



The Case for Canada

Canada and the U.S. share what is commonly referred to as the longest undefended border in the world with more than 80% of Canada's population living within 100 miles of that border.

Today's global investment community is faced with an incredible task. With sovereign entities struggling to maintain their solvency and U.S. debtholders accepting for the first time in history that their investments are no longer considered AAA-rated, it should be no wonder that the financial markets are wrought with uncertainty and heightened volatility. Investors are attempting to sort through a daily flood of information and political noise to distinguish reality from hype while their portfolios are battered by market volatility. The line between investment opportunity and risk has never been finer and investors need credible and timely information to successfully navigate these market conditions.

In the face of such economic instability and political uncertainty, investors must rely on fundamental research, intuition that comes from experience, and a sound yet flexible, investment policy statement designed to mitigate risk and identify the most attractive opportunities. In an effort to broaden investors' awareness and contribute to the investment research process, this paper highlights several critical and relevant themes in today's environment that we believe support the investment thesis for allocating investor capital to the Canadian financial markets. The summary points of our analysis include the following:

- We believe economic fundamentals support Canadian asset growth and the potential for strength in the Canadian dollar.
- Canada is a resource-rich country that may benefit from continued strong demand in the emerging market economies.
- Canada's financial system has remained intact throughout the recent credit crisis and Canada's ten years of fiscal and current account surpluses have improved Canada's international position.
- Geographic proximity to trade partners and infrastructure investment provide competitive advantages for continued international trade expansion.

The Canadian Perspective

Canada's stable economy has deep roots in the government's prudent fiscal policy, expansive international trade and business friendly environment. The country's multi-cultural makeup also contributes a diverse background that helps define the Canadian perspective as one that is truly global. Canada considers international trade a key driver of its economy and has stated that its current and future growth and prosperity depend on open world markets and a stable, predictable and transparent trading environment.⁽¹⁾ The external orientation of Canada's trade regime has not only facilitated the country's strong relative economic performance, but it has also aided its economy's successful adjustment to a number of external shocks, including the financial crisis of 2008.

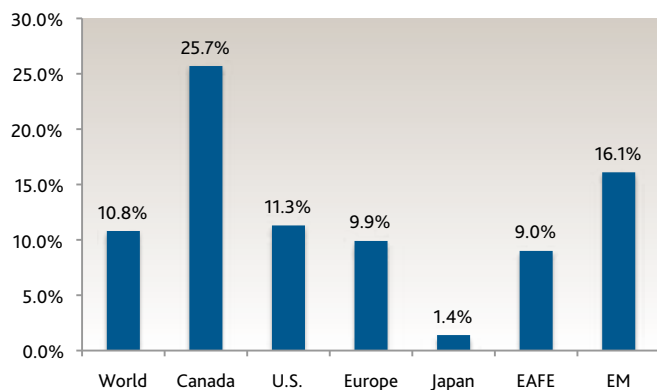
With a population of less than 33 million people, Canada ranks 11th and 8th in terms of gross domestic and gross national product, respectively.⁽²⁾ The UN Human Development Report places Canada slightly above the U.S. as one of the world's best places to live based on standard of living, educational attainment and life expectancy. With more than one million rivers, streams and lakes, Canada is the source of over 20% of the world's fresh water supply, in

addition to a fourth of its wetlands and 15% of its forests.⁽²⁾ Canada's major resource-based industries are fisheries, forestry, agriculture, petroleum products and mining (see Figures 1 and 2 for comparative statistics). Canada's exports fuel the robust infrastructure needs of many emerging economic regions, such as Asia and South America.⁽³⁾ Canada is comparable to the U.S. not only in its affluent standard of living and free market economic system, but also in its patterns of production and national emphasis on higher education.

Canada is now one of the world's most resilient economies and offers investors growth prospects unparalleled in many developed nations. According to *Invest in Canada (2010 Edition)*, business competitiveness studies consistently praise Canada's reliable regulatory environment, progressive contract and labor regulations, transparent government procurement and corporate governance structures, and strong judicial system.⁽⁴⁾ The World Bank Group's "Doing Business in 2010" identified Canada as first among G7 and OECD (Organization for Economic Co-operation and Development) countries for the lowest number of procedures required to establish a new business. Additionally, the commitment from

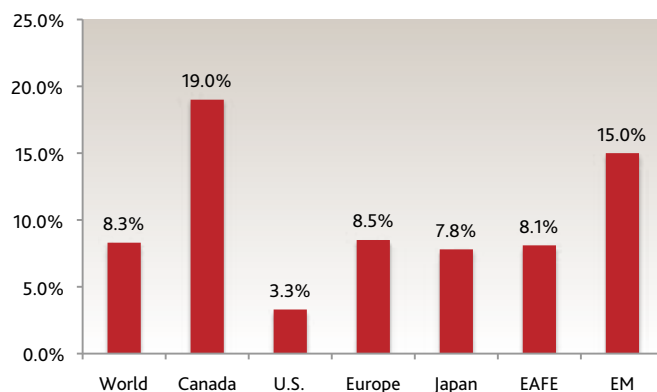
the Canadian Department of Finance to eliminate barriers to trade and investment facilitated US\$362.2 billion of accumulated foreign direct investment for the period 2000-2008, which ranks 6th globally and was greater than that of India, Brazil, Russia and Mexico.⁽⁴⁾ The country's ethnically diverse and highly educated work force attracts businesses seeking people with global awareness. Canada even ranks first in the OECD for its college completion rates.⁽⁵⁾ The flexibility afforded by Canada's best-in-class financial system and solid public-sector financing will result in lower interest charges, since public-sector deficits will not crowd out private capital markets as much as in other comparable countries.⁽⁴⁾

Figure 1. Energy Weight
(As a percent of respective index)



Source: Dundee Securities Corp., Thomson Datastream

Figure 2. Basic Materials Weight
(As a percent of respective index)



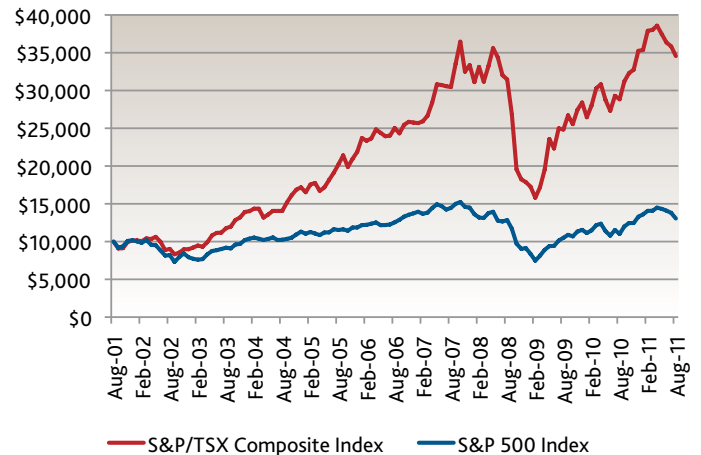
Source: Dundee Securities Corp., Thomson Datastream

Canada's weight in Energy and Materials is higher than all other regions and includes major exporters of resources.

Canada's economic strength is reflected in the relatively strong performance of the Canadian equity markets. Figure 3 illustrates the growth of a \$10,000 investment over the last ten

years if it were originally invested in the Canadian equity market (S&P/TSX Composite TR Index) versus the U.S. equity market (S&P 500 TR Index).

Figure 3. Growth of \$10,000 (USD\$)



The above investment assumes reinvestment of dividends.
Source: Morningstar Direct

Resources, Emerging Market Demand and Globalization

The growing emerging market demand for natural resources and commodities is well recognized throughout the world. Emerging market countries have been increasingly active investors in countries such as Canada because of the breadth and depth of natural resource and commodity availability. Canada produces and exports an array of natural resources and commodities, including crude oil, natural gas, metal ores, diamonds, wheat, lumber, paper and pulp, in addition to automobiles, heavy machinery and advanced technology products. Canada ranks first in world mineral exports and third in production behind the U.S. and Russia.⁽²⁾ The Fraser Institute, an independent and prominent "think-tank" based in Canada, recently ranked Canada as one of the world's most attractive jurisdictions for global mining firms, with four provinces (Alberta, Saskatchewan, Quebec and Manitoba) placing in the top ten internationally. Emerging economies throughout Asia have increasingly benefited from their trade relationships with Canada. The urbanization and migration to middle class across many Asian economies have also contributed to concerns about food scarcity, leading many countries to view potash and other Canadian agricultural commodities as vital resources to their continued prosperity.

Due in large part to technological development within the oil & gas exploration industry, Canada now has three regions which house some of the world's largest oil reserves: oil sands deposits of Alberta, Western Canada Sedimentary Basin (WCSB) and Atlantic offshore oil fields.⁽¹³⁾ Alberta's Athabasca Oil Sands are the world's second-largest proven oil reserves and have received \$170 billion in active and proposed investments.⁽⁴⁾ The development of Calgary's energy sector, coupled with the

Americas' reliance on Canada as a net oil exporter, has the potential to make the region a more strategic oil-investment hub than Abu Dhabi, United Arab Emirates or Houston, Texas.

While the energy sector remains the most prominent from an economic and employment standpoint, the diamond mining industry has also flourished. The Northwest Territories and Nunavut region have enabled Canada to become the third largest producer of high-quality diamonds, representing 11.4% of the world market.⁽²⁾ Canada's untapped, but commercially viable, reserves prompted Tiffany & Co. to open a diamond-finishing center in Yellowknife and De Beers to allocate nearly half of its 2004 exploration budget to projects in Canada.⁽²⁾

Significant natural resources, along with governments' pledge to foster foreign direct investment and commercial engagement on a global scale, solidify Canada's competitive advantage as a player in economic globalization. Canada's leadership in transportation and communication technology will not only help better supply the purchasing power demands of three billion new consumers with its metals, timber and oil resources, but should also help leverage Canadian production of wheat, corn and barley oilseeds in the face of forecasted grain shortages.⁽¹²⁾ As the per capita income gap between developed and emerging markets such as China, India and Brazil converges, Canada's commitment to further develop infrastructure networks and educational resources may afford Canada greater long-term viability.

Banking and Monetary Policy

As investors become increasingly concerned about the impact of the sovereign debt crises around the world, it may be instructive to recall how Canada narrowly averted bankruptcy during the 1990s. At the time, Canada's federal and provincial government debt ballooned to 120% of GDP. Interest expenses on these liabilities consumed one third of all government revenues⁽⁶⁾ and caused severe constraints on fiscal policy. Property values plummeted, economic growth stagnated and unemployment soared to 11%.⁽⁷⁾ Insolvency fears peaked in 1995 when a Wall Street Journal article famously called Canada "an honorary member of the Third World in unmanageability of its debt problem".⁽¹⁵⁾ The Canadian government, led by finance minister Paul Martin, designed and then successfully implemented a proactive recovery plan. Seeking to avoid massive tax hikes, and recognizing the shift toward overseas production of goods, the government trimmed program spending, reduced government employment by 14%, revamped its welfare system, reassessed federal grants to the provinces, and overhauled its personal and corporate tax structure. International business interests extolled the implementation of Canada's "Public-Private Partnership" to finance new initiatives as part of the plan to strategically develop growth oriented infrastructure through the privatization of public enterprises like Air Canada, Canadian National Railways and Petro Canada.⁽⁷⁾ The results were impressive: by the end of calendar year 1998 the \$36.6 billion deficit had become a \$3 billion surplus.

The lessons learned from the 1990s have paid off in the current financial crisis, driving Canada's staunch banking system,

modest balance-of-payments deficit, growth orientated fiscal policy and conservative monetary policy. Canada has gained recognition over the last several years for largely avoiding the mistakes that plagued the United States and European Union. Upon review of Canada's capitalization, management and regulatory framework, the World Economic Forum ranked Canada's banking system as the most sound in the world for the past three years.⁽⁴⁾ Additionally, Moody's Investor Service has ranked Canada's banks as first in the world for financial strength for the past two years. According to Global Finance magazine, six of the world's 50 safest banks are Canadian. Aided by a prudent regulatory framework, Canadian banks and insurers did not fail or require any bailouts⁽⁸⁾ during the financial and liquidity crises in 2008. Canadian financial institutions took decisive action, including diversification of revenues, consistent implementation of dividend policy to attract pension plan assets, and the upholding of reserve requirements for bank deposits to mitigate the problems experienced by others.⁽⁷⁾

Canada's ratio of non-performing bank loans as a share of total loans is the lowest among the G7 countries.⁽⁴⁾ High risk mortgage products, such as interest only payments, negative amortization schedules, no-documentation lending and adjustable-rate mortgages, are almost nowhere to be found in Canada. Unlike many U.S. financial institutions, Canadian banks do not originate and then distribute their mortgage assets. This results in better alignment of interests among interested parties and provides accountability. Simply put, Canadian banks did not compromise their lending practice standards and continued to make prudent underwriting decisions on a case-by-case basis, even as their international counterparts touted record profits. In 2010, the percentage of Canadian mortgages in arrears was approximately one-tenth that of American borrowers and the average Canadian home mortgage had a loan-to-value ratio of 50%.⁽⁸⁾ An analysis of Canada's net debt/GDP is illustrated in Figure 4.

Figure 4. *Canada's Net Debt and Deficit to GDP*

	Net Debt/GDP*	Budget Balance/GDP*
Canada	36%	-4.8%
U.S.	72%	-10.0%
France	67%	-8.3%
Germany	58%	-5.0%
U.K.	70%	-12.9%
Japan	113%	-8.8%
Italy	103%	-5.3%
Spain	49%	-8.1%
Ireland	49%	-11.9%

*2010-2011 Average; Source: CIBC World Markets

Canada has relatively low government debt and deficit to GDP.

International Trade and Proximity

Possessing a 65 hour transit time advantage over Los Angeles for goods shipped from the Asia-Pacific region, the port city of Prince Rupert, British Columbia is just one simple example of how Canada possesses geographical cost efficiencies that help insulate profits and attract additional commerce.⁽⁴⁾ Canada hopes to further leverage its nautical footprint to provide enhanced access to foreign markets through a \$1 billion investment into the Asia-Pacific Gateway and Corridor Initiative, which facilitates stronger infrastructure links between Canada, NAFTA and Asia.⁽⁴⁾ The Canadian government's desire to foster entrepreneurial agility, in addition to its reliable private and public industrial bases, foster Canada's ability to serve as a mainstream trading partner of emerging economies. Export Development Canada, a government agency that provides trade, finance and risk management services to Canadian investors and foreign investors, forecasted 57% growth in exports to Asian Pacific Countries in 2011.⁽³⁾ By strategically linking to Asia because of its unique geographic advantages, Canada seeks to become a key a source of strength in the global supply chain network.

The Canadian government understands that the country's long-term prosperity depends upon successful management of the imports and exports trade. The Canadian government has taken steps to lower tariffs on industrial manufacturers and plans to eliminate all duties on industrial inputs, including manufacturing machinery and equipment, by 2015.⁽⁴⁾ These measures should lower productions costs, strengthen competitive advantages and simplify the overall tariff structure. The potential savings from these and other planned initiatives may accelerate foreign business investment.

Canada May Suffer from Weakness in Commodity Demand

Our Canadian investment thesis highlights the country's well managed public finances, distinctive economic drivers and relative competitiveness in the global market place. Although Canada's consolidated banking sector does provide a more resilient financial foundation, investors must recognize the inherent drawbacks of Canada's imbalanced trade relationship with the United States and increasing dependence on emerging market demand. Canada's economic growth hinges on this concentrated bilateral trade relationship with the U.S.: 78% of Canadian exports are destined for the U.S. but only 20% of U.S. exports cater to Canada.⁽¹¹⁾ The 2008 recession exposed Canada's interdependence as energy exports abruptly slumped more than 50% and mineral production was slashed more than 30% to \$32.2 billion from \$47.0 billion.⁽¹¹⁾ Other notable challenges include a strong Canadian dollar, which could adversely affect resource and service exports, declining population levels and the reemergence of a threat to Canada's sovereignty in the Arctic region.⁽¹¹⁾ Furthermore, Euro zone debt default fears, a prolonged downturn in the U.S. economy and the perceived fragility of the global recovery process could adversely affect the medium-term economic health of Canada.⁽¹²⁾ Despite these vulnerabilities, evidence supports Canada's evolving prominence as a cornerstone of economic

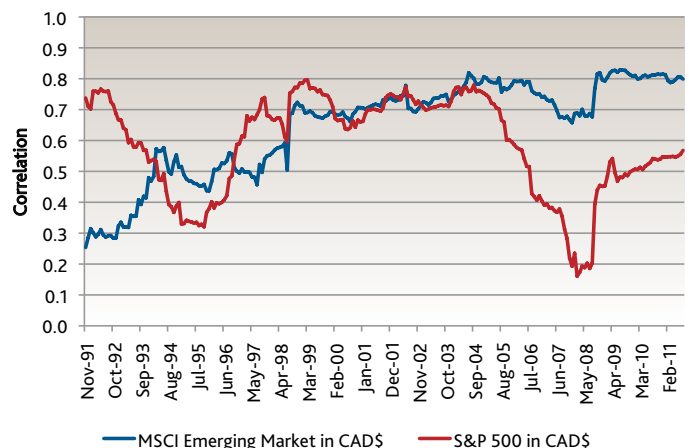
globalization because Canada is structurally stronger relative to many of its developed world counterparts and better positioned to capitalize on emerging market prosperity through a recovery phase. The transformation of our world economy, with seventy-five percent of growth coming from emerging markets, clearly presents a compelling opportunity for Canadian business. The evolving multidimensional factors of globalization that have resulted in extraordinary change over the past three decades help illustrate why the 'Case for Canada' is a complicated and multifarious one.

The Investment Opportunity

With the ever increasing globalization of economies, Canada brings expertise and strength in sectors of the markets not otherwise available elsewhere in the world (eg. Natural Resources, Financials). The Canadian equity markets are large and highly liquid, and have recently become more positively correlated to overseas growth and the demand for resources, especially within many emerging markets (Figure 5).

Developed markets such as Canada are generally considered safe relative to emerging markets as the higher return potential from emerging markets is typically accompanied by greater political, currency and governance risk. For investors seeking growth opportunities and/or exposure to the emerging markets, a dedicated allocation to Canadian equities may provide benefits similar to that of an emerging market allocation without the corollary exposure to political and country risks associated with direct investment in the emerging markets. U.S. dollar based investors seeking currency and country diversification due to concerns about events unfolding in Europe may also find an allocation to Canada an appealing alternative to the "Old World" developed markets.

Figure 5. Rolling 3 Year Correlation Relative to S&P/TSX Composite (CAD\$)



Source: Morningstar Direct

- Canadian Equities have a high correlation to emerging markets.
- Short-term declines or changes in correlation with US markets can stem from periods of a strengthening CAD\$ and market composition.

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