

Monthly investment commentary

SEPTEMBER 2007

AUGUST HIGHLIGHTS

- The S&P/TSX composite closed down 1.5% though it was off more than 8% mid-month amidst market volatility.
- Stock volatility climbed to highest point since February 2003.
- A flight to quality saw credit spreads widen in the fixed-income markets.
- Central banks and bank CEOs showed their commitment to offer support for market stability.
- North American employment and income trends still healthy.

THE WIND OUT OF INVESTORS' SAILS

Despite the seasonal weather, on the financial markets August was anything but smooth sailing. As confirmation of the choppy waters, the VIX index (a measure of volatility for the U.S. stock market) reached its highest point since February 2003.

Markets rippled worldwide as a new angle on the sub-prime "contagion" emerged (the credit crunch and liquidity concerns of short-term lending products) and rocked the boat.

Table 1 hardly tells the tale as stock markets re-bounded by month's end, leaving the S&P/TSX down 1.5% (not bad when you consider Canada's stock market index was down more than 8% mid-month) and the U.S. S&P500 'came about' ending the month up 1.3%.

ALL HANDS ON DECK

In Canada **Table 2** shows the S&P/TSX Financial sector had an impressive turnaround for the month of August, up 1.8% from its mid-month lows (down 4%). Investors breathed a collective sigh of relief when central bankers and Canadian bank CEOs called for 'all hands on deck' and took action to calm the market turmoil. The U.S. Federal Reserve lowered the banks' discount rate, and CEOs of major Canadian banks rallied together to announce their commitment to support any short-term lending products

incurring liquidity concerns. The result was an improved sentiment towards this sector. The smaller Information Technology sector was the best performing sector this month, largely based on news from Research in Motion (RIM) that signaled strong sales momentum and improved analyst sentiment towards the company.

The resource sectors were the laggards this month. The Energy sector felt the effects of a drop in oil prices in August, while the Materials sector gave back some of its stellar year-to-date gains. The Materials sector remains one of the strongest sectors year-to-date, up 14.7%, but this past month's general aversion to risk caused investors to shy away from this strong running sector.

In fixed income markets, the reaction to market volatility was a 'flight to quality'. The yield curve steepened and spreads widened as investors reconsidered their relaxed attitudes towards credit risk. Demand grew for Government of Canada bonds, but any product that was, even remotely, exposed to credit risk was sharply re-priced. The overall result for the Canadian bond market was a 0.9% return for the month and brought the year-to-date returns into positive territory.

Market returns	August	YTD
S&P/TSX	-1.5%	5.8%
S&P500 (US\$)	1.3%	3.9%
S&P500 (C\$)	0.4%	-5.9 %
NASDAQ	2.0%	7.5%
Russell 2000	2.2%	0.7%
FTSE 100 (U.K.)	-0.9%	1.3%
NIKKEI 225 (Japan)	-3.9%	-3.8%
EAFE (local currency)	-1.7%	2.5%
EAFE (C\$)	-2.9%	-4.5%
Canadian Bond Market	0.9%	0.2%
World Bond Market (US\$)	1.2%	1.7%

*local currency (unless specified); price only

PROFIT IS THE MOTHER OF INVENTION

A recent economist's quote gives us insight into how we got into this current credit crunch: "Profit is the mother of invention in financial markets, but fear is the father of

destruction. And unfortunately, they do tend to come in tandem.”¹ It’s been a low interest rate environment for quite a while now, and yield spreads over Government of Canada bonds were very narrow (i.e. nobody was being paid to take credit risk). As a result, investors began to aggressively search for debt products that provided greater yield. At the same time, many lending practices became indisputably lenient and relaxed, particularly in the United States (e.g. the sub-prime mortgage market). Structured debt products, because of their ability to package mortgages and other types of debt into financial products, could take advantage of the relatively relaxed views towards credit risk and provide opportunities for greater yield. As a result, they seemed to fit with investors’ demands.

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns	August	YTD
S&P/TSX	-1.5%	5.8%
Energy	-5.2%	0.7%
Materials	-3.7%	14.7%
Industrials	-1.2%	17.0%
Consumer discretionary	-1.0%	7.1%
Consumer staples	-1.6%	2.4%
Health care	-3.4%	-17.6%
Financials	1.8%	-0.1%
Information technology	8.6%	27.9%
Telecom services	-1.2%	23.2%
Utilities	-1.7%	0.9%

*price only

Everything was moving along quite smoothly until the U.S. housing market began to falter and defaults in the sub-prime mortgage markets began to rise. Worried investors began to ask questions about where and how much exposure there was to credit risks (like the sub-prime mortgage market) in the structured debt products they held, like asset-backed commercial paper. The ‘fear-factor’ showed up when some investors in these products couldn’t get a clear answer. The lack of transparency in some of these products became apparent, and worries about the sub-prime mortgage contagion spread to worries about investor confidence in the financial system. Problem became compounded when companies that borrow directly in the asset-backed commercial paper market to fund day-to-day operations

were unable to find buyers. Liquidity dried up on lack of investor confidence.

Fortunately, Canadian bank CEOs reacted quickly to reassure investors that they would maintain liquidity in their short-term lending products (a.k.a. the Montreal solution started by the National Bank). The central bankers also showed support for financial market stability (e.g. the U.S. Federal Reserve moved to lower the bank discount rate, and the Bank of Canada recently moved to put off rate hikes). So far, their actions appear to have helped.

AN IMPORTANT NOTE ABOUT STRUCTURED DEBT PRODUCTS AND ASSET-BACKED SECURITIES

While the practice of packaging mortgages and other types of debt into financial products (like asset-backed commercial paper and collateralized debt obligations) has taken place for a number of years, a marked deterioration in the quality of some of the underlying loans occurred in 2005 and 2006. Despite recent concerns, it is important to note that asset-backed securities (including asset-backed commercial paper, term asset-backed securities, and collateralized debt obligations) can be varied, complex, and (despite the current negative sentiment) cannot and should not be painted all with the same brush. A large majority of these products remain high-quality, transparent debt products, well suited for fixed-income portfolios.

CHARTING A COURSE THROUGH MURKY WATERS

Market uncertainty and volatility are likely to be the norm for the near term, and investor sentiment will be a key factor in determining the course of the markets. Yet North American economies and corporations remain on solid footing. Credit spreads are still below long-term averages and the banks remain well capitalized. Employment and corporate growth remain positive signals for corporate America.

For investors looking to chart a course through uncertain times, we caution against trying to time volatile markets. Maintaining a diversified portfolio that suits your risk tolerance is a reasonable, effective and comfortable way to reach your long-term financial destination.

¹ Richard Kelly, TD Bank Financial Group
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