

Monthly investment commentary

DECEMBER 2007

NOVEMBER HIGHLIGHTS

- After a strong October, North American equity markets experienced the sharpest one-month drop in nearly 5 years.
- A ‘flight to quality’ increased the demand for Government of Canada bonds and boosted returns in the Canadian Bond market.
- Oil prices spiked to near \$100 U.S. per barrel, and then dropped to \$89 U.S. per barrel by month’s end.
- The Canadian dollar hit an all-time record of \$1.10 U.S. before coming back down to parity with the U.S. dollar.

As fall disappears under a blanket of December snow, more than a few market watchers were happy to see November 2007 put to bed. This past November was not kind to capital markets as credit issues lingered and worries over the U.S. economy grew. As witness to November’s woes, the S&P/TSX, S&P500, Dow Jones and the NASDAQ all experienced the sharpest one-month drop in nearly 5 years (since December 2002). Many world equity markets didn’t fare much better than their North American counterparts. Save for an interesting reversal in the currency exchange (foreign investment returns benefited from the decline in the Canadian dollar this month), **Table one** shows a column full of negative index returns for November.

Market returns	November	YTD
S&P/TSX	-6.4%	6.0%
S&P500 (US\$)	-4.4%	4.4%
S&P500 (C\$)	0.7%	-10.3%
NASDAQ	-6.9%	10.2%
Russell 2000	-7.3%	-2.5%
FTSE 100 (U.K.)	-4.3%	3.4%
NIKKEI 225 (Japan)	-6.3%	-9.0%
EAFE (C\$)	2.2%	-4.8%
EAFE (local currency)	-4.3%	2.4%
Canadian Bond Market	1.5%	3.0%
World Bond Market (US \$)	1.4%	4.0%

*local currency (unless specified); price only

TELECOM GIANTS TOLD TO SHARE

The Canadian government announced a plan in November to encourage competition in the Canadian wireless communications sector (currently dominated by telecom giants such as Rogers and Telus). Not surprisingly that sector was hit hardest this month as investors anticipate greater price competition and lower profit margins going forward (**see Table 2**). The Canadian Information Technology sector performed best in November (though still slightly negative), helped by a take-over announcement of Cognos by IBM.

GOVERNMENT BONDS TOP WISH LIST

Like the last gift on a Christmas shopping list, investors were willing to take almost anything for the ‘no credit risk’ safety of a Government of Canada bond. As demand soared, prices rose, boosting that sector and lifting returns on the Canadian bond market (**see Table one**). This ‘flight to quality’ combined with the sharp re-pricing of risk, has created a significant jump in the credit risk premium for any bonds with credit risk, such as Canadian corporate bonds. This allows active portfolio managers to be more opportunistic about the corporate bonds they buy and hold in their portfolio. Yet, interest rates remain at relatively low levels, and in fact have dropped in 2007, making return expectations for bond funds modest at best.

S&P/TSX sector returns	November	YTD
S&P/TSX	-6.4%	6.0%
Energy	-8.7%	-1.0%
Materials	-7.8%	22.6%
Industrials	-6.5%	8.7%
Consumer discretionary	-8.6%	1.2%
Consumer staples	-9.8%	-6.8%
Health care	-3.8%	-22.3%
Financials	-3.3%	0.3%
Information technology	-0.1%	51.1%
Telecom services	-10.7%	11.6%
Utilities	-5.0%	5.0%

*price only

FLEETING SUPREMACY

Is it just me? Or did the enthusiasm over the rise in the Canadian Loonie feel about as fleeting as that glimmer of hope a Leaf's fan feels when their team makes the playoffs? You're excited and happy. People start to pay more attention and want to talk about it, but you just can't shake that feeling that "this might not last for long." After spiking to its highest point ever versus the U.S. dollar (\$1.10) on November 7th the Loonie landed closer to parity by the month's end. Oil prices were also volatile this month, rocketing to almost \$100 U.S./bbl on November 23, 2007 (following an Enbridge oil line explosion in Minnesota) but then dropped sharply to end the month at \$89 U.S./bbl.

CREDIT WORRIES CREATE A CHILL

Credit concerns remain a key worry on the minds of economists and investors alike, and therefore the subject of much debate. Until early 2007, when sub-prime mortgage market issues surfaced, cash had been easy to come by and relatively cheap. This liquidity fuelled much of the economic growth we experienced, both domestically and globally, and gives rise to the question, "Will the decrease in liquidity (cash flow) available to the marketplace choke off global growth, or will there be enough momentum to keep economic growth going?" To answer that question, a number of factors need to be considered.

1/ Grey days for financial institutions.

In November, a number of financial institutions began to announce the value (or lack thereof) of the investments on their books, including the asset-backed commercial paper they held and other investments affected by the sub-prime mortgage market. Many financial institutions warned of significant losses, and risk averse investors headed for the exit. As of November 30th the S&P500 Financial sector was down 16% year-to-date, and the weight of the sector had decreased from 22% to 19% - the largest sector weight decline since the fall in Technology in 2000. While the health and outlook for the Canadian Financial sector is better (it was actually the second best performing sector in Canada in November), it is not immune to investors' risk averse sentiment.

2/ Lending standards are tighter.

One part 'reversion to the mean' (many lending practices had become unreasonably relaxed), and one part 'balance sheet preservation' given recent losses (see issue #1), financial institutions have tightened their underwriting standards. It has now become harder and more expensive to borrow money, and not just for residential mortgages, but for all types of borrowers.

3/ The U.S. housing market continues to decline.

American homeowners find themselves in the unenviable position of having less equity in their homes due to declining home prices, and owning homes that are less affordable given mortgages that are harder and more expensive to come by (see issue #2). Not surprisingly, people feel uneasy about their financial situation and are more risk averse (see issue #1).

What had started as a problem with high-risk U.S. home mortgages that were embedded in structured products, has caused a squeeze on liquidity and a massive re-pricing of risk across all manner of assets.

CENTRAL BANK SECURITY BLANKET

In contrast to those economic headwinds, there are several factors at play that could stem the tide of evaporating liquidity, boost the U.S. economy, and maintain moderate global growth.

A/ Central banks have been accommodative.

Including the Bank of Canada's move to lower interest rates on December 4th, central banks have put their money where their mouth is in terms of adjusting rates to facilitate economic growth, calm financial markets and control inflation. To date, the central banks, including the U.S. Federal Reserve, have been relatively effective in striking this balance, and many believe they can continue to do so.

B/ Employment is very strong in North America.

Unemployment rates in the U.S. and in Canada are currently 4.7% and 5.9% respectively. With 70% of the U.S. GDP coming from personal spending, many believe the steady paycheque will be the key to keeping the U.S. economy going and recessionary fears at bay.

C/ Canada's economic health is strong.

It's not very Canadian to brag, but the reality is that on many economic indicators (like our housing, government budget surplus and consumer debt/equity ratios) Canada is in much better economic shape than our neighbours to the south.

How much and how far the effect of these factors extend to the economy and capital markets remains to be seen.

GOOD CHEER AND A PROSPEROUS 2008 TO ALL!

Despite the headlines, the proclamations of economists, and the predictions of market savants, there is little certainty in the outlook for 2008. So with market volatility becoming more the norm than the exception, taking a balanced and diversified approach to your investment portfolio may be the best way to keep the good cheer of the holiday season going. Speaking of good cheer, from everyone at London Capital, to you and yours – May you prosper in 2008 with good fortune, good health, and good company!

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