MacNicol & Associates Asset Management Inc.

OVERVIEW

There is no question that the financial fallout from the U.S. sub prime mortgage fiasco facing credit markets will negatively impact global growth.

1) will the U.S. enter a recession as the credit crunch spreads beyond sub prime mortgages to affect regular mortgages, credit cards, automobile loans, commercial property as well as rippling across the pond to impact G7 economies, and

2) to what degree can the ascension of China as a dominant economic power offset the anchor posed by the U.S. housing contraction?

The Fed on the other hand, may be telling us that they are as much in the fog as to what lurks around the corner as anyone else.

Growth in Europe and Japan also appear to be decelerating after experiencing a strong third quarter.

In one of the biggest acts of coordinated economic co-operation since 9/11, global central bankers have joined with the U.S. Federal Reserve in an audacious attempt to ease choked credit markets by unleashing a tsunami of liquidity into the financial system. This liquefying policy should help to stabilize the financial system.

UNITED STATES

The U.S. economy and its policymakers will continue to be preoccupied with the fallout from the sub prime crisis.

The credit crunch which has evolved from this mess is expected to slow GDP growth and has increased the probability of a recession.

Despite all this, economic indicators are not pointing to an economic meltdown, and the Fed remains accommodative.

Leading indicators are pointing to a stretch of very slow growth, not recession, and the export market has been helping to narrow the trade deficit.

The Bank Credit Analyst further points out that “many financial variables such as bond yields and foreign exchange rates have already made adjustments that should help shore up the economy”.

The mending process will be slow, painful, and in the end probably affect most sectors of the economy.

CANADA

We may have missed the recession that hit the U.S. economy in 2001, but odds are that we would not escape unscathed this time around.

Thirty five percent of Canadian GDP is exported, and the U.S. remains our most important trading partner.

A strong dollar, which ended the year up 17%, will present challenges to our manufacturing and export industries.

We made a policy decision to be mostly out of the U.S. dollar since 2001.

Canada’s housing market is not only holding up well, but is actually exceeding expectations.

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CHINA/ASIA
According to the World Bank, China has now overtaken the U.S. in manufacturing output, has become the second largest auto market and has surpassed Japan as the globe's second largest importer of petroleum.

COMMODITIES
With the driving foot firmly on the inflationary pedal and central banks looking to reduce their U.S. dollars holdings, gold is clearly in an upward trend.
A recent survey done by Barclay's Capital found that 45% of the respondents said that the agricultural sector would deliver the highest returns of all commodities in 2008.

RECOMMENDATIONS
We continue to like Canada and the Emerging Markets, and to a lesser extent Europe.
The ongoing transfer of wealth from financial paper assets to tangible assets, otherwise known as "store of value" assets, is a trend which will continue to positively impact commodities.
With regards to specific sectors, we continue to recommend minimal exposure to banks, preferring the insurance companies.
Soaring food costs are becoming a global phenomenon and the agricultural sector will provide opportunities.
We like gold as a hedge against inflation, a weaker U.S. dollar and political uncertainty.
Natural gas may become an interesting commodity.
Within our fixed income portfolios, we continue to recommend a short duration (2 – 3 years).
The reflationary program being undertaken by the global central banks should ultimately lead to higher interest rates, penalizing longer term bonds.

The year 2008, in particular the first half, is shaping up to be a very challenging year.
Preservation of capital will be paramount.
Volatility and uncertainty usually present opportunities.
Various parts of the global economy continue to do rather well and may prove to be immune or less affected by the credit turmoil.
As long as the U.S. economy avoids a serious slowdown, we remain cautiously optimistic.

There is an excellent article in the February 2008 edition of HARPER'S – "The Next Bubble – Priming the Markets for Tomorrow's Big Crash" by Eric Janszen that is available on our website www.maam.ca. If you would like us to mail you a copy please give us a call.

Finally, the following "Strategic Review" is courtesy of Mr. Ross Healy of Strategic Analysis Corporation (SAC). Ross and his team at SAC are an integral part of our trusted network. I thought you might find it informative.

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