

PERSPECTIVES

An exclusive report from TD Waterhouse Private Investment Counsel Inc.

Turning of the Tide

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The Canadian stock market has performed well in recent years, generating good returns for investors and out-distancing the U.S. equity market by a wide margin. Based on our reading of both the fundamentals and the currency situation, most client accounts have, where mandates permit, been very heavily weighted in Canadian stocks, which has proven beneficial for clients. **Our research suggests that changes in financial markets are at hand and it is time to change tactics accordingly.**

Canada's Out-Performance

For the five years from 2002 through 2006, the S&P/TSX Composite Index ("S&P/TSX Composite") has risen much more rapidly than its American counterpart, the S&P 500 Index ("S&P 500"). Specifically, the S&P/TSX Composite rose 10.92% per year, expressed in Canadian dollars, over that five-year period, while the S&P 500 inched ahead a more modest 4.32% per annum, expressed in U.S. dollars. For Canadian investors, those figures tell only part of the story. Due to the sharp rise of the Canadian dollar versus the greenback, which commenced in 2002, U.S. dollar denominated investments have not performed as well when expressed in Canadian currency. To be precise, when looked at in Canadian dollar terms, the S&P 500's return over the five years ending December 31, 2006 was -2.00% per year, almost 13 percentage points below the S&P/TSX Composite annual return. Chart 1 illustrates the difference in performance.

Canada's stock market out-performance over this period has reflected a sharp rise in commodity prices, brought about by the first period of synchronized global economic growth since the '90s. This growth, particularly

from the emerging economies of China and India, stimulated demand for commodities, especially oil and metals such as copper, nickel etc. The TD Commodity Index, depicted in Chart 2, tells the tale, roughly tripling over the five years in question. Not surprisingly, these higher prices increased the profitability and share prices of Canadian producers and, since resource companies comprise almost half the Canadian stock market, propelled the S&P/TSX Composite higher. In contrast, the American equity market has much more modest exposure to commodities and the U.S. is a net importer of oil, which adversely affected other segments of the American economy and shares prices.

The Road Ahead

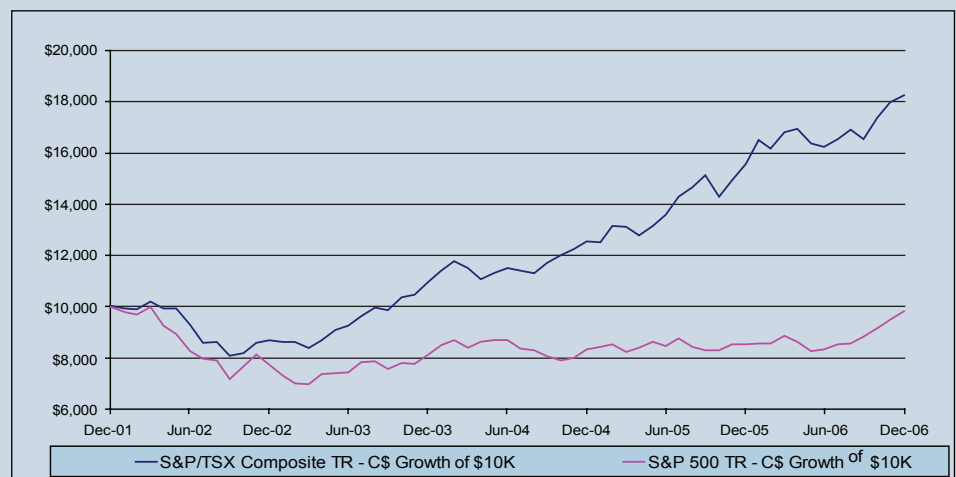
While the S&P/TSX Composite continued to out-perform the S&P 500 in 2006, though by a much narrower margin than

in the previous four years, we believe a change is at hand and U.S. stock market returns should exceed Canada's in 2007.

Why? **First**, Canadian stocks will not likely have the impetus of rising commodity prices in 2007, reflecting a moderation in demand caused by slower economic growth. At the same time, lower oil prices will be a net benefit for the American economy, corporate profits and stock market. **Second**, we anticipate that later in 2007, short-term interest rates may dip in the U.S. to a greater extent than rates in Canada, aiding stocks south of the border more than our own. **Third**, the valuation advantage Canadian stocks have enjoyed has disappeared and, at best, Canadian shares are no cheaper than those in the U.S. The well-documented difficulties in U.S. housing should not precipitate a recession and history suggests 2007's position in the presidential cycle may prove beneficial.

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Chart 1- S&P/TSX and S&P500, Growth of \$10,000 (Cdn)



Source: Bloomberg

The Currency Effect

One of the chief concerns voiced by investors regarding U.S. investments is currency. If U.S. equity returns over the past five years have been wiped out by a strengthening Canadian dollar, what's to prevent the same from happening in the future? In short, the answer lies in commodity prices. If we overlay the recent history of the Canadian dollar on top of the TD Commodity Index price chart – see Chart 3 – you find there is a very high correlation between the two. Where commodity prices go, our currency follows. We have felt that commodity prices would moderate and Canadian dollar would retreat from its high of 91 U.S. cents to a range approximating fair value in the mid-eighties, which is where the Canadian dollar is today. **We do not foresee a dramatic surge in Canadian dollar, so currency issues should not detract from U.S. equity returns in the year ahead.**

Chart 2 - Canadian Dollar & TD Commodity Price Index

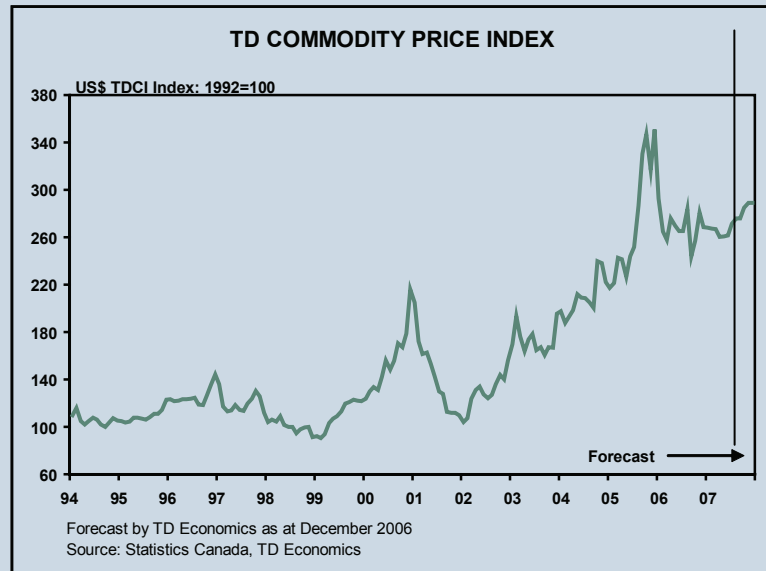
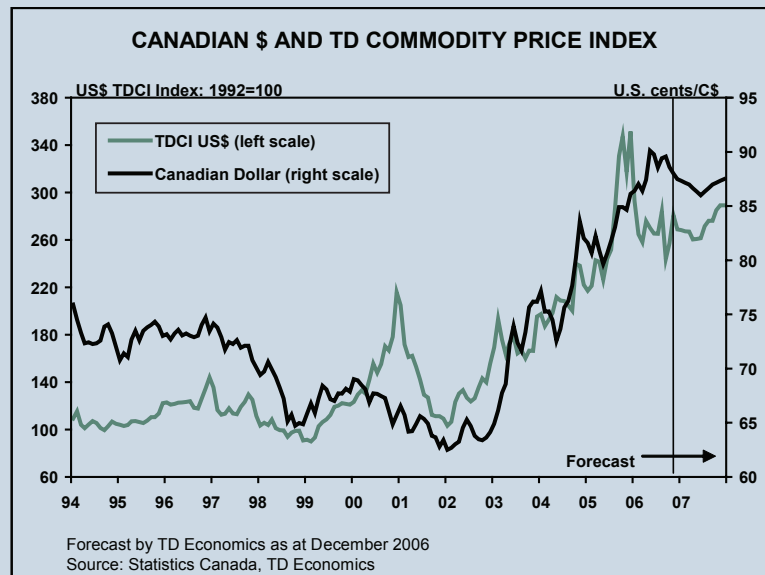


Chart 3 - Canadian Dollar Shares Strong Bond with Commodities



Taking Action

There are many good reasons for Canadian investors to have major holdings in Canadian companies. Their familiarity and the resultant level of comfort with the stocks plus the dividend tax credit are among them. At the same time, while commodity prices should moderate, we believe they will remain high by historical standards and at profitable levels for most producers. Therefore, we expect Canadian stocks to generate solid returns, just not as high as those in recent years or in the U.S. **The result is that, where mandates warrant, we will take profits, trimming our overweight position in Canadian stocks to adopt a more neutral stance vis a vis our U.S. weight.** The major international markets of Europe and Japan also present opportunities and in some instances, their positions may be increased as well.

We are taking these proactive steps to seek to enhance your returns, maintain effective diversification within your portfolios and control risk. Should you want to explore these measures further, do not hesitate to contact your Private Investment Counsel professionals.

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

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