What's Up With Canada?

A consequence of sitting in front of quote screens every day for a couple of decades is a tendency toward hallucination. Nothing serious, mind you, and nothing that cannot be resolved by getting up out of the chair and imitating Fred Astaire's dance across the ceiling in *Royal Wedding*, but hallucinations nevertheless.

Sometimes the visions have to be investigated to see whether they are real. The Standard & Poor's/Toronto Stock Exchange (SPTSX) index, much like our own indices, has been highly volatile of late. Its high-low-close volatility (a measure which incorporates intraday range along with interday change) of 17.16% exceeded the SPX' of 14.94% at the last reading. And on August 9, 2007, the same day when the European Central Bank stepped in to provide liquidity following BNP's suspension of redemptions from various subprime-tainted funds, the Bank of Canada stepped up to the plate with this press release:

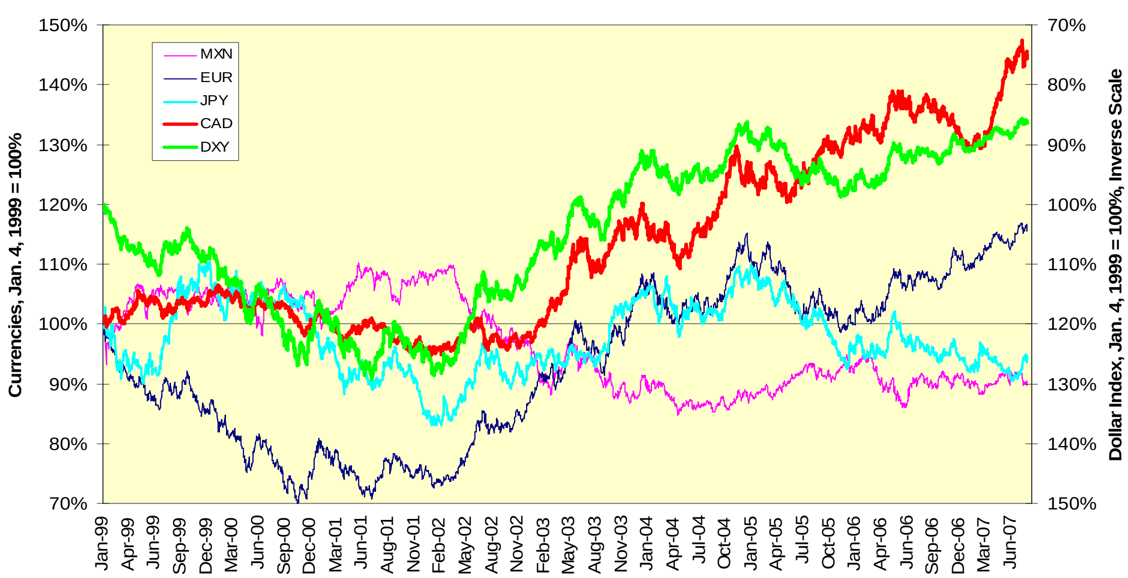
> *In light of current market conditions, the Bank of Canada would like to assure financial market participants and the public that it will provide liquidity to support the stability of the Canadian financial system and the continued functioning of financial markets.*
>
> *These activities are part of the Bank's normal operational duties relating to the stability and efficient function of Canada's financial system. The Bank is closely monitoring developments, and will deal with issues as they arise.*

Every central bank in the world should have one of these sitting in their computers and ready to go; our own Federal Reserve followed suit on Friday. In times of crisis moral suasion counts more than any particular rate.

Oh, Canada. Oh, Oh, Oh

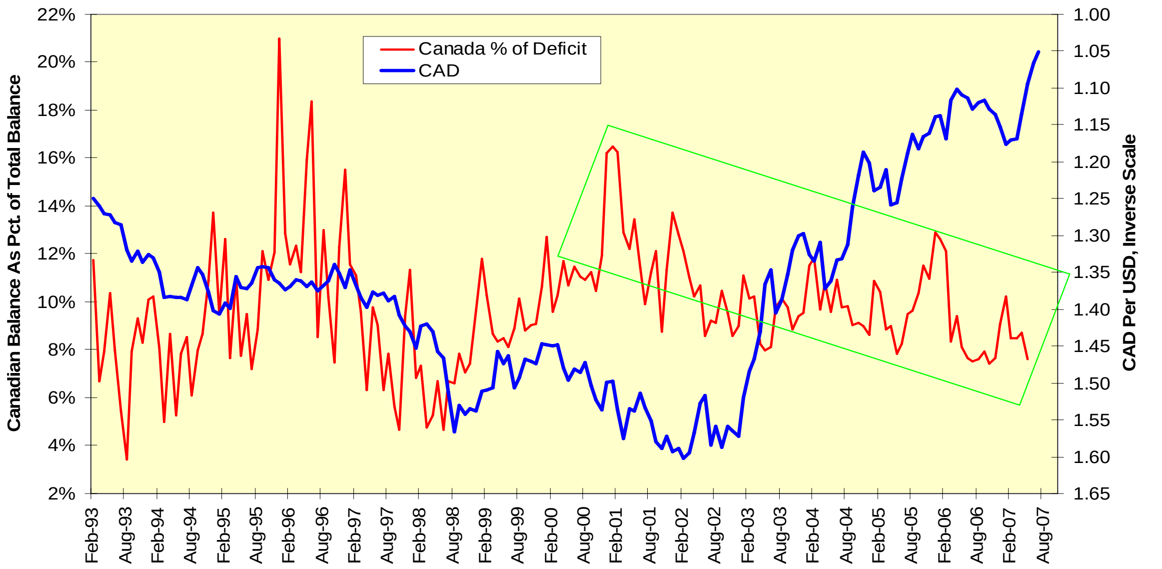
With this in mind, let's update an assessment of Canadian markets made in June 2006. And with good reason: A lot has happened north of the border over the past year. First and foremost, the Canadian dollar (CAD) has continued to put a great deal of distance between itself and more widely quoted currencies such as the euro and Japanese yen since the January 1999 advent of the euro.

Canadian Dollar Strength Continues



This is highly significant given that U.S.-Canada bilateral trade is the largest in the world. Even though we generally can reject the protectionist argument that a weaker currency leads to a correction of a trade deficit and vice versa, we should note how Canada's share of the U.S. current account deficit has declined for the past six years, as highlighted with the green rectangle.

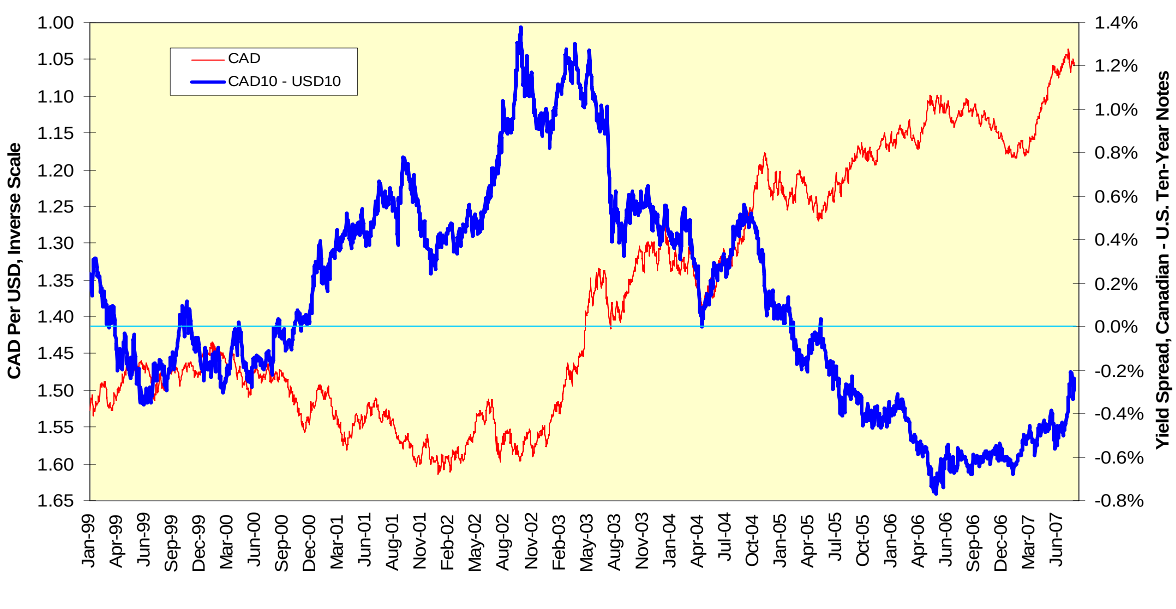
Currency Sensitivity of Canada-U.S. Trade Balance



Interest Rate Differentials

One by-product of the CAD's strength noted here last June was a negative gap between Canadian and U.S. ten-year note yields. This gap had been turning in Canada's favor since the summer of 2002, and accelerated with the strength of the CAD into mid-2006. Once the Federal Reserve stopped its rate-hike cycle in mid-2006, the yield on Canadian bonds started to rise faster than did the yield on American bonds. This disappearing rate gap and the fiscal drag of a stronger CAD placed a relative drag on Canadian stocks relative to American stocks.

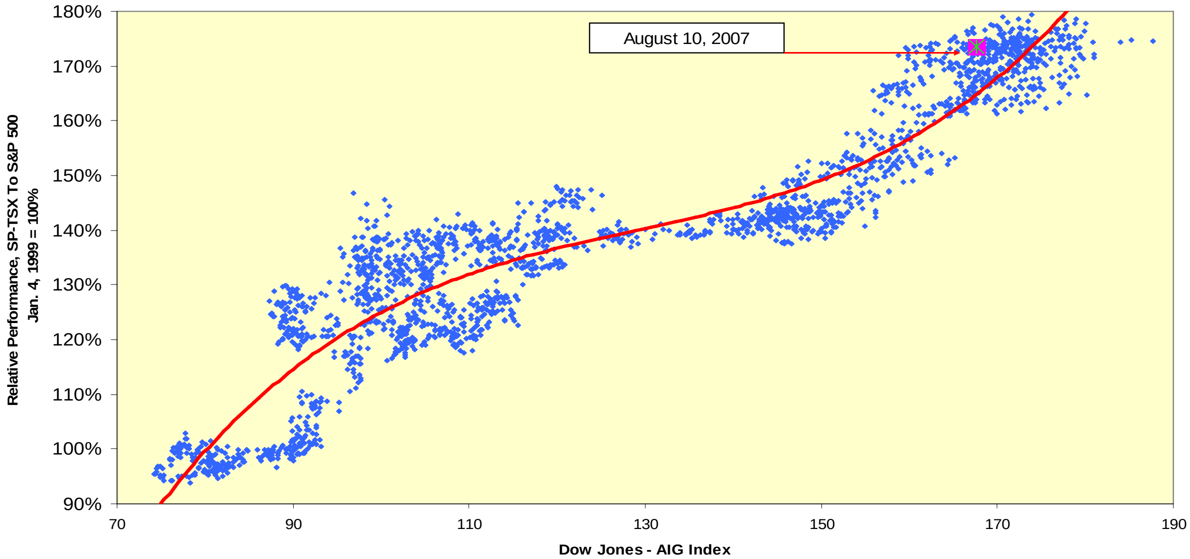
Note Gap's Currency Sensitivity



The Commodity Connection

We can add a slowdown in the commodity boom, the impetus behind last June's piece, to the list of concerns for Canadian equities. The relative performance of Canadian to American stocks is linked to commodity prices in a curvilinear manner. As commodity prices cannot rise ad infinitum, any relative gain of Canadian to American stocks should be driven by factors outside of the energy and basic materials sectors.

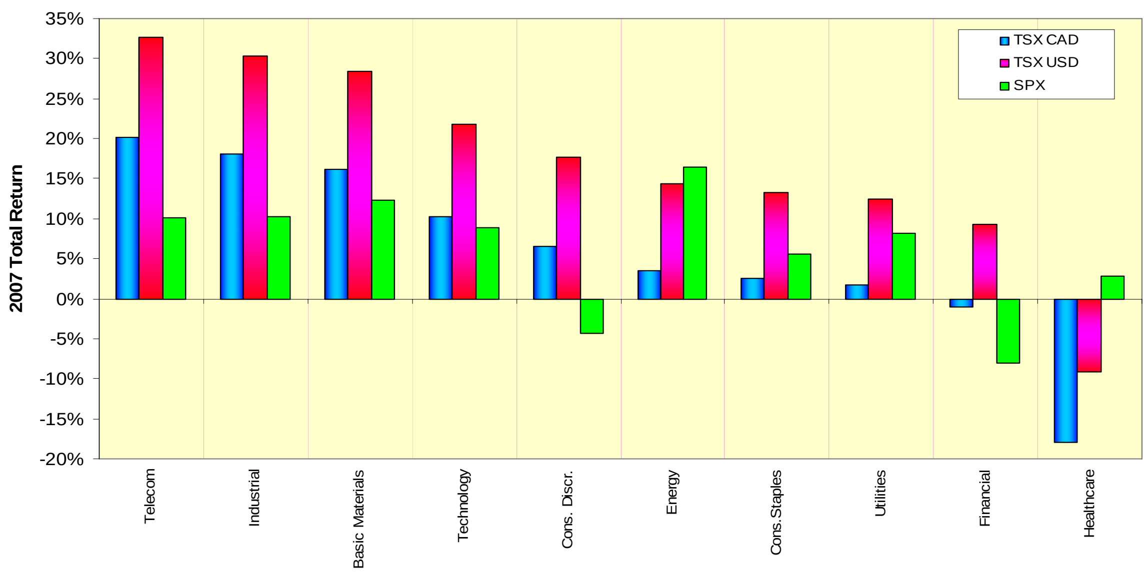
The Commodity Link



Relative Sector Performance

What has the comparative performance across economic sectors been in 2007? In U.S. dollar terms, the Canadian market has outperformed its American counterpart in every sector save Energy and Healthcare. In local currency terms, the U.S. outperformed its Canadian counterpart in Energy, Consumer Staples, Utilities and Healthcare.

Comparative Economic Sector Performance



As far as commodity dependence goes, the comparative picture is a mixed bag. The leading performers in Canada have been Sino-Forest, Thompson Creek Minerals, Equinox Minerals, Eastern Platinum, Petrobank Energy, Major Drilling and Alcan. Those have a pretty heavy Basic Materials flavor, do they not?

The underperformers in Canada include commodity-linked equities such as Fairborne Energy, Paramount Energy, Gammon Gold, Centerra Gold and Real Resources. Those have a pretty heavy commodity flavor, do they not? Apparently you cannot just buy any old commodity-linked firm in Canada anymore; you have to do some homework first.

Finally, prominent amongst the losers is Nortel Networks…even though the Telecommunications sector in Canada has been strong. There was a time in the late 1990s when the then-Toronto Stock Exchange 300 was called the TSE-1, with Nortel being that one. How the mighty have fallen.