

## Monthly investment commentary

NOVEMBER 2006

### Highlights

- TSX/S&P gains 9.5% year –to-date - representing the 13<sup>th</sup> best Aug-Oct performance of the last 50 years.
- Energy and Materials sectors were responsible for 60% of TSX/S&P gains, and twice the volatility.
- Economic weakness in both countries (Canadian manufacturing & U.S. housing) is concentrated and, so far, not spreading.
- Consumer spending remains solid and markets around the globe responded positively to lower fuel costs (oil prices hitting an October low of \$57.50/barrel).
- Volatility, particularly in the Energy and Telecom sectors, is expected as income trusts revalue based on new tax realities.

The end of October held true to its Halloween tradition. Investors found themselves facing a bag full of tricks and treats!

### AN INCOME TRUST GRIMM REAPER

First...the trick. At the end of the business day on October 31st, and just before the witching hour when trick-or-treaters hit the streets, Jim Flaherty (dressed as a solemn but fiscally responsible Finance Minister) announced his "Tax Fairness Plan". The proposed plan will result in a tax on income trust distributions, and effectively remove the significant incentive for any further conversions into an income trust (including the currently proposed BCE and Telus conversions). The 'trick' – a 2.4% one-day drop in the TSX/S&P on November 1st, and a likely bag full of short-term market volatility as income trusts get revalued by investors based on their new tax realities. But before we look into the eyes of November, let's check over our shoulder to see the October that was.

### A NOT-SO-SCARY OCTOBER

The rest of October was a relative 'treat' for investors. October bucked the trend of being a scary month for investors. In table one, you will see that all major world markets posted positive returns, with Canada leading the way.

Table 1– Summary of major market developments

| Market returns           | Oct. | YTD   |
|--------------------------|------|-------|
| S&P/TSX                  | 5.0% | 9.5%  |
| S&P500 (US\$)            | 3.2% | 10.4% |
| S&P500 (C\$)             | 3.6% | 6.5%  |
| NASDAQ                   | 4.8% | 7.3%  |
| Russell 2000             | 5.7% | 13.9% |
| FTSE 100 (U.K.)          | 2.8% | 9.1%  |
| NIKKEI 225 (Japan)       | 1.7% | 1.8%  |
| EAFE (C\$)               | 4.2% | 12.5% |
| Canadian Bond Market     | 0.4% | 3.8%  |
| World Bond Market (US\$) | 0.3% | 1.0%  |

\*local currency (unless specified); price only

The S&P500 also remained near its highs for 2006, with small-cap companies posting strong returns after a lack-luster September. European markets had a strong month. Annual inflation in the euro area fell to 1.6% in October from 1.7% a month earlier, thanks to lower oil prices. Meanwhile, the European Commission's index of economic sentiment increased to 110.3 in October - a five-year high. The combination left investors and the markets in the euro area feeling brighter. Fixed-income investors might have been spoiled by a July-to-September rally on the bond markets, but a 0.4% one-month return remains a healthy result. Overall, bond markets have been doing well on the uncertainty of the U.S. economy health, and the pause in interest rate hikes by central banks.

Table 2 - Sector level results for the Canadian market

| S&P/TSX sector returns | Oct.  | YTD    |
|------------------------|-------|--------|
| S&P/TSX                | 5.0%  | 9.5%   |
| Energy                 | 5.0%  | 1.4%   |
| Materials              | 10.1% | 26.3%  |
| Industrials            | 11.0% | 14.6%  |
| Consumer discretionary | 5.6%  | 10.6%  |
| Consumer staples       | 0.6%  | -2.2%  |
| Health care            | 3.6%  | -10.5% |
| Financials             | 2.0%  | 8.5%   |
| Information technology | 4.0%  | 11.1%  |
| Telecom services       | 4.4%  | 23.9%  |
| Utilities              | 1.4%  | -4.3%  |

\*price only

All ten sectors in Canada finished in positive territory for October, leaving the TSX/S&P with a very healthy 9.5% year-to-date return. This moves the index back to levels last seen in early May and close to its all-time highs. The industrial sector led the way with double-digit returns for the month. Stock specific announcements and declining fuel prices (hitting an October low of \$57.50/barrel) helped the airline and railroad stocks within that sector. Strong performance combined with the significant index-weighting of the Energy and Materials sectors saw those two sectors contributing 60% of the gain in the TSX/S&P during the month. Those same two sectors are also responsible for close to half of the TSX/S&P volatility in 2006. The Canadian reality is such that, given their heavy weighting in the index, when the Energy and Materials sectors move...the market moves.

In the U.S., the S&P500 also had a strong month. Despite slowing economic growth in the U.S. (3<sup>rd</sup> quarter GDP estimates have slipped to 1.6% from 2.6% in the previous quarter), markets have sustained and shown resilience. It is important to note that the weakness in growth in both Canada and the U.S. is highly concentrated - for the U.S. it's housing, and for Canada it's manufacturing -yet, so far, that weakness hasn't been spreading to the extent that was initially predicted. It seems the key to these resilient markets is a working, happy consumer.

## CONTENT CONSUMERS & REASONABLE CEOs

Consumer spending in both countries remain solid to date. Lower prices at the pumps, the resilience of the markets throughout the traditionally weak months of September and October, and healthy employment rates have kept consumers going. As for corporate America, business investment in the U.S. has not faltered either. Companies in both countries continue to feel good about their balance sheets. October saw the majority of companies reporting their quarterly earnings and pleasing analysts. It appears companies are focusing beyond the short-term growth slowdown and are preparing for healthy (though moderated) growth into 2007. To date, the markets are rewarding these companies for what they see as a reasonable and healthy approach to their growth outlook.

## GOOD ADVICE TO THE RESCUE

As we begin November, the focus in Canada is no doubt on the effects of the surprise news on income trusts. In the short-term we expect market volatility. The Energy and Telecom sectors will no doubt feel the effects of a revaluation of the income trusts and the proposed income trusts in the index. As with any period of significant market volatility, there will be winners and losers...but if you are playing the odds, bet on those investors focused on long-term, diversified investment strategies. It's times like these that proven strategies such as dollar-cost averaging and sticking to a balanced portfolio that's aligned with your risk tolerances pays off.

It's normal for investors to experience fear and concern about their investment savings, but the best antidote will be the sage advice of their professional financial advisor. Stick with the plan and keep long-term goals in-mind and you will be well positioned to withstand even the nastiest of Halloween tricks.

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