LONDON CAPITAL MANAGEMENT

Monthly investment commentary

February 2008

JANUARY 2008 HIGHLIGHTS
• Equity markets worldwide lost ground in January.
• Nine out of ten sectors on the S&P/TSX posted negative returns.
• Only the Canadian Materials sector managed positive returns, led by gold companies.
• The U.S. Federal Reserve announced a total of 1.25% in rate cuts in January.
• Since September 2007 U.S. rates have been slashed 2.25% in its attempt to stimulate the U.S. economy and stabilize financial markets.
• The Bank of Canada cut rates by 0.5% in January.

ONLY GOLD GLITTERED

Stock markets around the globe ended January in negative territory after an erratic and volatile start to 2008. Most gave back all of their 2007 gains in just one month (see Table 1), and many experienced their worst January in several years. For the NASDAQ, it was the worst January…ever! The credit crisis snowball that started with questionable property lending in the U.S., spread to structured investment products, then to the banks' balance sheets, and now has firmly hit stock markets.

In Canada, the S&P/TSX traded down more than 13% before rallying in the final weeks of January, ending the month down 'only' 4.9%. Losses in Canada were broad-based, with nine out of ten sectors posting negative returns (see Table 2). After a very strong run in 2007, the Information Technology sector gave back some of those gains. Likewise, as oil prices fell, so did the value of energy stocks in January.

Only the Materials sector managed to post positive returns in the month as both gold and base metal prices rose. Gold is considered a defensive holding during times of market uncertainty, so the heightened demand for the precious metal, along with the weakening U.S. dollar, helped gold prices rise 10.4% in January.

Results for bond markets were up in January as the flight to quality continued. Investors continue to look to the relative safety of government bonds to avoid the volatility and downside risk of equity markets. The central banks' actions to ease interest rates during the month also provided a boost to bond markets.

Table 1– Summary of major market developments

Market returns	2007	January
S&P/TSX	7.2%	-4.9%
S&P500 (US$)	3.5%	-6.1%
S&P500 (C$)	-11.9%	-4.9%
NASDAQ	9.8%	-9.9%
Russell 2000	-2.7%	-6.9%
FTSE 100 (U.K.)	3.8%	-8.9%
NIKKEI 225 (Japan)	-11.1%	-11.2%
EAFE (C$)	-7.0%	-9.0%
EAFE (local currency)	1.2%	-11.0%
Canadian Bond Market	3.7%	0.6%
World Bond Market (US $)	4.0%	1.7%

*local currency (unless specified); price only

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	2007	January
S&P/TSX	7.2%	-4.9%
Energy	5.0%	-7.0%
Materials	29.1%	4.4%
Industrials	8.6%	-3.9%
Consumer discretionary	1.8%	-10.8%
Consumer staples	-6.8%	-6.8%
Health care	-27.1%	-5.9%
Financials	-4.6%	-4.5%
Information technology	48.1%	-13.8%
Telecom services	16.2%	-12.2%
Utilities	6.9%	-2.5%

*price only

THE 'BERNANKE PUT'

The most dramatic of market moves this past month came on January 21st. While Americans were celebrating Martin Luther King, Jr. day, stocks from Brazil to Britain plunged on news of more trouble with financial service companies. Adding to this sector's uncertainty, monoline insurers (bond insurers) became the latest victim of the sub-prime mortgage contagion. Immediately following the January 21st slump in global markets (and the prospect that U.S. equity markets would also drop sharply) Ben Bernanke, Chairman of the U.S. Federal Reserve called a surprise 'pre-bell' meeting the morning of January 22nd during which he slashed interest rates by 0.75%. The expression 'The Bernanke put' (the belief that the Fed chairman will ride to the rescue whenever stock markets falter) was solidified. While the surprise move by the U.S. Federal Reserve effectively avoided an imminent market sell-off that day, it did little to alleviate longer-term economic worries.

THE ECONOMY VS THE STOCK MARKET

In fact, despite the U.S. Federal Reserve's actions, the risk of a U.S. recession has grown since the beginning of the year, and it is reasonable to believe that those countries reliant on trade with the U.S. (like Canada) will feel some negative effects from their weakened economy. But it does not mean it is all doom and gloom for stock markets. You don't need to forecast the economy to invest successfully. In fact, current economic conditions may have less effect on the near-term outlook for stock markets than you think. That's because of a key difference between capital markets and the economy:

- The economy is viewed through the rear-view mirror - by what has already taken place - such as unemployment rates, manufacturing data, retail sales, etc… All data based on what took place last month, or last quarter, or last year.
- Capital markets are forward looking. People buy and sell stocks based on what they think is going to happen in the future.

Since a recession is commonly defined as two consecutive financial quarters where production declines, and since you don't know if production declined until after the quarter has ended, by definition you don't know you're 'in' recession until after you've been 'in' a recession for a while. And by the time most people are thinking they may be 'in' a recession, stock prices have already adjusted for it. The same holds true when investors begin to think that things will get better. Stock prices will have already priced in the optimism before the economic shift has actually taken place. It is this predictive nature of the stock markets that give rise to old Wall Street proverbs like 'buy on bad news and sell on good news'.

DON'T LET SHORT-TERM PAIN DERAIL YOUR LONG-TERM GAINS

Months such as January 2008 can be unsettling and frustrating for investors, just as trying to guess the market's next move based on economic news, central banks actions, and the media hype that is sure to surround any large swing in the markets. To calm nerves, we suggest putting both time and diversification on your side. During times of economic uncertainty and volatile markets, investors are wise to maintain a well-diversified investment plan that suits both their needs and risk tolerance, and avoid the emotional reactions to headlines that can derail them from achieving their long-term investment goals.