



## Oil Prices and Canadian Versus World Stocks

Investors around the world were understandably concerned about the move in oil prices to the \$60 US a barrel level in late June. For virtually everyone except energy producers, the recent price action must be considered bad news for a simple reason: high oil prices act as a tax on consumers and businesses and are likely to slow

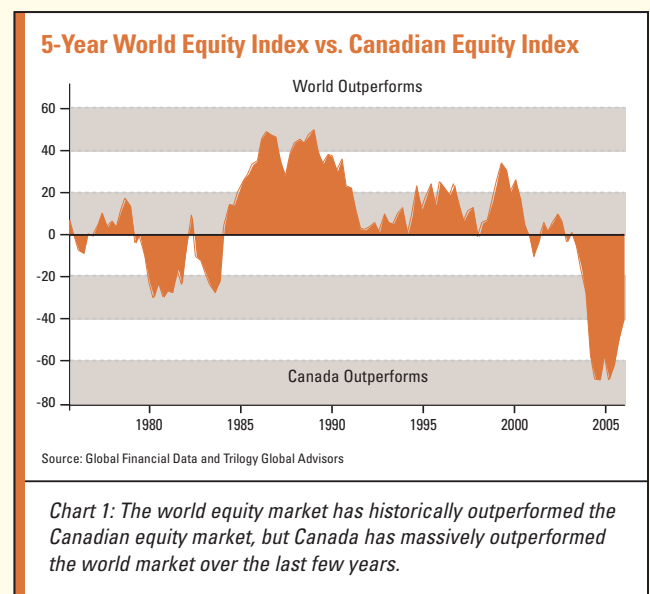
economic growth around the world. On that simple view, stocks have been lacklustre this year and bonds have managed to rally despite tighter monetary policy.

But you probably knew all that. The big issue for most investors is what the new oil price environment implies about how various markets will perform in the future. And while that certainly raises many complex issues, we would like to focus on a key decision faced by Canadian investors. Should they move more of their equity exposure back into Canadian stocks to take advantage of the favourable impact of high oil prices on Canada? Or should they be taking advantage of high oil prices to diversify away from the Canadian market after it has dramatically outperformed other markets?

Emotion argues for the former – Canadian equities have done exceptionally well relative to world equities over the past few years. Let the trend be your friend. However, basic investment logic – i.e. buy low, sell high – argues for the latter. A look at historical data supports the logical case for diversification, especially when the impact of high oil prices on the performance gap between Canadian equities and world equities is taken into account.

### World Equities Outperformed Historically

Over long historical periods, world equity markets have tended to treat Canadian investors well relative to the Canadian market. As shown in Chart 1, over five-year rolling periods, the MSCI World Index has outperformed the Canadian Index by an average of about 5% – or by about 1% per annum. However, the performance gap has varied widely and most recently has been massively in favour of the Canadian market.



We suspect that the recent performance gap has a lot to do with Chart 2, which shows how oil prices have soared in recent years. With Canada being a major energy producing nation, many Canadian companies have benefited from the increase in energy prices. In addition, the Canadian dollar has soared, reflecting Canada's improved terms of trade with the rest of the world.

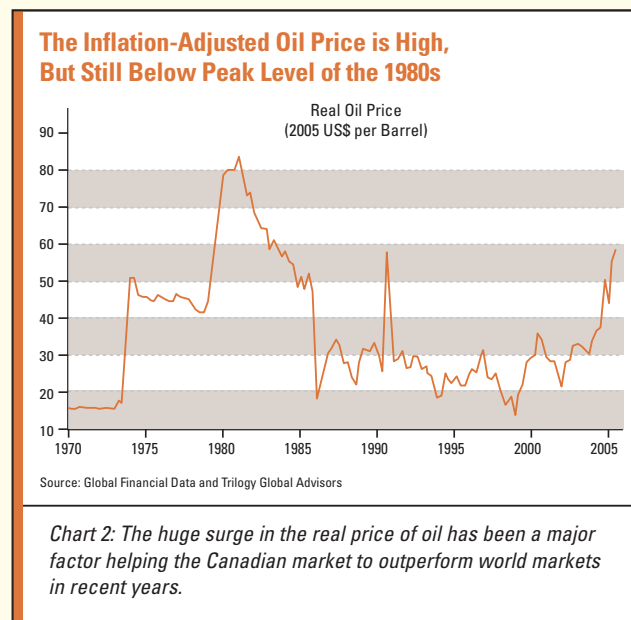
Chart 2, which shows oil prices in inflation-adjusted terms, illustrates that real oil prices are at the highest level since Iraq invaded Kuwait in 1990, but are still far below the peak reached in the early 1980s. To match that peak, oil prices would have to climb to over \$80 a barrel in today's dollars.

### Oil Explains the Performance Gap

How much have oil price movements affected the gap in performance between world equities and the Canadian market? As Chart 3 indicates, the answer is: a lot.

Chart 3 once again shows the five-year rolling performance gap between the World Index and the Canadian Index. Added to the chart is a line showing the five-year rolling percent change of the oil price as measured by the West Texas Intermediate benchmark price per barrel. The oil price change is shown on an inverted scale to make the relationship with the world versus Canada performance gap clear.

Historically, the world market has tended to outperform when oil prices have fallen. Conversely, the Canadian market has tended to outperform when oil prices were strengthening. Simple statistical analysis shows that movements in the oil price have explained about two-thirds of movements in the world versus Canada performance gap over the past

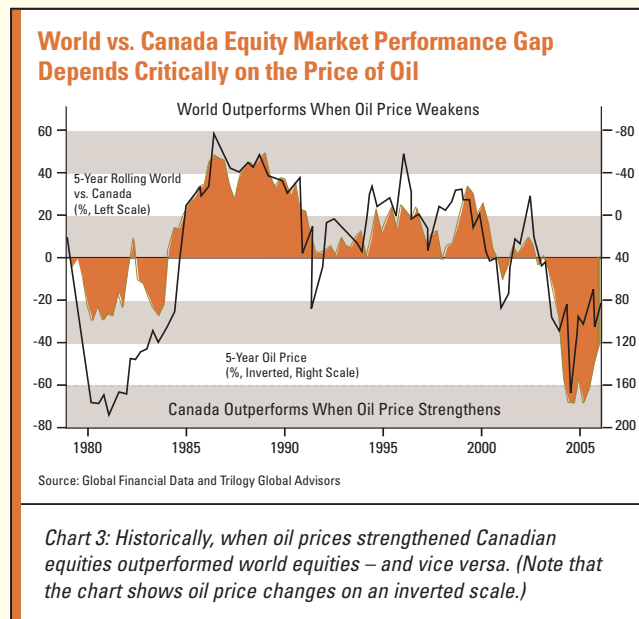


25 years. As these things go, that is an extremely strong relationship – and much stronger than many other indicators we looked at, including currency trends, relative valuations, etcetera.

This is not to say that the Canadian market is a one-trick pony. There is another one-third of the performance gap that cannot be explained by movements in the price of oil. However, clearly oil matters a great deal for whether the Canadian market is likely to outperform the world market going forward.

### Investing 101: Buy Low, Sell High

Today's oil prices seem based on a combination of OPEC's thirst for revenues, bottlenecks in the refining system and buoyant demand. With OPEC's members pumping oil as fast as they can, the world market has little spare capacity for dealing with additional shocks. As a result, oil traders are nervous and are demanding a substantial risk premium.



With oil inventories well above average and global growth slowing, it seems likely to us that prices will moderate going forward. In fact, a provocative report by Cambridge Energy Research Associates, a well-known energy consulting firm, argues that there could be a glut of energy in the next few years as new capacity comes on line. Several prominent China experts are also warning that China's oil demand may turn out to be overestimated as the Chinese bring on substantial coal-fuelled electricity generating capacity this year and next.

To be sure, momentum in the markets and any new shocks to the system could drive oil prices higher. However, in the time-honoured tradition of "buy low, sell high," we think investors should consider using periods of high prices to reduce exposure to Canadian equities relative to world equities.

The historical evidence lends strong support to this approach. As we demonstrated above, the performance gap between world equities and Canadian equities is highly correlated with trends in oil prices. And, historically, periods of high real oil prices have tended to be followed by periods of lower prices. As a result, the Canadian market has tended to underperform world markets in the five years following major spikes upward in oil prices – for the simple reason that such periods have been followed by oil price weakness.

Here's the data: from 1980 to 2004, the Canadian market has tended to underperform the World Index in Canadian dollar terms by a cumulative average of 11% over rolling five-year periods. However, looking at five-year periods when oil prices were below trend, Canada basically kept pace with the world market. In contrast, during periods when oil prices were above trend, as is currently the case, the Canadian market has tended to underperform foreign markets by a cumulative average of nearly 25% over subsequent five-year periods.

It may be that "this time is different," in view of global supply constraints, unlimited demand caused by the rise of "Chindia," etcetera. Only time will tell. Whatever the case, we think investors will do well to keep in mind a basic principle of investing: buy low, sell high.

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