

Monthly investment commentary

FEBRUARY 2007

JANUARY 2007 HIGHLIGHTS

- The S&P/TSX index rose one per cent over the course of the month after an initial drop of more than three per cent. Energy stocks combined with Metal & Mining stocks accounted for 81 per cent of that initial decline.
- Oil quickly slipped to \$50.59 in mid-January, the lowest level since July 2005.
- U.S. consumer confidence rose to its highest level since May 2002.
- January marks the eighth consecutive month of positive returns for the S&P500.
- North American central banks held interest rates steady, as inflationary concerns remained at bay.

If you were on vacation the first week of January, far away from watching any of the news about the Canadian stock market, you were lucky enough to avoid the news about the unpleasant start to 2007. The Canadian stock market didn't spend much time enjoying the positive results of 2006, and market-watchers saw a sharp drop of more than three per cent for the S&P/TSX during the first week of 2007.

WINTER HAS ARRIVED

The sharp drop in early January started off a volatile month, though you wouldn't know it by only looking at the month-end results. Most major markets posted positive one-month returns in January (see Table 1). A number of economic factors and data affected the markets and contributed to the volatility. Drawing the most headlines were the price of oil and natural gas. Since the highs experienced last July (\$78/barrel), crude oil has dropped 25 per cent. Oil prices began the year at \$61.06 only to suffer a sharp drop to a low of \$50.59 by mid-month, but then prices moved back up to finish the month at \$58.15. After a difficult 2006, natural gas prices rebounded with strong gains in January. Investors seeing the opportunity to buy-in at discounted prices after the rough year in 2006 and the seasonality of this commodity (heating our homes) moved natural gas prices higher. Yes, winter has arrived.

In Canada, exports of manufactured products are struggling because of a loss of international competitiveness. The most recent decline in the

Canadian dollar eased the competitiveness problem somewhat, but the currency shock of a Canadian dollar trading at a peak of 91 cents (U.S.) last June lingers and appears to have shaken business confidence.

A CANADIAN FROST

Canada's economy in the fourth quarter is estimated to have grown less than half the growth rate of the U.S. economy. The actual figures won't be released until early March, but they are expected to be well below the U.S. growth rate.

Fortunately the unemployment data in both Canada and the U.S. continues to show very positive results. Recent unemployment numbers came in even lower than expected, which has improved the mood of both North American central banks. In January, we saw the Bank of Canada and the U.S. Federal Reserve hold rates steady with no signs of a change in strategy anytime soon. While the Bank of Canada rate remained at 4.25 per cent, bond yields in Canada did move up due to positive economic data. The resulting decline in bond prices led to a slight drop of 0.1 per cent in the Canadian bond market for the month of January. For fixed-income investors, the Canadian yield curve continues to be relatively flat, significantly reducing the reward of moving into longer duration bonds. The overall low levels of interest rates, combined with the lack of compensation for the risk of holding longer-term bonds, continues to make it a challenge for fixed-income portfolio managers to re-create the returns experienced during the lengthy downward trend of interest rates experienced up until 2003.

Market returns	2006	January
S&P/TSX	14.5%	1.0%
S&P500 (US\$)	13.6%	1.4%
S&P500 (C\$)	13.9%	2.6%
NASDAQ	9.5%	2.0%
Russell 2000	17.0%	1.6%
FTSE 100 (U.K.)	10.7%	-0.3%
NIKKEI 225 (Japan)	6.9%	0.9%
EAFE (C\$)	23.9%	1.6%
EAFE (local currency)	13.8%	1.8%
Canadian Bond Market	4.1%	-0.1%
World Bond Market (US\$)	0.8%	-0.3%

*local currency (unless specified); price only

Table 1 shows the U.S. markets responded positively to the views of the Federal Reserve and to a series of positive economic data that was released in January. Consumer confidence rose to its highest level since May 2002.

Lower prices at the pumps, low unemployment levels, and slightly better news on the state of the weak U.S. housing market, helped boost U.S. consumer sentiment. In January, the Materials sector led the S&P500 gains. Global merger and acquisition activity and positive price momentum for steel stocks continued to push this sector higher. In fact, the S&P500 hit a six-year high of 1441.61 on Jan. 31, 2007, marking January as the eighth consecutive month of positive returns.

Table 2 shows seven of ten sectors in the Canadian market posted positive returns, and overall the S&P/TSX posting a decent one per cent return. The worst performing sector was Utilities, with a -6 per cent return for January. No significant news sparked the drop, but being an interest sensitive sector, it did feel the effect of bond yields moving up. Much of the volatility in the S&P/TSX came from the Energy and Material sectors as commodities, particularly oil, fell sharply earlier in the month before rebounding moderately. An unusually warm start to winter, combined with speculator selling as investors begin to wonder how much longer the commodity boom can last, are the latest causes to blame for the movements and direction of oil prices.

S&P/TSX sector returns	2006	January
S&P/TSX	14.5%	1.0%
Energy	3.2%	-1.3%
Materials	38.0%	3.2%
Industrials	12.7%	6.3%
Consumer discretionary	13.2%	4.0%
Consumer staples	3.9%	2.3%
Health care	-0.7%	-0.5%
Financials	15.9%	0.5%
Information technology	27.3%	0.9%
Telecom services	16.4%	2.5%
Utilities	2.1%	-6.0%

*price only

DRIVE CAREFULLY AND REACH YOUR DESTINATION

If January's rebound after a shaky start is any indication, the stock markets on both sides of the border continue to show strong resilience, and investors should benefit from doing the same. The merger and acquisition activity that set record highs in 2006, continue to play a significant role in fueling today's stock markets. Consumer sentiment continues to be positive, and unemployment rates are low. Yet, volatility will no doubt continue as each piece of economic data is released and scrutinized.

Like winter drivers, long-term investors will need to stay focused on their destination, be cautious not to overreact, and proceed at a speed (or risk tolerance) that is comfortable for them.



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