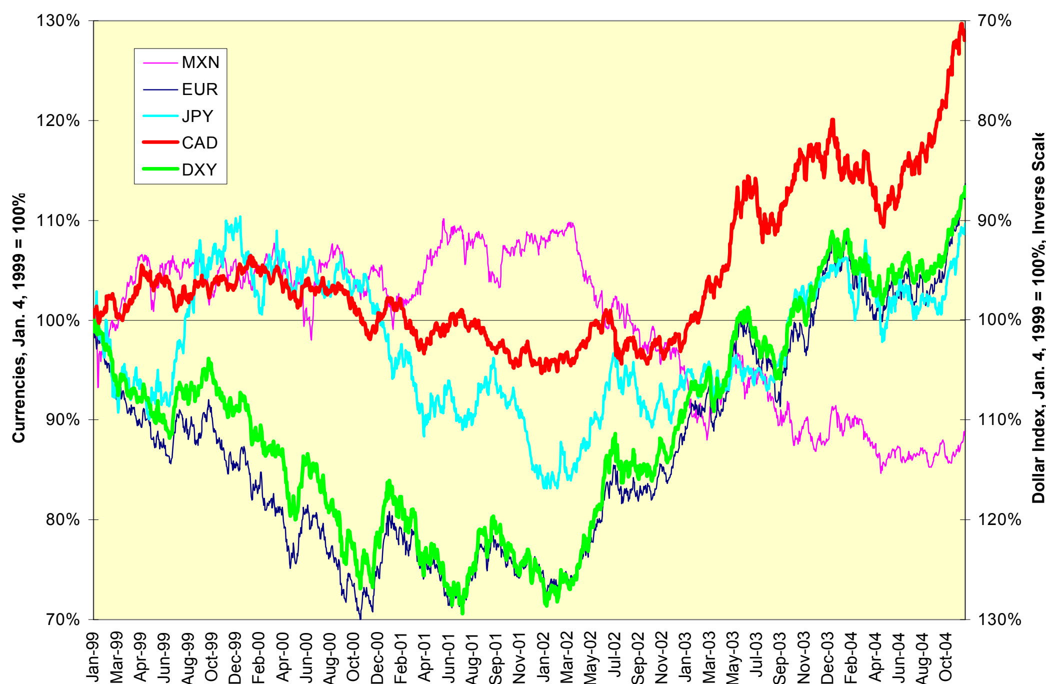
Canadian Markets To Stop Moving North

President Bush just completed a visit to Canada on his 2004 "Was It Something I Said?" tour. It should have served to remind Americans of the importance to us of our neighbor to the north. We are each other's largest trading partner, and yet while Canadians are intimately familiar with all aspects of the United States, Americans just take Canada for granted.

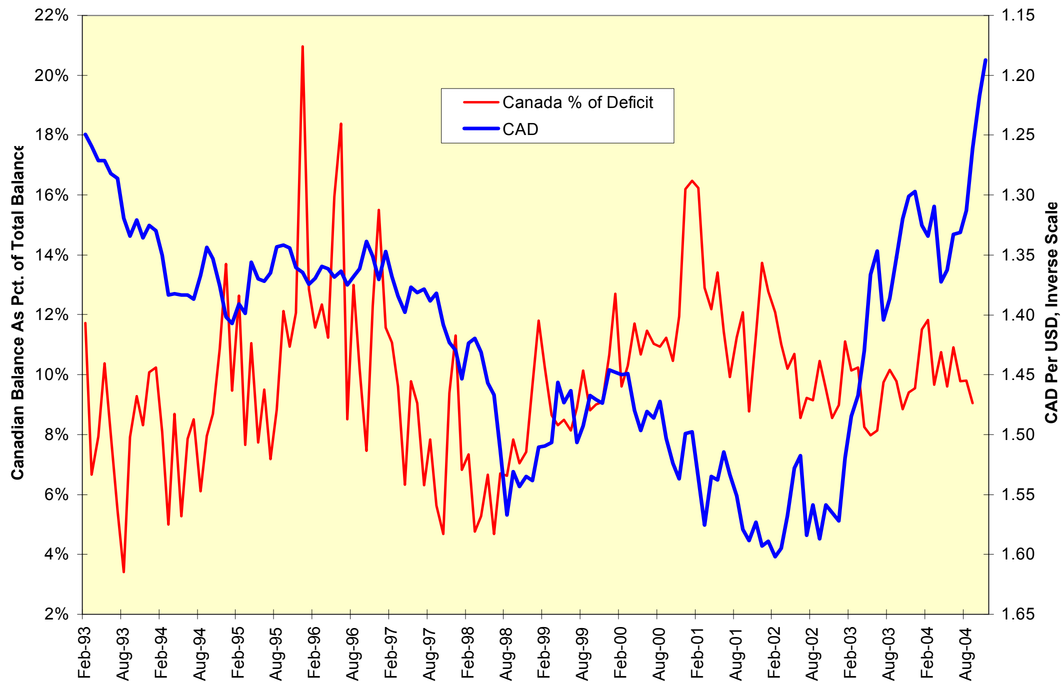
While every loud-barking dog has been obsessed with the dollar's decline against the euro, nary a mouse has squeaked about the Canadian dollar (CAD). It has risen 8.93% against the greenback in 2004, as opposed to a 6.82% increase for the euro. In fact, the Canadian dollar has outpaced the euro, the yen (JPY) and the Mexican peso (MXN. Mexico is our second-largest trading partner) since the euro's creation in January 1999. Its increase has outpaced the decline of the trade-weighted dollar index (DXY), in which the CAD has a 9.1% weight.



Trade Implications

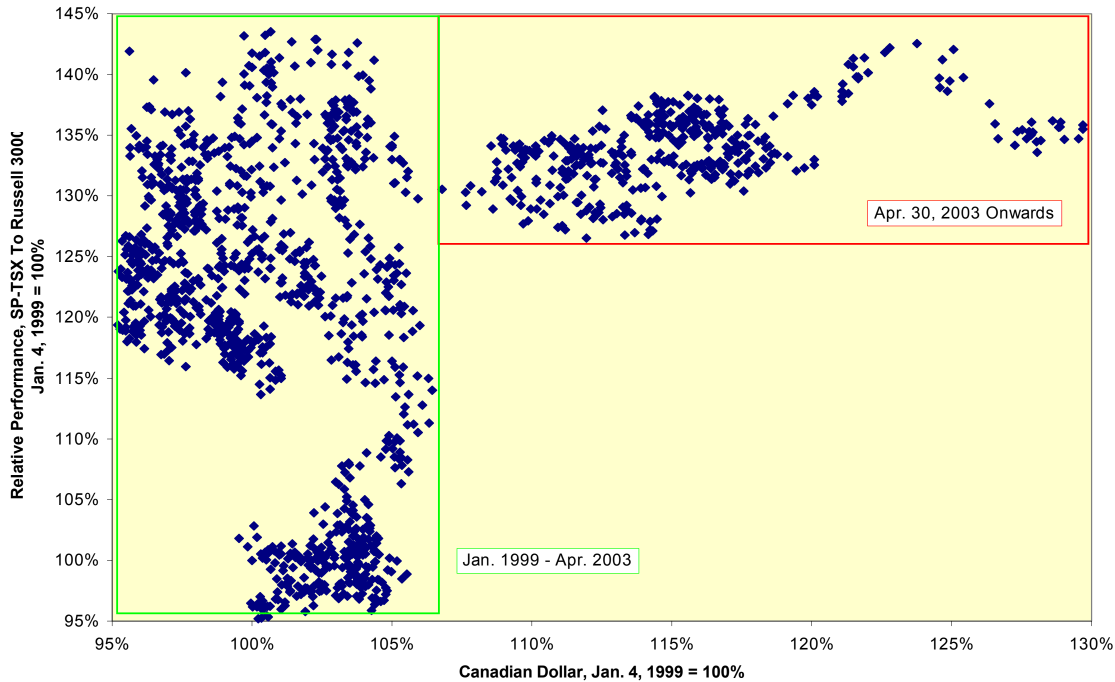
One of the many things dollar-hysterics and others afflicted with deficit attention disorder get wrong is the relationship between a foreign exchange rate and a bilateral trade balance. This error is particularly egregious in the case of U.S.-Canada trade; the two countries are part of a more-or-less functioning free trade zone, and much of the cross-border traffic is between subsidiaries of multinational corporations with operations in both countries. Most trade between the two countries, therefore, is affected only partially by currency fluctuations, and it is fair to say that the residual currency risks can be hedged in the very deep Canadian dollar market.

A casual observer would be hard-pressed to identify the impact on Canadian exports to the U.S. of a stronger CAD. In February 2002, it took 1.6 CAD to buy a dollar; by August 2004, that fell to 1.31 and is now 1.19. The percentage of the U.S. trade deficit accounted for by our net balance with Canada fell from 12.1% to 9.0% over that period. The surge in oil prices and the growth of Chinese exports probably were greater factors in affecting this percentage.

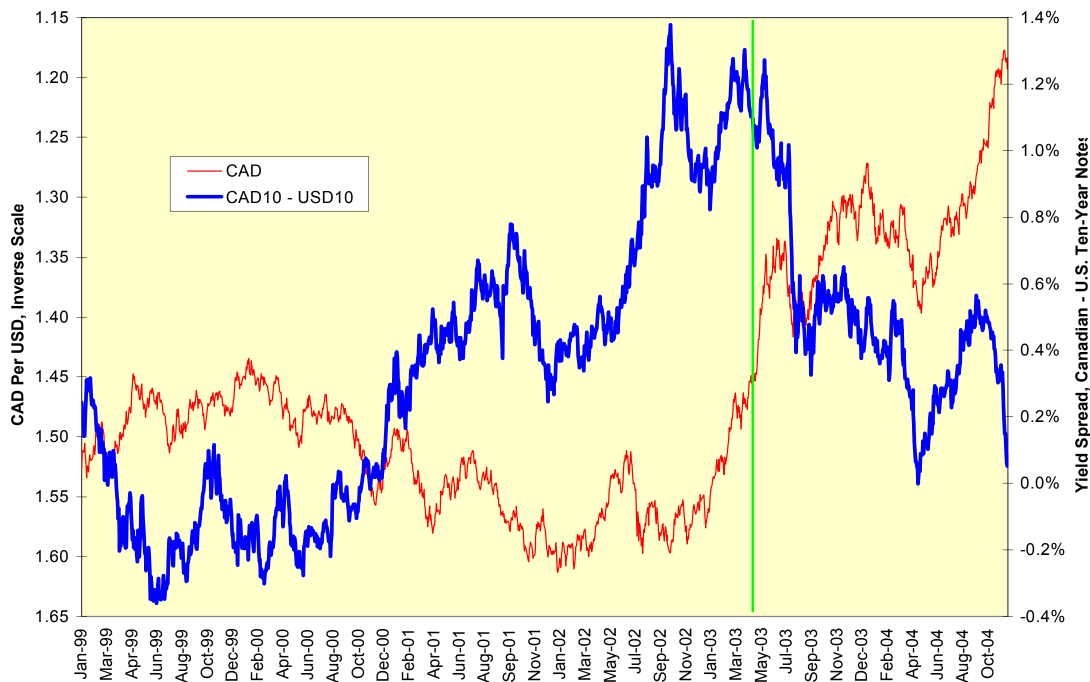


A Notable Relationship
U.S. interest rates were softening at the end of April 2003. On May 6, 2003, the Federal Reserve warned about the dangers of deflation on May 6, 2003. This window encompassed a very substantial shift in the relationship between U.S. and Canadian markets. While currencies do not affect trade balances in the short-term, they certainly can have an immediate impact on related financial markets.

Let's take a look at the relative performance of the S&P/Toronto Stock Exchange index to the Russell 3000 as a function of the CAD. Prior to the end of April 2003, the Canadian market had a very wide range of relative performance. After April 30, 2003, the Canadian market has outperformed its American counterpart, but only slightly, and despite the big CAD rally. The Canadian market has gained close to 20% in 2004 in USD terms, as compared to 8% for the Russell 3000.

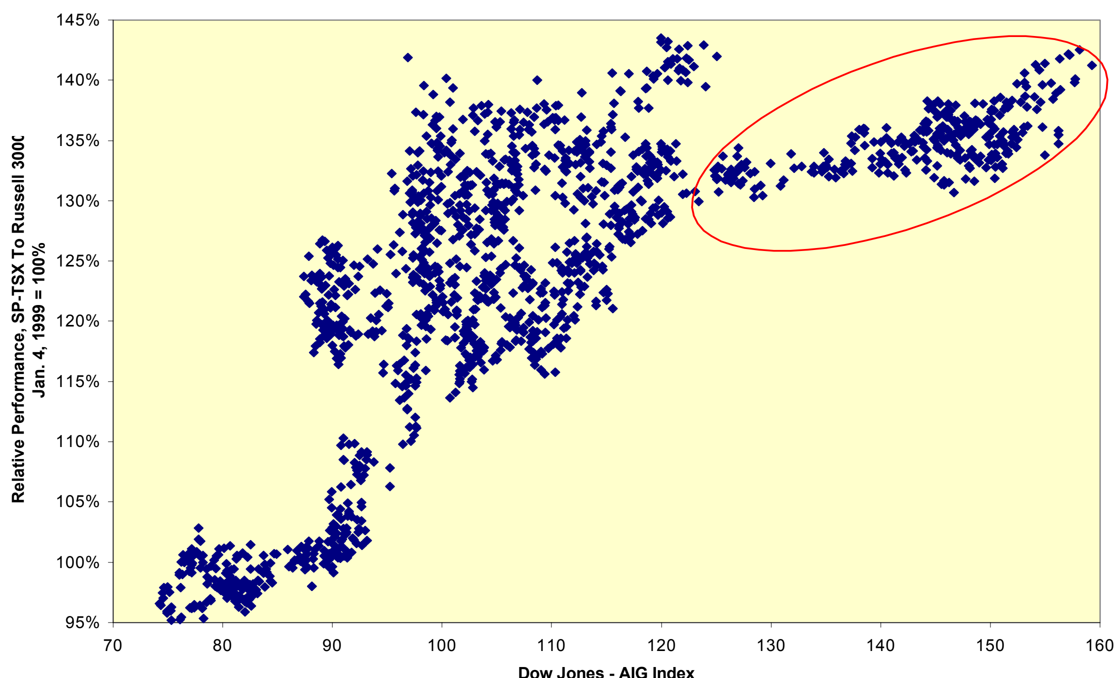


Did any other factors contribute to the Canadian outperformance? Yes; the first and most important of these was a declining rate gap at the ten-year horizon between Canadian and American Treasury notes. The Bank of Canada did not tag along with the Federal Reserve in its emergency rate cuts of 2003, and as a result inflationary expectations in Canada have been less American inflationary expectations.



A second and equally important development was the raw materials rally that accelerated in earnest in 2003. If we map the relative performance of the two stocks markets against the Dow Jones-AIG commodity index, we can see a

near-linear relationship form once the DJ-AIG moved over 125. Canadian mining and energy stocks have been particular beneficiaries of the global commodity rally.



An Interesting Combination

Many countries handle resource riches poorly; if nothing else, the import gains tend to swell the money supply and lead to a weaker currency and greater inflationary expectations. Canada dodged that bullet in this phase. By virtue of parting ways with the Federal Reserve's reflation policies, they have managed to keep a firm currency, and strong financial markets.

Should we expect a repeat, or restated, should we chase performance? Probably not: As U.S. short-term interest rates rise, the ascent of the CAD should slow, and that will serve to widen the note yield gap with the U.S. In addition, betting on a third year of a commodity rally in the face of rising interest rates is asking a lot. Investors in oil-related issues already are familiar with the disconnection between commodity-linked equities and commodities. What has been happening in oil and gas can happen in metals, too. A hiccup in Chinese demand will open that trapdoor with little warning. And, shifting away from commodities, can anyone reasonably expect another 150% move higher in Research In Motion?

During the height of the tech bubble Nortel so dominated the Canadian market that reference was made to the index as the "TSE 1." Two years later comparisons were flying around the Internet regarding the relative returns on Nortel and a case of empty Budweiser cans, a comparison particularly painful given the Canadian opinion of American beer. There is nothing in the present market to suggest such impending disasters, but neither is there anything to suggest anyone should overweight Canada either.

Just give Canada the respect it deserves for a great job of economic management over the past two years.