Canada and U.S. Markets – Directional Differences

There is an old saying that is used to describe the investment correlation between the economic health of the Canadian and the U.S. stock markets; "If the U.S. sneezes, Canada catches a cold". This phrase communicates the relatively tight correlation between the performance of the U.S. and Canadian equity markets. For much of their history these two markets, like two dancers on the floor, moved in sync. This fact had implications for investors. How much diversification was provided to a portfolio if the two markets experienced high correlation?

Times have changed. The composition of the Canadian equity market has changed remarkably over the past five to seven years, while the vast U.S. market remains what it is; a large, diversified, powerful market. Natural resources have always had a good home as part of our Canadian equity market; however they have never dominated our investment landscape as they do today. Natural resources (energy, copper, zinc, uranium, etc.) have muscled their way up to 30% of our index as a result of conflict in the Middle East and an insatiable resource appetite from a growing China.

The composition of our domestic market can vary widely over time. It is a reflection of changing times, opportunities, and growth of our immature market. Recall the days of Northern Telecom; the technology boom was underway and Northern Telecom at one point represented 30% of the Canadian Index. Today it is less than 1%. In addition, we have witnessed the elimination of a number of publicly listed Canadian companies through mergers, foreign takeovers, and a failing manufacturing sector.

Canada's growing materials and energy sectors have provided the fuel for outperformance against the U.S. based S&P 500 Index, and it has lowered correlations with that market. For the ten and five year periods ending December 2006, the average correlation between the S&P/TSX Composite Index and the S&P 500 Index was 77% and 80% respectively. However, over the more recent three and one year periods, the correlation fell to 61% and 64% respectively.

The current resource concentration of the Canadian market results in two things for investors. Firstly, it ushers in greater volatility. News that translates into resource uncertainty, such as the recent capture of British sailors by Iran immediately translates into changes in the price of crude oil, which in turn moves our market in lock step. Secondly, it has reduced the correlation of our market against the U.S. which provides greater opportunity for diversification.

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In addition, foreign investment managers can comfortably invest in Canada knowing they are diversifying their holdings and improving returns. The Canadian market has proved to be one of the strongest of the developed equity markets over the past five years, supported by a bullish commodity cycle, and an appreciating currency.

Our creation of a sophisticated U.S. based absolute return fund was, in part, a means to diversify our portfolios; however, it had other aspects that fueled its creation. We hypothesized that the Canadian equity market would struggle to continue its reach skyward and achieve out-performance against the U.S. market. The Canadian market does not have a strong track record against the U.S. over a long time period; however, recent years have been robust and rewarding.

Our Canadian portfolios are designed to minimize the impact of the narrow Canadian market concentrations through our extensive holdings in financial services and other sectors. We seek to develop portfolios that do not reflect the broader market but instead are balanced and composed of a diversified set of high-growth equities. Our addition of U.S. equities will, in many cases, contribute towards controlled portfolio growth and risk management.

Brownstone Team

Bob Thompson ▪ Wendy Adams ▪ Mario Vachon ▪ Ian Whitsitt ▪ Anita Kemp ▪ Cameron Reid ▪ Shannon Purvis

(403) 262-6067

www.brownstoneam.com