LONDON CAPITAL MANAGEMENT

Monthly investment commentary

October 2009

Q3 HIGHLIGHTS

- Global stock markets ended another strong quarter. Most world markets hit their 2009 highs during the three month period.
- The positive expectations for global growth that prevailed during the quarter supported the rise in equity markets and commodity prices alike.
- The Canadian dollar ended the quarter up 7.5% at $0.93(US). Rising commodity prices, U.S. dollar weakness and Canada's better relative economic conditions contributed to the loonie's strength.
- On the heels of the economic improvements seen during the third quarter, the International Monetary Fund's (IMF) economic forecasts for global growth in 2010 were raised to 3.1 per cent on October 1, 2009.

WINNING WAYS

The third quarter results for world markets were truly stellar (see Table 1). A combination of increased economic confidence and better than expected second quarter earnings results helped to fuel the advance. Here are just some of the equity markets' winning ways over the past quarter:

- The U.K.'s FTSE 100 index climbed 21 per cent in Q3 - its best three-month performance since the creation of the index in 1984.
- The S&P 500 hit a new 2009 high – the index ended the quarter up over 55% from its March nadir. In fact the combined return of the second and third quarter (+32.7%) was the strongest since 1975, and the second strongest since 1938.
- The S&P/TSX returned 4.8% in September – enough to make that its second best September result in 30 years.

Justification for this positive equity market response was backed-up by the International Monetary Fund's twice-yearly World Economic Outlook report on October 1, 2009, which raised the economic global growth forecast for 2010 to 3.1% from its previous forecast of 2.5% in July.

COLD HARD CURRENCY – COLD HARD EFFECT

Unfortunately one equity index stood out for the wrong reasons: Japan's NIKKEI 225 (see Table 1). Tokyo shares fell in September in spite of economic data improving in the U.S., a key market for Japanese exporters. Yen strength hurt Japanese exporters and Japanese financial stocks took a beating in response to proposed regulatory changes.

Table 1 also highlights another effect of rising currencies – the dampening effect of our strengthening Canadian dollar on foreign investment returns. Notice the 14% discrepancy from the S&P500 returns in Canadian versus U.S. dollar terms. Since dropping earlier this year, the Canadian dollar has more or less tracked commodity prices higher. While the growth-stifling effect of a strong loonie remains a concern (especially for Canadian exporters), it has yet to warrant an offsetting policy response from the Bank of Canada.

Table 1– Summary of major market developments

Market returns*	Sept.	Q3 2009	YTD
S&P/TSX	4.8%	9.8%	26.8%
S&P500 (US$)	3.6%	15.0%	17.0%
S&P500 (C$)	0.8%	5.8%	2.8%
NASDAQ	5.6%	15.7%	34.6%
Russell 2000	5.6%	18.9%	21.0%
FTSE 100 (U.K.)	4.6%	20.8%	15.8%
NIKKEI 225 (Japan)	-3.4%	1.8%	14.4%
EAFE (C$)	1.2%	9.3%	9.8%
EAFE (local currency)	1.9%	14.2%	17.4%
Canadian Bond Market**	0.9%	2.7%	5.6%
World Bond Market (US $)**	0.5%	2.0%	0.9%

* local currency (unless specified); price only
**total return
Source: S&P, National Bank, Royal Bank

HOLDING STEADY

The Bank of Canada stayed true to its promise earlier in the year and left the overnight rate at 0.25%. With helpful monetary policy, a stabilizing economic environment and inflationary concerns in check, it was a solid quarter for bond markets, particularly in light of the low-interest rate environment (see Table 1). Returns were boosted by a continued narrowing of credit spreads in both corporate and provincial bonds as well as by a slight decline in long-term government bond yields.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	Sept.	Q3 2009	YTD
S&P/TSX	4.8%	9.8%	26.8%
Energy	9.1%	8.2%	29.0%
Materials	8.9%	12.3%	25.9%
Industrials	2.0%	10.4%	14.4%
Consumer discretionary	0.9%	5.3%	5.6%
Consumer staples	-0.7%	-3.2%	-1.5%
Health care	15.0%	21.4%	32.6%
Financials	2.9%	14.9%	40.8%
Information technology	-6.9%	-8.1%	43.2%
Telecom services	0.0%	6.7%	-5.0%
Utilities	1.4%	2.3%	0.9%

* price only
Source: National Bank

FINANCIAL STRENGTH

Within the Canadian equity market, Table 2 highlights tremendously strong results from the three largest sectors of the S&P/TSX index. The Energy, Materials and Financial sectors comprise 76.6% of the Canadian equity index (at September 30, 2009). Rising commodity prices boosted the resource sectors in the third quarter, while the Financial sector (after months of being at the centre of the financial crisis firestorm) posted strong second quarter earnings and has been staging an impressive come-back. The defensive sectors, such as the Consumer Staples and the Telecommunication sectors which held up better during the downturn, have shown relative weakness as investors have recently been favouring the more cyclical sectors.

THE DIFFERENCE A YEAR CAN MAKE

Whether it's the Lehman Brothers collapse or the passing of the now famous troubled asset relief plan (TARP), as each one-year anniversary of shocking market events pass us by, it is impossible not to be struck by the extreme contrast between then and now.

THEN	NOW
• Corporate bonds (and anything else with credit risk) were completely shunned.	• Today there isn't enough corporate bond issuance to meet the strong demand of investors.
• Equity markets were on their way to 50%-60% declines from market highs.	• Equity markets are up 50%-60% from market lows.
• Commodity prices sink as global growth expectations evaporate, bringing the Canadian dollar down with it.	• Commodity prices rise on expectations of improved global growth, bringing the Canadian dollar up with it.

To say we've come a long way is truly an understatement – what a difference a year can make! We are still a long way from a full economic recovery. We can't ignore that labour markets and consumer health remain major points of concern. And while companies beat expectations in the second quarter, the bar is rising and companies will now have to move beyond the trend of cost-cutting to make-up for weak revenues. But the economy is beginning to rebuild, and investors are too.