



McLean Budden Perspective

Canada - A Developed Market Play for Emerging Markets Growth

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How to Play Emerging Markets with Less Risk

In examining global trends of the last ten years, and the resulting rise of emerging markets as a factor in world economic growth, we came across some interesting observations.

The global economy is only now absorbing the early implications of the industrialisation of many emerging markets, particularly China, India, Brazil and Russia. The industrialisation of emerging economies is on an unparalleled scale. They now account for a larger population than existed globally at the turn of the twentieth century. China is the second largest energy consumer and estimated to be number one by 2020. Some suggest India and China will use their excess foreign reserves to buy natural resources in order to achieve self-sufficiency.

We have witnessed a dramatic increase in the correlation between global markets over the last three years. Add to this a worldwide deleveraging cycle, increased demand for investments in countries with a competitive advantage, and companies enjoying the pricing power to benefit from emerging markets growth. These factors have seen Canadian equities thrust to the forefront of markets poised to benefit from global growth trends. Indeed, Canada is the world's fourth largest investment market, with close to 6% of world capitalization.

With its wealth of natural resources, stable politics, rule of law, good accounting standards and attractive investment returns, Canada is quickly becoming an ideal market for those interested in emerging market investments but looking for a complement to lessen volatility. Canada has a liquid and transparent market, dating back to 1861. It follows recognized accounting standards and offers streamlined regulations as well as a solid legal system. Banking in Canada is widely considered the most efficient and safest banking system in the world, ranking as the world's soundest banking system for the past three years, according to reports by the World Economic Forum. Additionally, Canada is the G7 member with the lowest debt/GDP ratio, as well as having a high quality of corporate governance standards.

According to the Forbes Global 2000 list of the world's largest companies in 2008, Canada had 69 companies on the list, ranking 5th worldwide. Canada is an efficient commodity producer. As long as commodities are important to emerging countries, pricing power reflects positively for Canadian commodity-based companies. Indeed, at December 31, 2010 the primary S&P/TSX Composite sectors are materials (23%), financials (29%) and energy (25%).

Canada enjoys competitive mining costs, thereby reducing earnings volatility. Canadian listed gold companies have assets that are among the lowest cost producers on the planet. The country has the highest grade of uranium reserves, with up to 19% grade, while the global grade is less than 1%. Additionally, Canada is the largest exporter of seaborne metallurgical coal, a leading producer of nickel, gold, diamonds, zinc and lead, and has large reserves of iron ore. (More high grade iron ore was recently discovered in Quebec.)

With the global middle class forecast to increase by another 2 billion by 2030, increased wealth will drive demand for protein – livestock's economic value will increase, and grain usage will accelerate, increasing pressure on grain prices, driving up both fertilizer usage and prices. This is attractive, considering that Canada is the world's second largest exporter of wheat, barley and canola. Indeed, commodities are one third of Canadian exports.

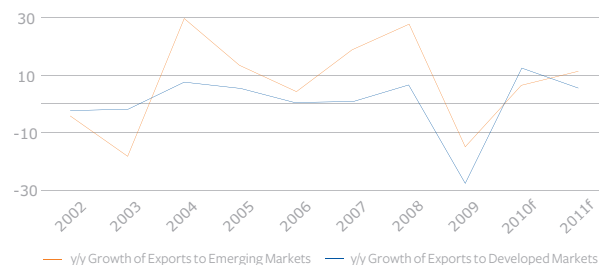
Arable land, water and technology are the main challenges for the world's population, especially in Asia. Canada has one of the largest sustainable freshwater resources – approximately 9% of the world's renewable water supply – and 70% of its potash reserves, but only 0.5% of the world's population. Additionally, Canada is one of the world's largest suppliers of lumber, pulp and paper products. Canada also has the second biggest oil reserve (oil sands) and substantial natural gas reserves, as well as shale gas.

The service sector in Canada is vast and multifaceted (retail, banking, high tech and business services) employing some three quarters of the Canadian work force and accounting for over two thirds of GDP.

Manufacturing accounts for over 13% of Canadian GDP. Manufacturing volumes between 1961 and 2005 kept pace with the overall growth in the volume index of GDP. The country is a leader in auto parts manufacturing and has the most efficient railroad system linking the Atlantic and Pacific oceans.

Canadian trade growth rates are expected to remain positive in 2011, with emerging markets exceeding 10% (see Graph 1).

Graph 1: Canadian Trade Growth Rates by Markets



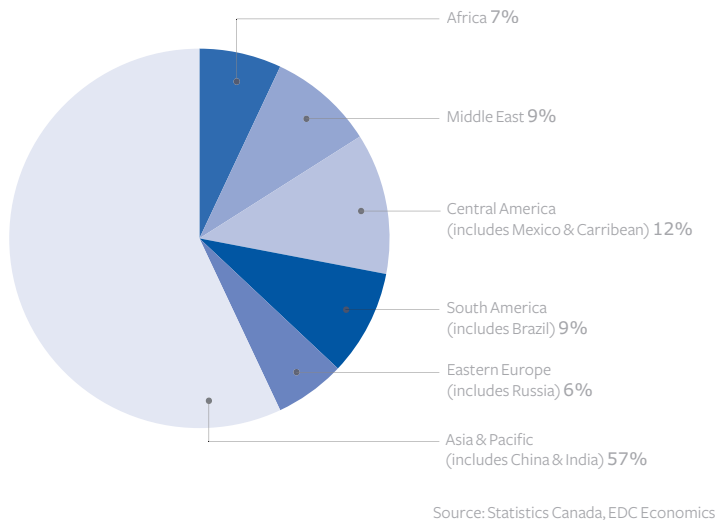
Source: Statistics Canada, EDC Economics

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Canada's trade with Asia & Pacific alone is expected to grow 57% in 2011 (see Graph 2).

Graph 2: Canadian Trade Growth Rates by Markets



Canadian export growth estimates for 2011 are: China 19%, Brazil 14%, Asia 11% and USA 6%. Statistics Canada estimated 2011 export growth per sector will be 30% for fertilizers, 10% auto parts and 8% industrial equipment.

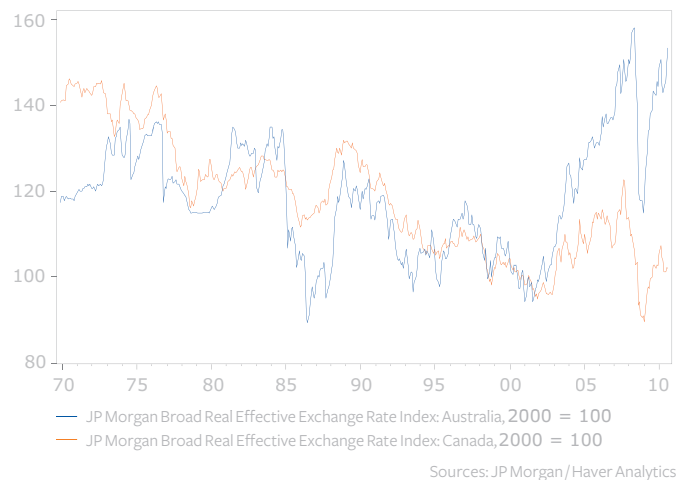
Canada's publicly funded health care system is an important attraction to investors, as it exempts companies from the high health insurance costs they must pay in the United States. Similarly the country has a cost effective education system: 90 research universities with 900,000 fulltime students and 175 colleges with 1,000,000 fulltime students.

Competitive as it is, there are always risk factors for any market. For Canadian companies most of the significant risks are external. These potential risks include the U.S. housing market, deflation, external monetary policies, fiscal austerity and protectionism. Potential concerns also include inflation and stalled production in China.

Notwithstanding these possible risks, Canada represents less vulnerability than virtually any emerging market providing similar investment opportunities and, currently, for those considering Australia as a similar opportunity, the Canadian dollar represents a cheaper alternative (see Graph 3).

So while we are currently slightly overweight in global equities, when it comes to emerging markets, Canadian opportunities may represent a prudent alternative to some emerging market opportunities.

Graph 3: Canadian dollar looks cheap versus Australia (January 2011)



If history is any indicator, emerging markets will undoubtedly remain volatile and their progress will not be straightforward. Nonetheless, the medium term case for continued industrialisation looks unstoppable.

Adding a Canadian equity component to emerging market exposure augments the risk return profile of holding emerging market equities in isolation. In our view, including Canadian equities in an emerging market portfolio will, on a risk adjusted basis reduce the volatility of excess return and increase the risk adjusted Alpha.

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