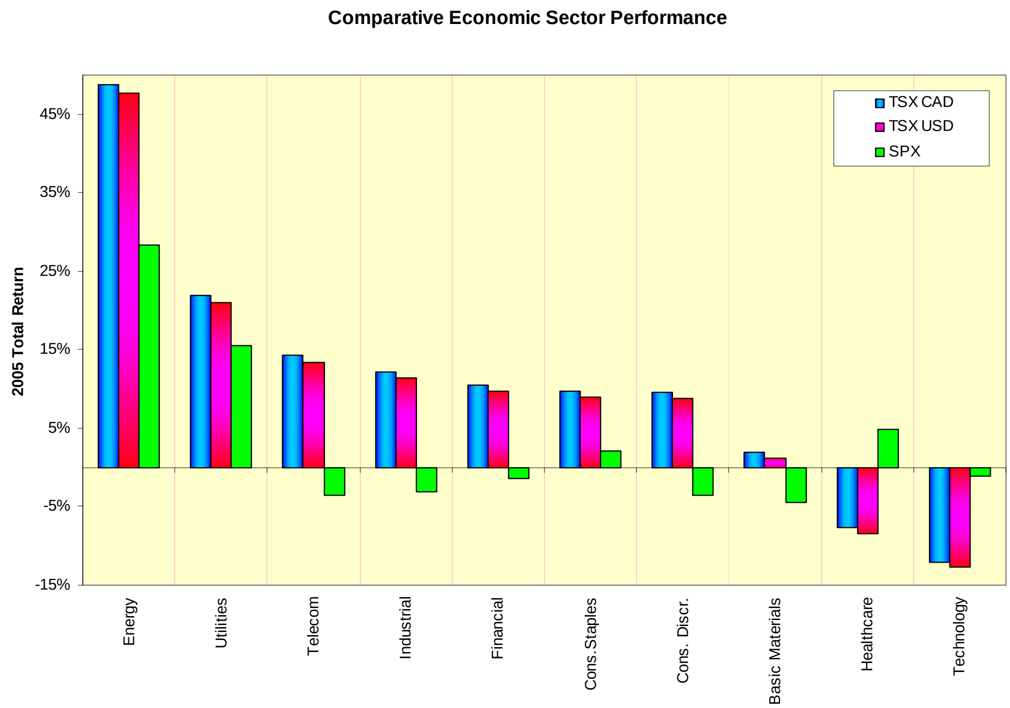
Canada Is A Country, Not A Sector

Being trapped by gravity is not necessarily a bad thing. It does keep your feet on the ground and keeps the earth locked in its orbit around the sun. But, as thousands of partners trapped in relationships can attest, sometimes it is just nice to feel you can break free.

So Canada must feel with regard to the United States. Their policies, their economy and their markets are linked inextricably to that of their larger neighbor. Americans, to the perpetual chagrin of Canadians, sort of take this for granted and assume that Canada's fate is joined to ours at the hip.

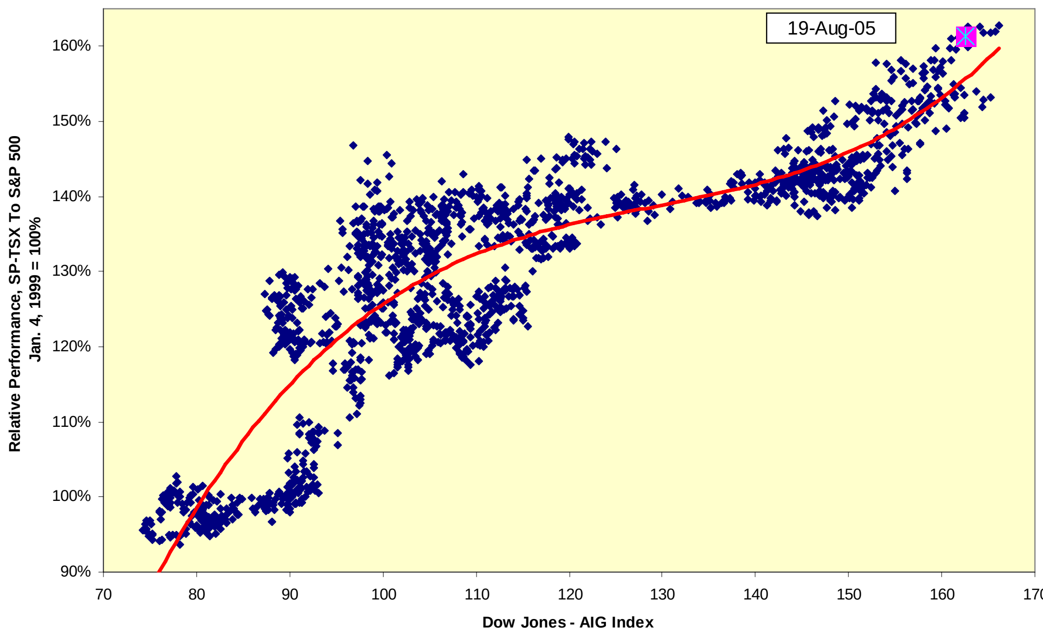
Not really, and certainly not in the case of the two countries' respective stock markets so far in 2005. The U.S. market as represented by the S&P 500 is up .64% year-to-date, while the S&P/Toronto Stock Exchange (SP-TSX) Composite index is up 13.58% in Canadian dollar (CAD) terms and 12.68% in U.S. dollar terms. But, as always, the top-down number seldom tells the entire story. How do the two indices compare to one another when broken into economic sectors?



The SP-TSX index' performance advantage clearly derives from massive outperformance in the energy sector; in U.S. dollar terms, its 48.8% gain dwarfs the strong 28.3% gain seen in the U.S. sector. Given this performance in energy, it might be easy to write the Canadian market off as some sort of one-trick pony dependent on high oil and gas prices.

The link between commodity prices and the two stock markets' relative performance cannot be dismissed. If anything, the most recent surge higher in commodity prices as measured by the Dow Jones – AIG index has led to an acceleration in the SP-TSX' relative performance.

The Commodity Link

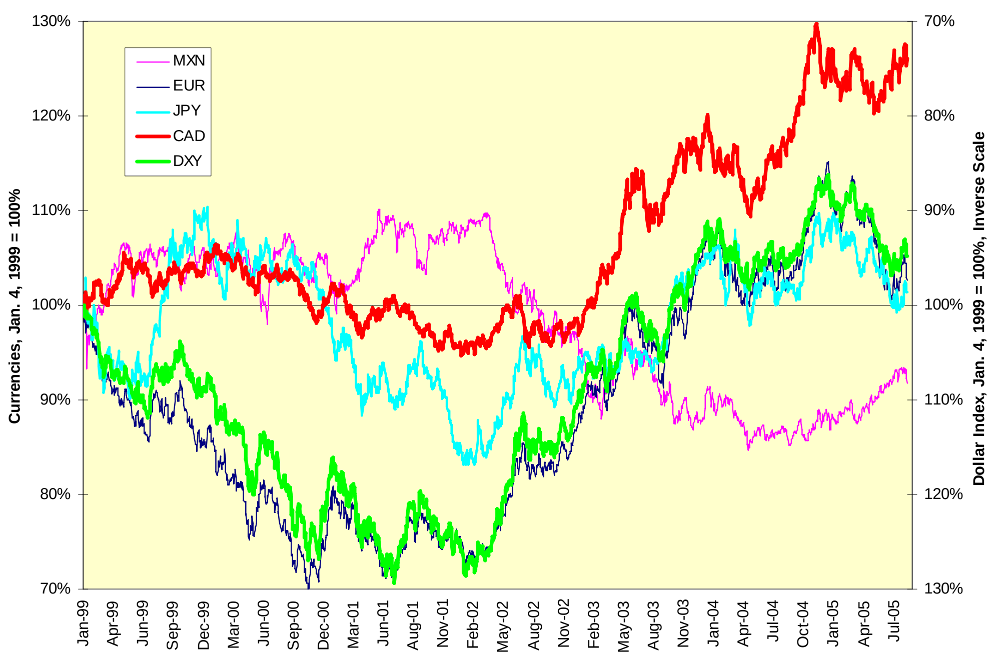


But the story is more complex than just higher commodity prices: The Canadian market outperformed its U.S. counterpart in every economic sector save Healthcare and Technology, sectors in which commodity prices play little if any role. What other factors might be at work?

The Canadian Dollar

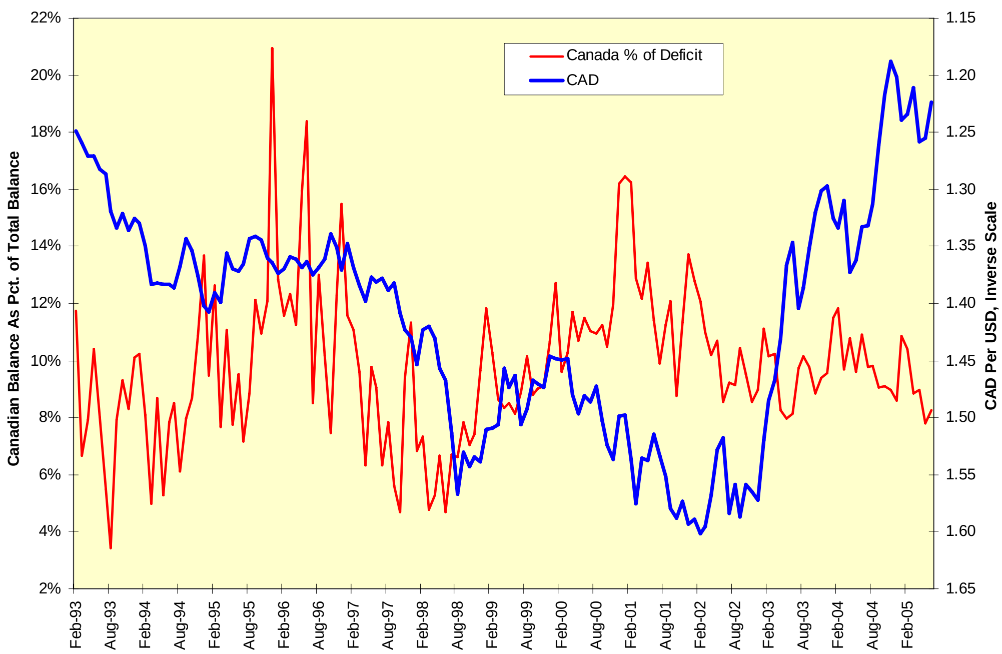
While the euro, the yen and the yuan get the attention, the CAD has put in a stellar performance since the euro's introduction in January 1999 in general and since the Federal Reserve embarked on its last and most manic phase of rate-cutting in 2003 in particular. Given Canada's role as the U.S.' largest single trading partner, accounting for 16.50% of total U.S. trade and 19.32% of total imports in 2004, the strengthening CAD represents a cost increase for the U.S.

Canadian Dollar Pulls Ahead



In yet another rebuke to those who persist in believing that a weaker U.S. dollar will somehow reduce the U.S. trade deficit, the stronger CAD has yet to dent the percentage of the U.S. trade deficit accounted for by Canada by an appreciable amount. And in the interest of being an equal opportunity afflicter, we should note that the weaker CAD of the late 1990s actually coincided with a reduced percentage of the U.S. trade deficit accounted for by Canada. As an aside, this will do nothing to stem the anti-Chinese protectionist tide rising in Washington.

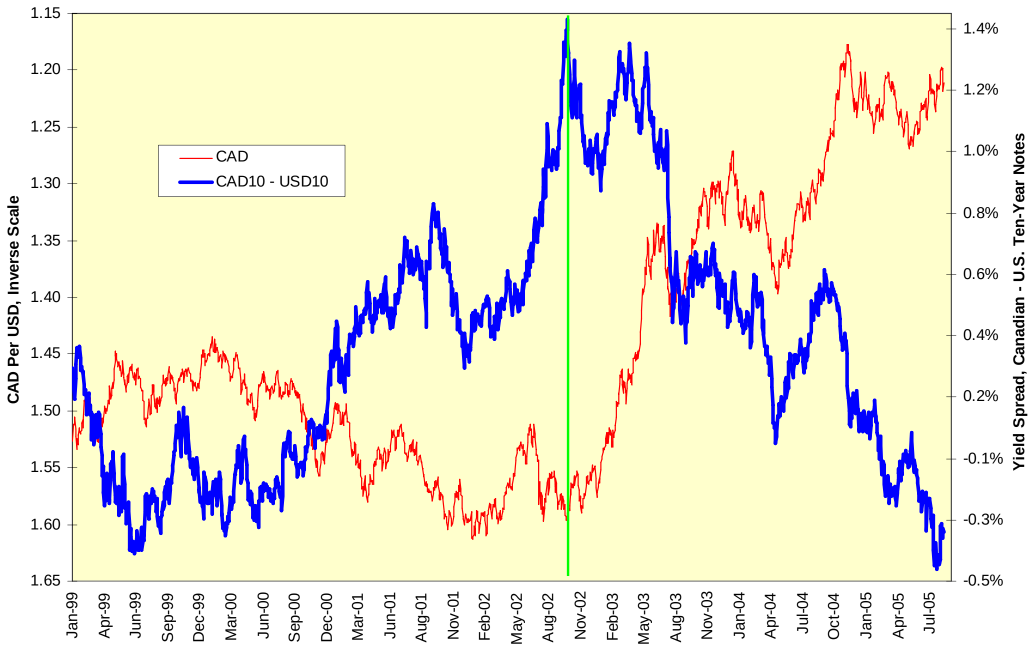
Currency Sensitivity of Canada-U.S. Trade Balance



Strength or weakness in a currency generally is a very poor predictor of how well a country's financial markets will fare. Indeed, the dollar's dive at the end of 2004 did letter to unseat either the U.S. stock or bond market. But in the case of Canada, the stronger CAD has led to a very tangible financial benefit, lower nominal ten-year note yields in comparison to the U.S.

Ever since the bear market bottom in October 2002, the CAD has advanced against the dollar while the spread between U.S. and Canadian ten-year notes has moved in Canada's favor. Despite all of the conundrum chatter on this side of the border, the U.S. government has had to pay more for its long-term debt than has Ottawa. This cannot be attributed to "measured paces" and other folderol, either: Even though the Bank of Canada has yet to raise its discount rate in 2005, the Canadian yield curve is flatter than its U.S. counterpart.

Note Gap's Currency Sensitivity



Virtuous Cycle

The Canadian markets have broken free of the U.S. for the time being and have moved in a virtuous cycle of lower interest rates, a stronger currency and a much stronger stock market. Much of this can be traced back to the effects of higher energy and natural resources prices; the cash inflows allowed the Bank of Canada to maintain a flat yield curve and keep the Consumer Price Index at a 1.7% year-over-year growth rate.

Can this keep on going forever? To ask the question is to answer it: The very same high energy prices and flat yield curves that are starting to make their presence felt in the U.S. economy will of necessity affect Canada. When your largest customer starts buying less, you know it immediately. And all of those small mining and energy companies who have been doing so well over the last two years will start to see their costs rise. It you are overweight Canada, especially Canadian energy issues, start taking some money off the table.