RBC Global
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Economic Compass

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HIGHLIGHTS

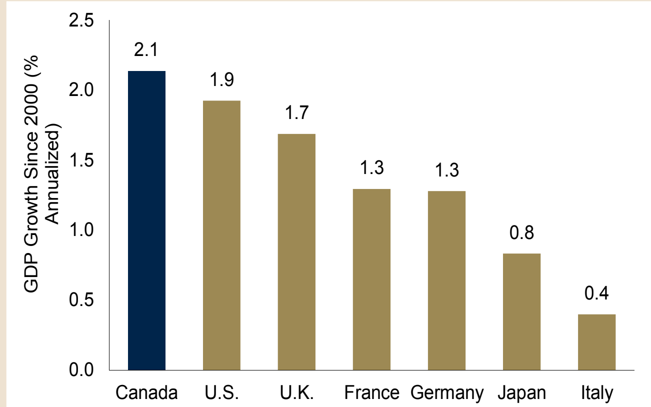
- Much of the developed world now basks in reviving growth forecasts, whereas Canada is less obviously on the ascent.
- We believe Canadian growth will disappoint markets for seven reasons.
- Among them are obvious constraints such as Canada's still unresolved housing overhang and chronic uncompetitiveness, and rather subtler ones having to do with a missing output gap and deteriorating terms of trade.
- Certainly, it isn't all bad news for Canada given promising exports, stimulative monetary policy and a falling currency.
- But the key message is that Canada's economic soft patch has merely been delayed rather than avoided, and that equity portfolios should thus remain moderately underweight the country.

TATTERED MAPLE LEAF

Since the global financial crisis struck, Canada has rightly been heralded as a flag bearer for economic resiliency. Relative to its peers, the country's banks and housing sector were more steadfast, its economy and workforce shrank less, and its central bank managed to avoid the temptation of quantitative easing. Stretching even further back – to the turn of the millennium – the Canadian economy has experienced the fastest growth in the G7 (Exhibit 1) and its stock market has materially outperformed.

However, this glowing narrative is starting to lose its sheen. Today, most of the developed world basks in reviving growth forecasts, whereas Canadian growth prospects have become somewhat tattered. We see seven key factors that will constrain Canadian growth over the coming few years, ultimately disappointing market expectations.

Exhibit 1: Canada had the fastest growth among G7 countries



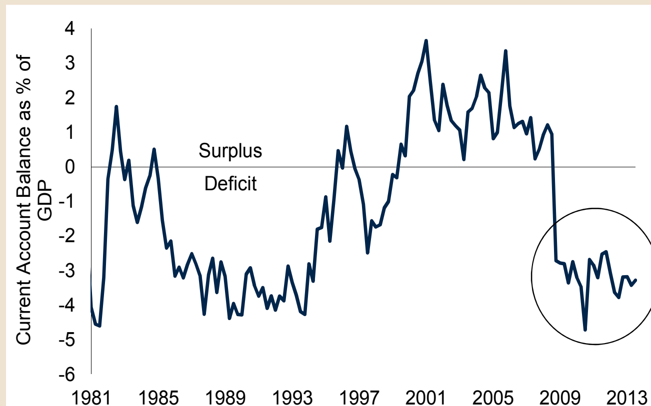
Note: GDP growth from year 2000 to 2012 annualized. Source: Haver Analytics, RBC GAM

1) Living large

The first problem is Canada's newfound penchant for living beyond its means, as conveyed by a large current-account deficit equal to 3.3% of GDP (Exhibit 2). Recent readings have been the loftiest in 20 years, bringing bad memories of an era that ultimately necessitated a downgrade to Canada's sovereign-debt rating. For international context, Canada's current-account deficit is now larger than the U.S. and a host of other nations (Exhibit 3).

In plain English, this means that Canadians buy a substantial \$65 billion more per year of goods and services than they produce. This is sustainable so long as foreigners are willing to continuously lend more to Canada, but it is not an optimal position to be in. Over time, some of the shortfall should be

Exhibit 2: Canada now in current account deficit



Source: Statistics Canada, Haver Analytics, RBC GAM

erased as foreign demand revives, but the rest will have to occur via spending restraint.

2) Missing output gap

Most of the world's developed nations can look forward to a period of outsized growth sometime over the next several years as their economies gain traction and begin to eat into the yawning gap between their actual output and their full potential.

In contrast, Canada won't benefit as much from this effect.

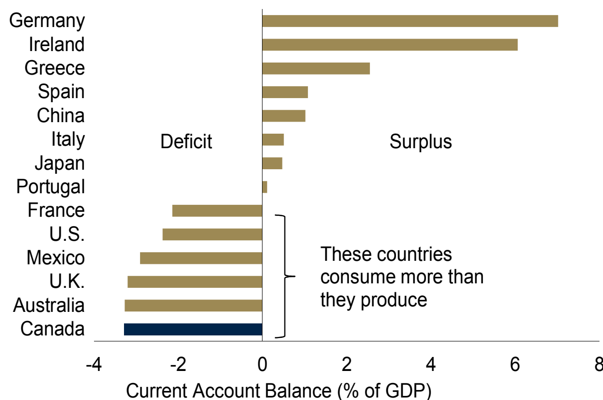
The standard claim is simply that Canada has less economic slack than most. The Bank of Canada figures that Canada's output gap is -1.5% of GDP, whereas the U.K. output gap is -2.7% and the U.S. is -3.5% (Exhibit 4).

We subscribe to a bolder version of this argument, in the belief that Canada's output gap is even smaller than the Bank of Canada thinks. Several clues hint at this. The central bank's own *Business Outlook Survey* now suggests that firms are facing the most difficulty meeting demand since before the global financial crisis struck, and that they are also confronting growing labour shortages.

Providing further evidence, Canada's official 6.9% unemployment rate slides to just 5.9% when adjusted for the aging population. This arguably puts the labour market past "full employment" (Exhibit 5).

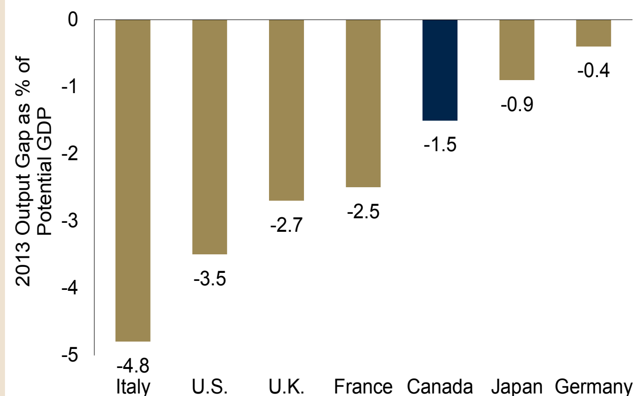
The counterpoint – that capacity utilization rates have not yet themselves reached prior norms – is less damning to this argument than it seems since the intensity of factory usage has been on a declining trend for more than a decade (Exhibit 6). Presumably, this is due to some combination of globalization, technological change and inferior Canadian competitiveness. It is not hard to imagine that many shuttered factories will never reopen, and thus that current capacity utilization rates could already be near normal.

Exhibit 3: Canada's inferior current account balance



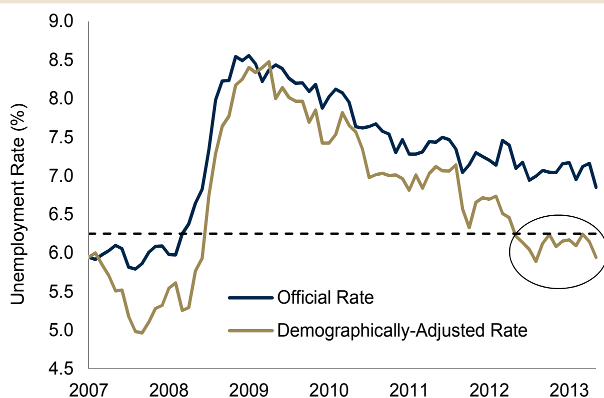
Note: Based on latest data available. Source: Haver Analytics, RBC GAM

Exhibit 4: Canada has relatively little slack



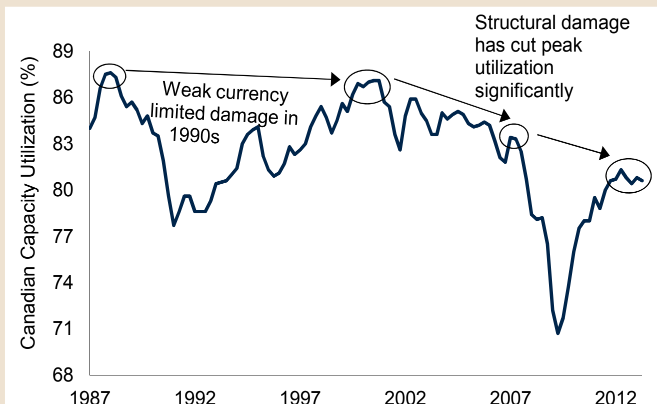
Note: BoC estimate for Canada, RBC GAM for U.S. and IMF for all others. Source: Bank of Canada (BoC), IMF, Haver Analytics, RBC GAM

Exhibit 5: Canada's demographically-adjusted unemployment rate is already normal



Note: Adjusts for aging population via lower unemployment rate and participation rate. Source: Haver Analytics, RBC GAM

Exhibit 6: Normal capacity utilization rate in structural decline



Source: Statistics Canada, Haver Analytics, RBC GAM

Stitching these threads together, our output gap model calculates that Canada's economy could even be performing beyond its sustainable potential (Exhibit 7). This may be a bit too bold, particularly given lingering evidence of labour-market damage.[1] Our working assumption is that a slight output gap of -0.5% exists.

What does this imply? It is unambiguously a sign of success that the Canadian economy now operates near its full potential. But, by extension, this leaves less room for the economy to grow and financial markets to rise in the future. It also hints that the threat of inflation is less distant than it seems.

3) Eventual housing weakness

For several years, Canada's housing market has repeatedly defied expectations for a serious swoon. Maddeningly (at least for those long prophesying doom), the latest data shows that activity has actually begun edging higher once more.

Past sources of strength

The root cause of this persistent buoyancy is not actually much of a mystery. Canadian borrowing costs have been quite cheap, paired with good access to credit. On the global stage, this has been a rare combination. Most countries have long been able to claim the first attribute, but few were able to claim the second until quite recently. The handful of countries that managed to deliver on both – including Australia, New Zealand, Norway, Sweden, Singapore and Hong Kong – experienced rousing housing booms. Given the imperative of maintaining lower rates, the natural government response has been to cool housing with repeated volleys of macroprudential reforms. As a general rule, each set of reforms has impeded the market's ascent for a handful of quarters before fading into the background.

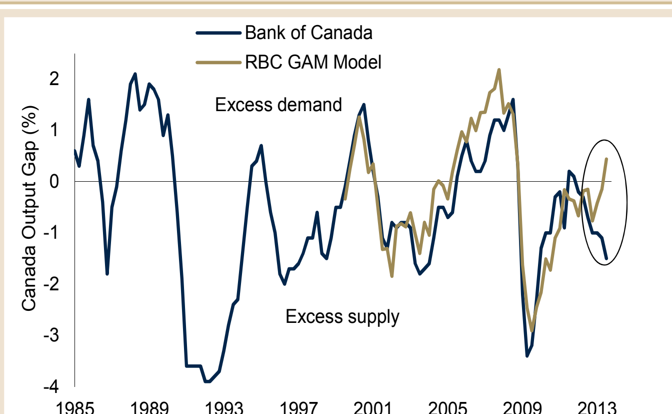
A superficial look at Canada's housing market reveals little to get worked up about (Exhibit 8). Housing starts are only slightly elevated,[2] inflation-adjusted residential investment is a normal share of GDP (Exhibit 9)[3], housing affordability is fine (Exhibit 10) and household credit growth has slowed to a normal clip (Exhibit 11).

Future sources of weakness

A closer examination, however, reveals two important caveats.

First, housing affordability is only normal because borrowing costs are historically low. As global bond yields rise and the Bank of Canada eventually lifts its overnight rate, affordability

Exhibit 7: Canada may have less slack than Bank of Canada thinks



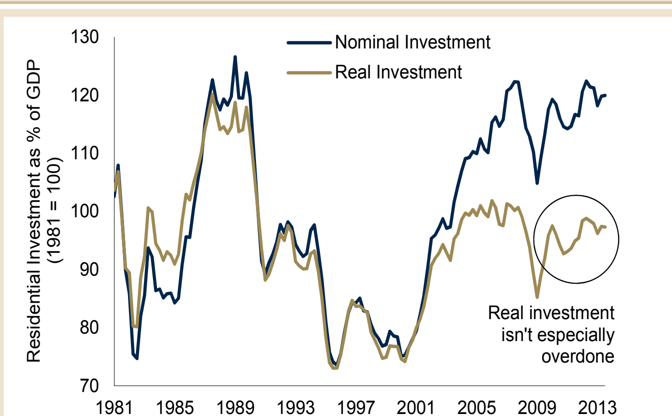
Source: Haver Analytics, RBC GAM

Exhibit 8: Canadian housing scorecard

	Activity	Price	Credit
NOW	Slightly above normal	So-so affordability	Already slowed
NEXT FEW YEARS	Moderate decline likely	Deteriorating affordability	Remain subdued

Note: Non-financial corporations only. Y-axis in logarithmic scale.
Source: BEA, Haver Analytics, RBC GAM

Exhibit 9: Diverging nominal and real residential investment



Source: Statistics Canada, Haver Analytics, RBC GAM

[1] The fraction of involuntary part-time workers is still high, as is the average duration of unemployment.

[2] It is an open question whether the cumulative construction over the past decade has oversupplied the market, but we believe it has mostly just served to offset underbuilding in the 1990s.

[3] In contrast, nominal residential investment is at an elevated share of GDP, but this is due to higher home prices, which are addressed later in the report.

will deteriorate, squeezing prices.[4] This is already becoming relevant, but shouldn't fully bite for another year or two.[5]

The second caveat is more immediately relevant. Although housing starts are only slightly elevated, the backlog of condominiums currently under construction is unprecedented, and bears a disturbing similarity to the construction excesses of the late 1980s in the single-family sector that presaged a drawn-out bust through the 1990s (Exhibit 12). In all, we figure there are 65,000 too many condos currently under construction across the country.

[4] Housing reversals are often sharper than expected, in part because valuations during booms were supported by unusually good liquidity and the pulling forward of household formation. As these two trends revert to normal, they reduce the fundamental fair value of a home.

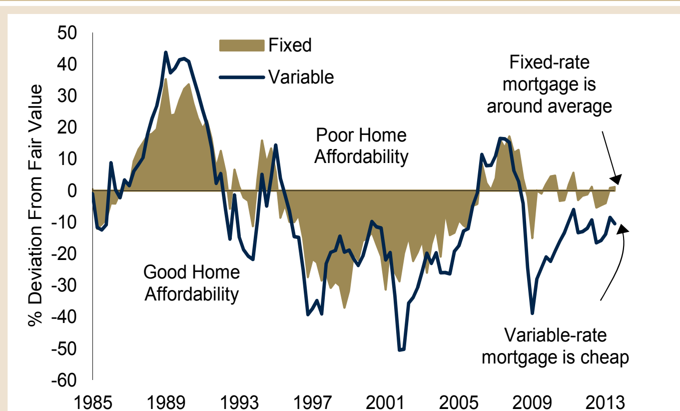
[5] Moreover, a higher rate environment may eventually reveal that some of the macroprudential reforms that have to date been jury-rigged to keep housing from wafting too high are excessively draconian at normal rates. Given that macroprudential rules are not meant to be tweaked regularly across the business cycle, policymakers will be reluctant to unwind such changes. In turn, the housing correction may ultimately be harder than it has to be.

What of the argument that the apparent condo excesses are simply the result of a shift in buying preferences due to downsizing baby boomers, delayed childbearing and a backlash against suburbia by those fed up with high gas prices and chronic traffic? There may be something to this, but it can't fully explain the speed at which the excess has formed, and for that matter this explanation would simply transfer the overbuilding into the single-family sector.

There are two possible outcomes to this period of overbuilding. One is that the bulge of new units could hit the market all at once, causing serious indigestion, substantially weakening condominium prices and curbing construction for several years.

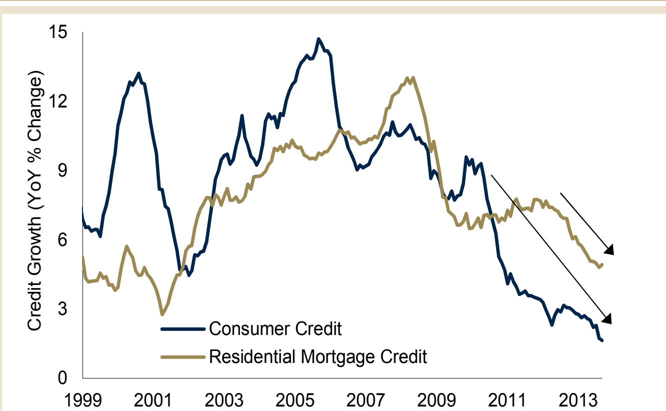
The second scenario is tamer, acknowledging that builders recognize the construction excesses in their midst and furthermore that demographic trends will become less friendly in the coming years (Exhibit 13). Builders could continue to drag

Exhibit 10: Canadian housing affordability



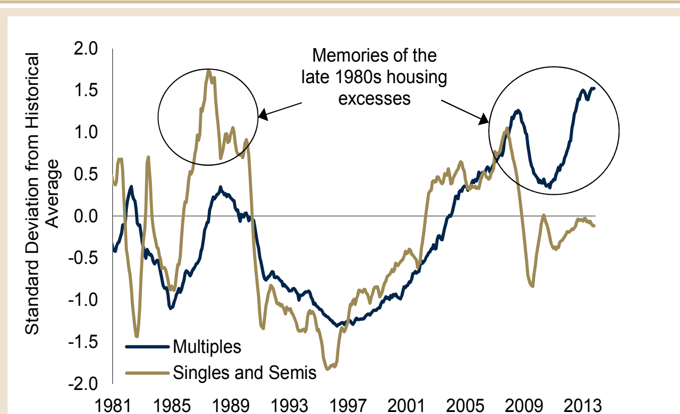
Note: Calculates the current carrying cost of a home versus the historical norm. Source: CREA, Statistics Canada, RBC GAM

Exhibit 11: Canadian credit growth decelerates



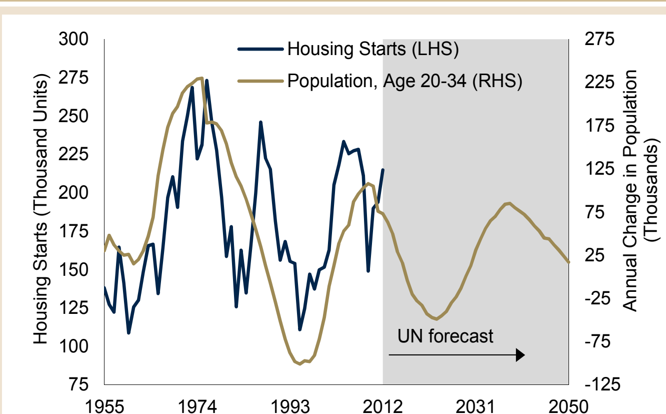
Source: Bank of Canada, RBC GAM

Exhibit 12: Glut in Canadian multi-unit housing market



Note: Dwellings under construction per 100,000 people, adjusted for population over 25 years of age. Multiples include row houses, condominiums and other. Historical average since 1976. Source: CMHC, Statistics Canada, Haver Analytics, RBC GAM

Exhibit 13: Housing starts should ebb over long run



Source: CMHC, United Nations, Haver Analytics, RBC GAM

their heels to help smooth the absorption of all these units. In so doing, they may manage to avoid substantially weaker prices at the cost of scrubbing future construction projects.

In both scenarios, less construction activity translates into a material drag on economic growth.

4) Credit constraint

Canada's household credit growth has already shrunk by two-thirds from its peak, to just 3.9% per year, nearly the slowest in three decades. However, personal incomes are rising at an even more sluggish 3.2%, meaning households are technically still leveraging up despite an elevated household debt ratio (Exhibit 14).

Aggravating matters, there remain pockets of ebullient household credit growth – most notably, the value of car loans is rising at an eye-watering 18% per year (Exhibit 15).

In this context, household credit is unlikely to reaccelerate, and may even slow a hair further. While this is welcome news from a debt vulnerability perspective, it nevertheless imposes a cap on consumer spending[6] and thereby on economic growth.

5) Business reluctance

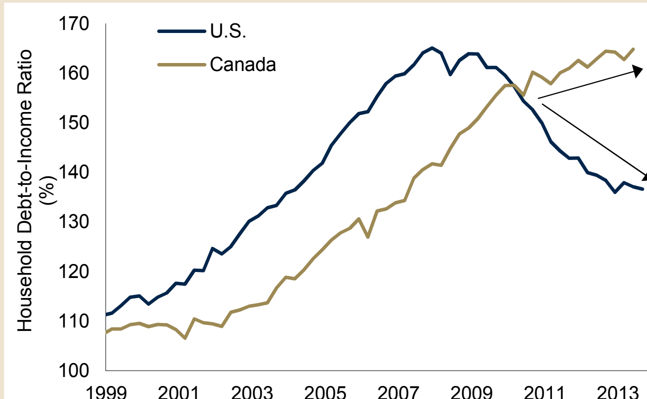
The Bank of Canada anticipates a material uptick in business investment to assist in Canada's economic revival. This is possible, but its extent may disappoint.

For all the talk of a corporate cash hoard waiting to be unleashed by better economic times, Canadian firms haven't actually accumulated any cash or net financial assets since the financial crisis struck. Moreover, the pre-existing cash holdings at resource firms are arguably necessary given the speculative nature of their business and the mismatch of highly variable revenues against large, lumpy expenditures.[7]

Canadian surveys of intended capital investment continue to blink yellow. Most prominently, the Bank of Canada's *Business Outlook Survey* shows subdued investment intentions over the next year (Exhibit 16). Perhaps this should not be surprising given that corporate profits are down in five of the last seven quarters.

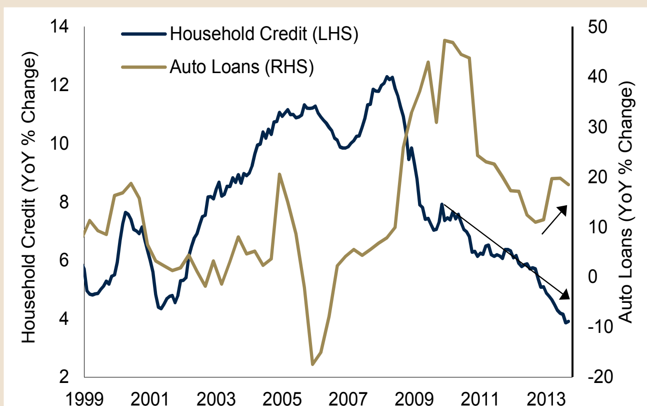
From a mean-reverting perspective, Canadian capital investment as a share of GDP is already elevated relative to its historical norm (Exhibit 17) and also relative to other countries (Exhibit 18). Furthermore, a disproportionate fraction of the existing investment is in "engineering structures," much of which occur

Exhibit 14: Canadian household leverage remains high



Source: Haver Analytics, RBC GAM

Exhibit 15: Canadian household credit declining but auto loans tick back up



Source: Bank of Canada, Statistics Canada, Haver Analytics, RBC GAM

Exhibit 16: Canadian business investment plans continue to slide

Source: Bank of Canada Business Outlook Survey, Haver Analytics, RBC GAM

[6] The outlook for modest consumer spending growth is also influenced by slow personal income growth, mixed home prices and an underperforming stock market.

[7] For more details, refer to Appendix A of an earlier *Economic Compass* entitled "Deconstructing the Great Cash Hoard."

in the now-faltering resource patch. There is the distinct risk that these measures ease down to more historically normal levels.[8]

On the subject of commodities, resource firms across the globe are increasingly expressing regret over the extent of their capital expenditures in recent years given faltering emerging market growth and weaker commodity prices (Exhibit 19). Many plan to temper their future actions:

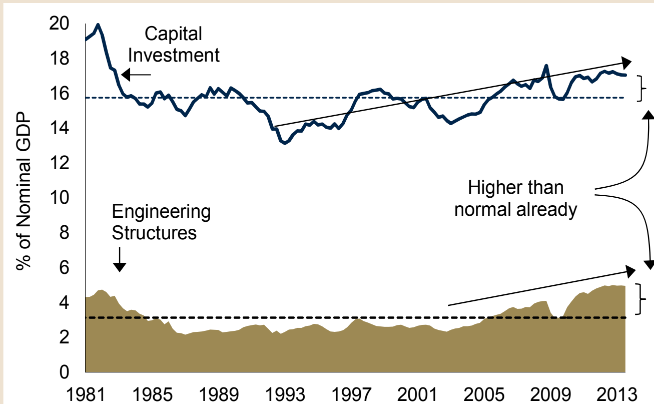
- **Global mining:** The consensus expectation for global mining capital expenditures is for a 10% decline in 2014 and a further 12% decline in 2015. BHP Billiton and Rio Tinto – the world's two largest miners – have announced plans to cut capital spending by an even greater 30% to 40% over the next two years.
- **Global oil:** Company filings show that global oil companies plan to increase their capital expenditures by a tame 3.6% in 2014.
- **Gold:** The swoon in gold prices over the past year hardly argues for robust investment, especially given how close prices now sit to the marginal cost of extraction.

There is also a Canadian-specific refrigerant to the resource chill. Canada remains among the highest cost producers of oil,[9] and declining oil prices are making new investments less urgent. Furthermore, the attraction of Canada's stable governance and good infrastructure – while legitimate – has weakened. On the former, strict (yet vague) new rules around the involvement of foreign state-owned enterprises (SOE) in Canadian businesses have essentially halted all new SOE investment. Between 2005

[8] It should be acknowledged that a high level of investment could bode well for Canada's long-term productivity growth, but this is of limited relevance over the next few years.

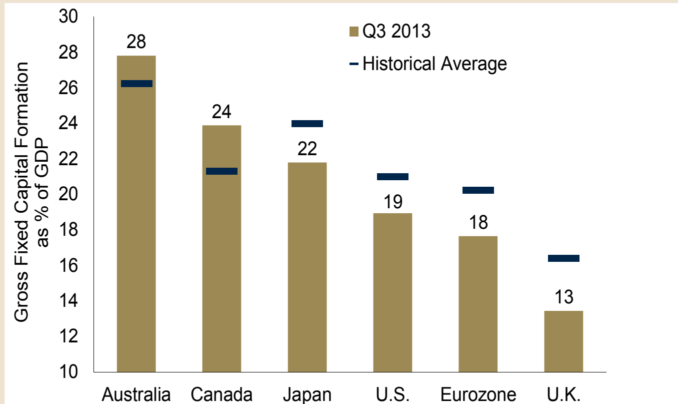
[9] The oil price required to provide a sufficient return on capital to justify a project depends enormously on whether the oil is extracted via conventional means, from offshore rigs, or via steam-assisted gravity drainage (SAGD), cyclical steam stimulation (CSS) or hydraulic fracturing.

Exhibit 17: Capital investment is already high versus history



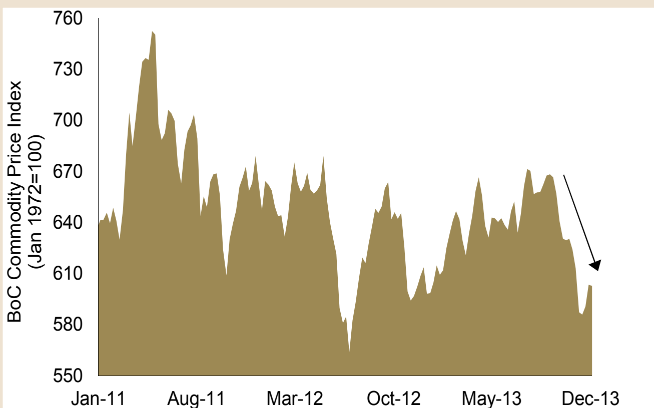
Note: All data are nominal. Capital investment excludes residential investment. Historical average since 1981, shown as dotted line in chart. Source: Statistics Canada, Haver Analytics, RBC GAM

Exhibit 18: Canadian capital investment high versus others



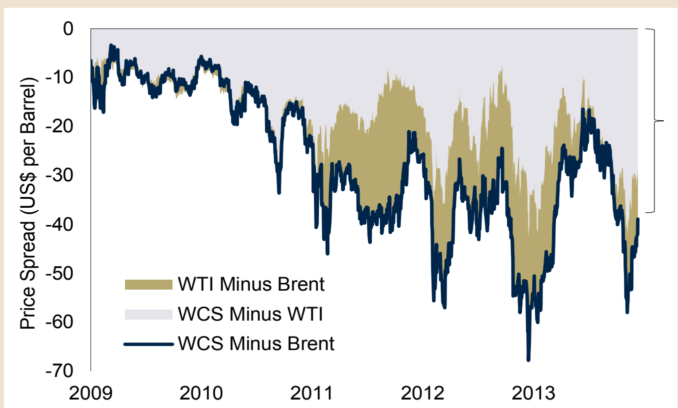
Note: Historical average since 1995 for Eurozone, 1993 for all other countries. All data are nominal. Q3 2013 numbers shown in chart. Source: Haver Analytics, RBC GAM

Exhibit 19: Lower Canadian commodity prices limit investment intentions



Source: Bank of Canada (BoC), Haver Analytics, RBC GAM

Exhibit 20: Canadian oil prices depressed



Notes: Price spreads between Western Canada Select (WCS), West Texas Intermediate (WTI) and Brent crude oil. Source: Bloomberg, RBC GAM

and 2012, this had driven an average of $5 billion per year of foreign investment into Canadian oil and gas alone. On the latter, transportation challenges have again intensified in the oil and gas sectors. This infrastructure shortfall is significantly depressing Canadian prices below the global norm (Exhibit 20), discouraging investment.[10]

Certainly, many businesses – including resource firms – will continue to invest heavily in Canada, but the prospect of a substantial acceleration in capital expenditures seems unlikely.

6) Lack of competitiveness

One of the silver linings of the global financial crisis was the way it allowed the worst-hit countries – the U.S, most prominently – to press the reset button. In shorthand, inefficient firms and reckless banks were driven out of business, under-producing workers were shed from the private and public sectors alike, and costs were trimmed. This purge has made the affected countries leaner, more competitive and better positioned for growth.[11]

However, because Canada's recession was far shallower, it was never forced to make as many tough decisions. In turn, Canada finds itself with a comparatively bloated business sector that struggles to keep pace.

Compounding this challenge, Canada was already losing competitiveness before the financial crisis struck. Since 2000, the combination of a stronger currency and inferior productivity growth has elevated the effective cost of Canadian labour by a stark 53% relative to the U.S. (Exhibit 21). This is evident in a spate of plant closings that continue to this day.

[10] We don't seriously doubt that pipelines will eventually be built and that rail shipments will be made safer, but this takes years to accomplish.

[11] It certainly bears acknowledging the negative aspects to this, including increased bankruptcies, increased unemployment and subdued wage growth.

As we detailed in an earlier *Economic Compass* entitled "Shrugging Off Canada's Competitiveness Shortfall," it is surprisingly difficult to pin blame for the poor productivity. Canada's labour quality is not obviously lower than the U.S., its capital intensity is no worse and its public policy is mostly good and improving.

In the end, blame must go somewhere, and plausible explanations range from the fact that resource-rich countries often suffer inferior productivity growth, to the recent discovery that countries with higher levels of population growth (such as Canada, via immigration) tend to experience lower productivity growth, to the fact that a thinly populated country does not enjoy the same economies of scale as a behemoth like the U.S., to Canada's perverse tax incentives that keep (inefficient) small businesses small.

With the exception of the Canadian dollar's strength (more on that shortly), few of these hindrances are about to vanish. As a result, Canadian competitiveness and productivity are likely to lag, with the implication that Canada's potential growth rate will remain lower than the U.S.

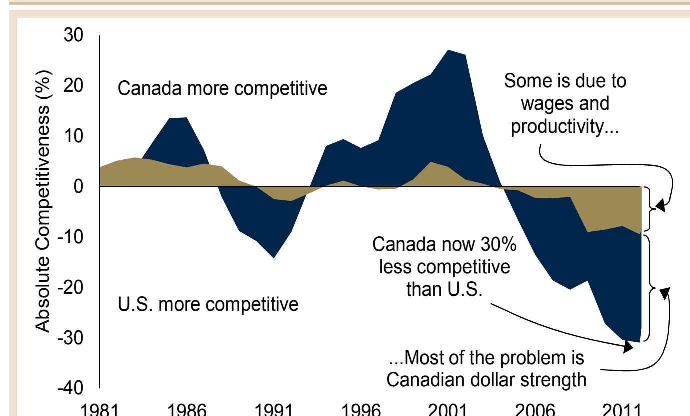
7) It'll feel even worse

How do we reconcile the notion that the Canadian economy may noticeably underperform the U.S. over the next few years with evidence that the two have historically experienced strikingly similar trajectories (Exhibit 22)? There are two answers.

First, although both countries generally experience a similar business cycle rhythm, their growth rates nonetheless diverge by a percentage point or more about 40% of the time.[12] Thus, our forecast that Canadian GDP growth of 2% in 2014 will underperform the U.S. by 0.75% is not a particular stretch.

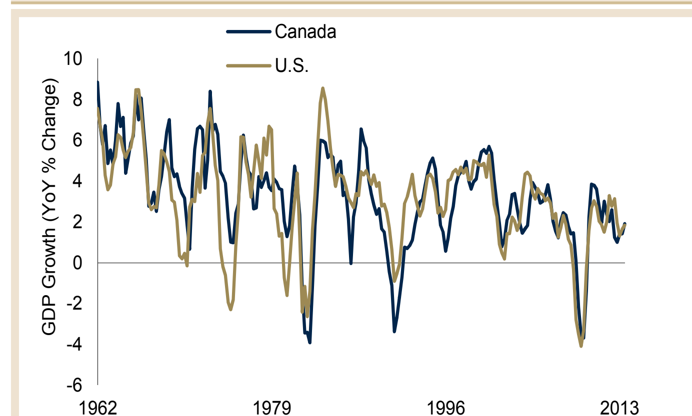
[12] Since 1990.

Exhibit 21: Canada-U.S. economic competitiveness



Note: Absolute Competitiveness calculated as currency-adjusted unit-labour cost ratio between Canada and the U.S versus the average relationship from 1981 to 2012. Source: RBC GAM, Haver Analytics

Exhibit 22: Canada and U.S. have similar growth trend



Source: Statistics Canada, Haver Analytics, RBC GAM

Second, this 0.75% GDP gap will feel worse than it looks to the average person. Real GDP fails to capture "terms of trade" effects, such as the advantage Canada has enjoyed in recent years via high export prices (thanks to elevated commodity prices) and low import prices (thanks to a strong currency). This has allowed Canada to import more things in exchange for what it exports.

Gross domestic income (GDI) ably layers the terms of trade atop GDP. Since 2000, GDI growth has outpaced GDP by a cumulative 4.2 percentage points (Exhibit 23), helping to explain why Canada felt so much better than the GDP numbers ever supported. Unfortunately, a reversal now looks to be underway. Commodity prices are down and the futures market looks for a further decline. The Canadian dollar has recently slipped and we expect a further drop to 92 U.S. cents. GDI will accordingly suffer, and so the Canadian economy should feel worse than the official figures indicate.

Offsets

These seven challenges are entirely real, but dwelling exclusively on them provides somewhat of a funhouse mirror perspective of the Canadian economy. After all, there are few signs that the Canadian economy is plunging lower right now.

Why is this? The answer is that partial offsets come in the form of rising exports, accommodative monetary policy, a weakening currency and a superior fiscal position. Let us evaluate these.

Rising exports

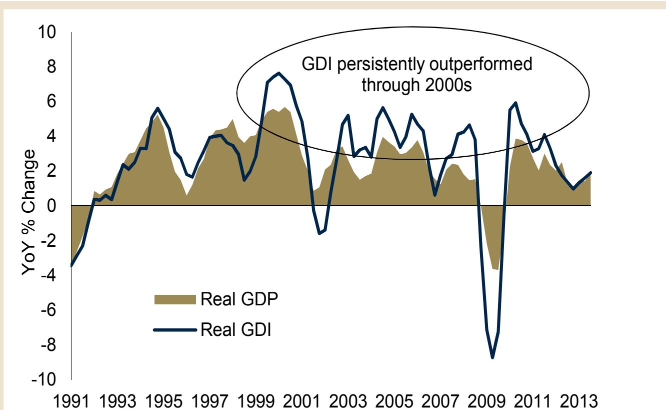
The one genuinely exciting part of the Canadian economy is the export sector. The volume of Canadian exports is already trending higher, with room for more as global demand gears up. We forecast developed world demand will double to 2% in 2014. And though emerging market forecasts are being downgraded left and right (and for that matter we maintain a below-consensus view), these nations still look to improve on the *annus horribilis* that was 2013. All of this should benefit Canadian exports.

There is even reason to think that Canadian exports could do a little better than a simple global uptick would suggest since they have underperformed relative to the Bank of Canada's U.S. activity index (Exhibit 24). Tilting exports toward Asia also holds some promise, even if success will be measured in decades rather than years (Textbox A).

On the other hand, export enthusiasm should not be blown out of proportion. The volume of Canadian exports is little higher today than at the turn of the millennium (Exhibit 25). Export growth is not automatic.[13]

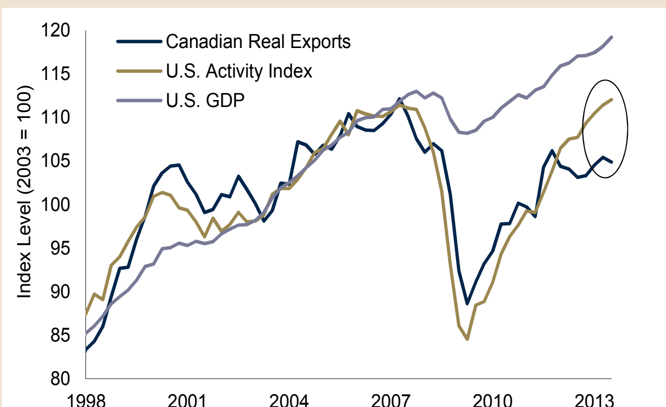
[13] The combination of inferior productivity growth, globalization and a rising Canadian dollar arguably explain this long stagnation. This last variable may finally be reversing, suggesting potentially better prospects ahead.

Exhibit 23: Canadian GDI should roll over in future



Note: GDI more closely approximates how the economy feels to businesses and households by reflecting the benefit derived from higher export prices and lower import prices, in addition to the usual GDP calculations. Source: Statistics Canada, Haver Analytics, RBC GAM

Exhibit 24: Linking Canadian real exports to U.S. economic activities



Note: U.S. Activity Index constructed using U.S. data including GDP, personal expenditures on goods, residential construction, investment in machinery and equipment, industrial production, motor vehicle production and motor vehicle sales. Source: Bank of Canada, Haver Analytics, RBC GAM

Exhibit 25: Exports volume has improved since Financial Crisis but only back to year 2000 level

Note: Monthly exports shown in chart. Source: Statistics Canada, Haver Analytics, RBC GAM

Finally, recall that our key argument is simply that Canada's economy will underperform its peers, not that it will fail to improve. In fact, any upside surprise to global growth would add to our conviction since only a fraction of the extra growth would land on Canadian shores, leaving Canada even further behind.

Stimulative monetary policy

It is easy to lose sight of the fact that the Bank of Canada is still generating sizeable monetary stimulus via its 1% policy rate, simply because the U.S. and other major central banks have done even more. The central bank's recent shift down to a neutral bias reiterates this. The efficacy of that stimulus has diminished somewhat as global yields have risen, but financial conditions are still good, and the stimulus has been delivered as much through a weaker currency (discussed next) as through interest rates.

As to the outlook for the Bank of Canada, although we calculate there is materially less economic slack in Canada than the central bank does, our subdued growth forecast offsets this view, permitting the existing monetary stimulus to remain in place well into 2015.

Soft currency

Currencies act as shock absorbers. When a country's economy outperforms its peers – as Canada did for several years – its currency frequently rises, tempering the extent of the outperformance. In a nutshell, this explains the Canadian dollar's relentless strength since the turn of the millennium.

As the Canadian economy now begins to underperform, the currency has begun to depreciate. Other factors support this trend, such as increasingly accommodative monetary policy and lower commodity prices. The weaker loonie, in turn, should help contain Canada's economic underperformance. As the Canadian dollar makes its way below 95 cents, auto-making costs in Canada are starting to come back in line with those in the U.S.

Fiscal flexibility

Canada's fiscal deficit is smaller than most of its peers, as is its net public debt load (Exhibit 26). Unquestionably, this represents a Canadian advantage, and a source of stability.

However, the advantage is not especially great over the next few years. In fact, a key new lift for the U.S. in 2014 is its fading fiscal drag. But Canada never slogged through all that much fiscal drag to begin with, leaving it less able to capitalize on this effect.

Furthermore, for all the virtue of a low public debt load, borrowing costs remain sufficiently low that it will be a smaller than usual advantage from a debt servicing perspective for several years to come.

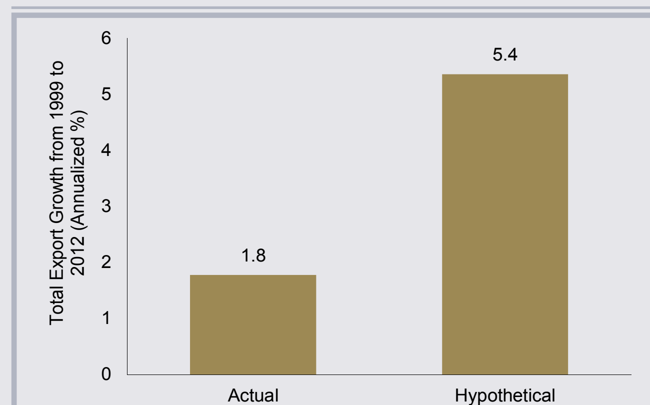
TEXTBOX A: CANADA'S ASIAN PROSPECTS

It is striking how much rosier Canada's trade picture would be if the country had managed to harness Asian growth as effectively as Australia. We calculate that if each of Canada's export sectors had grown at the same rate as their Australian counterpart, overall exports would have expanded three times more quickly since 1999 (Exhibit A).

Promisingly, there is evidence that Canada is starting to tilt the destination of its exports in this direction, which should enable structurally faster export growth over time.

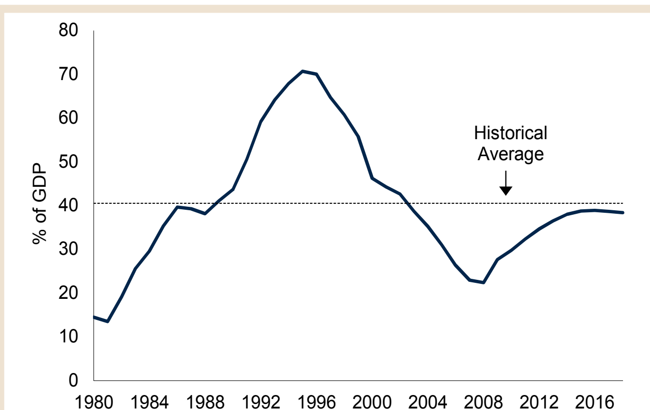
However, it takes time to shift export orientations like this. This is doubly true for Canada given the complication of the Rocky Mountains, limited west coast port facilities and the enormous Pacific Ocean. Expanding exports to Asia will not happen quickly, and so this shift is of limited consequences for Canada's outlook over the next few years.

Exhibit A: Geography constrains Canadian exports



Note: Hypothetical rate is derived by applying growth rates of Australian exports by commodity to Canadian commodity export shares since 1999.
Source: Haver Analytics, RBC GAM

Exhibit 26: Canada: General government net debt



Note: Historical average since 1980. Numbers after 2012 are IMF forecast.
Source: IMF, RBC GAM

All together now

While the Canadian economy isn't likely to grow particularly quickly over the next few years, some solace can legitimately be found in the formidable buffers that at least protect against a severe economic downturn. Unlike many countries, Canada still has ample room to deliver monetary stimulus and/or fiscal stimulus in a pinch, and its currency could decline appreciably without being undervalued.

Investment implications

How should investors handle Canada's tricky situation? Some caution is certainly apropos, and we continue to believe that Canada warrants a moderate underweight in equity portfolios. But the Canadian market certainly shouldn't be abandoned altogether, for four reasons:

First, domestic economic trends are of surprisingly limited importance for Canadian financial markets. Global developments dominate. We calculate that 98% of the movement in Canada's 10-year yield and at least 70% of the movement in the TSX can be explained by international rather than domestic developments.[14]

Second, it can be perfectly justifiable to invest in a country even when economic prospects are less than good. For the bond market, sluggish growth can actually be something of a sweet spot: too weak for government bonds to sell off, and too strong for credit spreads to push wider. For stocks, some global investors may desire exposure to a particular mix of sectors, such as the Canadian index's heavy tilt toward financials and resource stocks. Alternately, they may recognize that many of Canada's large companies are well run and enjoy attractive returns on capital.

Third, it must not be forgotten that a geographically diversified investment portfolio requires some exposure to one's home market, too. In fact, this domestic exposure should arguably be disproportionate to the home market's size given the advantage that comes from eliminating currency risk and paying favoured tax rates.[15] For Canadians, this means retaining some exposure to Canada.

Fourth, markets are forward-looking. They have already anticipated a fair chunk of this economic weakness story, as demonstrated by a 47-percentage-point underperformance in Canadian stocks and a 25-basis-point outperformance in the 10-year bond yield over the past three years.

The relevant question, then, is whether the Canadian market has conceded enough to constitute good value. Here, the evidence is distinctly mixed. Recall, for instance, that despite their recent underperformance, Canadian equities have still outpaced the U.S. by 35% since the turn of the millennium. With the maple leaf set to remain somewhat tattered over the next few years, we believe it is still premature to scale back to a full Canadian equity allocation. But let us not forget that by virtue of the relentlessly forward-looking nature of financial markets, the time for renewed investment in Canada will come far in advance of any turn in the economy itself.

[14] The bond market figure is based on a simple model that explains Canadian yields using the 10-year bond of 10 other countries. The equity market figure is based on a simple model that explains Canadian equity movements using the U.S. S&P 500 and commodity prices (which are arguably set on the global stage).

[15] A further reason is the patriotic virtue of allocating capital to one's home country in the hope of helping the economy.

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