

Monthly investment commentary

JANUARY 2007

Highlights

2006: A record-setting year

- Canadian mergers and acquisitions (M&A) shattered previous records at close to \$92 billion.
- S&P/TSX Composite Index and the Dow Jones both topped 12,000 for the first time in October.
- S&P/TSX outperformed the S&P500 (Cdn\$) for a fifth year in a row.
- Gold hit a 26-year high at \$732 an ounce in May.
- Oil hit an all-time \$78 high in July.

Market highlights

- The Materials and Financial sectors were responsible for over two-thirds of the S&P/TSX gains.
- Nine of 10 sectors of the S&P/TSX posted positive returns.
- Thirteen of the 15 stocks produced the most negative effect on the S&P/TSX in 2006 were income trusts.

As we begin the new year, a look into life's rear-view mirror will help put into perspective the year that was, and provide some food for thought for 2007. In 2006, financial market investors benefited from two fundamental investment principles: stick to the plan and don't put all your eggs in one basket.

WELL EXECUTED TURNS AND STRONG FINISHES

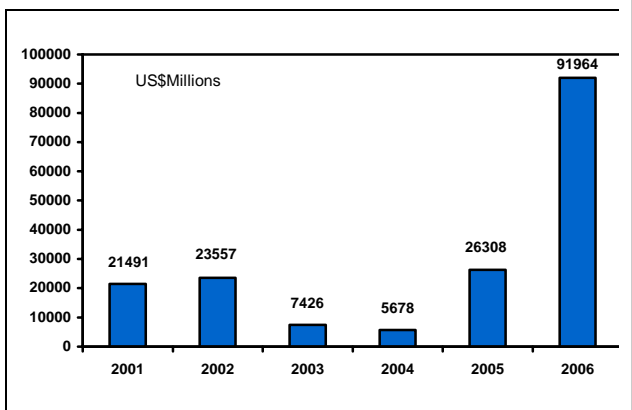
2006 was a record-breaking year for Canadian Olympic speed-skaters and financial markets alike. Both benefited from well-executed turns and strong finishes.

The North American markets did significantly better in 2006 than expected. The spring of 2006 gave rise to economic concerns over rising interest rates, energy prices and rising inflation. A new U.S. Federal Reserve Chairman, a new minority government in Canada and a faltering U.S. housing market did little to raise expectations and fuelled speculation for a sharp pull back in the stock markets. If the year ended in May of 2006, these market predictions would have been right. But 2006 was anything but a predictable, smooth ride for North American markets and strong returns during the last seven months of the year made all the difference.

On May 9, the U.S. Federal Reserve stopped raising rates to soften what seemed like an inevitable U.S. economy free-fall. U.S. consumer confidence surprised economists by being more resilient than expected despite the faltering housing market. Those corporations that had quietly, prudently and diligently been building their cash reserves found themselves in a very attractive position to take advantage of the favourable lending environment and they put their cash to work. **Chart A**, shows a virtual shopping spree in 2006 as merger and acquisition activity hit all-time highs and fuelled the stock markets.

Chart A – Total value of announced mergers and acquisitions of S&P/TSX companies

A shopping spree in corporate Canada



NBF Economic Research, Bloomberg

STICK TO THE PLAN

For many investors who believe they can predict the market's next move, it was likely a difficult year for them in 2006. Oil prices went from \$60 a barrel to a record \$78, then back down again. Gold hit a 26-year high at \$732 an ounce in May, only to trade in the mid-\$600 range by the end of the year. The S&P/TSX Composite Index and the Dow Jones both topped 12,000 for the first time ever in October of 2006. Topping the list of 'I never saw it coming' events were the income trust tax changes in Canada. The Oct. 31 federal government announcement to remove the preferential tax advantages for income trusts resulted in a one-day 295 point drop in the S&P/TSX. Fortunately it proved to be a short-lived pull back

in the markets and unless all your investments eggs were in the income trust basket, time and market resilience was on your side. The patient, who stayed invested throughout 2006, fared well as both the Canadian and U.S. markets produced better than expected years and rewarded investor patience with double-digit returns.

Across the globe, **Table #1** illustrates that all the major world markets finished the year in positive territory, with many providing double-digit returns. The EAFE(C\$) index led returns with 23.9 per cent gains in 2006. A closer look at those returns in local currencies shows a significant portion of these gains (approximately 10 per cent) can be attributed to the strength of the Euro against both the U.S. and Canadian dollars. Though **Table #1** shows the Japanese Nikkei 225 lagging the other indices for the year, it is hardly a poor showing. In fact, the modest returns of the Japanese market provide some comfort to investors as the Japanese economy appears to be gaining solid footing and moving beyond the volatile years since 1989.

Canadian fixed-income investors saw only modest year-end returns of 4.1 per cent in 2006. Fixed-income yields ended the year flat after having traded in a narrow range throughout most of 2006. For Canadian equity investors, **Table #2** shows the gains were spread across S&P/TSX sectors. Nine of the 10 sectors in the S&P/TSX finished the year with a strong fourth quarter. Most notably, the Materials sector ended the year with a whopping 20.3 per cent gain in the fourth quarter alone, and a 38 per cent gain for 2006. The Financial sector also had a strong year, returning 15.9 per cent. While the gains in both the Canadian and U.S. markets were wide spread across most sectors, the heavy weighting of the Financial and Materials sectors in Canada meant those sectors contributed the most to the Canadian index in 2006. The Energy sector, last year's darling, provided only modest returns in 2006, finishing the year up 3.2 per cent. Stocks within the Energy sector seemed to take a breather after their huge run-up in 2005, and the effect of the income trust announcement on the energy trust stocks pulled down the results of that sector.

RESOLVE TO BE RESOLVED IN 2007

Table 1– Summary of major market developments

Market returns	December	Q4 2006	YTD
S&P/TSX	1.2%	9.8%	14.5%
S&P500 (US\$)	1.3%	6.2%	13.6%
S&P500 (C\$)	3.4%	10.8%	13.9%
NASDAQ	-0.7%	6.9%	9.5%
Russell 2000	0.2%	8.6%	17.0%
FTSE 100 (U.K.)	2.8%	4.4%	10.7%
NIKKEI 225 (Japan)	5.8%	6.8%	6.9%
EAFE (C\$)	5.3%	14.8%	23.9%
EAFE (local currency)	4.2%	6.7%	13.8%
Canadian Bond Market	-0.8%	0.7%	4.1%
World Bond Market (US\$)	-0.8%	0.1%	0.8%

*local currency (unless specified); price only

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	December	Q4 2006	YTD
S&P/TSX	1.2%	9.8%	14.5%
Energy	-0.8%	6.8%	3.2%
Materials	0.3%	20.3%	38.0%
Industrials	-1.7%	9.1%	12.7%
Consumer discretionary	1.1%	8.2%	13.2%
Consumer staples	3.3%	7.0%	3.9%
Health care	4.4%	14.9%	-0.7%
Financials	3.1%	9.0%	15.9%
Information technology	3.6%	19.1%	27.3%
Telecom services	2.6%	-1.9%	16.4%
Utilities	5.4%	8.1%	2.1%

*price only

With surprising agreement, the majority of the market pundits are optimistic about the outlook for 2007 stock markets. They cite forecasts of a modest economic slowdown in the U.S., the continuation of a low interest rate environment and the expectation that M&A activity will remain high all point to strong equity markets in North America for 2007. Yet, it's important to not underestimate the risks the markets will face in 2007. A modest pull-back in stock markets following several



years of strong returns would not be uncommon, and there is little doubt that economic and political challenges lie ahead for 2007. Worries about inflation, a change in the interest rate environment and declines in the U.S. housing market could all lead to changes in consumer spending habits. In the U.S., George Bush faces decreasing popularity. The unpopular war in the Middle East will surely be highlighted by emerging presidential candidates for the 2008 U.S. election and could dampen consumer sentiment. Whether political, economic or some other unforeseen event effects the markets, hopefully our memories of the volatile ride in 2006 will help us resolve to two fundamental investment principles for 2007 - stick to the plan and don't put all your eggs in one basket.

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