LONDON CAPITAL MANAGEMENT

Monthly investment commentary

June 2008

MAY'S HIGHLIGHTS

- Canada's annual GDP rate declined by 0.3% in the first quarter of 2008, the first quarterly decline since the second quarter of 2003.
- Oil prices (West Texas) hit a new high on May 21st ($135/barrel), before settling to $127/barrel by the end of the month.
- Economic leading indicators in the U.K. and the euro-zone showed a distinct downtrend. The U.K. in particular faced a drop in home values and rising inflation in recent months.
- The S&P/TSX had a spectacular spring rally. The index was up 21.5% from March 20th intra-day low of 12,453 to May 21st intra-day high (and new record) of 15,128.
- The Canadian Energy sector, helped by surging oil prices, gained over 10% in May and accounted for over half of the S&P/TSX gains for the month. The cumulative year-to-date contribution (point gain) of the Energy sector is now over 85%.

DON'T HATE ME BECAUSE I'M BOUNTIFUL

An important differentiator between the 'have' and the 'have not' results for major world markets in 2008 has been the exposure to oil and other natural resources (see Table 1). And let's face it, bountiful Canada with our vast areas of above ground (e.g. corn, wheat and other grains) and below ground (e.g. oil) resources looks pretty good on that front.

The S&P500, FTSE 100 and EAFE indices could not keep pace with the strong Canadian market in May (see Table 1). In recent months, economic indicators for the U.K. and Europe have been on a downward trend. The U.K. in particular has suffered from the spread of the credit crisis in the U.S., falling home values (of similar magnitude to that of the U.S. housing market decline), and rising inflation concerns. All in all, it has kept investor sentiment for some of these developed countries gloomy at best. In the U.S. it was the Financial sector that just couldn't catch a break. The ongoing negative sentiment has kept investors away, and caused that sector to be the laggard of the S&P500 index for the month of May, and so far in 2008.

The S&P/TSX was boosted for the second month in a row by the Energy sector (see Table 2). Surging oil prices helped the stock performance of energy companies around the world. Information Technology companies also had a strong month across North America. In Canada, Research in Motion (RIM) drove the sector higher. RIM is by far the principal tech stock of the Canadian market, making up approximately 80% of the total weight in the Information Technology sector. RIM's announcement of the new BlackBerry® Bold™ smartphone was well received and drove the company's stock price higher, and with it the sector.

The Canadian Telecommunications sector was also moved by a one-stock story in May – but to the negative side. In an ongoing tug of war between BCE bondholder interests versus BCE shareholder interests, the bondholders gained traction this month. The Quebec Court of Appeal ruled in favour of the BCE bondholders, and that effectively put acquisition plans on hold, resulting in significant declines for that stock.

Table 1– Summary of major market developments

Market returns*	May	YTD
S&P/TSX	5.6%	6.4%
S&P500 (US$)	1.1%	-4.6%
S&P500 (C$)	-0.3%	-4.2%
NASDAQ	4.6%	-4.9%
Russell 2000	4.5%	-2.3%
FTSE 100 (U.K.)	-0.6%	-6.3%
NIKKEI 225 (Japan)	3.5%	-6.3%
EAFE (C$)	-1.1%	-5.3%
EAFE (local currency)	0.6%	-9.2%
Canadian Bond Market	-0.2%	2.3%
World Bond Market (US $)	-1.1%	0.1%

*local currency (unless specified); price only

WEALTH PRESERVATION

While fixed income investors made reasonable gains in early 2008, they have begun to see a reversal of those gains as the initial shock of the credit crisis subsided and investors regained some confidence in the equity markets (see Table 1). An overall low interest rate environment remains the long-term challenge for current bond investors. Yields for government and corporate bonds, having reached multi-decade lows, leave little room for further capital gains. Expected returns for both domestic and foreign bonds should be tempered and will not be what they were a decade or so ago, but investors should not necessarily abandon the asset class altogether. In addition to wealth preservation, fixed-income investments add an important diversification element to long-term portfolios - smoothing out equity market volatility, and limiting downside risk.

SPOILED OR FOILED BY OIL?

Oil prices topped $135/barrel in May. While many economists pontificate about one reason over another for high oil prices, it is more likely a function of a number of interrelated and often unpredictable factors. Oil prices in particular have reacted to a near 'perfect storm' of circumstances, including:

- a weak U.S. dollar
- strong demand from emerging markets*
- a relatively unchanged supply environment, and
- geopolitical concerns from oil producers like Nigeria and Venezuela.

To add insult to injury, speculators and momentum investors joined the fray, driving oil prices and price expectations even higher.

**The importance of developing economies in effecting the price of commodities should not be understated. They are responsible for 80% of the rise in global grain consumption, and 90% of the rise in global oil consumption.*

Canada might be an energy power, but oil at current price levels is an overall negative for Canada's economy. Expensive oil means slower global growth, which is not good news for any economy which relies heavily on exports.

No doubt, Canada's energy producing regions will get a direct profit windfall from higher oil prices (something that to date has benefited the overall Canadian economy) but at some point, the blow to Canada's energy-using sectors will outweigh those regional benefits. It's no secret that sectors such as the automotive, airline, and tourism industries have already felt the negative effects of fast-rising fuel prices. In fact, to the surprise of many, Canada's economy (as measured by GDP growth) actually shrank in the first quarter of 2008 in part due to weakening results in those sectors.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	May	YTD
S&P/TSX	5.6%	6.4%
Energy	10.4%	20.5%
Materials	7.4%	13.1%
Industrials	6.3%	10.3%
Consumer discretionary	-1.5%	-17.3%
Consumer staples	4.2%	-3.6%
Health care	-1.4%	-5.5%
Financials	1.3%	-4.6%
Information technology	8.8%	14.6%
Telecom services	-1.9%	-6.5%
Utilities	3.6%	-1.0%

*price only

Consumers, who have resisted change for years, may now be changing behaviours in response to higher oil prices. America might be addicted to oil, but there is still plenty of scope for changes in usage patterns. Given that the U.S. accounts for approximately one quarter of the world's oil consumption, small changes in behaviour could result in a significant effect on the world oil market, which could dampen demand down the road.

A SAVVY INVESTMENT SOLUTION

Mounting challenges to U.S. consumer spending and record oil prices could translate into volatile and narrowly focused markets (where one sector dominates overall market results) over the coming months. We've already seen examples of this play out in the early days of June - making a balanced and diversified portfolio (that considers both risk and return expectations) a particularly savvy investment solution for these interesting times!