JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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by Keith Cronin, JVB Senior Vice President of US Credits and International Sovereign Trading

Many Canadians like to refer to the United Nations Human Development Index with a sense of pride and a polite sense of patriotism. A mouthful for most, it rolls as naturally as a hockey puck in Toronto across the icy palates of America's northern neighbor. According to this UN gauge, Canadians argue, the great white north has got the highest quality of life on the planet. (In order to avoid global comparisons, for the sake of this journal, we'll just assume that the denizens of Zurich and Norway won't be reading this as they would surely pontificate to a similar claim). Canada is the world's second largest country by size (behind Russia), and despite a danger of being in the burly economic shadow of the U.S., has the ninth largest economy. As the winter Olympics gets under way in Vancouver, the fast money will be going on the Canadian hockey team to hoist the gold medal. Should the investing community be as optimistic about the Canadian economy?

Canada's economy is highly correlated to that of the US, both structurally and financially. The functionality of the economy is that of a market oriented system of economic trade and production. Like most developed nations the economy seems to be dominated by the service industry but what's interesting about Canada is the influence of the primary sector. We have noted in past periodicals the importance of raw materials and commodities within the realm of more developing economies like Brazil and South Africa. A similar importance can be associated to Canada, a G7 nation, which makes Canada a little unique compared to her peers. The role that commodities play within the Canadian economy cannot be underestimated. In fact, over a quarter of Canada's exports are derived from crude oil, forestry products or metals and the country's energy reserves make it one of the few developed nations that are a net exporter of energy. Canada has immense deposits of oil and gas and the oil deposits in Alberta, in western Canada, are the second largest in the world, behind Saudi Arabia. There is a definitive disequilibrium however that exists with regard to energy dispersal in Canada. Whilst the West has an immense abundance, places like Ontario have limited resources when it comes to energy and this obviously can make energy a political issue north of the border. The US was quick to seize upon Alberta's abundances when the Canada-US trade agreement was signed in the eighties one of the stipulations was that oil exporting Canada could not charge the US more for its oil than it was charging its fellow Canadians. This issue was obviously contentious then and it remains so now. We have already noted the high sensitivity of the Canadian economy to that of the United States. However, now we are seeing the Canadians begin to implement similar economic policies as we have seen from Brazil and Australia. They are trying to reduce their dependence upon the US economy and are focusing more on Europe and of course, and especially upon China. The economic outlook for the US does not bode well for Canada. With a modicum of growth likely to enhance the US in 2010 the future stimuli withdrawals that have to occur will temper growth in 2011. Add to that the burdens upon the US consumer who have to save more (if they are lucky enough to have a job) and the American banks that need to resuscitate their balance sheets, the American panacea seems illusionary, at least in the short run. Although Canadian unemployment is falling – with the rate now just over eight per cent – and the financial system is in relatively healthy condition, Canada cannot depend upon the US consumer or its own, and America's, fiscal stimuli to ward off a double dip. It seems logical then that commodity rich Canada is looking to commodity craving China to reduce her dependence upon her southern neighbors. Further uncertainty over the American economy, realized American financial weakness or escalation of US protectionist policies like the "Buy America" initiative will surely push Ottawa closer to Beijing even more quickly we feel.

The commodity correlation then has been played out quite obviously through Canada's currency. The "loonie" (as is its catchy financial sobriquet) has experienced market movements as decreed by risk aversion and commodity prices. Although the Canadian unit is not considered to be a high beta currency (like the commodity sensitive Brazilian Real) it is definitely considered a commodity currency. Thus, we have seen it move with a distinctive correlation to the price of oil. As the greenback has gained traction in recent weeks, as global risk aversion has intensified, we have seen commodities falter. This has affected commodity units but we feel the sell off on the Canadian Dollar may represent an opportunity. We have hitherto argued that countries like Australia and especially Brazil have sound fundamentals, but we feel that Canada's may be even sounder. According to the World Economic Forum, Canada's financial system is the soundest in the world. Despite the recent credit seizure and the ubiquitous massive global financial debacle no Canadian bank failed or sought a government bail out. This may be a function of the conservative nature of bank management, higher capital requirements or general Canadian apathy towards recalcitrant capitalism but it is a reassuring reality for investors with Canadian interests. We are even seeing some of this optimism filter into the corporate bond market

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ABOUT KEITH CRONIN

Keith Cronin is Senior Vice President of US Credits and International Sovereign Trading at JVB Financial Group, LLC, and also works with the firm's New York Institutional team. With almost a decade of fixed income trading experience, he began on HSBC's retail desk and moved on to HSBC's proprietary trading desk, wherein his specialty became trading Investment grade US Corporate Bonds. Mr. Cronin is a graduate of the University of Cork in the Republic of Ireland with an Honors Masters Degree in Economics.

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as spreads on Canadian corporate bonds are starting to diverge from those in the US. As we have seen global risk aversion we have seen US spreads widen but Canadian spreads have actually tightened in the past month as confidence in Canadian banks remains steadfast. Adding to the positive sentiment was a report that showed factory sales rose in December to the highest level in a year and the recent government pledge to impose tighter regulation of the mortgage industry only serves to instill further confidence in the Canadian system. Obviously caution always needs to be applied as the Canadian story will remain vulnerable to global factors, especially to China and any resultant commodity movements. Canadian officials are aware of the fragility of the global recovery and indeed of their own country's improving health. As a result, the Bank of Canada will likely hold the main policy rate at 0.25 percent until the middle of this year and GDP growth will likely moderate later in 2010 as Canada's, and the global community's, stimuli packages expire. Despite Canada's improving and sounder fundamentals a lot will depend on the price of oil. If we see a global double dip or anemic global growth then the 'loonie' may find that oil can be a lot slicker than ice but if not Canada may indeed claim the gold.•

Keith Cronin
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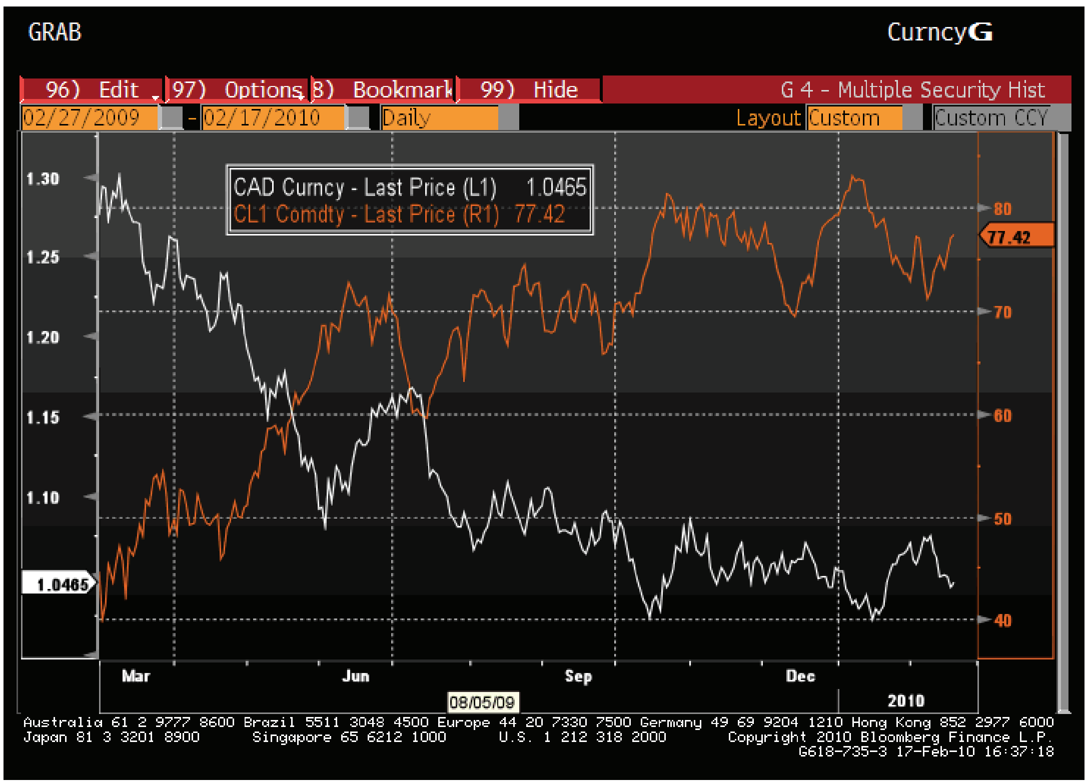

Source: Bloomberg 2/17/10

THE CORRELATION BETWEEN THE PRICE OF OIL AND THE DIRECTION OF THE CANADIAN DOLLAR SEEMS DEFINITIVE AND UNDERSCORES THE IMPORTANCE OF OIL FOR THE CANADIAN ECONOMY.

JVB FINANCIAL GROUP, LLC
MEMBER FINRA - SIPC

2700 N. Military Trail, Suite 200 / Boca Raton, FL 33431
(561) 416-5876 ● www.jvbfinancial.com

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