LONDON CAPITAL MANAGEMENT

Monthly investment commentary

April 2010

Q1 HIGHLIGHTS

- A strong March pushed stock indices into positive territory for the quarter.
- Canadian bond yields rose slightly amid increased anticipation that the Bank of Canada would raise rates.
- Canada and the U.S. saw improving economic strength, while the Eurozone struggled with sovereign debt issues and stubborn unemployment.
- The Canadian dollar ended the quarter at $0.99 U.S. (up 4.2%) and 0.73€ (up 11%). Driving factors behind the substantial rise include:
  - higher commodity prices,
  - a strengthening economic landscape, and
  - the prospect of rising interest rates in Canada
- Oil prices ended the quarter up 5.3% to $83.35 U.S. a barrel (WTI).

RESPECTABLE GAINS: EQUITIES

Equities powered ahead in March to finish the first quarter of 2010 with respectable gains. After a shaky start to the New Year, improving economic conditions helped equity markets in both emerging and developed markets perform well in the quarter. Unfortunately, the rising Canadian dollar took quite a chunk out of foreign investment returns for Canadians (see Table 1).

Table 1– Summary of major market developments

Market returns*	March	YTD
S&P/TSX Composite	3.5%	2.5%
S&P500	5.9%	4.9%
- in C$	*2.0%*	*1.8%*
MSCI EAFE	7.0%	3.6%
- in C$	*2.2%*	*-3.4%*
MSCI Emerging Markets	6.1%	1.1%
DEX Bond Universe**	-0.7%	1.3%
BBB Corporate Index**	-0.1%	3.4%

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

The S&P/TSX also recovered from the January losses and recorded a gain of 2.5% for the first quarter of 2010 (see Table 2). The Financial sector drove much of the positive performance during the quarter as the banks performed particularly well. Five of the six big Canadian banks beat earnings estimates during the quarter. The banks benefited from improving economic conditions, which resulted in lower loan loss provisions. On the flip side, the Canadian resource sectors were a drag on results so far this year. Large cap energy names reported disappointing earnings, while in the Materials sector; performance was mixed across the sub-sectors. The fertilizer and diversified metals companies saw strong results, but these gains were offset by weakness in gold companies.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	March	YTD
S&P/TSX	3.5%	2.5%
Energy	2.1%	-2.7%
Materials	0.4%	0.2%
Industrials	7.2%	5.6%
Consumer discretionary	3.1%	5.4%
Consumer staples	0.2%	-0.3%
Health care	8.9%	9.6%
Financials	6.7%	7.1%
Information technology	0.6%	6.0%
Telecom services	2.8%	4.3%
Utilities	4.3%	1.9%

*price only
Source: National Bank

TWO SIDES TO EVERY COIN

The Canadian dollar has been one of the strongest currencies in the world thus far in 2010. Canada is currently viewed as a very attractive place to invest: we are a resource-rich country (at a time when commodity prices are strengthening), with a strong and stable banking system, whose economic recovery seems well underway. Combine that with the prospect that Canadian interest rates may begin rising before those in the U.S. (increasing the value to foreigners of Canadian dollar-denominated debt), and it is little wonder that our Loonie has taken off as demand climbs. Unfortunately, as the Loonie flies higher, the view from our manufacturing and exporting industries is nothing but the tail end of the bird. As the dollar strengthens, so weakens the attractiveness of our export prices - seriously dampening their outlook despite Canada's broader economic recovery.

LONGER, STEEPER CLIMB BACK

Putting aside the Canadian bravado (usually an oxymoron) that emerges when our dollar nears parity, the U.S. economy (having a longer and steeper climb back) has shown convincing signs of improving during the first quarter of 2010. U.S. GDP growth has shown recent strength. U.S. consumer confidence has improved significantly, and along with it, consumer spending was up for the fifth straight month in February. Statistics from the U.S. manufacturing industry (ISM Manufacturing Index) have shown the best results since July 2004, with the exports component reaching a 21-year high on strong global demand for U.S. manufactured goods. Even the beleaguered U.S. job market found solace in March by growing by 162, 000 jobs, the highest monthly gain in three years. (Source: Bloomberg, Barclay's)

Across the pond, our European friends could use some good news. The U.K. continues to struggle with achieving economic recovery after being badly beaten down by the credit crisis. In the Eurozone, a high jobless rate continues to cause concern, and the heightened risk of sovereign debt default isn't helping to boost investors' confidence in the area - threatening to weaken both the Euro and their ongoing economic recovery.

RISING EXPECTATIONS: FIXED INCOME

While bond markets benefited from the economic uncertainty that hurt equities earlier in the year, we are now seeing a noticeable shift in Canada towards focusing on the prospect of upcoming interest rate hikes. Much needed economic stimulus in 2008/2009 (which included extremely low interest rates) helped rescue the economy from a serious recession. Now that our economy has begun growing again, it's time to remove some of the stimulus to moderate the economy growth. Therefore, it's highly anticipated that interest rates will increase from the current ultra-low levels. When and by how much has been hotly debated, but the mere anticipation (recall the market is always a forward-looking entity) has already begun to show up in bond returns. In March we saw modestly rising bond yields (particularly for shorter duration bonds) cause bond prices to fall slightly and bond returns to give back some of the gains made earlier in the year (see Table 1).

Much has been made of the negative outlook for fixed-income investors in recent news and media reports. While the prospect of rising interest rates is a headwind for bonds, what seems to have been forgotten are the overall benefits of investing in fixed-income within a well-diversified, long-term portfolio. Consider that fixed income remains an important diversifier and can reduce the volatility in a long-term portfolio as bond and equity markets quite often don't move in sync with each other. There are also several factors that may help keep a lid on rising bond yields in Canada, including a secular trend (stemming from an aging demographic) keeping the demand for income-oriented investments (including bonds) strong. Likewise, inflation expectations are currently contained, and the slack in the economy with corresponding lack of wage inflation should keep a limit on overall inflation expectations in the near future. Finally, it is important to remember that despite the proclamations of market forecasters, the future is not known. If we saw another big economic stumble, equity markets would suffer and bonds would be likely to outperform.

If you have a long-term financial goal in mind, and you don't have the time horizon, or the stomach to handle taking significant risk and volatility, then chances are you should have a fixed-income component to your portfolio. While the outlook for bonds has diminished, your desire to stick to your long-term goals should not. The reason we are talking about rising interest rates is because our economy is doing well – overall, not a bad problem to have.