C | A

CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT: NAFTA—BRACING FOR A DOWNTURN

March 31, 2001

Ian Kennedy
Robert Lang
Stuart Wall
Laura Brooks
Leigh Pate

NAFTA - Bracing for A Downturn

For better or worse, the North American Free Trade Agreement (NAFTA) tied the economic fates of Canada and Mexico to that of the United States. Canada and Mexico soared on the wings of the United States while its economy flourished—but now the tether has become onerous, casting a shadow over the prospects of the NAFTA partners. Both the Toronto Stock Exchange 300 (TSE 300) and the Indice de Precios y Cotizaciones (IPC) enjoyed double-digit growth over the last five years, as their market caps more than doubled. While their fundamentals have just begun to show signs of stress, the pace of deterioration may accelerate as the U.S. economy slows. How should investors brace themselves against this possibility?

Integration and Its Limits

The 1993 introduction of NAFTA accelerated the convergence of business cycles and integration of capital markets among its partners. Canada and Mexico are now the top two trading partners of the United States, which absorbs about 75% and 90% of their exports, respectively. Canada's trade totals 87% of its GDP, while Mexico's totals 74%. In 1999, foreign direct investment (FDI) in Mexico totaled $11.2 billion, up dramatically from annual investments of $3.7 billion between 1988 and NAFTA's launch in 1993.

Their equity markets have also developed substantially in recent years. Over the last ten- and five-year periods, the TSE 300 has posted average annual compound returns of 10.4% and 10.6%, respectively (all returns are in local currency unless noted otherwise). Over those periods, the IPC returned 21.7% and 13.3%, and the Mexican Bolsa has actually outperformed the Nasdaq and S&P 500 since 1988. Investors committing $100 to the IPC in January 1988 would have seen their savings grow to $977 by March 2001, compared to $202, $451, and $534 of potential earnings in the TSE 300, S&P 500, and Nasdaq, respectively (see Table A). Over the last five years, the capitalizations of the Canadian and Mexican equity markets roughly doubled. Canada grew from approximately $200 billion in 1996 to approximately $750 billion at its peak in August 2000, and Mexico from just under $50 billion in 1996 to almost $120 billion at its peak in March 2000 (see Table B).

During these years, equity returns were driven by both "old" and "new" economy stocks, which demonstrates the extent to which their economic structures have changed since NAFTA was established. The traditional economic mainstays of Canada's exports—energy and forestry—have declined in relative significance over the last five years, while its manufacturing and services industries have grown more important. The financials sector currently accounts for 30% of FTSE Canada's market cap, up from 19%

in 1996; the information technology sector reached a market cap of 22% in December 2000 (before falling to 12% by March 2001), up from 12% in 1996; while the resources sector currently carries a 14% weight, down from 26% in 1996 (see Table C).

Although Canada's economy has grown relatively more diversified and less dependent on commodity exports, its equity market remains highly concentrated. The largest ten stocks in the TSE 300 account for 34.2% of its total capitalization, while the largest 20 make up 50.5%, and the largest 30, 60.7% (see Table D). Nortel Networks alone comprises 8.3% of the index. (In comparison, the S&P 500's largest ten shares hold a 23.2% market weight, largest 20, 35.2%, and largest 30, 43.1%.)

The Mexican economy has made similar advances. From 1989 to 1999, exports grew nearly 300%, comprising 30.8% of GDP, up from 19.0% a decade earlier. Mexico has reduced its dependence on oil and agriculture, while developing its manufacturing and service industries (see Table E). In 1989 oil comprised 22.4% of the nation's total exports, but by 1999 that figure had fallen to 7.3%, and over the decade, exports of manufactured products as a percentage of total exports grew from 70.9% to 89.5%. In 1999, the service industry accounted for 67% of GDP.

FTSE Mexico is even more highly concentrated than FTSE Canada. FTSE Mexico is driven by a few sectors: non-cyclical services (40.4% market cap), cyclical services (18.9%), and basic industries (13.9%). The largest five companies in the IPC account for 54.3% of its market cap, while the largest ten comprise 75.0%. In particular, it is dominated by a handful of companies: Telefonos de Mexico (17.9%), Wal-Mart de Mexico (11.0%), and Grupo Financiero Banamex Accival (9.8%).

The American Contagion

The stalled U.S. economy is beginning to take its toll on Canada and Mexico. In the first quarter of 2001, MSCI Canada returned -16.0%, but Mexico managed to hold up better, with a 2.5% return. Although the dynamic of Canada's downturn mirrors many aspects of the U.S. slump, the absence of American-style excesses may cushion its fall. North of the border, manufacturing activity is falling, capital spending on technology is dropping, the labor market is showing signs of weakness, exports are decelerating sharply, and domestic demand is beginning to slow. GDP growth is now forecast to reach 1.3% for 2001, a pale shadow of its 4.1% rate in 2000—and even this may prove overly optimistic. However, the reverse wealth effect and threat of an investment bust are less pronounced in Canada than in the United States. Net financial wealth among Canadian households was around 250% of disposable income, much less than 450% in the United States, and Canucks hold about 95% of equity assets as a percent of disposable income, compared with 175% in the United States. TSE 300 operating earnings are forecast to grow between 5% and 10% in 2001, though this could fall significantly, possibly to -15% if the United States suffers zero growth this year.

Mexico remains the most vulnerable of all Latin American countries to a U.S. slowdown in general and a drop in U.S. consumption in particular. South of the border, the manufacturing sector is the epicenter of its incipient slowdown, while exports are also beginning to slow. GDP growth is expected to decline to around 3.2% this year, from 6.9% in 2000. However, relatively high levels of consumer spending may reduce the shock of a prospective hard landing by the Yanquis. Over recent years, low inflation boosted real wages, which bolstered consumption, but the reverse wealth effect could surface if the downturn intensifies.

Corporate profits in Mexico are expected to be down across the board in 2001, as margins are getting squeezed by weaker prices, higher costs, lower-than-expected sales, and the strong peso. In the past, Mexican companies used their dominant market share to keep profits and real prices high, but stronger government antitrust policies now threaten this practice. Consensus expects US$ per share earnings to grow 7.3% in 2001, down from 9.0% in 2000 and 50.6% in 1999—but analysts warn that these forecasts may still be too optimistic.

The main risk for the Mexican economy is how the central bank manages the conflict between its inflation target and a deterioration in its balance of payments. Reduced demand for its imports could aggravate its current account balance, which could put downward pressure on the peso and re-ignite inflation. In 1998, the Banco de Mexico reacted to the Asian crisis by significantly devaluing the currency, while keeping a loose monetary policy. This policy soon unleashed inflationary pressures, nearly wiping out competitive gains that were achieved from the nominal devaluation. Since then, the central bank has successfully contained inflation by jacking up interest rates and maintaining a very tight monetary policy. In real terms, the peso is stronger today than just prior to the December 1994 devaluation, but officials are worried that the U.S. slowdown will hurt the peso, which could revive inflationary pressures.

Dependent, But Not Defenseless

Are the Canadian and Mexican equity markets simply shadows of the U.S. market? In recent years, equities both north and south of the border have experienced a sharp rise in correlations with U.S. equities (see Table F). For example, the 36-month rolling correlations of the TSE 300 with the S&P 500 are currently 0.79, compared with its 12-year mean of 0.70, while they are 0.78 with Nasdaq. In Mexico, correlations between the IPC and S&P 500 and Nasdaq are currently 0.69 and 0.74, both up sharply from around 0.20 in 1997. The volatility of these correlations implies that equities could become less correlated with U.S. markets in the future. However, unless their economies reacquire some pre-NAFTA traits, the convergence of their business cycles suggests that high levels of correlations will probably persist for the foreseeable future.

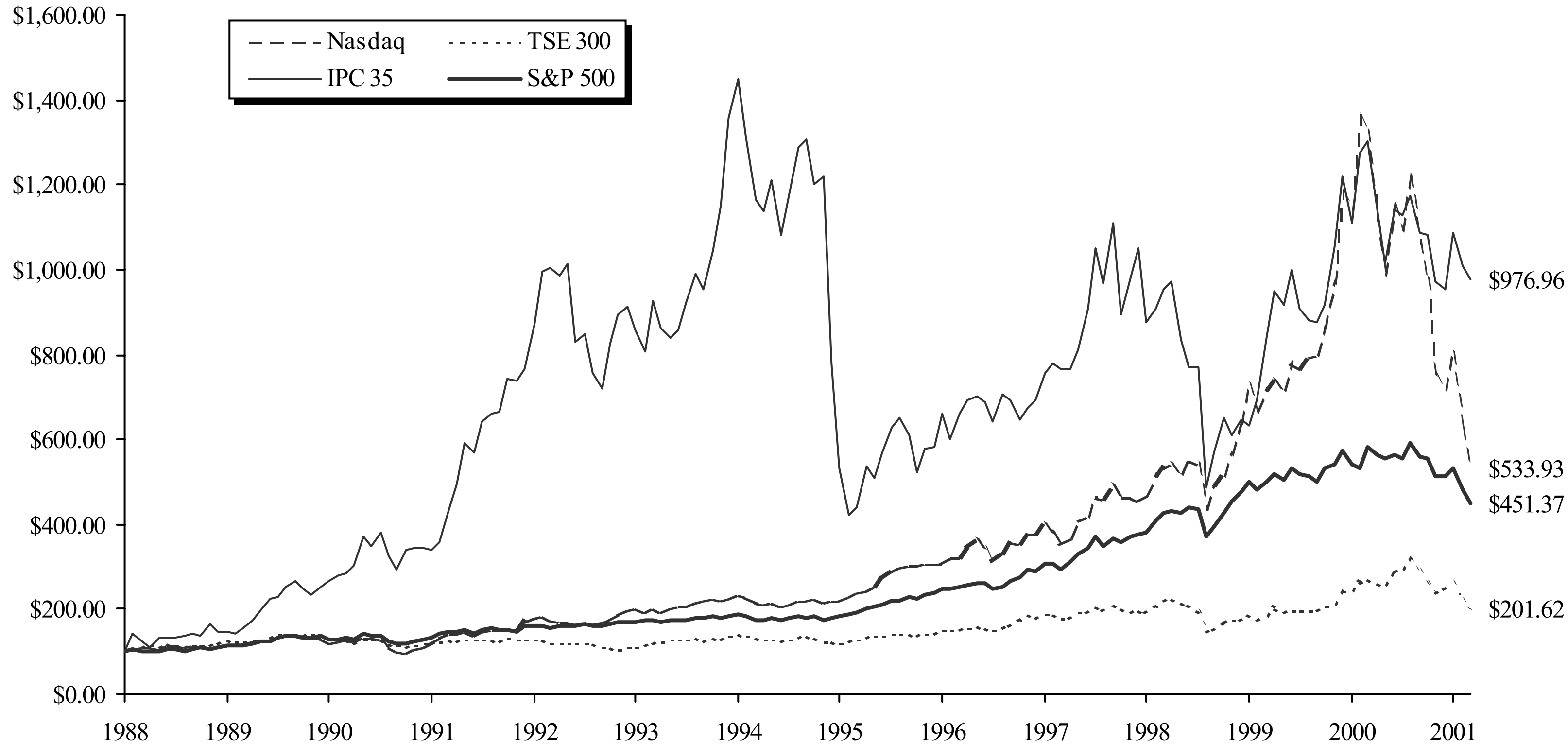
Nevertheless, investors may be able to find nuggets of diversification opportunities among certain sectors (see Table G). For instance, correlations between the Canadian and American cyclical services sector are 0.20, and they are 0.39 for the non-cyclical services. However, the resources sector carries a 0.79 correlation, while it is 0.73 for information technology, and 0.79 for financials. Mexican investors enjoy slightly higher levels of diversification. Correlations with the financials sector in the United States are 0.52; cyclical services, 0.50; basic industries, 0.44; and non-cyclical services, 0.57.

In short, domestic investors in Canada and Mexico may be able to ride out the storm by seeking shelter in sectors that are less correlated with U.S. equities. Although NAFTA has accelerated the convergence of business cycles, the distinct characteristics of the Canadian and Mexican economies may be able to cushion them somewhat against the sharp slowdown in the United States. However, if the squall turns into a hurricane, which unleashes a credit crunch in international markets, there will be nowhere to hide from the tempest.

Table A

COMPARATIVE CUMULATIVE WEALTH: IPC 35, NASDAQ, S&P 500 AND TSE 300

February 1, 1988 - March 31, 2001
(January 31, 1988 = $100)



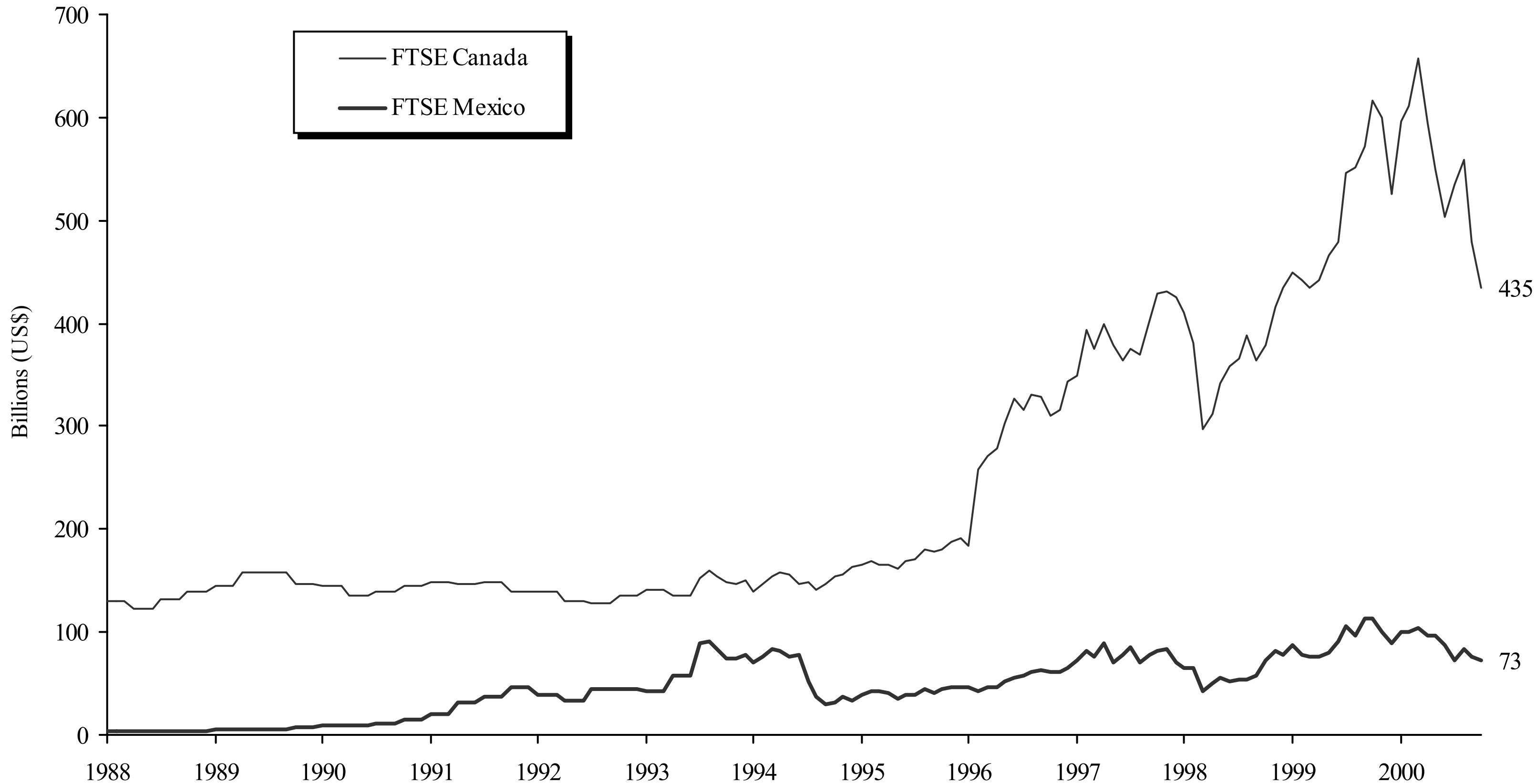
Source: Datastream International.

Note: Data are based on price returns.

Table B

MARKET CAPITALIZATIONS OF FTSE CANADA AND FTSE MEXICO

June 30, 1988 - March 31, 2001



Source: Datastream International.

Note: FTSE indexes cover 82% to 90% of each market's capitalization.

Table C

FTSE MEXICO AND FTSE CANADA SECTOR WEIGHTS

As of March 31, 2001

	Percent of FTSE Canada Index (%)	Percent of FTSE Mexico Index (%)
Resources	14.0	2.6
Basic Industries	7.9	13.9
General Industries	8.1	4.1
Cyclical Consumer Goods	1.6	---
Non-Cyclical Consumer Goods	4.7	8.8
Cyclical Services	9.3	18.9
Non-Cyclical Services	8.3	40.4
Utilities	4.0	---
Financials	29.6	11.2
Information Technology	12.4	---
	100.0	100.0

Source: Datastream International.

Note: Figures may not total due to rounding.

Table D

TSE 300 AND IPC 35 TOP HOLDINGS

As of March 31, 2001

	TSE300		IPC 35		
	Holdings	% of Market Value	Holdings	MKT	% of Market Value
1	Nortel Networks Corp	8.3	Telefonos de Mexico		17.9
2	Thomson Corp	3.9	Wal-Mart de Mexico		11.0
3	Royal Bank of Canada	3.4	Grupo Financiero Banamex Accival		9.8
4	BCE Inc.	3.4	Carso Global Telecom		8.2
5	Toronto Dominion Bank	2.9	Cementos Mexicanos		7.5
6	Bombardier Inc. Class B	2.7	Grupo Financiero BBVA-Bancomer		6.5
7	Bank of Montreal	2.5	Grupo Televisa		4.4
8	Bank of Nova Scotia	2.4	Grupo Financiero Inbursa		4.3
9	Manulife Financial Corp	2.4	Fomento Economico Mexicano		2.8
10	Canadian Imperial Bank	2.3	Savia		2.6
11	Alcan Inc.	2.2	Grupo Carso		2.5
12	Canadian Pacific Ltd.	2.1	Grupo Bimbo		2.4
13	Imperial Oil Ltd.	1.9	Kimberly-Clark de Mexico		2.2
14	Great West Lifeco Inc.	1.6	Grupo Modelo		1.9
15	Loblaw Cos Ltd.	1.6	Apasco		1.7
16	Sun Life Financial Services CDA Inc.	1.5	Organizacion Soriana		1.6
17	Power Financial Corp	1.4	Wal-Mart de Mexico		1.5
18	Weston (George) Ltd.	1.4	Grupo Sanborn's		1.4
19	Canadian National Railway Co.	1.3	Grupo Continental		1.2
20	PanCanadian Petroleum Ltd.	1.3	TV Azteca		1.2
21	Shell Canada Ltd. Class A	1.3	Grupo Industrial Alfa		1.1
22	Alberta Energy Co. Ltd.	1.2	Corporacion Interamericana de Entretenim		1.1
23	Petro-Canada	1.1	Grupo Financiero Banorte		0.9
24	TransCanada Pipelines Ltd.	1.1	Tubos de Acero de Mexico		0.9
25	Suncor Energy Inc.	1.1	Industrias Penoles		0.6
26	Barrick Gold Corporation	1.0	Consorcio ARA		0.5
27	Talisman Energy Inc.	0.9	Gruma		0.4
28	Brascan Corp Class A	0.9	Grupo Elektra		0.4
29	Power Corp Canada	0.8	Vitro		0.3
30	Celestica Inc.	0.8	Controladora Comercial Mexicana		0.3
	% in Largest 10 Holdings	34.2	% in Largest 10 Holdings		75.0
	% in Largest 20 Holdings	50.5	% in Largest 20 Holdings		92.5
	% in Largest 30 Holdings	60.7	% in Largest 30 Holdings		98.9

Source: Factset.

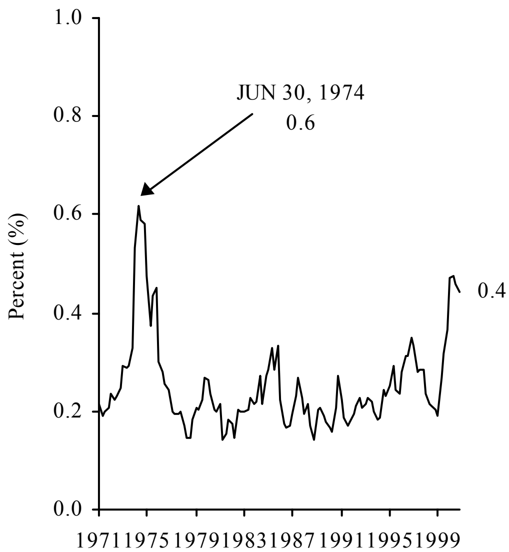
Note: The IPC 35 Index lists two different classes of Wal-Mart de Mexico.

Table E

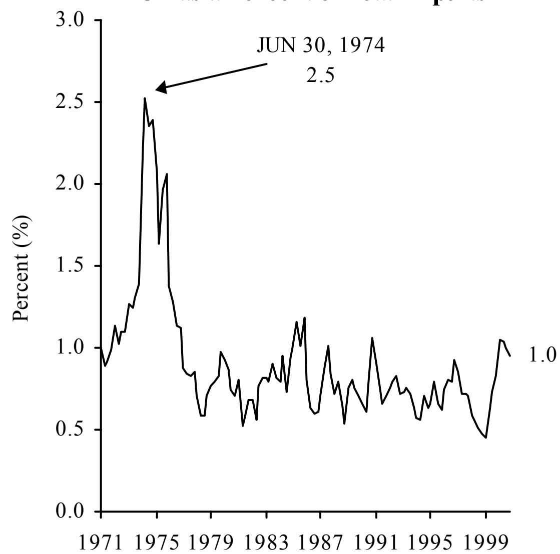
OIL EXPORTS FOR CANADA AND MEXICO

March 31, 1971 - December 31, 2000

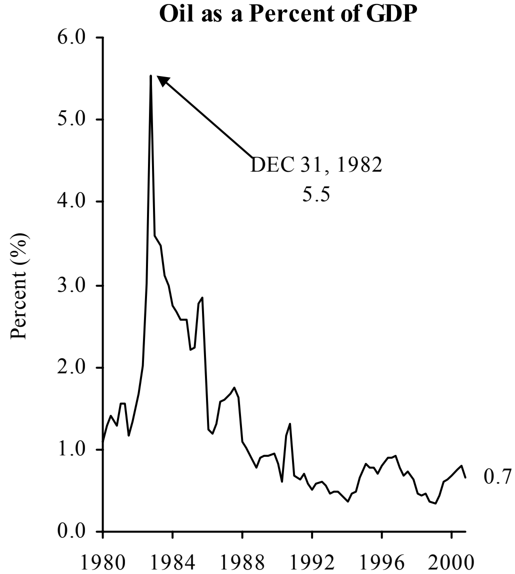
Canada
Oil as a Percent of GDP



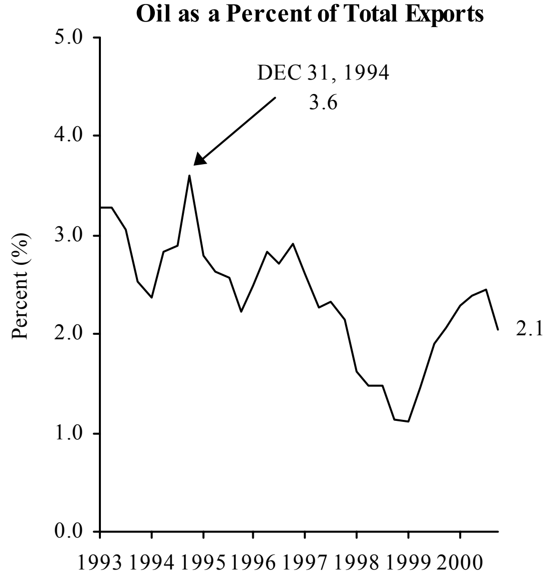
Canada
Oil as a Percent of Total Exports



Mexico
Oil as a Percent of GDP



Mexico
Oil as a Percent of Total Exports



Source: Datastream International.

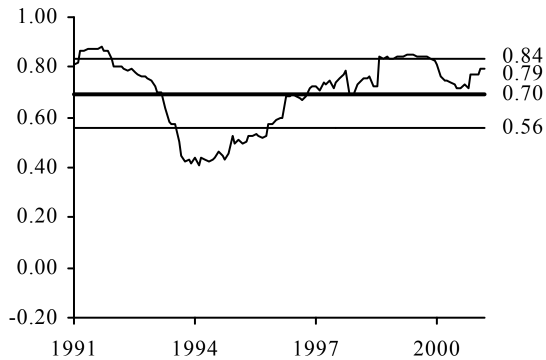
Notes: Oil exports include crude oil and petroleum exports. Data for Mexico oil exports as a percent of GDP and Total Exports are from March 31, 1980 through December 31, 2000 and March 31, 1993 through December 31, 2000, respectively.

Table F

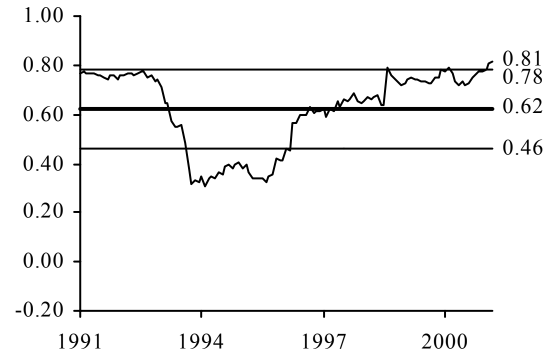
36-MONTH ROLLING CORRELATIONS IN LOCAL CURRENCY

February 1, 1988 - March 31, 2001

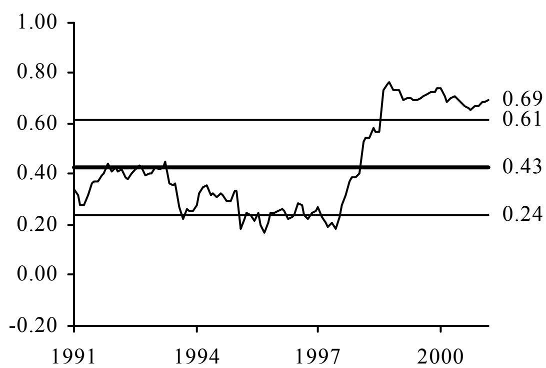
S&P 500 and TSE 300



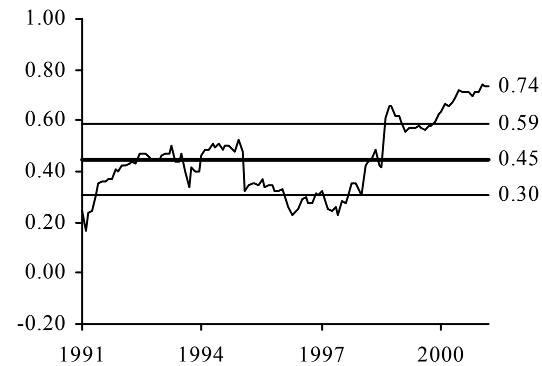
Nasdaq and TSE 300



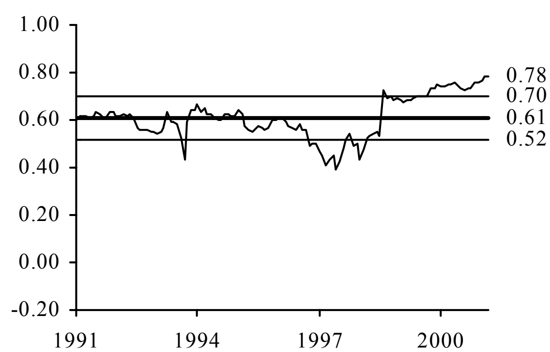
S&P 500 and IPC 35



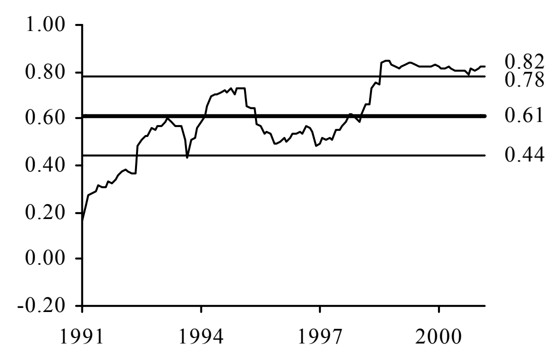
Nasdaq and IPC 35



MSCI EAFE and TSE 300



MSCI EMF and IPC 35



Mean
One Standard Deviation

Sources: Datastream International, Standard & Poor's, and *The Wall Street Journal*. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: IPC 35 and Nasdaq performance are price change only.

Table G

36-MONTH ROLLING CORRELATIONS IN LOCAL CURRENCY

January 1, 1994 - March 31, 2001

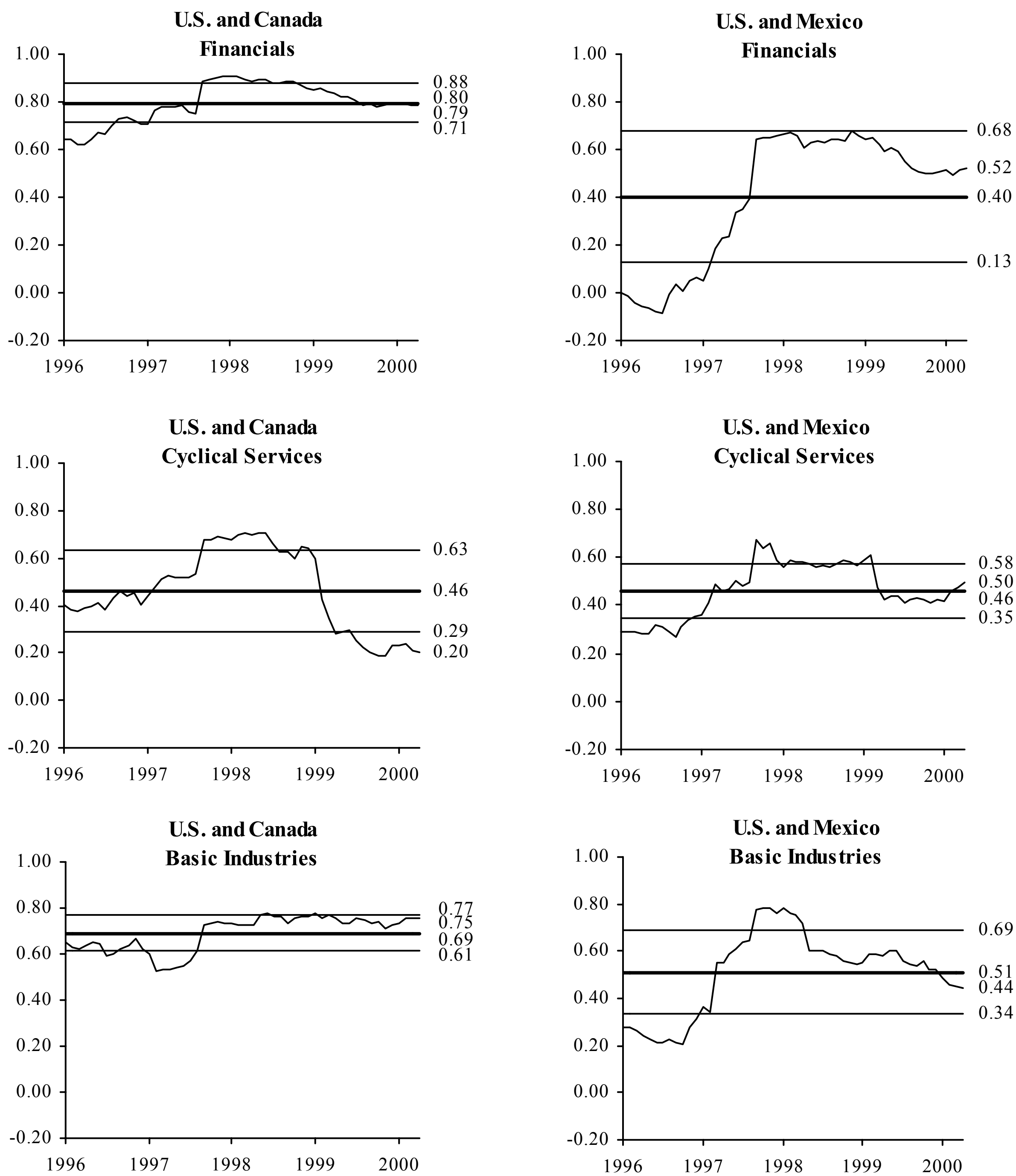
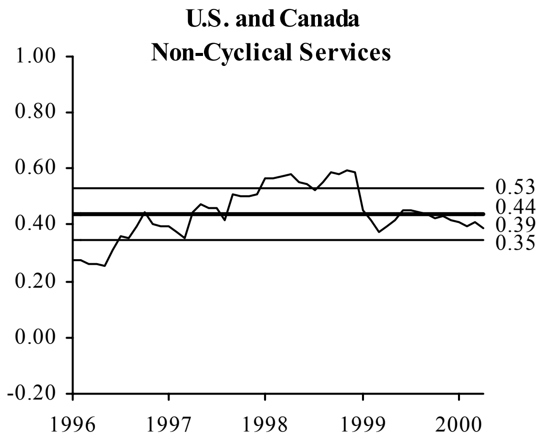
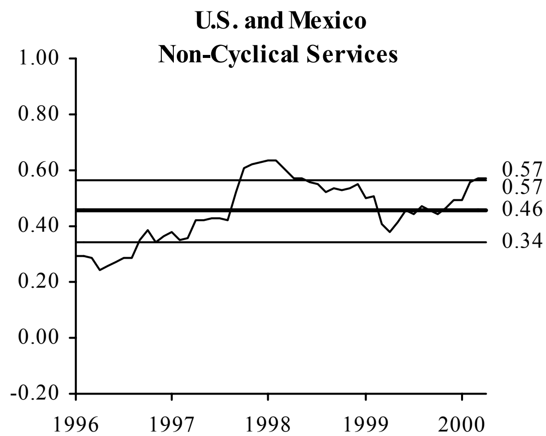


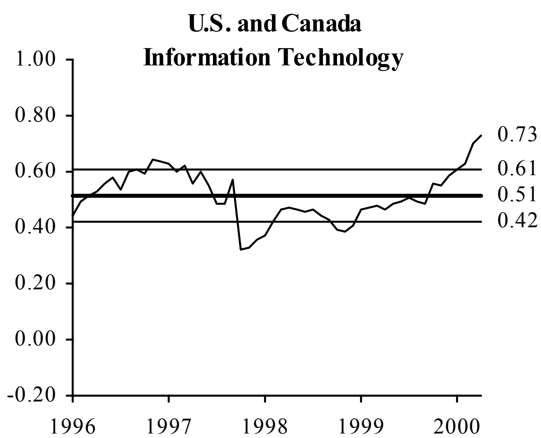
Table G (continued)

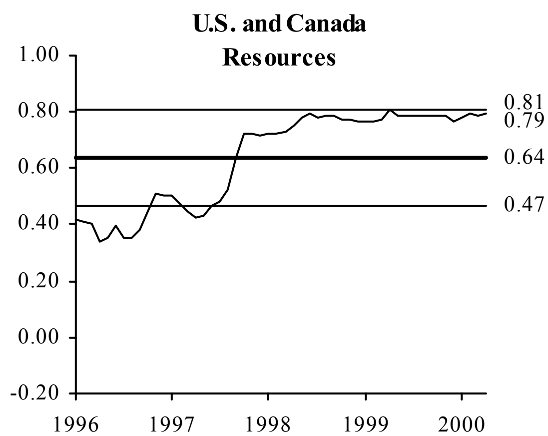
36-MONTH ROLLING CORRELATIONS IN LOCAL CURRENCY

January 1, 1994 - March 31, 2001









Mean
One Standard Deviation

Source: Datastream International.