LONDON CAPITAL
MANAGEMENT

Monthly investment commentary

August 2010

JULY HIGHLIGHTS

- Investors found relief in the results of the European bank stress tests. Investors with improved confidence traded away their 'safety' assets (which had rallied in the second quarter of 2010) for more cyclical, risky assets.

- **Unwinding of the 'safety trade'**
  - Gold prices fell while oil, fertilizer products and base metal prices rose (Gold -5%, Oil +4%, Ammonia + 7%, Urea +14%, Copper + 12%, Zinc +14%, Aluminum +11%)*
  - U.S. dollar (the most liquid currency in the world) fell out of favour, while the Euro and the Canadian dollar gained significant strength.
  - Bond prices declined across most terms, while global equity markets rallied (see Table 1).

- Canadian economy continues to deliver stronger results than the U.S. where economic growth continues to be sluggish despite some positive news from U.S. companies.
- Despite varying economic conditions, both Canadian and U.S. corporations experienced strong second quarter earnings growth.

EUROPEAN VACATION

Some people called the results of the European bank stress tests a 'confidence stabilizer'. I called it 'as good a reason as any' to pull up a Muskoka chair and crack open a cold beverage on a hot July day. Either way, investors around the world took the opportunity to relax a little and world markets showed their relief with a significant July rally (see Table 1).

As investors' anxiety lifted, July presented us with a textbook unwinding of the 'flight to safety' trade that had dominated the second quarter of 2010. Money that had poured into bonds, the U.S. dollar and gold (all traditional safety plays for anxious investors) made their way back into the more cyclical assets like oil, base metals, stocks and currencies such as the Euro and the Canadian dollar.

Table 1– Summary of major market developments

Market returns*	July	YTD
S&P/TSX Composite	3.7%	-0.3%
S&P500	6.9%	-1.2%
- in C$	*3.5%*	*-2.9%*
MSCI EAFE	4.6%	-4.8%
- in C$	*5.8%*	*-8.9%*
MSCI Emerging Markets	5.8%	0.2%
DEX Bond Universe**	0.1%	4.3%
BBB Corporate Index**	0.4%	6.4%

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

BEING RESOURCEFUL

As a commodity-based country, Canada is tied to the outlook of economies around the world. In July our equity market did benefit from improvements over second quarter expectations for economic growth, particularly from Europe and China. China is now the world's largest user of energy. It consumed 2.3 billion tons of oil-equivalent in 2009. This compares with 2.2 billion tons in the United States**. Commodity markets rallied in July in part because investors were less worried about a significant Chinese economic slowdown – quite the sentiment change from the second quarter of 2010.

While the Canadian Energy sector seemed to benefit from this improved global economic outlook, why was the Canadian Materials sector (see Table 2) the only sector in Canada to land in negative territory this past month? The answer lies in the attraction, or lack thereof, of a shiny yellow metal. Gold prices took a breather last month after several months of strength, trading down over five per cent as Eurozone sovereign debt fears abated. The sell-off was despite a weaker U.S. dollar (usually a driver of higher gold prices), confirming the fact that strength in gold over the past several months was primarily a fear-trade driven. Unfortunately, with well over 50% of the Canadian Materials sector in gold companies, the strength in other commodity-based companies, such as diversified metals and mining companies which were up over 18%, were not enough to pull that sector out of the red. While the poorly performing gold companies were down over 10%, the strong performing were up over 18%. In contrast on the S&P500, where gold stocks are only a small portion of the Materials sector, the sector took top spot with a return of 12% for the month.

LONDON CAPITAL MANAGEMENT

Canada's Research in Motion (RIM) drove results for the small, but top performing, Information Technology sector in July. RIM rebounded from its drop in the second quarter… and a few signal reception problems with Apple's new iPhone didn't hurt their competitive positioning either!

WHEAT UP FOR ME

Wheat prices spiked up a spectacular 42% in July as two major grain-producing countries suffered weather-related crop damage (heat wave and drought in Russian, and flooding in China). For Canadian farmers higher crop prices boosts the farm's balance sheet and puts some wind in the sails of fertilizer and agricultural machinery companies too.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	July	YTD
S&P/TSX	3.7%	-0.3%
Energy	3.9%	-4.6%
Materials	-1.5%	-0.7%
Industrials	6.0%	4.4%
Consumer discretionary	3.7%	10.3%
Consumer staples	8.1%	-2.4%
Health care	1.6%	23.1%
Financials	5.9%	1.4%
Information technology	9.5%	-12.9%
Telecom services	1.7%	8.8%
Utilities	6.7%	1.6%

*price only
Source: National Bank

A SOMEWHAT SUNNIER NORTH

Canada has been out-performing the U.S. since the economic recovery began. Undeniably the U.S. economic recovery has been sluggish. This is particularly true when it comes to jobs. Job growth in the U.S. remains a sore spot - whereas Canada has now replaced almost all of the jobs lost during the recession, the U.S. has replaced hardly any.** It is not surprising then that consumer confidence in the U.S. remains low. The Bank of Canada responded to the improving economic data by raising central bank rates 0.25% in July, while the U.S. Federal Reserve responded to the weaker economic data in the U.S. by holding steady their ultra low central bank rate. Fortunately, the U.S. Federal Reserve appears willing to err on the side of providing too much stimulus rather than not enough, especially with inflation edging lower.

On the bright side, U.S. companies in general are showing healthy corporate profitability and improving balance sheets. Companies are holding a lot of cash and their debt levels are declining. The next rational step will be an increase in hiring - a crucial step in sustaining the economic recovery in the U.S. So while some economic conditions are improving in the U.S., in the near term we appear to be in a 'wait and see' scenario.

ENJOY THE REST OF THE SUMMER

July's positive response by the markets does not mean that the 'all clear' is being sounded for equity markets. It only reflects the emerging belief that Europe's sovereign debt crisis may be past its peak. While the overall signs for global economic growth remain positive, most expect the pace of economic expansion to moderate and investors remain fickle and cautious. Something that is likely to continue for some time to come, so don't be surprised by short-term volatility. However, the bottom line is that corporations are doing better, and stronger corporate earnings translate to stronger stock prices in the long term.

So put a well diversified and risk-appropriate investment plan in place, and then sit back in your favourite summer chair, relax, and enjoy the rest of the summer!

*Source: NB Financial, Bloomberg
** Andersen Economic Research Inc.

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