LONDON CAPITAL MANAGEMENT

Monthly investment commentary

August 2009

JULY'S HIGHLIGHTS

- Equity markets continued to recover as economic signs emerged signalling that the recession is nearing its end. Of note, the S&P500 had its best performing month of July since 1988, and many world markets have seen a recovery in the 30 to 50 per cent range since early March lows.
- The Canadian dollar hit a 10-month high of 92.77 cents (U.S.).
- Base metal prices (like copper, nickel and zinc) rose more than 10% in July on expectations of improving global growth. Oil prices ended the month at $69.28/barrel (WTI) – more or less flat for the month.
- Second quarter U.S. GDP declined less than expected (-1% annualized), while Canada's monthly GDP rate for May declined slightly faster than had been forecasted (-0.5%) with challenges in the manufacturing sector weighing on growth.

I CAN SEE CLEARLY NOW THE RAIN HAS GONE

Complaints about this summer's weather can be heard across the country, with many areas experiencing conditions that are either too hot, too cold, too wet or too dry. But on Bay Street and Wall Street this July, it's been blue skies, warm summer winds and just enough rain to get things growing again. In less meteorological terms:

- Credit concerns and extreme risk-aversion have eased substantially.
- Second quarter corporate earnings reports showed, by and large, better than expected results.
- The ongoing release of economic data showed an improving scenario for global economic growth, and;
- The U.S. in particular showed signs of emerging from the ashes of the economic downturn.

The sunny combination of factors is burning away the dark recession clouds and equity markets around the world experienced another month of healthy equity gains (see Table 1).

Could there be dark clouds on the horizon for equity markets? Yes - there are still a number of challenges looming over the economic landscape that could slow down or stall the market's recovery. Most notably, unemployment rates continue to climb across North America and that threatens to reduce consumer confidence, slow consumer spending, and result in even more home foreclosures. While corporate earnings and balance sheets are showing improvements, additional economic pressures like these could impede earnings growth.

Bond markets, while still influenced by the overall improving credit conditions, were more affected in July by simple supply and demand issues. In short, too much supply of government bonds being issued (driving prices down), and not enough corporate bonds being issued to meet demand (driving prices up). The end result was a narrowing of the interest rate spread between the government and corporate bonds, and a more or less average return for bond markets this month.

Table 1– Summary of major market developments

Market returns*	July	YTD
S&P/TSX	4.0%	20.0%
S&P500 (US$)	7.4%	9.3%
S&P500 (C$)	-0.1%	-3.0%
NASDAQ	7.8%	25.5%
Russell 2000	9.5%	11.5%
FTSE 100 (U.K.)	8.5%	3.9%
NIKKEI 225 (Japan)	4.0%	16.9%
EAFE (C$)	1.0%	1.5%
EAFE (local currency)	7.6%	10.6%
Canadian Bond Market	0.7%	3.5%
World Bond Market (US $)	0.6%	-0.5%

*local currency (unless specified); price only

WHO'S SOAKING UP THE SUN

As markets rebound from their early March lows, there has been a growing divergence in sector leadership. Why are some sectors rebounding so strongly, while others are being left behind?

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<u>Moving from 'fear of the markets' to a 'fear of missing out on the markets'</u>

During the market turmoil of 2008 and early 2009, the extreme flight-to-safety response from investors caused a mass exodus from equities all together, or within equities, to the more defensive sectors such as Consumer Staples, Telecommunications and Utilities (which, relatively speaking, held up better during the market downturn). Now, as many equity markets rebound, investors are anxious to make back their losses and are willing to take on additional risk in return to avoid 'missing out'. They are foregoing their previous risk-aversion tendencies for a new found comfort with the cyclical sectors (like the resource sectors, Industrials and Information Technology) (see Table 2 for the S&P/TSX sector returns). These cyclical sectors tend to respond more quickly to improving economic conditions, but also tend to be more volatile.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	July	YTD
S&P/TSX	4.0%	20.0%
Energy	-0.4%	18.8%
Materials	3.2%	15.7%
Industrials	3.9%	7.7%
Consumer discretionary	1.9%	2.3%
Consumer staples	-4.5%	-2.9%
Health care	0.1%	9.4%
Financials	10.7%	35.7%
Information technology	0.0%	55.9%
Telecom services	1.4%	-9.7%
Utilities	-0.2%	-1.6%
*price only		

<u>Everyone loves a come-back</u>

Those sectors hardest hit during the market turmoil now have more room for their stock prices to recover. The Financial sector in particular falls into this category. While credit conditions were roiling, financial company stock prices were hammered down. Some rightly so, as balance sheet revelations uncovered tenuous circumstances, but many financial companies also suffered from indiscriminant selling and a loss of faith from investors. As many financial companies are now emerging from the ashes, investors have been taking advantage of their historically low stock prices – helping the sector to rebound significantly from its oversold positions.

THE CURRENCY EFFECT

Against the U.S. dollar, the Canadian dollar has been on quite a tear lately with hardly a summer-time retreat. While cross-border shopping may be back on your list of summer excursions, the high Canadian dollar does threaten to dampen exports, hamper Canada's economic recovery, and put even more manufacturing jobs at risk. To add insult to injury, the strong returns in foreign investment have all but been eliminated (see Table 1 for the marked difference between the S&P500 returns in U.S. versus Canadian dollars: a 12.3% difference so far this year, and a 7.5% difference in July alone!).

Why have we seen these large currency movements? Good news about the economy is bad news for the U.S. dollar. That's because the U.S. dollar is considered to be a 'safe-haven currency' for investors worldwide due to the high degree of liquidity it offers – something that is particularly valued during times of global financial turmoil. As capital market conditions improve, investors are selling off their U.S. cash holdings to free up money for other investments with greater return opportunity, not necessarily within the U.S. With more sellers than buyers, the value of the U.S. dollar has dropped.

In contrast, good news about the economy tends to boost the Canadian dollar. As global economies show a resurgence of activity (particularly in emerging markets), resource-rich countries like Canada stand to benefit from the increased demand that global growth creates for commodities. This, coupled with the Governor of the Bank of Canada and others proclaiming that Canada will emerge faster and stronger than many other industrialized nations, gives convincing reason to attract investors to Canada – boosting the demand and value of the Canadian dollar.

TIME TO RE-GROUP

The equity market recovery of the last few months have allowed for relative calm and clarity to return to the capital markets – making it a good time to regroup on both the opportunities and risks facing markets.

Stock prices are affected by a multitude of factors at any given time, including corporate earnings, valuations, investor sentiment and economic conditions. Lately, positive leading economic indicators have lifted confidence and created some reassurance that we are not headed for the extremely deep, long, drawn out recession that so many had predicted only a few short months ago. This has been the welcomed news needed to help fuel the recent market recovery. However, the recent strong equity market rally was also helped by the fact stock prices are coming off of very depressed levels - a catalyst that, by its very nature, is bound to dissipate.

Likewise, corporations will be entering the remaining months of 2009 and into 2010 facing a changed consumer (particularly in the U.S.). Today's consumer is not only worried about losing their job, but they also have a lot of debt to pay off. From the Federal government right down to the average person on the street, a process of de-leveraging is going to need to take place – sooner or later. This repairing of household balance sheets and reprioritizing of savings over spending may hamper the recovery of corporate earnings results. How companies deal with this changing landscape will determine their ability to continue recovering, and hopefully thrive in the coming months and years.

So while the economic skies are undoubtedly clearing, expect short-term market gyrations and plan for them with a well diversified portfolio and keen focus on your long-term goals – because markets rarely go straight down…or straight up.