LONDON CAPITAL MANAGEMENT

Monthly investment commentary

June 2010

MAY HIGHLIGHTS

- Heightened market volatility dominated the month as investor sentiment soured.
- European sovereign debt issues and Chinese economic stimulus tightening measures overshadowed positive developments in corporate profitability and domestic economic conditions.
- Investors renewed their 'flight to safety' instincts - moving away from equities, commodities and euros, and into government bonds and the U.S. dollar.
- Oil dropped almost 14% as the U.S. dollar rose in value, while expectations for global demand dropped.
- Canada's Q1, 2010 GDP grew at a 6.1% (q/q ann.) - the best three-month performance since late 1999.
- The Bank of Canada raised interest rates 0.25% - the first rise in three years.
- The U.S. unemployment rate dipped to 9.7 per cent and Canadian employment was up for the fifth straight month.

THE MISSING HEADLINES

During the month of May, newspaper headlines could have read:

- North American companies show strong earnings and healthier balance sheets.
- OECD (Organization for Economic Co-Operation and Development) raises global economic growth forecasts as economic activity builds.
- U.S. employment starting to pick up.

Table 1– Summary of major market developments

Market returns*	May	YTD
S&P/TSX Composite	-3.7%	0.1%
S&P500	-8.2%	-2.3%
- in C$	*-5.1%*	*-1.8%*
MSCI EAFE	-8.0%	-6.1%
- in C$	*-9.8%*	*-14.4%*
MSCI Emerging Markets	-5.6%	-4.7%
DEX Bond Universe**	1.2%	2.4%
BBB Corporate Index**	0.2%	3.8%

*local currency (unless specified); price only
**total return, Canadian bonds
Source: Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

Instead, newsprint and investor sentiment took a decidedly negative focus during the month. While a meaningful pullback in markets (particularly after a substantial rally lasting more than a year) was not all together unexpected, it did serve as a harsh reminder that investor sentiment can be fickle, and that capital markets never only go straight up.

FLIGHT TO SAFETY DOMINATED MARKET RESULTS

The month ended with major world equity markets giving back the gains they made earlier in the year. Investors renewed their 'flight to safety' instincts – selling out of riskier assets (such as equities and commodities) and moving into the safe-haven appeal of the U.S. dollars and government bonds. Even with the Bank of Canada raising rates 0.25% (which was largely anticipated and priced into bond markets), the 'safety-trade' boosted fixed-income results (particularly in government bonds) during the month of May (see Table 1).

In Canada, despite overall strong earnings reports (which helped some sectors stay in the black), the results of the S&P/TSX reflect the diminished investor confidence and broad weakness in equities (see Table 2). Energy stocks lost ground alongside the price of oil, which dropped close to 14% over the month. Despite gold stocks benefiting from the strong demand for physical gold (gold is still considered a safety play during times of market uncertainty), the Materials sector lost ground as other commodities such as copper, nickel and zinc dropped in value.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	May	YTD
S&P/TSX	-3.7%	0.1%
Energy	-4.1%	-4.3%
Materials	-2.6%	3.1%
Industrials	-3.5%	1.0%
Consumer discretionary	1.3%	9.0%
Consumer staples	-0.3%	-5.9%
Health care	-2.8%	7.6%
Financials	-5.1%	1.3%
Information technology	-8.5%	-6.8%
Telecom services	0.6%	7.2%
Utilities	-1.9%	-4.3%

*price only
Source: National Bank

THE ACTUAL HEADLINES

Europe continues to face challenges related to the difficult fiscal situations in several countries, particularly Greece, Portugal and Spain. Austerity measures, a decline in the value of the Euro, and slower economic growth have weighed heavily on market sentiment recently. The drop in the value of the Euro has made it one of the worst performing major currencies year-to-date versus the U.S. dollar, and has had a significant negative effect on the returns of European investments when converted back into Canadian dollars (see Table 1).

China's shift away from their ultra-accommodative economic stimulus strategy also caused investors to worry that the economic giant from the east would not generate the insatiable demand for goods and services that the global economy had become used to. Having said that, given the strength of China's recovery and their rising real estate prices, tightening monetary policy to mitigate against inflationary trends and the risk of asset bubbles are prudent actions for long-term sustainable growth.

UPBEAT DATA DESPITE DOWNBEAT SENTIMENT

Closer to home, recent economic and earnings growth data have been upbeat and have confirmed that the recovery has transitioned into a more sustainable phase - one that includes corporations with healthier balance sheets and improving profits, and an improving job market in both the U.S. and Canada.

Canada continues to show resilience in the current environment, benefiting from strong consumer spending, a healthy financial sector, a strong housing market and a lower level of unemployment than that of the U.S. A rebound in global industrial production and trade has improved the outlook for demand of natural resources, further contributing to strong economic momentum.

The U.S., the world's largest economy, has also shown strength on the back of an improving domestic economy and a rebound in consumer sentiment. Economic data for durable goods orders and new home sales both came in above estimates recently. While the job market continues to be challenging, there have been positive signs recently of employment growth in the U.S. A sustainable trend in job growth is critical to a sustainable recovery and will be watched closely over the next several months.

The bottom line is that it is not unusual to have a significant pullback after a prolonged period of strong market recovery. While we expect heightened volatility to continue until investors feel that current global economic concerns in Europe and Asia are contained, the fundamental improvements that we have seen in the health of corporations and the economy bode well for long-term investors.

THE BEAUTIFUL GAME

This month an intense outpouring of emotions and misspent work-time will commence around the world as the 2010 World Cup gets underway in South Africa. There are sure to be surprises and upsets, but the team that reigns supreme will do so through the strength of both their offensive and defensive play.

During times of heightened market volatility long-term investors should also rely on both their defensive and offensive play. A diversified, risk-appropriate portfolio can mitigate the impact of market volatility on your portfolio (defence), while providing a disciplined approach to benefiting from long-term growth opportunities at times of market strength (offense). Why not improve the odds of meeting your financial GOOOOOOOAAAAALLLLLL!!! (Sorry, couldn't resist).