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### Market Commentary

**Canadian Equity Markets** - The Canadian stock market began 2007 on a positive note returning 2.60% in the first quarter, however this was a marked decline after returning 10.42% in the final quarter of 2006 as measured by the S&P/TSX Composite Index. ▶

**US Equity Markets** - The U.S. equity markets posted negative performance of -0.23% during Q1 2007, down from an attractive 11.29% earned in the final months of 2006 as measured by the S&P 500 Total Return Index. ▶

**Global Markets** - Buoyed by positive economic growth, international markets rallied in Q1. ▶

### Highlights

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#### Have You Registered for the Mellon Analytical Solutions Client Conference?

This year's Mellon Analytical Solutions Client Conference will be held in Charleston, North Carolina from May 21 to 23. This conference has proven to be a great networking and educational opportunity for all our clients. ▶

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## Market Commentary

By: Cynthia Shaw & Stephen Lidington

### Canadian Equity Markets

The Canadian stock market began 2007 on a positive note returning 2.60% in the first quarter, however this was a marked decline after returning 10.42% in the final quarter of 2006 as measured by the S&P/TSX Composite Index. The S&P/TSX Composite did, however, outperform its U.S. counterpart by 2.83% as measured by the S&P 500 Index. The growing Telecommunication Services and Industrials sectors have helped the S&P/TSX Composite beat the S&P 500 Index. Earning an attractive 7.92%, the Telecommunication Services sector was the strongest performer in Q1 2007, its growth led primarily by positive sentiments in the Internet software and services stock market. The Industrials sector ended in second place, posting earnings of 6.90% due to higher energy prices and a gasoline shortage following a fire at an Ontario refinery. This shortage contributed to a national price increase at the pumps in January and February 2007. Other top performers for Q1 2007 included the Consumer Discretionary and Financials sectors, earning 4.89% and 3.21% respectively. As the weakest performer, the Utilities sector suffered immense losses at the start of 2007, earning a meagre -5.79% thanks to unseasonably warm weather during winter 2007.

The Canadian stock market began to rebound in early March 2007 thanks in part to strong corporate earnings in the Financials sector. This has helped the S&P/TSX Composite recoup much of its losses in the early months of 2007. For investors looking to Canadian equities for opportunity, Canada is poised for stronger economic performance throughout 2007. Financial conditions in Canada remain favourable as financial institutions and markets continue their willingness to lend, while business profitability and overall financial health remain solid. The economy is also characterized by attractive dividends from Canadian stocks. This bodes well for cash flows as well as prosperous business, energy and real estate income trusts as they remain the fastest growing asset class in Canada.

### Style Analysis

During the first months of 2007, the small-capitalization tier fared better than its large-cap counterpart. This is a notable difference from the trend in the final quarter of 2006, which saw growth stocks at each capitalization tier as the preferred investment style. The Small-Cap Growth Index returned 5.33% while the Small-Cap Value Index returned 6.12%. The Large-Cap Growth and Value indices returned 2.94% and 2.43% respectively. This trend toward smaller capitalization stocks was driven by the increase in fast-growing, low-priced Canadian small-cap companies demonstrating explosive price appreciation and profit potential. Unlike their larger rivals, these companies have more room to grow and can move more quickly to capitalize on opportunities.

### Canadian Economic Overview

At the end of 2006, the Canadian economy was operating at or just above its production capacity, following weaker-than-expected growth in the second half of 2006. The Canadian economy has performed well in recent years, narrowing its per-capita GDP gap with the United States. However, economic indicators and consensus forecasts suggest that this momentum will not continue. Despite the fact that economic growth rates are slowing in North America, evidence of an impending recession is not yet apparent.

While growth slowed for much of 2006, the economy regained momentum by year end. Real GDP rose by 0.1% in January 2007 following a 0.4% hike in December 2006. At the end of 2006, broad-based gains in manufacturing, trade and retail spending reflected economic growth at its fastest monthly rate in more than a year, setting the stage for stronger activity in early 2007. Growth in both the goods and services industries continued into January 2007; however, economic growth in the first quarter led to a

moderate drop in residential construction, keeping GDP growth below par.

The Canadian economy has always had a remarkable ability to cope with any conditions. In March 2007, stimulated by a buoyant labour market that saw the employment rate grow to 63.5% (its highest level in 31 years), Canada's housing market continued to thrive with housing starts at levels associated with boom times. Despite this huge employment growth, the unemployment rate remained unchanged at 6.1% even though more people entered the labour market. Canadian exports slowed in February 2007, down 2.1% from a record high in January. This was due partly to a 15-day railway strike that interrupted regular transportation patterns, making it difficult for exporters to ship their products to the border. However, with a strong global outlook and with energy prices remaining high, the demand for Canadian exports is likely to pick up. In addition, consumers paid 2.0% more in February 2007 for the goods and services included in the Consumer Price Index (CPI) than they did in February 2006 – a substantial acceleration over previous months. Lastly, soaring commodity prices led to burgeoning activity in provinces with abundant oil and gas resources. Although the resulting rise in exchange rate has had a dampening effect on other provinces, even those with more sluggish growth continue to expand at around 2% a year.

In the United States, economic growth has slowed in recent quarters. This reflects in part the economy's transition from rapid expansion in preceding years to a more sustainable pace of growth. However, continuing increases in employment have helped sustain consumer spending (CPI increased 2.4% over the 12 months ending in February 2007); this should continue to support economic expansion in upcoming quarters. Growth in the Canadian economy is also expected to accelerate to 3% in 2008 owing to an expected recovery in the U.S. economy.

#### *Monetary Policy*

The Bank of Canada's overnight rate remained unchanged at 4.25% at the end of Q1 2007. In line with the Bank's outlook, this level should help achieve the 2% inflation target over the medium term. With a steady overnight rate, the Canadian economy would see minimal impact on other interest rates, such as those for consumer loans and mortgages, as well as on the exchange rate of the Canadian dollar.

The Bank of Canada projects that the Canadian economy will continue to operate near its production capacity throughout 2007 and 2008, and has signalled that it intends to hold the overnight rate steady in the foreseeable future. Inflation has evolved largely in line with the Bank's expectations, with total CPI inflation slightly lower than projected and core inflation slightly higher. With the economy operating near its production potential, core inflation should return to 2% in the first half of 2007 and stay there throughout the projection period.

The Canadian dollar continues to rise steadily, and by March 31, 2007 had moved to a high of US \$0.8655. The once lowly loonie, moving in step with commodity prices, picked up steam as oil and metal prices rebounded. But the biggest driver has been the underlying weakness in the U.S. dollar and that country's struggle with budget and trade deficits.

In the United States, the Federal Reserve has kept the target rate for federal funds at 5.25% after tightening the policy rate at the end of 2006 in response to inflationary pressures. Core inflation remains somewhat elevated, so monetary policy may eventually need further tightening to reduce inflation at an appropriate pace. However, because core inflation is currently above the levels most conducive to sustainable growth, the Fed's primary concern remains the risk that inflation will fail to moderate as expected. On a positive note, incoming data have supported the view that the current policy stance is likely to foster sustainable economic growth for the United States.

#### *The Bond Market*

In the steady interest rate environment set by the Bank of Canada, the broad market Scotia Capital Bond Universe Index finished Q1 2007 returning 0.91%, a marked increase from the fourth-quarter return of 0.70%. Performance across the mid-term to long-term maturity tiers was positive for the quarter with mid-term bonds returning 1.11% and long-term bonds returning 0.58% as measured by the Scotia Capital Bond family of indices. Short-term bonds also achieved a positive return of 1.04% in first quarter 2007. The Bank of Canada completed its tightening cycle, helping to stimulate the positive performance of short-term bonds.

Canada's elimination of its foreign investment cap on pension and retirement funds has dramatically boosted the nation's bond market. This means that major bond buyers can purchase more bonds issued in Canada by foreign governments and companies. With interest rates remaining steady and low in most parts of the world, bonds provided returns that essentially matched their coupons. Prices for very long maturities continued to be strong as demand from pension funds and insurance companies has not been

satisfied by new government or corporate issuances.

The U.S. bond market performed poorly in the first quarter of 2007 as the Lehman Aggregate Bond Index returned 0.63%, down from stunning earnings of 5.60% in fourth quarter 2006. Concerns about increasing stock market volatility and risk aversion pushed investors toward the safer Treasuries. While the 10-year Treasury note fell in early March, renewed inflation concerns pushed the yield back up to 2.96% at quarter end. The 10-year yield climbed back above the two-year yield, eliminating the inverted yield curve that defined 2006. In the United States, interest rates remain low; therefore, fixed-income securities have yielded unattractive returns.

### **U.S. Markets**

The U.S. equity markets posted negative performance of -0.23% during Q1 2007, down from an attractive 11.29% earned in the final months of 2006 as measured by the S&P 500 Total Return Index. After months of solid market gains, a sudden rise in risk aversion tainted investor outlook in early 2007, pushing U.S. stocks sharply lower. The broad market, as measured by the Russell 3000 Index, fell 2.3% during this time.

The Utilities sector posted the highest return in the first quarter, earning 8.35%. This was followed by the Materials sector earning 8.02%. Both sectors are experiencing stronger-than-expected earnings growth. However the lowest performing sectors include Financial Services (earning -3.68% due to a sell-off of Financial Services stocks) and the Information Technology sector (earning -1.80% after a Technology stock sell-off amid fears of a global economic slowdown).

### *Style Analysis*

As reflected by the Russell family of equity indices, the United States saw a similar style in Q1 2007 as the Canadian economy, where smaller capitalization stocks held up better than their large-cap counterparts. The Small Cap Russell 1000 Value returned -2.94% and the Small Cap Russell 1000 Growth returned 2.55%, while the Large Cap Russell 1000 Value and Growth indices earned -2.34% and -3.02% respectively. This trend toward smaller capitalization stocks was fuelled by an increase in fast-growing, low-priced U.S. small-cap companies with explosive price appreciation and profit potential.

### **International Markets**

Buoyed by positive economic growth, international markets rallied in Q1. The top-performing index for a second consecutive quarter was the Nordic Countries Index returning 6.45% for the quarter (all numbers reflect gross index performance in local currency) while the bottom performer, the MSCI Far East Index – the broadest Asian equity performance benchmark – still managed to return 2.18%. The MSCI EAFE Index – the pre-eminent international equity performance benchmark – finished the quarter with a return of 2.79%, despite a (0.63) net loss in February.

The MSCI EMU Index – the pre-eminent Europe-only equity performance benchmark – wrapped up the quarter returning 3.33%. The MSCI EMU's performance was exceeded only by the Nordic Countries (a subset of the MSCI EMU) for quarterly performance. These moderate quarterly returns come in the face of increasing money market interest rates across the maturity spectrum, with longer maturities beginning their rise in January and shorter term ones in February. Financial jitters in late February, however, scaled back expectations of an early March ECB rate hike, and money market rates backed off slightly. Reflecting these developments, the money market yield curve flattened in late February and March after spiking in December 2006 and January 2007.

The MSCI Far East Index – the broadest Asian equity performance benchmark – yielded a first quarter return of 2.18%. This index is nearly 91.5% correlated to the MSCI Japan Index, which saw a fourth quarter return of 2.02% while the other two members, MSCI Singapore and MSCI Hong Kong, earned returns of 9.09% and 0.69% respectively.

The outlook for growth in Japan – the world's second largest economy – remains optimistic. Markets expect the Japanese GDP to continue growing below 2% until late 2007, when the benefits of consistent private domestic demand will bring about real economic effects. Japan continues to distance itself from the economic deflation that has long overshadowed its economy. The CPI increased steadily (albeit moderately) as the Bank of Japan held off on hiking its main policy rate. This led to a slight rise in interest rates, but also to a larger depreciation of the Yen versus the dollar. In the last half of 2007, a higher interest rate is expected from the Bank of Japan as is a general depreciation of the dollar – which should favour the Yen along with most major currencies.

The MSCI Pacific Index (which includes Australian and New Zealand markets), along with the MSCI Far East members, returned 2.80% for the quarter. Australian markets as measured by the MSCI Australia

Index started 2007 with strong growth at a quarterly return of 5.76%. Australia's economy continues to benefit from the country's relative proximity to China and a high demand for Australian commodities.

### **Emerging Markets**

Most of the world's emerging market economies experienced a slight correction through the first two months of 2007, with all MSCI standard Emerging Market international indices posting losses. Some markets were hit harder than others over those months, but March saw an encouraging recovery that helped most of these regional indices finish in positive territory. The top performing index for the quarter was the EM Latin America Index with a 3.90% return, while the BRIC (Brazil, Russia, India and China), which last quarter had produced a 22.59% return, was this quarter's weakest performer, losing -2.02%.

Commodity-heavy Latin American markets, supported by continuing strong demand for energy and materials, had a strong 2006 overall despite mid-year political tensions. In Venezuela, President Hugo Chavez's campaign for "21st century socialism" is being implemented at the expense of the Venezuelan economy. Effects of the decline in fiscal revenue (a 5% VAT tax break) and the imminent downturn of private investment are already being seen through a -15.23% loss measured by the MSCI Venezuela Index. This is compounded by economic predictions of double-digit inflation for 2007.

Emerging Asian market performance continued to be diverse and unpredictable through first quarter 2007, as it was throughout 2006. For the quarter, the top-performing MSCI Malaysia Index returned 15.39% with Pakistan close behind at 14.32%. The previous top performer, the MSCI China Index – which returned a staggering 35.61% in the fourth quarter of 2006 – saw a comparatively poor Q1 2007 finishing at -1.85% on March 30.

The core Chinese economy, which grew at an aggressive 10.7% in 2006, can be interpreted as an encouraging indicator, although it may be storing up problems for the future. As investment wanes and industry slows, China's lacklustre quarter should be interpreted as a cautionary sign. The Chinese economy was expected to remain strong until after the 2008 Olympics in Beijing, but economic expectations are already signalling a weakening Chinese economy. GDP growth is anticipated to fall to 9.5% for 2007 and 9% for 2008. Furthermore, the Chinese current account surplus is expected to tighten from 7.8% of GDP in 2006 to 6.3% in 2008.

The Indian financial markets suffered in February, closing out the quarter at -5.38%. Elsewhere, the MSCI Korea Index finished in positive territory at 2.42% for the quarter, despite tense relations with neighbouring North Korea. South Korea remains in a good position to prosper from upgrades to the crumbling north if the nuclear standoff can be resolved. While consumer confidence in South Korea is seen to be firming up, the short-term view remains somewhat pessimistic.

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## Market Benchmarks

As of March 31, 2007 - Canadian Dollars

	QTR Ending	YTD Ending	1 Year Ending	3 Years Ending	5 Years Ending	7 Years Ending	10 Years Ending
<b>Cash</b>							
Scotia Capital 30day T-Bill	1.04	1.04	4.14	3.06	2.91	3.34	3.59
Scotia Capital 90day T-Bill	1.04	1.04	4.18	3.07	2.98	3.47	3.74
<b>Bonds</b>							
Scotia Capital Bond Index Long Term	0.59	0.59	6.51	8.33	10.04	8.74	9.21
Scotia Capital Bond Index Mid Term	1.11	1.11	5.83	4.97	7.38	7.35	7.17
Scotia Capital Conv. Res.Mort.3	1.36	1.36	5.83	4.80	6.12	7.08	6.62
Scotia Capital Conv. Res.Mort.5	1.43	1.43	6.60	5.31	7.08	7.91	7.28
Scotia Capital Bond Universe	0.91	0.91	5.46	5.11	7.03	6.98	7.00
Scotia Capital Bond Index Short Term	1.04	1.04	4.56	3.25	4.98	5.65	5.53
<b>Equity</b>							
S&P/TSX Composite Index	2.60	2.60	11.42	17.70	13.10	6.75	10.35
S&P/TSX Capped Composite Index	2.60	2.60	11.42	17.70	13.10	9.42	NA
S&P / TSX 60	1.81	1.81	12.38	18.75	13.18	6.01	10.95
S&P/TSX Midcap C\$	4.49	4.49	10.66	17.75	14.40	8.62	NA
S&P/TSX SmCap	5.43	5.43	8.37	9.94	10.42	9.35	NA
Nesbitt Burns Small Cap	6.01	6.01	8.98	16.06	16.37	12.94	10.81
Barra Canada Large Cap Growth	2.94	2.94	8.24	15.39	11.34	1.06	7.66
Barra Canada Large Cap Value	2.43	2.43	14.20	20.24	15.10	15.78	13.59
Barra Canada Small Cap Growth	5.33	5.33	9.36	15.43	14.97	6.69	9.22
Barra Canada Small Cap Value	6.12	6.12	7.24	20.23	18.62	19.50	13.06
<b>Foreign Bonds</b>							
LB Aggregate Bonds C\$	0.63	0.63	5.41	-1.09	-1.26	2.91	4.55
<b>Foreign Equity</b>							
S&P 500 w/DIV	-0.23	-0.23	10.59	5.38	-0.40	-2.37	6.27
MSCI EAFE C\$ Cmp	3.25	3.25	19.36	15.18	8.93	2.00	6.70
MSCI EAFE Net Dividend C\$	3.18	3.18	18.86	14.73	8.51	1.65	6.37
MSCI World C\$ Cmp	1.71	1.71	14.71	10.28	3.99	-0.52	6.38
MSCI World Net C\$	1.61	1.61	14.16	9.76	3.50	-0.94	5.95

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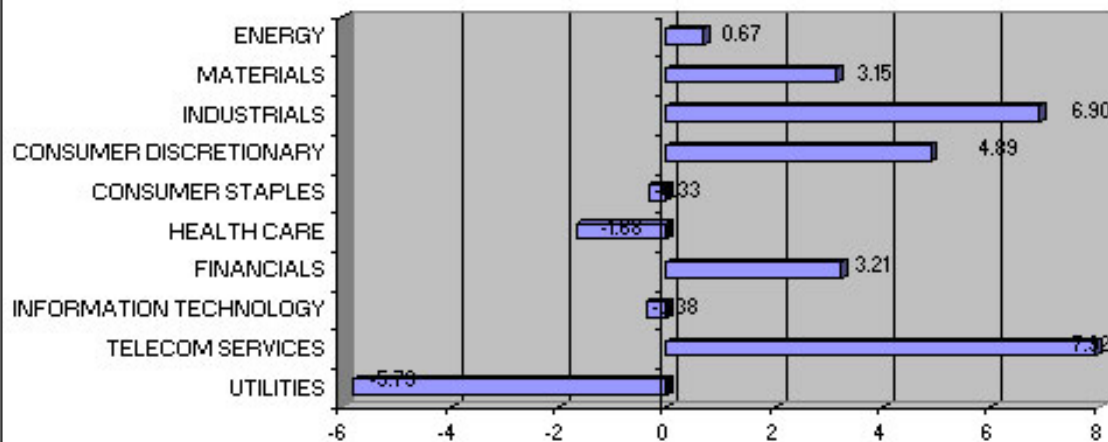
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### S&P/TSX Composite Sector Performance

CLASSIFICATION	QTR ENDING	YTD ENDING	YEAR ENDING	3 YR ENDING	5 YR ENDING	7 YR ENDING	10 YR ENDING
Total Gross of Fees	2.60	2.60	11.42	17.70	13.10	6.75	10.35
Energy Sector	0.67	0.67	-1.64	28.59	22.91	25.07	17.07
Material Sector	3.15	3.15	25.40	21.66	15.58	16.48	6.89
Industrials Sector	6.90	6.90	10.30	14.72	4.16	5.59	6.78
Consumer Discretionary Sector	4.89	4.89	14.69	13.32	5.91	4.63	8.41
Consumer Staples Sector	-0.33	-0.33	6.52	4.80	4.29	14.84	16.89
Health Care Sector	-1.68	-1.68	-8.28	-8.53	-12.42	-7.97	-4.82
Financials Sector	3.21	3.21	15.11	19.25	16.85	19.44	16.58
Information Technology Sector	-0.38	-0.38	14.81	-2.66	-1.38	-23.88	-2.33
Telecommunication Services Sector	7.92	7.92	31.36	19.25	14.63	0.75	16.88
Utilities Sector	-5.79	-5.79	10.46	14.15	13.78	19.74	13.26

**S&P/TSX Composite Sector Performance**  
Quarter Ending March 31, 2007



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The Report Writers solution retains all Generator functionality in some form, either directly or through similar functionality in Workbench. Through Report Writers, you still have access to performance returns, market values, cash flows, standard deviations, equity and fixed-income security level analytics with earnings estimates, corporate fundamentals, index returns and descriptive data as well as multiple asset classes.

As part of our commitment to ongoing improvements to the product, we will, during 2007, issue multiple releases and additions to Report Writers capabilities. MAS is building a single, integrated query and report-writing capability that can be used on any type of data, whether it is related to accounting, transactions or performance. In June, we plan to add accounting holdings and transactions data. From an analytics perspective, MAS anticipates releasing summary level analytics data in June. This will complement the existing performance data and security level analytics and enable you to combine performance and analytics data into the same report for the first time. We are also planning to add both granularity and periodicity to the performance data with Daily and Security level return information.

For more information on this new reporting tool, please contact your Relationship Manager or Shawn Menard at 416-643-6400.

### Have You Registered for the Mellon Analytical Solutions Client Conference?

This year's Mellon Analytical Solutions Client Conference will be held in Charleston, North Carolina from May 21 to 23. This conference has proven to be a great networking and educational opportunity for all our clients.

Conference invitations were sent in March. If you have not received your invitation and are interested in attending, please visit our website to quickly access the latest information: [www.mellon.com/mas2007](http://www.mellon.com/mas2007). If you have any conference-related questions, please contact our Conference Coordinator, Emily Whooley at: [whooley.e@mellon.com](mailto:whooley.e@mellon.com) or 617-381-9403.

We look forward to seeing you in Charleston.