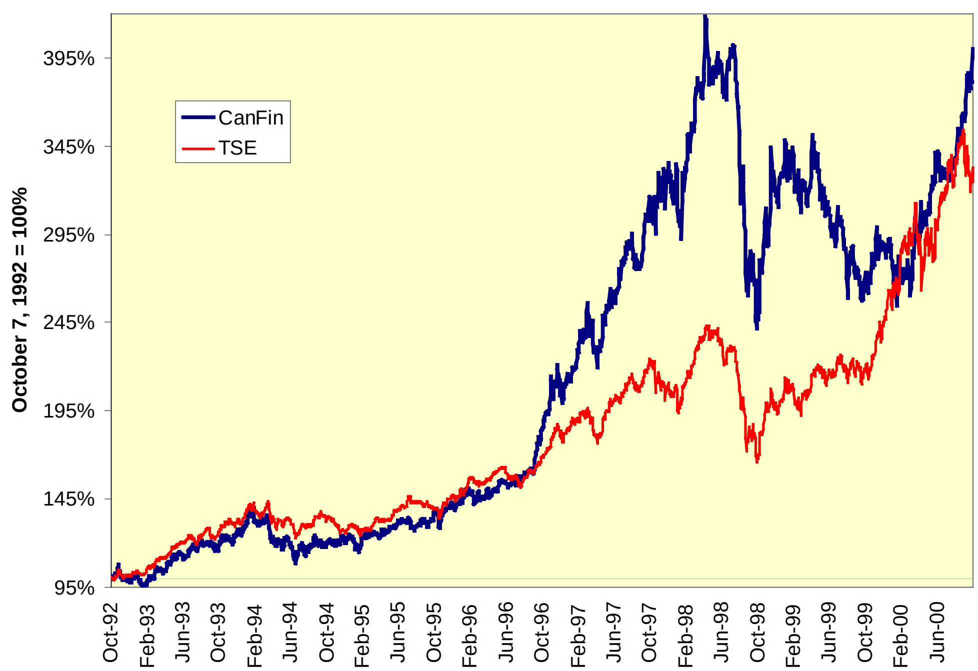
Whoever Thanks Canadian Banks?

Nortel Networks has been such a dominant component of the Toronto Stock Exchange 300 (TSE) this year that some have joked the index should be renamed the TSE 1. The stock accounts for close to 29% of the index all by itself, and its 23.4% gain so far in 2000 goes a long way to explaining the TSE's 24% gain in Canadian dollar (CAD) terms -- 19.25% in USD terms -- this year. Only the senior Chinese indices, the Shanghai and Shenzen, have outperformed Toronto in 2000.

But our neighbor to the north is more than a one-man band with a few gold mining and oil drilling stocks thrown in for good measure. The TSE's financial services sub-index, which accounts for 17.7% of the TSE's market capitalization, has outperformed the broad market in 2000, and has outperformed even more spectacularly in years past. From mid-1996 to the height of the Asian financial crisis in the winter of 1997-1998, the financial services index' gain was twice that of the broad market, a feat it then performed in reverse until the resolution of the Russian financial crisis in late 1998.

Canadian banks are poised to provide some further excitement, and soon. They've already returned more than 36% this year.

Relative Performance: TSE 300 And TSE Financial Services Index

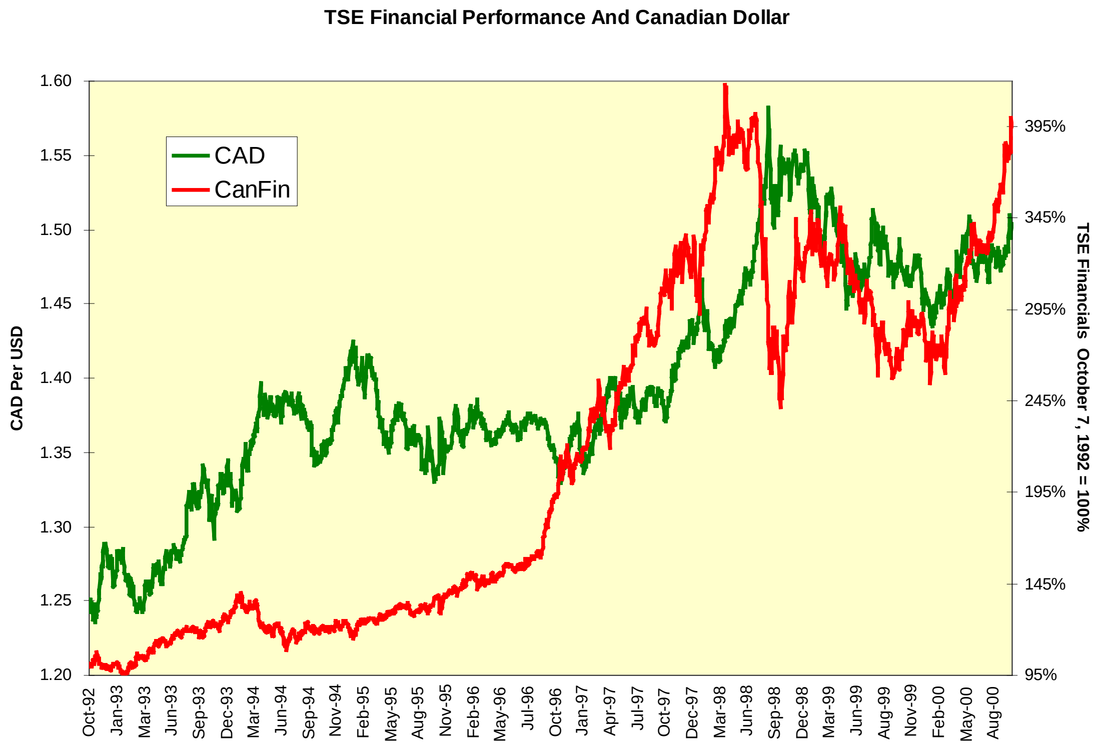


The Role Of The Bank Of Canada

Being Governor of the Bank of Canada must be one of the more bittersweet positions in global finance. On one level you're the head of a major central bank, and on the other level you're torn with the endless federal-provincial political stresses besetting Canada and you're no doubt held hostage to U.S. monetary policies. BOC Governor Gordon Thiessen probably spends a lot of time wondering about Alan Greenspan's next move; the reverse is less likely.

Like banks everywhere, Canadian banks benefit from a low cost of funds, a normal yield curve, and steady economic growth. Any hint of BOC monetary ease or other conditions likely to produce this environment shows up in strong bank stock performance. It also shows up in a weaker CAD; as much as any exchange rate in the world, the CAD/USD rate is a function of interest rate differentials and not of trade imbalances or political uncertainties, the never-ending efforts of Quebec Separatists notwithstanding.

The BOC has been loath to match fully the Federal Reserve over the past eighteen months in its credit tightening efforts. It's no accident, therefore, that the financial services index took off after the Fed's last tightening in May 2000: The threat of further BOC actions had been minimized, if not removed altogether, and this is unalloyed good news for the banking sector.



Merger Politics

The CAD and Canadian banks are entwined in yet another manner. Prime Minister Jean Chretien may call a snap election this month, with the vote to be held on November 27 (wouldn't it be wonderful if we adopted this parliamentary artifact and compressed our interminable elections into a two-month span?). Canadian markets fear a burst of fiscal recklessness and monetary largesse; this drove the CAD to a 14-month low last week.

More important for banks, however, the election campaign and the question of whether Chretien's Liberal government will approve bank mergers have placed industry consolidation in limbo. Canada, bluntly speaking, is over-banked. The domestic banking market has been protected politically from global competition. No Canadian bank is a player in global markets, and no global giants are serving the Canadian domestic market. American visitors to Canada are struck by the physical presence of the same group of bank office towers in every city of significance.

Canada's political culture, as many were reminded with the recent passing of longtime Prime Minister Pierre Trudeau, is far more statist and protectionist than the U.S. It is doubtful a re-elected Chretien or even Progressive Conservative leader Joe Clark would give a green light to a wave of bank mergers at the cost of large-scale white collar layoffs. The large players -- Bank of Nova Scotia, Bank of Montreal, Canadian Imperial Bank of Commerce, Royal Bank of Canada, and Toronto-Dominion Bank -- will no doubt have a large say in who shall remain and who shall disappear from the scene. Since bank mergers have become both a political issue and a topic of market speculation in Canada, we can be certain the number allowed by the next government will be greater than zero.

Basket Of Banks

One way to play a wave of industry consolidation is to buy the group as an index; alas, there are no futures, options, or exchange-traded funds on the financial sub-index. We can, however, achieve addition by subtraction: A purchase of index futures on the TSE 100 can be offset with weighted sales of non-financials such as Nortel, Seagram, Bombardier, and Bell Canada Enterprises (BCE).

The resulting synthetic bank basket should benefit from both the macroeconomic trend of looser monetary policy, the expected consolidation of the banking industry, and the Canadian market reality that Nortel can't keep going up forever in the face of global technology weakness. Not a bad combination for an investment strategy. Now, what can we do with all those office towers?