LONDON CAPITAL MANAGEMENT

Monthly investment commentary

January 2008

2007 HIGHLIGHTS

Volatile markets

- The S&P500 volatility index (VIX index) hit its highest level since 2003 as concerns over the U.S. economy and credit conditions rocked stock markets around the globe.
- Despite the volatility, the S&P/TSX and S&P500 experienced their fifth straight yearly gain in 2007.
- The biggest driver of the S&P/TSX was the Materials sector, while a 127% rise in Research in Motion (RIM) propelled the Canadian Information Technology sector to top spot for 2007.
- M&A activity hit new highs (in $ values) in 2007, led by the Alcan and BCE acquisitions, but dropped off sharply in mid-summer as credit crisis ensued.
- Credit woes pulled the Canadian Financial sector into negative territory.
- The DEX Bond Universe Index (Canadian bond market in Table 1) had a strong fourth quarter, up 1.5% in November alone.

Soaring loonie

- The value of the loonie rose nearly 20% in 2007, ending the year at $1.0088 (US$).
- The rise in the Canadian dollar helped mitigate inflationary pressures, but Canadian exports became less competitive on the global market.
- Canadians investing abroad and in particular in the U.S., saw their foreign market gains vanish with the currency exchange (see Table 1).

A year for gold, black gold and more

- The price of oil soared in 2007 (up nearly 60%), and gasoline was up over 30%.
- Gold was up over 30% to hit a multi-decade high and the biggest annual gain since 1979.
- Cash crops and grains also rose in price - wheat and soybean prices soared over 75%.

There is nothing like a U.S. housing market meltdown, a couple of gigantic write-downs at major financial institutions and a credit crunch, to take the fun out of a perfectly good bull run on the stock market.

True, most of the major world markets finished up in positive territory for the year (at least in local currency terms), but it was anything but 'a given'. Just a few weeks ago, it looked as if 2007's gains might disappear before the first strains of Auld Lang Syne. In fact, North American markets experienced their most volatile year since the current bull market began. But if you're a market watcher…you already knew that!

A YEAR OF UNPREDICTABILITY

The highs and lows of economic and market news in 2007 came in dramatic and volatile fashion. The highs were marked by record-breaking values for the Canadian dollar, North American stock markets, oil, gold and other commodity prices. While the lows (including two distinct correction periods in mid-summer and late fall) stemmed from a slowing U.S. economy, the downward spiral of the U.S. housing sector and subprime mortgage concerns. With globalization and financial engineering, the holdings of subprime debt had spread around the world, creating volatility and losses in capital markets world wide. This led to a general flight to quality and a drying up of liquidity in lending markets (not just mortgage-related lending). While consumer resilience and central bank action seem to have helped calm markets (at least in the short term), the market's linchpin is the ability of the U.S. economy to withstand the increasing recessionary pressures. Should the U.S. fall into a recession, it will no doubt be a significant inflection point for capital markets in 2008.

Table 1– Summary of major market developments

Market returns	Dec.	Q4 2007	YTD
S&P/TSX	1.1%	-1.9%	7.2%
S&P500 (US$)	-0.9%	-3.8%	3.5%
S&P500 (C$)	-1.8%	-4.3%	-11.9%
NASDAQ	-0.3%	-1.8%	9.8%
Russell 2000	-0.2%	-4.9%	-2.7%
FTSE 100 (U.K.)	0.4%	-0.2%	3.8%
NIKKEI 225 (Japan)	-2.4%	-8.8%	-11.1%
EAFE (C$)	-2.3%	-1.5%	-7.0%
EAFE (local currency)	-1.2%	-3.2%	1.2%
Canadian Bond Market	0.6%	2.7%	3.7%
World Bond Market (US $)	0.0%	2.1%	4.0%

*local currency (unless specified); price only

Despite the volatility, the emerging markets continued their march forward in 2007 – most countries posting double-digit positive returns in 2007. China topped the group with another outstanding year of 161% returns, despite a negative fourth quarter. On other major markets, most had positive returns, including the S&P500 and the S&P/TSX fifth straight yearly gain. On the flip side, 2007 marked Japan's first annual market decline in five years as investors reacted to the U.S. housing and credit market crisis slowing growth in Japan's biggest overseas market.

Likewise, the Canadian stock market ascent was anything but steady as volatility defined the market in 2007. A look back at 2007 shows monthly S&P/TSX returns that varied from +5% to -6%. In Table 2 you can see that, in Canada, the Financial sector was hit hardest by the credit crisis with December alone being down 4.9%. It was the Materials sector that drove the Canadian index returns last year, as this sector was boosted by strong commodity prices (like gold and wheat), as well as announcements of large M&A deals such as the Alcan & Rio Tinto deal. The Waterloo-based information technology company, Research in Motion (RIM) of 'BlackBerry-fame' had an absolutely stellar year. With a 127% return in 2007, RIM drove that sector to top spot for the year.

For fixed-income investors, the Canadian bond market finished the year strong with significant fourth quarter gains. In fact, just under three-quarters of 2007's gains came in the last three months of the year. The same concerns that rocked the equity markets led the 'flight to quality' straight into 'risk-free' Government of Canada bonds. Demand for Government of Canada bonds soared, while credit products (such as corporate bonds) experienced a significant re-pricing. In the end, while a 3.7% return for the year may not seem high, most bond managers are considering it a good year given the current low interest rate environment.

WITH GLOWING HEARTS WE SEE THEE RISE

Named Time magazine's Canadian Newsmaker of 2007, the Canadian dollar's rapid rise stole the headlines this year. Beyond being big news, the dramatic rise of the Canadian dollar touched nearly every Canadian in one way or another. Besides getting a rare 'bird's eye' view of our neighbours to the south, the stronger Canadian dollar helped to mitigate inflationary pressures in Canada, and was good news for those wanting to buy a cheap car stateside…but bad news for the Canadians making them. Any Canadian firm that depends on U.S. customers felt the exchange pinch in 2007, as the rising dollar created an ever growing challenge to maintain competitive pricing abroad. As Buzz Hargrove, National President of CAW (Canadian Auto Workers Union) put it, "We went from being the lowest-cost producer of vehicles around the world for GM, Ford, and Chrysler to probably one of the highest." And a quick look at Table 1 also shows foreign investment returns vanishing when converted back into Canadian dollar terms.

VOLATILITY THE NAME OF THE GAME

Going forward, continued market volatility can be expected as investors are still weighing out the concerns of a slowing U.S. economy threatening to slip into a recession against a strong global growth story.

Like many years, 2007 was filled with negative news stories and we can anticipate that 2008 will have more of the same. After a five year bull run, it makes a lot of sense to manage your capital market expectations for 2008. The best lessons are often those learned from experience, so leave it to volatile markets to reinforce the importance of developing a well considered, long term investment plan…and sticking to it.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	Dec.	Q4 2007	YTD
S&P/TSX	1.1%	-1.9%	7.2%
Energy	6.0%	0.8%	5.0%
Materials	5.3%	3.1%	29.1%
Industrials	-0.1%	-8.0%	8.6%
Consumer discretionary	0.6%	-4.9%	1.8%
Consumer staples	0.1%	-7.7%	-6.8%
Health care	-6.2%	-10.5%	-27.1%
Financials	-4.9%	-6.5%	-4.6%
Information technology	-1.9%	11.7%	48.1%
Telecom services	4.1%	-4.3%	16.2%
Utilities	1.8%	3.3%	6.9%

*price only