



Published since 1992

The Quarterly Letter

The Quarter in Review...

The most striking event of the third quarter was undoubtedly the credit market crisis, which was triggered at first in the United States, but whose repercussions then spread to other parts of the world. The commercial paper market has collapsed affecting investor confidence in financial institutions.

Following several good quarters, stock markets were already expecting an eventual correction. So nothing else was required to instigate a correction of some 10 to 15%. The soothing reaction from central banks allowed the markets to recover slightly, but uncertainty and volatility remain. Observers are especially questioning the conta-

tion effect of the American financial crisis on the American economy, and by ricochet, on the world economy.

The risks of an economic contraction are real considering the pitiful state of credit, the collapse of securities and record high oil prices. However, we believe that the leeway available to central banks is sufficient to re-energize the economy, if need be. Let's not forget that the Fed recently cut the discount rate by half of a percentage point to 4.75%, a rate that was only 0.5% a few years ago.

Considering the situation in the last three months, our portfolios have performed quite well. Instead of declin-



ing, they actually gained significant ground in the third quarter, which very few managers can claim to have accomplished. In spite of this, we remain vigilant during this turbulent period.

Do not hesitate to contact us if you have any questions or comments.



Le groupe Dalpé-Millette

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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
June 2007	4.43	4.56	4.56	13097	13409	2262	0.9385	0.7008	116.45
July 2007	4.56	4.57	4.53	13869	13212	2227	0.9378	0.6870	111.55
Aug. 2007	4.00	4.38	4.43	13660	13358	2187	0.9430	0.6910	109.12
Sept. 2007	3.96	4.21	4.34	14098	13896	2300	0.9970	0.7052	115.26

The Bond Market



As many were expecting, the Bank of Canada announced on September 5th that it was keeping its overnight rate unchanged at 4.50%. The Bank has clearly adopted a neutral position now.

This decision represents a major shift for the Canadian central bank. Just recently, on July 10th, the Bank not only raised its overnight rate by one-quarter of one percentage point, but it also signalled that future rate increases were in the cards, stating that “some modest further increase in the overnight rate may be required to bring inflation back on target over the medium term.” The Bank’s decision falls within the context of the unrest that has shaken financial markets, emanating from the subprime mortgage collapse in the American market.

In the United States, the Federal Reserve lowered its benchmark interest rate by half a point on September 18, a more significant reduction than anticipated.

In doing so, the American central bank cut its rate for the first time in four years. While an interest rate cut was expected, analysts thought it would be only a quarter point reduction. The rate is currently at 4.75%. This decision comes while the real estate market continues its downturn and while the mortgage credit crisis is starting to impact the economy.

The Federal Reserve pushed interest rates up 17 consecutive times over a two-year period to try to keep inflation pressures from getting out of hand then left rates unchanged for more

than a year to see if its anti-inflation campaign had succeeded. The difficulties noticed on the credit market have increased pressures on the American central bank to cut its rates.

The American bond markets have benefited from the Fed’s conciliatory words and from the stampede towards high quality securities. The rates for 10-year US Treasury Notes were down to 4.46% in mid-September from 5.03% at the end of June. Likewise, the rate for 10-year Canadian federal bonds retreated to 4.46% from 5.03%.

In this context, the J.P Morgan American bond index posted a return of 3.9% for the quarter and the Scotia McLeod Universe Index posted a return of 1.7% over the same period.

The American Federal Reserve reduces its benchmark rate by 0.5%.

The Currency Market



On September 20th, the Canadian dollar reached parity with the U.S. dollar for the first time since November 25, 1976.

This new 31-year high follows a spectacular gain of 16.2% by the Canadian dollar since the beginning of 2007. This dazzling increase, distancing us from the historical low of \$0.62 US posted on January 2002, is due to many factors, from the state of our economy to global economic conditions. However, the main reason remains the crash of the American dollar. For years now, the United States has been facing both enormous trade deficits (they import much more than they export) and extraordinary government deficits. This

double deficit has depreciated the value of the greenback.

Combined with the change in expectations for American monetary policy, this has eroded the value of the American dollar. This drop against almost all major currencies occurs while the world economy is progressing at full throttle. The emerging countries of China, India, Brazil and Russia are all experiencing strong growth. These countries are producing for Europe and America, while their populations are increasingly consuming more and more goods, thus increasing the price for raw materials.

And since natural resources

represent over half of all Canadian exports, emerging countries must purchase Canadian dollars to buy base metals and oil. This demand has contributed to the country’s economic growth over the last few years as well as to the increase of our currency.

For its part, the euro has hit an all-time high against the U.S. dollar. The euro reached \$1.42US for the first time, helped by the prospect of an increase in interest rates in the euro zone, contrasting with the expectations of monetary ease in the United States. This divergence between interest rates in the euro zone and the United States favours the European currency.

The loony reaches parity.

Canadian Stocks



The stock market got all of our attention over the 3rd quarter of 2007. July started off with a roar, but ended backtracking. The decline continued in August, but the market finally regained momentum in the last week of the month. The market then came to life in September. Surprised by the lowering of the U.S. benchmark interest rate by half a point, the reaction was direct, the market approved the decision. It was thus an action-packed quarter for the TSX, which ends the quarter with a return of 1.4%. These fluctuations are the direct result of the financial crisis shaking the United States economy.

Let's now take a look at the behaviour of the TSX/SPX sub-sectors for the quarter.

Information Technology is in first place with 14.4%. HD TV, e-commerce and video over internet were all responsible for the success of this sector. Research In Motion, with an excellent performance, greatly contributed to the situation. Furthermore, it is rumoured that Microsoft Corp intends to acquire the company.

The Materials sector comes in second place. China is keeping this sector busy with its strong demand for copper and aluminium. Moreover, Teck Cominco has surprised the market by submitting a relatively high friendly offer for Aur Resources, allowing the sector to post a return of 12.4%.

The Utilities are in third place with 5.7%, while 4th place is reserved for the Financials sec-

tor, which posted 0.1%. The latter was in free fall, but was cushioned somewhat by the solid results posted by the banks, such as the TD, which exceeded analysts' forecasts. Scotia Bank also experienced an excellent quarter.

The Industrials sector is in 5th place with a return of -0.2%. It was somewhat slowed down by the increase in fuel costs, an essential component for this sector, seeing as it is so closely linked to the Transportation Industry.

The Consumer Discretionary sector finishes in sixth place. The summer period gave this sector a boost; the hotel, restaurant and leisure industry ranking first in this sector. The automobile component had a couple of good months in July and August, giving the sector a return of -0.9%.

The Consumer Staples sector takes 7th place with -2.3%. Tobacco has been supporting this sector for the past five years.

The Telecommunications Services sector ends up in 8th place with -2.7%. In this sector, BCE is the talk of the town. The change of control in favour of Ceberus and its Canadian partners is stimulating the conversation. Rogers remains a dominant figure with its expansion into the media subsector.

The Energy sector gets ninth place with -3.2%. Mother Nature usually dictates the behaviour of this sector at this time of

the year. This year, the storm is not weather-related but financial. High risk loans have deeply affected this sector. Investors have cashed in their profits in a restless market. The price of a barrel of oil is around \$80, an all time high. An Alberta government-appointed panel recommended that the government substantially increase the royalties payable to the province. This move did not please the market.

Bringing up the rear, we find Health Care. This sector is still last, as it has been for many quarters.

Overall, the Canadian economy is doing well. Real GDP has increased by 3.4%. Salaried workers have continued to grow, increasing in numbers by almost 4%. They have, in fact, contributed greatly to the rise in consumer spending. Exports are up 1.4% and imports jumped by 3%, two third of this increase being largely attributable to automobile products.

Housing starts of single-family homes rose 1.8%. The Canadian labour market benefited in August from job creation that approached its historical average, with a gain of 23,300 jobs. The unemployment rate held steady at 6.0%, its lowest level in the last 33 years. In conclusion, there are currently more Canadians at work than ever before.

The Canadian stock market experienced a fidgety quarter, in unison with the rest of the world. Our dependency on the American economy and on sectors sensitive to global economic growth has contributed to this volatility.

US Stocks

The summer was turbulent: definitely not for the faint of heart. The summer season was marked by a crisis of confidence following difficulties in the high risk real estate loan sector, usually called subprime mortgages.

The third quarter had started off on the right foot, some indices hitting record highs in mid-July. Stock markets then started retreating as the mortgage crisis pulled liquidity from the money market. The American Federal Reserve reacted by injecting billions of dollars into the inter-bank market to facilitate transactions and, then, lowered its discount rate. The result: a small respite at the end of the quarter, the major American indices ending the third quarter with respective returns of 3.6% for the Dow Jones, 1.6% for the S&P 500 and 3.8% for the Nasdaq.

In mid-August, North Ameri-

can indices were all below their level at the beginning of the year, but have bounced back since then to end in positive territory for the year-to-date. The 30 blue-chip index, the Dow Jones, posted a return of 11.5%, the broader S&P 500 index 7.7% and the Nasdaq 11.9%.

The weakness in the housing market continues to affect our southern neighbours. Recent data about building permits, residential construction and housing completions all posted significant declines. The housing industry is experiencing its most significant downturn in 16 years, something to take seriously.

The first downturn in employment in four years, in August, has revived many fears concerning the economy's strength. The prospects for consumer spending are troubling as American consumers were able



to count until now on a relatively strong labour market to finance their spending and their increasing debt burden.

Furthermore, the leading index for manufacturing activity has indeed declined in August (second consecutive drop, bringing the index to its lowest level since last March), but the drop is still relatively modest. In the same vein, the leading indicator has also dropped in August, but the trend does not indicate a downturn of economic activity for now.

Finally, the tightening of credit conditions, the decline in the price of houses and the increase in mortgage payments erode the balance sheet, but the increase in household disposable income, the sustained growth of corporate earnings, which have significant liquidities, and the good performance of foreign trade are all elements that favour growth.

Roller coaster equity markets, North American stock exchanges are subjected to investors' fears over the credit crisis.

International Stock Exchanges



This summer, the world's central banks have intervened, by injecting billions of dollars in the financial system, to overcome the most significant credit crisis in over a decade, caused by the difficulties of the subprime mortgage market in the United States. This said, global economic growth remains stable.

European stock markets have followed a similar trend to the American indices. In France, the CAC-40 index dropped 5.6% while the DAX index in Germany and the MIB-30 in Italy posted returns of -1.8% and -4.4% respectively this quarter. For the year to date, they have returns of 3.1%, 19.2% and -2.9% respectively.

In the euro zone, indices are running out of steam, but the unemployment rate is at a low, retail sales have increased for the first time in four months in August and the improvement in the labour market is continuing.

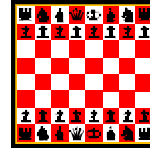
In China, the inflation rate hit a ten-year record high. For the fifth time since last March, interest rates have been increased to stop this escalation. The country is experiencing the strongest growth in the world and is trying to slow down its economy by asking banks to increase their reserves. The Hong Kong Hang Seng index gained 24.7% over the last three months and 36.0% since the beginning of the year.

Coming as a surprise to most strategists, machinery orders in Japan have jumped this summer. Recent statistics on the economic growth are however very disappointing: reduction in business spending, in construction starts and in retail sales. The NIKKEI 225 took the rap and dropped 7.5% this quarter and 2.6% over the year.

In the United Kingdom, growth is continuing at a good pace sustained by the rise of consumer spending, which is boosted by the real estate market. The inflation rate is at its lowest level since March 2006. The leading British index ended the 3rd quarter with a return of -2.1% and was up 4.0% for the year.

China remains the main engine of world activity.

Review of Portfolio Activities



In July, we have made a few portfolio transactions, selling our Alcan holding and reducing the one in Power Corp. These operations allowed us to increase our investment in the oil sector (good timing, since the price of oil jumped 10% from \$73 to \$81 a barrel since our transactions) and to reduce the equity weighting within our portfolios.

This portion currently represents 53% of the portfolio of our typical client, whereas it was close to 60% three months ago. We had foreseen the last correction to some extent without knowing what would trigger it (see Quarterly Letter – Second Quarter 2007) and we had decided to keep some ammunition in case of an exaggerated drop in the market. The correction was not significant enough and our crystal ball is not

transparent enough to allow us to reinvest in stocks, and thus have an overweight position in equity within our portfolios.

Since we consider the current period as a mid-cycle adjustment, we do not want to significantly reduce our holdings in stocks, but we are aware that some volatility could still be just around the corner for a few quarters.

The equity portion of our portfolios has returned +17.5% since the beginning of 2007, an exceptional return considering the situation (the Morgan Stanley World Equity index is down 5.9% for the same period), and we do not wish to jeopardize everything with an untimely daring gesture. Caution is called for and we will continue to follow the situation very closely, while

taking into account both the short and medium terms.

In our opinion, the 1/2 of 1% reduction in rates in the United States at the end of September signals a change in monetary policy, which will see rates fall as low as necessary to avoid, at all costs, a recession in United States. The debt level in the U.S. is too high for the American central bank (the Fed) to risk a severe slowdown by being too slow to react to the real estate and credit crisis.

This will allow extending the current economic cycle by a few years, probably two to three. Adding the vigour of the Asian emerging economies to this scenario, we are optimistic for the future of the resource sector and the Asian stock markets.

Caution is called for in the current environment, but also a medium-term vision.

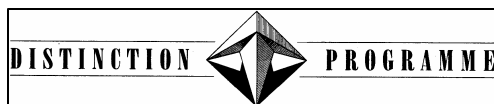
Members of the Dalpé-Milette Group:

Marc Dalpé, Associate Portfolio Manager	(514) 281-8768	mdalpe@sabius.com
Jean-Marc Milette, Investment Advisor	(514) 281-8763	jmilette@sabius.com
Assistants:		
Chantal Beaulieu	(514) 281-8682	cbeaulieu@sabius.com
Chantal Bouchard	(514) 281-7401	cbouchard@sabius.com
Annie Dagenais	(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



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