Canada And The Costs Of Sobriety

Higher Interest Rates Have Led To Underperformance

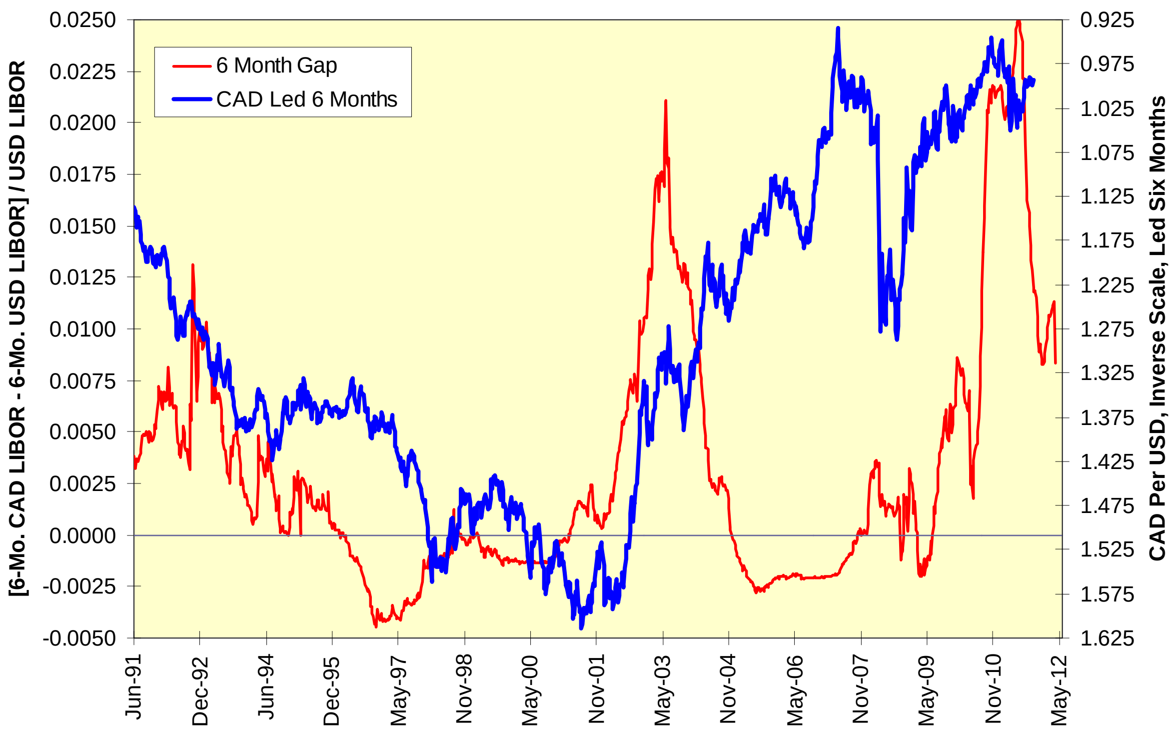
Has the chaperone ever been the hero in popular culture? No, and if yesterday's discussion of the relatively strong prospects by default for the U.S. dollar could focus on the self-trashing by Japan and Switzerland and the foibles of the Eurozone, Canada has to be excluded from consideration. The consequences for U.S. investors in Canadian equities are negative as evidenced by the 4.3% return year-to-date for the iShares MSCI Canada fund (EWC) as compared to a 12.1% gain for the Russell 3000 (IWV).

Higher Interest Rates Matter

Canada prides itself, rightfully, on dodging the brunt of the 2008-2009 financial crisis because it never went as overboard on a residential real estate bubble as did the U.S. and others. As an aside, Ben Bernanke does not think the U.S. residential real estate bubble was a consequence of a deliberate attempt by his predecessor to create a residential real estate bubble and to celebrate homeowners "extraction" of equity from their houses. Any institution wishing to study the principle of infallibility should pay a visit to Constitution Avenue.

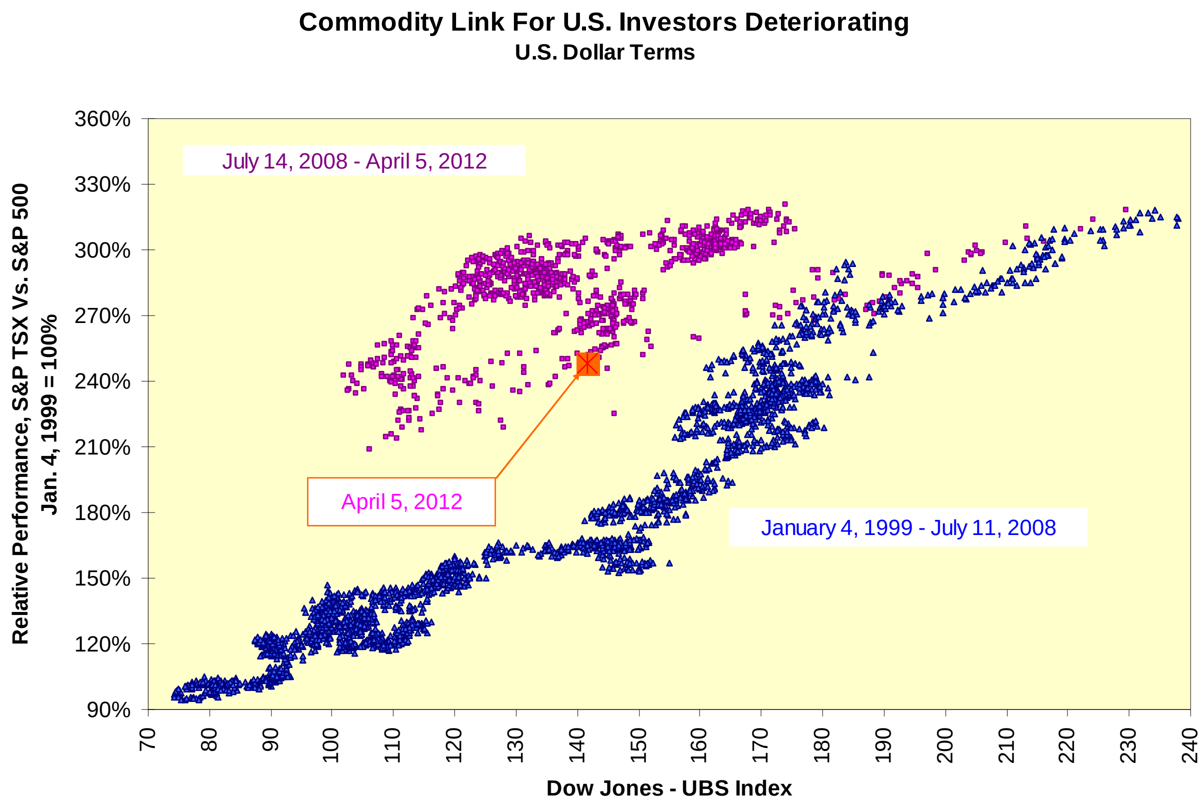
Canadian short-term interest rates have been higher than their U.S. counterparts since QE1, often stunningly so. There are many ways to illustrate this spread; let's use the rate gap between six-month CAD and USD LIBOR divided by six-month USD LIBOR. This rate gap between two economies with so many trade and financial links has keep the CAD bid over the period and has led to downward pressures on the Canadian share of U.S. external trade.

Six-Month Rate Differential And The Exchange Rate



Weakening Commodity Connection

The CAD and the relative performance of the Canadian stock market had been driven by the price of physical commodities for most of the past decade; it was in fact correct to call the Canadian dollar a "commodity currency." That relationship is deteriorating; not only is the CAD becoming much more of a straight interest rate arbitrage play, but the relative performance of the Canadian market has been declining as a function of the Dow Jones-UBS index. As I note in the chart below, what had been a linear relationship between the two markets prior to the July 2008 commodity peak has turned into something far less deterministic.



If we go back to the October 2011 global market low, the Basic Materials Select SPDR (XLB) has outperformed the Canadian resource sector rather handily. Of course, the area of greatest U.S. outperformance has been in the technology sector thanks to the struggles of Research In Motion (RIMM).

As long as Canada keeps its short-term interest rates normal in an abnormal world, its financial markets will suffer from the chaperone complex: Everyone else is having a better time or at least pretends they are.