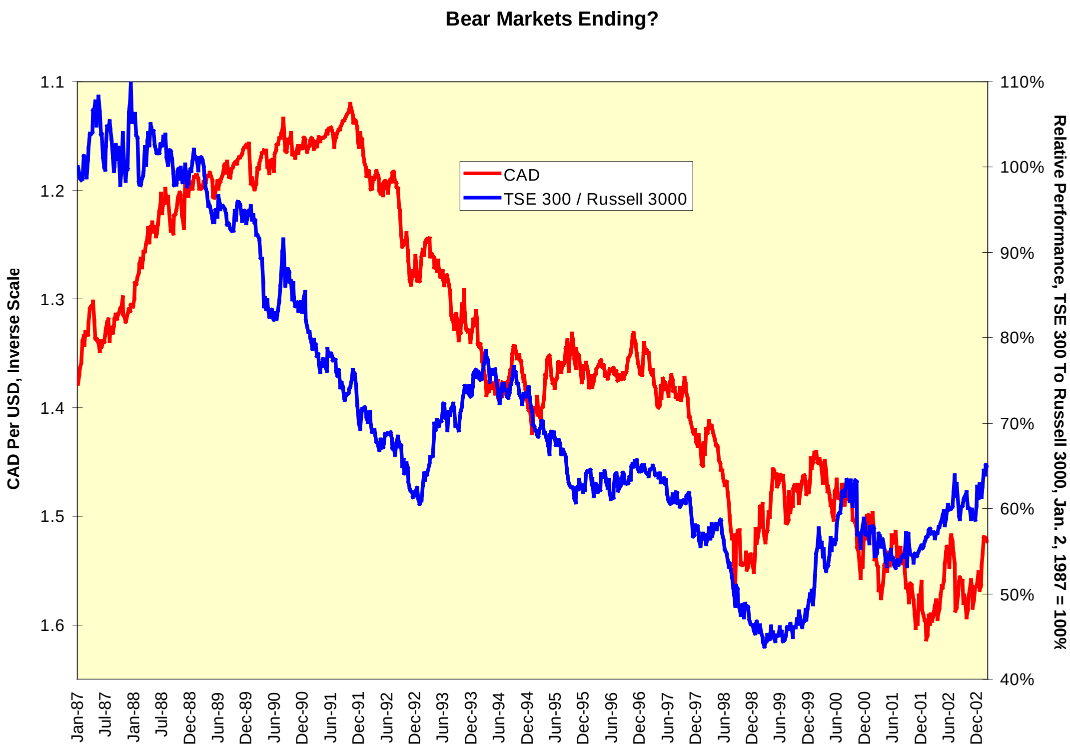
Northern Lights Shine On Canada

Standard & Poor's has run some print ads asking how many stocks are in the S&P 400 MidCap index. Kind of a cute little attention-getter, no? Not so fast: How many stocks are in the Toronto Stock Exchange 300 index? The answer - seriously - is 228. If there is better evidence for a market massacre than that, I don't want to see it.

Of course, back in the days when the TSE 300 actually had 300 members, wags referred to it as the TSE 1 due to the outsized weight of Nortel Networks: In October 1999, Nortel and its former parent BCE (Bell Canada Enterprises) combined for 25.9% of the index' capitalization. The two now account for just 6.55%, which certainly is achieving diversification the hard way.

Well, the darkest hour is just before dawn, especially in a place where the sun barely shines for a good deal of the year (Canadians are grateful for their winter; it suppresses the intercontinental ballistic mosquitoes plaguing their brief summers). One of the best-kept secrets in the world of investing is how well Canadian stocks and recently the Canadian dollar (CAD) have been doing relative to their American counterparts. The reasons lie in the commodity and currency markets.



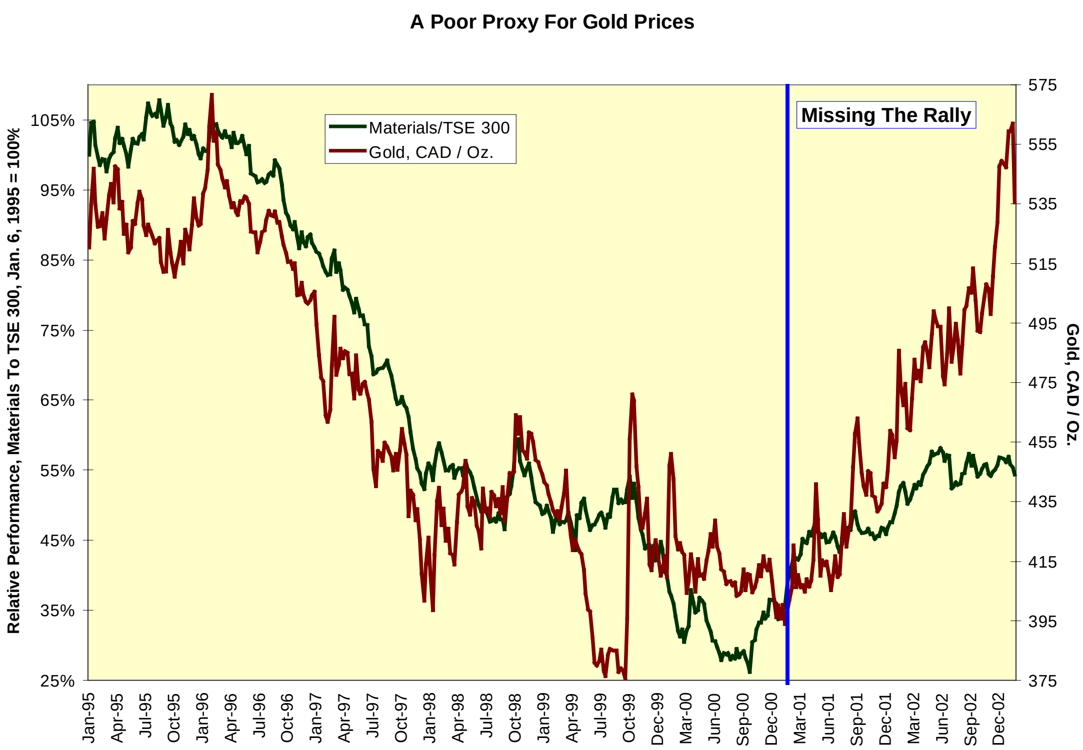
The CAD had been in a steady decline against the greenback from the end of 1991 to early 2002. The decline represented a particularly pernicious tax on Canadian consumers; each country is the other's largest trading partner. The weakening CAD, or "loony" as it is known affectionately for the waterfowl gracing one side, (Question: Did we ever call a buffalo nickel a "Buffy?" Didn't think so) raises the price of American imports for Canadian consumers. Canadian interest rates had to remain higher than their American counterparts over much of this period, and that in turn slowed the growth of the Canadian economy and undermined its stock market.

Barely Resourceful

It would be easy to ascribe the relative fortunes of the TSE 300 to strength in gold mining and to some extent petroleum-related stocks, and there is some truth to that. Since the March 2000 peak, the 29-member energy sub-index has advanced 69.7% in U.S. dollar terms, and the 46-member materials (read "mining") sub-index has gained a total of 13.9% for American investors; together these two sub-indices together account for 30.8% of the TSE 300.

The largest sub-index, at 32.25%, is the 26-member financial sub-index. This group has gained by 43.1% in U.S. dollar terms.

That Canadian financials outperformed the mining stocks in the midst of a recession and the first gold rally in two decades is something of a surprise at first. However, the top three firms by weight in the materials index are aluminum producer Alcan, Barrick Gold and nickel miner Inco; the newsprint giant Abitibi-Consolidated is number 5, followed by the fertilizer firm Potash Corporation. Barrick has been in the news of late for foolishly hedging its gold production, thereby eliminating the only reason ever to own a gold producer. This stunt cost CEO Randall Oliphant his job. The only other gold producer in the top six actually exposed to gold prices, with a 6% weight, is Placer Dome. In other words, the Canadian materials index is a poor proxy for gold prices.



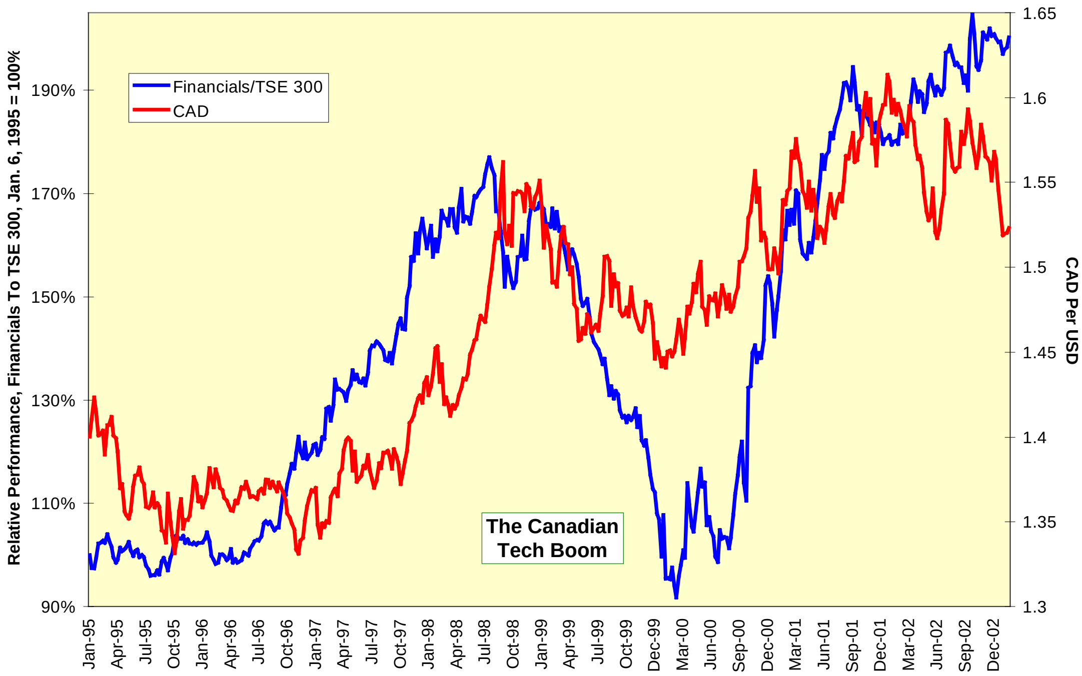
More Bank For The Buck

Canadian banks, on the other hand, enjoy an unusual advantage. NAFTA aside, they are virtually immune to global competition. No Canadian bank is a player in global markets, and no global giants are serving the Canadian domestic market. Go to any Canadian city of any significance and you will see the office buildings of the same five banks: Royal Bank of Canada, Bank of Nova Scotia, Toronto-Dominion, Bank of Montreal and Canadian Imperial Bank of Commerce. There was some speculation in 2000 that Prime Minister Jean Chretien was going to permit some consolidation in the Canadian banking industry, but that predictably went nowhere.

The relative performance of Canadian banks is linked to that of the CAD. Canadian monetary policy perforce is tied to that of the United States (that must be fun). However, when the Bank of Canada does diverge from the Federal Reserve, Canadian banks can benefit. They had a lower cost of funds during the 1997- 1999 period and today are less affected by the Fed's yield curve compression that has reduced lending margins in the U.S. The Canadian swap curve today is below the American swap curve at the short end and above it at the long end, in both cases by about 12 basis points, and this is an advantage for Canadian banks.

The only exception to this bank-CAD link came during the Canadian tech stock boom when Nortel and JDS Uniphase made everything else in the TSE 300 a relative underperformer.

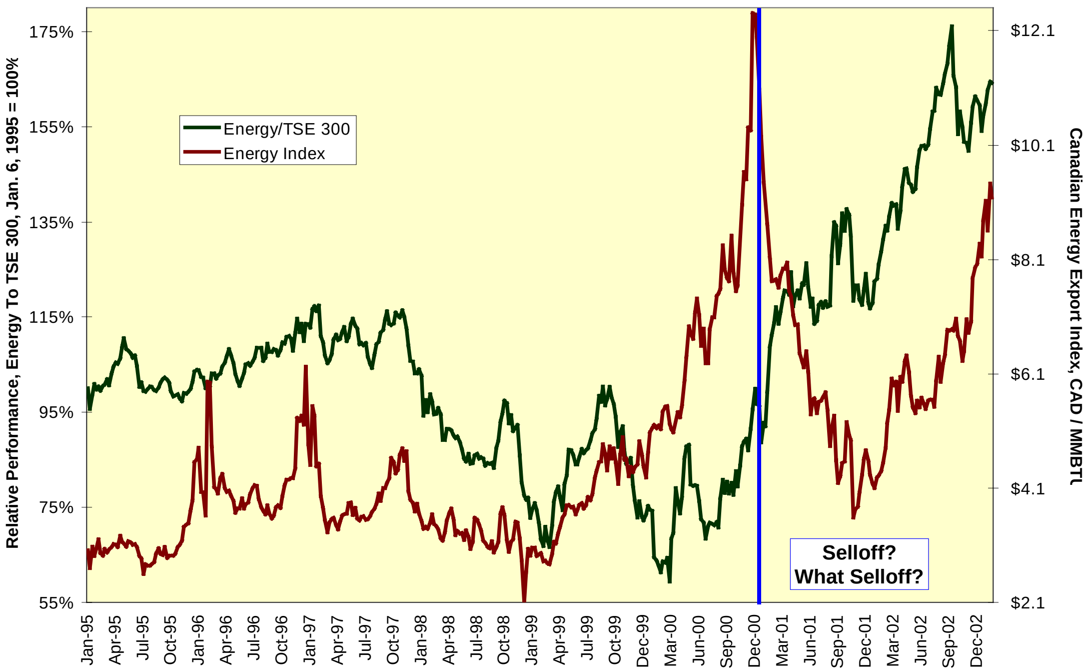
Canadian Banks' Currency Link



Energy To Burn

Markets are supposed to be discounting mechanisms, cool and collected, and not given to hysterical outbursts of panic at every errant economic datum. Nice theory, isn't it? The energy sub-index, however, has done a nice job of remaining focused on the long-term bull market in energy. Once it started to outperform the broad TSE in the spring of 2000, it kept on chugging higher regardless of a sharp downturn in energy prices in 2001. The energy price index represents a blend of 62% natural gas prices and 38% crude oil prices, the relative mix of Canadian energy exports to the U.S., converted to CAD per million BTU. Right now, the outlook for these stocks continues to be strong.

Canadian Energy Stocks Kept On Going



The whole concept of international economics as pioneered by David Ricardo in the 18th century is based on competitive advantage. Canada is doing a good job of maximizing its natural advantages of a strong resource base and the ability to protect its banking sector. American investors can join the party by buying into these industries. If we do it enough, we might even be able to find another 72 stocks to round out the TSE 300 once again.