

Weekly Market Strategy

March 8, 2010

Canadian Equity Strategy

CANADIAN NATURAL RESOURCES – Q4 CASH FLOW ABOVE EXPECTATIONS

Last week Canadian Natural Resources, one of Canada's largest exploration and energy production companies reported earnings. Below we provide commentary on the quarter from Mark Polak, Scotia Capital's senior energy analyst.

Canadian Natural Resources (CNQ) reported Q4 cash flow per share (CFPS) of \$3.14 slightly above Scotia's estimate of \$2.86 and street consensus of \$2.92. Production came in at 575 thousand barrels of oil equivalent per day (Mboe/d), in-line with Scotia's estimate of 568 Mboe/d and Street consensus of 577 Mboe/d. Quarter over quarter production was flat as the company met Q4 guidance of 561- 597 Mboe/d from higher natural gas and lower oil production.

There was no change to 2010 production guidance of 586 - 643 Mboe/d and capital spending of \$3.9 billion. The company layered on an additional 100 thousand barrels per day (Mbbbl/d) of crude oil hedges and has effectively hedged about 45% of its oil production utilizing various crude collars between ~\$60-\$100/bbl.

Horizon Production Disappoints - After averaging 66.9 Mbbbl/d in Q3, Horizon production rose only slightly to 70.2 Mbbbl/d last quarter. This was at the low end of its guidance of 70-85 Mbbbl/d. The company made good progress, with 71 Mbbbl/d in October and record production of 97 Mbbbl/d in November (capacity is 110 Mbbbl/d). However, equipment reliability challenges in the Hydrogen plant and downtime relating to a Coker furnace caused an extended shut down, resulting in December production of 42 Mbbbl/d.

Production is ramping back up and averaged 72 Mbbbl/d in January and 84 Mbbbl/d in February. Going forward, CNQ will be adopting the same monthly production reporting as Suncor and Canadian Oil Sands Trust. We view this as slightly positive as it will result in fewer quarterly surprises. The company continues to expect to reach 110 Mbbbl/d on a sustained basis by mid 2010.

Horizon operating expenses were \$40 per barrel for the year, which were reasonable given ramping up of the project and operational mishaps in 2H/09. For comparison, other mining projects, such as Suncor and Syncrude, averaged ~\$35 per barrel in 2009. CNQ expects Horizon operating expenses to average \$31-\$37 per barrel in 2010 while Suncor expects \$35-\$39 per barrel and Syncrude at \$35 per barrel.

Stock Split and Dividend Increase - The Board approved another 2 for 1 stock split which is subject to shareholder approval at its Annual General Meeting on May 6. This is the fourth time that the company has split its stock, following 2 for 1 splits in May 2005, May 2004 and June 1993.

With an estimated \$2.6 billion and \$2.3 billion in free cash flow in 2010 and 2011, respectively, the company has increased quarterly dividend by 43% to \$0.15 per share from \$0.105 per share, payable April 1. The Board has also approved and filed a normal course issuer bid to purchase up to 2.5% of its issued and outstanding common shares.

Year-End North American Benchmark Information

	Recent	2010F	2011F
S&P/TSX Composite Index			
TSX Level/Target	11,975.14		12,750
TSX Earnings	\$546.81	\$775.00	\$850.00
TSX P/E	21.90	16.45	N/A
TSX Dividends	\$318.38	N/A	N/A
TSX Yield	2.66%	N/A	N/A
S&P 500			
S&P 500 Level/Target	1,138.70		1,225
S&P 500 Earnings	\$62.46	\$75.00	\$82.00
S&P 500 P/E	18.23	16.33	N/A
S&P 500 Dividends	\$22.49	N/A	N/A
S&P 500 Yield	1.98%	N/A	N/A
Fixed Income & Currency			
BoC Overnight Rate	0.25%	1.25%	2.25%
Canada 10-Year Bond	3.468%	4.50%	4.50%
Cdn/U.S. Dollar	\$1.0288	\$0.99	\$0.96
U.S. Fed Funds Rate	0.25%	1.25%	2.25%
U.S. 10-Year Treasury	3.679%	4.80%	4.80%
U.S. Dollar/Euro	\$1.3626	US\$1.53	US\$1.48
Commodities			
Gold	\$1,134.65	US\$1100.00	US\$1250.00
Oil (WTI)	\$81.50	US\$90.00	US\$92.00

Source: Scotia Capital, Bloomberg.

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CNQ continues to reduce total debt now at \$9.6 billion from \$10.6 billion in Q3/09, with a debt to capital ratio of 33% below its targeted levels of 35 - 45%. Scotia estimates net debt to 2010 cash flow of 1.2x versus the group average of 0.9x

Scotia maintains its 1-Sector Outperform rating on CNQ and one-year target of \$92. The stock is also on the Portfolio Advisory Group's Canadian Recommended List.

Gareth Watson, CFA – *Director, Portfolio Advisory Group*

U.S. Equity Strategy

Results were mixed for international equity markets in February with North American stocks outperforming their European peers as the risk of a sovereign debt crisis hangs heavy over the European economy and market. Much of the stock markets attention last month was focused on Greece where public finances are in shambles. There are concerns the crisis could spread to other countries in Europe including Ireland, Spain, Portugal and even the U.K. For this reason, Greece and its European partners will do what is necessary to keep the country from defaulting.

U.K. stocks outperformed markets on the continent. A reminder the U.K. chose not to join the European Monetary Union and adopt the common currency. However, U.K. finances are not in good shape either and in fact the country may have a larger sovereign debt problem than Portugal, Ireland, Italy, Greece and Spain. The U.K. has a weak economy, its debt to GDP ratio is just behind Japan's, there is a possibility of a hung parliament, and the Bank of England has been funding much of the deficit (which cannot last forever). Credit Suisse estimates fiscal tightening in the U.K. has to be equivalent to 7-8% of GDP just to stabilize government debt relative to GDP.

Currency generally weighed on returns for Canadian investors last month, materially so in the case of the U.K. as the British pound fell sharply against the Canadian dollar. While the London FTSE was a relatively solid performer gaining 3.2% in local terms, on a currency adjusted basis the index fell 3.3%. The Loonie also rose against the euro, Hong Kong and Aussie dollars, resulting in foreign currency losses for investments in those regions, but fell against the Mexican peso and Brazilian real.

As for U.S. sectors, eight of 10 finished the month higher led by Consumer Discretionary, Industrials, Materials, and Technology. Telecommunications and Utilities were the laggards. Materials and technology benefited from a reacceleration in M&A activity. Announced mergers and acquisitions of U.S. companies have totalled more than US\$125 billion in the first two months of the year. By month end, 482 of 500 companies in the S&P 500 had reported earnings. Almost 73% of companies reported positive earnings surprise, a downtick from Q3, but still above long-run averages. Adjusted Q4 earnings were US\$16.78 for the S&P 500, largely unchanged from Q3 with reported earnings of US\$16.90.

Almost 75% of the stocks in the S&P 500 finished the month higher. Airgas Inc. (ARG), Cliffs Natural Resources (CLF), and Millipore Corp. (MIL) were the three gainers. Airgas popped after receiving a takeover offer from rival Air Products (APD). Shares of Cliffs Natural Resources jumped 41% after North America's largest iron-ore producer posted earnings that doubled expectations. Millipore soared 37% after Thermo Fisher Scientific (TMO) agreed to buy the medical device maker for approximately US\$6 billion. Other notable movers included JDS Uniphase (JDSU), Office Depot (ODP), and Coca Cola Enterprises (CCE). Coca Cola (KO) agreed to buy assets North American distribution and bottling assets from CCE. The biggest decliners last month were H&R Block (HRB), Dean Foods Co. (DF), and New York Times (NYT). Shares of H&R Block and Dean Foods fell after lowering earnings guidance.

Paul Danesi, CIM – *Director, Portfolio Advisory Group*

Economic Outlook

In the U.S. last week, there was a significant amount of economic data released, but the focus was on the monthly employment report. The headline employment report for February came in at -36,000, which was worse than the previous month, however was still above the expectations which called for a 68,000 contraction, due to the heavy snow storms. The BLS noted that severe winter storms that hit the U.S. in February “may have affected payroll employment and hours; however, it is not possible to quantify precisely the net impact of the winter storms on these measures.” The unemployment rate stayed unchanged at 9.7%. In other news, pending home sales both month over month and year over year were down to -7.6% from 1% and 8.8% from 10.5% respectively. Personal Consumption and Expenditure data both month over month and year over year were down by 0.1% each, at 0% and 1.4% respectively, and ABC Consumer confidence was slightly better at -49 from -50.

In Canada last week, GDP month over month rose by 0.2% to 0.6% in December while quarterly GDP rose to 5% from 0.4% marking the biggest quarterly increase in nine years. The majority of this growth came from consumers, builders, exporters and governments. The Bank of Canada left its target for the overnight rate unchanged at 0.25% with mention that the growth and inflation have been higher than policy makers expected. On top of this, employment plans are picking up, and hiring is expected to increase over the next three to four months. However, the conditional commitment to leave rates unchanged until the end of the second quarter of 2010 remains in place. Business sentiment and confidence in Canada is also gaining positive momentum as small and mid-sized business confidence improved in 10 of 13 industries in February. Building permits month over month fell to -4.9% from 2.4% previously.

Last week Ottawa presented the Federal Budget for 2011 fiscal year. The deficit for fiscal 2010 (ending March 31) is expected to be \$54 billion versus the \$56 billion September estimate. A \$49 billion shortfall is projected for Fiscal 2011, and deficits of \$28 billion, \$18 billion and \$9 billion are forecast in the following three years, a very minor \$2 billion shortfall is forecast for fiscal 2015, and balanced books are expected to return in 2016. The deficit reduction strategy includes no tax increases, as plans remain to reduce the corporate income tax rate to 15% by 2012. According to Scotia Economics, the FY11 shortfall, at 3.0% of GDP, will remain the envy of our G7 partners as will Ottawa’s net debt, peaking at just over 35% of GDP in FY11 and FY12.

Scotia Economics also highlighted as a centre-piece of the Budget is making Canada a tariff-free zone for industrial manufacturers, a first among the G-20. All remaining tariffs on manufacturing inputs and machinery & equipment will be eliminated by January 1, 2015, with most removed immediately. Nonetheless, they saw the market reaction to this budget as muted, with many of the factors driving the near-term deficits already known. Canada’s fiscal advantage relative to most of its trading partners is well known, and would allow some unexpected slippage in the deficit reduction path. Scotia Economics does believe there will, however, be significant impact on industry from the decision to make Canada a tariff-free zone, as well as from the measures to close perceived tax loopholes.

This week in the U.S. wholesale trade and the treasury statement will come out on Wednesday, Trade balance comes out on Thursday, and consumer sentiment, retail sales and business inventories will be released on Friday. In Canada, housing starts comes out on Monday, while new housing price index and the employment and unemployment rate will be come out at the end of the week.

Amy Billingham – Associate, Portfolio Advisory Group – Fixed Income

Equity Indices - Weekly Performance

Equity Index	Close	Weekly Change		YTD Return
	03/05/2010	Points	%	%
S&P/TSX Composite Index	11975.14	345.51	+3.0%	1.95%
Dow Jones Industrial Avg.	10566.2	240.94	+2.3%	1.32%
S&P 500	1138.7	34.21	+3.1%	2.12%
Nasdaq Composite	2326.35	88.09	+3.9%	2.52%
FTSE-100 (London)	5599.76	245.24	+4.6%	3.45%
CAC-40 (Paris)	3910.42	201.62	+5.4%	-0.66%
DAX (Frankfort)	5877.36	278.90	+5.0%	-1.34%
Nikkei (Tokyo)	10368.96	242.93	+2.4%	-1.68%
Hang Seng (H.K.)	20787.97	179.27	+0.9%	-4.96%

Fixed Income Strategy

RENEWED APPETITE FOR RISK; GOVERNMENT BONDS WEAKEN AS EQUITIES RALLY

U.S. Treasuries sold off as investor were buying riskier assets. As most major U.S. equity indices finished the week with a positive print, U.S. Treasury yields rose by 0.05% to 0.08% on the front end of the curve while long Treasury yields rose by 0.09%. The renewed appetite for risk was partly due to a series of positive economic releases, including Nonfarm Payrolls coming in better than expected at -36,000 when the market was anticipating a loss of -68,000 jobs. The unemployment rate remained unchanged at 9.7% in February.

Government of Canada bonds weakened on the back of strong corporate earnings and a much better than expected Q4 Gross Domestic Product (GDP). Yields on shorter term bonds rose by 0.08% to 0.27% whereas 30-year Canada bond yields rose by 0.04%. Q4 GDP was reported at 5.0% versus a predicted 4.2%, while GDP rose 0.6% month-over-month in December when the consensus was calling for a positive 0.4% print. Canada also had a very strong 5-year bond auction last Wednesday as the 2.5% coupon bond due June 1st 2015 became the new benchmark.

There were a lot of central bank activity across the globe, which hinted towards the normalization of monetary policy.

The European Central Bank and the Bank of England kept their benchmark interest rates unchanged at 1.0% and 0.5% respectively as the market anticipated. The Reserve Bank of Australia hiked their rates by 0.25% on March 2nd to 4.0%. As expected, the Bank of Canada (BoC) left the overnight rate unchanged at 0.25% and they reiterated their conditional commitment to remain on hold until the end of June 2010. In other news, Ottawa presented the budget for the 2011 fiscal year as the government focuses on reducing the deficit by cutting down expenditures and relying on economic growth. The federal government is anticipating a \$49 billion budget deficit for 2010-2011, but lower deficits going forward, ending at a \$2 billion deficit for fiscal 2015. At \$49 billion, the deficit is just 3.0% of our GDP and will bring the total federal debt to \$567 billion, just over 35% of domestic output and putting Canada in an enviable position compared to the other G7 nations. The BoC is expecting for GDP to advance at an average annual rate of 2.5% from 2011 to 2013.

In the corporate bond market, Canadian spreads were modestly tighter and the focus was on new issue activity. Credit spreads (yield pickup over the benchmark) narrowed by approximately 0.02% to 0.04% across all sectors. The cable and telecommunication sector outperformed in response to the Canadian government's announcement that they would start looking into deregulating foreign ownership. Meanwhile, selective credit spread tightening was seen in non-bank asset-backed-securities and long dated corporate bonds. On the other hand, bank spreads were modestly wider in spite of much better than expected Q1 results. On the new issue front, we had 3 deals in 3 days with Citigroup Finance Canada raising \$250 million of 3-year notes, Enbridge Inc. issuing \$500 million of 10-year notes and Brookfield Asset Management Inc. doing a \$300 million deal of bonds due in September 2016.

Supply will be the focus for the week ahead. Canada will auction \$3 billion of 2-year notes while trade balance and job numbers will also be released this week. In the US, the Treasury Department will auction \$74 billion in bonds beginning Tuesday (3-year, 10-year and longs), while trade data and retail sales will also be out.

Canadian Bond Yields - Weekly Change

	Mar 5	Feb 26	Change (bps)
Canada 2-Year Bond	1.51	1.28	23
Canada 10-Year Bond	3.47	3.39	8
Canada 30-Year Bond	4.06	4.02	4
BoC Target Overnight	0.25	0.25	0
Prime	2.25	2.25	0
U.S. 2-Year Bond	0.90	0.82	8
U.S. 10-Year Bond	3.68	3.61	7
U.S. 30-Year Bond	4.64	4.56	8
Federal Funds	0.25	0.25	0
Prime	3.25	3.25	0

Source: Bloomberg

Bond Index Performance (YTD)

	Mar 5	Feb 26	Change (bps)
DEX Universe Bond Index	2.00%	2.00%	0.00%
DEX All Government Bond Index	1.00%	2.00%	-1.00%
DEX All Corporate Bond Index	2.00%	3.00%	-1.00%

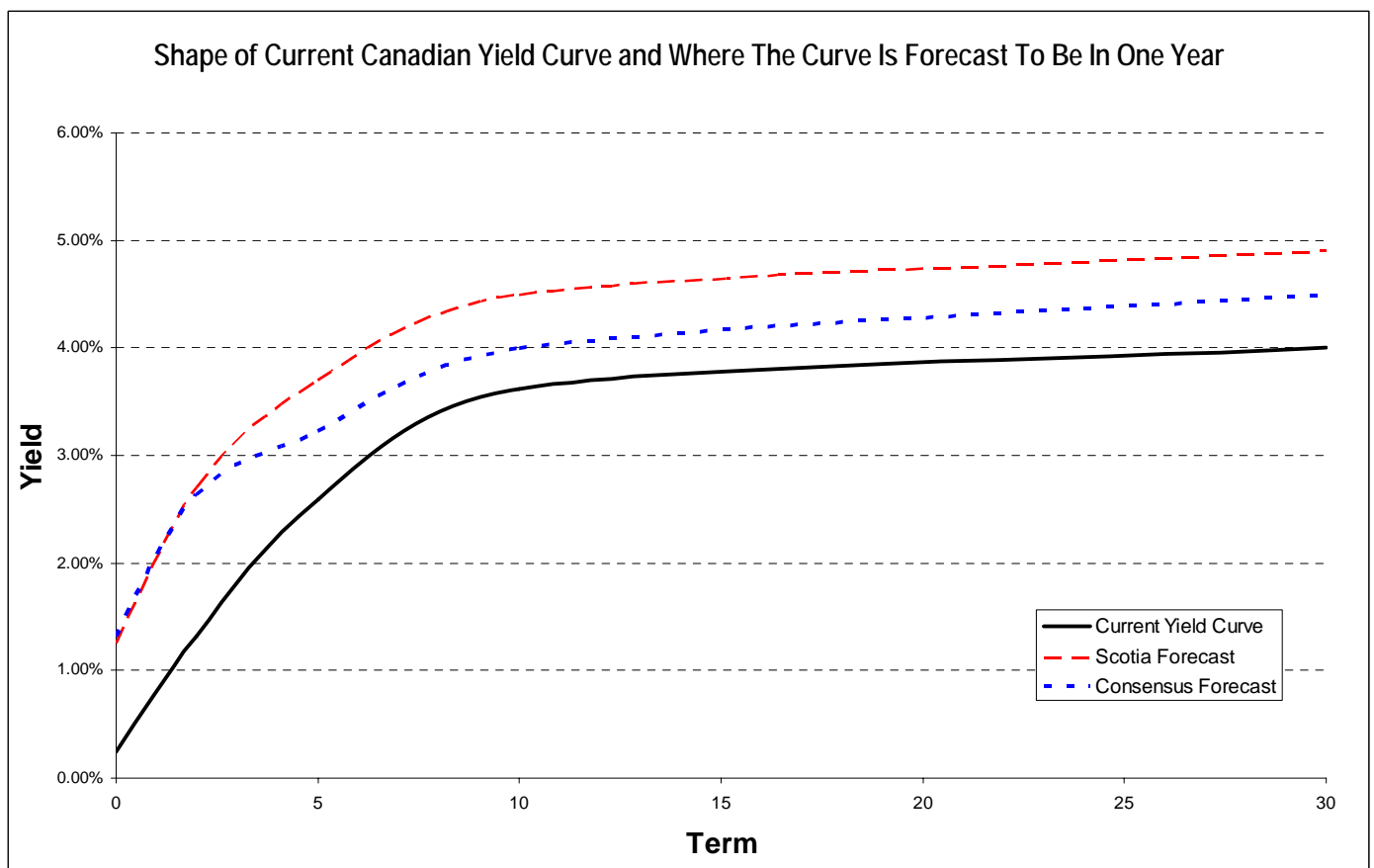
Source: PC-Bond

Portfolio Advisory Group Fixed Income – Current Recommendations (changes in blue)

1. Term Call – below benchmark duration; overweight cash
2. Sector Call – Underweight Canadas, overweight provincials, municipals and corporates
3. Currency Call – Recent strength in the Canadian dollar means little upside to foreign currency trades
4. Alternative Strategies – overweight high yield, overweight Emerging Markets Debt, underweight inflation protected.

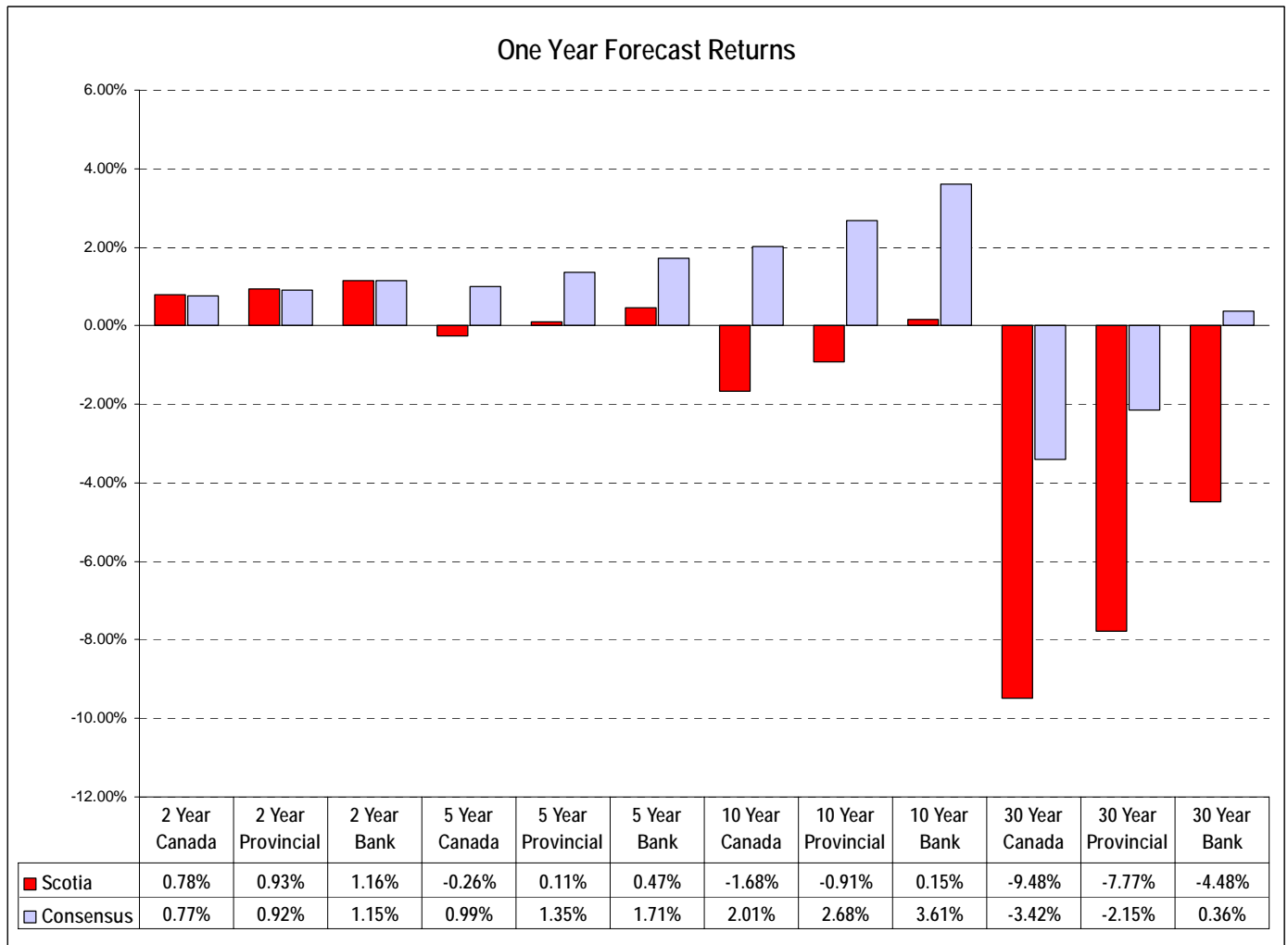
Portfolio Advisory Group Fixed Income – Current Recommendations (changes in blue)

1. **Term Call** – With both Scotia Economics and Bloomberg Consensus forecasts calling for bond yields to rise across the spectrum over the next 12 months, maturities beyond 5-years are expected to post negative returns over the next 12 months. We therefore recommend active investors remain in the very short end of the maturity spectrum, or in cash.



Source: Scotia Economics and Bloomberg

Weekly Market Strategy

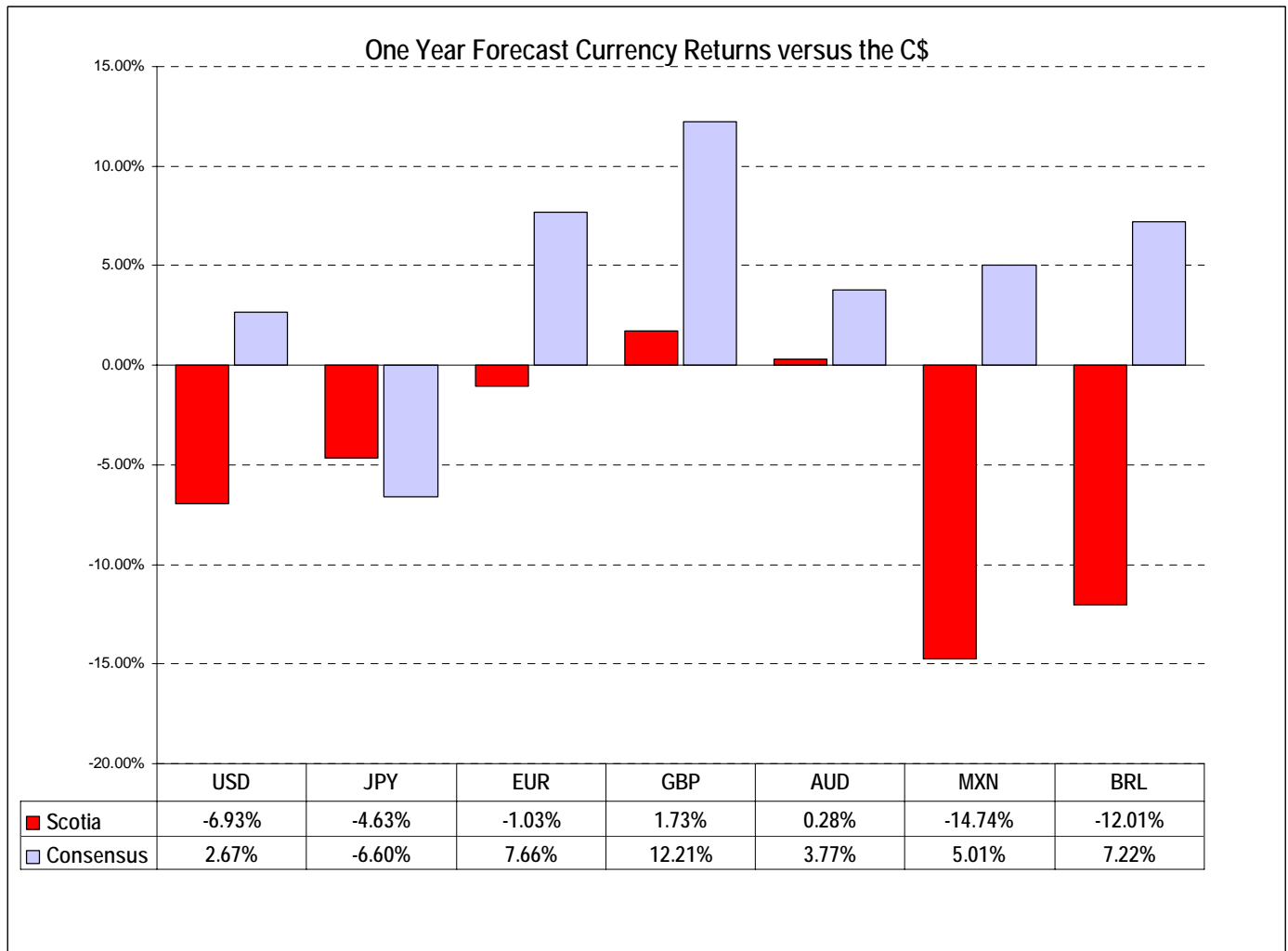


Source: Scotia Economics and Bloomberg

2. **Sector Call** – In conjunction with our term call (to remain in cash or very short term investments), we recommend investors look to the provincial, municipal, and corporate sectors for yield enhancement. Credit spreads (the yield pick up over Canada bonds) still remain attractive in the provincial and municipal space, and although corporate bond yields are at multi-decade lows, there is still a significant yield pick-up available in the short end of the yield curve versus T-Bills and Canada bonds.

3. **Currency Call** - Scotia Economics' and consensus forecast expectations are for the Canadian dollar to outperform most major currencies over the next year, therefore we recommend Canadian investors remain in Canadian dollars for their fixed income holdings at this time.

Weekly Market Strategy



Source: Scotia Economics and Bloomberg

4. Alternative Strategies: Within a broadly diversified portfolio our recommendations are as follows:

- a) **High Yield** – In conjunction with our positive equity market outlook for the next 12 months (based on the outlook for economic recovery), we now recommend investors shift to an overweight position in high yield debt.
- b) **Emerging Markets** – **Similar to our outlook for high yield and equities**, we continue to see value in this sector versus both investment grade and high yield. Hence, we continue to recommend maintaining an overweight exposure.
- c) **Inflation Protected Bonds** – with current real yields in the area of 1.55%, and the market pricing in an effective long term inflation rate of 2.50%, we see limited value in Canadian Real Return Bonds, and hence recommend an underweight exposure to the sector.

Weekly Market Strategy

-S&P/TSX Composite Index



-Dow Jones Industrial Average



Weekly Market Strategy

-NASDAQ



- S&P 500 Index





Definition of Scotia Capital Equity Research Ratings & Risk Rankings

We have a three-tiered rating system, with ratings of 1-Sector Outperform, 2-Sector Perform, and 3-Sector Underperform. Each analyst assigns a rating that is relative to his or her coverage universe.

Our risk ranking system provides transparency as to the underlying financial and operational risk of each stock covered. Statistical and judgmental factors considered are: historical financial results, share price volatility, liquidity of the shares, credit ratings, analyst forecasts, consistency and predictability of earnings, EPS growth, dividends, cash flow from operations, and strength of balance sheet. The Director of Research and the Supervisory Analyst jointly make the final determination of all risk rankings.

Ratings

1-Sector Outperform

The stock is expected to outperform the average total return of the analyst's coverage universe by sector over the next 12 months.

2-Sector Perform

The stock is expected to perform approximately in line with the average total return of the analyst's coverage universe by sector over the next 12 months.

3-Sector Underperform

The stock is expected to underperform the average total return of the analyst's coverage universe by sector over the next 12 months.

Other Ratings

Tender - Investors are guided to tender to the terms of the takeover offer.

Under Review - The rating has been temporarily placed under review, until sufficient information has been received and assessed by the analyst.

Risk Rankings

Low

Low financial and operational risk, high predictability of financial results, low stock volatility.

Medium

Moderate financial and operational risk, moderate predictability of financial results, moderate stock volatility.

High

High financial and/or operational risk, low predictability of financial results, high stock volatility.

Caution Warranted

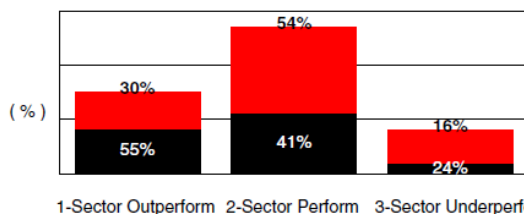
Exceptionally high financial and/or operational risk, exceptionally low predictability of financial results, exceptionally high stock volatility. For risk tolerant investors only.

Venture

Risk and return consistent with Venture Capital. For risk-tolerant investors only.

Scotia Capital Equity Research Ratings Distribution*

Distribution by Ratings and Equity and Equity-Related Financings*



* As at February 28, 2010.
Source: Scotia Capital.

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- Percentage of companies within each rating category for which Scotia Capital has undertaken an underwriting liability or has provided advice for a fee within the last 12 months.

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None.

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