

Canada's sweet spot

Growth, stability, commodities attract investors

February 4, 2011 – Canada appears once again to be in the proverbial sweet spot for investors. Rising commodity prices, especially crude oil and copper, a surer footing for economic growth in the developed world, and civil strife in Egypt combined to push Toronto's resource-heavy S&P/TSX Composite benchmark index to a 52-week high last week. A rosy November GDP report and a surge in January employment numbers put the icing on the cake.

Reacting to the strong employment report, the Canadian dollar rose to its highest level since May 2008, climbing to US\$1.01 and touching a 52-week high. Statistics Canada reported on Friday that 69,200 new jobs were created in January, more than three times the 15,000 that had been widely expected. Even with a sizable increase in part-time and self-employed workers, the private sector – the real engine of productivity – hired to fill 23,000 new positions, in itself considerably more than the earlier estimates of *total* employment. The unemployment rate ticked up slightly, to 7.8% from 7.6% in December, as the number of Canadians actively seeking jobs rose.

Bolstering the loonie's strength, Canada's gross domestic product grew 0.4% month-over-month in November, as the services sector sprang back to life, growing 0.5% month-over-month, and retail activity grew 1.4%. Notably, oil and gas extraction increased 2.4% in November, while in the mining sector, iron ore extraction surged 10.8% month over month. Expansion in the mining, oil and gas sectors speaks to growing momentum in global growth, with apparently insatiable demand for raw materials from emerging Asia, especially China.

With manufacturing activity gaining strength globally, demand for raw materials like iron ore, to make steel, and copper, to make just about everything else, keeps ratcheting up. In the US, the Institute for Supply Management reported that its manufacturing index jumped to 60.8 in January from 58.5 in December, accelerating at its fastest rate since May 2004. Any reading over 50 indicates growth.

The reports are the same just about everywhere. In the UK, the Markit manufacturing index rose to 62 from 58.7 in December. Its index for the eurozone climbed only marginally to 57.3 from 57.1. And a measure of China's manufacturing activity by HSBC rose to 54.5 in January, also marginally up from December's 54.4 reading. Copper, a main ingredient in manufacturing around the world, rose to a record high of US\$4.54 per pound as a result.

As prices of key metals like copper and iron ore climb to record highs, Canadian miners join Canadian oil and gas companies in growing earnings and rising profitability. Last week, for example, Canada's largest energy company, Suncor Energy Inc., reported almost a three-fold increase in fourth-quarter earnings, year-over-year.

Share prices of all the mining and energy majors have been rising steadily since last July. So much so that the S&P/TSX Capped Metals & Mining Index is up 100% since then – in only eight months. The Capped Energy Index is up about 27% in the same period. And the Capped Materials Index is ahead 37%. Contrast these with the Capped Financials Index, which has lagged these – and the S&P/TSX Composite as a whole – advancing only 17% since last July.

The commodity boom, and attendant beneficial effects for resource economies like Canada's, shows no sign of flagging just yet. The Thomson Reuters-Jeffries/CRB Index of key commodity prices rose to a new high last week, to 341, up 38% since last July. The fly in this particular ointment, however, is inflation. And this will become a growing problem through 2011.

Climbing raw materials prices pushed up a key price index in January – Statistics Canada's Industrial Product Price Index (IPPI) in December. The measure, which charts product prices as they leave the warehouse, was up 0.7% month over month in December, tailing a 4.2% monthly advance in raw materials prices. Those price increases haven't made their way to retail stickers yet. But a growing squeeze on corporate margins makes price pass-throughs inevitable in the not-too-distant future.

Price pressures on various "soft" commodities are already being felt on store shelves, in everything from t-shirts to coffee. Much of that is strictly a function of the supply/demand equation, with La Niña-generated global weather patterns contributing to supply constrictions, while red-hot emerging-market growth continues bolster demand. However, the inflationary effects of two years' worth of money printing by the US Federal Reserve Board and other Western central banks cannot be easily dismissed. At an extreme, pricing pressures lead to shortages and rationing in closed economies, like Egypt's, where the current dictatorship is getting a hard lesson in basic economics.

Inflation is becoming a real problem in the emerging nations, which have started to tighten monetary policy (probably too little, too late), while resisting calls to hobble their appreciating currencies for fear of choking off their export-dependent growth. Central bankers and government leaders from China to the eurozone have raised the red flag over climbing inflationary expectations. However, the US Fed, almost alone, continues to defend its easy money policies, known as "quantitative easing," saying last week, "I think it's entirely unfair to attribute excess demand pressures in emerging markets to US monetary policy." He added that emerging nations have all the tools they need to check excessive demand in their own countries.

In Canada, the headline consumer price index (which measures price levels for all items) rose at an annual 2.4% in December. The "core" rate, which excludes prices of "volatile"

items like food and energy, rose to an annual 1.5%, still below the Bank of Canada's target 2% for inflation. So while inflation is increasingly becoming a factor in analysts' projections, it hasn't yet become a game-changer. Canada's controlled inflation, solid economic growth, and large, liquid resource-based stock market have truly put it in the sweet spot for investors.

For Toronto's S&P/TSX Composite Index, that's meant another week of solid gains. For the week, the S&P/TSX Composite advanced a healthy 2.7%. And in January, the index advanced 0.8% from the year-end close.

In New York, the Dow Jones Industrial Average advanced 2.3% through the first week of February, after closing January with a 2.7% monthly gain. The S&P 500 Composite Index likewise started off February with a 2.7% week-over-week advance, after finishing January ahead 2.3% for the month.■

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