be funded without difficulty by both international donors and commercial banks. Central Bank reserves are slowly increasing this year, and the central bank is vigilantly overseeing the problems in the banking sector.

Belize bonds

Belize bonds have been among the best performing bonds in EM, rallying over 50% in price since we wrote about them in February. Back in February, the 15% yield on the bonds made them the highest yielding sovereign in Latin America, and we were sure that any risks were outweighed by the tremendous yield. The current yield-to-maturity of 9.8% is still high relative to some other single-B countries. Jamaica 2025 bonds currently trade at a yield of about 8.2%, while Dominican Republic 27s trade at a yield of 7.1%. If Belize can resolve some of the idiosyncratic risks we described above, we could see it tighten toward some of these other Caribbean credits. Belize's debt burden is lower than that of Jamaica and its long-term growth rates have been higher, which should help in the long-run. The Dominican Republic's dynamic economic growth story and keen investor interest demonstrated in the last issuance should ensure that Belize trades wide to that credit, however.

Our recommendation on Belize bonds, while certainly not as forceful as when the bonds were at 15%, continues to be an overweight, on the grounds that the yield could compress somewhat in the next year if the government finally manages to resolve some of the outstanding issues. While there are potential risks, the credit does offer the advantage that the largest risks are uncorrelated with most of the global economic issues affecting other countries in the region.



Emerging Markets

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The following article was first published on December 14, 2010.

Is Mexico Temporarily the 51st State?

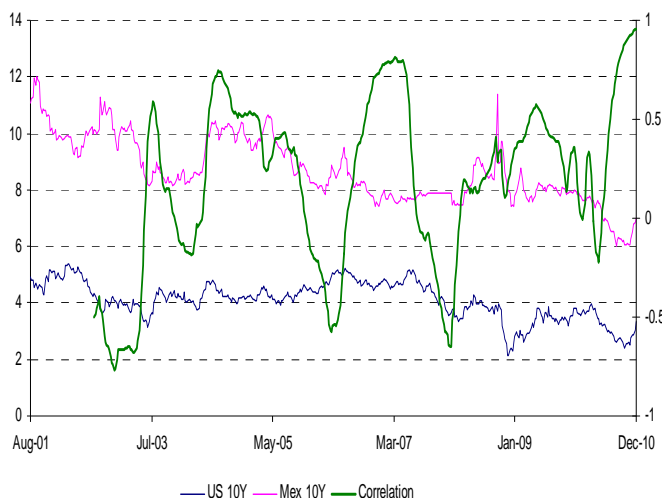
Correlations between Mexican and US long-term yields are at record highs, with a beta that has exceeded one. We are not sure such a high beta is justified by fundamentals, especially once we consider the likely idiosyncratic causes for the recent sell-off in US Treasuries.

In the eight weeks ending December 10th, US 10Y bond yields rose by 76bp, while Mexican yields followed closely, rising by 94bb. As shown in Figure 1, correlations between the two series have risen dramatically, driven largely by the recent co-movement. The relationship between the series is of course crucial for Mexico rates traders. A high correlation can also be bad for the value of the debt exchange warrants which Mexico issued last week (see our article, "Mexico warrants: Strategy, effects and valuation").

Judging by recent performance, one would think that the two always move together and, that somehow, the structural links between the two countries ensure the persistence of such a relationship. The first hypothesis is fairly easy to discard. As the graph shows, the correlation spends almost as much time below zero as above zero, and the average correlation during this period is only 0.18. Now, one might instead postulate a conditional relationship; for example, that Mexico and US yields move together, but only under certain conditions. It seems desirable, for example, to exclude particular idiosyncratic periods like late-2008 and early-2009 because they were characterized by an increase in risk aversion and a flight-to-quality that caused US Treasuries to rally and EM assets to sell-off. The problem with such a conditional theory is that it also tends to exclude the current period; surely the combined forces of QE and US politics on fiscal issues are unusual enough to suggest that there should also be no correlation this time as well.

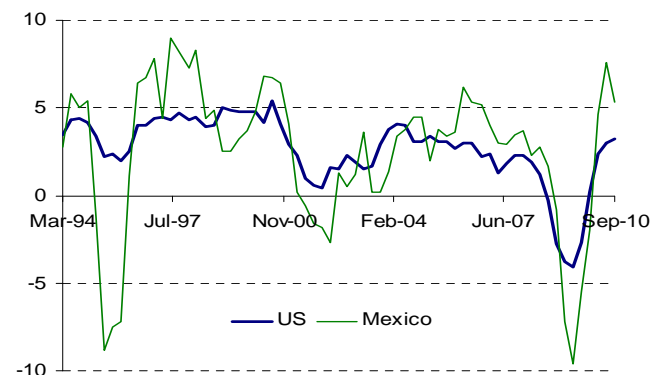
We will discuss the causes of the US sell-off and how they should impact Mexico at the end, but before we do that we should consider some of the general macro links. Well known to even casual observers is the strong relationship between economic performance in Mexico and in the US. As shown in Figure 2, economic growth in Mexico follows US growth closely, with a beta that is usually above one, and more recently above two.

Figure 1 - US and Mexico 10Y yields and correlations



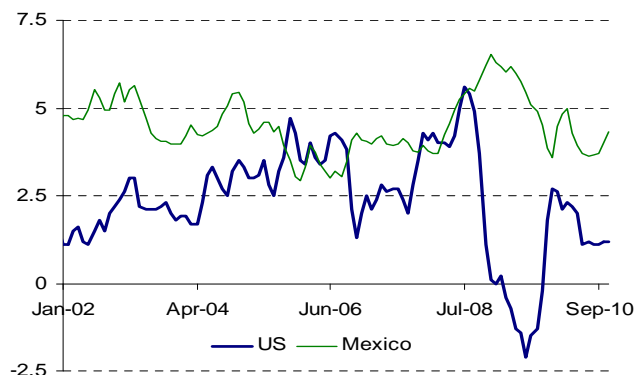
Source: Bloomberg, Scotia Capital. Correlations are 52-week rolling correlations in levels.

Figure 2 - Economic Growth



Source: Bloomberg. Quarterly YOY growth shown.

Figure 3 - Inflation



Source: Bloomberg. YOY monthly CPI shown.

Emerging Markets (continued)Araceli Espinosa (5255) 9179-5237
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One would think that such strong linkages in economic output would translate into similarities in inflation patterns. For example, output gaps in the US should both impact prices in the US and also affect prices in Mexico through the transmission of that output gap. Figure 3 shows that there is almost no positive correlation between CPI in the US and in Mexico, except perhaps in the worst parts of the recent crisis, where prices were affected globally. Interestingly, US inflation was more volatile than Mexican inflation, contrary to what the high Mexican growth beta would have suggested. Correlations for CPI are actually highly negative for the last 8 years, 5 years, and even 2 years. Correlations in core inflation are very close to zero for the last eight years and five years, though admittedly highly positive during the past two years. This lack of correlation suggests that monetary policies between the two countries might also be less related than many would assume.

A frequent question is whether Mexico will hike before or after the U.S., with developments over the last few months suggesting that Mexico may be first. Certainly, there is a link between the cycles, but it is again weaker than many assume. Consider the recent history of rate changes in the US and Mexico, as shown in Figure 4. In late 2005, Mexico was raising rates while the US was lowering rates. In the early stages of the financial crisis, Mexico was actually raising rates as the US was lowering them. Ultimately, while the US cut rates in total by 5%, Mexico only cut by 3.75%--the beta for Mexico is again less than one.

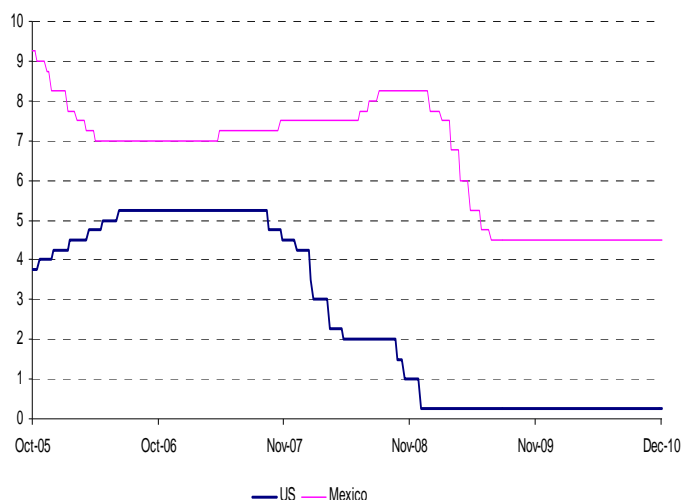
The brief analysis we have presented shows that linkages in output are much stronger than linkages in monetary variables. If recent movements in US Treasury yields were the result of an unexpected shock to US economic growth, then surely Mexican growth and Mexican monetary policy would also be affected. Instead, the recent drivers are probably more related to US monetary phenomenon. QE represents a direct attempt to influence long-term US yields, and should not have much of an effect on Mexican yields. Similarly, decisions by Asian central banks on whether to hold reserves in the form of US Treasuries also should not affect Mexico. If anything, one would think that Latin American local currency bonds would benefit as central banks become more likely to diversify their holdings. Finally, recent concerns about tax cuts, are probably more related to concerns about future inflation in the US and less so about future growth, and here again the beta with regards to the effect on Mexico should be less than one.

We note that long-term yields in other Latin American countries sold off as well in the last two months, rising by 40bp to 60bp in Peru, Brazil, and Colombia. Here the betas relative to US Treasuries are below one. We imagine that the rise in Treasuries makes local instruments less attractive to foreign investors; as result, local traders in these countries, on the expectation of fewer future flows from abroad, may be adjusting the prices of their bonds downwards. We are not sure if that is justified, but the Mexico puzzle is deeper, considering that it has had a beta above one. Interestingly, Colombia yields followed US Treasuries downwards with a beta of greater than one earlier in the year, but sold-off with a beta less than one, suggesting that traders in that country distinguish between different drivers of US Treasury movements.

In the first quarter of the year, we think Mbono prices were aided by the pending inclusion in the WGBI index, resulting in an Mbono rally that was somewhat at odds with the weakness in the US Treasury market. The fact that most of the effects of WGBI are now past may explain why the correlation has been able to increase.

While we expect Mexican rates to take their cue from US Treasuries going forwards, we could see the beta decrease somewhat. For example, today US Treasuries sold off by 20bp but Mbonos outperformed, with yields rising by only 13bp. If, on the other hand, enough traders continue to trade Mexico with a high beta to the US, we could see some interesting opportunities in Mbonos emerging in the long-run.

Figure 4 - Short-term rates in the US and Mexico



Source: : Bloomberg, Scotia Capital. Correlations are 52-week rolling correlations in levels.



Fiscal Policy

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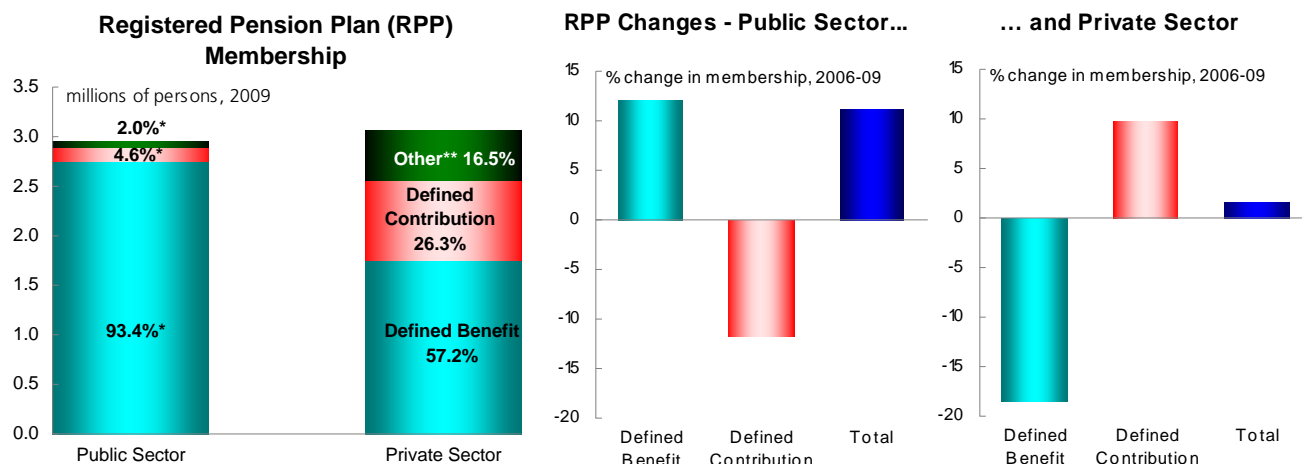
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Enhancing Canada’s Retirement Income Options

At the upcoming federal/provincial/territorial Finance Ministers' meeting on December 20, a key issue will again be retirement income adequacy. Since the downturn, many aspects of Canada’s retirement income system have required attention. Corporate defined benefit (DB) registered pension plans (RPPs) emerging from the recession with larger unfunded liabilities have spurred government reforms to assist firms with their RPP repair and to offer members increased protection, particularly in the event of the corporation ceasing operations. The latest initiatives are Ottawa’s proposals for federally regulated private-sector RPPs that include requiring an employer to fully fund a benefit change upfront if the change reduced the plan’s solvency ratio below 85%.

A further concern is the retirement savings options for workers with no access to a workplace pension plan and for the self-employed. Over 70% of private-sector employees are not covered by an employers’ pension plan, and the number of private-sector workers with DB coverage is shrinking (see charts below). At the Finance Ministers’ meeting last June, Ottawa backed a “modest” increase in Canada Pension Plan (CPP) premiums and benefits to step up retirement saving. A drawback of this suggestion is that it raises payroll deductions for individuals covered by DB employer plans who may not need increased coverage, and does not adequately address the substantial needs of workers without an RPP. This difficulty has prompted other suggestions, including giving individuals the choice of raising their CPP contributions.

Traditionally, RPPs have been established around the employer/employee relationship, but pooled pension plans either through financial institutions or operated at arm’s length by governments, also could offer efficient investment management and administration to individuals without an employer RPP . The federal Finance Minister is now suggesting the options of “Pooled Registered Retirement Plans” provided by regulated financial institutions. The trend towards innovation and “pooled plans” is mirrored in the recently announced draft amendments by Ottawa and Saskatchewan for the Saskatchewan Pension Plan (SPP), a voluntary defined contribution pension plan established by the Province in 1986, distinguished by its lack of employer/employee relationship. The SPP's key advantages include its portability for Saskatchewan residents and its arm's-length, cost-effective professional investment capability. Since its inception, annual returns have averaged 8%, its membership currently numbers 30,000 and its assets outstanding as of September 30 were just over \$280 million. A major disadvantage was its very low \$600 annual contribution ceiling. The suggested changes would raise the annual ceiling to \$2,500 as of 2010 and align the tax treatment of the SPP with other tax-assisted retirement savings vehicles. (The latter adjustment would require that the larger SPP contribution be sourced from earned income, subject to an individual's unused room for RRSP contributions.) The SPP changes, in turn, raise a key concern related to the policy reforms required to achieve truly equitable retirement saving options for all workers. Using the federal Public Service Plan as a benchmark, for individuals with no DB plan, the limit on tax-deductible contributions to RRSPs, defined contribution plans or the proposed pool plans will have to rise far more substantially than current legislation outlines to level the ‘retirement income’ playing field.



*Percent share of total membership. **Includes hybrid and composite plans. Source: Statistics Canada

Foreign Exchange Markets

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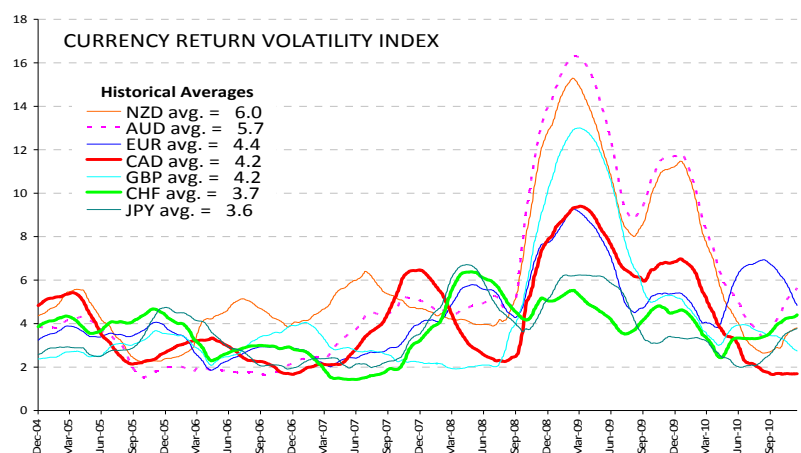
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Does Low CAD Volatility Make it the New CHF?

It is evident to anyone who trades CAD that the past few sessions has proven to be ones of extremely low volatility, despite an abundant amount of market moving data in both the US and Canada, as well as important global macro events generally focused on the Eurozone. It is almost as though CAD has decided to take its holidays early this year as USDCAD has seen some absolutely miniscule daily ranges, like the 21-point range during North American hours on Friday the 10th of December. This short term anomaly actually obscures an interesting dynamic at play in the FX market; an apparent collapse in short and medium term volatility in USDCAD. With this in mind, we have constructed a volatility index which ranks the major currency pairs (against the USD) based on 1-year historical daily returns in order to analyze this dynamic. (see chart 1). This index highlights that though volatility has been abnormally low in the past week, there is something more “thematic” that has been developing in the market for USDCAD over the course of 2010.

Let’s take a look at our constructed index first. It is reassuring to know that the index captures some of the features that we would like to see based on what we’ve observed over the past couple of years. First, it is consistent with the stylized fact that general FX volatility had spiked in late 2008 through early 2009, before proceeding to decline to pre-financial crisis levels. In addition, the index captures the fact that AUD and NZD have typically been the most volatile currencies on a daily returns basis over the past two years, while EUR’s volatility index spiked to the highest amongst the majors during the worst point of this year’s Eurozone financial crisis, and still remains high on a relative basis. In addition, AUD, CHF and JPY volatility have been trending higher in line with their outperformance and propensity to trend against the USD since mid 2010. However, CAD has also outperformed, so why is the volatility index showing an absolute plunge (beginning in February) and a near term flat-lining in CAD’s volatility? Superficially speaking, this is due to the fact that USDCAD’s propensity to trend in a forceful manner ended in 2010, as the pair became a range trade that rarely saw a peak above 1.07 or a move below parity. Synthesizing our fundamental views on the currency and utilizing data from speculative positioning in the futures market provides some colour on this.

Chart 1



Essentially, CAD fundamentals have strong enough to differentiate the currency positively from other majors, particularly given the key themes that have driven the FX market during the past year: US quantitative easing, FX reserve diversification, and the dual nature of the global growth recovery that has favoured currencies linked to emerging market themes and commodities (like AUD and CAD). CAD’s emerging market / commodity connection, and the ability of the economy to bounce back from the recession, helped entice foreign investment and CAD-supportive flows including those from official global reserve managers. Speculative positioning data sums this up quite succinctly as the market was net long CAD against the USD for nearly all of 2010. Shorts dared not enter in force for more than an opportunistically short period of time, and longs remained undaunted in the face of flare-ups in risk aversion. However, CAD failed to display the same trending behaviour as was seen in AUD as the economic connection to the US restrained sharp trades through parity and also kept the Bank of Canada from raising rates more aggressively in the near term.

Considering all of these factors and our forecast for fairly restrained CAD strength in 2011, the currency’s stability begs the question of whether CAD can be the new CHF? That is, can CAD become a favoured store of value and a currency vehicle for safety as is the case with CHF. Looking at option-implied vol as well as our volatility index, it appears that if one were to look at the past few months, this could be one’s conclusion. However, there are significant differences and the Canadian dollar is not about to displace the Swiss franc as the market’s safe haven of choice. Certainly CAD has shown an inordinate amount of stability recently, but we believe that this reflects the tension between Canada’s inherently strong currency fundamentals, and the limits to which CAD can sustainably appreciate past parity against its main trading partner. The market is well aware of this and trades to parity have a tendency to bring in natural USDCAD buyers who remember the brief but violent 2007 surge through parity, and how unsustainable such a rapid move was. This is why we see only a slow grind lower in USDCAD, with a lower average volatility environment (though not as low as is currently the case) being more likely.

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However, over time a longer span of time, CHF has still proven itself to be a currency of greater stability, thus underscoring its status as a store of value. Indeed, Chart 1 shows that CHF tended to score extremely low over time in terms of our volatility index as it has averaged only 3.7 since 2004 (versus 3.6 for JPY, 4.2 for CAD and GBP, 4.4 for EUR, 5.7 for AUD and 6.0 for NZD). Another positive feature of CHF comes from the stability of its volatility structure; whereas CAD's volatility index itself has gone through great swings and periods of volatility, CHF's has been admirably stable, a key feature in a currency that serves as a store of value.

Looking at CHF and CAD from a more quantitative point of view, we have estimated an empirical density function for USDCAD and USDCHF daily returns (using kernel density estimation-see Chart 2 with CAD's density in red and CHF drawn in a thin black line). Visually it appears as though USDCHF returns tend to be more peaked and perhaps even more tightly clustered, save for days when CHF gains 1% or more against the USD (note that the graph is for USDCHF, so -1 indicates a gain in CHF of 1% against the USD). This is confirmed by a quick calculation of kurtosis and skewness for CHF returns which come in at 2.21 and -0.25 versus 2.32 and 0.21 for CAD returns respectively. This tells us that CHF's distribution is on average skewed towards a greater frequency of larger positive returns against the USD vis-à-vis CAD (relative to a perfectly normal distribution). On the other hand, the kurtosis actually tells us that CAD is on average more tightly clustered around 0, however the empirical histogram and the skewness statistics suggests to us that this may be because CHF is subject to more extreme "up days" than CAD and less of the extreme "down days" (note the higher frequency clusters for CAD on the extreme right hand side of the distribution). Essentially, a store of value against the USD is more desirable if tends to be biased towards upside gains rather than the downside, as in the case of CHF.

Finally we look at the more recent CAD and CHF price action, over the past six months to be exact, as that is the time period that our index tells us has been responsible for the sharp drop in CAD volatility. Bringing the same analysis to bear (see Chart 3), it looks as though CAD has been less stable from the point of view of more frequent extreme losses (right hand side) and thus greater positive skewness, CAD also has a greater propensity to cluster around zero with less extreme days of gains against the USD. These observations are confirmed by the kurtosis and skewness statistics from this shorter term period. This shows the difficulty that CAD has in making significant gains against the USD relative to CHF, a quantitative expression of the difficulty in trading past parity.

In summary, though CAD volatility has been trending much lower, it seems only temporary as the currency is caught between a fundamentally supported position against the USD and a difficulty in pushing too far below parity in the near term. Thus we have a type of illusory stability in CAD for the time being, versus a much longer history of stable price action out of CHF, which underscores its role as a favoured currency store of value. What could change CAD's outlook and increase volatility? Well, certainly risk aversion borne out of concerns regarding US economic weakness (tax cuts have taken care of that for the time being) or Asian EM growth faltering and bringing a negative knock-on impact to commodity prices. In addition, while we don't foresee that Bank of Canada raising rates until the second half of next year, the moment it gives its assent to additional monetary tightening and a greater policy rate spread versus the Fed, CAD may stand a solid chance of recapturing a trend. In the meantime, use CAD as a defensive play against sovereign risk and to gain exposure to emerging market growth dynamics (without the volatility of AUD), but not as a replacement to CHF which seems to continue to look like the currency of choice as a longer term low volatility store of value.

Chart 2
USDCAD and USDCHF Distributions

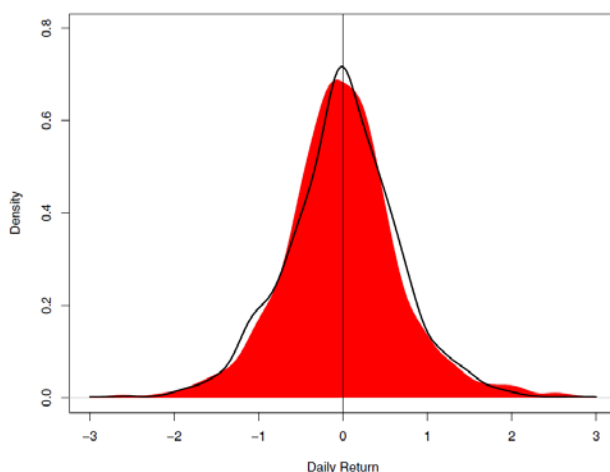
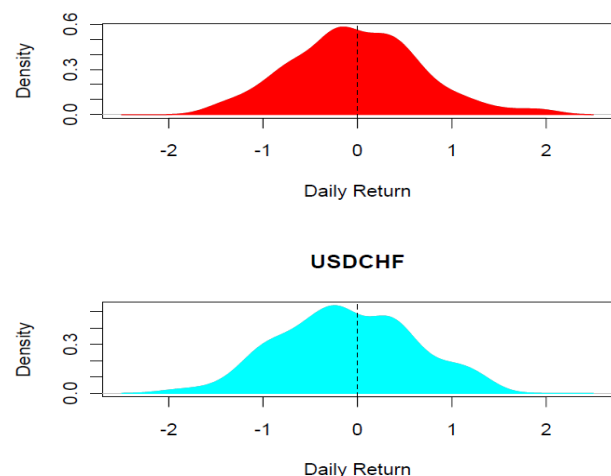


Chart 3
USDCAD

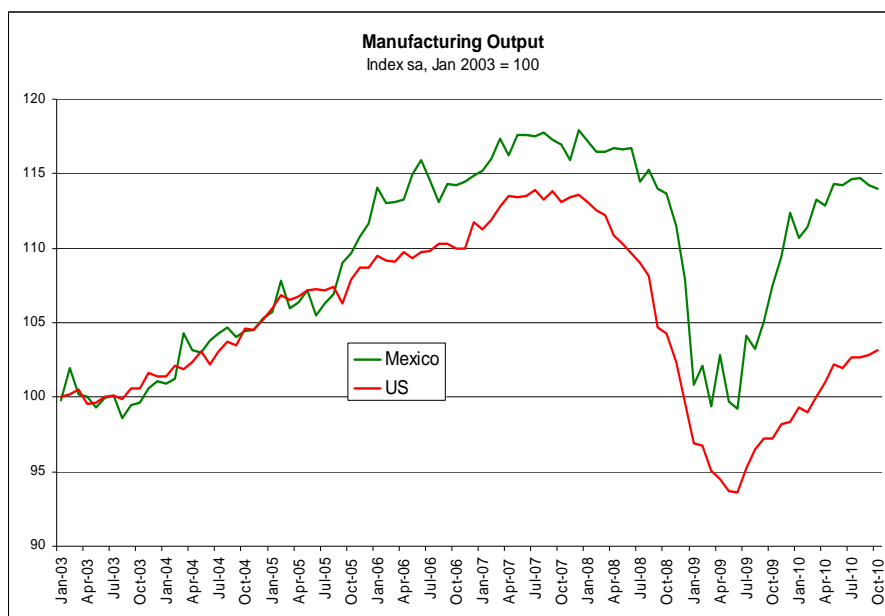


International MarketsOscar Sánchez (416) 862-3174
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The manufacturing-led economic expansion that took off during the second half of 2009 has successfully ignited domestic demand activity. While this balanced growth picture took six to eight months longer than we originally estimated, it is likely to remain effective during the upcoming year barring any significant global economic shock.

While Mexican manufacturing activity still lies below the levels reached prior to the 2009 recession, it has been approaching those peaks at a healthy rate. The seasonally adjusted index of manufacturing output stands on average (through October) 7% above the level registered during the second-half of 2009, and 15% over the bottom in June of that year (please refer to adjacent chart). Although there is an undeniable link between Mexican and U.S. manufacturing activity, the rebound in the former has been more pronounced.

Namely, U.S. factory output during the second-half of this year (through November) is 6% above the average of the corresponding period of 2009, and 8% above the June 2009 bottom. Thus, the recovery in Mexican factory output has been almost twice as dynamic as that north of the border.



Looking ahead, the uptrend in manufacturing will continue to be supported by the slowly improving conditions in the U.S. market, and a persistent drive towards export diversification. For instance, 30% of Mexican automobile sector exports are now destined to non-U.S. markets, with South America and Asia playing a more prominent role. Moreover, the Mexican peso has retained a relative weak stance vis-à-vis alternative markets as it has appreciated by a mere 5% year-to-date against the U.S. dollar. This cost competitive edge is likely to persist as the uncertainty brought about by looming key provincial elections in 2011 and presidential elections in 2012 are likely to keep the currency from strengthening substantially in the next two years.

The favourable outlook for manufacturing is complemented by a now evident ignition in activity within locally oriented sectors. This has implied that industrial sector gains have been amplified as utilities and construction have entered into an expanding phase. These developments are further confirmed when analyzing service sector performance as it is expanding at a healthy over 5% y/y rate, underpinned by improving labour market conditions supported by bank credit growth and portfolio capital inflows. The picture for inflation somewhat echoes the arguments outlined above as domestically oriented service price pressures are once again rising within the context of slightly up trending price pressures. Rising input costs have translated into a rebound in merchandise goods inflation, a development that could exacerbate during 2011 as commodity prices continue to be elevated due to relatively healthy economic developments worldwide. As non-tradable goods prices continue to pick up pace due to rising domestic demand, the combination of these two forces could imply a serious inflationary threat. In such a scenario, the Bank of Mexico might be forced to act pre-emptively notwithstanding possible monetary inaction on the part of the U.S. Federal Reserve. In summary, while we expect Mexico's GDP to expand by 3.5% y/y in 2011, following a 4.8% gain this year, the risk to our outlook is certainly on the upside notwithstanding a lacklustre performance on the part of U.S., whose output we anticipate will grow by a subpar 2.5%.

Preliminary estimates for the week of December 20 – 24

 **Canada**

<u>Date</u>	<u>ET</u>	<u>Indicator</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
12/20	(08:30)	Wholesale Trade (m/m)	Oct	0.5	0.7	0.4
12/21	(07:00)	CPI, All items (m/m)	Nov	0.2	0.3	0.4
12/21	(07:00)	CPI, All items (y/y)	Nov	2.1	2.3	2.4
12/21	(07:00)	Core X8 CPI (m/m)	Nov	0.1	0.2	0.4
12/21	(07:00)	Core X8 CPI (y/y)	Nov	1.5	1.6	1.8
12/21	(08:30)	Retail Sales (m/m)	Oct	0.4	0.5	0.6
12/21	(08:30)	Retail Sales ex. Autos (m/m)	Oct	0.5	0.7	0.4
12/23	(08:30)	Real GDP (m/m)	Oct	0.3	0.3	-0.1

 **United States**

<u>Date</u>	<u>ET</u>	<u>Indicator</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
12/21	(07:45)	ICSC Chain Store Sales - Weekly (w/w)	Dec. 18	--	--	0.8
12/22	(07:00)	MBA Mortgage Applications (w/w)	Dec. 17	--	--	-2.3
12/22	(08:30)	GDP Deflator (q/q a.r.)	Q3-T	2.3	2.3	2.3
12/22	(08:30)	GDP (q/q a.r.)	Q3-T	2.8	2.8	2.5
12/22	(10:00)	Existing Home Sales (mn a.r.)	Nov	4.70	4.75	4.43
12/23	(08:30)	Initial Jobless Claims (000s)	Dec. 18	423	420	420
12/23	(08:30)	Personal Income (m/m)	Nov	0.3	0.3	0.5
12/23	(08:30)	Continuing Claims (mn)	Dec. 11	4.11	4.11	4.14
12/23	(08:30)	Personal Consumption (m/m)	Nov	0.5	0.5	0.4
12/23	(08:30)	PCE Deflator (y/y)	Nov	1.1	1.2	1.3
12/23	(08:30)	PCE ex. Food & Energy (y/y)	Nov	0.9	0.9	0.9
12/23	(08:30)	Durable Goods Orders (m/m)	Nov	-0.7	-0.6	-3.4
12/23	(08:30)	Durable Goods Orders ex. Trans. (m/m)	Nov	1.2	2.0	-2.7
12/23	(09:55)	U. of Michigan Consumer Sentiment	Dec-F	--	74.6	74.2
12/23	(10:00)	New Home Sales (000s)	Nov	297	300	283

Source: Bloomberg and Scotia Capital Economics

Preliminary estimates for the week of December 20 – 24

Europe

<u>Date</u>	<u>ET</u>	<u>Indicator</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
12/20	(02:00)	GE Producer Prices (m/m)	Nov	--	0.3	0.4
12/20	(04:00)	EC Current Account (EUR bn)	Oct	--	--	-13.1
12/20	(10:00)	EC Consumer Confidence	Dec	--	-9.0	-9.4
12/20	(19:01)	UK GfK Consumer Confidence (index)	Dec	--	-22	-21
12/21	(05:00)	IT Unemployment Rate (%)	Q2	--	8.3	8.5
12/22	(04:30)	UK GDP (q/q)	Q3-A	--	0.8	0.8
12/22	(04:30)	UK Business Investment (q/q)	Q2-P	--	-0.2	-0.2
12/22	(04:30)	UK Current Account (GBP bn)	Q2	--	-8.5	-7.4
12/23	(02:45)	FR Consumer Spending (m/m)	Oct	--	0.9	-0.7

Asia/Oceania

<u>Date</u>	<u>ET</u>	<u>Indicator</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
12/20		JN New Composite Leading Economic Index	Oct	--	--	97.2
12/20		JN Coincident Index CI (index)	Oct	--	--	100.7
12/20	(23:30)	JN All Industry Activity Index (m/m)	Oct	--	-0.2	-0.8
12/20		JN BoJ Target Rate (%)		0.10	0.10	0.10
12/22	(16:45)	NZ GDP (q/q)	Q3	--	0.1	0.2
12/22	(20:00)	PHI Imports (y/y)	Oct	--	--	24.6
12/22	(20:00)	PHI Trade Balance (US\$ mn)	Oct	--	--	751

Source: Bloomberg and Scotia Capital Economics

Global Auctions for the week of December 20 – 24

North America

Country	Date	Time	Event
US	12/20/2010	11:00	U.S. Fed to Purchase USD7-9 Bln Notes/Bonds
US	12/20/2010	11:30	U.S. to Sell USD 29 Bln 3-Month Bills
US	12/20/2010	11:30	U.S. to Sell USD 28 Bln 6-Month Bills
US	12/20/2010	14:00	U.S. Fed to Purchase USD6-8 Bln Notes/Bonds
CA	12/21/2010	10:30	Canada to Sell CAD7.4 Bln 98-Day Bills
CA	12/21/2010	10:30	Canada to Sell CAD2.8 Bln 182-Day Bills
CA	12/21/2010	10:30	Canada to Sell CAD2.8 Bln 364-Day Bills
US	12/21/2010	11:00	U.S. Fed to Purchase USD7-9 Bln Notes/Bonds
CA	12/21/2010	11:15	Canada to Repurchase CAD1 Bln Cash Management Bonds
US	12/21/2010	11:30	U.S. to Sell 4-Week Bills
US	12/21/2010	14:00	U.S. Fed to Purchase USD1-2 Bln TIPS
US	12/22/2010	11:00	U.S. Fed to Purchase USD1.5-2.5 Bln Notes/Bonds

Europe

PD	12/20/2010	06:00	Poland Cancels 52-Week T-bills Auction
FR	12/20/2010	09:00	France to Sell EUR3.5 Bln 84-Day Bills
FR	12/20/2010	09:00	France to Sell EUR1.5 Bln 357-Day Bills
SP	12/21/2010	04:30	Spain to Sell 3, 6 Month Bills (SGLT)
SZ	12/21/2010	05:30	Switzerland to Sell 3-Month Bills (SWISTB)
HU	12/21/2010	05:30	Hungary to Sell 3-Month Bills (HTB)
HU	12/21/2010	06:30	Hungary's Central Bank to Sell 2-Week Bills (MNB)
UA	12/21/2010	12:00	Ukraine to Sell 3-Year Bonds
UA	12/21/2010	12:00	Ukraine to Sell 6-Month Bills
UA	12/21/2010	12:00	Ukraine to Sell 12-Month Bills
RU	12/22/2010	06:00	Russia to Sell Up to RUB15.19 Bln OFZ Bonds; series #25071
RU	12/22/2010	08:00	Russia to Sell Up to RUB10.53 Bln OFZ Bonds; series #25074
HU	12/23/2010	05:30	Hungary to Sell 12-Month Bills (HTB)

Asia/Oceania

SK	12/20/2010		Korea Central Bank to Sell KRW1 Trn 91-Day Bonds
TH	12/20/2010	22:00	Bank of Thailand to Sell THB22 Bln 28D Bills
TH	12/20/2010	22:00	Bank of Thailand to Sell THB12 Bln 91D Bills
TH	12/20/2010	22:00	Bank of Thailand to Sell THB12 Bln 182D Bills
TH	12/20/2010	22:00	Bank of Thailand to Sell THB20 Bln 2Yr Bonds (BOT12DA)
HK	12/20/2010	22:30	Hong Kong to Sell HKD28.565 Bln 91-Day Bills Q1051
HK	12/20/2010	22:30	Hong Kong to Sell HKD9 Bln 182-Day Bills H1097
JN	12/21/2010	22:45	Japan to Sell 2-Year Bonds
MA	12/21/2010	23:00	Bank Negara to Sell MYR1.5 Mln 63-Day Islamic Notes (85/10)
MA	12/21/2010	23:00	Bank Negara to Sell MYR1 Bln 306-Day Notes (78/10)
MA	12/21/2010	23:00	Bank Negara to Sell MYR2 Bln 63-Day Notes (77/10)
IN	12/22/2010	04:30	India to Sell INR 20Bln 91-Day Bills
IN	12/22/2010	04:30	India to Sell INR 10Bln 182-Day Bills
NZ	12/22/2010	20:30	New Zealand Plans to Sell Government Bonds
MA	12/22/2010	23:00	Malaysia to Sell MYR110 Mln 182-Day Bills (47/10)
TA	12/22/2010	23:00	Taiwan to sell TWD30 Bln 30-Year Bonds
CH	12/23/2010	22:00	China Government to Sell 91-Day Bills
IN	12/24/2010		India to sell INR 40-50Bln 5-9Year Bonds
IN	12/24/2010		India to sell INR 40-50Bln 10-14Year Bonds
IN	12/24/2010		India to sell INR 20-30Bln 20 & above Year Bonds

Source: Bloomberg and Scotia Capital Economics

Events for the week of December 20 – 24**North America**

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
CA	12/20/2010	10:00	Finance Minister's Meeting in Kananaskis

Europe

PO	12/20/2010		Portugal Year-to-Date Budget Report
HU	12/20/2010	08:00	Hungarian Central Bank Sets Benchmark Interest Rate
UK	12/20/2010	19:01	BOE's Haldane Speech Released
HU	12/21/2010	03:30	European Council President Van Rompuy Speaks
UK	12/22/2010	04:30	Bank of England Releases Monetary Policy Committee Minutes
HU	12/23/2010	11:00	Hungarian Law makers Vote on 2011 Budget

Asia/Oceania

AU	12/20/2010	19:30	Reserve Bank's Board December Minutes
JN	12/21/2010		BOJ to Hold Regular Policy-Setting Board Meeting in Tokyo

Source: Bloomberg and Scotia Capital Economics

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