

Investment Outlook

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The U.S. stock market's struggle for direction

BY R.J. GORMAN, CFA, CHIEF PORTFOLIO STRATEGIST, TD WATERHOUSE

The most vexing asset class for many investors in recent years has been U.S. equities. Long a source of relatively consistent, high returns, U.S. stocks, which have historically enjoyed high returns, have lagged throughout this decade. The chart on the following page illustrates this point.

Since peaking in 2000, the Standard & Poor's (S&P) 500 index fell for two years until the fall of 2002 and has struggled to recoup lost ground since then. In fact, the S&P 500 is still below its highest level reached in 2000 and for Canadian investors, the news has been worse. Due to the rise of the Canadian dollar in recent years, which has the effect of reducing the returns of foreign investments, the S&P 500 lost 6.73% per year, expressed in Canadian dollars, in the six years ending in mid-2006.

Fortunately, Private Investment Counsel clients have generally not been greatly affected by the lacklustre U.S. stock market. Client portfolios have typically been heavily overweight in Canadian stocks, taking advantage of strength in our home market, and have had relatively modest U.S. exposure.

What's ahead for the U.S. stock market? Are we in for more of the same or a change in direction? Strong countervailing forces are giving rise to sharply differing points of view.

The bear's case

It is not difficult to construct a bearish case for U.S. stocks in 2007. First, the flattening of the yield curve, which we have written about in past editions, has come to pass. This means that short-term interest rates, such as those of three-month



The bottom line is that your portfolio holds high-calibre companies that are well positioned for the year ahead.

Treasury Bills, have risen to equal longer-term rates of 10-year bonds, for example. This is important because a flat yield curve could typically indicate a slowdown in economic growth in the coming months. Notably, those same short-term rates have recently exceeded longer-term rates, causing a mildly inverted yield curve.

This is potentially ominous since an inverted yield curve, and the accompanying tight credit conditions, very often mean a looming recession. While neither the extent nor duration of the yield curve's inversion to date dictates a recession, we are monitoring this development very closely.

Second, the downturn in the U.S. housing sector, cited in our January forecast issue, is

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The U.S. stock market's struggle for direction

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upon us. Since housing is more sensitive to the availability and cost of credit, the above-mentioned rise in interest rates has made itself felt first in the residential real estate market. In short, house sales are down, inventories of unsold homes are up, prices have fallen in some markets and foreclosure activity is up. At the same time, U.S. homeowners' refinancing of their homes, which accounted for as much as two percentage points of growth in consumer spending, is declining and will be a drag on economic growth.

And since the U.S. real estate boom has accounted for a high percentage of new jobs in recent years, its decline could have widespread fallout.

Third, corporate America has consistently generated double-digit profit growth over the past three years. As economic growth slows to the 2% range in early 2007, profits could fall and result in share price weakness.

The bull's case

First among positive factors for the U.S. stock market is valuation. Even as U.S. corporate profits have risen briskly, the price/earnings (P/E) multiple that investors have assigned to U.S. stocks has fallen from about 30

in 2000 to 15-17 today. This is a very reasonable valuation by any standard.

Second, U.S. stock valuations are also attractive versus fixed income alternatives. Bond yields have fallen in recent years, so even as falling P/E multiples have made stocks cheaper, bonds have become more expensive. So stocks could be good value compared with fixed income options.

Third is monetary policy. We expect short-term U.S. interest rates to plateau this fall and begin to decline either late this year or early next. This is very important. Just as rising short-term rates have compressed P/E multiples in recent years and are prompting slower growth in the U.S., we expect that easing monetary policy will be beneficial for the stock market.

The fourth point pertains to the relationship between financial markets and politics. Long-time readers may recall past references to the U.S. presidential cycle. Put simply, this refers to the behaviour of the stock market in the four years of each presidential term.

In brief, based on our review of Standard & Poor's data from its inception in 1927, U.S. stocks tend to make little progress in the first two years of

a presidency and perform well in the second half of the term. Why? Essentially, because harsh medicine in the form of monetary policy and the legislative agenda is doled out shortly after the presidential election and eases in the second half of the term as the next election approaches. While historical tendencies should not be relied upon, the easing monetary policy we foresee supports the view that 2007, the third year of the current presidential term, should be positive for the U.S. stock market.

Fifth, while we believe the housing slowdown will be a significant problem, especially in coastal markets such as Florida and California, it should not precipitate a recession. More likely, we will see a slowdown in economic and corporate profit growth.

Finally, currency risk should not be the factor it has been over the past three years. Most of the Canadian dollar's appreciation is likely behind us. If commodity prices retreat as the U.S. economy slows, the Canadian currency might slip against the greenback.

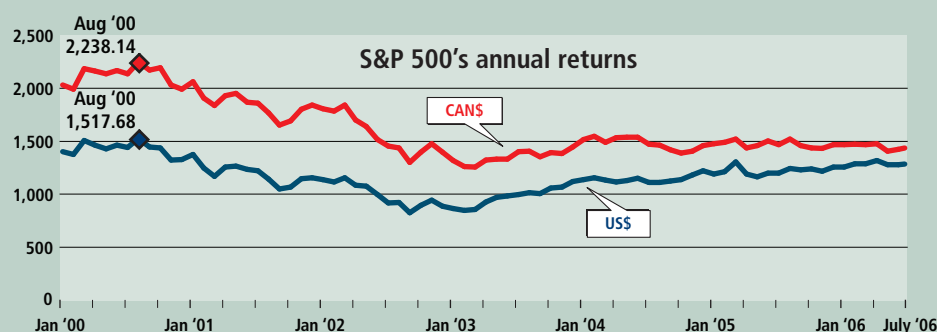
The bottom line

On balance, we believe that the positive factors outweigh the negative and that the U.S. equity markets will rise for a fifth consecutive calendar year in 2007. The principal risk to this forecast is that the U.S. Federal Reserve could elect to invert the yield curve for a sustained period, which would increase the odds of a recession.

Your portfolios have very little exposure to the U.S. housing sector, consumer durables manufacturers or the regional banks and sub-prime lenders which could be vulnerable to the real estate slowdown. Instead, you hold very high-calibre companies that are well positioned for the unfolding environment and which should serve you well in the year ahead. ■

S&P 500 struggles to reach its former high

U.S. stocks, which historically have enjoyed high returns, have been slowing down over the current decade. This trend lends to mixed predictions for the coming months, from an economic slowdown to a looming recession.



Source: Standard & Poor's Index Services S&P 500 Monthly Returns, July 31, 2006

2006 year-end tax planning for investors

As another year comes to a close, it's an opportune time to review your financial picture with your Portfolio Manager and to explore any year-end tax saving opportunities. Here are eight to consider.

1. Donate and save tax (changes for 2006)

Donations are not only a good way to give back to the community, but can also reduce the amount of taxes you pay. The tax savings can be quite substantial — for each dollar of donation in excess of \$200 each year, you can save anywhere from \$0.39 to \$0.48 in taxes, depending on your province of residence.

The maximum amount of donations you can claim each year is 75% of your net income (100% in the year of death and preceding year). You can carry forward any donations that you cannot or choose not to claim this year to any of the next five years. You may choose not to claim your donations this year if your total donations are less than \$200. In this case you may want to save your donation receipts until an amount greater than \$200 is collected in order to take advantage of the greater tax benefits provided to those donations over this threshold.

One of the most effective ways to

give to a registered charity (other than a private foundation) is to donate publicly listed securities (shares and bonds) and mutual funds and segregated funds that have appreciated in value. Starting May 2, 2006, if you donate these shares or mutual fund securities, you do not have to include any part of the gains as taxable income on your tax return, yet you are entitled to a donation tax receipt for the full value of these shares or securities.

Another effective donation strategy is to donate publicly listed securities acquired through the exercise of employee stock options. Typically when an individual exercises a stock option, he or she is required to pay tax on 50% of the increase in value between the strike price and the exercise price of the security, either in the year of exercise or a subsequent year. However, if the security is donated within 30 days of exercise, then no tax will be payable on the exercise of the stock options.

One way to benefit from the elimination of capital gains on donations of publicly listed securities is to set up a donor-advised account with the Private Giving Foundation (PGF). This allows you to develop a long-term strategic philanthropic plan and build a legacy of giving that may go on for future

generations. The PGF, a unique initiative of TD Waterhouse, is an independent public charity that allows you to enjoy many of the same benefits as a private foundation. Because you are contributing to an existing foundation, there are no upfront fees, legal, or administrative work, and it may be set up in less than 24 hours. Please contact your Portfolio Manager for more information.

2. Lower your taxes with dividend income (new for 2006)

The federal government has proposed to reduce the federal tax rates on dividends received by Canadian resident individuals from taxable Canadian public corporations after 2005. Several provinces have followed suit, announcing specific changes to their dividend tax rates as well.

3. Use the \$2,000 pension tax credit to reduce tax (new for 2006)

If you are age 65 or older this year, and do not receive pensions other than CPP/QPP, you may want to consider converting an RSP to a RIF to take advantage of the \$2,000 (vs. \$1,000 for 2005) pension tax credit. This non-refundable tax credit is worth

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Current Private Investment Counsel strategy

Portfolio weighting

- Modest overweight in equities
- Slight underweight in bonds, with a somewhat shorter term than benchmarks
- Overweight corporate bonds, where mandates permit
- Where applicable, income trust holdings focus on higher-quality issues with stable, sustainable distributions
- Overweight Asian holdings within international equities

Percentage return for indices

(For the period June 15, 2006 – September 15, 2006)

| | |
|------------------------------------|------|
| Scotia Capital Universe Bond Index | 3.1% |
| S&P/TSX Composite Index | 4.6% |
| S&P 500 Index | 5.6% |
| MSCI EAFE Index* | 8.3% |

* Morgan Stanley Capital International Europe, Australasia and Far East Index

2006 year-end tax planning for investors

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approximately \$460 (2006) in combined federal and provincial tax savings if used to offset the taxes payable on the first \$2,000 of RIF withdrawals.

4. Make RESP contributions

Don't forget to make your Registered Education Savings Plan (RESP) contributions before year-end. You can contribute up to \$4,000 per beneficiary each year. However, unlike RSP contribution room, you cannot carry forward this room to a future year (that is, you cannot contribute \$8,000 next year), and RESP contributions are not tax-deductible.

5. Realize capital losses to save tax

You may want to consider selling some of any unprofitable investments and using the resulting losses to offset capital gains realized this year or in any of the previous three years. This is commonly referred to as "tax loss selling."

The Canadian tax rules require that capital losses realized in a given year be used to offset the capital gains realized in that year first. If total losses exceed total gains, then any net losses can be carried back to offset net capital gains arising in any one or more of the previous three years, or the net losses can be carried forward indefinitely.

Before selling a security for a loss, be sure to consider its investment merits and its "fit" within your overall investment portfolio. Your Portfolio Manager can assist you in making this determination. You should also be aware of the "superfi-

cial loss" rules. These rules are designed to discourage the practice of selling a security for a loss, only to buy it back immediately afterwards.

The superficial loss rules require you to wait 30 calendar days (including weekends and holidays) before buying back the same security you sold earlier, in order to realize the loss. Otherwise the loss cannot be claimed, but it does not disappear and is added to the cost of the repurchased security. This has the effect of reducing any future capital gains arising from the later sale of the security.

The date that a security is bought or sold for Canadian tax purposes is its settlement date. For Canadian and U.S. stocks and most mutual funds (except money market funds), a three-day settlement is used. For Canadian and U.S. options and most money market mutual funds, a one-day settlement is used.

The 30-day waiting period applies when an individual sells a security and his or her spouse or common-law partner, or a company controlled by either one or both of them, buys back that same security within the 60-day window period. In this case, the amount of the loss will be added to the cost of the security repurchased by the spouse, common-law partner, or company.

6. Trigger capital gains in in-trust accounts

You may actually want to realize capital gains this year if you have established in-trust accounts for a child or grandchild,

who is a minor. Capital gains realized in an in-trust account can be taxed in the hands of the minor child or grandchild, if the account is properly structured. If the child or grandchild has little or no other income, approximately \$16,000 of capital gains can be realized in 2006 before the child has to pay tax.

7. Pay your deductible expenses before year-end

If you are looking to claim certain deductible expenses such as safety deposit box fees, investment management fees, certain accounting and legal fees, tuition fees, childcare expenses, spousal support payments or medical expenses, you should make sure you pay them before year-end so you can deduct them on your 2006 tax return.

8. Time your move to save tax

If you are moving to another province for whatever reason, you may want to time your move to save tax. Your provincial tax liability is generally based on your province of residence on December 31. Since provincial tax rates vary from province to province it may make tax sense to accelerate or hold off your move until early 2007. ■

If you are interested in using a tax preparation and planning service, please contact your Portfolio Manager who would be pleased to arrange this service, which is available for TD Private Client Group clients through Tax Services†.*

The information in this newsletter is current at September 15, 2006.

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