

Monthly investment commentary

JUNE 2007

MAY HIGHLIGHTS

- Canadian dollar hit 94.07 cents U.S. (June 1), the highest level since July 1977.
- Market records included the Dow Jones and the S&P500 hitting all-time highs, as well as the NASDAQ reaching a seven-year high.
- Canadian GDP growth was up 3.7 per cent (Q1 annualized), and significantly stronger than that of the U.S. which was up only 0.6 per cent (Q1 annualized) – the weakest showing since the end of 2002.
- Core inflation in Canada is running at a four-year high, heightening the odds of an upcoming rate hike.
- Average gasoline price (May) up 7.4 per cent year over year.

In May, North American stock markets hit new highs, unemployment reached a 33-year low, and the Canadian dollar met 30-year highs. However, it was rising inflationary concerns that weighed heavily on the minds of central bankers and economists during the month.

INFLATION THE PREDOMINANT CONCERN

In the U.S., despite a continued slow down in economic growth, controlling inflation seemed to take precedent over renewing growth in the economy. In his May 9 Federal Open Market Committee statement, U.S. Federal Reserve Chairman Ben Bernanke said, “In these circumstances, the committee’s predominant policy concern remains the risk that inflation will fail to moderate as expected.” Likewise in Canada, core inflation is at a four-year high, which heightened expectations of potential upcoming rate hikes, after a full year of steady Bank of Canada rates.

David Dodge, Bank of Canada governor, has a lot more on his mind these days than his upcoming retirement plans in January 2008; his most recent Bank of Canada interest rate statement clearly signals that rate hikes are coming.

The soaring Canadian dollar – a treat for those planning summer vacations abroad – has created headaches for the manufacturing sector that was already dealing with higher energy, materials and transportation costs. Raising rates, while slowing the economy and moderating inflation, could send the dollar even higher and pummel the already bruised Canadian manufacturers and exporters of goods. If both inflation and the dollar continue to rise, Dodge could find himself walking a fine line between curtailing inflation and supporting Canadian exporters and the manufacturing sectors.

Table 1– Summary of major market developments

Market returns	May	YTD
S&P/TSX	4.8%	8.9%
S&P500 (US\$)	3.3%	7.9%
S&P500 (C\$)	-0.2%	-0.9%
NASDAQ	3.1%	7.8%
Russell 2000	4.0%	7.6%
FTSE 100 (U.K.)	2.7%	6.4%
NIKKEI 225 (Japan)	2.7%	3.8%
EAFE (C\$)	-2.3%	0.2%
EAFE (local currency)	2.7%	8.2%
Canadian Bond Market	-1.4%	-0.5%
World Bond Market (US\$)	-0.9%	-0.3%

*local currency (unless specified); price only

BLACK GOLD, A RED-HOT LOONIE, AND A BLUE STREAK OF M&A ACTIVITY

In table 1 you’ll see all the major markets around the globe posted positive returns in May – at least in local currency. Because the Canadian dollar rose steadily in May, the exchange rate for Canadians who invest abroad took away from otherwise positive returns for both the S&P500 and EAFE index. Globally, merger and acquisition (M&A) activity shows no signs of slowing, and it continues to fuel gains in the equity markets.

The pace and capacity for continued M&A activity have led to increased investor confidence and some tolerance for negative economic news. In May, American stock markets seemed unfazed by weak economic news such as the first quarter GDP annualized growth number, which was up only 0.6 per cent, the weakest since the end of 2002. Recession fears seem to have calmed as investors appear to have gained comfort with the soft-landing scenario for the U.S. economy.

Looking at the larger picture, the world economy continues to surprise with higher than expected GDP growth, including steady growth from Europe and the emerging markets. However, it was the resource-heavy S&P/TSX that led the way this month with a very strong 4.8 per cent return in May (see table 2). The S&P/TSX had its best month so far this year, which contributed to over half of the year-to-date gains. Both the Energy and Materials sectors moved up on a combination of M&A activity and persistently high oil and commodity prices. The Information Technology sector was the strongest sector in May, bolstered by RIM and Nortel, while the Consumer Staples sector saw broad weakness and finished the month slightly in negative territory.

In contrast, the Canadian bond market sold off in May. Bond prices dropped with the release of positive economic data and because of an increased likelihood that the Bank of Canada may enter into a tightening campaign and raise interest rates in the near future.

THE COST OF TIMING CURRENCY

Many economists and investors are spending a lot of time and effort trying to determine the next currency move, the next interest rate hike and which market sector will see the next run. In light of this, remember the saying: "Time is the only true currency in life." Investors focused on a long-term investment strategy can benefit because they don't get caught up in short-term views and news – and as a result, they have time to focus on the things that are most important to them.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	May	YTD
S&P/TSX	4.8%	8.9%
Energy	6.4%	9.1%
Materials	8.0%	12.0%
Industrials	6.8%	19.4%
Consumer discretionary	1.7%	8.8%
Consumer staples	-0.8%	2.4%
Health care	0.1%	-4.1%
Financials	1.7%	4.8%
Information technology	12.2%	6.0%
Telecom services	4.8%	23.8%
Utilities	5.3%	3.0%

*price only