LONDON CAPITAL MANAGEMENT

Monthly investment commentary

AUGUST 2007

JULY HIGHLIGHTS

- Investor confidence was shaken by escalating worries over the faltering U.S. sub-prime mortgage market and the spill-over effect of tightening credit conditions.
- Investors' response during the last week of July was a broad-based sell-off on most major markets, including a more than 5% drop for the S&P/TSX.
- Despite the wild ride, the S&P/TSX remained fairly flat for the month - helped by solid gains in the Materials sector. (see Table 2).
- Overall commodity prices held up well in July. Oil prices hit an all time high - ending July at $78.21/barrel (West Texas).
- Early signs point to stronger than expected Q2 2007 corporate earnings in Canada and the U.S.
- Global growth still expected to be strong – growing at nearly 5% through 2008.

WHAT A DIFFERENCE A WEEK CAN MAKE!

Whether it's taking a summer vacation to recharge your batteries, or a sharp drop in equity markets, a week can do a lot to change moods and perspectives.

With one week left in the month of July, investors turned their focus to the problems of the U.S. sub-prime mortgage market, the rising cost of debt, and the resulting slowdown effect it could have on merger & acquisition (M&A) activity. All in all, investors lost confidence and their appetite for risk, and a sell-off ensued that added up to a 5% drop on the S&P/TSX.

The effect of this pull-back was felt worldwide as most major markets (see Table 1) ended the month in negative territory, though earlier gains in 2007 left many in positive territory on a year-to-date basis. Despite strong global growth and solid economic data, the mood and health of the U.S. consumer (a net importer of goods) remains an important element to supporting global economies, and July's sympathetic reaction of global equity markets reminded us of that.

Bond markets kept their focus on the re-pricing of credit risk. While a flight to quality saw modest gains to government-issued bond returns, corporate bonds took a hit. With all eyes focused on the rising cost of debt, yields rose on corporate bonds and pulled down their returns. The Canadian bond market finished the month just slightly in positive territory, up 0.1%.

Table 1– Summary of major market developments

Market returns	July	YTD
S&P/TSX	-0.3%	7.4%
S&P500 (US$)	-3.2%	2.6%
S&P500 (C$)	-2.9%	-5.5%
NASDAQ	-2.2%	5.4%
Russell 2000	-6.9%	-1.5%
FTSE 100 (U.K.)	-3.7%	2.2%
NIKKEI 225 (Japan)	-4.9%	0.1%
EAFE (local currency)	-3.3%	4.2%
EAFE (C$)	-1.3%	-2.0%
Canadian Bond Market	0.1%	-0.7%
World Bond Market (US$)	1.3%	0.5%

*local currency (unless specified); price only

SURPRISED? IT'S ALL RELATIVE

Carmen, Manitoba (southwest of Winnipeg) setting a new Canadian humidex record of 53°C…that's a surprise. A 57-month old bull market that has seen a rise of 156% (since October 2002) having a pull-back of 5%...maybe not so much!

Concerns about rising interest rates and the spill-over effect of the U.S. sub-prime mortgage market have been around for months. Yet in July, investors gained a broader perspective on the problem when news hit that even the big financial institutions were starting to have trouble off-loading debt at their previously enjoyed low-yields. The next thing you know, everyone is talking about the "sub-prime mortgage market contagion".

In a nutshell, the "sub-prime mortgage market contagion" comes down to the cost of borrowing money. Here's a snapshot:

1) Problems arose in the risky and aggressive U.S. sub-prime mortgage market (not in Canada) and caused investors to become more credit-risk weary (in the U.S. and in Canada). As a result, they started demanding a higher yield to take on risky credit (creating upward pressure on borrowing rates).

2) The low cost of debt was one of the prime drivers of M&A activity (particularly for leveraged buy-outs). Therefore, the rising cost of debt is expected to dampen the pace of M&A activity as financing these deals is becoming more costly – putting a squeeze on the profitability of the deals in the first place.

3) Companies that have already leveraged their assets and taken on more debt are now facing higher costs to finance that debt and that can eat into their expected profits.

Since one of the main drivers of the equity markets since Q3 2006 has been the volume and pace of the M&A activity (of which leveraged buy-outs was a popular approach to financing these deals), investors felt they had more than enough reason to worry and reconsider their appetite for equities.

A RE-PRICING OF RISK? OR THE START OF SOMETHING A BIT MORE LASTING?

With some re-pricing expected, the question now is: "Is this a mere re-pricing of risk? Or the start of something a bit more lasting?"

There is little doubt that investor confidence has been shaken and that corporate America will be sharpening their pencils one more time before they consider the feasibility of additional leveraged buy-out deals. Having said that, economic fundamentals (at a corporate level and on a macro economic level) continue to be undeniably strong.

Early signs show Q2 2007 corporate earnings exceeding expectations in both Canada and the U.S. Globally, growth is expected to continue at nearly 5% through 2008, strong by any standards. The demand for commodities will be a net benefactor of that global growth and a strong supporting factor for the Canadian economy. Inflation is contained and interest rates are still at relatively low levels. Unemployment remains low on both sides of the border, and while the housing market in the U.S. continues to struggle, many believe that as long as a steady paycheque keeps coming in the door, consumers' relative health (and spending habits) will remain intact.

REGRETS ARE FULL OF SHORT-TERM ACTION, AND LONG-TERM INACTION.

We continue to expect a reasonably constructive year in equity markets, but not without volatility. In fact, we expect significant volatility through to the end of 2007 as investors remain jittery about just how far the credit concerns and problems in the U.S. sub-prime mortgage market will spill over.

During volatile times – in particular when headlines of dramatic gains and losses on the markets begin to appear daily - we caution investors against knee-jerk reactions to changes in market sentiment. The problem with short-term actions (or reactions) to market news is that you can never plan for the exact moment when the markets will turn – for the better or the worse. Whereas a long-term strategy can do just that – allow you to plan. You can create a long-term strategy knowing full well that there will be times (such as now) of significant volatility, and therefore you can build your strategy accordingly. If you feel compelled to take action now, consider taking the action of sitting down with your financial advisor. Review your long-term strategy and don't forget to plan for volatility by ensuring your investments are well diversified and personalized to your risk tolerance. It's action you won't regret!

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	July	YTD
S&P/TSX	-0.3%	7.4%
Energy	-1.3%	6.2%
Materials	7.0%	19.2%
Industrials	0.0%	18.4%
Consumer discretionary	0.1%	8.2%
Consumer staples	0.8%	4.1%
Health care	-11.5%	-14.7%
Financials	-3.7%	-1.8%
Information technology	1.5%	17.7%
Telecom services	0.0%	24.8%
Utilities	4.8%	2.6%

*price only