LONDON CAPITAL MANAGEMENT

Monthly investment commentary

November 2010

OCTOBER HIGHLIGHTS

- Global equity markets maintained momentum in October, whereas bond markets were more subdued and relied on income generation to stay in positive territory for the month.
- Anticipation of a second round of quantitative easing by the U.S. government encouraged equity markets and commodity prices with the hopes of spurring growth in the U.S. economy.
- The CRB Industrials (commodity index) rose 11.4% in the month.
- The Canadian dollar approached parity with the U.S. dollar to end the month at $0.983 (USD). The catalysts included:
  - Canada's fiscal advantages (particularly relative to the U.S.), such as stronger bank credit flows, stronger job growth, stronger consumer health and stronger housing market;
  - Rising commodity prices; and of course,
  - A weakening U.S. dollar.
- The Bank of Canada held steady on overnight lending rates, deciding not to stray too far from the current U.S. monetary policy. *Trivia: When was the last time the U.S. Federal Reserve raised rates? June 29, 2006!*

NOT SO SCARY AFTER ALL

October wasn't so scary after all. Despite the bad rap for being a month investors should fear, October turned out to be rather pleasant. Global markets were generally positive for the month, and year-to date results are impressive, particularly for the Canadian S&P/TSX and the U.S. S&P500 (see Table 1).

Table 1– Summary of major market developments

Market returns*	October	YTD
S&P/TSX Composite	2.5%	7.9%
S&P500	3.7%	6.1%
- in C$	*2.5%*	*2.2%*
MSCI EAFE	1.8%	-1.3%
- in C$	*2.8%*	*-0.9%*
MSCI Emerging Markets	2.2%	8.3%
DEX Bond Universe**	0.2%	7.7%
BBB Corporate Index**	0.3%	10.5%

*local currency (unless specified); price only
**total return, Canadian bonds
Source: Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

While investors' moods still appear to be well contained, they have significantly improved since spring when sentiment was in the dumps. As a result even modest improvements in outlook have driven some impressive gains for capital markets.

What put the spring back in the step of investors this past October?

- The U.S. quantitative easing plan had been well telegraphed, and while few expect it to be the magic elixir to cure all economic ills, most feel it will boost economic momentum in the U.S.
- Second quarter corporate earnings season has been unfolding in both the U.S. and in Canada, and results to date have been strong.
- U.S. mid-term elections were correctly forecasted to result in political gridlock for the U.S. While that may not sound positive at first, it does impose a calming effect on markets as it is unlikely any major bills (like financial reform and health care), or major tax hikes will get passed into law. In other words, the risk of a 'political shock' to markets from a major federal policy change has decreased.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	October	YTD
S&P/TSX	2.5%	7.9%
Energy	1.5%	-1.0%
Materials	4.1%	24.0%
Industrials	2.1%	11.9%
Consumer discretionary	2.8%	17.9%
Consumer staples	4.4%	8.2%
Health care	8.2%	49.5%
Financials	1.6%	3.8%
Information technology	11.2%	-13.1%
Telecom services	0.1%	17.3%
Utilities	-0.9%	7.7%

*price only
Source: National Bank

In Canada, two of the smallest sectors, Information Technology and Health Care (2.6% and 0.8% weight in the S&P/TSX respectively) were the top performing sectors in October (see Table 2). Research in Motion's demonstration of their new BlackBerry tablet computer, "PlayBook", got investors excited again, boosted its stock price and thus the sector. In the Health Care space, strong results came from improved investor sentiment.

Smaller sectors aside, driving the overall results of the S&P/TSX in October was the Materials sector helped by stronger commodity prices, particularly within the Metal and Mining companies. Commodity prices have continued to rise faster and further than generally expected this year. The CRB Industrials (commodity index) has risen 34% year-to-date, and 11.4% in October alone.

REASON' FOR EASIN'

While the second wave of quantitative easing by the U.S. Federal Government (dubbed QE2) wasn't announced officially until early November, it was well telegraphed and therefore the majority of its initial effect on stock markets was felt in October. As the numbers show (see Table 1), the response by stockholders, who are anticipating an economic boost and a net gain for equity prices, was predominately positive.

With all this talk about quantitative easing, it's worth lowering the microscope for a moment.

What is QE2? Some call it large-scale asset purchases; while others call it printing money and writing cheques. QE2 is the U.S. government (who no longer has room to effect economic change through lowering interest rates) announcement that it will be become a buyer of U.S. government bonds, creating a spike in demand and pushing yields down. In other words, QE2 is the U.S. government's way of using market forces of supply and demand to lower borrowing rates. Lower interest rates across the board are expected to prompt businesses and consumers to borrow and spend – i.e. give a boost to economic growth.

The hope is that by buying significant treasuries, the government will push yields down enough (and for long enough) to give the economy enough time to garner some positive momentum. Economic growth will mean increases in prices (i.e. inflation), something that is needed in the U.S. to keep them from falling into a deflationary and economic tailspin.

The risk. While the rationale is essentially sound, not everyone is pleased with the idea of the U.S. printing more money to buy up these bonds. By printing more money it will put further downward pressure on the value of the U.S. dollar, making the exports of other countries (like China, India, Japan, and yes, Canada) less competitive. It will also increase commodity prices which are valued in U.S. dollars, creating some of that inflationary pressure. While the U.S. needs some inflationary pressure to get closer to 'normal' levels, much of the world does not. Some countries, especially those in emerging markets, may be hurt by these extra inflationary concerns.

There also lies a risk for bondholders. While the immediate effect on bond prices may be positive (i.e. as the government enters the buying market and pushes demand higher, bond prices will rise), inflation is ultimately not a bondholder's friend. Low yields on bonds will eventually translate into low returns for bondholders. We've already experienced that in money market investments, where buying a near-zero yielding T-bill results in, you guessed it, near-zero returns. Active bond managers will have their work cut out for them in positioning their portfolios to seek out higher-yielding opportunities, while working within the risk parameters of their given mandate.

KARMA

The November mid-term elections in the U.S. may have reminded you of the old adage "a country gets the politicians it deserves" – some call it 'Karma'. In the investing world, we say "there is no free lunch". Big returns mean big risks, and low risk means low returns. Most of us are wise to accept this reality and ensure we have a well diversified portfolio that is geared towards our long term goals and that balances our expectations for risk and return. This likely means a portfolio that includes a combination of bonds and equities, designed to match your risk tolerance and your time horizons. Here's to good karma!

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