



WEALTH MANAGEMENT



2007 Market Commentary

Canadian investors generally had mixed results in 2007. When one looks at their investment statement at the end of the year the results will look something like this:

- Bond funds were relatively flat
- Canadian equity funds were positive but not stellar
- Foreign returns were negative

In any given year there are typically three or four underlying themes which generally account for returns for Canadian investors. In 2007 these themes were (in no particular order):

- Resource Prices
- Sub-Prime
- The Loonie
- Fear of Recession

We will discuss how each of these has impacted your returns from Canadian and foreign markets.

Resource Prices

The Canadian stock market is very concentrated and driven primarily by three sectors: Energy, Material and Financials. These three account for about 70% of the S&P TSX Index. Therefore as these sectors go, so goes the Canadian stock market.

In 2007 we saw significant price appreciation in the oil price (Energy) and gold (Materials). Many other commodities saw large gains as well. The demand for resources by foreign nations, primarily emerging markets like India and China, continued at a very strong pace in 2007. Stocks in the Energy and Materials sectors had good but not spectacular returns.

Sub-Prime Mortgages

The complexity of the sub-prime issue is beyond the scope of this commentary but in very general terms the issue comes down to high risk mortgages from the United States being repackaged and sold to other investors around the world as low risk debt.

Because the ultimate purchasers did not have a sense of the true risk involved, these securities were not properly priced according to their risk. Once this whole mess started unraveling, there was no market for these securities because there was no sense of the true risk involved.

As these securities are revalued at greatly reduced prices, you are seeing many financial institutions forced to announce massive losses due to this re-pricing. The market does not like uncertainty when it comes to risk and in the second half of 2007 started to punish the firms holding these securities and that sell off continues today.

Financial stocks started the year in fine shape but during the course of the summer the sub-prime issue came to the forefront and subsequently hurt the Canadian financial stocks. The question became how much exposure Canadian banks have to the sub-prime securities. Some investors decided to sell first and find out later. As a result the Financial sector finished the year lower than

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they started 2007. This issue continues to plague the markets into 2008 and will likely linger until the sub-prime losses are fully recognized.

The Loonie

If one looks at the return on the S&P 500 in the US, it was actually positive in 2007 (about 3.5%). Our dollar rose about 15% over the course of 2007, at one point reaching \$1.10 US. The appreciation in the loonie worked against US holdings so much that most US funds were significantly negative in 2007.

The same effect occurred with international markets but not to the same extent as the US. Our dollar was positive with respect to many foreign currencies but less so than the US dollar.

Why did the loonie take flight to such a degree? That is impossible to answer definitively but it appeared to be a combination of demand due to rising commodity prices, selling of the US dollar by foreign entities and general strength of the Canadian economy.

Over the long term, currency gains and losses tend to wash each other out. Exchange rate risk is just something we must endure in order to have exposure to international investment opportunities.

Fear of Recession

Markets typically price in news or concerns in advance. Recession fears have been prevalent in the markets for some time and justifiably so. Economists seem to be of the opinion that the US is either in recession or very near to it. Whether a recession occurs or there is a near miss, a slow down has been factored into market returns around the world.

The major question is now how much of the US slowdown will spread beyond its borders to Canada and the rest of the world. The current growth in emerging markets is moving along at full speed. Is the US effect enough to derail that growth or even slow it down? We will only know the answer to this in retrospect.

The argument in favour of international investing remains valid. Canada represents only a very small percentage of the global markets. In addition, our market is concentrated in the three sectors mentioned above while other industries have little, if any representation whatsoever. History has shown us time and again that investing our savings in a narrow basket of opportunity is logic that is severely flawed.

At Peter Watson Investments, we believe in the benefit of a well diversified, total portfolio approach. This has not changed even in light of the global currency movements of the recent past and the ongoing issues in the United States.

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