NATCAN WEEKLY MARKER

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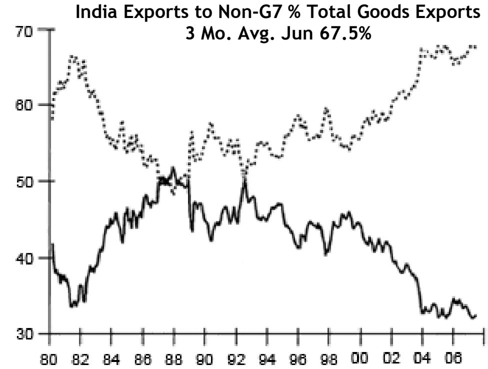
EMERGING ECONOMIES: THE SUBJECT OF A POSITIVE CONTROVERSY

Emerging economies have been experiencing very rapid growth for several years now. Favourable demographic and financial trends as well as great success in the export area have translated into strong equity market returns. Investors are now questioning the health of the U.S. economy and by extension, expressing doubts about the emerging world's ability to withstand a slowdown. In this week's edition of the Marker, we examine key drivers of economic and equity market performance in the emerging world.

BOOMING ECONOMIES

The emerging world has been the greatest beneficiary of globalization. The International Monetary Fund (IMF) reports that emerging countries' share of world trade has increased from 20% to 45% between 1972 and 2006. In the past five years, Asia contributed to over half of world GDP growth. In terms of purchasing power parity, the Organisation for Economic Co-operation and Development (OECD) has identified the U.S., China, and India as the world's three largest economies at the end of 2006. China has replaced the U.S. as the most important trading partner of Hong Kong, Taiwan, Korea, and Vietnam. India now exports twice as much to non-G7 countries as shown in the chart, and the growth rate of those exports was recently 50% higher than to developed (G7) countries.

India Exports to Non-G7 % Total Goods Exports
3 Mo. Avg. Jun 67.5%



Source: ISI Group

SOARING EQUITY MARKETS

Investors have taken good notice of this growth, and emerging market returns have been extremely strong over the past five years. Having historically traded at a discount to developed markets, emerging markets recently moved to parity with developed countries on basic valuation metrics such as P/E ratio. This has contributed to making certain observers nervous about emerging market returns in the future. Yet the combination of stronger - and potentially more sustainable - economic growth, large currency reserves resulting from booming exports, and greater resilience to recent market pullbacks could argue for a smaller valuation gap *for a subset* of the emerging markets universe.

	1 year	2 years	3 years	4 years	5 years
MSCI Emerging Markets C$	27.1	29.0	29.4	26.3	24.3
MSCI Emerging Markets US$	45.2	39.4	37.1	34.9	36.0

Sources: MSCI, Natcan

ECONOMIC DECOUPLING PUT TO THE TEST

One of the key debates raging among investors globally is whether the notion of decoupling can withstand a significant U.S. slowdown. Proponents of decoupling emphasize the fact current U.S. difficulties are mainly domestic in nature and centered on local real estate dynamics and related financing issues. The fact that two emerging countries, Singapore and Abu Dhabi, have recently injected massive amounts of capital in two of the world's leading banks, Citigroup and UBS, highlights how far their financial strength has improved. A recent encounter with specialist emerging market investors who spend a great deal of time on site suggests a significant slowdown of local economies is simply not at hand in the short term. Opponents of the decoupling theory on the other hand insist the world has become even more integrated, and that all countries will be made to feel the impact of a major U.S. slowdown or recession. They remind us that exports have grown faster than the overall emerging economies and as such, leave those with significant exposure to a global slowdown.

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Emerging economies continue to boom as they benefit from globalization and their young populations move into productive economic activity. Investors certainly have taken note of these developments and pushed valuations up significantly in recent years. Similar to high growth stocks, emerging countries will remain sensitive to economic cycles. The key to success in this important asset class is most likely to involve good judgment in discerning which emerging markets deserve capital. Those with trade and financial surpluses are likely to continue to outperform, but beware of countries dependent on foreign capital. Looking forward, investors will likely realize one size does not fit all where emerging equities are concerned.

Michael Quigley, CFA
Senior vice president, Distribution

FINANCIAL MARKETS

RETURNS AS AT DECEMBER 7, 2007 (%)	MTD	QTD	YTD
S&P/TSX	1.31	-1.27	9.80
S&P 500	2.17	-0.02	-6.86
S&P/TSX Small Cap	0.82	-6.28	-0.59
Russell 2000	2.85	-1.28	-13.07
MSCI EAFE	1.46	2.58	-0.89
MSCI World	1.91	1.34	-3.31
Scotia Capital Overall Universe	-0.17	1.93	2.86

	RATES AS AT DECEMBER 7, 2007
CAD/USD	1.01
CAD/Euro	1.47
US Treasuries yield 10-yr/30-yr	4.12/4.58
GOC bond yield 10-yr/30-yr	4.03/4.20
Fed Fund Rate (target)	4.50

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.