LONDON CAPITAL MANAGEMENT

Monthly investment commentary

OCTOBER 2007

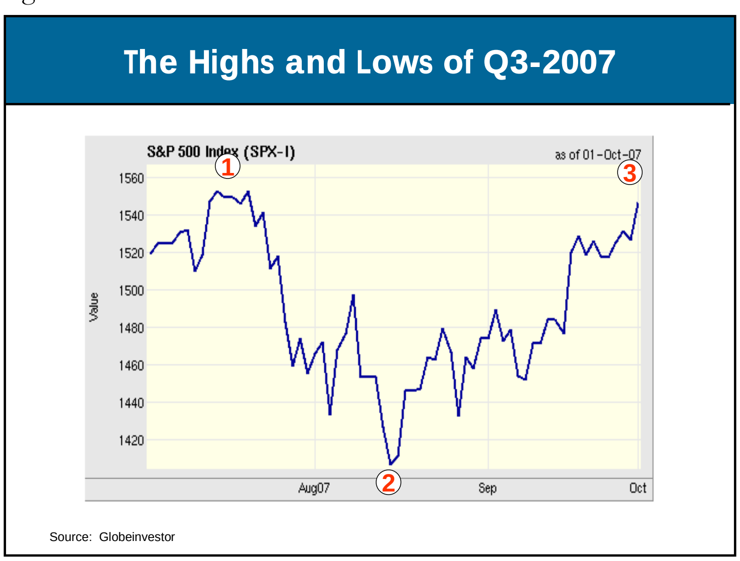
SEPTEMBER HIGHLIGHTS
• Canadian dollar hits parity with the U.S. dollar for the first time in 31 years. • Oil prices end the month above $81.47 US per barrel, up $20 so far this year. • Gold prices rose over nine per cent to $743.50 US in the month of September. • Stock markets rebounded with a v-shaped recovery from summer-time lows. • U.S. Federal Reserve lowered target interest rates by 50 basis points (0.5 per cent) in September.

THE HIGHS AND LOWS OF Q3-2007

Despite feeling sad to see summer end, each fall we're still grateful for the routine that, once again, returns to our lives. A sharp rebound from a summer-time market correction doesn't hurt either.

The third quarter of 2007 was the proverbial roller coaster ride for stock market investors with dizzying turns, sharp drops and steep climbs.

Figure 1.



Using the S&P500 as an example (see Figure 1), we note some of the defining points in the third quarter:

(1) July 19 marked the high point for the S&P500, the culminating effect of increasingly confident investors, and merger and acquisition activity fuelling stock market gains.

(2) The housing market in the U.S. was already a concern, but it wasn't until the other 'sub-prime shoe' dropped that we all paid attention. The sub-prime market contagion spread and the S&P500 dropped 11.7 per cent within a month of its record highs.

(3) Fast forward to the end of September and the markets followed that drop with an equally impressive rise.

Most major indices followed suit in their recovery from summer-time lows (see Table 1).

Table 1– Summary of major market developments

Market returns	Sept.	Q3 2007	YTD
S&P/TSX	3.2%	1.4%	9.2%
S&P500 (US$)	3.6%	1.6%	7.6%
S&P500 (C$)	-2.2%	-4.7%	-8.0%
NASDAQ	4.0%	3.8%	11.8%
Russell 2000	1.6%	-3.4%	2.3%
FTSE 100 (U.K.)	2.6%	-2.1%	4.0%
NIKKEI 225 (Japan)	1.3%	-7.5%	-2.6%
EAFE (C$)	-1.1%	-5.3%	-5.6%
EAFE (local currency)	2.1%	-3.0%	4.6%
Canadian Bond Market	0.7%	1.7%	0.9%
World Bond Market (US $)	0.1%	2.6%	1.8%

*local currency (unless specified); price only

Several factors contributed to this v-shaped recovery. Among these factors were market professionals who saw the low point in August as a re-entry point after waiting for the 4.5 year old bull market rally to retreat before jumping back in and putting cash to work.

However, the most significant jump in the markets came on and after Sept. 18, 2007. The U.S. Federal Reserve (Fed) announced a greater than expected rate cut of 50 basis points. This marked their first rate cut in the U.S. in more than 4.5 years, which sent a psychological message to investors that they were concerned about the health of the U.S. economy and were going to help out. Investors reacted swiftly, sending global stock markets soaring and the U.S. dollar in further decline (hitting 15-year lows in September).

FLYING HIGHER THAN AN EAGLE

It actually happened! The Canadian loonie hit parity with the U.S. dollar on Sept. 28. Since its all-time low in January 2002, the rise in the Canadian dollar amounts to a 60 per cent appreciation. What is behind this incredible run? The recent rise of the Loonie was as much about where investors wanted to be (in Canada, for its natural resources and commodities), as it was about where they didn't want to be (in the U.S., where housing market concerns and a slowing economy created uncertainty). Globally, the loonie is widely seen as a petro-currency, closely tied to the rise and fall of oil markets. The $20 rise in oil prices year-to-date provided some of the fuel to the loonie's rise this year. The loonie's rise in value vaporized positive foreign returns in September once those returns converted back into Canadian dollars (see Table 1).

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	Sept.	Q3 2007	YTD
S&P/TSX	3.2%	1.4%	9.2%
Energy	3.5%	-3.2%	4.2%
Materials	9.1%	12.4%	25.2%
Industrials	1.0%	-0.2%	18.1%
Consumer discretionary	-0.1%	-0.9%	7.0%
Consumer staples	-1.4%	-2.3%	1.0%
Health care	-1.1%	-15.4%	-18.6%
Financials	2.1%	0.1%	2.0%
Information technology	3.7%	14.4%	32.6%
Telecom services	-1.5%	-2.7%	21.3%
Utilities	2.6%	5.7%	3.5%

*price only

The Canadian stock market gained ground in September with a healthy 3.2 per cent rise, and year-to-date returns up by 9.2 per cent (see Table 2). These gains have largely been driven by the resource sectors. Rising oil prices boosted the Energy sector. In the Materials sector, several sub-sectors (gold, diversified metals, and fertilizer and agricultural chemical companies) experienced a particularly strong month. This past month, the Fed's move to lower rates saw an influx of investors moving into gold and gold-exchange-traded funds as a viable alternative to holding the weakened U.S. dollar. This boosted gold prices, which in turn helped the gold companies within the Materials sector.

Likewise, the Industrial sector has also been one of the strongest performing sectors in Canada in 2007. In particular, the railroad companies caught the eye of both private equity investors and some high profile institutional funds. The favourable attention moved stock prices higher in that sub-sector.

For Canadian fixed-income investors, September proved to be a solid month with reasonable gains – particularly for a year where muted returns are to be expected. With the Fed's greater than expected rate cut, speculation grew in September over whether the Bank of Canada would hold, or perhaps even lower, rates at its next rate announcement meeting on Oct. 16. As a result, bond yields fell and provided a modest boost to returns.

PARITY…BUT NO CLARITY

A strong stock market, a soaring rise in the Canadian dollar, strong commodity prices…there's a lot for Canadians to feel good about. Yet we caution against too much optimism as there are always two sides to every coin.

When markets rebound so quickly, it is easy to forget the anxieties of just a few weeks ago. The rising Canadian dollar is challenging for exporters, forestry companies and manufacturers who are vulnerable to a strong loonie. Re-adjusting to a stronger Canadian dollar will take time for those industries, and in the process, there will be some winners and some losers. Likewise, it is far too early to determine whether September's rebound could be the beginning of another strong leg for the bull market, or just be the next phase of a new, and more volatile, stock market.