LONDON CAPITAL MANAGEMENT

Monthly investment commentary

March 2008

FEBRUARY 2008 HIGHLIGHTS
• Oil hits record high at $101.58/barrel (WTI)
• Gold soars to above $970/ounce
• Bank of Canada cuts rates by 0.5% (March 4)
• $168 billion U.S. economic stimulus package was approved Feb 7th

A CLOUD – WITH A GOLDEN LINING

The Canadian stock market pulled ahead in February (see Table 1), helped in no small part by commodity prices such as record high oil and soaring gold prices. The U.S. slowdown has not stopped the commodity price rally, and this has been the proverbial 'golden egg' for the Canadian economy. Both the Energy and Materials sectors were strong contributors to the S&P/TSX returns in February and helped recover some of the market losses from January (see Table 2). Financial and consumer-reliant companies (on either side of the border) didn't fare as well as their earnings continued to fall prey to the ongoing credit concerns and economic worries.

Capital markets in the U.S. continued to struggle under a cloud of economic worries (see Table 1); consumer confidence plunged; inflation soared; and home prices slumped. The combination did nothing to lift the spirits of capital market investors. Among the lackluster returns from foreign markets, the S&P500 was a laggard in February (-3.5%) feeling the full brunt of the economic concerns. During the cold month of February, it was pretty hard to warm up to the economic data that was coming out of the U.S. Dearer oil, rising commodity-induced inflation and a consumer who has both high debt levels and no longer the ability to use their home as a personal ATM machine didn't bode well for the economic outlook south of the border.

A GOOD STABILIZING OFFSET

Equity market gains often result in bond market weakness, but the continued flight to safety drew investors to government bonds and boosted the overall Canadian bond market (see Table 1). Having said that, expectations for fixed-income returns remain lackluster with the number one reason being the historically low interest rate environment that we find ourselves in. And (just like Mats Sundin) we don't see that going anywhere anytime soon! Inflationary pressure from higher oil and food prices are expected to be offset by the deflationary impact of a higher Loonie and slower economic growth – keeping near term expectations for interest rates low. In step with this theory, we saw the Bank of Canada reduce rates by another 0.5% on March 4th, causing short-term yields to move even lower. As of the end of February, to hold a 2-year Government of Canada bond (considered a 'safe' credit and interest rate bet) investors are getting paid a mere 2.8%...that's an annual rate! Now take off inflation, and there just isn't much of a yield pick-up to be had.

Table 1– Summary of major market developments

Market returns	Feb.	YTD
S&P/TSX	3.3%	-1.8%
S&P500 (US$)	-3.5%	-9.4%
S&P500 (C$)	-5.7%	-10.3%
NASDAQ	-5.0%	-14.4%
Russell 2000	-3.8%	-10.4%
FTSE 100 (U.K.)	0.1%	-8.9%
NIKKEI 225 (Japan)	0.1%	-11.1%
EAFE (C$)	-0.2%	-9.1%
EAFE (local currency)	-0.9%	-11.8%
Canadian Bond Market	1.3%	2.0%
World Bond Market (US $)	0.7%	2.4%

*local currency (unless specified); price only

But investment returns aren't the only reason to hold fixed-income products. For those exasperated by low fixed-income returns, remember that (particularly during volatile equity markets such as those we've been experiencing) fixed-income investments provide a good stabilizing offset to a diversified portfolio – a key consideration for conservative and risk adverse investors.

U.S. RECESSION?

The official U.S. business cycle scorekeeper, the National Bureau of Economic Research, uses a variety of monthly indicators – not just GDP – to determine business cycle turning points, taking about six to eighteen months to identify a turning point after it occurs. As investors have already begun to appreciate, the definition hardly matters at this point. In the volatile and fickle world of capital markets, nobody waits around for six to eighteen months to figure out how they feel about their money. And that's exactly why we've already seen the capital markets price in much of the risk of a U.S. economic slowdown.

But this is an election year in the U.S., and there are a lot of key players (i.e. the current President of the United States) keenly interested in ensuring that the economic slowdown be as soft and short as possible.

The U.S. Federal Reserve has been aggressively easing their monetary policy to offset the gathering recessionary forces. But if you want to do something to help the economy quickly, you will use fiscal policy, because monetary policy takes more time to work. The U.S. Congress gave final approval on February 7th to a $168 billion economic stimulus package that will send tax rebate cheques to more than 110 million U.S. households. This is a big stimulus package, and in combination with unprecedented rate cuts, it should go a significant way to ensuring a pick up in consumer spending and a revival to the U.S. economy.

HAS CANADA DECOUPLED?

Canadians are somewhat protected from the rising prices for commodities given that these products are generally priced in U.S. dollars and our Loonie is soaring. So while inflationary pressures linger in the U.S., they are relatively tame in Canada. Also, the monetary easing in Canada is likely to be more effective than it is in the U.S. as Canadian consumers are in better financial shape and are more likely to respond to rate cuts.

For Canada, the real ace in the hole has been our natural resources, and specifically commodities like oil, grains, gold and other metals. The emerging economies are keeping world agricultural and energy demand high. Emerging markets as a group now account for more than half of world GDP.

But despite having lots of something the world wants and needs, and despite starting from a much better financial position, Canada will not be immune to the U.S. economic slow down. We have not decoupled our economy from that of our neighbour to the south. The soaring Loonie has cut deep – reducing the competitiveness of our exports and significantly hurting manufacturers. Not only are our exports less competitive, but demand from our number one trading partner (the U.S.) has dropped off as the American consumer begins to reign in their spending and hunker down for an economic slowdown. While Canada is largely expected to avoid a recession, many industries and provinces will have their own mini-recessions. Our overall economic growth will slow, but fortunately it is not expected to stall completely.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	Feb.	YTD
S&P/TSX	3.3%	-1.8%
Energy	8.7%	1.1%
Materials	9.0%	13.9%
Industrials	5.0%	0.9%
Consumer discretionary	-5.3%	-15.5%
Consumer staples	-3.2%	-9.7%
Health care	0.3%	-5.5%
Financials	-3.4%	-7.7%
Information technology	4.7%	-9.7%
Telecom services	2.0%	-10.5%
Utilities	-1.2%	-3.6%

*price only

HOW SHOULD INVESTORS PROTECT THEMSELVES IN POOR ECONOMIC TIMES?

The answer is patience. Patience may not sound like the hot investment tip of the year. It isn't a sexy, new or radical investment strategy, but it is a much needed virtue when investing in difficult economic and market conditions. There is a positive to be found in a market retrenchment - value is being created. This is when investors get the opportunity to acquire the very best companies at discounted prices. Staying in the markets and being there to take advantage of the full economic recovery means the end result is a bigger bang for the buck on the same capital outlay – and that's a good investment tip.