

PwC Capital Markets Flash

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Up, up and away...but?

The greatest green shoot of all sprouts this week. Preliminary US GDP growth is 3.5% for the third quarter, signaling a technical end to a two-year US recession and halting a four-day slide in equity prices – the S&P 500 finished the day up 2.25% while the TSX rose 2.5%. By and large, the headline grabber this week was volatility in currency markets.

What is the PwC perspective on the loonie? Read our In Focus section this week to find out.

	Oct 29, 2009	Crisis Extreme	Sept 1, 2008	Pre-crisis Extreme ¹	Bi-weekly Movement
CDN\$/US\$	\$0.935	\$0.771	\$0.936	\$1.091	▼
S&P 500	1,066	677	1,278	1,565	▼
S&P/TSX	11,075	7,567	13,300	15,073	▼
LIBOR ²	0.28%	4.82%	2.81%	1.11%	▼
TED Spread ³	0.23%	4.64%	1.10%	0.14%	▲
OIS Spread	0.23	1.85	0.47	0.14	▼
S&P/LSTA ⁴	1,381	895	1,293	1,335	▼
CBOE VIX ⁵	25	81	21	10	▲
Baltic Dry Index ⁶	2,986	663	6,691	11,793	▲
WTI Crude Oil ⁷	\$79.87	\$33.87	\$111.55	\$146.85	▲

Source: Bloomberg

- Over five-year period.
- BBA US LIBOR, three month.
- Difference between rates on interbank loans and three month US Treasuries. Indicator of perceived credit risk.
- Mirrors market weighted performance of leveraged loans. Tracks returns in leveraged loan market.
- An expectation of the market's 30-day volatility, measured by tracking the money calls on companies in the S&P 500. Historically, VIX values greater than 30 are associated with high volatility and values below 20 are associated with low volatility.
- An indicator that predicts future economic activity by measuring global shipping supply and demand for commodities, such as building materials and coal.
- West Texas Intermediate (WTI), also known as Texas Light Sweet, is a type of crude oil used as a benchmark in oil pricing and the underlying commodity of New York Mercantile Exchange's oil futures contracts.

Highlights in this issue

- Despite a recent temporary flight to US dollar safety, on a trade-weighted basis, the greenback has declined 15% since February 2009, continuing down the path of a decade-long deterioration. In contrast, the floating currencies of many of America's trade partners, including Canada, have appreciated to unwind global trade imbalances.
- While currency volatility has far-reaching global impacts, closer to home, Canadian dollar strength is:
 - Worsening the trade competitiveness of the manufacturing, forestry and agricultural dependent provinces; and
 - Holding inflation below the Bank of Canada's target 2%, thereby frustrating monetary policy and raising the specter of further economic weakness.
- There are four forces that argue for continued near-term volatility: a return to risk, competitive devaluation, quantitative easing-induced inflation and the phenomenon of commodity currencies. It remains difficult, however, to predict a quantum of global volatility given that select forces are opposing.
- In Canada, consensus is for a loonie north of \$0.96 by the end of the fiscal year.

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Notable economic news

Monetary policy

- Silencing speculation that the Bank of Canada will follow in the footsteps of its Australian counterpart, the Canadian central bank holds its target overnight rate at 0.25% citing ongoing economic “fragilities”. The move reinforces the bank’s commitment to keep rates near their “effective lower bound” until mid-2010.
- Norway becomes the first European central bank to raise interest rates after the financial crisis. In raising rates, Norway is joining the vanguard of central banks that are reversing the easing cycle. The move is all about inflation – a subject on which Mr. Carney has been aggressively trying to get international investors to focus on. Norway’s underlying inflation rate is now close to the Norges Bank’s target of 2.5%.
- Despite extraordinary monetary stimulus, inflation remains at bay, thanks in part to the strong dollar.

Inflation/deflation

- Canadian headline inflation is negative for the fourth consecutive month, with September prices falling 0.9% year-over-year.
- Soft domestic demand contributes to the latest deflation reading, but the main source of decline is a drop in energy prices. Indeed, core prices (excluding energy and food) continue to rise, albeit at a modest pace, alleviating concerns that a Japanese-style deflationary trap is upon us.
- In the US, the inflation story is similar. September headline inflation is negative, with prices down 1.3% year-over-year as a result of lower energy costs, but core inflation comes in at +1.5%.

US housing

- The Commerce Department reveals that new US home sales dropped 3.6% in September, reversing a five month upward trend.
- Some attribute the change to the fact the effects of the government’s \$8,000 new home tax credit are wearing off.
- A rebound in home prices is seen by many as a prerequisite to a sustained US economy recovery, bolstering household balance sheets and restoring consumer confidence.

Canadian Industry Data

- Retail Sales
 - Canadian consumers remain remarkably resilient in the face of economic uncertainty. Retail sales jumped 0.8% in August month-over-month, more than offsetting July’s 0.5% decline.
 - With the strong loonie weighing on exports, a recovery in the retail sector will prove crucial to the Canadian economic recovery, although the risk of more competitive foreign goods, especially from the US, may dampen the Canadian retail recovery.
- Manufacturing
 - The Canadian manufacturing sector continues to struggle, hampered by weak US demand and a strong loonie.
 - New data reveals that Canadian manufacturing shipments dropped 2.1% in August from the previous month and are 19.1% below August 2008 levels.

Consumer Confidence

- A weak job market continues to weigh on consumer confidence in the US. The Conference Board’s consumer price index drops 5.7 points to 47.7 in October, its lowest reading since July.
- While the index is well up from a cyclical low of 25 in February, the latest setback reveals ongoing pessimism about job prospects and the economy in general.

Notable M&A

- Continuing the trend of state-owned Chinese funds securing access to Canadian-owned resources, China’s main sovereign wealth fund is investing \$500-million into SouthGobi Energy Resources, a coal mine located in southern Mongolia near the Chinese border. SouthGobi’s majority owner is Canada’s Ivanhoe Mines Ltd. China Investment Corp’s investment is structured as a 30-year secured debenture convertible to common equity.
- Toromont Industries puts forward a \$597-million bid to buy Enerflex Systems Income Fund as it tries to build a dominant natural gas compression business. Toromont offered \$13.50 a unit in cash and stock, a 34% premium

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over Enerflex's closing price prior to the offer. Toromont has already locked up 28.5% of Enerflex's units.

- Terra Industries announces it will purchase a 50% interest in Agrium's Carseland nitrogen production assets for \$250-million. According to Michael Bennet, Terra CEO, the transaction is consistent with Terra's pure-play nitrogen strategy, and it will be immediately accretive to Terra's shareholders. The closing of the acquisition is subject to certain conditions, including Terra's raising \$600-million of debt capital.
- State-run South Korea National Oil (KNOC) agrees to buy Canada-based Harvest Energy Trust for C\$1.8-billion plus the assumption of C\$2.3-million of debt. The offer represents a 37% premium over the 30-day weighted average trading price of the units on the TSX.
- Rogers Communications makes an undisclosed multimillion-dollar investment in Vuguru, a web video studio being spun off by former Disney chairman Michael Eisner. This deal signals a change in the Canadian broadcasting landscape and pushes cable companies further into content ownership and production lines of business.
- Unilever agrees to purchase the personal care business of Sara Lee for \$1.8-billion. The Anglo-Dutch group which already owns brands like Dove, Lux, and Sunsilk, would further strengthen its category leadership by bringing in brands such as Sanex and Radox. According to Unilever's CEO Paul Polman, the Sara Lee brands have strong consumer recognition and are an excellent fit with Unilever's existing business.
- Dole Food, the world's largest fresh fruit and vegetable company, prices its IPO of 35.7 million shares at \$12.50, under the expected \$13-\$15 range. Total proceeds of the completed offering were \$446-million. Among investor concerns was Dole's debt which is relatively high at 4x EBITDA (post IPO), more than 50% higher than the leverage levels of its rivals Del Monte and ConAgra Foods.
- CIT Group expands its current \$3-billion senior secured credit facility by an additional \$4.5-billion. The new tranche is being financed by a diverse group of lenders, including many of the company's bondholders. Despite a commitment letter from Carl Icahn to provide CIT a new \$4.5-billion term loan as an alternative to the current plan, CIT's Board of Directors decided to proceed with funding from the group of lenders instead due to a lack of evidence of Mr. Icahn's ability to fund the commitment. Chairman and CEO Jeffrey M. Peek said: *"We believe this secured financing will serve the best interests of all stakeholders and...will allow us to continue to serve our existing small business and middle market customers as we advance our restructuring plan."* CIT lends to about one million companies, making it a source of hard-to-find credit in the wake of the financial crisis.
- L-3 Communications, a key contractor in the aerospace and defense sector, announces it has secured a \$1-billion, three-year revolving credit facility. Financial covenants include a consolidated interest coverage ratio of three times, a consolidated leverage ratio of four times debt to EBITDA, and a consolidated senior leverage ratio of 3.5 times debt to EBITDA. Pricing is based on the debt rating with a range of LIB+400 for BB/Ba2 to LIB+225 for BBB+.

Notable capital raises

- Pengrowth Energy Trust announces the successful closing of a \$300-million bought deal financing. The trust issued 28.8 million units at C\$10.40 each. According to Pengrowth's CEO Derek Evans, the funds will be used to support capital expenditures while focusing on acquisitions, and repaying indebtedness.
- FirstService announces that a syndicate of underwriters will purchase \$70-million of convertible unsecured 6.5% debentures maturing on December 31, 2014. At the holder's option, the notes can be converted into subordinate voting shares. FirstService will use the proceeds of the offering for general corporate purposes, to repay existing indebtedness, and to finance possible acquisitions.

In Focus

Foreign Currency – Up, up and away...but?

"We hate you guys. Once you start issuing \$1 trillion-\$2 trillion...we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do."

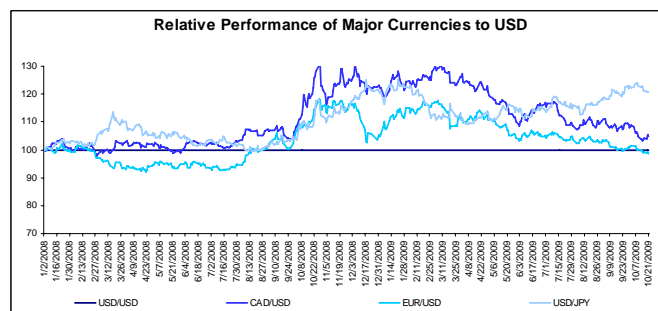
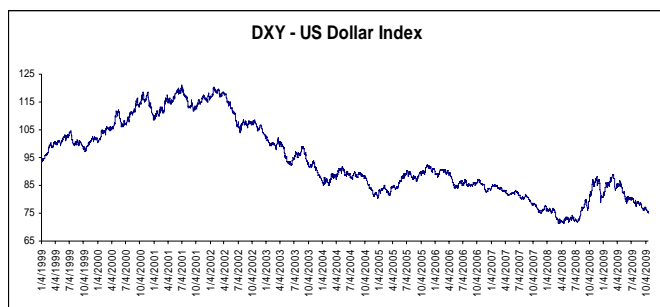
—Luo Ping, Director-General, China Banking Regulatory Commission (February 12, 2009)

In recent days, talk of unofficial competitive depreciation strategies, the death of the US dollar and a wide array of other outlier foreign exchange (FX) conspiracy theories are grabbing mainstream media headlines.

What is the PwC perspective? Read our In Focus section this week to find out.

Witness unprecedented volatility in currencies since September 2008 – Denarius...

- Despite a recent temporary flight to the US dollar, on a trade-weighted basis, the greenback has declined 15% since February 2009, continuing down the path of a decade-long deterioration.
- In contrast, the floating currencies of America's trade partners have the inauspicious burden of appreciating to facilitate the unwinding global trade imbalances.
- As set out in the graph in the accompanying column, beginning in the September 2008, the Canadian dollar and yen have appreciated relative to the greenback, after a lengthy period of relative stability.



Currency volatility has a negative impact on the Canadian economy – Loonacy!

- While currency volatility has far-reaching global impacts, closer to home, Canadian dollar strength is:
 - Worsening the trade competitiveness of the manufacturing, forestry and agricultural dependent provinces (especially trade to the US); and
 - Holding inflation below the Bank of Canada's target 2%, thereby frustrating monetary policy and raising the specter of further economic weakness.
- While most media have been focusing on the dollar-inflation link, PwC perspective is that one of the most devastating impacts of Canadian dollar appreciation is its impact on US-Canadian trade, specifically manufactured goods.
- To highlight how important US-bound manufacturing trade is to our economy, consider that:
 - Manufactured goods make up 54% of total Canadian merchandise exports and contribute 14% to annual GDP (the second largest component of GDP).
 - 76% of total manufactured goods go to the US market, with the next closest destination for exports being the UK at only 3%.
 - Manufactured goods shipped to the US contribute over \$220-billion to Canada's trade balance.
- So, exactly *how* bad is currency appreciation for the US-bound manufacturing trade sector of the Canadian economy? The answer is simple – very bad.
 - A dollar at, or close to par with the US greenback eliminates the competitive pricing position that Canada enjoyed right up to mid-2007 when the

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dollar started to climb. Effectively, the rise from 2003 levels of \$0.70 to par simply means that the cost of our goods is now 30% more expensive.

- At 30% higher, many more global manufacturers can compete with our goods.
- Consider this illustrative example. At \$0.70, a Canadian manufacturer received \$1.43 for each dollar of sales made to a US customer. At \$0.94, that manufacturer would receive \$1.06. That company would need to generate a 26% operating margin simply to break even. A lower margin would result in outright profit loss.

Increased volatility is expected in the near term – A pound of flesh?

The FX rollercoaster ride is far from over. There are four forces that argue for continued near-term volatility:

1. A return to risk

- The US dollar has traditionally been viewed as a safe haven for investors. Typically, in times of heightened uncertainty, investors flee high-risk stocks in favour of more secure US dollar denominated investments such as treasuries bills or bonds. Reiterating this sentiment, in a recent address, Shaun Osborne, chief currency strategist for TD securities remarked: *“the US dollar is a proxy for risk appetite. When investors are risk averse they buy dollars, and when they are seeking risk they sell US dollars.”*
- With improvements evident in global economies, investors have a renewed risk appetite and are selling US dollar denominated positions and re-entering global equity and debt markets.
- Continued improved economic data coming out of the US may further contribute to “pro-risk” investor appetite and, in turn, exert further downward pressure on the greenback. Conversely, should markets correct, we may experience a second flight to US dollar safety (although some controversially postulate that the US dollar is losing its status as a safe haven currency).

2. Competitive depreciation

- With few intervention tools left, some countries are expressing interest in intentionally weakening their currencies to gain export trade advantages and to slow imports.
- On March 12, 2009, Switzerland became the first western country to deliberately depreciate its currency to improve the competitiveness of its exports and entice tourists to Switzerland.
- In light of a 2009 year-to-date South Korean won appreciation of 13% against the US dollar, the Bank of Korea intimated earlier this month that it will enact tools to devalue the won to shelter its export led economy from further weakness.
- Perhaps somewhat controversially, some postulate that the US has been on a path to competitive depreciation for some time. Such a strategy makes US exports more attractive to foreigners (thereby boosting the domestic economy).

3. Quantitative-Easing (QE) induced inflation

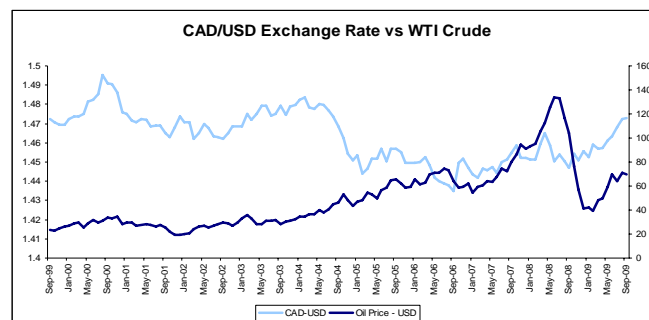
- Quantitative easing describes an increase in the size of a central bank's balance sheet through an increase in the supply of money. In simple terms, if the supply of money is increased, its value will decline. While the mechanics are more complex than this, common sense and historical precedent support a cause-and-effect relationship.
- Why are central bankers embarking on QE? The answer is straightforward. There are no other options left to battle a potential deflationary spiral:
 - In normal circumstances, when a central bank wants to increase the supply of money to spur economic growth, it does so by moving overnight rates. With nominal rates close to zero, the interest rate mechanism is exasperated and the US and UK are caught in a “liquidity trap”, a phrase most commonly associated with the decade-long economic stagnation in Japan in the 1990s.
 - Faced with the possibility of a Japanese-style liquidity trap and deflationary spiral, the Fed and Bank of England have both resorted to massive QE programs to spur growth and generate positive inflation expectations. These programs have largely

involved buying so-called “toxic” financial institution assets, including mortgage-backed securities, Freddie Mac/Fannie securities and various other financially engineered securities.

- Despite the massive QE efforts in the US and UK, we have yet to experience QE-induced inflation. This is because financial institutions have kept funds in reserves, rather than increasing lending. When banks finally begin drawing down excess reserves for lending, we may see the first signs of inflation or currency depreciation. And, compounding the problem of inflation, if central bank QE strategies are not reversed by selling central bank assets back to the market in exchange for cash, there is risk of *significant* inflation and currency depreciation.
- The only situation in which QE would have no impact on currency valuation is if central bankers have pulled off the miraculous feat of creating the exact amount of liquidity that was lost via financial institution losses.

4. The phenomenon of commodity currencies

- As set out in the accompanying graph, there exists a fairly steady relationship between the Canadian dollar and the crude oil price. This is largely due to the fact that Canada exports over 2 million barrels of oil per day and, since global commodities are priced in US dollars, even a small increase in the price of crude results in a significantly increased demand by Canadians to exchange US dollar revenue receipts.
- The recent swing from a monthly average WTI crude price from a low of \$39 to a high above \$70 has been a major contributor to similar swings in the loonie. The correlation between high oil prices and the US/CAD exchange rates means that the path of future oil prices will be an important determinant in the level of the Canadian dollar.
- Many economists are forecasting \$80+ crude through 2010, which may only serve to further support a strong loonie.

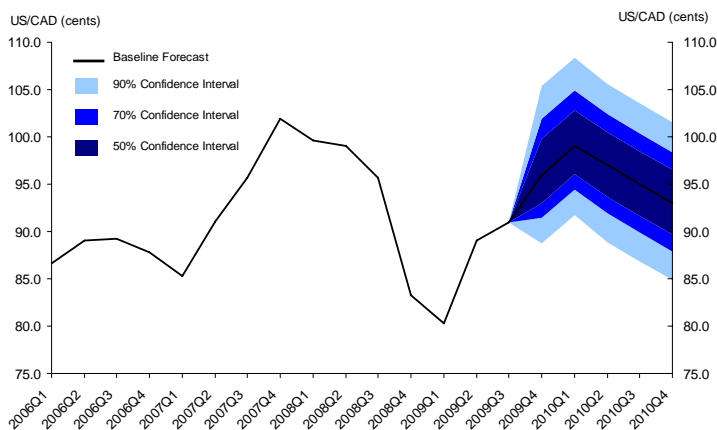


Canadian Outlook – Our franc perspective...

- The rapid appreciation of the loonie has prompted the Bank of Canada to publicly warn that it will take action if currency appreciation continues. Last week, Mr. Carney boldly stated: *“Markets should take seriously our determination to set policy to achieve the inflation target... Markets sometimes lose their focus. We don't lose our focus.”*
- In addition to concerns about trade competitiveness and downward pressure on GDP, chief among the central bank's trepidations is that a rising loonie may thwart the bank's ability to achieve its mandated 2% inflation target.
 - A high Canadian dollar feeds through to the price level through lower import prices and depresses the overall price level. Because nominal interest rates are bumping hard against the zero lower bound, the bank is not able to cut rates in order to get inflation back on its preferred path.
- Because conventional monetary tools are exhausted when interest rates are effectively zero, the bank has only unconventional means left to address the rising loonie:
 - Direct intervention in the FX markets by buying and selling currencies; or
 - Following in the footsteps of the US and UK and embarking upon QE.
 - In practice, because any intervention in foreign exchange markets by the Bank of Canada is likely to be unsterilized (that is, not offset by equivalent sales of domestic credit), intervention and QE are basically the same strategies, but accomplished through slightly different means.

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- Nonetheless, barring any extraordinary measures by the Bank of Canada, the PwC Economics team currently expects the loonie to continue on its trajectory towards parity by the end of the year. The graph below is our baseline outlook for the quarterly average US/CAD exchange rate from Q4 09 to Q4 10. The forecast is presented with 50%, 70% and 90% confidence intervals to factor the daily volatility of exchange rates and uncertainty underlying the forecast.



- Our forecasts are inline with major Canadian banks, all of whom expect a loonie above \$0.96 by the end of the fiscal year.

How are currency fluctuations affecting you?
Listen to our podcast to find out.

- In episode 22 of Strategy Talks, Dean Mullett and Helen Malloy Hicks speak with Vanessa Iarocci, a vice-president in the Corporate Finance practice and editor of PwC's Capital Markets Flash and Rozanne Kibel, a director in the Corporate Finance practice, about the ups and downs of currency in these challenging economic times. Listen to or download the podcast at www.pwc.com/ca/strategytalks.

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For more information on our Corporate Finance services, please contact one of the following people.

Toronto

Vince De Luca*

vince.deluca@ca.pwc.com
416 815 5185

Keith Mosley*

keith.mosley@ca.pwc.com
416 941 8307

Dean Mullett*

dean.mullett@ca.pwc.com
416 814 5724

Montreal

Nicolas Marcoux*

nicolas.marcoux@ca.pwc.com
514 205 5302

Vancouver

James McGuigan*

jim.j.mcguigan@ca.pwc.com
604 806 7594

Calgary

Brooke Valentine

brooke.valentine@ca.pwc.com
403 509 7471

Edmonton

Stephen Kent

stephen.kent@ca.pwc.com
780 441 6793

Editors & Contributing Authors

Vanessa Iarocci

Vice President
vanessa.s.iarocci@ca.pwc.com
416 941 8352

Dianna Paw

Analyst
dianna.paw@ca.pwc.com
416 815 5081

Francesco Battistelli

Contributing Economists

Brendon Ogmundson

brendon.ogmundson@ca.pwc.com

Mark D. Parsons

mark.d.parsons@ca.pwc.com

To provide feedback on this publication or to sign up for similar publications relating to the energy and natural resources section, please email:

capital.markets.flash@ca.pwc.com

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