Canada's Resource Trap Closing

"I know what you're thinking. 'Did he fire six shots or only five?' Well, to tell you the truth, in all this excitement I kind of lost track myself." -- Clint Eastwood as Inspector Harry Callahan

With all of the excitement, a euphemism if there ever was one, going on in world markets over the past six weeks, I sort of lost track myself. I have an honored spot on my quote screen for the S&P/Toronto Stock Exchange index, but being a typical American and being conditioned to several years of strong Canadian performance, I just lost track.

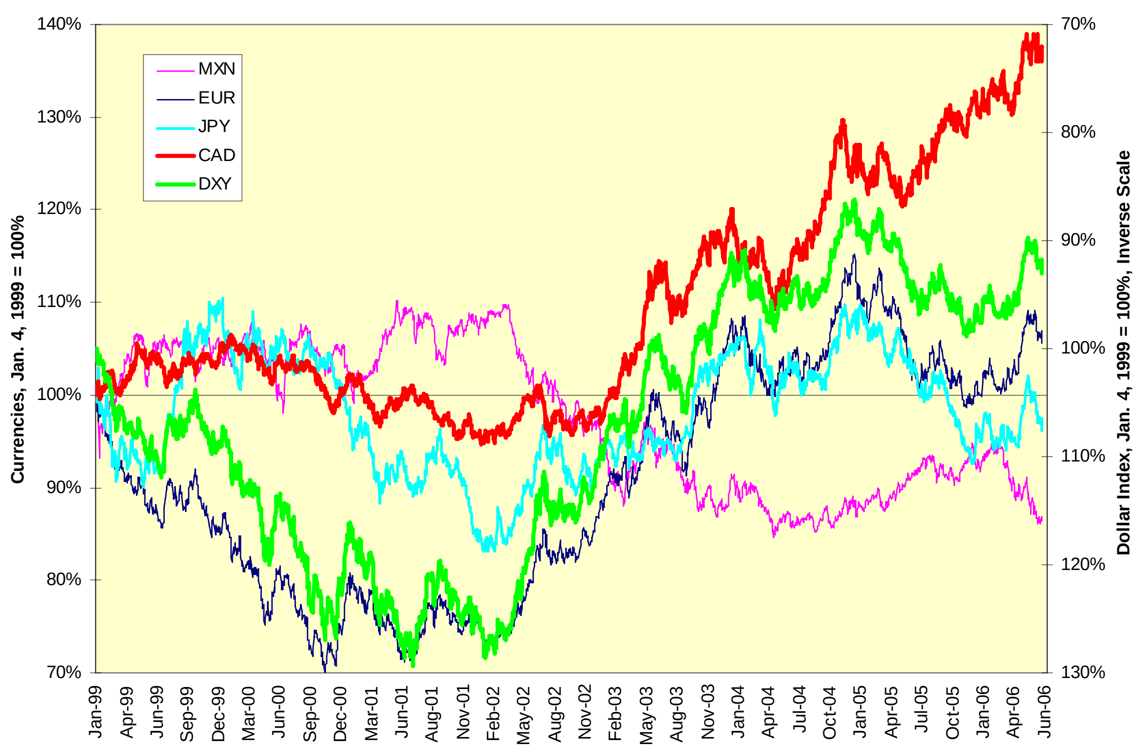
I should not have done so. The index has lost 7.25% since May 11 in Canadian dollar (CAD) terms - 9.17% in U.S. dollar (USD) terms - compared to a loss of 4.49% for the S&P 500 in U.S. dollar terms. To what can we attribute this sudden relative weakness? Let's update a series of analyses from last August in response. They point to Canadian markets stretched by strong and prolonged moves in the CAD and in commodities markets.

The Canadian Dollar

International diversification, which I recommend for the sheer thrill of losing money around the clock in all sorts of different countries for reasons you cannot articulate, inevitably involves currency risk. Sometimes U.S. investors see the USD weaken and the nominal value of their foreign investments increase. Sometimes, as in 2005, the USD strengthens and the strong local currency gains you thought you were getting evaporate.

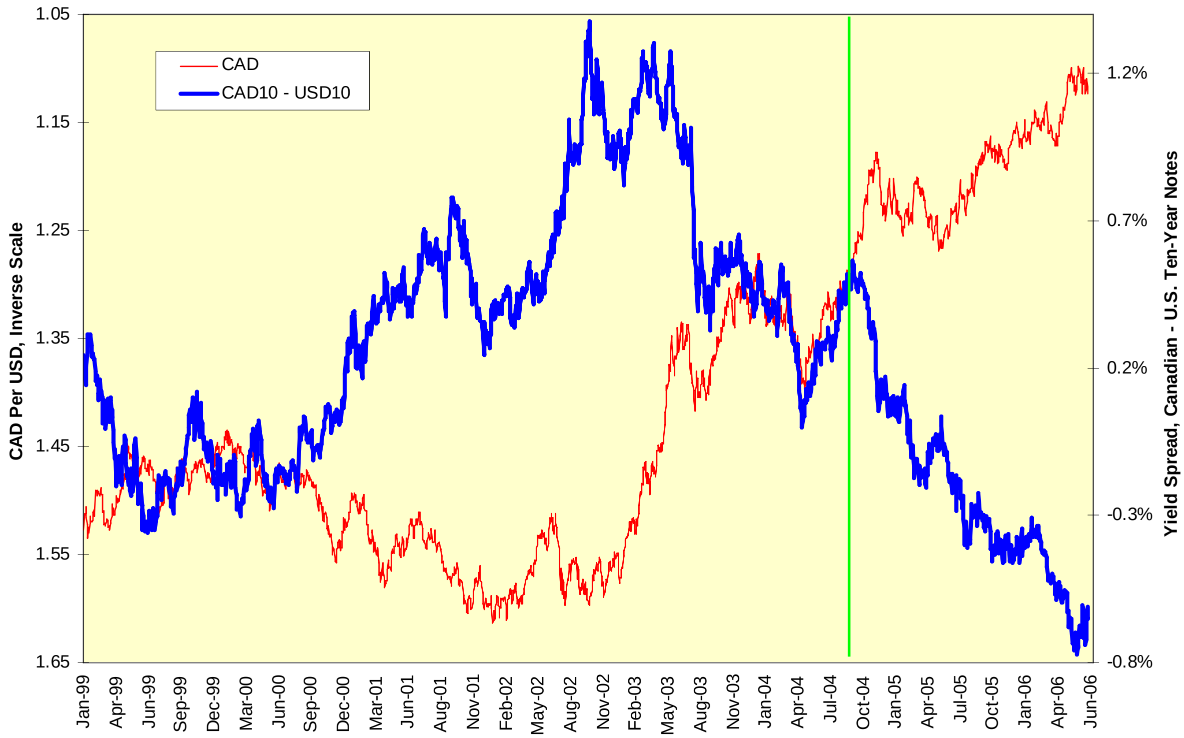
U.S. investors in Canadian equities have benefited from a strong CAD for more than three years now. In fact, the CAD has gained far more against the dollar than has the euro or yen since the January 1999 advent of the euro. Both the USD and CAD have gained strongly against the third member of NAFTA's, currency, the Mexican peso (MXN) over this period.

Canadian Dollar Pulls Ahead



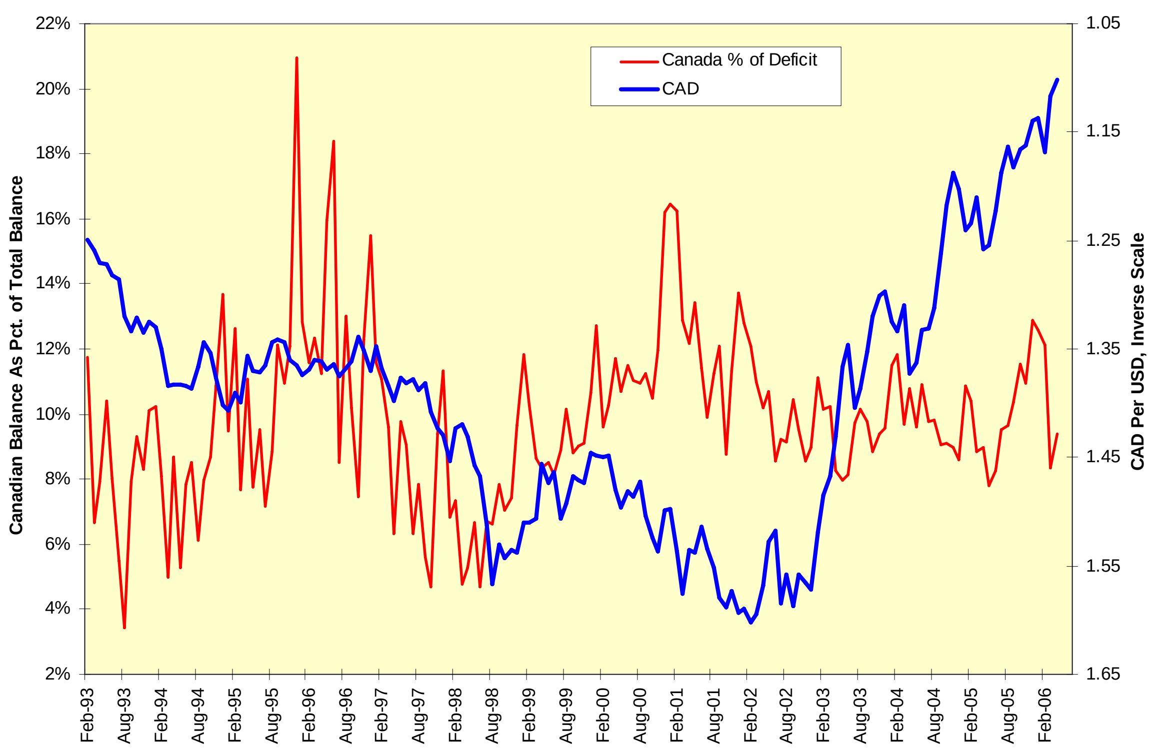
The strong CAD has been something of a double-edged sword for Canada. It has kept Canadian ten-year note yields below those of the U.S. in almost inverse fashion since the Federal Reserve's rate-raising intentions became apparent in late 2004. The ten-year Canadian government bond yields 60 basis points less than does its American counterpart, and all else held equal this should be considered a positive for the country's economy.

Note Gap's Currency Sensitivity



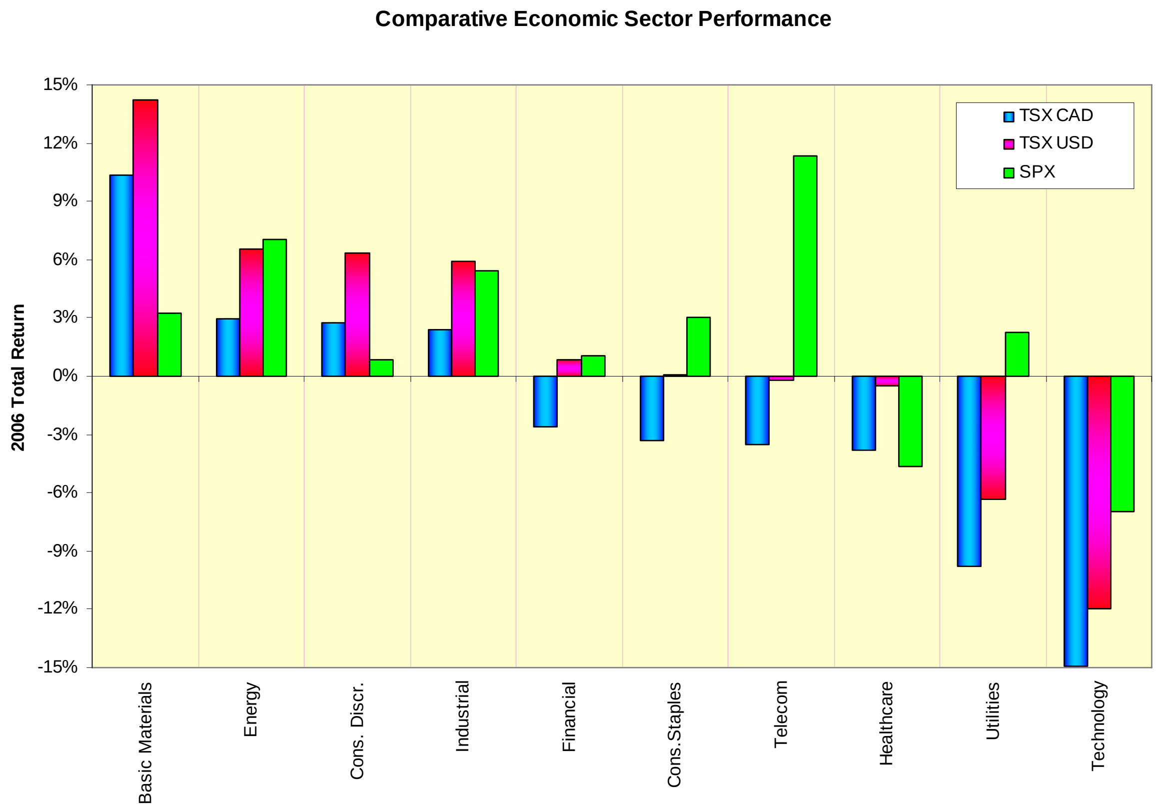
But we live in a world of competitive devaluations. Much of the U.S.-Canada bilateral trade not priced in USD, which rules out petroleum and many other commodities, is intra-company trade. Many U.S. manufacturers, particularly in the automobile industry, have Canadian subsidiaries whose cost competitiveness declines as the CAD strengthens. The stronger CAD has suppressed Canada's share of the U.S. trade balance.

Currency Sensitivity of Canada-U.S. Trade Balance



Stocks And Commodities

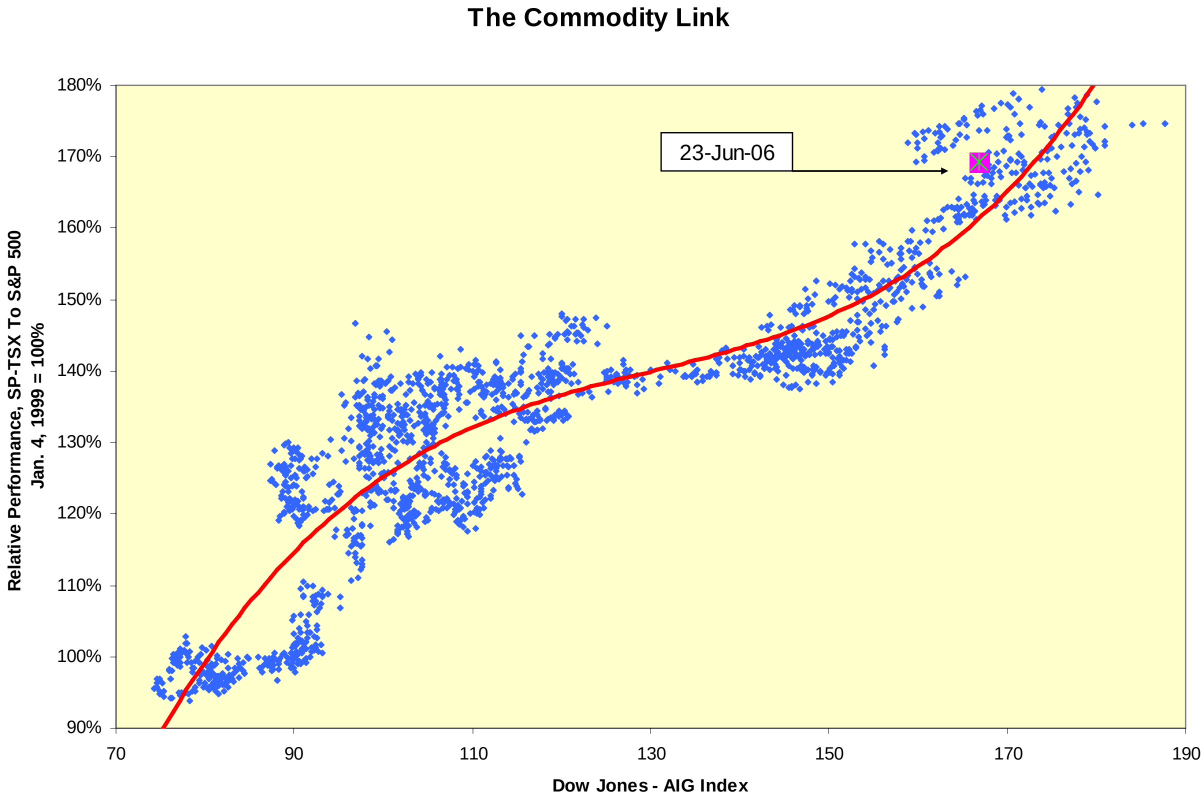
We noted last year how the Canadian stock market outperformed the U.S. market in all economic sectors save for Healthcare and Technology, two sectors where commodity prices play little or no role. The sector-by-sector performance comparison is vastly different so far in 2006. The U.S. market has outperformed in energy, financials, consumer staples, telecommunications, utilities and technology. The Canadian market has outperformed in basic materials, consumer discretionary, industrials and healthcare. And in all cases, the strong CAD has boosted returns to U.S. investors.



The split performance map suggests a change in underlying economic processes. Even though Canada's energy sector is vibrant - the oil sands projects in Alberta are quite profitable at current prices - the American sector is outperforming. This is a common curse for resource-dependent stocks: A prolonged period of high prices leads to both increased production costs and to high-cost/diminishing return investments.

The two basic materials sectors have been doing much better in 2006 than they did in 2005. We can attribute this to the unexpected and rather gaudy rally in base metals prices, a topic last covered here in May. But even if base metals, agricultural and forest products prices stay high for a long time, it will not mean the stocks will perform well on a relative basis. Costs will rise, as noted above.

The recent pullback in physical commodity prices as measured by the Dow Jones-AIG index has had an immediate and near-linear effect of the relative performance of the Canadian stock market. Further small pullbacks in the DJ-AIG index will have a muted effect as firms will get to close some of their higher-cost facilities; a large and significant pullback in commodity prices will have significant negative consequences for Canada's relative performance.



Movie fans know the rest of Harry Callahan's entreaty to the quivering miscreant on the pavement by heart: "But being as this is a .44 Magnum, the most powerful handgun in the world, and would blow your head clean off, you've got to ask yourself a question: Do I feel lucky? Well, do ya, punk?"

An American investor in Canadian equities - and yes, there is an ETF, the iShares MSCI Canada index fund - has to ask the same question. Any downturn in global growth will affect basic materials and commodities negatively and will weaken the CAD. In a world populated by hawkish central banks, how lucky do you feel?