STUART INVESTMENT
MANAGEMENT LIMITED

The Macroeconomic Case for Canada:

Cautious Near-term, Bullish Longer-term

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Summary

This report examines the fundamental case for investing in Canada, both in equities and the Canadian dollar. In general we expect Canada to be an attractive investment destination over the intermediate to longer-term. At US$0.80 cents (C$1.25 per US$), the Canadian dollar appears undervalued relative to the U.S. dollar and the Euro. Canada is a resource-rich country. This will work to its advantage as the world economic growth, especially in Asia, returns to its potential. Canada's banking system and its fiscal condition are in relatively much better shape than those of other G7 economies and most other industrialized economies as well.

Near term, we are cautious on the Canadian dollar and equities. The GDP contraction and rise in unemployment will continue through most of 2009. Given its tight link to the fortunes of the U.S. economy, our main concern is the continued difficulties facing the U.S., especially the need to re-capitalize the banking system and the impact of rising unemployment. Additionally, the world economic slowdown is likely to keep a lid on commodity prices in coming quarters. Further, productivity gains in Canada have been chronically weak and productivity is currently contracting. However, these current negatives offer what we believe is an opportunity to accumulate Canadian equities in the resource, banking and related sectors at prices that offer a highly favourable longer-term risk-adjusted returns.

The Canadian Economy and the Dollar

The economy: Near-term, the Canadian economy, like that of most of the industrialized nations, is declining. Following a drop of 3.4% in the fourth quarter of 2008, first quarter 2009 GDP is likely to show a further contraction in excess of 6%. Second quarter 2009 GDP is also likely to decline, albeit by less than the first quarter. Leading indicators for the economy are still falling. And mortgage delinquencies are, with a lag to the U.S. housing market, accelerating to the upside.

Growth in the second half of 2009 will remain below potential. For all of 2009, the drop is GDP is likely to be near 3%, on par with the drop in the U.S. and Europe. Growth in 2010 is also likely to be in line with the average of other G7 countries near 2%.
Of particular near-term concern is the year-over-year drop in exports, 18%. This drop is due to the:

- Lagged impact of the high Canadian dollar in 2007 and early 2008,
- Slowdown in world economic growth, and more recently,
- Drop in commodity prices and exports.

Automotive-related exports have fallen by 48%, and energy, metal, chemical and mineral exports have also fallen 28%.

The drop in exports coupled with a smaller drop in imports has led to a reversal of the Canadian trade balance from a surplus of C$3.1 billion in January, 2008 to a C$1.0 billion deficit in January, 2009. Although Canada continues to enjoy a surplus with the U.S., 90% of the reduction in the Canadian trade balance is due to a reduction in the trade surplus with the U.S. The drop with the faster-growing Asian countries is negligible.

The weakest link in on otherwise positive long-term Canadian economic story is productivity, which declined 1.1% in 2008 and is likely to decline in 2009, as the drop in economic output outpaces the drop in hours worked and reduction in capital costs. Conversely, however, as the economy picks up, productivity rebounds rapidly as demand increases. Employers will be slow to rebuild their labour force and invest in capital equipment in the initial stages of recovery.

While weak productivity is a distinct negative, the reversal of this decline will ultimately enhance profits. Further, in contrast to the U.S., future profit potential remains positive. Likely U.S. policy to expand health care but cut costs, coupled with the future claims of medicare and social security, will ultimately result in higher taxes. Profits moved from 12% to 20% of the share of income over the past three decades; most of this increase came at the expense of the wage share. Current administration policies, coupled with the above-stated health and social security liabilities, will reverse the trend rise in the profit share. In contrast, with medical care already broadly available to Canadians, productivity increases in medical care in Canada should ensure that the bottom lines of corporate profits are not as adversely affected.

The Canadian Dollar: From a low of US$0.62 (C$1.60/US$) in December, 2001, the Canadian dollar "rocketed" to an intra-day high just above US$1.10 (C$0.90/US$) in early November, 2007. Clearly, the US$0.62-cent bottom was an overshoot that greatly undervalued the Canadian dollar. Similarly, the US$1.10 high was just as unsustainable. More importantly, the speed of adjustment (a rise of 77% in less than 6 years) undermined the competitiveness of manufacturing in Canada. However, the rise in energy and other resource prices during much of this period ensured that the Canadian trade surplus would be maintained. In contrast, the fall in resource prices coupled with the adverse terms of trade and the world economic recession has pushed the trade surplus to a negative that is likely to prevail for the next couple years.

The initial pullback in the Canadian dollar, to the US$0.96-US$1.03 level was the result of the sharp overshoot to the upside that reversed the favourable terms of trade with a vengeance. However, the more recent collapse to the US$0.77-US$0.85 (C$1.30 to C$1.18 per US$) level is the direct result of the sudden contraction in the Canadian economy coupled with general flight to the U.S. dollar and Yen, away from the Euro.

Although it will take time for the Canadian dollar to recover, we believe that "value" vs. the U.S. dollar lies broadly in the US$0.80-US$0.90 (C$1.25 to C$1.10 per US$) range. If correct, moves under US$0.80 cents per Canadian dollar are buying opportunities.

Near term, economic problems coupled with the lagged negative impact of these conditions on the trade balance will likely keep the Canadian dollar at or below value. Recall that even as the economic and fiscal conditions improved in the late 1990's the Canadian dollar continued to fall. However, that was a period of extreme optimism for the U.S. dollar and that contributed to Canadian dollar weakness and the downside overshoot. In the present situation, concerns for both the U.S. dollar and Euro and the fact that the Yen may have moved up too fast, should be supportive factors for the Canadian dollar. Thus, we doubt the Canadian dollar will overshoot to the downside to the degree that it did at the turn of the century.

Specifically, our 3-4 month forecast for the Canadian dollar is US$0.78-US$0.84 cents, or roughly the range for the past 5 months. For investors, we would accumulate near the bottom of that range. Speculators might consider writing 3-6 month puts at the bottom of the range and balance a portion of the risk by writing calls the top of our range on near-term rallies. However, given our longer-term bullish bias we would "underwrite" on the long side.

Longer term (2-4 years), we see the Canadian dollar returning to the top of our value range (US$0.90 or C$1.10) or higher. As indicated below, the return to more favourable resource pricing as China and India continue to grow and as Europe, the U.S. and Japan resume growth will boost resource prices. Further, Canadian productivity should rebound. Finally, Canadian fiscal conditions, the relative integrity of the banking system and the stable democracy will insure that Canada is an attractive investment destination. The willingness and ability of Canadians to invest surplus funds overseas will keep the Canadian dollar from having the pronounced rally that was exhibited in the 2001-2007 rally. Thus, we expect a gradual appreciation to come in stages once a basing period is completed in 2009.

The Canadian Resource Advantage

Despite the adverse terms of trade resulting from the fast rising Canadian dollar in the early 2000's, Canada managed to increase imports by 14% or C$60 billion from 2004 to 2008. During this period, exports of Canadian resources increased by C$87 billion, thus accounting for more than 100% of the increase. The increase in energy exports alone

accounts for C$58 billion. Despite a significant drop in the export of forest products, resource exports now represent more than 63% of total exports, up from 50% in 1994.

Near term the outlook for Canadian exports remains negative. We expect a further drop in exports near the double digit range in 2009. Much of this drop will be due to recent price declines in resource prices (despite the recent rebound) and the ongoing slowdown in world growth.

As the world recession is reversed, the demand for commodity resources will once again expand. Canada is not only resource rich, but is a dependable supplier of energy, agricultural staples, metals and minerals. Even without major price increases that were exhibited in the 2005-2008 run-up in commodity prices, Canada stands to benefit from expanded export levels, especially to Asia.

Energy: Near term, the outlook for energy prices and exports is neutral to negative. Oil prices have already rebounded from the post bubble sell-off and inventory liquidation, but inventories remain high. This is also the case with natural gas and coal where available supplies exceed demand. Historically, the lag time in drilling is long and once the initial rebound in commodity prices due to the end of inventory liquidation occurs, prices stay in a narrow range with a downside bias. Those with "shut-in" capacity, especially OPEC countries are strapped for cash and often expand production or, in the case of OPEC nations, "cheat" in order to maintain revenue. As a result, absent a supply disruption in the Middle East, prices are likely to remain in, say, the US$40-$65 level for the next few quarters.

One of Canada's immediate problems is that it is, on the margin, a relatively high-cost oil producer. Thus, the demand for incremental Canadian energy is highly leveraged to the price. Indeed despite the longer term prospects for expanding energy exports, the most recently released statistic indicates a year-over-year decline in energy exports of 18%, more than 100% of it coming in the past few months.

Nevertheless, given the longer term prospects that oil will get scarcer while Asian demand increases rapidly, investment in Canadian resources such as oil and tar sands will continue to attract capital over the longer term. As demand rebounds, it will tax supplies as relatively "cheap" oil continues to be harder to find. For the first time, crude demand temporarily exceeded available OPEC and non-OPEC maximum supplies during the most recent oil price spike. Previous spikes resulted solely from fears of supply disruptions and Saudi Arabia's ability to withhold product in order to balance supply and demand.

Agriculture and fertilizers: Just as energy became the "scarce" good in the recent global expansion, water and food may well be in a similar situation when world growth, especially in Asia resumes. As China's arable land continues to be eroded by urbanization and its water contaminated by industrialization, it will likely be forced to import more food and to use fertilizers more intensively. As important is the tendency of an increasingly wealthy population to eat more meat and wheat-based products. Longer-run Canada will continue to benefit from both these developments. It is noteworthy that,

despite the huge drop in manufacturing and energy exports in recent months, Agricultural exports have been relatively stable.

Metals and Minerals: As is the case in energy, pricing for metals, minerals and chemicals will be difficult for several quarters to come. We think the recent equity rally in these and energy-related stocks adequately reflects the likelihood that current G20 policies will prevent the world economy from falling into a more extended downturn. The fall in GDP of industrialized nations more than offsets the effect of continuing, if slower growth in Asia. Thus demand for industrial metals and materials is likely to be stagnant in coming quarters.

There are some positive signs. A significant portion of stimulus packages around the world are directed to building inventory, both in information systems and in the more traditional "bricks and mortar' area. Much will also go into alternative energy production. Even efforts to conserve energy often involve material investments. Such is the case, for example, in attempts to make carbon-based solutions "clean".

Another positive is that levels of production in, for example, housing and autos have fallen below the longer-term demand for replacement. Moreover, in Asia, growth in the use of building and manufacturing materials is likely to grow disproportionately as the income and wealth of households in India and China increase.

On balance, then, while supplies of aluminum and lumber remain in chronic oversupply, steel, which historically was in oversupply, went into deficit in the most recent expansion as the long run depreciation of steel-producing facilities finally brought capacity into line with expanding demand. As world demand begins to recover in 2010, basic metal and material producers should begin to have more pricing power. Producers and refiners of metals such as steel and copper, where supply remains more closely aligned with demand, should benefit first.

Precious metals have a story of their own. Although we are not as concerned about inflation as many observers (the more immediate problem is the potential for deflation), underlying demand for precious metals is likely to increase as Asians become wealthier and as fear for the safety of the Euro and U.S. dollar ebbs and flows. Although we are reluctant to speculate on the price of gold, silver and platinum, current prices would have to fall much more to curtail what we think will be expanding sales volumes for both jewelry and hoarding purposes. Thus equities of refiners should do well over the longer term.

Banking

The "big five" banks in Canada are, collectively, in much better shape than U.S. or many European banks. Because banking is such a critical part of the economy we single out this sector for analysis. We also highlight specific banks to make the case that, unlike in the U.S., Canadian banks are more investment than speculative vehicles.

As with assessment of the Canadian economy and resource sector, our positive longer-term view is tempered by near term caution. Like Wells Fargo and GE in the U.S. we consider Canadian banks, while much more sound than, say, Citicorp or Bank of America, in the "early innings" of their loan-loss problems. In the case of Wells Fargo and GE, which escaped the huge write-downs from imprudent residential mortgage loans, losses in credit card defaults and commercial real estate loans are now rising rapidly. Similarly, Canadian banks are more closely tied to the general economy and therefore face mounting loan losses in coming months. In addition, the Canadian mortgage loss cycle has lagged the U.S. While not as onerous as in the U.S., residential loan losses are beginning to rise rapidly. Through the end of 2008, it appears that Canadian banks are somewhat behind in setting aside loss reserves.

Despite our near term concerns, the longer-term case for Canadian banks is compelling. Canadian bank leverage ratios are considerably more prudent than those of most U.S. banks and the quality of the loan portfolios is better. Further, dividends are much better protected than was the case in the U.S. Canadian bank profits are understandably under pressure, but per share earnings appear to satisfactorily cover dividends. If there are cuts, they will be not be as deep as those for U.S. banks. Finally, the decline in bank stock prices, to date, is greater than the current and forecasted earnings declines. Note, however, our own assessment is that earnings forecasts for Canadian banks have further to fall as loan-loss reserve set-asides are likely to be greater than currently forecast, and as the depth of the 2009 recession negatively impacts loan demand.

The Royal Bank of Canada (RY) is reflective of the above general comments regarding banking. The loans to tangible capital ratio, although down from just below 5, remains above 4, a level only now being achieved by Citicorp, for example, after huge public and private capital injections. Further, per share earnings are expected to remain above the C$2 dividend, a 5.4% yield based on a C$37 price. U.S. investors in the Canadian ADR realize a similar yield and benefit or lose from appreciation of contraction in the value of the Canadian dollar. However, loan-loss reserves, 0.8% of outstanding loans at the end of 2008, are well below the 1.3% peak in the 2001 downturn. With this recession much more severe than the previous one, we think the banks will become more aggressive in their set-asides in 2009. This will likely keep a lid on further appreciation from the current equity level. And we would not be surprised to see a pullback, although the price is not likely to challenge the US$20.61 low of February 23, 2009.

Over the near term, our strategy is similar to that for the Canadian dollar. Given our assessment that there remains bad news to come in the next couple quarters, we are sellers of US$25 July puts of RY, willing to receive an annualized return in excess of 100 percent in the event that the stock price remains above the strike price or, alternatively, willing to accumulate the stock below US$25. An alternative strategy for buy and hold investors is to buy the stock at current levels, collect the dividend and write 3-6 month covered calls above the current price to enhance yield. Given our near term caution but longer term bullishness, we would write calls well above the current price and would not extend beyond a 6-month maturity. A third strategy for the non-options account is

simply to accumulate over the 3-6 month period, attempting to achieve an average price below US$28 (or C$35).

Toronto-Dominion (TD) and Bank of Nova Scotia (BNS), the second and third largest banks, have similar characteristics to those of RY. However, the dividend yields are slightly higher, but the forecast earnings are lower relative to current earnings. Both have lower loan-loss ratios relative to those of the past recession, so further set-asides will likely be somewhat greater. Our strategy for these banks would mirror that for RY.

The Fiscal and Monetary Situation

Near term, both fiscal and monetary policy in Canada will reflect the cyclical economic downturn. An announcement of still lower rates and implementation of some form of quantitative easing are likely at the Bank of Canada's (BOC) April 23 meeting. Complementing this will be a scheduled fiscal budget deficit at the Federal level. However, given that Canadian banks hold less "toxic" assets than U.S., U.K. and many Euro-based banks, expansion of the BOC's balance sheet and liabilities that may eventually fall on Canadian taxpayers is likely to be far less than is the case in the U.S. and/or the U.K.

As the table below indicates, Canada's fiscal condition and, therefore, its public credit stance are consistent with the most favourable of the G7 countries. Perhaps, as important, is that Canada has been on a secular trend to lower its debt-to-GDP ratio. In 1995, Canada was second only to Japan as having the highest ratio and its structural deficit (adjusted for cyclical circumstance) was also high at above 7%. Currently it has no structural deficit as opposed to the U.S. where the structural deficit is above 5%.

Debt as a Percent of Nominal GDP

Country	Year		
	2000	2008	2010 est.
Canada	82.1	63.0	66.9
U.S.	55.2	73.2	82.5*
Euro Area	75.3	70.7	74.7
U.K.	45.1	58.7	69.4
Germany	60.4	64.8	66.3
France	65.9	72.5	79.0
Japan	135.4	173.0	177.0**

*Likely to be several percentage points higher based on CBO's recent update
**Likely to be higher pending announcement of additional stimulus package
Source: OECD Outlook, as of March 2009

Finally, since the mid 1990's, Canada has been able to make progress in reducing the deficit, independent of whether the Tories or Liberals held power. In contrast, the U.S. deficits swung from "huge" in the early 1990's to surpluses in the late 1990's back to

huge deficits in the past few years. And more often than not, no agreement has been reached on the yearly budgets. Given its current economic predicament, coupled with the structural deficit, there is little prospect that, absent a rational agreement between political parties, the U.S. ratio of debt to GDP will be lowered in coming decades. In contrast, rational (with respect to deficits) budgets have been and are likely to continue to be agreed on in Canada. Thus Canada can exhibit much more flexibility as funding requirements and economic problems arise in the future.

The Opportunity

On balance, Canada should benefit in the coming years from a return to growth, spearheaded by China and other Asian countries, which will need to import resources to satisfy growing domestic demand. Further, Canadian banks should benefit disproportionately from a return to a more stable, regulated banking system, capable of sustaining real growth, but limiting excessive financial engineering which is unrelated to making service and goods production more efficient. Despite our near term caution, the current depressed environment offers an opportunity to accumulate Canadian resource-based and financial-related equities that offer a combination of current income and above-average growth.

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