CANADA PLAYS CHINA CARD

Trade friction and energy leverage has led to an unprecedented Canadian policy of “speak loudly and carry a big piece of lumber” policy towards the United States.

The long running dispute over American tariffs on Canadian lumber escalated to the point last week that Canadian Prime Minister Paul Martin indirectly linked settlement with continued U.S. access to Canadian energy supplies. Meanwhile, Canadian Natural Resources Minister John McCallum was off to China to meet with Chinese oil, mining and forestry officials.

This is serious business. Part of the 1994 NAFTA Free Trade Agreement guaranteed that Canada would remain the favored supplier to the U.S. It might surprise you to learn that Canada supplies 17% of U.S. oil imports, 16% of our natural gas and nearly all of our hydroelectric power. The Canadian government owns the vast majority of the country’s energy resources and Canada exports more than 1.5 million barrels a day to America representing 8% of U.S. consumption.

China’s Lengthening Reach

Meanwhile, China’s aggressive moves in Canada’s energy sector are raising eyebrows in Washington. Chinese government has earmarked $100 billion for overseas acquisitions of oil and gas. The Chinese are going on a buying spree investing in Canadian energy companies and recently plunked down $2 billion to build a thousand mile pipeline from Alberta tar sands to port on the west coast and onward to Beijing and Shanghai. While the oil reserve numbers for Saudi Arabia are under scrutiny, Canada has recoverable reserves of roughly 175 million barrels. Much of it is in oil sand that is processed profitably at oil prices of $20 or higher and T. Boone Pickens thinks that Canada’s oil sand production could reach 6 million barrels a day

There are now about 1 million ethnic Chinese residing in Canada and China is now Canada’s second largest trading partner. Last month, Chinese President Hu Jintao visited Canada and declared that the two countries had upgraded their relations to a “strategic partnership”.

The US’s Waning Grasp

This Chinese-Canadian power play puts America in real jam. You could write a book about the long simmering lumber dispute but a Nafta panel recently ordered the U.S. to return $5 billion of collected tariffs to Canadian lumber companies. Relations with Canada were also weakened earlier this year when Canada announced that it would not contribute to the American-led missile defense program even though 90% of Canadian citizens live within 100 mile of the border between the two countries and Americans purchase 85% of total Canadian exports.

What’s going on? Part of the answer is that the vast majority of Canadians oppose the policies of the Bush Administration. The issue is sensitive in many areas across Canada that are highly dependent on the lumber industry and Mr. Martin and his party are preparing for national elections expected early next year. It is always a vote getter to poke a stick in the eye of the elephant to the south.

How to Play

While Canadian-American relations have seen better days, the energy boom has certainly been beneficial to investors in Canadian markets. The Canada iShare (EWC) tracks the MSCI Canada Index that has 40% exposure to Canada’s energy and materials sector. While the S&P index is up only 3%, the Canada iShare is up 16.6% year to date and 28.8% over the past twelve months.

Speaking of timber, it is smart to have some timber exposure in your portfolio and I have had timber REIT Plum Creek Timber (PCL) in our core portfolio for over two years. Here is why I like it. First, timber is a great inflation hedge and over the past 100 years has risen 3% above the average annual inflation rate. Secondly, timber is not correlated to stocks or bonds and thus is a great “shock absorber” to cushion your portfolio when shares are declining. During the 1970s bear market, timber rose in value while stocks went down. Thirdly, from 1973-2000 timber yielded an average annual return of 15%. Last but not least, timber valuations are attractive after some declines during 2000-2002 especially relative to real estate prices. During 2004 Plum Creek was up 23% and this year it has traded between $34 and $39 finishing last week just over $35 with an attractive dividend yield of 4.3%.

It behooves the U.S. to negotiate a settlement to the lumber dispute as soon as possible and lock up Canadian energy sources before the Chinese get the jump on us. Investors can’t do much about improving Canadian-American relations but they can improve their portfolios by adding exposure to timber as well as to Canada as both an energy and China play.