Canadian Renaissance

Sometime near last year's September lows, levels which we now seem determined to at least test and possibly puncture, an e-mail began flying around the Internet claiming you would have been better off buying $1,000 of Anheuser Busch's (BUD) flagship Budweiser in 2000 and returning the cans for deposit than buying $1,000 worth of Nortel (NT) stock. Numbers varied, but the aluminum cans going back to Alcoa (AA) would have fetched about $75, while the Nortel scrip would have been $43 birdcage liner.

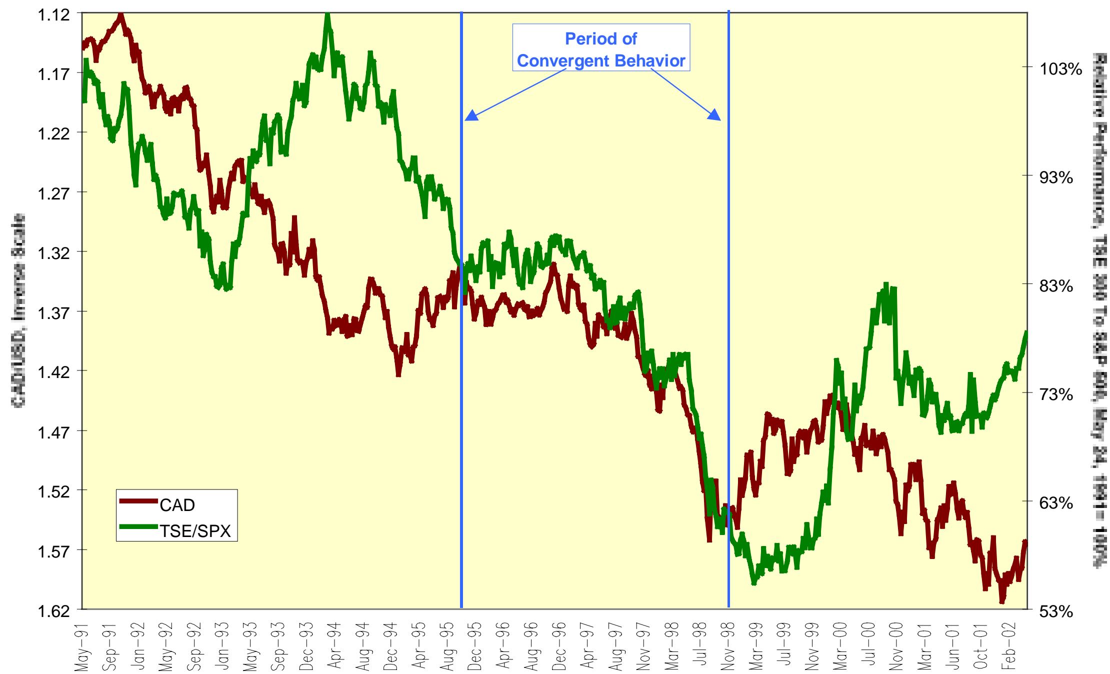
This must have been doubly insulting to our Canadian cousins, none of whom miss an opportunity to denigrate the quality of American suds. A typical joke, which will be left unanswered to preserve the dignity of this space: "Why is an American beer like making love in a rowboat?" But, as our subject this week is Canadian markets in general and their resource stocks in particular, and not any national treasures such as Molson (MOL), let's move on.

Return Of The Loony
To make matters worse, the Canadian dollar (CAD), affectionately dubbed the "loony" in honor of the dimwitted waterfowl gracing the coin's aft side, was losing ground not only to the greenback but to fellow NAFTA partner Mexico's much-feared peso. The Bank of Canada has been forced to keep rates increasingly firmer than comparable American rates in compensation, but this served only to lower the expected return on Canadian assets.

Will Rates Support The CAD This Time?

The weakness of the CAD in response to what has been higher nominal Canadian rates at the six-month horizon since early April 2001 has been as puzzling as a similar weakness in the euro (EUR). In both cases, the failure of economists' beloved interest rate parity model could be explained only by higher expected returns on U.S. assets. Now that the U.S. stock market is disappointing and demoralizing everyone and everything in sight, both the EUR and the CAD are moving higher.

Given the potential for an abrupt drop in the USD, should we expect money to flow into Canadian equities? The relationship between the CAD and the relative performance of the Toronto Stock Exchange 300 index to the S&P 500 index offers few clues by itself. There are periods of both convergent and divergent behavior. Between September 1995 and October 1998, the TSE's relative performance mimicked that of the CAD; both weakened simultaneously. But, the TSE outperformed the S&P 500 throughout 1993 with a weakening CAD.



Are Higher Rates *Good* For Stocks?

A third relationship is possible with these three indicators, and that is between the relative performance of the TSE to the S&P 500 and the rate gap between Canada and the U.S. The two major turning points in money market rates visible over this long period led changes in the relative performance of the two stock indices by roughly 18 months.

This isn't to suggest, of course, that higher interest rates per se are good for a stock index any more than it is to say that low rates are a negative for stocks, the recent experience notwithstanding. It does say, however, that a relative increase in the price of money precedes relative economic growth and hopefully corporate profits. You remember corporate profits, don't you?

Mining Profits

The Canadian economy is far more dependent on the extractive industries such as oil & gas production, mining and timber production than is the American economy, and it is hardly any secret that resource plays have been doing well of late. Given the experience of the 1970s, these sectors may be able to perform relatively well for several years before they attract a gush of new investment and inevitably fall prey to overproduction.

The top performing issue in the TSE 300 has not been a gold miner, however, but rather Co-Steel (CEI), a mini-mill steel producer able to benefit from those ill-advised tariffs slapped on by the Bush administration two months ago: They've gained 189% so far this year. Then we have a long list of gold miners: Kinross Gold, TVX Gold, Iamgold, Lionore, Echo Bay Mines and Glamis Gold.

Some of the Canadian energy firms haven't done too poorly, either. Hurricane Hydrocarbons has already logged a 101% return so far in 2002, and Niko Resource, CHC Helicopter, Baytex Energy, Meota Resources, Ultra Petroleum and Storm Energy have returned more than 40%.

These are nominal returns in CAD. Should the CAD continue to appreciate against the USD, your returns will go up apace. Several words of caution are in order, of course. First, the last Canadian mining boom attracted many unscrupulous operators to the Vancouver Stock Exchange; even the Toronto Stock Exchange suffered a black eye in 1997 with the demise of Bre-X under a cloud of geological and accounting scandal. Second, the recent miscues of the Bush administration notwithstanding, the economic policies of the Ottawa government often take McGovernite goofiness to its illogical extremes. Third, resources stocks are like airlines: They're best traded, not owned. Selling too soon is the one strategy proven over time.

But, enjoy the Canadian Renaissance while you can. Just don't imagine the Mona Lisa knocking back a Moosehead lager.