It's Big, It's Cold, It's Canada!

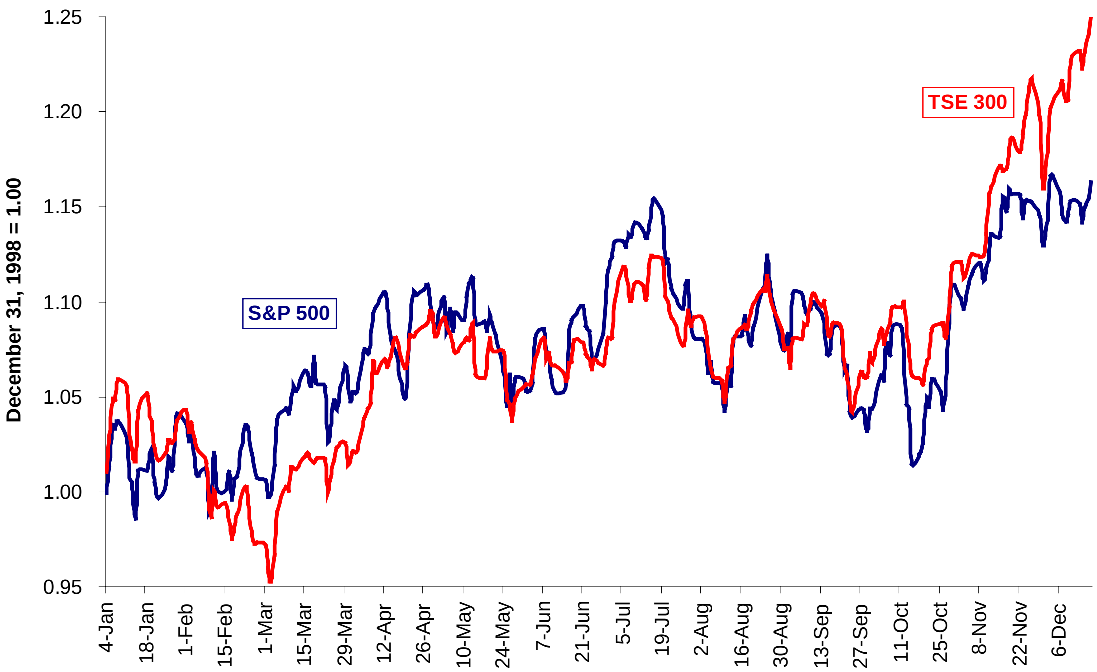
Since the most direct route for Santa Claus to reach the U.S. will take him over Canada, he might as well look down and take a look at a few investment opportunities. They're sure to beat the in-flight movie, whatever they are.

The principal Canadian equity index, the Toronto Stock Exchange 300 (TSE 300) has a very different composition than the S&P 500; the index is roughly one-third primary resource production and distribution-related.

TSE 300 Composition	
Group	**Weight**
Industrial Production	30.13%
Financial Services	14.63%
Utilities	14.36%
Oil & Gas	8.58%
Communication & Media	7.19%
Consumer Products	4.04%
Metals & Mining	3.94%
Gold & Precious Metals	3.70%
Conglomerates	2.81%
Merchandising	2.60%
Paper & Forest Products	2.33%
Transport & Environment	1.84%
Pipelines	1.83%
Real Estate	1.39%

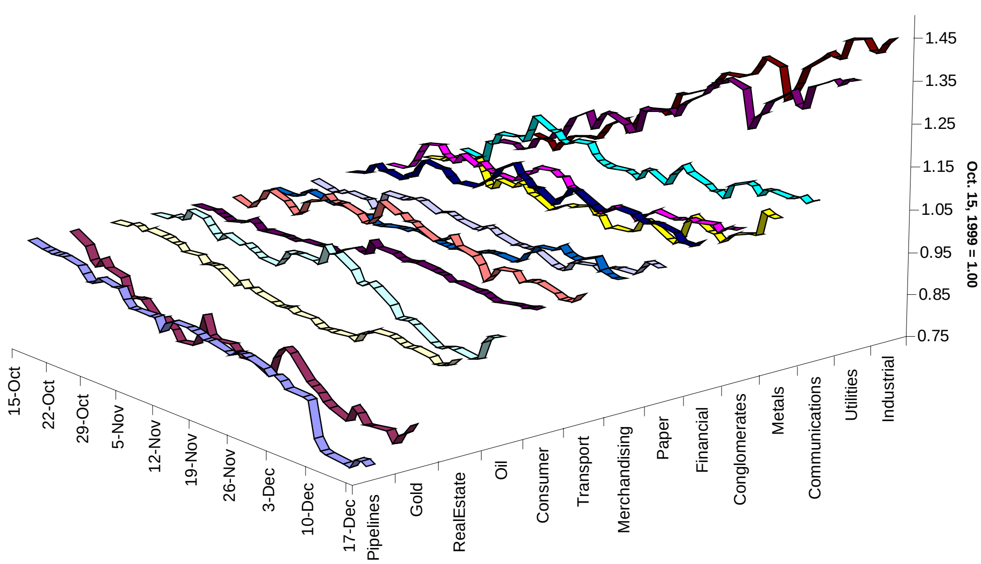
Given this "old economy" orientation -- there is no specific group designated as "computers and technology" -- it is surprising how well the TSE 300 has done relative to the S&P 500 during 1999. Even more surprising is when this outperformance occurred: During the mid-October through present period coincident with the NASDAQ's stupendous rally.

Relative 1999 Performance: TSE 300 Vs. S&P 500



The pattern becomes even more puzzling when we break out the relative performances of the fourteen groups enumerated above. Since October 15, 1999, the hottest groups on the TSE have been the Utilities and Industrial Products, two groups that have been relatively weak in the U.S. The question becomes, therefore, why have the apparently prosaic stocks of Canada contributed to the outperformance of the TSE against the S&P 500 in this period?

TSE Group Relative Performance



One part of the question is answered easily, and that is by an odd classification scheme. Nortel Networks, a leading telecommunications stock, is in the Industrial Production group, where it accounts for

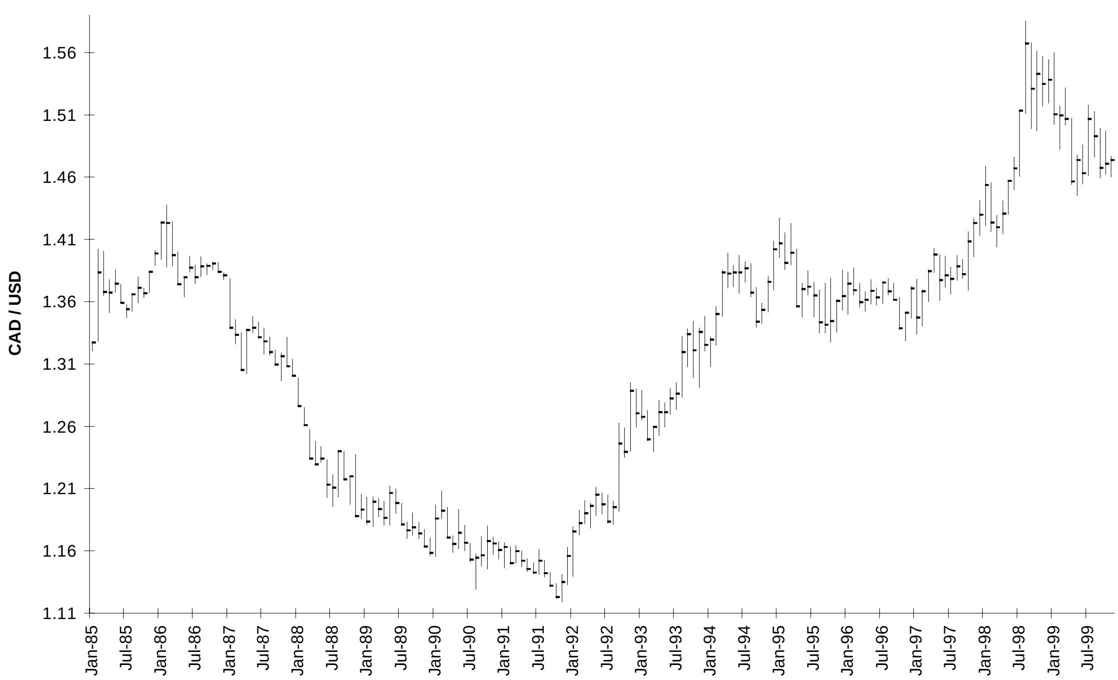
51.445% of the 25-stock sub-index' weight. The Utilities sub-index is dominated even more by BCE, Inc., a mobile telecommunications services firm; this single stock accounts for 73.058% of the 21-stock sub-index' weight. The two stocks together account for 25.909% of the TSE 300's market capitalization; the two largest stocks in the S&P 500, Microsoft and General Electric, account for only 9.116% of market capitalization by way of comparison.

A second part of the question is answered by the Canadian dollar (CAD) exchange rate. The CAD weakened steadily between December 1991, the time of the Fed's most aggressive rate cutting, and August 1998, just prior to the first of three U.S. rate cuts in the midst of the global financial crisis. The CAD/USD exchange rate moved from 1.135 to 1.567 in that period, a 38% drop in value. While this may have pleased Canadian exporters, especially oil exporters whose products were priced in USD, it imposed a terrible penalty on foreign investors exposed to a continuously declining currency.

Moreover, the Canadian economic cycle was lagging the U.S. This is not surprising given the weakness in global commodity prices; nearly 35% of Canada's export revenue is resource-linked. The Bank of Canada was trying to avoid matching American rate increases, and that maintained pressure on the CAD as returns on Canadian paper remained below those of the U.S. During July 1999, yields on 3-month Canadian dollar deposits in the eurodollar market were yielding 175 basis points over 3-month eurodollars; this gap has since closed to a still-high 106 basis points.

Once U.S. rates started to move higher in mid-October 1998, the CAD stabilized and began to firm. Periods of rising U.S. interest rates, such as 1987-1991, coincide produce periods of CAD strength; the Bank of Canada is forced to maintain higher interest rates than it desires in order to stem capital outflow and inflationary pressures.

Canadian Dollar Exchange Rate



The present confluence of trends -- stronger global economy, a revival of metals and energy prices, and higher interest rates -- suggest a forthcoming period of outperformance by Canadian financial assets, especially for U.S. investors, with much of the gain deriving simply from CAD appreciation.

Given the weight of Nortel and BCE in the TSE 300, we need to apply the Dirty Harry test of investing: How lucky do we feel? A downturn in tech stocks in the U.S. will have a disproportionate impact on the TSE 300. We can counter this risk either by avoiding the two high-tech highfliers and concentrating our investments in Canadian value stocks or by simply exposing ourselves to Canada via Canadian dollar futures.