LONDON CAPITAL MANAGEMENT

Monthly investment commentary

May 2010

APRIL HIGHLIGHTS

- The Canadian economy continues to expand with steady job creation and auto sales are back at pre-recession levels.
- North American equity markets showed strength, while Europe and Asia lagged.
- Sentiment quickly turned sour in the last days of April in the face of European sovereign debt worries, resulting in sell off that gained steam in the first days of May.
- Canadian bond yields rose further in anticipation that the Bank of Canada may raise rates.
- Oil prices ended the month up 3% to $86.11 USD a barrel (WTI).
- Gold prices also rose 6% on strong physical demand.

FROM FIRE AND ICE TO OIL AND WATER – APRIL SAW IT ALL

Despite so many global woes and worries (an Icelandic volcano; a devastating oil spill off the coast of Louisiana; and Greece's struggle with fiscal issues and spreading labour unrest) markets took a more localized and domestic view of the world in April, resulting in diverging results on world markets. North American markets showed strength, while emerging markets and European markets struggled more (see Table 1).

Table 1– Summary of major market developments

Market returns*	April	YTD
S&P/TSX Composite	1.4%	4.0%
S&P500	1.5%	6.4%
- in C$	*1.6%*	*3.5%*
MSCI EAFE	-1.6%	2.0%
- in C$	*-1.9%*	*-5.2%*
MSCI Emerging Markets	-0.2%	1.0%
DEX Bond Universe**	-0.1%	1.2%
BBB Corporate Index**	0.2%	3.6%

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

A CHOOSIER INVESTOR

Both Canadian and U.S. markets benefited from solid economic data coming in, including good retail sales, improved consumer confidence and stabilizing U.S. home prices. Canadian home prices are by and large past the 'stabilizing stage' and in many areas of the country the housing market can be comfortably called 'robust'.

That's not to say there aren't some economic worries that could affect North American markets. Currently the U.S. has elevated unemployment levels, and even with some recent improvements, it remains a headwind to economic growth. Closer to home, Canadians could face their own debt concerns should interest rates rise faster or higher than anticipated. However, for the most part, we are seeing the signs of a sustainable economic recovery in North America, and our corporations, consumers and capital markets showed signs of that improving confidence in April.

At the stock level, reported corporate earnings were strong in April on both sides of the border. Stock valuations, while certainly elevated from their low levels of a year ago, are still reasonable. And, for the most part, companies demonstrated good top-line revenue growth (i.e. sales), not just better earnings through cost-cutting measures, as was the case earlier in the market's recovery. Whereas a year ago almost all stocks moved in a near perfect correlation (first down…then up), now we are seeing evidence of a choosier investor - differentiating by sectors and stocks (a potential bonus for professional stock-pickers such as bottom-up portfolio managers).

A closer look at the Canadian market (Table 2) reflects an even split between those sectors in the red, and those in the black in April. Some of the more notable laggards included the Utilities and Consumer Staples sectors – both defensive sectors, and therefore not as likely to shine in rising equity markets. The Utility stocks can also be more sensitive to macro economic factors such as rising interest rates. The mere anticipation of interest rate hikes was enough to dampen the sector's results, in spite of the fact that interest rate hikes have yet to happen and the timing of which is still unknown. The Consumer Staples sector was dragged down more by company specific news. Specifically the Canadian pharmaceutical retailers were negatively impacted by the announcement of the Ontario government drug reforms and the concern that other provinces may follow suit.

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Table 2 - Sector level results for the Canadian market		
S&P/TSX sector returns*	**April**	**YTD**
S&P/TSX	1.4%	4.0%
Energy	2.6%	-0.2%
Materials	5.7%	5.9%
Industrials	-1.0%	4.6%
Consumer discretionary	2.1%	7.7%
Consumer staples	-5.4%	-5.7%
Health care	1.0%	10.7%
Financials	-0.3%	6.8%
Information technology	-3.9%	1.8%
Telecom services	2.1%	6.6%
Utilities	-4.2%	-2.4%

*price only
Source: National Bank

On the up-side, it was the resource sectors that pushed the S&P/TSX into positive territory. Gold prices helped drive the Materials sector higher, as gold bullion prices rose with strong physical demand (i.e. jewelry demand from India). Energy stocks benefited from the positive economic outlook for North America and higher oil prices during the month of April.

INCOME SMOOTHS OUT BOND MARKET RETURNS

In a continuation of the same theme we saw in March, anticipation of rising interest rates in Canada was priced into Canadian bond returns in April. The yield curve flattened as short and mid-term government bond yields rose higher, causing those bond markets to see a drop in their values. Fortunately the income generated by the bonds helped offset the decline in market value they experienced, leaving the overall bond returns for the month more or less flat. (See Table 1)

A CHINESE PROVERB FOR THE AGES

In Asia we continue to see good economic growth, and yet investors are getting nervous about the Chinese government tightening their lending programs and pulling back some of their stimulus efforts. Contemplating the Chinese economy not growing as rapidly, as some have come to expect, has led to much more muted and flat returns from China and the emerging markets. A message for all those investors…

"Be not afraid of growing slowly, be afraid only of standing still"
Chinese proverb.

GREECE IS THE WORD

Europe on the other hand has a heavy cloud hanging over it – and we aren't just talking about the volcanic ash plume. Greek sovereign debt troubles have clouded European economic recovery efforts, finally breaking out into stormy conditions in the early days of May. Reflecting the poor sentiment, government bonds from Greece, Portugal and Spain were all downgraded, and Greek bonds hit the lows of junk bond status – a rarity for a Eurozone country. Greece has become the proverbial 'canary in the coal mine' as their uncertainty has spread to 'who could be next' scenarios across many other European countries.

Beginning in the last few days of April, and carrying on with gusto in the beginning of May, almost all risk assets (such as stocks and commodities) reversed course and sold off sharply. What seemed to be sparked by a fluke (rumours of a 'typo' at a stock trader's desk) were then fuelled by rising concerns over Greece. The 'flight to safety' trade suddenly returned. Stock markets fell, and demand for Government bonds and U.S. dollars rose sharply as investors sought safety and liquidity.

But what has changed? In fact, very little is new in terms of global economic concerns, and there is little to nothing about Greece's fiscal situation that we didn't already know back in March and April. Markets are driven by people and their emotions, neither of which are completely predictable. The cause and effect of events that concern the capital markets can rarely be timed, and trying to do so is much more likely to cause you more grief than comfort.

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