REVIEW AND COMMENTARY
3RD QUARTER 2013

Oh Canada

For the last several years, most global equity markets have improved. In the title of our Q1 Review and Commentary, *The Tale of Two Indices,* we discussed the SP/TSX and SP500 indexes (Canada and US respectively) and outlined the different dynamics of both indices and the reasons for the relative disparity of the two indices' performances. While we still think there will be some catch up eventually, the recent performance of another index, the Australian SP/ASX 200, with so many similar characteristics as ours, has increased our conviction that Canada's index could outperform on an absolute and relative basis, both the US and Australian markets.

Here are some simple statistics. The Dow Jones and SP500, the two large cap indices in the US are up 22.1% and 24.4% so far this year. The SP/TSX is up 5.3% year to date and has yet to set new interim 5 year highs as have both the US and Australian indices. The SP/ASX 200 is up 12% so far this year and recently set a new 5 year high. The SP/TSX, Canada's major equity index, on the other hand remains well below the interim high in the spring of 2011; however, they both remain below their all-time highs. The renewed interest in Australian results may bode well for the future attractiveness of Canadian equities.

One of the many reasons Australia has garnered so much favour with investors is the improving economies in Asia. China is a big contributor, as is Japan. While debate continues on the health of the Chinese economy, evidence suggests that a soft landing has been achieved and that, while sporadic, the Chinese economy is improving. Growth estimates vary, however, the Chinese Government remains confident with its own estimates of 7.5% growth, at least presently. Even if it is less, say 6.5 to 7% growth, it remains a significant amount of demand from the world's second largest economy.

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As China strengthens, so should commodity prices. As commodity prices go, so will the Australian economy and, to a similar degree, Canada's economy. Further support for strengthening commodity prices lies in a recent study from McKinsey. Fraser Thompson, senior fellow at McKinsey Global Institute, cites "emerging market demand and supply constraints" will be the major factors behind the upward resumption of commodity prices and the report goes on to say that the commodity 'super cycle' is still alive and ready to resume. Surprisingly, major news agencies provided this rather bold statement with little coverage or maybe it just isn't as newsworthy as US government Senate/Congressional bickering or Federal Reserve conversations focusing on the question, 'To Taper or Not to Taper'. The McKinsey study states that while technological improvements have increased yields on many mines and wells there remain 'structural supply issues' that should keep marginal costs, and thus prices, relatively high. Another important estimate to support the resurgence of commodity prices is the influence that a growing population growth in China and other emerging countries will have on basic resources. The report estimates that 750 million more people will live in Indian and Chinese cities by 2030. This is less than a generation away and the incremental yearly changes will have a significant socio-economic impact on those countries imports sooner rather than later.

While Canada has a diverse economy, we are perceived primarily as resource oriented by international investors, as is the case for Australia. However, our resource strength is different. Australia's exports are more heavily weighted towards metals, Canada's more toward oil. Australia's major trading partner is China, and despite being a smaller country, Australia's exports to China are almost three times as much as Canada's. While China's economy is important to Canada, Canada's largest trading partner is the United States. The US economy is improving, albeit slowly. Some signs of optimism is that many high end consumer discretionary companies such as, Lamborghini, the luxury car maker, are focusing their attention back to the US markets from the higher growth emerging countries. Chief Executive Officer Stephan Winkelmann said in a recent interview that demand for their high priced vehicles in the US are now at pre- 2008 financial crisis levels. If the US Congress and Senate can manage not to disrupt their economy too much with their ongoing inability to build a consensus, Canada's prospects remain attractive. If the commodity super cycle resumes, as McKinsey anticipates, our future may be even brighter and international investors will be singing our praises even more than we do.

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