

## Monthly investment commentary

JULY 2007

### JUNE HIGHLIGHTS

- A volatile June, but strength in April and May boost year-to-date returns in the S&P/TSX.
- Inflation concerns remain and the Bank of Canada is expected to raise rates.
- Bond markets remained weak.
- The broader U.S. economy appears to be shaking off the housing slump.
- The Canadian dollar rose sharply in the second quarter, to the 94 cent range.

The first half of 2007 provided very strong results for stock markets, but is the volatility in June a sign of a “glass half full,” with plenty of room for additional growth or a “glass about to tip over,” ending the bull-run for equities?

### GLASS HALF FULL OR ABOUT TO TIP OVER?

Six-years of ultra-low interest rates provided the growth stimulant for corporations, private-equity funds, consumers and, almost everyone other than income investors. But with rising bond yields and a murky outlook for interest rates, investors are becoming skittish, and it’s hard to say if June’s volatility was a sign the party is over or just a shake up to see if we’re all still awake.

Table 1 shows that all major equity markets posted healthy returns for the first half of 2007, with the lion’s share of the returns coming in the second quarter. Even the volatility in June wasn’t enough to offset the gains built up after the Shanghai stock scare of late February. Worldwide, some common factors contributed to the strong gains in equity markets.

- Strong global growth - global GDP is close to 5 per cent
- Persistent merger and acquisition activity - borrowing costs were relatively cheap, and investment opportunities looked attractive to private equity and corporations alike
- Unemployment rates are at relatively low levels

London Capital Management Ltd.

In Canada specifically, the demand for our natural resources (oil and base metals in particular) kept commodity demand and prices high, and provided steady fuel for the resource heavy S&P/TSX.

Keeping Americans working seemed to make all the difference in the U.S. The comfort of a regular paycheck helped investors all but shrug off U.S. recession warnings and a weak housing market.

**Table 1– Summary of major market developments**

Market returns	June	Q2 2007	YTD
S&P/TSX	-1.1%	5.6%	7.7%
S&P500 (US\$)	-1.8%	5.8%	6.0%
S&P500 (C\$)	-2.6%	-2.7%	-3.5%
NASDAQ	0.0%	7.5%	7.8%
Russell 2000	-1.6%	4.1%	5.8%
FTSE 100 (U.K.)	-0.2%	4.8%	6.2%
NIKKEI 225 (Japan)	1.5%	4.9%	5.3%
EAFE (C\$)	-0.5%	-2.7%	-0.3%
EAFE (local currency)	-0.4%	4.9%	7.8%
Canadian Bond Market	-0.3%	-1.7%	-0.8%
World Bond Market (US\$)	-0.5%	-1.3%	-0.8%

\*local currency (unless specified); price only

### CANADIAN MANUFACTURERS HAVE LITTLE LOVE FOR SOARING LOONIE

During 2007, the loonie took flight, as the Canadian dollar rose from 83 cents U.S. to the 94 cent range, up approximately nine per cent. While the Canadian dollar is a show of strength for the Canadian economy (encouraging foreign investment in our country), manufacturers share little love for the rising loonie. For manufacturers, a rising Canadian dollar means their exports are less competitive on the global market and sales in manufactured exports have begun to see declines. Likewise, for Canadians investing abroad, their returns have been eaten away by the currency exchange. As an example of the currency effect, consider the difference in S&P500 results in local versus Canadian currency for the first six months of 2007, 6.0 per cent returns versus -3.5 per cent.

Yet these worldwide trends noted above directly benefitted the Canadian stock market. Global demand for commodities helped boost the Energy and Materials sectors, as can be seen in Table 2. Merger and acquisition activity saw stock prices rise in the Telecommunications sector (though earnings strength in the wireless industry also helped). More people working places demands on roads, rails, airports and homes. Canada's industrial sector is benefiting from the growth in infrastructure and infrastructure spending, in particular the aerospace and defence companies.

For fixed-income investors, June proved to be a difficult month as the fixed-income market began to price in an anticipated rate hike, and even a possible second rate hike by the Bank of Canada.

### DODGE'ING THE INFLATION BULLET

You may not follow the Consumer Price Index (CPI) releases, but you likely have noticed that your grocery bill and gasoline bill have gone up. Inflation in Canada has been on the rise and with it the chances of the Bank of Canada Chairman David Dodge raising interest rates before the end of the year.

Rising interest rates and the higher cost of borrowing could stifle the buying spree of private equity funds, corporations and consumers alike. Productivity is slowing putting pressure on company earnings. This in turn is causing valuations (price to earnings) to rise - a sign the market is getting more expensive and less appealing to investors. These factors together potentially signal tough days ahead for the markets.

But market optimists take a different view. They point to strong fundamentals supporting the markets – most of which haven't changed.

- Global growth rate running at close to five per cent.
- Strong global demand for commodities.
- Low unemployment in both Canada and the U.S.
- A resilient consumer that seems to have weathered the housing market downturn in the U.S.
- The continuation of strong merger and acquisition activity.

**Table 2 - Sector level results for the Canadian market**

S&P/TSX sector returns	June	Q2 2007	YTD
S&P/TSX	-1.1%	5.6%	7.7%
Energy	-1.3%	7.8%	7.6%
Materials	-0.5%	8.2%	11.4%
Industrials	-0.9%	11.2%	18.3%
Consumer discretionary	-0.7%	3.6%	8.0%
Consumer staples	0.9%	4.1%	3.3%
Health care	0.4%	-0.7%	-3.7%
Financials	-2.7%	-0.6%	1.9%
Information technology	9.3%	16.4%	16.0%
Telecom services	0.8%	16.6%	24.8%
Utilities	-4.9%	5.1%	-2.1%

\*price only

Regardless of which view you hold, containing and eventually reducing inflation will be key as to whether the equity markets will continue making gains in 2007. As central bankers take the next few months to weigh out their concerns about economic growth and inflation, investors are best to maintain their long-term view and to expect volatility over the coming months. Consider this quote from Sam Ewing, writer and radio announcer.

*"Inflation is when you pay \$15 for the \$10 haircut you used to get for \$5 when you had hair."*

There is little benefit to worrying about either problem.