



# The Quarterly Letter

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## The Quarter in Review...

Market volatility continued to be the dominant theme during the second quarter of 2007. This volatility is fed in particular by fears related to the impact of sturdy world economic growth and rising inflation on long-term interest rates. Indeed, the bond market is in decline by about 1% in Canada and in the United States since the beginning of the year.

Our typical client experienced an excellent return this quarter, the equity portion of his/her portfolio recording about 9.8%, versus a drop of 2.6% for the Morgan Stanley World Index. Our overweight position in Canada, going against

most "expert opinion", has once more proven us right in the context of a rising Canadian dollar.

This significant volatility will continue as long as the market remains unsure as to the average level of long-term rates in the next 24 to 36 months. We would not be surprised to see a 10% correction in the stock market if long-term rates pursue their ascent. This would certainly allow us to use our ample liquidity to shop for bargains.

We remain relatively convinced that stock markets will offer better returns than income securities during the



next few years and we are trying to keep this in mind amid the current fickle environment.

Enjoy a pleasant summer!



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## Selected Statistics

Month	Interest Rates			Stock Exchanges			Currencies		
	Canada Short-Term	Canada Mid-Term	Canada Long-Term	CAN TSX/SPX	USA DJII	Intern. EAFE	USA\$	EURO	YEN
Dec. 2006	4.17	3.99	4.09	12908	12463	2075	0.8581	0.6504	102..21
Mar. 2007	4.17	4.02	4.11	13165	12354	2147	0.8655	0.6491	102.06
April 2007	4.16	4.11	4.15	13417	13063	2235	0.8961	0.6566	107.24
May 2007	4.29	4.55	4.50	14057	13628	2263	0.9319	0.6935	113.30
June 2007	4.43	4.56	4.56	13097	13409	2262	0.9385	0.7008	116.45



Le groupe Dalpé-Millette

## The Bond Market



Although the Bank of Canada is currently maintaining its overnight interest rate at 4.25%, it admits that economic growth and inflation during the first part of year were sharply stronger than expected. Under these circumstances, the Bank of Canada now considers that there is a risk that inflation remains above the target rate of 2%. Consequently, after one year of stable interest rates in Canada, it seems that a first increase will be on the agenda this year.

During its last meeting, the American Federal Reserve left its leading rate unchanged at 5.25%, for an eighth consecutive time. The president of the American central bank, Ben

Bernanke, is prudently optimistic when it comes to the growth outlook for the American economy, all the while warning markets against inflationary risks.

In this context, no segment of the market escaped, since bond rates for all terms rose. Since May, 2, 5, 10 and 30-year terms recorded respective increases of 29,45,41 and 30 basis points. American bond rates underwent increases similar to those for Canadian bonds. On June 7, the 10-year bond rate reached 5.25%, a peak unseen since June 2006. Developments in the bond market are reminiscent of 2006. Indeed, following an increase in rates during the first 6 months, markets had a change of heart during the

second half of the year. In June 2006, core inflation in Canada was at 1.7%. It is currently at 2.5% and has been equal to or greater than the Bank of Canada inflation target rate of 2% for over eight months. Market conditions are quite different this year.

The rise in bond rates last month has significantly decreased investor returns. The Scotia Capital Universe bond index recorded a return of -1.67% for the second quarter of 2007 (-0.78% year-to-date), and the American bond market recorded a return of -0.53% over the same period (-0.95% year-to-date).

Bond rates rise for all terms.

## The Currency Market



Following over four years of continuous appreciation that has led the loonie from an historic low of \$0.62 US in 2002 to an historic peak of \$0.91 US in 2006, the Canadian dollar continues to surprise. In June, it broke through the \$0.94 US mark, a level unseen for almost 30 years.

The factors explaining the appreciation of our dollar have remained essentially the same for several months. The recent strength of the loonie is not only due to the weakness of the American greenback, several other factors are at the origin of the loonie's flight. Among oth-

ers, Canada has been experiencing a wave of mergers and acquisitions that have generated significant capital inflow into the country since the beginning of the year. In addition, the industrialization of countries like China and India, that will practically fuel half of the world's growth in 2007, constitutes a good backdrop for Canada, which benefits as a net exporter of natural resources. Interest rate expectations have also supported the Canadian dollar. Interest rate spreads have narrowed, inciting foreign investors to take advantage of more interesting rates in Canada than in the United States.

The Canadian dollar is not only eclipsing the greenback, it is the new star of the exchange market. It has appreciated against all major currencies in 2007.

The loonie rose 9.4% in 2007 against the USD. Its ascent is just as striking when comparing its value to the following historic dates: \$0.9067 US a year ago, \$0.8011 US two years ago and \$0.7320 US three years ago.

The loonie at an historic 30-year peak.

## Canadian Stocks



The second quarter was dominated by market volatility. The leading Toronto index stagnated in April, over-performed in May and ends June with a loss. In conclusion, the SPX/TSX ends the quarter up 5.6%.

Let us turn our attention now to sub-sector performance for the second quarter of 2007. In first place, we find the Telecommunications sector with 16.6%, thanks in part to mergers and acquisitions (M&A), of which BCE, and to the amazing performance of Rogers. In second place, the Information Technology sector with 16.4%. The Industrial sector follows with 11.2%. The recent performance of this sector is essentially due to Road and Railway Transportation seconded by Engineering. The Finally history repeats itself. The Materials sector comes in 4th place with 8.2%. Aluminium provided the mo-

mentum for its good performance with announcements and rumours of M&A activity, in particular Alcoa's bid for Alcan. Zinc, copper and aluminium, always in high demand by emerging countries, are the magic ingredients for this sector. The Energy gains 7.8%. The increase was supported by the relatively high price of crude oil.

The Financial sector loses 0.6%, the announcement of an increase in interest rates adversely affecting the banks. The Health Care sector is again in loss territory with a return of -0.7%. The Utility sector drops 5.2% in spite of the support of the Electricity sub-sector

The CN strike, which lasted a good portion of February, had a minimal impact on the Canadian economy in general. Consumer spending is the main

source of growth with a contribution of 2.2% to real GDP, representing more than half of its advance. A 3.2% increase in weekly wages contributed to the vitality of domestic demand. The Canadian labour market recorded a loss of 5,200 jobs for April and the creation of 9,300 jobs in May, a performance below the historic average. We are currently experiencing a small pause in the labour market. As for the unemployment rate, it remains unchanged at 6.1%, its lowest level in 30 years.

On another front, construction starts of detached houses rose by 1.2%, a slight decrease compared to the last quarter. The annual rate of inflation did not move much; it was 2.2% in March and 2.3% in April, still under high surveillance by the Bank of Canada.

A volatile but impressive stock market for the second quarter of 2007.

## US Stocks

The second quarter of 2007 started off with a roar and ended with a whimper, when, amongst other events, a wave of rate increases buffeted the markets. Both the Dow Jones and the S&P 500 reached several new peaks.

We will not want to forget May of this year, which disproved the old saying “*Sell in May and go away*”. In this month alone, the Dow Jones, the S&P 500 and the Nasdaq climbed 4.3%, 3.3% and 3.2% respectively.

The second quarter ends with returns of 5.8% for the S&P 500, 8.5% for the Dow Jones and 7.5% for the Nasdaq. With half of the year already behind

us, these same indices have risen 6.0%, 7.6% and 7.8% respectively.

On the positive side, we can point to the unexpected strength in retail sales. This rally in consumer spending at the tail end of the quarter, supported by the good performance of the labour market, reinforces the idea of solid growth following the sluggish 0.6% growth in the first quarter, the worst quarterly result in over four years.

Furthermore, the growth in business inventory levels and the improving trade balance should contribute to the quarterly advance in GDP, which was not the case this winter. In

addition, American markets reacted well this quarter to encouraging news about inflation, rising profits and the continuing wave of mergers and acquisitions.

However, some figures released at the end of the quarter are disappointing. Consumer confidence is tumbling and industrial production is stagnant. The effect of the increase in the price of gas (energy prices jumped 5.4% in May) has clearly had an impact on the consumer price index, which experienced its strongest increase since the tornadoes of September 2005.



## International Stock Exchanges

The fear of rapid increases in interest rates across the planet has contributed to the wave of profit-taking in the markets following a period of growth over the last few months. In China especially, exports, sales in the retail sector, industrial production and rising inflation are adding to the risks of rate increases. The Hong Kong Hang Seng index ends the quarter up 10.0% and the semester up 9.1%.

At the beginning of June, the decline in the Shanghai stock exchange composite index was making headlines. However, contrary to its fall on February 27 of this year, the Shanghai exchange did not drag down international financial markets in its wake.

In Japan, the economy is on the road to a fifth consecutive year above its potential rate, sustained by consumer spending and export growth that has more than doubled in May. The Japanese stock exchange ends the quarter up 5.0%, and climbs 5.3% since the beginning of the year.

In the euro zone, the vitality of the economy continues to surprise while the household confidence index is at its highest level in over six years. The German index is leading the march with an increase of 15.8% this quarter and ends the semester with an enviable return of 21.4%. The confidence of German investors however has decreased unexpectedly at the end of the quarter.

While France's index gains 7.5% this quarter and 9.3% after six months, Italy's index advances by 1.3% and ends the quarter up 1.6%. Since economic conditions remain favourable in this zone, the European Central Bank has increased its leading rate at the beginning of June.

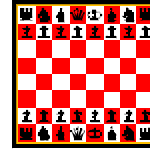
In the United Kingdom, inflation fell in May to its lowest level in seven months, but remains nevertheless too high for the authorities, thus rendering additional rate increases more likely. Great Britain's index rose 4.8% this quarter and 6.2% on a year-to-date basis.



The big American indices are running out of steam following many weeks of uninterrupted gains this quarter.

Thanks to a strong world economy, a new upsurge in interest rates cools off market momentum.

## Review of Portfolio Activities



We have experienced a pretty active quarter, making many portfolio transactions. Almost 15,000 individual portfolio transactions were carried out on behalf of our clientele. This activity is partly the result of market volatility, but mostly of our decision to position the portfolios in line with our expectations for the next few years. To summarize, we acted and reacted.

Our backdrop, mentioned many times in our recent Info Sabius, is based on a strong worldwide economy, increasing inflationary pressures and interest rates, as well as on continued growth in emerging market economies and in earnings of corporations engaged in the production of natural resources. Our recent transactions must be seen in this light to be properly understood.

However, the increase in long-term interest rates since the beginning of the year (expressed by the negative return of bond market indices)

compromises the valuation of the stock market. We know that long-term interest rates are the main driver determining the level of market indices. When rates increase, valuation ratios are lowered. Fortunately, the stock market has been able to resist increases in interest rates until now due to relatively low valuation ratios. However, this situation is beginning to worry market participants, thus explaining the higher volatility.

We are trying to adjust in the short term without losing sight of the 18 to 24-month time horizon. The secret is a matter of striking the right balance.

By and large, we carried out the following types of transactions over the quarter:

1. reduction in our average term for fixed income securities by selling our longer maturity securities, which are impacted more by increases in

interest rate. These transactions have been useful, seeing that the value of the securities sold has dropped by almost 6% in the last two months;

2. adoption of a neutral position in the income securities / equity mix and a slight accentuation of a pro-growth bias. The purchase of SNC-Lavalin, HudBay Minerals, FXI IShares China 25 Index (Chinese «blue chips») and Canadian Oil Sands fall within this vision; and

3. reduction by a third of our position in Alcan, the target of a takeover bid.

A correction in the market is possible if long-term interest rates increase by another 1/2 to 1%. Nothing serious, but sufficient to give us the opportunity to buy quality stocks at depreciated prices. Our significant liquidities would then be put to use.

A busy quarter, which saw numerous transactions designed to position portfolios in line with our views on the market over the next few years.

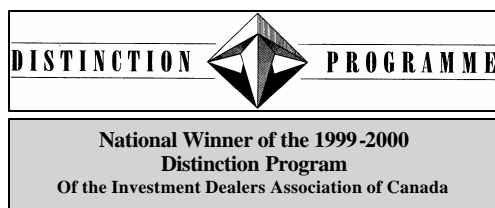
**Members of the Dalpé-Milette Group:**

Marc Dalpé	(514) 281-8768	mdalpe@sabius.com
Jean-Marc Milette	(514) 281-8763	jmmilette@sabius.com
Chantal Beaulieu	(514) 281-8682	cbeaulieu@sabius.com
Chantal Bouchard	(514) 281-7401	cbouchard@sabius.com
Annie Dagenais (en congé)	(514) 281-8709	adagenais@sabius.com
Anna Gastaldi	(514) 281-8715	agastaldi@sabius.com
Véronique Levrey	(514) 281-8725	vlevrey@sabius.com
Audrey Sanchez	(514) 985-1842	asanchez@sabius.com

1170 Peel Street  
Suite 300  
Montreal, Quebec  
H3B 0A9

Fax: 514-987-1214

**WWW.SABIUS.COM**



The Dalpé-Milette Group



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