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ECONOMIC SCENARIO 1992

Moderator:	KENNETH W. STEWART
Panelists:	PETER G. MUNRO*
	PAUL W. BOLTZ†
Recorder:	KENNETH W. STEWART

The panelists will discuss the economy for the remainder of the year through 1992. Both United States and Canadian economies will be discussed with an emphasis on the United States.

- Where do we see interest rates going?
- What about the recession?
- Now that Desert Storm has turned to Muddy Waters, where do we go from here?

MR. KENNETH W. STEWART: We have a well-qualified panel to discuss our topic, the Economic Outlook for 1992. We know that 1991 has been a year of dramatic events. Between the war in the Middle East, the breakup of the Soviet Union, and other world changes over the past year, including the well-publicized failure of several large life insurers, the North American insurance-buying public has experienced a period of rapid change and uncertainty at home and abroad. This panel will outline their views of the economic outlook for 1992 and discuss how it shapes investment strategies for 1992 and the years ahead.

Our panel members, Paul W. Boltz and Peter G. Munro, are well-qualified for this task. Mr. Boltz is vice president and financial economist at T. Rowe Price Associates, Inc., and also serves as Vice President of several of their investment funds. He has a B.A. in Economics and a Ph.D. from the University of Illinois and is President of the Baltimore Economic Society. Mr. Boltz was previously vice president, Capital Market Research at Continental Bank, spent eight years at the Federal Reserve Board and one year as a staff economist for the Council of Economic Advisors, in the Executive Office of the President. Paul Boltz will speak mainly on the international and U.S. outlook.

Our second speaker, Peter Munro, is senior vice president, securities, at London Life Insurance Company. Mr. Munro has a B.A. in Economics and an M.B.A. from the University of Notre Dame and is a Chartered Financial Analyst. Mr. Munro oversees all bond, money market, equity, and private placement activity of London Life, and its treasury and risk management functions. Prior to London Life, he spent several years with the Bank of Canada, was pension fund manager for a major corporation, was vice president, Domestic Money Management for the Bank of Montreal, and senior vice president and treasurer of First City Trust. Peter Munro also will speak on the

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international economic outlook and the outlook for Canada. His views on the U.S. outlook may present a counterpoint to Paul's comments. Peter will close by describing investment strategies by major asset class.

MR. PAUL W. BOLTZ: In 1951, a year that we will discuss briefly later, the Federal Reserve and the Treasury decided the World War II controls on the Federal Reserve were limiting its ability to make counter cyclical monetary policy, and there was an agreement made in 1951 between the U.S. Treasury and the Federal Reserve Board that it could indeed make a compensatory monetary policy. When we look at the rate of growth in the first year following recessions, we see that coming out of recessions, the U.S. economy explodes (Chart 1). To put this in perspective, we look at the long-term trend rate of growth of the economy over the whole 40-year period, 1950–90. The trend rate of growth of the U.S. economy over that period was 3.15%. The story is that coming out of recessions, the rate of growth of the U.S. economy almost always about doubles, getting up to 6%, sometimes even greater, although not always. Following the 1969–70 recession, we only got up to the trend rate of growth. The 1980 recession led right into the 1981 recession. The economy never got up a head of steam and the rate of growth was only around 3%. Since we think that the economy is going to grow at about a 2.5% rate this year and at about a 3% rate next year, this is not catastrophic. This is just the trend rate of growth of the economy.

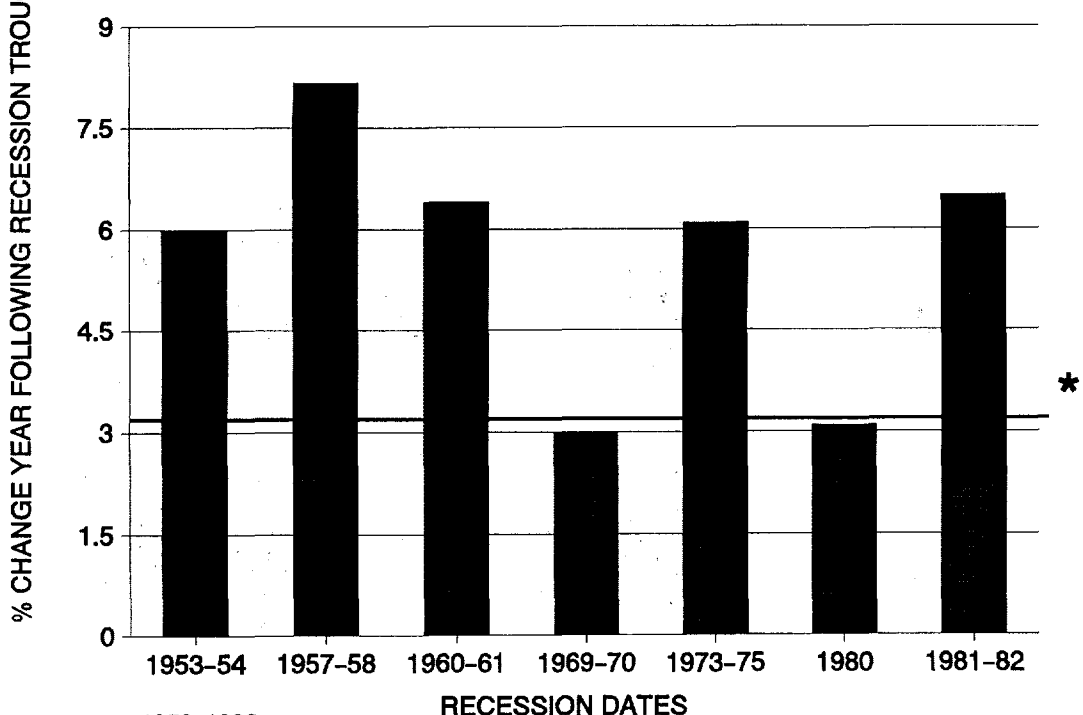
The U.S. economy is not dying, but it is on a diet and diets can be quite uncomfortable. Chart 2 shows the rate of growth of the economy and the rate of increase of the GNP price deflator, the broadest measure of inflation that we have, and on the right side of the chart is our forecast. You can see that there are three negative bars there, and those are the three successive quarters of negative economic growth in the U.S. economy, during the fourth quarter of 1990 and the first and second quarters of 1991. On October 29, 1991, we're going to get the third-quarter GNP for the U.S. economy, and we're expecting something around 2.5% real economic growth. This would mean that the recession ended sometime around mid-year. U.S. recessions are not dated quarterly, however. They're dated monthly, and we think the end month will probably be June 1991, plus or minus a month, when the National Bureau of Economic Research makes that determination.

The inflation story in the U.S. is quite interesting now, and is having an important impact on the yield curve. Let me discuss briefly the inflation story. Consumer price inflation was running at a 6% rate before the Iraqi invasion of Kuwait, and afterwards stayed at 6% since oil prices were so high. So far this year the CPI has been running at only about 2.7%, but this is overwhelmingly due to declines in energy prices, with some help from lower food prices. If we took out energy from the price measure and looked at the rate of inflation in the U.S., we would see that in 1990 the inflation rate was 5.2%, and so far this year, 4.2%. This shows the U.S. rate of inflation, without the energy component, has not declined a great deal as has been customary during American recessions.

Consumer sentiment has really caused the economy to turn around and come back (Chart 3). The latest readings indicate that consumers remain wary and concerned about current conditions, but six months out, they think conditions will improve. I agree.

ECONOMIC SCENARIO 1992
CHART 1

GNP GROWTH FOLLOWING RECESSIONS



* Average 1950-1990

Economic Growth and Inflation

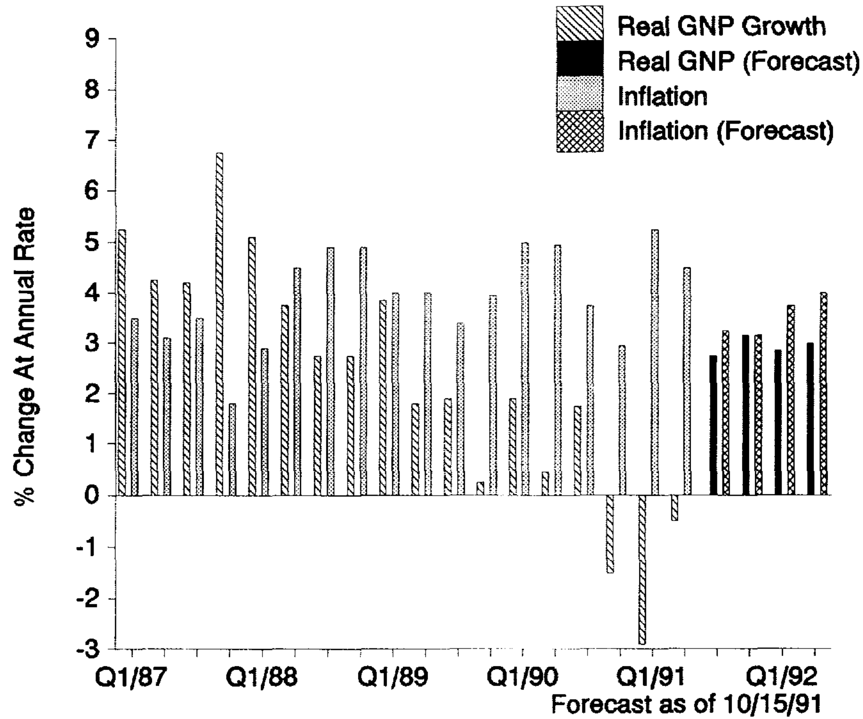
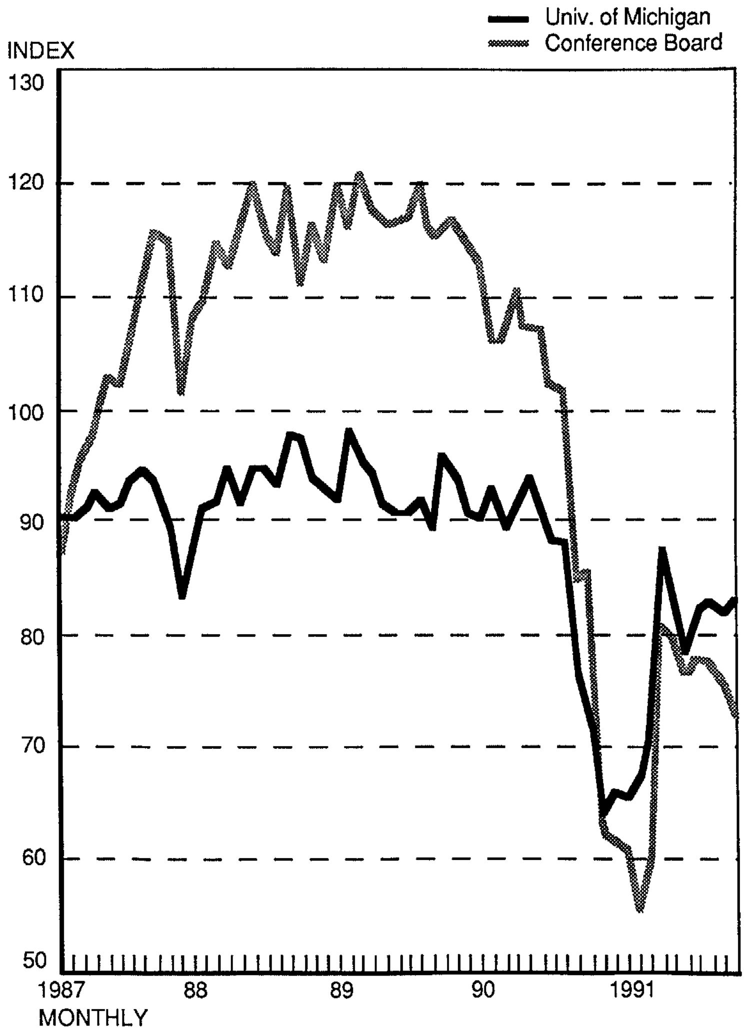


CHART 3

CONSUMER SENTIMENT



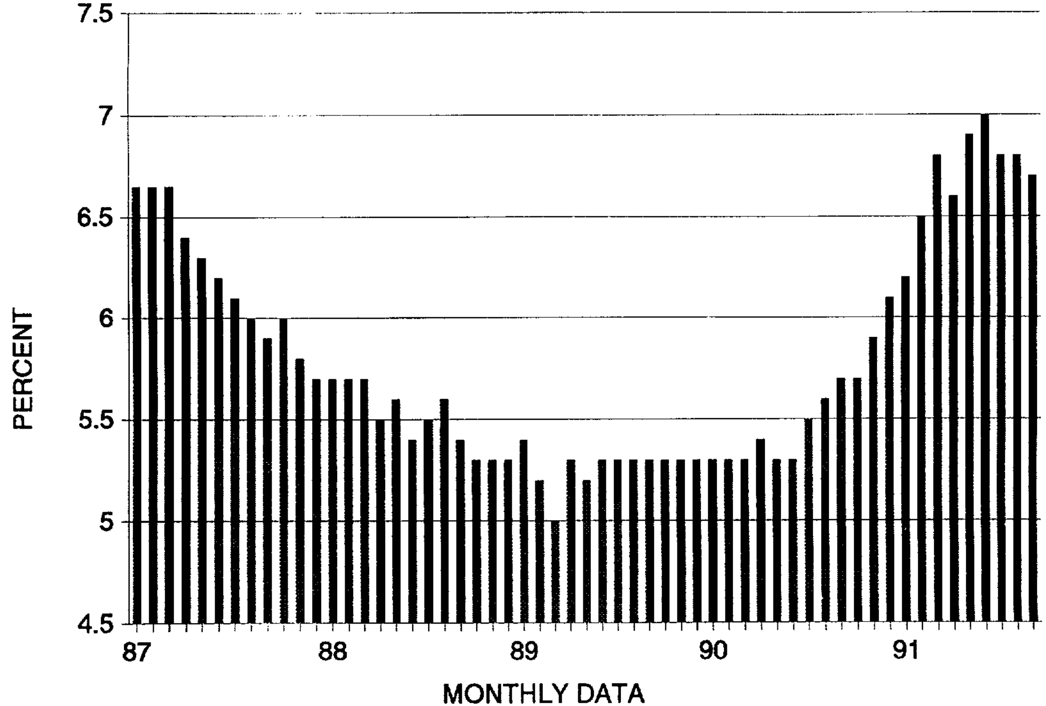
There are two major surveys that are done in the U.S. on consumer sentiment: one done by the University of Michigan, the other by the Conference Board. In 1987 we had the stock market crash here and abroad, and that event was supposed to bring the end of the world. Luckily the world did not come to an end at that time, and consumer sentiment actually went to nearly euphoric levels. The U.S. economy had an incredibly wonderful period in 1988 and 1989. However, a combination of ingredients, the main ones being war jitters and soaring oil prices that brought back bad memories of the 1970s, caused consumer sentiment to really plunge, and these feelings got us down into recessionary levels. The stunning victory in the Iraq war led to a strong bounce back, but since then we've been kind of wobbling off and not really going anywhere but perhaps edging a bit lower. Consumers still remain wary.

One thing that we're going to have to struggle with in the 1990s in the U.S. is the consumers' desires to raise their savings rate, and this is a good news, bad news story. The U.S. needs more savings. We are bringing in a tremendous amount of capital from abroad. This is not a good long-term situation. Short term, however, it means that consumers will not be spending in a big burst as they did in 1983 and 1984. Because of this the recovery will be slower and more gradual. As we go into the mid-1990s we could get to a state where consumer spending will indeed pick up because of income growth, but the savings rate will remain somewhat higher.

Now let's turn more specifically to the determinants of consumer sentiment. Consumers are influenced by two things: job availability and the rate of growth of income. At the moment the unemployment rate is off its recession high which hit 7% (Chart 4). To put that 7% in perspective, the unemployment rate now at 6.7% is lower than for most of the time over the last 15 years. There was a stretch of 6.5 years starting in early 1980, where the unemployment rate was higher than it is today. Jobs really are available, though this last decline in the unemployment rate was displayed in the media as almost unparalleled bad news for the American people. This is probably the most watched economic series by the household sector, and it's coming down. This is the right direction; consumer sentiment is working for us. Income also is working reasonably well for us, as real income has started to turn up with the lower inflation helped by energy. Now right behind consumers, not surprisingly, is business sentiment. This is the purchasing manager's index (Chart 5). This is an imperfect tool, but it's the only one that we have monthly that's any good at all. It is an extremely good indicator of when recessions end. I presume this is because the people who set the end of recessions look at this series, but we have drawn the end of the recession around June. As soon as that series starts to turn up, the recessions in the past have in fact been over, and business sentiment has really bounced back. This makes this recession average, for the post World War II period, an 11-month recession. The decline though is much smaller than average. The average decline in U.S. recessions had been 2.5%; this looks like it's only going to be around 1.1%.

Mixing this up has been the strength of the dollar, which is a matter of some concern for us for several reasons. We have plotted the dollar back here to 1971 to put this in a long-term perspective. You can see that the recent back-up in the dollar, while it may be impressive in percentage terms, doesn't get it anywhere near -- not even remotely close -- to the strength of the dollar in the mid-1980s. Chart 6 shows the Federal Reserve's trade-weighted foreign exchange value of the dollar. This is about

UNEMPLOYMENT RATE



ECONOMIC SCENARIO 1992
CHART 4

1911

CHART 5

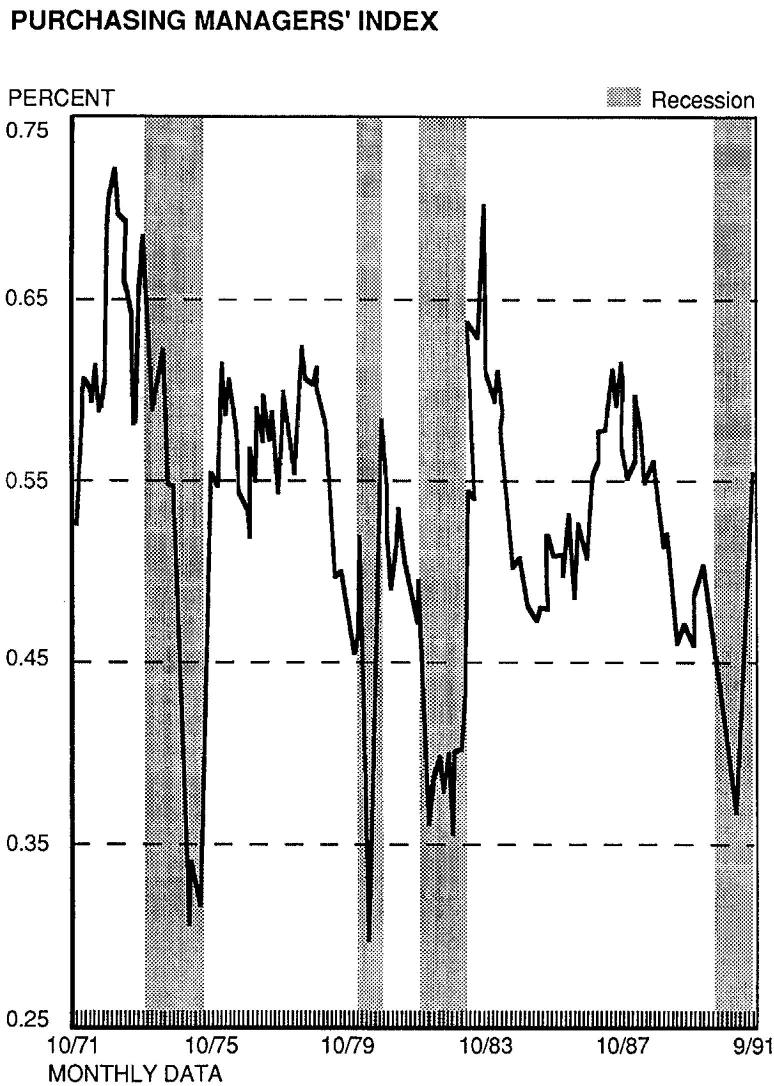
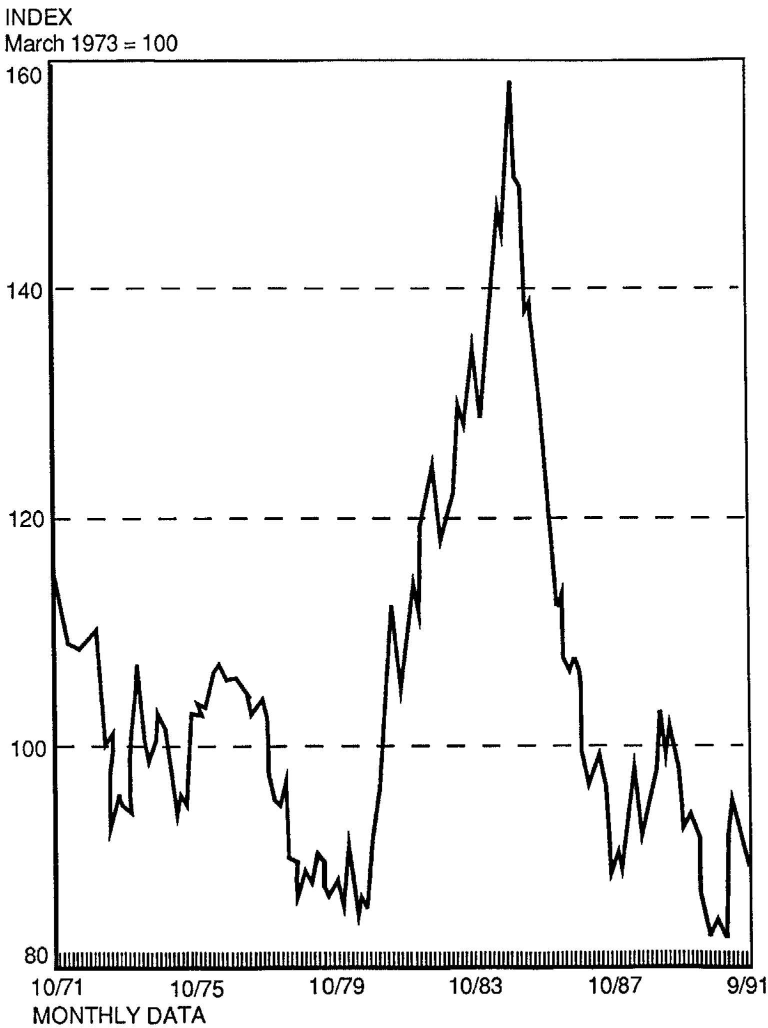

PURCHASING MANAGERS' INDEX
PERCENT
Recession
0.75
0.65
0.55
0.45
0.35
0.25
10/71
10/75
10/79
10/83
10/87
9/91
MONTHLY DATA

CHART 6

FOREIGN EXCHANGE VALUE OF THE DOLLAR



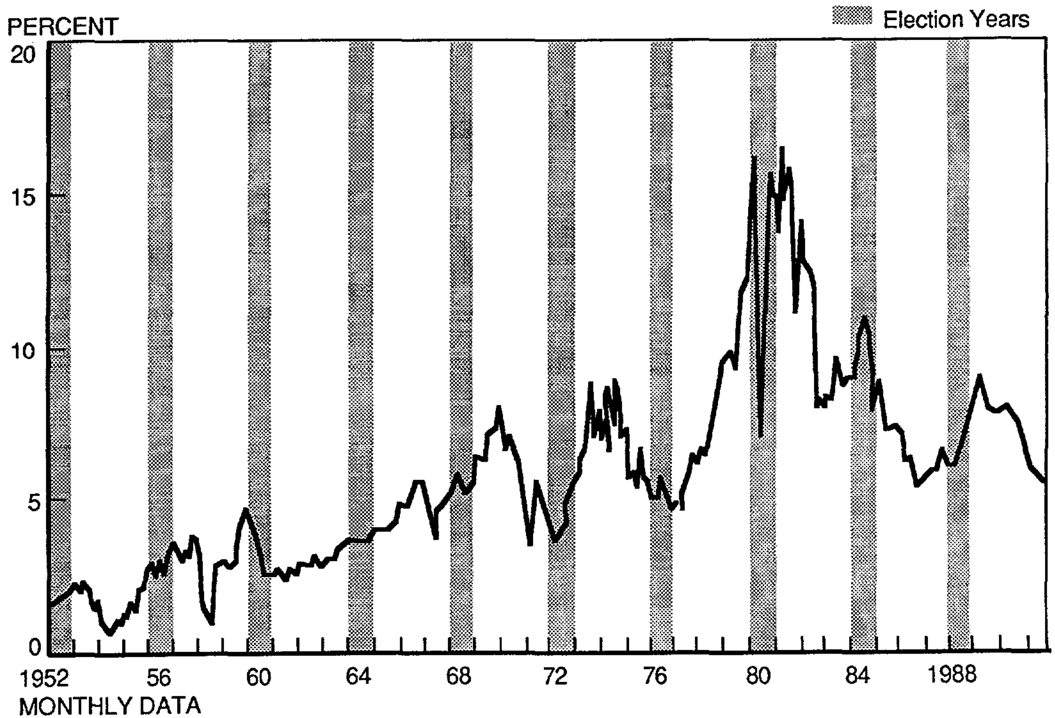
as good an index as any of what the dollar is doing. What we really have to worry about is not so much the dollar strength in terms of hurting U.S. exports, hurting our business abroad, but the relative growth of our trading partners. If they slow down a lot, no matter what happens to these little movements in the dollar over here, it's not going to affect our exports as much as that slow-down will. The strength of economic growth abroad is over long periods of time, and it is the major determinant of how well our exports do. At the moment, the world economy is performing reasonably well. According to estimates of the Organization for Economic Cooperation and Development (OECD), the European economic community and the Bank of Japan and others, it appears that the world economy will be moving up toward its trend rate of growth near 3% next year. I believe the U.S. and Canada, and probably Britain, Australia, New Zealand -- all the English-speaking countries that have been in recession -- will probably be coming out of recession. Of course, Canada is a major trading partner of the U.S. and this should jointly affect our exports as well.

Let's talk a little bit about election years. There seems to be a near universal belief that during election years interest rates fall in the U.S. There are several specific myths that circulate like clockwork every four years in the U.S. See which ones of these you subscribe to. There never was or will be a recession in an election year. How about that one? The Federal Reserve Board guns the economy every four years, and interest rates always fall in election years. This is, in fact, all nonsense. Recessions occurred in 1960 and in 1980, both election years. The one about interest rates though is the subtle one. If you look at Chart 7, you can see that in virtually every election year interest rates rise, and it's easy to see from the chart why that would be the case: there was a secular rise in interest rates over the whole period, and during prosperity interest rates tend to rise. So in any given year, the odds always favored that interest rates would rise whether it was an election year or not, and in fact they did. The one serious decline in interest rates was in 1960, when interest rates really did plunge.

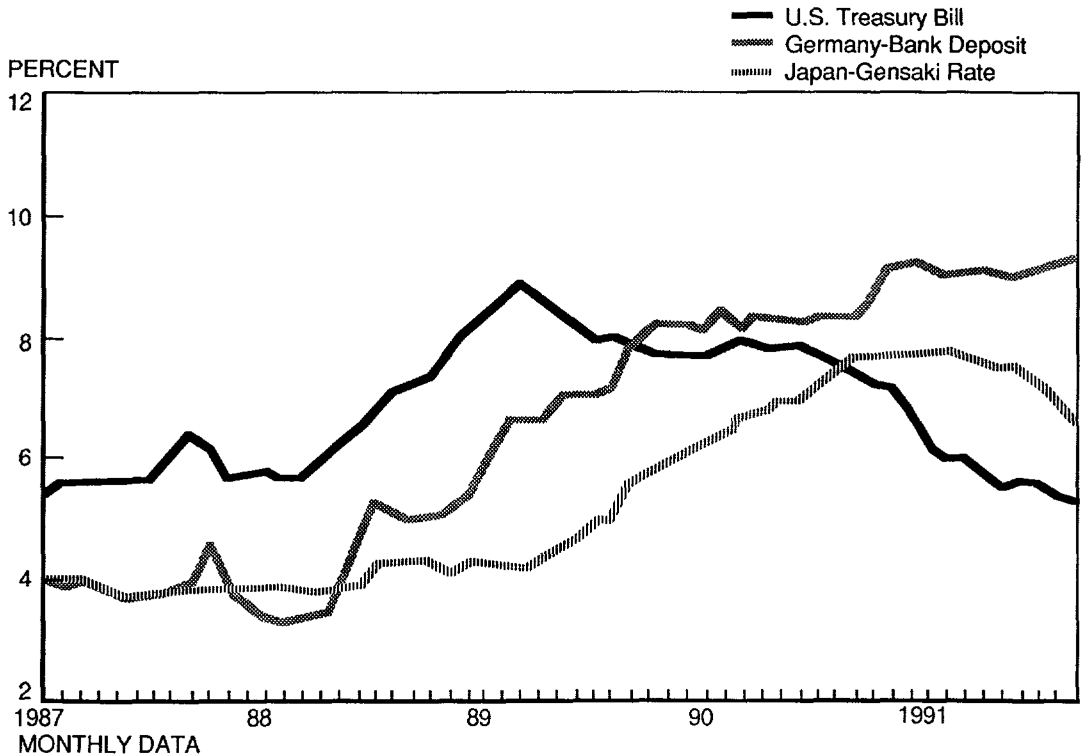
There is one pattern that's really quite interesting, and it is mainly political. I did spend some time at the Federal Reserve Board as you heard in the introduction, and I've always wondered why the Fed Chairman or the Federal Open Market Committee would want to support incumbents all the time. I've never been able to figure that out, but here's an interesting fact. In the 10 elections since the 1951 accord, the incumbent party has won five times and has lost five times. It's as simple as that. If the Federal Reserve Board was trying to influence events, they evidently didn't do very well. There is one pattern though that has emerged clearly: it's not an economic pattern, but it is a sharply political one. In studying the election outcomes since World War II, you cannot fail but to see this pattern. All Republicans, all of them, who won the presidency were overwhelmingly re-elected. In contrast, no Democrat elected to the presidency won re-election. I would note for those of you who may have just returned from an extended visit to Inner Mongolia that Mr. George Bush is a Republican.

Short-term interest rates have been dragged down in the U.S. by the Federal Reserve. In Chart 8, we show the U.S. Treasury bill rate, the German Bank Deposit Rate, and the Japanese Gensaki Rate. We find it impossible these days to watch U.S. markets in isolation, not when you're the world's largest debtor and a huge importer of capital. Japan and Germany, who have far superior inflation histories over the last 10, 20,

3-MONTH TREASURY BILL RATE



SHORT-TERM INTEREST RATES



and 30 years, have much higher short-term interest rates than we do at the moment. Normally this would be a formula for the U.S. dollar to go down sharply, but we saw in the earlier chart that it did not. Probably the main reason it did not get so weak with these interest rate relationships as people fled the U.S. dollar was that we did win the war in the Gulf and people were impressed by that. They think we're at a good point in the business cycle, and the dollar has been able to hold up.

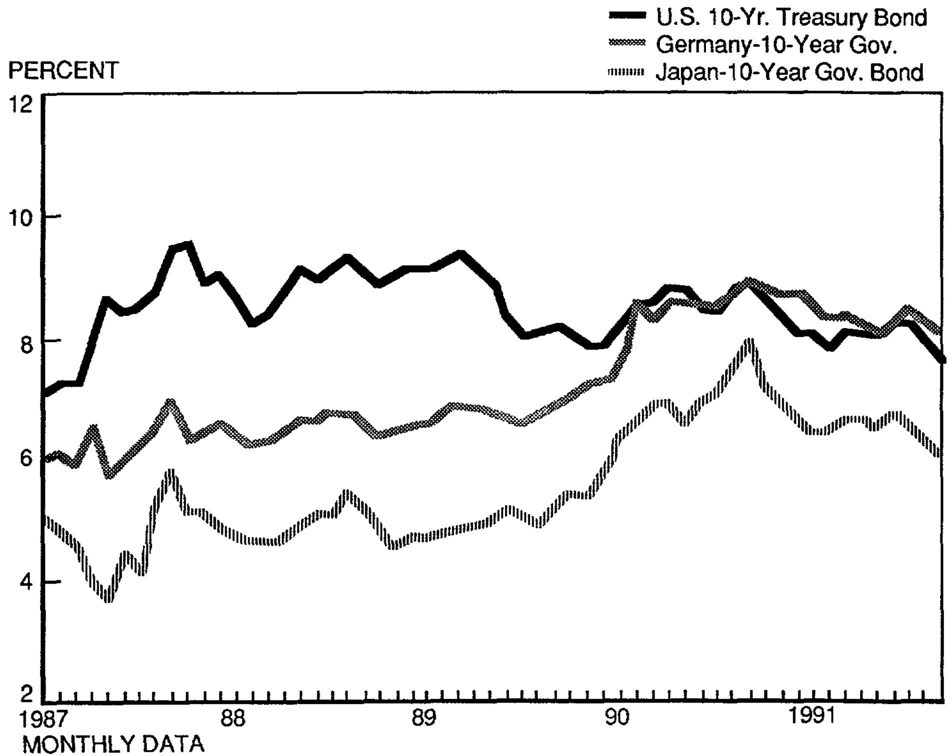
Even more amazing is the relationship in bond yields which goes beyond short term developments. The following are all exactly equivalent in terms of credit risk as the short term. We show here the U.S. 10-year treasury, the German 10-year, and the Japanese 10-year (Chart 9). You can see that the U.S. and German rates are basically on top of one another despite our having twice the average rate of inflation in the 1980s compared with Germany (5.9% versus 2.9%) (as a matter of fact, at the moment the German 10-year is slightly above the American 10-year). Meanwhile, the spread of U.S. rates over Japanese rates has narrowed enormously as Japan struggles with a series of financial and political scandals, and probably a slowdown is coming up ahead. This behavior of interest rates has been remarkable from my perspective because we ended up with an extremely steep yield curve during an American recession. The steepness of the current U.S yield curve, i.e., the spread between short term interest rates and long-term interest rates, is about as high as it ever gets. This is an incredibly steep yield curve, and it is normally associated with and emerges during periods of high prosperity when the Federal Reserve Board is reluctant to tighten and the economy is storming along. This may actually be a good indication from the market that the economy will pick up next year.

Since I'm from a securities firm, I would now like to talk a little bit about stock prices. I'm not a stock market analyst, but I would like to discuss briefly in conclusion what our equity portfolio managers have been telling me recently. In Chart 10 we have the Standard & Poor's (S&P) 500 overlaid with the recessions in the U.S. I wanted to illustrate the point that there are stock market cycles and then there are business cycles. There are more stock market cycles than there are business cycles. During recessions, as you can see, the stock market customarily pauses as it reappraises the earning stream going forward, and this was no exception, though the U.S. stock market has come back fairly strongly, especially the small capitalized stocks. Nevertheless, you can see the recession pattern here. You can see also other down turns like the 1987 down turn which was not associated with any business cycle developments whatsoever: on the contrary, the economy was performing extremely well. As we look forward, we see that the stock market tends to move in long steps, big broad steps, and then churns for a few years before it goes off on a platform again. I think what we would describe ourselves as cautiously optimistic. We think there's a lot to be pleased about as we look forward. Stock market prices in the U.S. basically tripled in the 1980s and, frankly, that would be too much to hope for in the 1990s. You'd have to have a terrific increase in earnings, a huge decline in interest rates, or a multiples rally like you have in Japan to get that to occur again, and we can't really get ourselves revved up quite that way. We do have some good news. The Cold War is winding down, and defense spending here and abroad can be diverted to real investment.

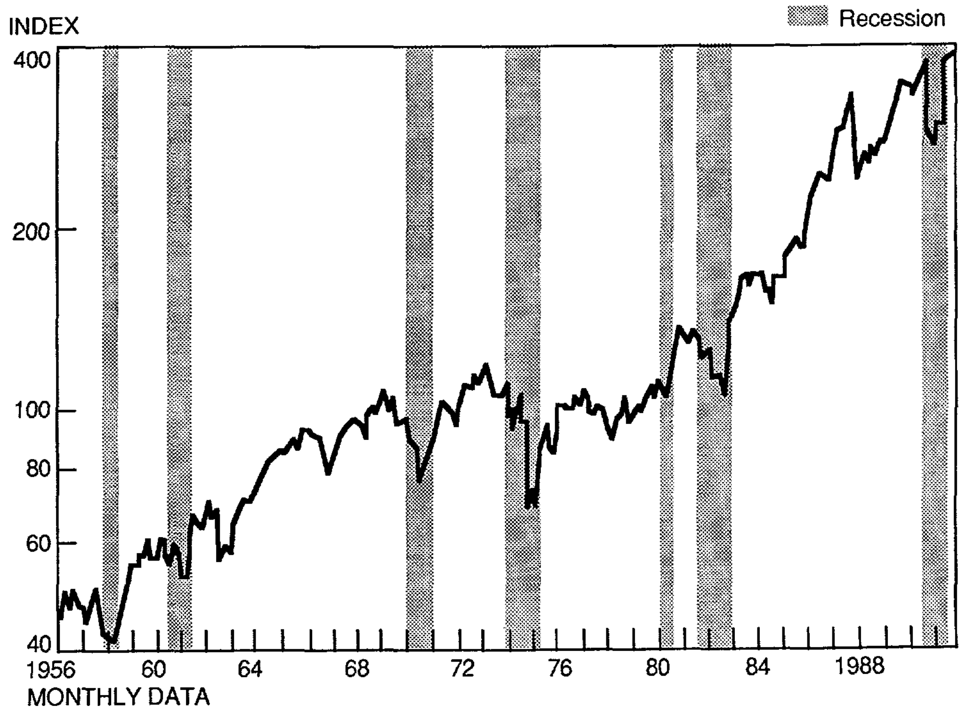
Let's talk about the peace dividend. I hope they don't squander this on tax cuts. We already have a deficit that is 4% of GNP. At any rate, the stock market is going

PANEL DISCUSSION
CHART 9

LONG-TERM INTEREST RATES



S&P 500 STOCK PRICE INDEX



forward with this good news on the political and economic fronts. You know the economic developments in Germany and the Americas and elsewhere, but we do have relatively high real interest rates. We have a household sector that wants to save more, and where I think that on balance economic growth will be restrained, so that the stock market will be relatively restrained as well. I should say though for those of you who are stock investors that there's something very exciting happening in small capitalized, high-tech stocks. They languished in the late 1980s as the blue chips took off, but there are some exciting developments. One of our small high-tech mutual funds that we sell to the public was up 46% in the first nine months of this year. Now as impressive as this is, I'm not going to recommend that you buy at the top, but you want to stay alert to sell offs to try to get in this thing. When this cycle has occurred in the past, it lasted 3-5 years and now it apparently began less than a year ago, so that we seem to still be in the early phases of the cycle.

Let me conclude by summarizing my economic forecast. We expect economic growth about 3% next year, interest rates to edge up gradually, and since next year is divisible by four, we are forecasting that there will be a national election in the United States of America.

MR. PETER G. MUNRO: Paul and I hadn't compared notes before this started, but we do have some similarities and you might see a few differences in our forecasts.

In the 1980s we were much more short-term trading oriented in the investment business, and right now we're getting back to the basics. At our company, these "basics" mean a more disciplined approach to planning and managing our investment portfolios. Our assets are segmented by major product groups, strategies are built up by segment, then aggregated and tested at the corporate level. Our investment strategy process is really very basic. We start with an economic and capital market outlook, we then take account of our asset and liability requirements, and the final piece is the portfolio manager's forecast of market conditions and returns. When we put these together we come up with two outputs: (1) asset mix; (2) investment strategies within each asset class.

What I would like to do with you is to review our current economic and capital market outlook, and then give you some idea of the broad strategies we are following. Like anybody else, we have many alternative scenarios. What I'll try to do is give you an idea of the mainline scenario, and go over some of the mainline projections with you without hedging too much. I'll touch briefly on Germany and Japan, and then spend a little more time on the U.S. and Canada.

In the last year, the economic cycle in the G-7 countries has been out of sync. The U.S. and Canada have experienced recession, and reacted by lowering interest rates. Japan and Germany, on the other hand, have seen strong demand growth. They have had some inflationary pressures, and they have maintained a tighter monetary stance. Other major continental countries in Europe have generally avoided recession, but they have now started to slow down significantly. During 1992 a gradual convergence in real output gains between North American and Western European economies is likely to emerge. The recent easing of monetary policy in North America and in the European Economic Community (EEC) economies should lead to convergence in growth rates. German inflation will probably remain higher than in the rest of the European community. Table 1 shows our forecast for lower GNP and lower inflation in 1992 for Germany. You can see the trend to lower rates of increase in both the GNP and in the CPI number we're forecasting for the 1990–92 period. In Japan we think price increases will diminish as pressure on resources recedes and additional industrial investment occurs. In Table 2, you can see our expectation of a slight easing in Japanese inflation, and we see the GNE down from 1990's 5.7% to the 3.25-3.75% area in 1991 and 1992. Basically we see the inflation gap between North America, the EEC, and Japan decreasing. We see a trend toward convergence at lower rates.

TABLE 1
German Economic Outlook

Percent change	1990	1991e	1992e
GNP	4.7	3.1	2.3
Consumption	4.1	3.3	2.2
Investment	9.3	9.0	6.0
Industrial Production	5.1	3.5	2.7
Consumer Prices	5.1	3.5	2.7

TABLE 2
Japanese Economic Outlook
(Fiscal years beginning March 30)

Percent change	1990	1991e	1992e
GNE	5.7	3.3	3.6
Consumption	3.5	3.6	3.4
Plant & Equipment	13.6	5.6	8.0
Industrial Production	5.6	2.2	4.0
Consumer Prices	3.3	2.8	2.6

In the U.S., the evidence still points to relatively slow and unbalanced recovery in 1992. The manufacturing sector is reviving, but the services sector is languishing. Moderate inflation pressures are reflected in recent producer and consumer price indices. We see two conditions as necessary to ensure a balanced and sustainable recovery: (1) price stability needs to be assured, and (2) concerns centered on structural adjustment issues require resolution. These structural issues refer to continuing weakness in commercial real estate markets, the continuing consolidation and restructuring in financial services, the high debt income ratios of households and businesses, and impaired credit availability as depositing institutions attempt to improve their balance sheets. These structural imbalances need restoration before a balanced and sustainable recovery occurs.

In our view, a restrictive fiscal policy and industrial and financial structural adjustments arising from both domestic and international competitive pressures will together restrain economic output gains in 1992. Other factors will also exert a disinflationary influence on the economy. Corporate profits are expected to increase by about 12% in 1992 as a result of improved domestic demand and some widening of margins. Industrial production is expected to rise by about 4.5%, and some inventory buildup is expected. We think that the Federal Reserve Board's actions are directed at alleviating credit constraints in the system. There is little evidence that suggests that the U.S. economy is experiencing a broad-based credit crunch. However, the U.S. banking and financial sector is facing structural difficulties. As deregulation, financial innovation, and competition have proceeded, capital strength has become the key to the stability and success of banks. We expect to see more mergers and acquisitions occur in 1992. Competition in the services sector has increased because of deregulation, increased foreign competition, and investment.

Against this background, Tables 3 and 4 we see 1992 for the U.S. economy showing some of the other forecast numbers like pretax profits and after-tax profits, and some of the inflation numbers. I point out that our forecast is below what we see as the consensus for next year. We see a GNP, or GDP as it's now called, increase of 2.3% compared with the consensus of 3%, and we see a CPI increase of 3.1% compared with what we see as a consensus of 3.5%.

TABLE 3
U.S. Economic Outlook

Percent change	1990	1991e	1992e
GDP	1.0	−0.4	2.3
Personal Consumption	0.9	0.2	1.8
Nonresident Investment	1.8	−5.2	2.0
Changes in Inventories*	−3.6	−14.0	17.0
Federal Government Export	2.6	2.1	−1.0
State & Local Government	3.0	0.2	1.0
Housing Starts**	1.2	1.02	1.18
Industrial Production	1.0	−1.1	4.5

* ($BB)

** (Mm of units)

TABLE 4
U.S. Economic Outlook

Percent change	1990	1991e	1992e
Pretax Profits	−1.0	−5.9	12.0
After-Tax Profits	0.0	−3.8	15.0
GDP Deflator	4.1	3.6	2.3
PPI	4.9	2.0	2.9
CPI	5.4	4.1	3.1

Turning to the Canadian market, in Tables 5 and 6, we show a number of similar indicators for Canada. The Canadian recovery we see as extremely feeble in an absolute sense and relative to post-war recoveries. There are a number of special factors that are affecting this recovery, and I will mention some of them. The Free Trade Agreement with the U.S. has forced restructuring of Canadian manufacturers and businesses. There have been a number of relocations to the U.S. of Canadian companies to take advantage of the favorable business environment. We see these adjustments as continuing, but they will also restrain the recovery in Canada.

Another factor is the Bank of Canada, which is determined to fight against inflation in this country. We think that the Bank of Canada's policy will be successful, and it will lower inflation to around 3% by the middle of next year. Another major factor in Canada is that the business sector faces severe competitive pressures, and these pressures are aggravated by relatively high interest rates in Canada and some really disconcerting tax trends in this country. A lot of them now are at the provincial level. The structural difficulties, high capital costs, and onerous debt levels will result in sub-par growth in 1992. Corporate profits have been severely hit because of weak industry selling prices in Canada, a high Canadian dollar, and high real rates. A modest pick-up in profit margins is expected next year because of lower unit labor costs, higher productivity, some volume growth, and lower interest rates. We forecast a recovery in profits next year, but we're really starting from a very weak base where profits in Canada were decimated in 1990, and we think 1991 numbers at year end will show the same thing. So the forecast for Canada is some rise, and again we think we're below consensus. We see 1992 growth in Canada at 3.5% as the consensus, and you can see from Table 5 that our forecast was 2.6%. Our forecast is a CPI increase of 3% next year where we think the consensus is more like 3.6%.

TABLE 5
Canadian Economic Outlook

Percent change	1990	1991e	1992e
Real GDP	0.5	-1.3	2.6
Final Domestic Demand	0.5	-1.2	2.7
Consumption	1.3	-1.8	2.6
Business Fixed Investment	-4.6	-6.0	4.0
Government Export	3.0	2.9	2.4
Inventory Change*	-2.4	0.45	1.2
Housing Starts (000's)	183.0	145.0	165.0
Industrial Production	-4.3	-4.0	3.5

* ($BB)

TABLE 6
Canadian Economic Outlook

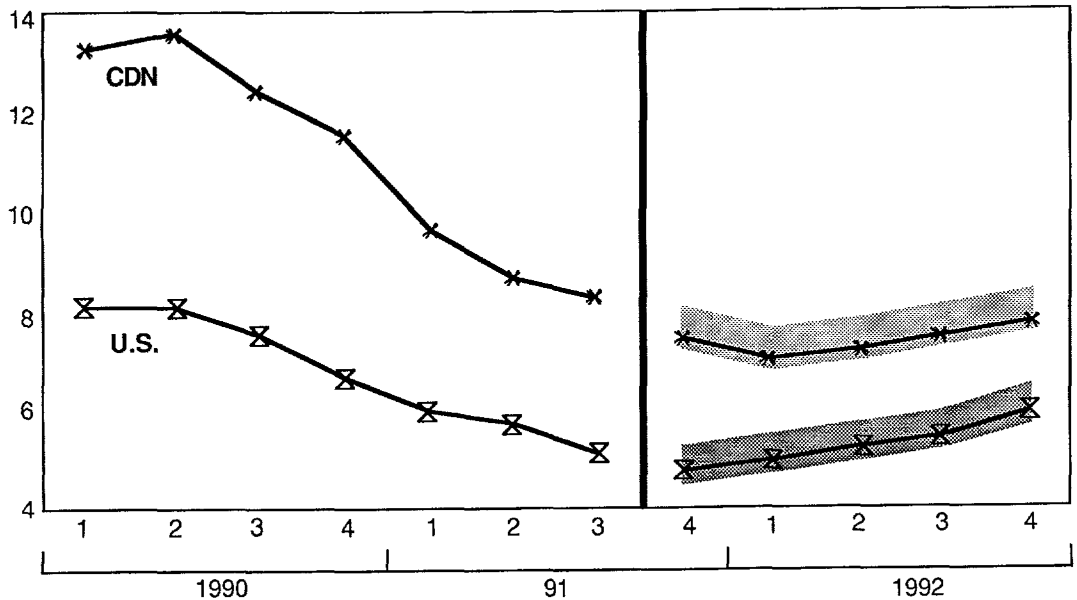
Percent change	1990	1991e	1992e
Pretax Profits	-30.5	-45.2	21.0
After-Tax Profits	-41.3	-60.9	45.0
GDP Deflator	3.0	3.5	2.5
CPI	4.8	5.5	3.0
CPI (excluding GST & Indirect Taxes)	4.8	3.8	2.7
Industry Production Prices	0.3	0.3	2.4

I would now like to turn to our views on rates and currencies, and then talk about some broad investment strategies. I mentioned the outlook very briefly in terms of Germany and Japan, a little bit more in terms of Canada and the U.S. My comments on strategies will be geared to Canada as virtually all of London Life's assets and liabilities are denominated in Canadian dollars. However, our views on the Canadian markets reflect, to a large extent, how we see developments unfolding in the U.S. markets as well. We see the U.S. dollar as likely to weaken relative to the German mark from its current level of 1.70 to probably 1.60 this winter. Later we see it strengthening as the German economy slackens and the U.S. economy strengthens. The Japanese current account and capital position will improve, and we think this will provide some strength to the yen relative to the dollar. The near term trading range we see at about 125-132, and the Canadian dollar will remain relatively strong on the basis of our expected better inflation performance. Anybody who has looked at the Canadian dollar recently will notice that it is at 13-14 year highs. If you're familiar at all with the investment business in Canada, basically we've been forecasting a weaker Canadian dollar for four or five years.

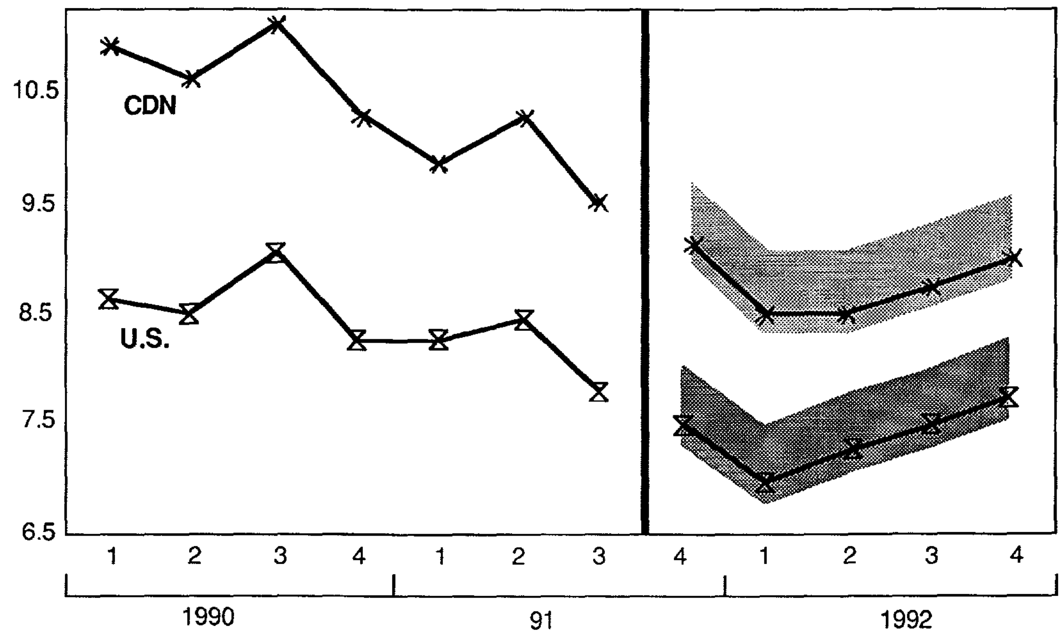
Chart 11 shows Canadian and U.S. Treasury bills and shows actual and projections. We see short-term rates in both Canada and the U.S. heading lower until about the middle of 1992. Liquidity is increasing because of deleveraging on the part of consumers and businesses. In Canada, short-term rates, nominal and real, should decline relative to the U.S. I think the Bank of Canada's monetary stance will produce lower inflation relative to the U.S. Chart 12 shows long government bond yields in Canada and the U.S. on the same basis, actual and projected. We think the long-term rates in the U.S. will decline given the favorable inflation prospects. There are constraints to rapid and sharp declines, and these arise mainly from the size of the budget deficit and international indebtedness. In Canada long-term rates are also expected to decline. We expect to see a narrowing of the long-term rates in Canada relative to the U.S. I think you can see that by the sharper pick-up in our projections for U.S. long-term rates. Again the forecast is similar to what we have on the short term side where we see a bit further easing, and then a pick-up through somewhere around the middle of next year through year end.

In terms of our broad investment strategies, I'd like to talk to you about four or five major markets. In spite of differences in the Canadian and U.S. markets, there are fairly strong parallels to asset strategies in the U.S. market. In the public bond markets, we're looking at any major correction as an opportunity to deploy funds. The market has come a long way over the last few months. Just to put that in perspective, long-term Treasuries in the U.S. rallied from the yield level of 8.50% around the end of June to 7.80% recently (and more recently up toward 8%). Over the same period, long Government of Canada bonds rallied 100 basis points from 10.30-9.30%. Given our views on the fragile economic rebound and positive trends in inflation, we view any correction as a buying opportunity. For those of you who are interested in the Canadian scene in particular, we're really concentrating on the federal government issues because spreads of provincial government issues and corporates relative to Canada's have narrowed quite a bit (actually too much in our opinion). In the private placement market, we don't see a huge demand for long-term fixed rate funds. Therefore, we'll be spending a lot of time in our own portfolios on credit administration, monitoring, and reviewing our holdings. This is not unlike what U.S. companies may be doing to work on the credit risks in their portfolios. We'll be taking a very hard look at any new deals to make sure that we get the security and covenant packages we need, and that we get rates that adequately compensate us for the risks we perceive.

CDN & U.S. T-BILLS
Actual & Projections
(3-Month)



CDN & U.S. LONG BONDS/TREASURIES
Actual & Projections



PANEL DISCUSSION
CHART 12

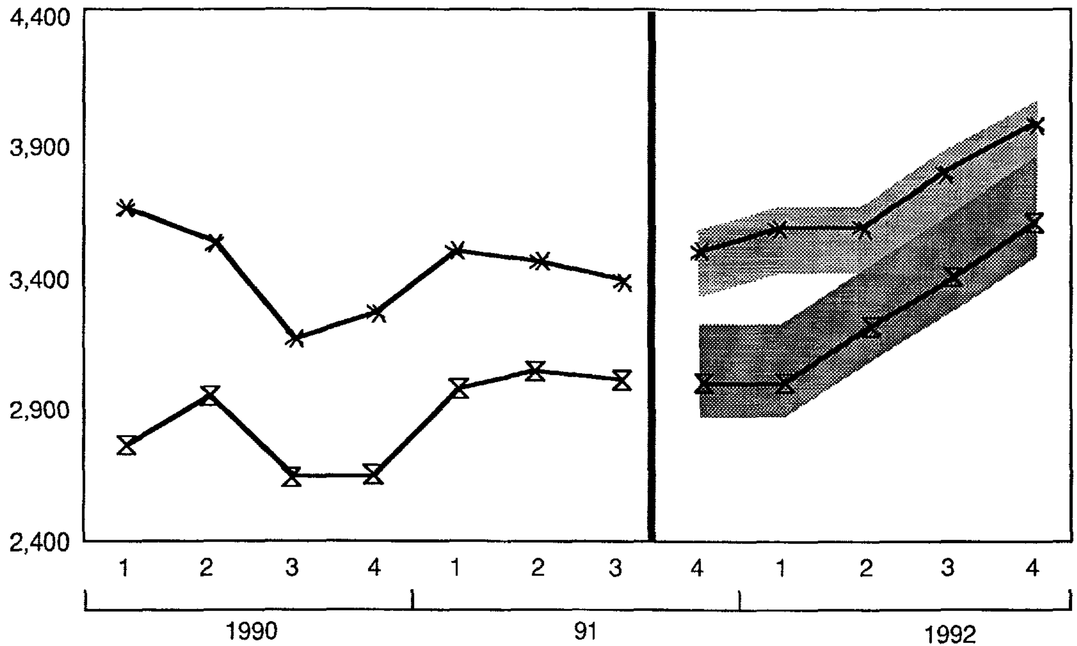
Chart 13 shows the Toronto Stock Exchange 300 Index and the Dow Jones Industrial on the same basis, with actuals up until the third quarter of 1991, and then projected for the fourth quarter and the first quarter of next year. In terms of the equity markets, we have lowered our estimates of 1991 and 1992 earnings, as have many others. We could easily see some temporary weakness in the Toronto and New York markets as third-quarter earnings continue to show little improvement. However, we believe that the worst of the market declines are behind us, and we're positive on the next 12-18 months. The favorable influences that we are keying on are the trend to lower inflation in the U.S., the corporate restructurings that are taking place, and the expected earnings rebounds in 1993. We pushed out the expectation of a rebound from 1992-93, and we can easily see 10-15% returns or higher over the next 15 months. In terms of levels, I'll give you a forecast of perhaps 4,000 on the TSE 300 composite index versus the current 3,400-3,500, and maybe 3,600 on the Dow.

In the commercial mortgage market, demand for funds in Canada has been sluggish all year, reflecting the recessionary environment. However, recent declines in long-term interest rates have sparked some interest by commercial borrowers wishing to replace existing floating-rate debt with lower long-term fixed-rate cost. We're forecasting little commercial development in Canada because of the depressed markets. There is widespread vacancy throughout the office, retail, and industrial markets as a result of the severity of the recession, with its accompanying plant closings, decline in retail sales, and business failures. We will continue to pursue commercial mortgage lending, without compromising loan quality.

One of the areas that does hold promise for us, and one that not many insurance companies are actively involved in, is the direct origination of single family residential mortgages. We see this as a particularly attractive market as the characteristics of the residential mortgage in Canada are ideal for matching against our 1-5 year savings and investment products. A portfolio of residential loans provides diversification of risk, both geographically and by credit, and it is relatively liquid given the short average term of the portfolio and high levels of cash flows. These factors allow us to manage the asset/liability match quite closely. I mentioned this market holds promise for us. We're able to access mortgage product in good volume through a joint venture we have with Royal LePage Real Estate Services Limited, called Royal LePage Mortgage Company. This company is providing us with broad access to the residential home resale market and the mortgages that are attached to finance them.

As a final point, I'd like to say just a few words about our direct investments in real estate. Our strategy hasn't changed much in recent quarters. We are concentrating on management of our existing portfolio with an emphasis on maintaining income and occupancy levels, and on completing projects already under development with our joint venture partners. At London Life, we don't have our own development team: we always do joint ventures with well-known developers. Market conditions here continue to be soft, and we are forecasting little, if any at all, appreciation in values or rents over the next several years. As such, we're not undertaking any new development projects, but we are monitoring the markets carefully. And the properties we're looking at are income producing, not development properties, on existing buildings as long as they are well located, have good income streams, and are priced reasonably. There have been a number of transactions in the market here in Toronto that we

TSE 300 & DJIA
Actual & Projections



didn't think were properly priced and in which we haven't participated. We think some people are just paying too much for properties at this stage of the cycle.

In summary, the North American economies are in a sub-par recovery with plenty of risks on the horizon. However, as long as we can identify them and properly assess those risks, we're prepared to look through the weakness to take advantage of current and emerging opportunities. A great deal of our time will be spent ensuring that any such new investments will represent high-quality assets for our company in the long run, and on managing the credit risks and values in our current portfolios.

MR. YUAN CHANG: There has been some talk that this recession is different. It seems to me that there is a convergence of a number of different types of cycles, the short term economic and business cycles, and then the long-term cycles of commercial real estate. Perhaps there is even a buildup in Western production capacity that is being financed by the Third World. There are a number of other problems in the long-term cycle, and then on top of all that is the debt load and the service restructuring. All these things seem to say that recovery is hard to sustain. What does each speaker think is the probability of a double dip?

MR. BOLTZ: The U.S. economy, in general, is very hard to slow down as we found out in the early 1980s when we needed double-digit interest rates. In fact, some of us have been surprised that the economy has slowed down as much as it did even with the war jitters and oil prices. But the questioner is exactly right because there are several cycles that are overlaying the business cycle, though we can talk ourselves into a state of keen depression if we focus too much on these. We have to recognize that all recessions in the U.S. have more or less similar developments.

We all remember the Real Estate Investment Trusts (REITs) of the mid-1970s that made that 1974-75 period pretty grim. Real estate has gone through a lot of difficulties in the U.S. Admittedly the investment boom of the 1980s, the long over-arching real estate investment boom (especially in commercial property where we had a building boom in the 1920s and a building boom in the 1980s), is going to take a long while to unwind. That is why our recovery is going to be modest, but I don't think that it's capable of pushing us into a double-dip recession. That would have been very easily possible if the U.S. Congress had dodged a bullet and not decided to underwrite the Savings and Loan (S&L) mess through the U.S. taxpayer. That is much better than a great depression, which is the way we treated the overbuilding in the 1920s, and that didn't work out very well.

We also have a service cycle where the service industries, for the first time in the post-war period, are getting hammered hard during a recession. During earlier recessions in the U.S., while the service sector was not impervious, at least it went through them reasonably well. The financial services are also being hammered. Financial service stocks have rebounded enormously in the U.S., and it looks like the worst is over. The inventory cycle graciously was not as brutal as is often the case in the U.S., and inventory liquidation, while a very important contributor to the three quarters of decline, was not horribly brutal. We have auto inventories that were under fairly tight control at the beginning of the recession and are now under extremely tight control. They are at about their lowest levels that we've seen in decades. As we look forward and put the pieces together, unless consumers suddenly really turn off and think that they shouldn't go out and spend at all as they did last summer and last fall, we don't see the pieces there for another downturn.

MR. MUNRO: We look at a variety of alternative scenarios, and normally we would have a more positive scenario, a mainline scenario, and a more negative scenario. At this point, our only alternative scenarios are weaker. We don't have forecasts that show better growth than this. There are a number of events that could trigger a weaker 1992 in terms of growth, and I didn't talk about a number of those. There are all kinds of risks and you can probably name a dozen or two off the top of your head, including the failure of the Arab/Israeli peace talks and liquidity constraints in Canada and the U.S. A while ago it was very popular when you were making forecasts and looking at investment strategies to talk about a financial accident in the system; we don't talk about that much but it's still a possibility. The deleveraging -- we're talking about consumers and business -- could easily have a more dampening effect than we're currently projecting. In terms of the financial services stocks, mainly the banks in Canada, they have also rebounded strongly, but I think that has more to do with asset quality, where the worst of the loan losses are behind us, and the positive impact on earnings from lower rates in Canada and U.S. Just one last comment on the service sector. One topic that has been talked about in the U.S., and probably even more so in Canada as a result of the Free Trade Agreement, is the restructuring that is taking place in manufacturing. What is not talked about, and is probably as big a factor, is the restructuring that is taking place in the service sector. You don't have to look any further than insurance companies. Of course, we're using a lot of nicer words now. We're using right-sizing instead of down-sizing, and reengineering instead of layoffs. But the short answer is we see only weaker scenarios, and we put the probability at about 20-25% for a double dip.

MR. STEWART: We've seen over the last number of years the emergence of some major regional trading blocks, the emerging block centered in Japan, the obvious one in Europe, the European Economic Community (EEC), and now potentially a North American common market. What happens to the parts of the world economy that are outside these major trading blocks, and how might that push your forecasts off track?

MR. MUNRO: For the countries outside of these major trading blocks, the short investment answer is "who cares." In our forecast we think that we will have a North American free trade agreement by the end of next year (Canada, the U.S., and Mexico), and that it will be expedited and it will be signed. We're not adjusting the forecast, because we have already taken account of these types of factors, and we think that the major trading blocks will continue.

MR. BOLTZ: The emergence of these free trade agreements seems to us extremely positive. Only this morning I was hearing on CNN that European Free Trade Association (EFTA) was thinking of joining the EEC en masse. The whole thrust of this era that we're living in now is something that the U.S. has been pursuing aggressively since World War II, namely freeing up the international trade so that we can get economies of scale. At our firm we mainly focus on the major industrialized countries because, while we like to invest in countries, we especially like to be able to get the money back out, and there is a fairly short list of countries where you can reliably do that. It's very easy though to get into any country you want, but getting money out again in a form you recognize is trickier. For those of our more adventuresome clients, we do offer some vehicles for investing in the, shall we say, second world, though I can't think of any third-world countries that we would like to get involved in. We have a vehicle, for example, the New Asia Fund, which will look at countries like Taiwan, Thailand, Hong Kong, Singapore, Malaysia, and Indonesia. We will look at and think about Eastern Europe, but we'd like to see a judicial system put in place, something that vaguely resembles at least medieval times if not modern times so we can get our money back out. But we do look, and some of the really exciting growth prospects are in the second-world countries. In fact, some second world countries are really verging on becoming first-world countries, for example Spain. There are some good vehicles out there, but you have to stay so closely attuned to political developments that it's a very tricky business.

MR. STEWART: Peter, in your remarks you talked about the international economy having moved into a period of slow recovery, lower interest rates, and lower bond yields. I'd put this question to the panel generally: what is in your view the long-term trend of real interest rates?

MR. MUNRO: If you look at real rates of interest, long-term government bonds on an historic basis, I believe that the studies show a 3% real return over and above inflation. Let me speak just to Canada and let Paul talk about the U.S. In Canada in the last five years or more, we've been spoiled with long-term real rates of 6%. In the 1980s, in a period of rising inflation and some lack of fiscal policy restraint, we had bond buyers in Canada going on strike, and they refused to buy Government of Canada long-term bonds at anything less than 5% or 6% real rates; that's double the historic trend. What we see now is a move back toward the 3% level, although very grudgingly because we've been spoiled. One of the developments you may not be aware of is that in Canada we're seriously considering index-linked bonds. Given the real rates we've experienced, many buyers like ourselves are telling the government that their bonds are very nice but we're probably not going to buy bonds with a 3% or 4% real rate of return when we can get more than that in the market. The trends are there in terms of inflation, and if the economy is as weak as we expect, if the restructurings continue, if those sorts of trends are in place, we should have lower rates and lower real rates so we think that premium will come down. As a guess, it will be coming down from the close to 6% level more toward 4%, and then, if the favorable trends continue, back to the historic average.

MR. BOLTZ: I would like to comment on that as well. This 3% real rate of return on risk-free assets emerged mainly from studies of British consuls, which are bonds that have no maturity date but just pay interest forever. The records on them in the City of London are extremely good and they go back hundreds of years. We looked at real interest rates in the U.S. going back to the 1830s, because if you dust off your Sidney Homer history of interest rates, you'll see that the New York money market rates are also very good and go back early into the 19th century. We could look at the short-term yields as well as the corporate bond yields, and what you see is interesting: very long cycles of high real interest rates followed by low real interest rates. Unless you're an investor who plans to live 75-150 years, this 3% may not be relevant for your portfolio planning because you may not live long enough to see the cycles work out. For example, after the Civil War, in the period of greenbackism when inflation in the U.S. went to the moon, we subsequently had a long period of high real interest rates, and then when U.S. Grant went back on the gold standard in his administration, we had sky-high real interest rates which attracted British capital to the U.S. In the early post-World War II period in terms of military and economic power, the U.S. stood astride this planet like no other single nation had ever stood before. At that time the U.S., not surprisingly, had very low real interest rates as capital from all over the world came in. We had tremendous investment opportunities; we were the amazing wonder kid of all time in terms of the economic growth we achieved with stable prices, as for example in the 1950s. When we got to the Vietnam period and up to our era, the monetary policy changed the real interest rate environment in the U.S. drastically. Through the 1970s we still had negative treasury bill rates below the rate of inflation, even before taking into account taxes. We ended up, not surprisingly, with the highest peacetime inflation we had ever had in the U.S. As we came into the 1980s and that monetary policy, there was a shift. The investors finally woke up and said they would like a real rate of return; now they get it. I believe these high real interest rates will persist for quite some time until three things happen in the U.S.: (1) we must get the federal budget deficit down; (2) if we can't do that, we have to find another way to stop importing so much capital from abroad; and (3) we have to find some way so that global credit demands won't compete with ours. Those global credit demands are really rising because of developments in Eastern Europe and very exciting developments in Latin America as well. There are many demands for capital in the world, and with the integration of capital markets we feel those pressures in the U.S. With our fiscal policy, we think real interest rates will remain high through probably most of the 1990s.

MR. RAYMOND B. BIONDI: Earlier we heard about the lack of wisdom of taking the peace dividend as a tax cut. I was wondering if we might make an exception for the hotly debated capital gains tax cut?

MR. BOLTZ: Our industry makes its tiny little income off fees attached to total assets under management, and if the capital gains tax reduction were enacted, the value of those assets almost as night follows the day would go up. As an unbiased observer, I would like to say that I think that's probably the best idea I've heard since sliced bread. As a political matter I don't think it is popular around Washington, D.C. at the moment. I would like to say "peace dividend" is a misapplication here; there is no peace dividend. We spent the peace dividend in the 1980s by running huge deficits during peacetime. The point is that we have a deficit in the U.S. that is rising as a share of GNP; it's up 4% and to talk about a peace dividend now is just demagoguery. The U.S. should be running a surplus at the federal level in order to save up for the Social Security retirees in the next century. In fact, one of the reasons people are saving more and putting their money in mutual funds as well as in their pension funds, banks, and thrifts and so forth, is that people really are waking up and getting nervous about Social Security and feeling that there really isn't going to be any serious money there.

FROM THE FLOOR: What do you think about our junk bond market? With the coming growth as both of you expect, does it mean that we can breathe a little easier about a junk bond holding that we have in the insurance industry?

MR. BOLTZ: Peter was just saying that they don't have junk in their portfolio. We do have a junk bond mutual fund. We have parties at our firm when funds go through a certain number, and at one point it went through $1 billion and we had a party. We've had several parties since then for the same number. If your market timing is superb, you can make a lot of money in that market, but the short answer to your question is yes. Corporately we think that if our economic forecast is indeed correct and we do go into a moderate recovery without a double dip, then the junk bond market will begin to function and perform better. We have seen issuance actually start to pick up, albeit very modest issuance compared with just two, three, or four years ago, but that market isn't going to go away. Whatever you may think of Michael Milken and Ivan Boesky, this was a very interesting financial innovation. Most firms, even firms that are household words in the U.S., are not able to get into investment grade bond markets, they can't get quite that good. This so-called junk bond market gave them access to private creditor markets directly, without intermediaries that took a fair cut. It's a development like the commercial paper market, which also went through a meat grinder of its own with the Penn Central bankruptcy and subsequent developments. The junk bond market has gone through 18 meat grinders at last count and got tremendously bad press, but there it is. It's over a $200 billion market, and we think it will gradually get its bearings. More realistic appraisals will be made with the long-term outlook, and the market will continue to function. As it happens, the junk bond market and the prices in that market were amazingly good indicators of how the economy was turning and how it was performing. The junk bond portfolios, at least this year, have so far performed extremely well in terms of total return.

MR. MUNRO: Paul and I were just conferring, and as I said we don't have a junk bond portfolio. Very often in investments it's better to be lucky than smart, and the lucky part of it is that we have very few liabilities in U.S. dollars. Our assets and liabilities are concentrated in Canada. A number of the Canadian insurance companies that do have junk bond portfolios will have it in their U.S. portfolio. We don't have a public junk bond market in Canada for a couple of different reasons, but it's very similar to the commercial real estate and commercial mortgage side in Canada which arguably is in better shape than in the U.S. The reasons basically center on our financial system. Much as we in the insurance business or in financial services like to complain about Canadian banks being ever expanding and gobbling up various sectors of the industry, we do have a strong banking system that supplies credit to some of these lesser credits. In Canada, there really is only one junk bond fund, and it's not all that big and I don't know how well it's doing to tell you the truth. The other factor is, to use a parallel on the commercial mortgage side, that we are a much smaller market: we only have three major centers, Toronto, Montreal, and Vancouver, with maybe one or two other regional centers. We have fewer players, and they are generally stronger and we know them quite well. For example, in the commercial mortgage market, we are dealing with second and third generations of developers, so we know the people, we know their financial status and how good their covenants are, so there's not the same need for alternative financing that you find in the U.S.

MR. STEWART: The Canadian national banking system as you said does in fact provide better access to credit for small and emerging businesses, although never as good as the small and emerging businesses would like.

FROM THE FLOOR: Mr. Munro, just how do you see the very high levels of provincial and federal deficits impacting on real and nominal interest rates in Canada?

MR. MUNRO: The high level of provincial government borrowing to fund the provincial deficits is going to have a factor on spreads much more so than availability. We see the spreads of provincial government bonds to federal government bonds in this country as unduly narrow, and we expect that they will increase. However, as you know, in Canada we now have three provincial NDP governments, socialist governments. It's still very early but the Ontario government, being the largest borrower, is talking about the right sorts of things. Whether they will do the right sorts of things remains to be seen next year, but basically what they are talking about is holding the line on spending, and the talk that they are using is much tougher than the previous liberal and conservative governments. The problem might be that, given the weak economic environment, this year (and what we see for next year) tax revenues will be down. So if there is an increase in the provincial deficit and if they hold the line as they say they will, the increased deficit will be the result of lower tax revenues and not increased spending. If they can show that sort of performance, then we don't expect a disaster. We expect that they will come to market, they will have to pay more in terms of wider spreads, but the funds will be available.

MR. LOUIS M. WEISZ: You talked about the annual federal deficit in the U.S. relative to the GNP. What about the level of total accumulated debt that the government has, compared to the GNP, for the U.S. versus other countries?

MR. BOLTZ: That's an important question, and some people who are not worried about the federal budget deficit look at this number. Since World War II we have had a long period of decline up until about 1980 or 1981 where the outstanding federal debt as a share of GNP fell. What we did was to inflate away its value; for years the U.S. Treasury wasn't paying much out in real terms on interest rates. Long-term investors who bought 20-year bonds right after World War II or (if they hadn't learned their lesson) in the 1960s, lost real purchasing power all those years. During the 1980s, debt as a share of GNP began to rise again. There is a problem in comparing it with other countries: many other countries, such as Belgium or Italy, have a lot more debt; many other countries, such as the U.K., have a lot less debt. There isn't a universal economic relationship where you can say high is good and low is bad. The point is that the U.S., unlike Italy or Belgium, imports a huge amount of capital to support the federal budget deficit. In doing that, we've made ourselves the world's largest debtor, which Italy and Belgium are not, but which countries like Brazil are. We borrowed a huge amount of money from abroad, and we went on a consumption binge in the 1980s; I think that's the problem. It's not so much how big the debt is relative to GNP; the point is how do we get this money and where are we getting it from and what does it mean to U.S. economic power. I think it's quite ominous that we have become the world's largest debtor, and I think we see evidence of it every day in the inability of the Federal Reserve to bring down long-term treasury yields during this recession. Long-term treasury yields, in the 7.8-8.5% range just cited earlier by Peter, are exactly in the same range they traded in all the way through the late 1980s when we were prosperous. This is a very unusual recession in the U.S. because long-term yields really didn't plunge, and this resembles the 1960 recession in that regard. I think we should feel ourselves reasonably fortunate that we got out of the recession in seemingly good order.