REVIEW & COMMENTARY
3RD QUARTER 2007

Northern Exposure

If you were an international investor, over the last quarter, particularly the last 5 to 6 weeks, you would have looked at Canada as a bit of an investing sweet spot. Oil prices hit new highs, the Loonie appreciated significantly and the credit crunch was relatively minor in comparison to other G8 countries. But to us Canadians, we had a slightly different view. Most liked the idea that traveling internationally was going to be considerably less expensive, but a surging Loonie, higher commodity prices and market volatility meant much of the same old rhetoric; how vulnerable are our economy and equity markets?

In August of this year, we had one of those mornings, in the midst of the credit concerns, where the TSX was down close to 600 points. Oil prices were reaching all time nominal highs, the credit crunch was gaining momentum and the dollar was well on its way to parity. How could Canada survive? Well it has and will. One of the reasons why oil prices hit these levels was that the US dollar was depreciating quickly against all major currencies. Since almost all commodities are priced in US dollars many responded to the lower US dollar by simply adjusting the nominal prices for most commodities higher. There was not a significant change in supply and demand metrics, more a point of maintaining purchasing power.

In terms of the credit crunch, Canadian financial institutions were not as badly mauled as many of their US and European counterparts. While there may be some ‘shoes’ still to drop, disclosure by the major banks has suggested minimal exposure. Further, strong dividend increases announced at the quarterly earnings report suggest that they have some confidence in the near term future of their operations. In fact, at the time of writing, two of Canada’s major banks have announced their intention to buy foreign banks- one in the US, valued at over $8 billion, another a smaller acquisition in the Caribbean. Not all international institutions have fared as well.

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The credit crunch is serious. While Canada and many Canadian companies experienced the literal shut down of the asset backed commercial paper (ABCP) market, the extent of the losses does not compare with what has been disclosed so far in the US and Europe. Billions have been written off but, as many international institutions have disclosed, they are merely guessing as to the extent of the impairment- they aren't quite sure what the market value is for many of these structured products. And in Britain, which boasts one of the most sophisticated financial systems in the world, September brought something the British hadn't seen for over 140 years- a run on a bank. Northern Rock, that country's fifth largest mortgage lender, experienced a panic by depositors that many would never have considered a remote possibility 6 months ago. But Northern Rock had done exactly what so many other institutions and lenders had done; loaned money aggressively with limited regard to the qualifications of the borrower. They were allowed to do this due to the massive popularity of the securitization of these loans. (Securitization is when a mortgage or similar product is re-packaged and sold to another investor). Once the borrower runs into trouble the quality of these products drops dramatically given his ability to pay is diminished. Once this happens there are no more willing buyers and those that currently hold these securities want appropriate replacements. This is not the kind of "Northern Exposure" you need.

The problems surrounding the subprime/mortgage and ABCP markets are serious. Real estate prices in the US have fallen, in some locations, dramatically. And this trend may take some time before it reverses. And while it would appear that liquidity problems surrounding the commercial paper market are starting to abate, there are many lessons from the past quarter that we should all keep in mind:

First, the Canadian market place is a good place to be. The commodity cycle continues to have support that suggests it will continue considerably longer than a typical cycle. While oil prices are high, certainly higher than we had predicted, much of the recent strength is based on a weaker US dollar rather than supply and demand concerns. And unless this reverses, further upward pressure should be limited.

Second, a stronger Canadian dollar may provide some productivity gains. Other institutions may follow two of our Canadian Banks and start to look more aggressively toward acquisitions in the US. While Canadian companies past adventures into the US marketplace have met with some disappointment, it would appear that timing, given the currency, may provide strong support. Certainly, it will be important for Canadian companies to not sit back and become acquired- instead become the acquirer.

Third, when financial institutions make simple products into significantly more complex ones- beware! It usually means that they are making more money than they should and will never fully understand the risks until it is too late. Moreover, stick to simple investments that are understandable- in the long run you will do considerably better.

Finally, remember that while Canada represents only a small portion of the world wide economy, it is in a bit of a sweet spot. Resource rich, stable economy, a strong currency and an advanced and competitive financial system suggest good things for the future for our country. This is the kind of "Northern Exposure" you need.

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