

## Monthly investment commentary

MARCH 2007

### FEBRUARY 2007 HIGHLIGHTS

- In spite of setting several new highs in February, the S&P/TSX Composite finished the month of February up only 0.1 per cent as global markets reacted to the sharp decline in the Chinese markets, Greenspan's comments and weak U.S. economic data.
- Before experiencing its biggest one-day drop since September 2003, the NASDAQ recorded a six-year high, reaching levels not seen since the height of the tech boom.
- Corporate America recorded its 14<sup>th</sup> consecutive quarter of double-digit earnings growth.
- Negative housing news in the U.S. continues to put pressure on U.S. consumers.

For some investors, the shortest month of the year probably didn't end soon enough. The Feb. 27 drop in world stock markets caused investors to snap to attention and remember some of the more 'inconvenient truths' about investing in the stock markets.

### INCONVENIENT TRUTHS

February 2007 made us face a number of 'inconvenient truths':

- Just because it was your favourite picture of the year doesn't mean it's going to win the Oscar;
- A groundhog's prediction won't make it feel like spring in February; and
- Equity markets that go up, up and up will eventually come down.

### WHAT GOES UP

On Feb. 27, North American investors woke up to news from China that the Shanghai and Shenzhen stock exchanges dropped a sharp nine per cent in one day. The origin of the sell-off was a response to rumours in China of capital gains taxes and a tightening in IPO regulations, which seems obscure enough to be of little importance. However, the extent to which the shockwaves were transmitted through stock markets throughout the world underscores we're not immune to globalized financial market volatility.

**Table 1** shows almost all world markets posted negative returns for the month, wiping out the earlier gains made in the year. Prior to Feb. 27, the Chinese stock market had experienced remarkable growth. Likewise, earlier in February, the S&P/TSX and NASDAQ hit all-time and six-year highs respectively. While a sharp drop for stock markets is never welcome news, many market pundits believe a correction to equity markets was overdue and ongoing volatility is likely as investors rethink their comfort with risk. In fact, in the days following Feb. 27, world markets experienced some recovery, albeit markets were distinctly 'twitchy' – reacting to each piece of economic data, market news or comment from the current (or former) U.S. Federal Reserve chairman.

Market returns	February	YTD
S&P/TSX	0.1%	1.1%
S&P500 (US\$)	-2.2%	-0.8%
S&P500 (C\$)	-2.9%	-0.4%
NASDAQ	-1.9%	0.0%
Russell 2000	-0.9%	0.7%
FTSE 100 (U.K.)	-0.5%	-0.8%
NIKKEI 225 (Japan)	1.3%	2.2%
EAFE (C\$)	0.1%	1.7%
EAFE (local currency)	-0.6%	1.2%
Canadian Bond Market	1.3%	1.2%
World Bond Market (US\$)	1.1%	0.8%

\*local currency (unless specified); price only

**Table 2** summarizes the results across sectors in Canada for the S&P/TSX. Each sector was more or less affected by overall market weakness at the end of the month, though Information Technology (one of the smaller weighted sectors in the S&P/TSX) was up seven per cent for the month of February. These gains can largely be attributed to stock-specific results as Nortel and Research in Motion experienced strong stock gains on positive corporate earnings news. The Utilities sector reported a -2.7 per cent return for the month of February, after giving back some of the strong gains it experienced in the latter part of 2006.

**Table 2 - Sector level results for the Canadian market**

S&P/TSX sector returns	February	YTD
S&P/TSX	0.1%	1.1%
Energy	-1.8%	-3.1%
Materials	1.0%	4.3%
Industrials	-0.5%	5.8%
Consumer discretionary	-1.3%	2.7%
Consumer staples	-1.8%	0.5%
Health care	-2.0%	-2.5%
Financials	1.0%	1.5%
Information technology	7.0%	7.9%
Telecom services	1.1%	3.7%
Utilities	-2.7%	-8.5%

\*price only

The fixed-income market made some gains at the end of February, as bad news for equities translated into good news for bonds. Up until that point, fixed-income markets had been trading in a narrow range, providing investors with only moderate, albeit stable, returns. Stock market volatility and heightened sensitivity to economic data can drive nervous investors to the bond market. This flight-to-quality reaction may provide some positive gains for fixed-income investors, amidst the volatility of the equity markets.

### HE SAID "POSSIBLE" NOT "PROBABLE"

It hardly matters what Alan Greenspan actually said at a business conference in Hong Kong. What seems to matter is that despite the fact he hasn't been the U.S. Federal Reserve chairman for over a year, he hasn't escaped the word-by-word scrutiny of his former job. The mere mention of the word recession was enough to generate worry about the U.S. economy. In reality, sentiment about the U.S. economy remains mixed. On the negative side, the recent release of the Q4 2006 GDP rates showed a reduction from expectations to

2.2 per cent (down 1.2 per cent further than expected), and negative news for the housing market as sales took a turn for the worse in January. However, most market pundits are not calling for a recession in 2007, and neither was Greenspan. The current U.S. Federal Reserve Chairman, Ben Bernanke, remains more optimistic about the outlook for the U.S. economy with no fundamental changes from his earlier views of a slowing, but still strong U.S. economy. Inflation remains under control, corporate America has just recorded its 14<sup>th</sup> consecutive quarter of double-digit earnings, and merger and acquisition activity remains robust. The soft landing scenario versus a hard landing for the U.S. economy continues to be the most likely.

### INCONVENIENT TRUTHS = TIMELY REMINDERS

If the recent trading days are any indication, the market volatility in 2007 will be more pronounced than investors experienced in 2006. Should economic fundamentals remain strong and inflation pressures remain modest, equity markets should prevail through this volatility. Fixed-income investors are experiencing the result of low relative interest rates and a relatively narrow trading range, so while equity market volatility may prove beneficial to bond markets, return expectations should remain modest.

Inconvenient truths, by definition, aren't what we like to hear, but they can be timely reminders. In this case, the recent volatility reminds us to maintain a long-term approach for our investment portfolio, avoid the tendency to make emotion-based investment decision by investing within our personal risk tolerances, and that predicting how, when, and to what degree the markets will react to market and/or economic news is anything but an exact science.

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