How a Stronger C$ Can Affect You

Paul Harris and Paul Gardner

When thinking about an eighty cent dollar the obvious question comes to mind with regards to your investments. How does it affect me? Well it does affect you, and on many different levels. Let's take a look at the effects a strong Canadian dollar can have.

Currency Effect

Whether you are a large energy firm earning U.S. dollar revenues or a retail investor holding U.S. assets in your RRSP, the strong Canadian dollar has cost you 20%.

From the investing side, there are investors who have been overexposed to the U.S. markets. One of the mechanisms that caused the heavy weighting to the U.S. was the US$ RRSP-eligible funds that allowed investors to be leveraged beyond the 30% foreign content limits. These funds were introduced in the mid-90s in order to capture the euphoric investment wave that was occurring in the U.S. (Remarkably, at its height, Canadians sent over 50 billion dollars southbound—and some economists wonder why the Canadian dollar sold off in that period!)

Whatever your exposure to the U.S. equity market, you generally didn't make money this year. Corporations are facing the same challenge. Any company that sells into the U.S. has to deal with the issue of currency conversion, basically converting a weak U.S dollar to expensive Canadian ones. Unless hedging was established by companies, a loss of 20% to the bottom line is in order.

Which Sectors are most Vulnerable?

With regards to the TSX sectors, the materials and energy sectors are most vulnerable to the conversion effect. Most commodities are priced in U.S. dollars. Whether it is lumber, oil, coal or fertilizer, they all receive most of their revenue in U.S.dollars and convert it back to Canadian dollars. Now, of course, some or all of these firms hedge. But when looking at the corporation in a pure form the conversion must be considered as an added cost.

Now, we never like or dislike a company simply for currency exposure. We must go deeper. The operational side is where the vulnerability of a stronger Canadian dollar lies.

Operational Issues

For a number of years companies never had to worry about being inefficient. Now they have to cut costs aggressively in order to be competitive against their American cousins. Canadian public companies have been slow to make adjustments. The ones that don't will pay the price. The operational margins that have been healthy for exporters will suffer if they don't take action quickly and directly. Already we are seeing it happen with employment for manufacturing. Employment has fallen 3% since last year.

When we look at who is most vulnerable or who will benefit, the conclusion is quite obvious—exporters get hurt and importers benefit. But let's delve into this issue deeper.

The Vulnerable

The material and industrial sectors are the most vulnerable of all the TSX groups. As mentioned before, their resources are sold in U.S. dollars and produced in Canadian dollars (not assuming any hedges or offshore manufacturing, which obviously happens). Already these sectors are hurting from the Canadian dollar's strength. Profits from the material group have dropped 15% from last year's level. Companies, such as Bombardier and Cameco, will face the ongoing challenge of cutting costs. They will have to adjust to the new realities of the day. Another issue for the materials sector is their valuation. The material industry trades at a very expensive forward P/E of 70x and the industrials trade at 30x. The euphoria of the expectation for a rebound in growth from the U.S. is far outweighing any negative effects of the Canadian dollar's strength.

The precious metal group is only slightly affected. As the U.S. dollar falls, gold generally outperforms. This allows gold producers to sell their commodities at a higher price. To offset the higher gold price, gold companies have to convert their U.S. revenue (since gold is priced and paid in U.S. dollars) from weak U.S. dollars to strong Canadian dollars. Therefore, in the end, the gold sector would only benefit slightly.

The energy sector will be hit as well since they have U.S. dollar revenues. We would hesitate to downgrade the sector for this reason though. The sector still trades with the assumption that next year oil will drop to $22 and gas to $3, which we don't believe will happen. Therefore, the sector still is cheap and has other elements of risks to worry about before you start buying or selling oil or gas stocks with just the currency in mind.

The Beneficiaries

Historically, sectors that focus on the consumer and sectors that are domestic-based tend to benefit from a strong loonie. There are two sectors that stand out and for different reasons. The retail sector (consumer discretionary/consumer staples) should benefit from an eighty cent dollar. Most goods are imported from the U.S. or China. Obviously, a Canadian company's purchasing power goes a longer way today. Although we are in a very competitive landscape, there is a chance that their operational margins could increase due to the lower costs of goods bought. Both, HBC and Leon's Furniture come to mind when thinking of companies in the sector that could benefit from a strong Canadian dollar.

Telecommunication firms also would benefit. Most of their purchases are from U.S or Asian manufacturers. Both of these regions are mostly based on the U.S. dollar. As long as there is a Canadian customer at the end of the production process there will be a chance to earn more on sales. We caution and emphasize that in this environment there will be new entrants into the marketplace. As we have found out (and have written in previous articles), it is very difficult to earn excessive margins at the finished goods level.

Both the financial and real estate sectors are somewhat immune to the great foreign exchange question. Both expenses and revenue are generated in Canadian dollars. The one advantage that is obtained for these sectors is once again purchasing power. These sectors might actually be able to competitively bid for U.S. assets. One of the large group advantages is that instead of being the pursued, we will be the pursuer. With the Canadian dollar strong, mergers and acquisitions will reverse itself. Instead of Americans buying our assets, we will be buying their assets.

Overall

When we make decisions with regards to our client's portfolios, the foreign exchange effect is one of the last pieces of information that we consider. As in everything, when relating to investment analysis, this issue must be taken in context of the overall fundamentals of the company in question. A company in a bad business, with or without a cheap loonie, can only survive so long. Over the long run, if a company can not adapt to changing market conditions, then the company will become another casualty of a badly executed business plan.

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MoneySaver Events

The activities listed here are those attended by Dale Ennis and other *MoneySaver* staff. *MoneySaver* does not make transcripts available for any of its conferences.

➢ Our search for a conference facility in Wexford, Ireland is complete. There is nothing acceptable to us at a reasonable rate.

Therefore, we have turned our attention to the Dublin area. A lot more choice with comfortable access from the Dublin airport makes it attractive.

The Irish hosts are reluctant to make arrangements with a private Canadian company outside the travel industry. Consequently, we have approached tour companies for our conference needs. Since they can "buy in bulk", we expect to negotiate an affordable deal with them.

The conference dates appear to be narrowed down to September 4th or 5th to September 7th or 8th inclusive. Other special tours will be made available before and after these dates.

We will announce the details on these approved packages in the next edition.

For Your Interest

Name	% Ret Dec03	YrEnd Dec02	5 Yr Ret	Quart Dec03	YrEnd Dec02
TSX Communications & Media	22.5	-27.2	0.5	1	4
TSX Conglomerates	25.4	-4.9	15.6	1	2
TSX Consumer Products	9.7	-27.7	4.8	3	4
TSX Financial Services	27.3	-2.9	11.7	1	2
TSX Gold & Precious Metals	18.2	27.2	5.9	1	1
TSX Industrial Products	40.8	-50.4	-10.6	1	4
TSX Merchandising	19.4	0.2	7.5	1	1
TSX Metals & Minerals	55.1	-4.9	16.1	1	2
TSX Oil & Gas	25.0	13.7	23.3	1	1
TSX Paper & Forest Product	-2.0	3.1	8.4	4	1
TSX Pipelines	28.4	11.0	12.0	1	1
TSX Real Estate	44.1	-7.6	8.3	1	2
TSX Transport & Environment	24.9	-7.4	7.2	1	2
TSX Utilities	17.2	-15	11.7	2	3
S&P/TSX 60	25.5	-14.0	5.9	1	3
TSX 100	26.8	-13.3	6.1	1	3
TSX 200	26.4	-6.5	10.0	1	2
TSX 35	25.0	-17.4	10.3	1	3

Data as of December 31, 2003
Source: Morningstar Canada, 800-531-4725