

September 26, 2007

ECONOMIC INDICATORS

CANADA

	Dec. 2006	August 2007	
GDP ⁽¹⁾	2.7	2.5 ⁽²⁾	↘
CPI ⁽¹⁾	1.6	1.7	↗
Unemployment	6.1	6.0	↘

UNITED STATES

	Dec. 2006	August 2007	
GDP ⁽¹⁾	2.9	2.0	↘
CPI ⁽¹⁾	3.2	2.0	↘
Unemployment	4.5	4.6	↗

(1) Year-over-year % variation
(2) June 2007

Sources: Statistics Canada, U.S. Dept. of Commerce, U.S. Dept. of Labor Statistics.

EQUITY INDICES

% Change	2007 in local currency	2007 in C\$	
S&P/TSX	8.0	8.0	↗
S&P500	7.6	-7.6	↘
Russell 2000	3.2	-11.7	↘
Nikkei	-5.3	-16.1	↘
S&P 350 Europe	3.5	-5.0	↘

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THE CANADIAN DOLLAR IN FOUR POINTS

Last week, parity between the Canadian and U.S. currencies has drawn a lot of attention. We prefer to spare our readers from an additional analysis of how and why it happened*, but we will share a few things we learned from years in the financial markets.

1- Currency movements are unpredictable

A lot of economists had correctly predicted that the loonie would go to par. But it does not mean they will get it right the next time. As demonstrated long ago by Nobel Prize recipient Paul Samuelson, currencies, just like stocks and bonds, fluctuate randomly over time. Statements such as: "I knew it would happen", "It will go higher", "It can't go much higher" carry no weight in our view. The same goes for the proponents of the "reversion to the mean" theory, who speculate that some of the Canadian dollar appreciation must revert towards some sort of "fair value". To us, the only fair value is the price set by the market here and now.

2- It is appropriate to diversify equities outside Canada

The Canadian dollar appreciation hurts investors who are properly diversified in U.S. and international equity markets, because the returns of non-Canadian stocks have been partly cancelled out by currency losses. But let's face it: the Canadian stock market is all about resources and financial services. The diversification and safety of any all-Canadian equity portfolio pales in comparison to a well-balanced global portfolio. Nonetheless, it is frustrating to experience low returns during a bull stock market due to foreign currencies depreciation.

3- Currency-hedged funds may be a solution

A solution in this respect is to use funds which are hedged against currency movements. The manager of such funds enters into derivative product transactions in order to remove the effect of currency movements. This allows investors to better capture the domestic returns of foreign stocks.

4- Hedging comes at a cost

Economists have demonstrated that there are no incremental returns from holding foreign currencies. Therefore, hedging the foreign exchange risk of U.S. and International stocks is a no-brainer, right? Not exactly. Hedging strategies come at a cost, just like insurance. There are transaction and management costs. Currency-hedged funds also are likely to be less tax-efficient, because derivative transactions will trigger capital gains. But worst of all, investors won't always find a currency-hedged version of the exact fund they are looking for, with the right style, structure and manager. We believe that investing is the game of capturing market returns at the lowest possible cost. In this light, each investor's decision about how much to hedge relies on their personal balance between costs and benefits.

Raymond Kerzerho, Director of Research

*For a quick read about our view on the Canadian dollar appreciation fundamentals see: "A Loonie with Teeth", October 2004 at

http://www.techmodels.com/CMS/_includes/ShowImage.asp?id=316&rep=PWL

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