LONDON CAPITAL MANAGEMENT

Monthly investment commentary

October 2010

Q3 HIGHLIGHTS

- Global equity markets rose strongly, particularly towards the end of the quarter.
  - S&P500 had its best September since 1939!
- A weaker U.S. dollar and a stronger macro-economic backdrop helped to boost commodity prices.
  - The CRB Industrials (commodity index) rose 27% in the quarter, with base metal prices leading the way.
  - Gold hit record highs, ending the month at $1301.47/oz (U.S.$), though once adjusted for inflation the peak price is actually several hundred dollars higher.
- Strong and persistent investor demand fuelled bond markets and pushed long-term yields lower.
  - The 30-year Government of Canada bond yields fell below 3.4% during the quarter - dropping below the lows hit during the depths of the financial crisis in 2008.
- The Bank of Canada raised overnight lending rates to 1.0% during the quarter before signaling a more cautious view on the economy.
- Canadian GDP fell by 0.1% in July, confirming that the Canadian economy has lost some of its forward momentum.
- The U.S. Federal Reserve has not raised rates since before the financial crisis.
  - Talk of a second round of quantitative easing has surfaced in an effort to help spur growth in the U.S. economy.

TO THE EARNEST SOULS

The only people who were let down by September's markets were the earnest souls who spend hours studying the seasonal trends of stock markets in hopes to presage the next market move. Known historically as an ugly month for stock markets, this September saw global markets rise strongly across the board.

Better economic news fuelled the stock market rebound at the end of the third quarter (see Table 1). Worries about an economic stall-out subsided and investors chose to concentrate on the positive implications of a slower, but steadier, pace of growth.

Table 1– Summary of major market developments

Market returns*	Q3 2010	YTD
S&P/TSX Composite	9.5%	5.3%
S&P500	10.7%	2.3%
- in C$	*7.3%*	*-0.3%*
MSCI EAFE	6.5%	-3.0%
- in C$	*12.0%*	*-3.5%*
MSCI Emerging Markets	11.9%	5.9%
DEX Bond Universe**	3.2%	7.5%
BBB Corporate Index**	3.9%	10.2%

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

NOT SINCE 1939

The U.S. S&P500 in particular had an impressive run. The S&P500 rose 9% in the last month of the quarter, which turned out to be the best September performance for the index since 1939, and the best monthly gain since April 2009 when stocks were springing off their bear market lows. The U.S. index was helped by a strong performance in the Telecommunications sector. This sector is traditionally seen as a defensive sector consisting of companies with stable cash flows and that tend to pay a high relative dividend. In today's low interest rate environment, this opportunity for income appealed to investors and gave a lift to stock prices.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	Q3 2010	YTD
S&P/TSX	9.5%	5.3%
Energy	6.2%	-2.5%
Materials	18.1%	19.0%
Industrials	11.2%	9.6%
Consumer discretionary	7.9%	14.7%
Consumer staples	14.8%	3.7%
Health care	14.0%	38.2%
Financials	6.7%	2.2%
Information technology	-1.7%	-21.8%
Telecom services	9.6%	17.1%
Utilities	14.1%	8.7%

*price only
Source: National Bank

Across both the Canadian S&P/TSX (see Table 2) and the U.S. S&P500, the Materials sectors were very strong this quarter, in particular fertilizer, metals and mining stocks. China is a key driver for base metals prices, but the weak U.S. dollar has also played a significant role. The fertilizer stocks (most notably Potash Corp.) advanced 58% in the quarter after Potash Corp. received a hostile takeover bid from global mining giant BHP Billiton.

A 3-PACK OF WORRIES SUBSIDES

Equity markets, including those markets in developing countries, sprang back to life toward the end of the third quarter as a three-pack of macro-economic worries all subsided.

A slowdown in China's economic growth: A string of Chinese economic indicators (industrial production, retail trade, imports and fixed asset investment) have been stronger than expected. This has calmed fears of a disruptive Asian economic slowdown.

The potential for a double dip recession: Toward the end of this quarter, a number of better than expected U.S. economic indicators such as employment, capital goods orders, manufacturing activity and retail sales have calmed fears that the U.S. could again be sliding back into another recession.

European sovereign debt: European sovereign debt crisis was our major concern this summer and it is now abating. The draft Basel III regulations (an international regulatory framework for banks) will more than double capital requirements. Stronger balance sheets will give banks a greater ability to absorb losses and the global banking system will be more capable of dealing with another financial crisis.

To be sure, many headwinds and challenges still exist. Canada in particular has dampened its expectations for economic growth reflecting sluggish U.S. demand and the negative effect of a strong Loonie on exports. But continued recovery seems do-able, and consumer, corporate and federal finances are under repair. Ultimately this will contribute to economic strength. It will take time however, and there will most certainly be volatility along the way.

HIGH DEMAND. LOW YIELD.

Investors' demand for fixed-income product has been strong and persistent, helping returns in fixed-income markets to be nicely rewarding on a year-to-date basis (see Table 1). This is despite the fact that bonds are offering historically low yields, and the fact that the fundamentals for equity markets are relatively appealing with both attractive valuations (stock prices) versus historic averages and earnings growth that is expected to be strong over the next couple of quarters. And yet, flows are continuing into fixed-income products in search of comfort (government bonds) and income (corporate bonds).

For those following the trend, caution is warranted. It remains highly anticipated that interest rates will increase over the long term from these historic low levels, albeit the increase is expected to be gradual. Likewise, corporate balance sheets are improving and cash piles are stacking up. Eventually, companies need to do something with that money, and we are seeing an increased likelihood of share repurchases, corporate acquisitions and dividend increases – a positive for equity investors.

Eventually, money goes where the money is. A swing of money from bonds to equities would hurt bond prices, and when combined with the current uneasiness of investors, it is raising expectations for a volatile trading environment (both for equities and fixed-income) to linger throughout the rest of the year.

WEIGHING OUT THE RISKS AND REWARDS

Long term investors will need to balance the risks and rewards of their investment plan. Realistic views on both will be critical. A plan based solely on return expectations will bring an investor to their knees during times of extreme market volatility (such as we experienced in the not too distant past). And yet, a plan based solely on safeguarding assets and avoiding all risk is likely to fail to meet expectations and goals.

The most successful investors are those who clearly see the balance that must always be struck between risk and reward. No one is as blind as those who do not wish to see.

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