



TD Economics

Special Report

October 25, 2006

CANADA'S IMAGE AS A GLOBAL RESOURCE GIANT

More than just perception....it's a reality

Canada has always been perceived as a nation with an economic base deeply rooted in natural resources. This message has long been transmitted through Canadian equity and currency markets, where buying and selling has often been closely tied to swings in world commodity prices. At no time has this dynamic been more apparent than in recent years. As world commodity prices have shot up since 2002, few stock market indices around the world have surged by more than the S&P TSX, while few currencies have strengthened to a greater extent vis-à-vis the U.S. dollar than the loonie.

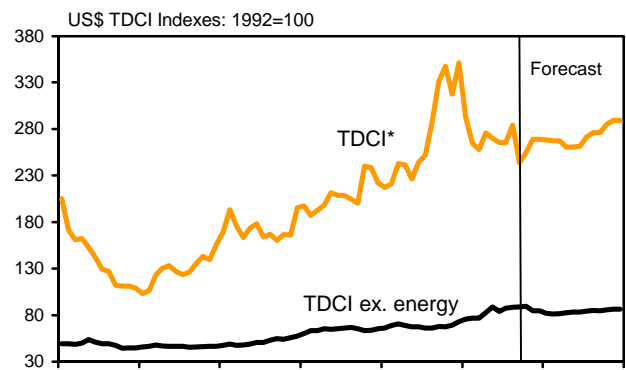
At the same time, what is the likelihood that this image of Canadians as “hewers of wood and drawers of water” has become out of step with reality? Although few would deny that the country’s resource sector remains alive and well – and continues to be a major economic generator, it is equally hard to refute the fact that the Canadian economy has undergone structural changes over the past 25 years that have shifted in the economic balance from goods-producing to a number of service-producing industries.

In this report, we take a closer look at the economic contributions of the resource sector both today and in comparison to the past. We conclude that despite facing a multitude of headwinds over the last few decades, the resource sector has managed to evolve and adjust, thus maintaining its impressive position within the nation’s economic fabric. What’s more, with the consensus having formed around the expectation that commodity markets have entered a “new era” of higher prices, both the perception and reality of Canada as a global commodity powerhouse are almost certain to remain in place. In the final section, we discuss the implications of this conclusion for investors.

HIGHLIGHTS

- **Canada’s resource sector is truly a global powerhouse**
- **Some cooling in resource activity in store, but sector’s L-T outlook is favourable**
- **Resource growth potential will continue to open doors for attractive L-T equity returns**
- **Still, the rising resource contribution to Canada’s economy suggests domestic financial markets may be more prone to S-T gyrations**
- **The S-T volatility raises the need for Canadians to take better advantage of geographic diversification**

TD COMMODITY PRICE INDEX (TDCI)



* Index of 18 Canadian resource commodity prices; Actual data to September 2006; Forecast by TD Economics as at October 19th 2006; Source: TD Economics

Predictions of resource sector’s demise unwarranted

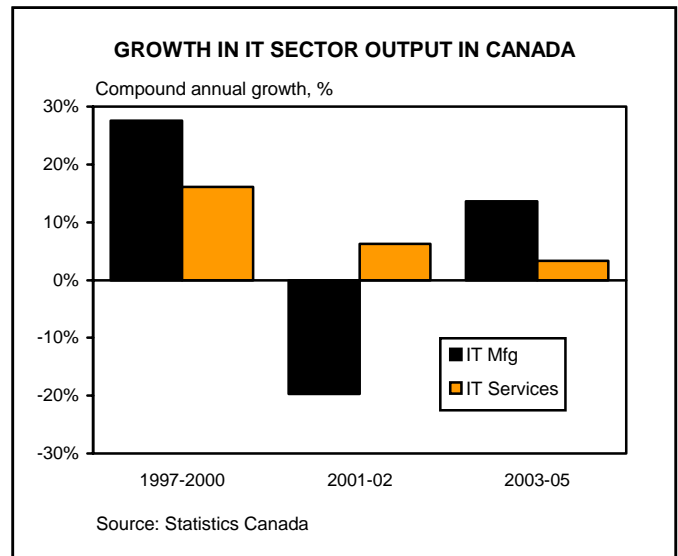
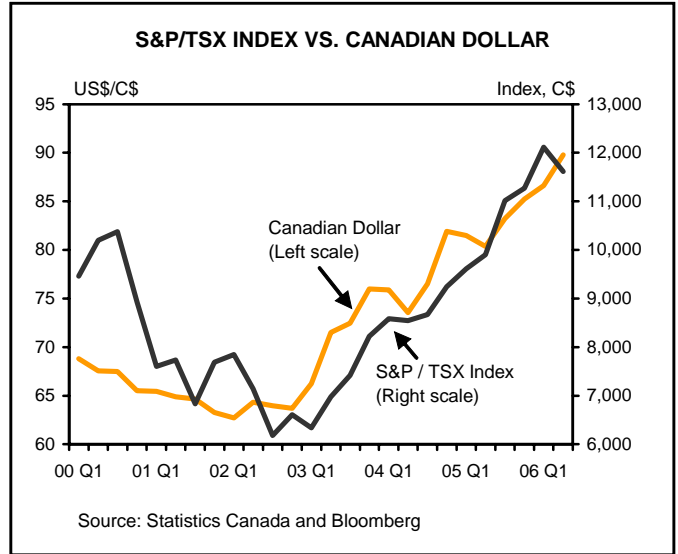
The boom underway in commodity markets is even more dramatic when placed in context of the general sentiment that prevailed a mere 5-6 years ago. In the late 1990s, the “new economy” industries of information technology were growing at a hectic rate, spurring chatter of a virtuous cycle of productivity-led growth and prosperity well into the future. At the same time, the fortunes of the “old economy” resource sector – as defined in the topic box below – continued to sour. In fact, some forecasters even went as far as to predict the eventual demise of Canada’s resource industries. Others (i.e., Sachs et al) referred to the “curse of natural resources”, warning that resource-based economies would experience significantly lower growth than those that devoted scarce capital to rapidly-expanding knowledge-based industries.

As we now know from 20:20 hindsight, those predictions proved to be way off the mark. The high-tech sector stumbled badly in 2001-02 – demonstrating that those areas were not immune to resource-style boom-bust cycles – while world commodity markets would ultimately

Resource Sector Defined

For the purposes of this note, the resource sector has been defined to encompass downstream and upstream activities in the areas of energy, minerals and metals and forestry. The sub-components of each industry, which are shown in the table below, were selected based on the North American Industry Classification System (NAICS).

Energy Sectors
Oil and Gas Extraction
Electric Power Generation, Transmission & Distribution
Natural Gas Distribution
Support Activities for Mining and Oil & Gas
Petroleum & Coal Products Mfg.
Pipeline Transportation
Petrochemical Mfg.
Minerals and Metals
Mining (except Oil & Gas)
Non-Metallic Mineral Product Mfg.
Primary Metal Mfg.
Fabricated Metal Product Mfg.
Forestry
Forestry & Logging
Wood Product Mfg.
Paper Mfg.

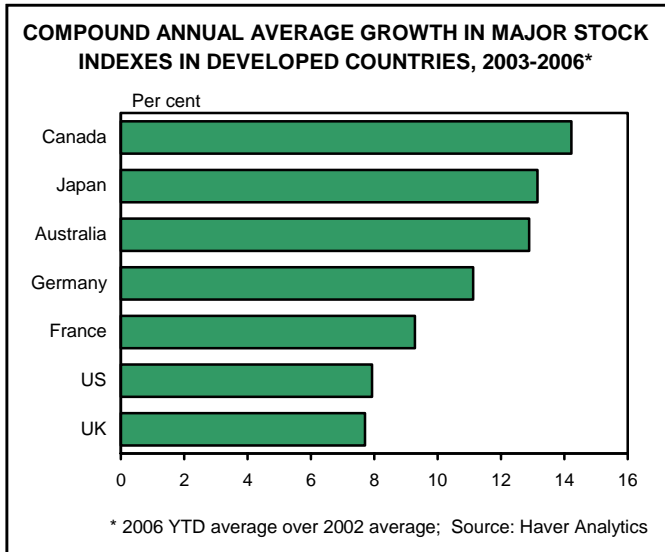
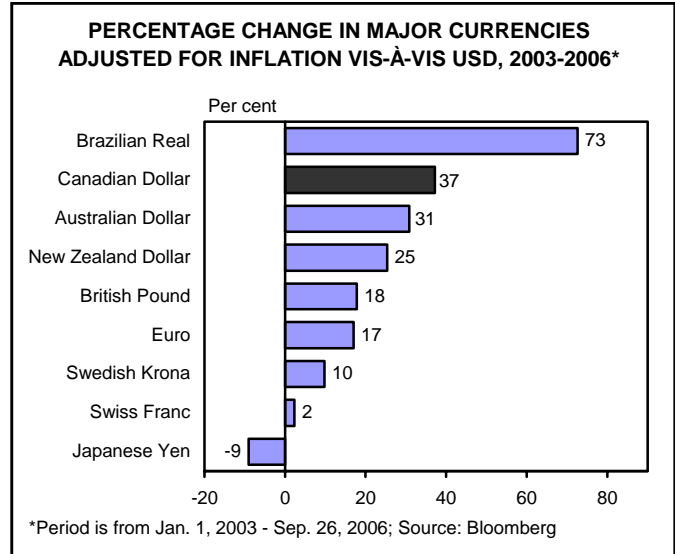


bounce back, halting the 15-year secular downtrend in prices.

The abrupt turn in the fortunes of world commodity markets has reflected a confluence of factors on both the demand and supply sides of the equation. Over the past decade, demand for most commodities has picked up strongly, owing to rapid industrialization of China, India and other developing economies. In contrast, gains in supply of commodities such as crude oil and metals have lagged behind, constrained by cuts implemented to exploration budgets in the 1990s. Accordingly, supply-demand balances for many commodities have tightened significantly. Other global factors also swung in support of commodity prices, including a structural decline in the U.S.

dollar and the rekindling of global inflationary pressures that provided a boost to real asset prices.

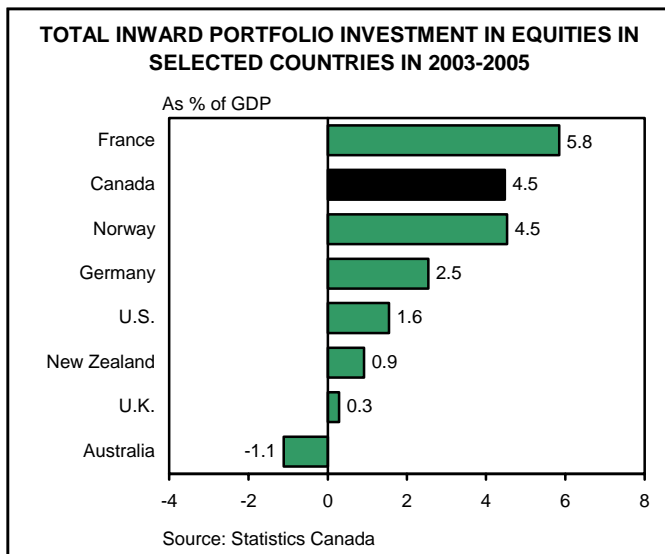
While an improvement in fundamentals got the ball rolling in 2002-03, the momentum has been sustained in part by growing investor enthusiasm. Notably, the commodity market has also become increasingly attractive to large institutional investors – such as hedge funds and pension funds – in view of abundant liquidity, declining relative returns on fixed-income investments and the launch of exchange-traded funds (ETFs) and other investment vehicles that have facilitated direct investor participation in commodities. It has been estimated that as much as \$100 billion in investment funds have been directed into commodities worldwide over the past few years.

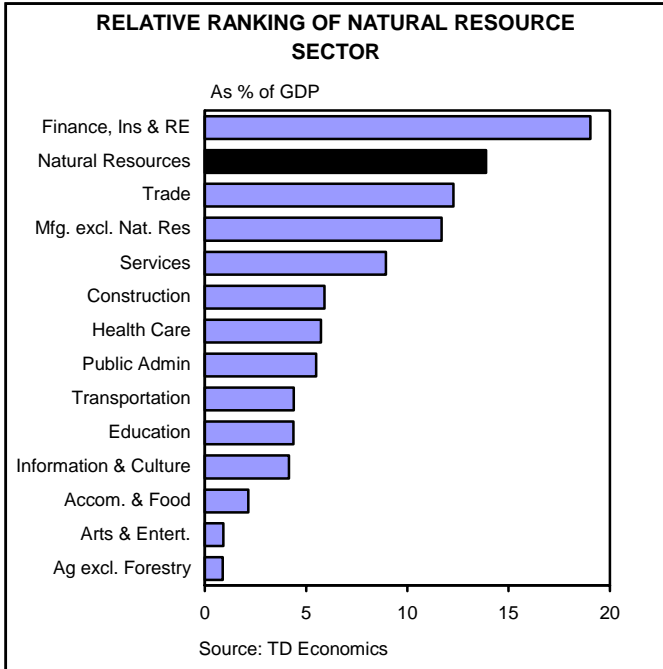


Canada has moved into the spotlight

In addition to gaining direct commodity exposure, many investors have opted to take the more traditional – and indirect – approach of participating in the commodity rally through either purchasing shares of resource companies or investing more broadly in commodity-oriented markets. Markets that have attracted increased attention include the likes of Australia, New Zealand, Norway, Finland and – above all – Canada.

- Since 2003 – the first full year of the commodity rally – Canada’s S&P TSX has outshone other major world indices by returning roughly 14% per year on a compound annual basis.
- Over the same period, the Canadian dollar has climbed by a total of almost 40% against the U.S. dollar in real terms, ranking second to only the Brazilian Real.
- Data on portfolio investment reveal that foreign purchases of Canadian equities surged by 4.5% of GDP over the 2003-05 period, outstripping most other industrialized countries, including Australia. Moreover, figures released so far this year suggest another banner performance in 2006, with some \$17 billion in net foreign purchases in the first half alone.
- After posting weak inflows of foreign direct investment (FDI) in 2003 and 2004, Canada has emerged as world-leading magnet since early 2005. The spate of high-profile foreign acquisitions of Canadian firms announced in recent months suggests that 2006 will be no different.





Certainly, not all of the strong international investor interest in Canada can be chalked up to the resource boom. In fact, the country's investment climate began to take a turn for the better in the mid-to-late 1990s, when governments moved to put their fiscal houses in order, cut their debt-loads and lowered personal and business taxes. The restructuring put in place by the private sector during, and in the aftermath of, the early-1990s recession also began to bear fruit. Furthermore, Canadian producers enjoyed success penetrating the U.S. market following the implementation of the 1988 Free Trade Agreement (FTA), which assisted in transforming the nation's current account position from deficit to surplus. However, the improvement in commodity markets over the past few years has considerably turned up the momentum in favour of Canada.

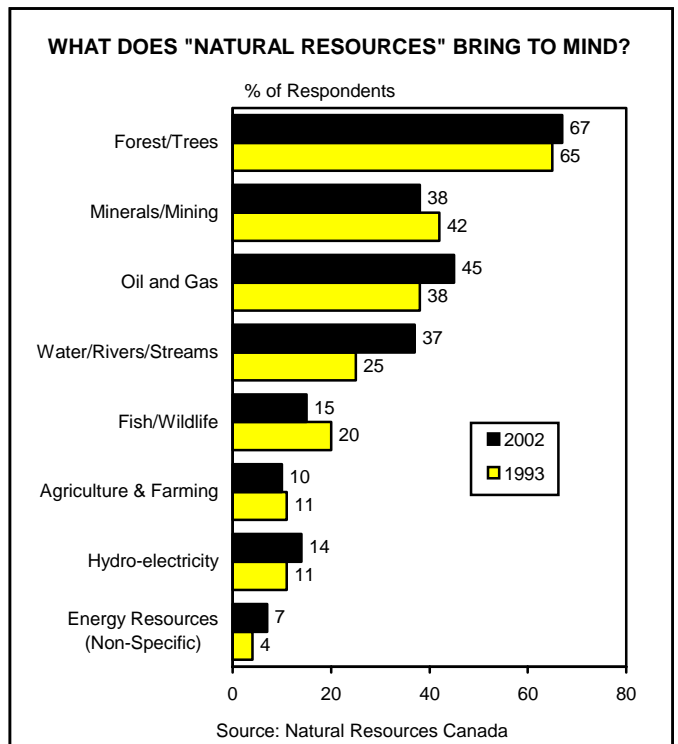
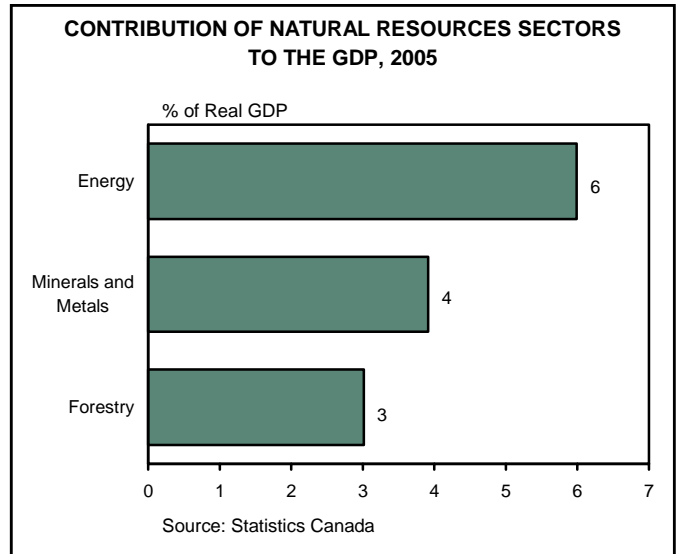
Canada's resource sector a global powerhouse

Although foreigners' take on Canada is influenced by media images of a nation with vast forests, abundant rivers and wide-open frontiers, research shows that Canadians themselves see this country in a resource light. A survey carried out by Natural Resources Canada in 2002 – which corresponded to a low point for commodity markets – revealed that 41% of respondents surveyed viewed resource industries as the number-one economic contributor in Canada. Admittedly, that proportion was down from the 48% reading recorded in 1993. Still, more individuals continued to perceive resources as a bigger driver than

either manufacturing or services. And, if this survey were held today, it would undoubtedly point to a rebound in the importance of the sector in Canadians' eyes.

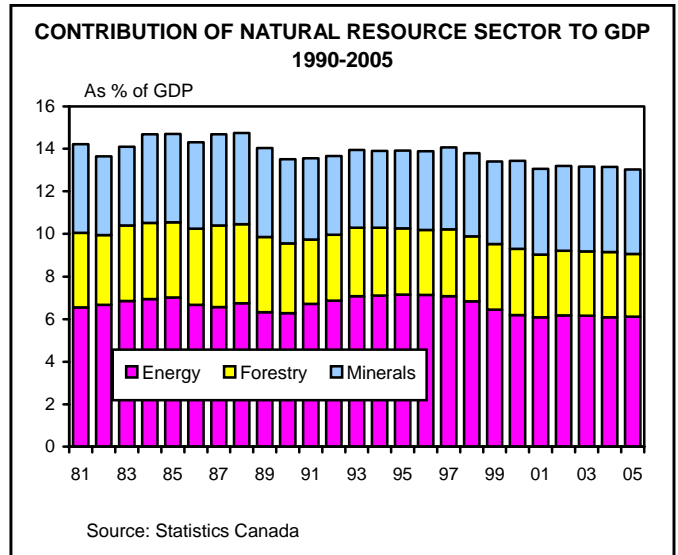
How well does the data line up?

If that's the perception, what is the data telling us about the sector's *actual* contribution? In the accompanying table, we provide a snapshot of GDP and employment shares for the sector as a whole and its key industries. More

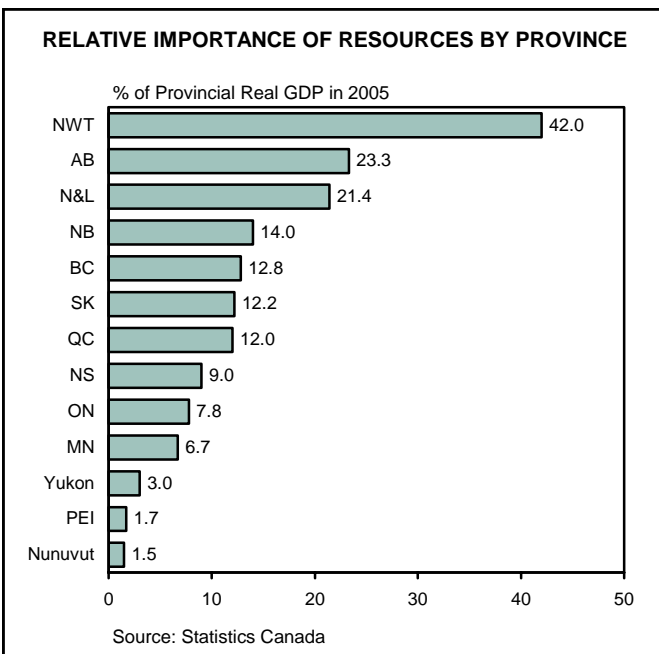


detailed figures are included in Annex 1 on page 16.

The combined activities of Canada's primary and resource-based manufacturing and service industries contribute 13% to Canadian real (inflation-adjusted) gross domestic product, ranking second to only financial services (19%) in terms of importance. At 1 million jobs, the resource sector is also the second largest employer in Canada, although its share of total employment is a more modest 7%. Moreover, while energy stands out as the largest resource industry in terms of real output, the mining and forestry industries come out ahead in terms of relative employment shares.

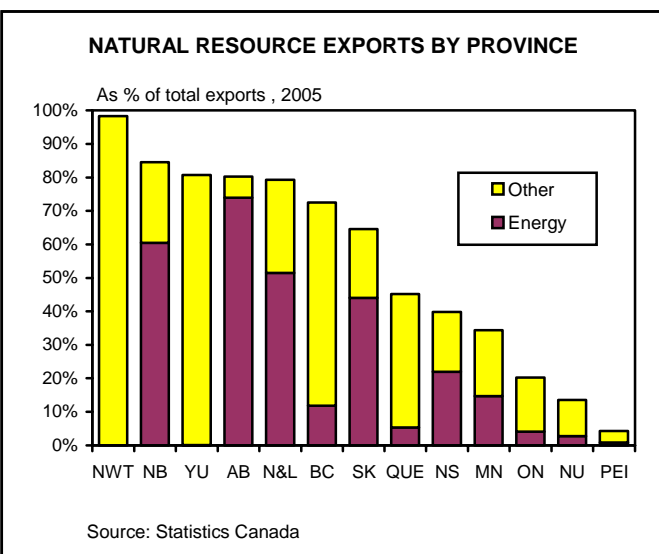


What may come as a surprise to some is that this relative output share of resources has not changed all that much in the past 25 years. In 1981 (the first year comparable data are available), the share of real GDP attributable to resource activity stood at 15% of GDP, or only 2 percentage points higher than its current share. This relatively stable trend may go some way in explaining why Canadians and investors alike continued to look at Canada through a resource lens even during the difficult markets of the late 1980s and 1990s.



Output share understates true importance

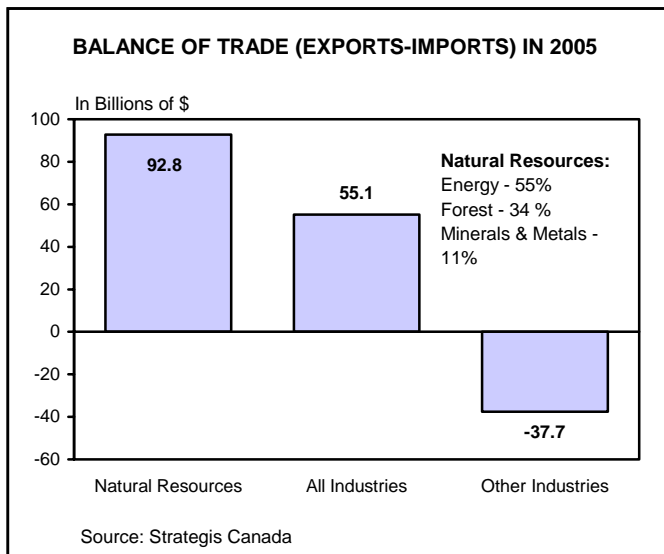
The real output readings confirm that the resource sector still carries considerable weight in the Canadian economy. Still, they understate the true footprint left by the commodity-based industries on the national landscape. For one, these are average figures. In some provinces and territories – notably in the N.W.T., Alberta and Newfoundland & Labrador – the resource share of real output climbs to more than 20% or double the national average. In all jurisdictions except PEI, Nunuvut and Ontario, resource exports make up at least one third of total provincial-territorial exports. Further, many smaller communities in Canada are dominated by resources. As many as 350 communities across the country are dependent on the forestry sector while more than 100 are highly reliant on the mining industry. Even in Ontario, which has a relatively small resource share of about 8%, some smaller northern communities like Greater Sudbury have resource shares as high as 15-20%.



Second, while the share of Canadian real output at-

tributable to resources is significant, it pales in comparison to the contributions made by the sector to income, exports and government revenues:

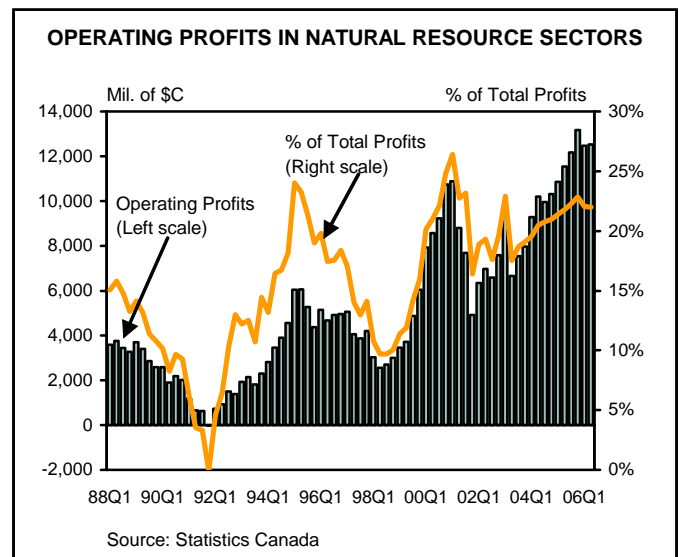
- *Corporate profits* – natural resources sector’s operating profits accounted for about one-quarter of total operating profits in Canada in 2005, led by surging bottom lines in the energy, and to a lesser extent, the mining sectors. In contrast, financial performances in the forestry sector have remained under pressure.
- *Capital spending* – last year, the resource sector accounted for almost 40% of total private non-housing investment (\$67 billion) in Canada. Of this amount, the energy sector contributed \$56 billion or 32% of the Canadian total.
- *Wages and salaries* – while comprising only 7% of employment, the sector’s share of total labour income in Canada tips the scales at 9%, reflecting the relatively high wages paid by resource companies.
- *Foreign Direct Investment (FDI)* – almost two-thirds of the \$40-billion-odd foreign direct investment in Canada was allocated to resources.
- *Trade surplus* – in 2005, the resource sector accounted for 40% of total Canadian goods exports, with all three areas making significant contributions. Even more impressively, with exports of energy, forestry and minerals far outstripping imports, Canada is running a massive \$93-billion trade surplus in the resource sector. Indeed, without the resource sector, Canada’s sizeable \$55 billion merchandise surplus would transform into a \$38 billion shortfall.



RESOURCE IMPORTANCE IN CANADA'S ECONOMY IN 2005
 Level in Bil. C\$ unless otherwise specified

	ALL RESOURCES		ENERGY ONLY	
	Level	Share	Level	Share
Real Output	138.6	13%	64.3	6%
Operating Profits	47.7	22%	33.6	15%
Capital Spending	66.6	25%	55.6	21%
Wages & Salaries	47.8	9%	10.4	2%
Direct Employment (In Mil.)	1.0	7%	0.2	2%
Foreign Direct Investment	25.2	62%	--	--
Trade Surplus	92.8	168%	51.0	92%
Government Revenues [^]	20.9	8%	18.0	7%
Large Companies out of top 50 (# based on assets size)	10.0	20%	7.0	14%

[^] Only includes government royalties; Royalties, fees and income taxes from Gas & Oil were \$27 bil. in 2005;
 Source: Natural Resources Canada, Statistics Canada, CAPP and FPIInfomart

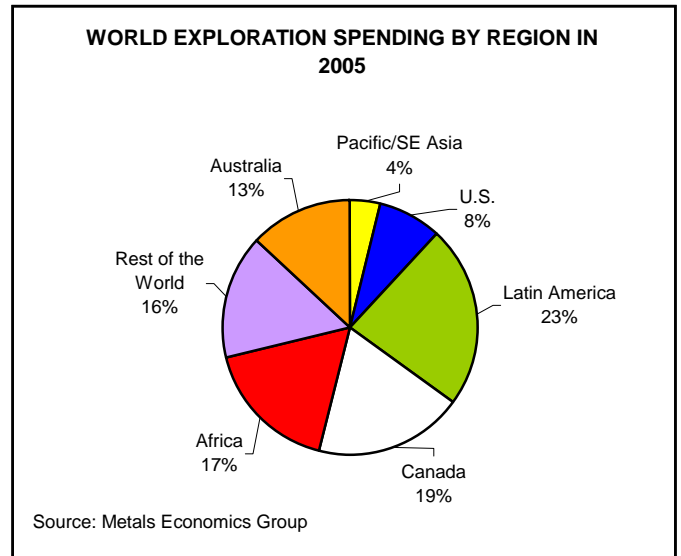


- *Government revenues* – direct royalty payments of resource companies to provincial governments alone amounted to \$21 billion in 2005, or about one-tenth of total provincial revenues. That figure excludes the substantial corporate and personal income tax payments made by companies and their employees to governments, since these figures are not available.
- *Large companies* – resource companies occupy 10 of 50 spots, or one in five, on the list of Canada’s largest private and public companies based on asset size.
- *S&P TSX index weighting* – in 2005, the resource-oriented energy and materials sub-indices together comprised 43% of the market capitalization of the overall S&P TSX Composite Index, split between energy (28%)

and materials (15%).

- *Public and private equity raised* – Among the \$47 billion of new public and private equity raised in Canada last year, some \$15 billion (one third) was attributable to oil and gas and mining industries alone. Of that amount, oil and gas made up \$11 billion and mining about \$4 billion.

Finally, these statistics cited above represent only the *direct* contributions to gross domestic product from the resource sector, but exclude indirect contributions, including the increase in economic activity that flows from, say, purchases by resource companies of machinery and equipment, financial services and transportation services. It has been estimated that for every dollar in mining production revenue, an additional 41 cents in gross revenue is generated across other industries. Forestry’s “multiplier effect”



Some Stylized facts on Canada’s Resource Sector

General

- World’s 4th largest endowment of natural resources, after Saudi Arabia, Venezuela and Norway (Source: World Bank).

Energy

- World’s 3rd largest producer of natural gas and 7th largest producer of crude oil
- World’s 2nd largest proven oil reserves (272 billion barrels) after Saudi Arabia
- 3rd largest generator of electricity within OECD

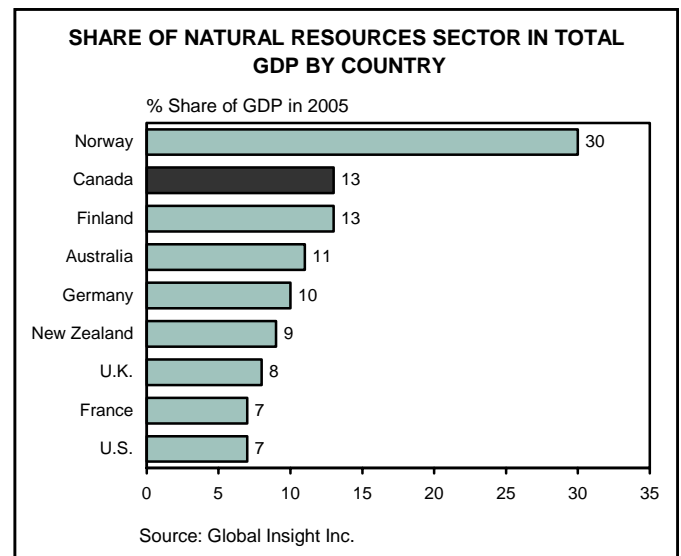
Mining

- World’s largest producer of potash and uranium
- World’s 3rd largest producer of nickel, aluminum and diamonds
- Top 5 world producer of zinc, gypsum, molybdenum, platinum and asbestos
- Top 7 world producer of gold and copper

Forestry

- 2nd largest endowment of timber resources
- World’s largest exporter of forest products
- World’s largest producer of wood pulp

Source: Natural Resources Canada



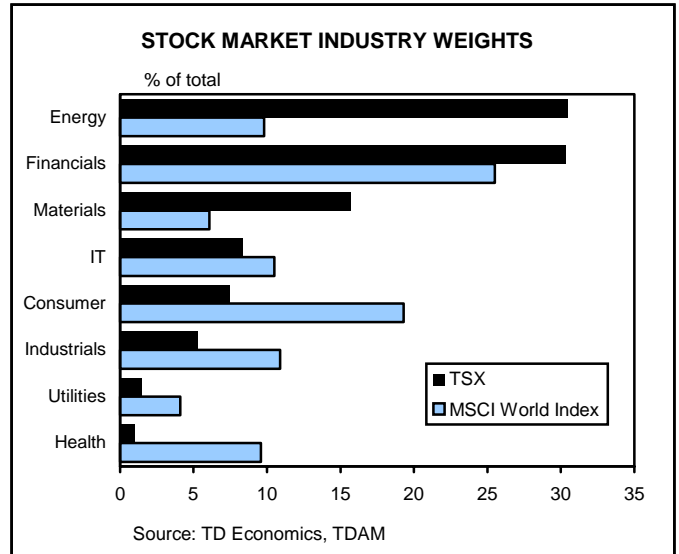
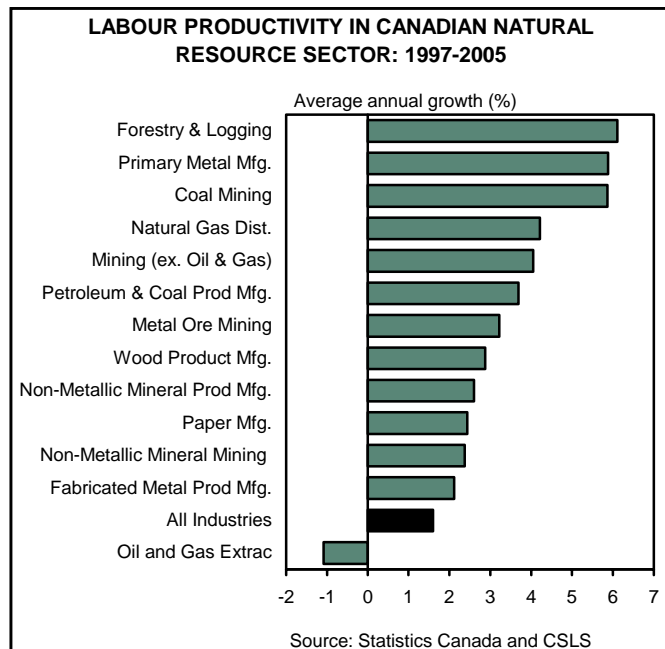
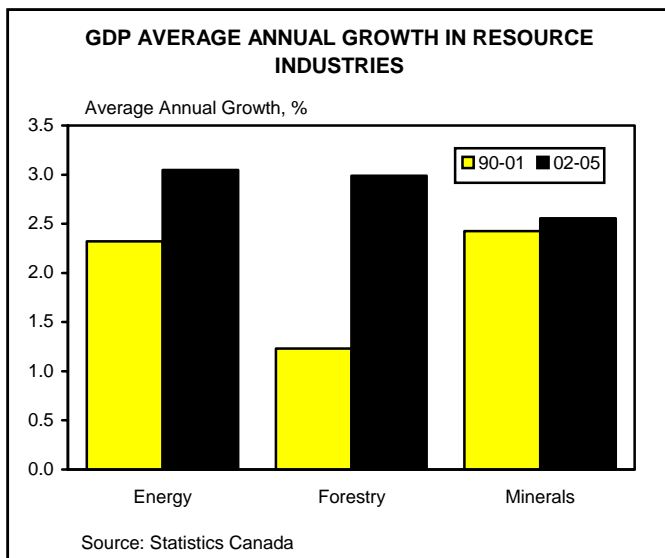
is even higher, at 65 cents. Hence, the economic impact of swings in resource activity quickly adds up, especially in the smaller resource-based communities.

Canada’s resource sector a big player internationally

Based on the evidence presented thus far, it is fair to say that the fortunes of the resource sector remain a critical cog in Canada’s economic wheel. But, the country’s status as a favorite resource play has also a lot to do with its prominent position on a global scale. Canadian listed companies lead the world in raising equity for exploration and mineral development, while about one-fifth of mineral exploration expenditures are targeted for Canada, surpassing all other countries. Even more impressively, this country is a world leading producer in virtually every re-

source area – a diversity that is unrivalled throughout the world, save perhaps Russia. However, Canada is second to none if its relatively low political risk and open access to the large U.S. market are also factored into the equation.

International comparisons on resource dependence are made difficult by the fact that output data are not directly comparable. Still, rough estimates carried out by TD Economics using data from Global Insight along with government industry output figures confirm that few countries in the industrialized world are as dependent on their resource sectors. For example, other G-7 economies record resource-



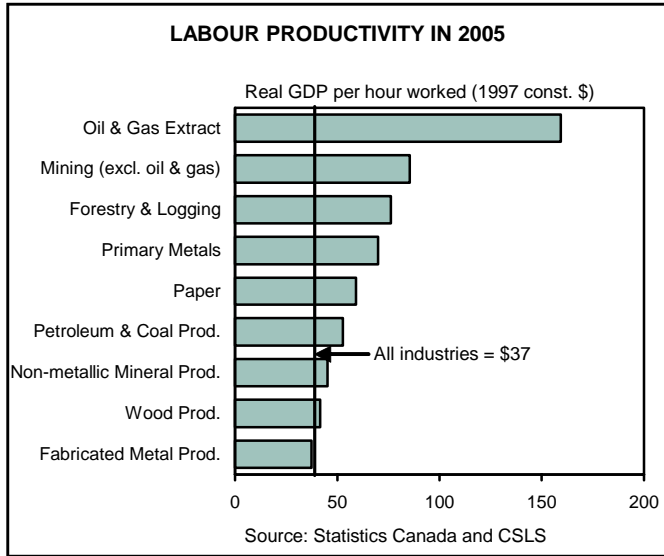
to-GDP shares in the 5-10% range – lower than Canada’s 13% – with the U.S. and France occupying the bottom end and Germany at the upper end. Outside of the G-7, Norway’s resource share of total output stands at about 30%, well above that of Canada, while Finland and Australia are in the same ballpark at 11-13%. Still, an important differentiation is that in contrast to Canada’s highly-diversified resource cluster, Norway’s resource sector is heavily concentrated in energy products, Finland in forestry and Australia in mining and metal products.

Resources make up more than 40% of S&P TSX

Perhaps the most striking comparison is the share of resources in stock market industry weights. As noted earlier, within Canada’s S&P TSX Composite Index, energy and materials represent more than 40% of the total. (Indeed, if a third group – financials – was also included, these three areas would represent a stunning 70-75% of the index). In stark contrast, the average world stock market – as measured by the MSCI World Index – has a total of only 14% devoted to these two resource areas.

Canadian resource sector has evolved

These striking statistics – at least to some extent – reflect a sector that is currently enjoying its best times since its hey-day in the 1970s. A decade ago, life was considerably more challenging for resource producers, when commodity prices were following a one-way ticket down and earnings were under pressure. There were also sector-specific challenges, such as the imposition of U.S. duties on



cases, industries coped by moving to expand their businesses in new markets. Along with metals companies, pulp and potash producers have been successful in penetrating the rapidly-growing Chinese market.

Perhaps the best example of strength in exploiting new opportunities is in the nation's energy sector. As conventional crude oil production and reserves began to taper off in the 1990s, the industry turned its attention to feeding the hungry U.S. appetite for natural gas. In fact, few Canadians recognize that natural gas has overtaken crude oil in terms of value of production, and is a much larger contributor to both Canadian exports and to government coffers. (See TD report, "Why is it Always Oil? The Untold Story of Natural Gas," released February 2006).

Canadian softwood lumber shipments in the mid-1990s.

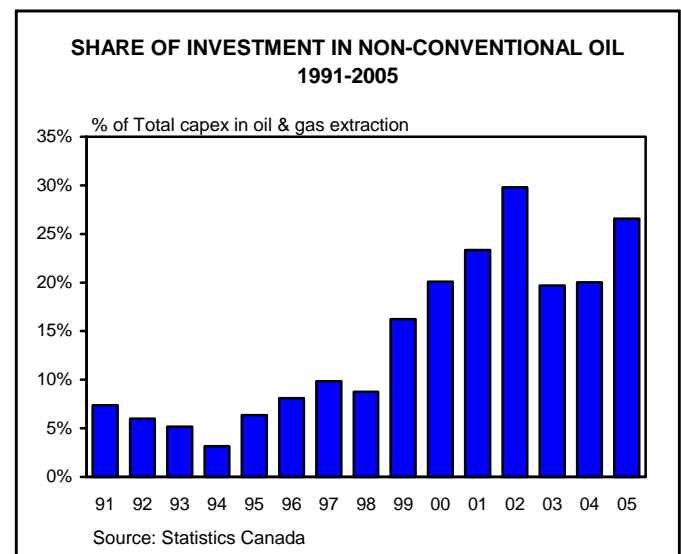
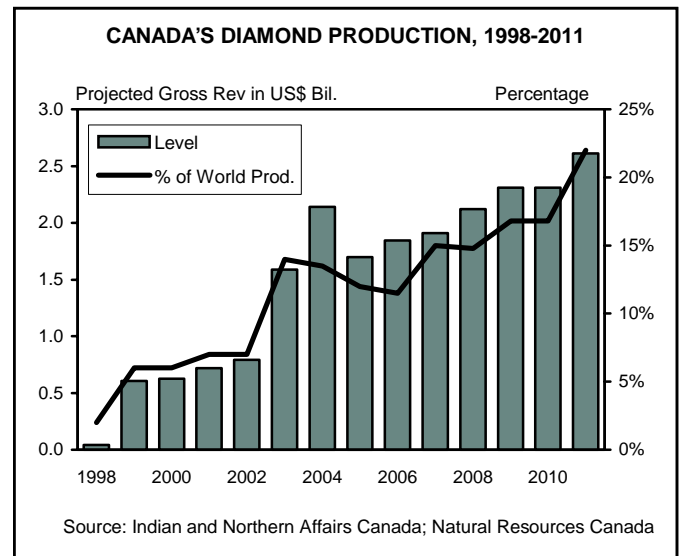
Yet, through it all, the resource sector managed to expand, thus maintaining its position as one of Canada's largest drivers of economic activity and jobs. Better still, this area continued to post a rising contribution to Canada's trade surplus – which was no easy feat in view of the dampening impact on export earnings from declining commodity prices.

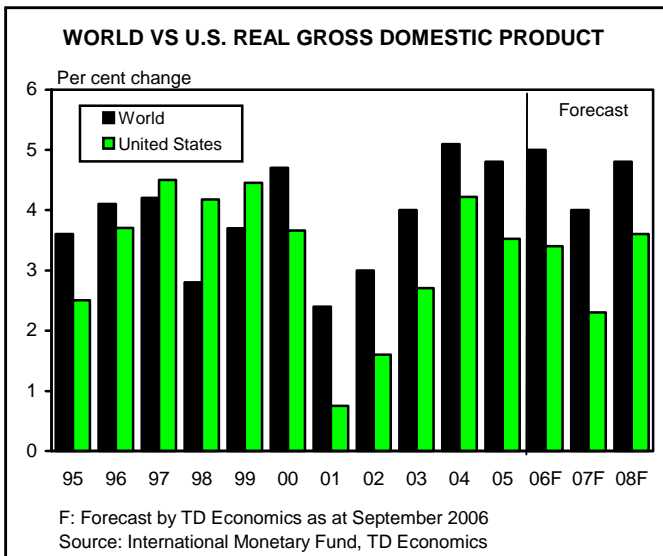
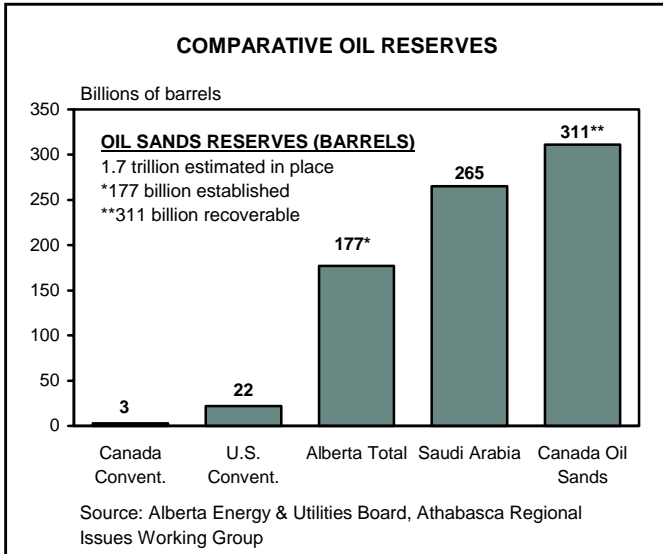
Resource companies ramp up productivity

Some of this resilience can be attributed to the sector's success in raising productivity. In the 1997-2005 period, growth in output per hour in most resource-based industries exceeded the average of the Canadian business sector of 1.5% per year. In three areas – forestry, primary metals and coal mining – productivity growth came in more than triple the average tally. These gains have widened the productivity gap between the resource sector and other areas of Canada's economy. The *level* of output per hour worked in oil and gas extraction is now four times that of the Canadian average. In most other resource areas, the gap ranges between 10% and double.

Churning within the sector

As importantly, the sector has evolved with changing markets and needs, with some declining industries being replaced by emerging stars. Success on this front is critical in an area which is dominated by the production and extraction of non-renewable resources. Canada's diamond industry has come from virtually nowhere 10-20 years ago to emerge as third largest producer on the planet. In other



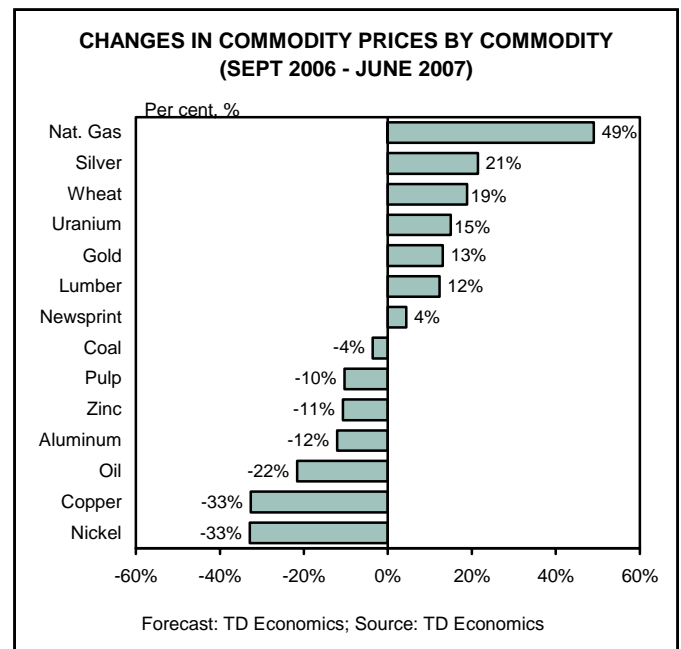


More recently, however, declining conventional reserves of crude oil and natural gas – combined with high energy prices and new technological innovations – have shifted strategies toward development of unconventional sources, such as crude bitumen, coal-bed methane and coal gasification. In particular, Alberta’s oil sands is poised to attract in excess of \$100 billion in new investment over the next decade in order to develop a share of the region’s massive proved reserves of more than 170 billion barrels. By 2025, it is estimated that oil sands production will reach more than 4 million barrels per day, which could place Canada third or fourth on the list of world’s top oil-producing nations.

Correction likely in 2007, but longer-term outlook bright

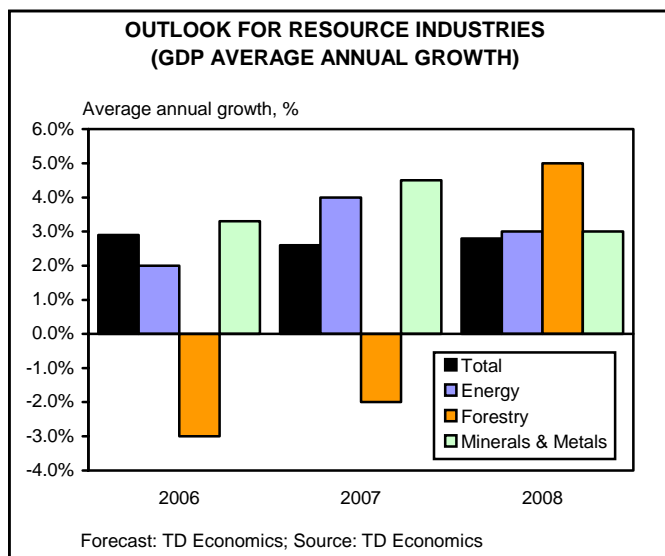
With a growing number of forecasters upgrading their long-term projections of resource consumption in light of the insatiable demand for commodities from China and other developing Asian economies, the long-term prospects for commodity markets have strengthened considerably. Put simply, as evidence of this longer-term secular uptrend in demand and prices emerges, the period of low prices during the late 1980s and 1990s will become an increasingly distant memory.

That said, along this long-run path, resource markets will always be prone to periodic corrections. And, in our view, a number of commodity markets are ripe for a significant downward adjustment on the heels of the hefty gains recorded in recent years. The major catalyst for this adjustment is expected to be mid-cycle slowdown in the U.S. economy, a global locomotive that consumes as much as 15-25% of most global commodities. This cooling-off period is projected to lead to a slackening in the sector’s supply-demand fundamentals, and perhaps even importantly, put a damper on the high levels of investor enthusiasm that have recently permeated commodity markets. Indeed, recent selling pressure indicates that these concerns have already begun to manifest themselves within forward-looking markets. Since the summer, crude oil and natural gas prices have pulled back sharply, pushing the S&P TSX Energy index down by some 15%. The S&P TSX Materials index is down by about 8%.



As we discuss in more detail in the monthly *TD Commodity Price Report*, commodity prices are expected to experience bouts of downward pressure until mid-2007, before regaining their footing in the second half of next year in line with a strengthening U.S. economy. This setback will not be lost on the Canadian economy. Just as higher prices have catapulted profits, exports and government revenues into the stratosphere, falling prices will not come without a payback. Still, in light of the fact that the anticipated drop in prices represents more of a temporary correction than a return to a bear market, respective resource contributions to the Canadian totals will remain high in the coming quarters, while employment and output shares continue to hold at their recent levels of 13% and 7% respectively.

Keep in mind that not all resource industries face the same near-term prospects. In our view, crude oil and base metals appear vulnerable to price corrections in the order of 10-33% by mid-2007 from average levels in September (see chart on previous page). In the case of nickel, which has shown signs of particular froth, the pull-back is likely to be even larger. Notwithstanding the fact that prices for these commodities will remain relatively high from a historical perspective, the abrupt change in fortunes is likely to cause some temporary unease. Most concerning are the near-term challenges facing Canada's forestry sector, as lumber producers battle with declining U.S. homebuilding activity and pulp and paper makers confront increasing international competition and, in some markets such as newsprint, falling structural demand.



At the other end of the spectrum, prices for precious metals and natural gas are expected to record modest gains over the near term. In the case of bullion, an ongoing depreciation in the U.S. dollar will provide support to prices, while natural gas demand benefits this winter from a return to more seasonal temperatures compared to last year.

An additional near-term risk facing the resource sector is on the cost side. Over the past few years, increasing shortages of labour and materials have led to sky-rocketing project costs, particularly in the oil patch. In fact, between 2003 and 2005, cost estimates for several multi-year oil sands projects were revised up by 20-65%. Upward cost pressures are likely to subside to some extent in the coming months as growth in overall resource activity eases and material costs simmer down. At the same time, however, wage pressures facing producers are expected to remain stubbornly high, especially in view of the scarcity of skilled employees and ongoing labour demand requirements for multi-year oil sands expansion plans.

Leveraging strength to confront long-term challenges

The healthy longer-term picture for commodity prices

Longer-term Challenges Facing Canada's Resource Sector

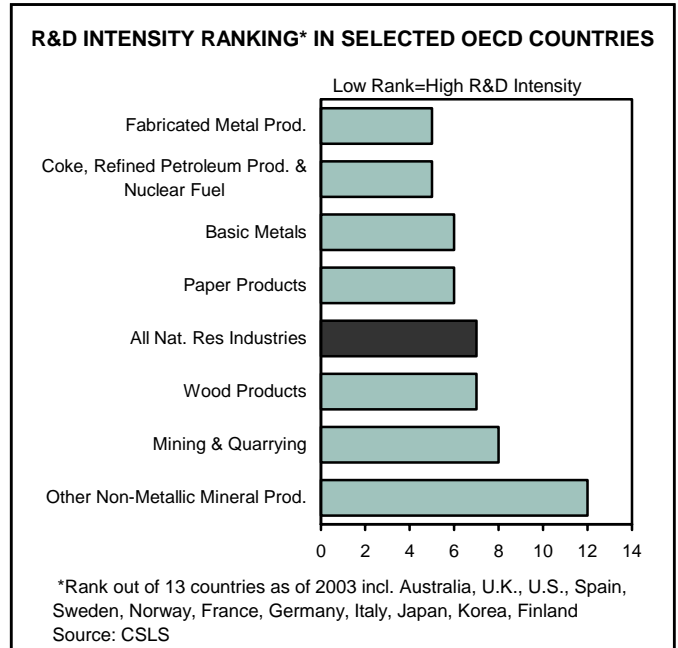
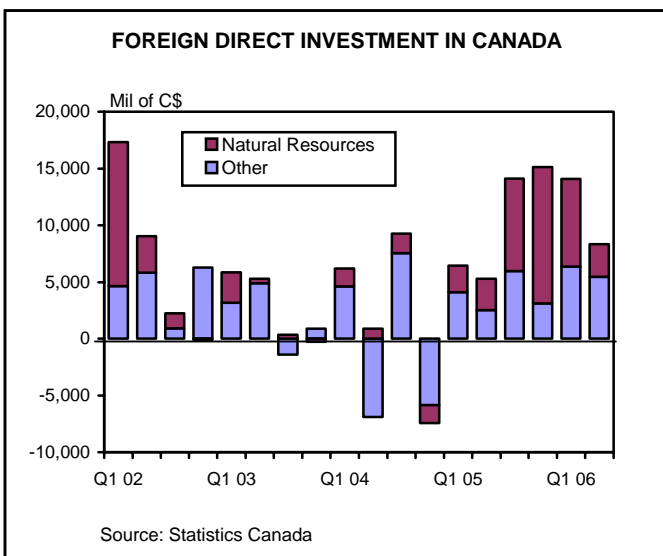
- Climate change and other environmental issues
- A still-high regulatory burden
- Outstanding aboriginal land claims and First Nation's increasing desire to benefit from resource development
- Infrastructure deficiencies
- High finding and development costs, notably off-shore oil development
- Aging population and skills shortages
- Raising world standing in productivity growth and R&D intensity
- Sector-specific challenges, including:
 - Pine beetle infestation, competition from emerging markets and/or high costs (forestry)
 - Declining conventional natural gas supplies (oil patch)
 - Rising Chinese production capacity (pulp, steel, aluminum and other metals)

and global demand will enable the resource sector to tackle a number of challenges from a position of relative strength. We list some of these challenges in the text box on the previous page. For instance, it will be critical for producers in the oil patch to step up their efforts to cut greenhouse gas emissions and reduce water use through new technologies and processes. In the forestry sector, the need to confront the pine beetle infestation in Western Canada, increasing production in developing markets and/or structural market changes will take centre stage. More generally, resource players will be facing many of the same pressures experienced in other sectors, including the impact of an aging population on the sector's already-stretched talent pool and growing infrastructure deficiencies. And, while the productivity performance of Canada's resource sector stands out at home, it lags behind some of its key international competitors, while comparatively low R&D levels of Canadian companies may leave our domestic resource industries at a long-term disadvantage.

Still, just as Canada's resource sector has proved resilient in the past, one cannot underestimate the sector's ability to take on these longer-term challenges head on. Significant investments by the sector in new capital, training and research will be necessary. Moreover, governments will need to turn their tax, regulatory and other policy levers in order to ensure that Canada's climate for resource investment remains among the best in the world.

Conclusions and implications for investors

The long-term outlook for Canada's resource sector is favourable. As such, resource-related activities will re-



main a major driver of real output and job creation in this country, as well as make disproportionately large contributions to national income, exports, capital spending and government revenues. In this context, the current perception of Canada as an international giant in the area of resources and a key global resource play is unlikely to fade any time soon.

This resource growth potential will continue to open up doors for attractive equity returns in Canada over the medium-to-longer run. Investors will be able to get a piece of the action by investing in Canadian publicly-traded companies, many of which will likely take on increasing global reach. In addition, more direct exposure to the commodity market can be gained through a number of recently-created commodity-linked funds that are available to the retail sector. While investor interest in commodities will ebb and flow, these new vehicles are likely to prove more than just a fad. Furthermore, new innovations on that front are almost certain to emerge down the road.

Foreign acquisitions a concern to investors

Canada's comparative strength in resources not only provides opportunities for investors, but challenges as well. The first centres around the impact of consolidation within the global resource sector, and more specifically, foreign acquisitions of Canadian players. Armed with their significant financial weight built up over the past few years, Canadian companies are well-positioned to expand abroad. And, to some extent, these firms have been taking advan-

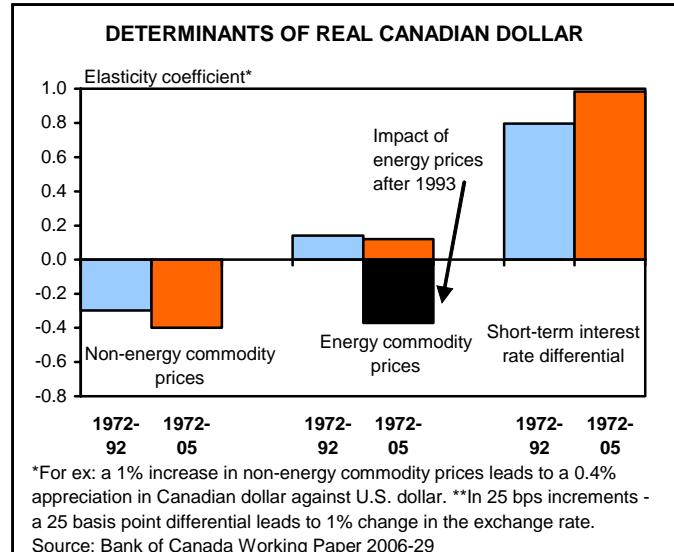
Are Canadian Financial Markets Becoming More Volatile?

Historically, Canada's S&P TSX Composite Index has recorded more volatility in daily returns compared to a number of its international peers, such as the S&P 500 (see chart). This development reflects, at least to some extent, the lower degree of sectoral diversification of the Canadian market. It also has something to do with the relatively high weighting of the Canadian benchmark index attributable to resources, which tends to record considerably more volatility than most areas, including financials. Over the 20 years, the combined share of the resource-based energy and materials sub-indices in the S&P TSX has averaged just over 30% compared to just under 30% for financials.

The brightening long-term fundamentals for commodity markets suggest that, if anything, the resource sector's share of the S&P TSX is set to rise from its longer-term average. Indeed, the resource share of S&P TSX market capitalization had climbed to a record of 48% in July 2006 before pulling back to its current still-high level of 43%. And, while this year may mark a high point, it seems improbable that in light of the TD Economics' commodity outlook, the sector's weight will drop below 35% on a sustained basis going forward. Thus, in light of the sector's relatively large propensity to endure short-term swings, the average volatility of the S&P TSX may be at risk of rising.

Canadian dollar more tied to resources

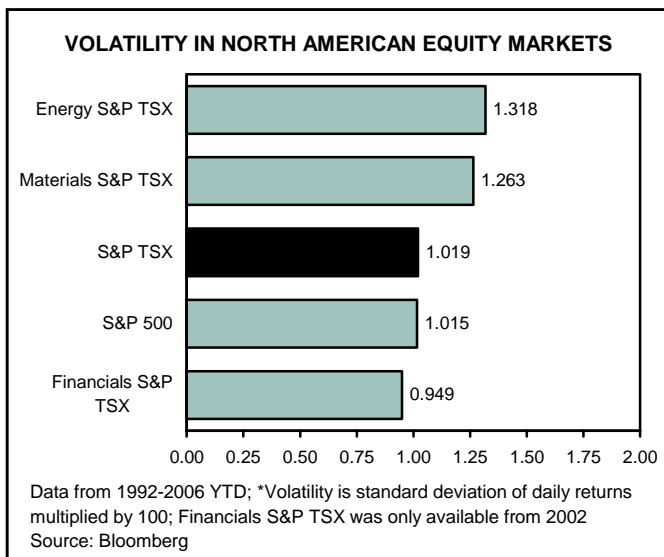
Commodity prices have always been an important driver of Canadian exports, so it would reasonably follow that changes in these prices would feed through to the value of the Canadian dollar. The Bank of Canada



has spent considerable time researching this issue. In the early 1990s, the Bank found robust relationships between the Canadian dollar and three explanatory variables – the Canada-U.S. short-term interest rate differential, the price of non-energy commodities and the price of energy commodities – over the period 1972-1992. Still, while higher world prices for non-energy commodities typically caused the currency to rise, higher energy prices were associated with a weaker currency over the period.

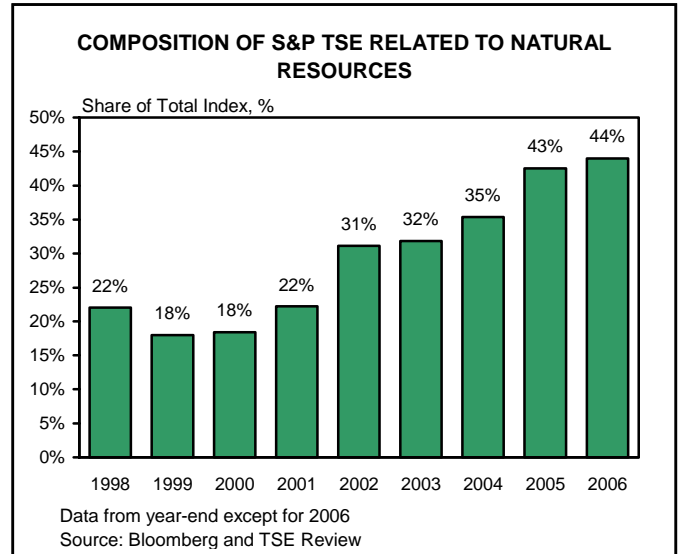
More recent research by the Bank has shown that the sign of the energy-price variable has actually switched to positive since 1993, meaning that a rise in prices of crude oil is now consistent with a higher loonie. The most popular explanation for this structural change is the growing importance of energy products in Canada's trade surplus. Accordingly, the positive impact on Canadian export earnings from rising energy prices now appears to outweigh the negative impact on demand in Canada's major export market, namely the United States.

All other things equal, the opposite (and thus dampening) influences of changes in energy and non-energy commodity prices on the value of the Canadian dollar pre-1993 likely reduced currency volatility. This is because energy and non-energy commodity prices often move in tandem over economic cycles. But, now that both drivers appear to be working in the same direction in terms of influencing the Canadian dollar, exchange-rate volatility may very well have risen of late. And, indeed, a look at standard deviations of daily currency movements shows that the currency has experienced some increase in volatility over the past decade compared to its 25-year record.



tage of global opportunities that have arisen. Yet, it is the foreign takeovers of this country's prized resource names, including Falconbridge, Inco, Domtar and Placer Dome, that have been dominating the headlines over the past few years.

Much of the debate about foreign acquisitions has focused on their potential hit to both output and jobs in Canada. Although there is an argument that the underlying asset (i.e., the resource) is fixed on Canadian soil, thus mitigating the risk of large investment reductions and layoffs in Canada, there are fears about the possibility that head offices would be consolidated in the new home country, demand for business services and financial-market activities in Canada would fall and top Canadian talent would



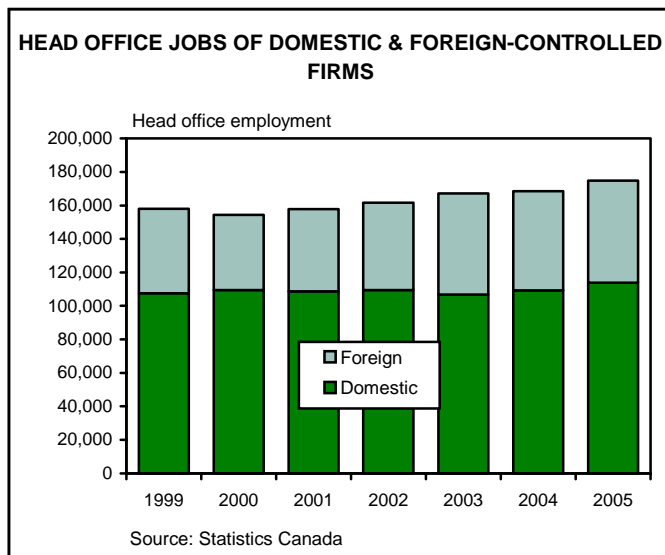
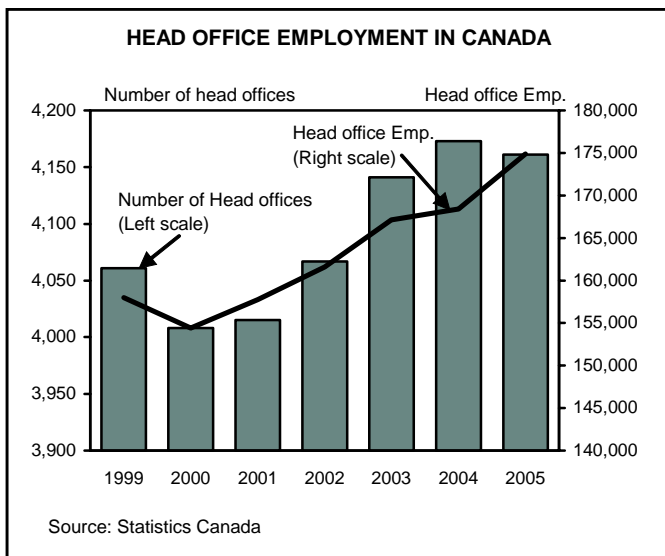
move abroad. Still, the case is not clear-cut. For instance, Canada could be well-positioned to benefit in the event that the domestic operations of the foreign-controlled firm are strengthened by the synergies and diversity of the larger entity, not to mention the rewards of knowledge transfer from the foreign acquirer.

A Statistics Canada study, released in July 2006, went some of the way in alleviating fears regarding the economic impact of takeovers. It found that both the number of head offices and head-office employment in Canada actually increased over the 1999-2005 period, owing to births in new *foreign* head offices.

As the debate about economic impact of takeovers rages on, the investment community has some legitimate concerns about the side-effects of foreign takeovers. Although the elimination of the foreign property rule by the federal government in 2005 has given pension funds and other large institutional investors free rein to invest their funds abroad, they still tend to allocate as much as 25% to Canadian equities. Over time, pension fund managers are almost certain to review the appropriateness of their asset mixes. In the short run, however, the disappearance of some of Canada's large corporate powerhouses could force these managers to re-invest their assets in an ever-shrinking pool of less liquid names.

Investors need to be mindful of risks

A second important issue relates to risk. While it is clearly the case that the combination of sound fiscal policy and low inflation have made the Canadian economy as a whole less prone to wild rides than in the past, the truth of



the matter is that resource output and income will always be more vulnerable to abrupt changes in fortunes than other major sectors. And, this is challenge is unlikely to change soon, especially with commodity prices becoming increasingly influenced by fickle global investment flows and often determined by factors outside of Canada's borders (and in many cases, through the actions of less politically-stable countries). Moreover, as we point out in the text box on page 13, the direct link between resource prices and the performance of Canadian equity and currency markets, if anything, appears to have strengthened in recent years. Putting it all together, notwithstanding our belief that Canada's long-term economic and investment picture remains rock solid, there is good reason to believe that volatility will remain the watchword in Canadian financial markets going forward.

As we argue in a September 5th, 2006 report entitled, *10 Reasons Canadians Should Invest Abroad*, an excellent way for domestic investors to manage the risk of excessive short-term gyrations in Canadian markets is to take better advantage of geographic asset diversification. Despite the elimination of the foreign content rule and the fact that Canada's equity market is less than 4% of the global total, Canadian investors have apparently been moving the other way. Although mutual funds are only part of the investment universe, a survey released by the Investment Funds Institute of Canada showed that the value of investments in U.S. and foreign mutual funds stands at only 22% of total holdings, down from 38% in 2000. As we point out in that report, geographic diversification may actually improve investment returns without increasing risk.

*Derek Burleton, AVP & Senior Economist
416-982-2514*

*Natasha Apollonova, Economist
416-982-2555*

KEY ECONOMIC INDICATORS FOR THE NATURAL RESOURCE SECTORS - 2005

Sector	GDP (chained, 1997\$, seasonally adjusted)		Employment* (average of monthly data for 2005, unadjusted for seasonal variation)		Exports		Trade Balance
	Value (\$billions)	Y/Y % chg.	Value (All Employees)	Y/Y % chg.	Value (\$billions)	Y/Y % chg.	Value (\$billions)
Energy	64.2	2.6%	245,122	3.9%	86.4	25.2%	51.8
Oil and gas extraction	23.5	-1.5%	45,215	5.9%	65.6	25.2%	40
Electric power generation, transmission and distribution	22.6	5.4%	93,538	0.2%	3.1	55.3%	1.9
Natural gas distribution	3.2	-2.0%	14,300	-1.2%	--	--	--
Support activities for mining and oil and gas	7.2	14.2%	70,935	9.1%	--	--	--
Petroleum and coal products manufacturing	2	-3.6%	21,134	4.2%	15.5	24.0%	8.5
Pipeline transportation	4.9	2.7%	--	--	--	--	--
Petrochemical manufacturing	0.8	-11.4%	--	--	2.1	4.8%	1.4
Minerals and metals	42	2.4%	389,402	-0.7%	53.5	12.2%	9.6
Mining (except oil and gas)	9.9	-1.0%	46,156	-2.6%	16.4	31.3%	10.3
Non-metallic mineral product manufacturing	5.6	4.2%	60,320	0.4%	2.8	-2.1%	-1.3
Primary metal manufacturing	12.3	2.6%	84,329	-2.4%	25.4	7.0%	6.1
Fabricated metal product manufacturing	14.2	4.0%	198,596	0.1%	8.9	3.7%	-5.5
Forest Products	32.3	-0.9%	271,393	-3.6%	41.8	-6.0%	32
Forestry and logging	7.2	-0.8%	49,366	-5.7%	0.6	18.8%	0.1
Wood product manufacturing	13.7	1.3%	131,569	-1.2%	19.7	-8.3%	16.6
Paper manufacturing	11.4	-3.5%	90,458	-5.8%	21.4	-4.4%	15.3
All industries	1,072.30	3.0%	13,728,068	1.7%	435.6	5.8%	56.1

* Using Survey of Employment, Payrolls, and Hours (SEPH), which excludes self-employed; Source: Natural Resources Canada