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Time To Go Long On Canada

The key is globally sensitive market timing.

BY WILLIAM ROBSON

Cynics are fond of saying that Canada is the country of the future—always has been; always will be. For investors looking for alternatives to U.S. equities, an indication that Canada is finally about to realize its potential would be most welcome. Could it finally be Canada's turn?

The answer is yes, though many jaded Canadian investors, acutely conscious of their country's shortcomings when compared to the United States, take a different view. Their international friends and colleagues will be familiar with the case they make against Canada and its markets.

On average, Canada taxes investment and entrepreneurship more heavily than does the United States. Canadian productivity growth lagged that of the United States for much of the past decade and government monopolies and regulations hobble key parts of the Canadian economy, including areas of future growth, such as health care.

The political scene can also unnerve potential investors. In 1995, secessionists in the Province of Quebec came frighteningly close to victory in a referendum. And for almost 10 years, the conservatively oriented opposition in the national parliament has been crippled by a regional split and personal infighting. Public-sector unions dominate the labor scene, obstructing efforts to improve the performance of health and education programs. Meanwhile, Canadian advocates of lower taxes and more market-oriented public policies have long faced the handicap of a reflexive branding as "too American"—the charge that such steps are threats to Canadian identity and independence resonates loudly in the media and in public debate.

However, investors familiar with the glum assessments of their Canadian colleagues need to put these criticisms in perspective. Many financially savvy Canadians are deeply frustrated that their compatriots do not more readily embrace growth-friendly policies and more enthusiastically espouse global competitiveness as a national goal. Frustration with the slow pace of economic reform, in turn, tends to be reflected in overly pessimistic assessments of Canada's long-term prospects.

Despite the Canadian dollar's decline against its U.S. counterpart during 2000 and 2001, Canada's domestic economy has outgrown the U.S. economy since 1998. The relatively strong performance of Canadian equity markets since then, moreover, has a very good chance of being sustained in the future.

Looking at the fiscal climate, Canada's public sector underwent a wrenching adjustment from deficits to surpluses in the 1990s. The virtuous circle of falling debt and

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interest burdens continues. Federal and provincial governments have been cutting taxes and further reductions in such damaging levies as top-rate personal income taxes, corporate income taxes and capital taxes are under way. Most significant over the long run—and in contrast to the U.S. situation—Canada's social-security retirement programs, the Canada and Quebec Pension Plans, are now more fully funded and ought to be able to meet their obligations, while maintaining their payroll charges at less than 10 percent of covered earnings.

The impression of chronically weaker productivity growth in Canada than in the United States also does not survive close inspection. The unimpressive aggregate figures during the 1990s arose from a relatively poor performance in the electronic and electrical machinery sectors— industries that are larger in the United States and were more vital in those years but which now are much out of favor. Elsewhere, the cross-border comparison is not one-sided. Canada has as many leaders as laggards, including resource industries that suffered far less from inept management or lazy workers than they did from weak product prices. Indeed, the latest aggregate figures show no significant differences in Canadian and U.S. productivity growth in recent years. Investment in new information technology was not so much lower as slower in Canada: the productivity gains from that investment were delayed, but are now arriving.

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Even the political situation permits a more optimistic assessment. The secessionists' near-victory in 1995 may well prove to have been their swan-song. Most of the leaders of that era now have left the stage, while the pronounced shift in Quebec's population from relatively young and radical in the 1970s and 1980s to relatively old and security-oriented makes the advent of a new cohort of secessionist leaders attracting large followings increasingly unlikely.

Political divisions among conservatives at the national level, moreover, have not prevented moves to a more investment-friendly climate. Strong conservative provincial governments have cut taxes, deregulated, and set higher standards for public services. The national Liberal administration has felt secure enough to undertake important fiscal and industrial-policy reforms. And the socialist party, representing public sector unions at the national level, has gone from disaster to electoral disaster.

One of the most promising indicators of good future returns on Canadian investments is the very discontent that Canadian financiers and business leaders so often express. After a romantic fling with economic nationalism a generation ago, Canadians have become increasingly outward-looking and critical of their competitive failures. Like the United States, Canada has open and information-rich capital markets that are quick to punish mistakes and reward successes. Informed criticism and technical expertise are increasingly characteristic of Canadians as a whole. Many provinces have elementary and secondary education systems with high standards and freedom of parental choice that produce results equal to the very best in the world, while Canada's post-secondary enrollment rates are now the world's highest.

All these factors make a compelling case for Canada as a destination for investment over the long term. The recent performance of the Canadian dollar, however, provides a compelling reminder of the critical importance of market timing. Though the Canadian and U.S. economies are more similar than is often appreciated, the greater weight of commodity-producing industries in Canadian output and exports makes the Canadian-U.S. dollar exchange rate highly sensitive to resource prices.

For investors in resource industries, this tendency provides a kind of hedge, reducing the margin between world-price-determined revenues and Canadian-price-determined costs when commodity prices are strong and providing a cushion when they are weak. For investors in more domestically oriented industries, it makes the ideal timing of investments in Canada a function of the state of the world economy as a whole. Canada has not been as lucrative a place for financial market investments when world demand for its commodity exports was weak as when demand for its exports was strong.

As a result, a further key criterion for equity market investors looking to increase their portfolio weightings of Canadian stocks is their outlook for the world economy as a whole. Those who are gloomy about the prospect for recovery in the developed world and continued expansion in the heavier resource-using economies of Asia will want to hold off. Those looking for exposure to renewed world growth on a base of strong domestic fundamentals, by contrast, will say that now is indeed Canada's turn. ◆