Capital Markets Report

2003

Financial Markets Division
Financial Sector Policy Branch
May 2004

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OVERVIEW

In a context of improving investor confidence and continued low interest rates, but also of geopolitical upheaval, the year 2003 saw some sectors of Canadian capital markets regain buoyancy while others continued to grapple with challenges.

With respect to early stage financing, **Canadian venture capital (VC) activity** declined over the first half of 2003 but saw a modest uptick as the year wore on. VC activity in both Canada and the U.S. has been in overall decline since peaking in 2000, but the Canadian VC industry performed relatively well, ranking second internationally in per capita levels of activity in 2002. However, performance data recently released by the industry indicate that near- and medium-term returns to investors have generally been weak.

In **fixed income markets**, the main story in 2003 was the extension of investor appetite for yield and willingness to take on credit risk. The spreads on investment grade debt tightened somewhat over the year, but spreads on high yield debt decreased significantly, with Canadian high yield bonds continuing to be marketed primarily in the U.S. Net issuance of corporate debt was subdued compared to the years from the mid-1990s until 2002, constituting a substantial pause in the so-called “crowding in” phenomenon of impressive overall growth in corporate issuance since net government issuance began its sharp decline.

In contrast to private equity markets, **public equity markets** rebounded in 2003, both in Canada and globally, registering overall gains for the first time in four years. Nevertheless, initial public offering (IPO) activity was sluggish, particularly in the U.S. In Canada IPO activity was stronger, although well over 80% of money raised from new offerings was in the **income trust sector**, which continued to grow dramatically in 2003, albeit at a slower pace than in 2002, with total market capitalization approaching $60 billion.

The major story in **foreign exchange** markets was the dramatic rise in the Canadian dollar, which by year-end had attained decade-high levels against its U.S. counterpart. This was generally attributed to U.S. dollar weakness, although the Canadian dollar held its own against other major currencies as well.

VENTURE CAPITAL

Overview

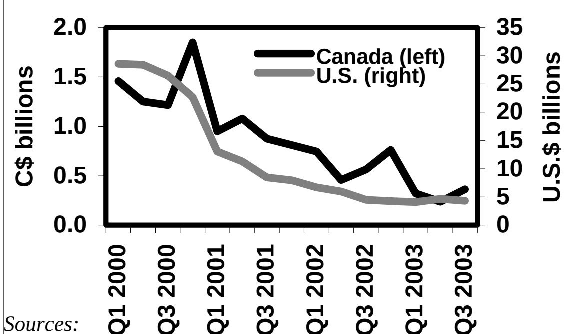
The level of activity in the venture capital (VC) industry has been declining since reaching a peak in 2000, but Canada has generally weathered the downturn better than the U.S. (Figure 1). Following two straight quarters of decline and the weakest investment climate since 1996, Canadian VC activity picked up in 2003 Q3.[1] However, while VC disbursements[2] have picked up from the first half of 2003, fundraising[3] has remained slow throughout the first three quarters of 2003. Performance data has shown low returns for Canadian VC firms compared with the U.S., especially over the longer term. On the other hand, the improved performance of technology stocks and recent merger and acquisition activity involving Canadian high tech firms provide signs that exit opportunities may be opening for VC-backed companies. In the U.S. VC activity has remained sluggish for both fundraising and disbursements, which are expected to record a third consecutive annual decline.

A) Fundraising Activity

In the first three quarters of 2003 Canadian VC firms raised $1.3 billion, making it unlikely that fundraising for the year will match the 2002 total of $3.2 billion. In 2002 Canada ranked second among developed countries in VC fundraising per capita, up from 11th in 1999.

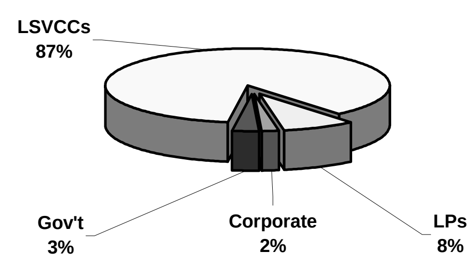
Labour sponsored venture capital corporations (LSVCCs), which raise funds primarily from individual investors, accounted for the bulk of new commitments for the first three quarters of 2003. LSVCCs raised $1.1 billion, or 87% of the total in the first three quarters (Figure 2), down $100 million from the same period in 2002. Limited partnerships (LPs), after a strong year in 2002, could not carry that momentum over into 2003, managing to raise only 10% of the 2002 total, or $111 million. However, many Canadian LPs were still in fundraising mode during the fourth quarter of 2003. Pension funds appear to be retreating from this asset class, having last committed funds for direct investment in 2001, and continue to show reluctance to invest in LPs.

Figure 1: VC Disbursements in Canada and the U.S. Since 2000



Sources: Macdonald & Associates, Thomson Venture Economics.

Figure 2: VC Fundraising by Type of Investor (First 9 Months 2003)



Source: Macdonald & Associates.

A recent development has been the announcement of joint initiatives between Canadian and U.S. VC firms geared to attracting investors across North America. A joint fund raised by Canadian-based

[1] Canadian VC data lags by one quarter.
[2] Investments by VC firms in portfolio companies.
[3] Capital raised by VC firms from outside investors such as pension funds or high net worth individuals, or earmarked for VC investments in portfolio companies.

Primaxis Technology Ventures Inc. and Silicon Valley-based Draper Fisher Jurvetson in the third quarter of 2003 is one example of this new development. A further sign of maturation in the Canadian VC industry has been the introduction of funds of funds. These investment vehicles are set up to make investments among a selection of private equity fund managers, who in turn invest the capital directly in companies. Edgestone and TD Capital Partners are two Canadian firms that have recently entered this area. However, the timing has not been favourable as fundraising had limited success in the first three quarters of 2003.

In the U.S. fundraising fell to $4.3 billion in the first nine months of 2003, a decline of approximately 23% from the same period in 2002. Fundraising activity remains slow in the U.S. because many VC firms are still sitting on uninvested capital raised in 2000 and 2001. However, many blue-chip VC firms are expected to raise new funds in the next couple of years, albeit much less than in previous years.

B) Disbursements

Disbursements to portfolio companies declined in both Canada and the U.S. in the first nine months of 2003. Canadian companies received $920 million, a 49% decline from the same period a year earlier. The second quarter of 2003 proved to be one of the most difficult periods for the Canadian VC industry. Disease outbreaks, together with an unstable geopolitical landscape, appear to have played a role in depressing VC activity to a seven-year low. However, after two straight quarters of decline, disbursements in the third quarter increased 50% from the previous quarter to reach $361 million. Meanwhile, in the U.S. disbursements were down 24% over the third quarter of 2003. One of the key differences between 2003 and 2002 is the lack of large transactions over $20 million, the relative prevalence of which in 2002 had helped to drive up aggregate numbers (Table 1). A brief look at the names of the companies also reveals another interesting development. In 2002 the top five companies were all from the information technology (IT) sector, whereas in 2003 only two were from the IT sector. Two of the top five companies came from the life sciences sector, which had a good year relative to others.

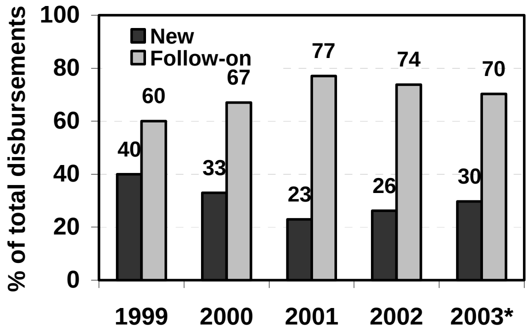
Table 1: Top Five Deals ($ millions)

2003 (first nine months)	
Company (City)	**Amount**
Medicago Inc. (Sainte-Foy)	28.00
Engim Canada (Ottawa)	27.75
Critical Telecom (Ottawa)	16.63
OncoGenex Technologies Inc. (Vancouver)	15.67
Joseph Ribkoff Inc. (Dorval)	15.62
Total	**103.67**
2002 (first nine months)	
Company (City)	**Amount**
Catena Networks (Kanata)	112.50
Innovance Networks Inc. (Ottawa)	88.00
Hyperchip Inc. (Montréal)	70.00
Inkra Networks (Burnaby)	45.90
ITF Optical Technologies Inc. (Saint-Laurent)	37.54
Total	**353.94**

Source: Macdonald & Associates.

Follow-on disbursements accounted for 70% of the total over the first nine months of 2003 (Figure 3). VC firms continue to be cautious in their investment strategy, focusing on companies already in their portfolio, making it difficult for companies to attract their first round of VC. Technology companies appear to have been hit hard as their share of new disbursements declined from 70% in 2002 to 50% in the first three quarters of 2003.

Figure 3: New Versus Follow-On Disbursements



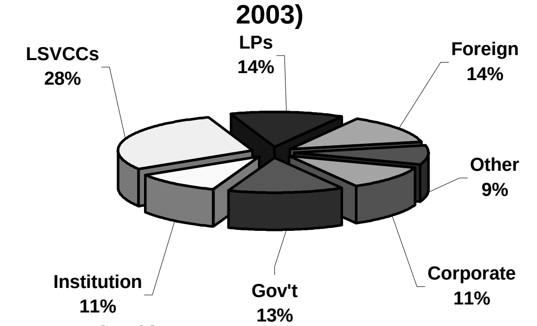
Source: Macdonald & Associates.
*First nine months.

Of special note is the sharp decline in disbursements by foreign investors (mainly American venture firms and strategic corporate groups that invest in IT) in the first half of 2003. For the first nine months of 2003 foreigners accounted for only 14% of all disbursements, compared to 26% for all of 2002 (Figure 4). On the positive side, foreign investment is showing signs of renewed vitality as disbursements in the third quarter totalled more than the first two quarters combined ($64 million vs. $25 million and $35 million respectively). It is likely the strengthening of the IT sector in the third quarter that explains the recent change. Once again LSVCCs were the most active domestic investor in the first three quarters of 2003, with $262 million (28% of the total) disbursed. Note the relative parity of disbursements by investor types other than LSVCCs in Figure 4.

As in previous years the IT sector absorbed the majority of disbursements, $163 million or 54% of the total in the first three quarters of 2003. However, this was down from 65% in 2002, whereas the life sciences sector's share of disbursements increased to 26% ($79 million) in the first three quarters of 2003 from 19% in 2002. The most popular IT sub-sector in the first three quarters of 2003 was communications and networking, attracting $110 million or 12% of total disbursements, although these numbers are lower when compared to 2002, when the sub-sector accounted for 27% of total disbursements. Once again Internet companies continued to lose ground as their share of total disbursements continued to decline in 2003.

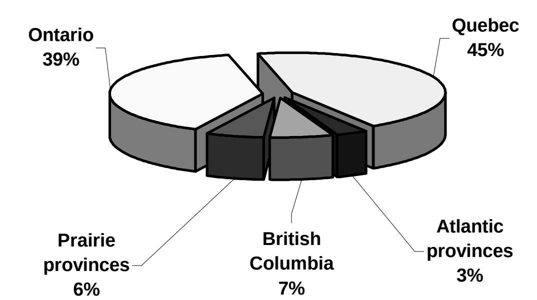
In the first six months of 2003 the strength of the life sciences sector pushed Quebec into the lead in terms of disbursements (Figure 5). But with the resurgence of IT in the third quarter of 2003, the situation reverted to previous patterns, with Ontario receiving the largest share of disbursements during the third quarter. The increase in IT disbursements can be largely attributed to a resurgence of activity in the Ottawa Valley, as disbursements in the area totalled $100 million in the third quarter of 2003 compared with only $12 million in the previous quarter.

Figure 4: Disbursements by Investor Type (First 9 Months of 2003)



Source: Macdonald & Associates.

Figure 5: Disbursements by Province (First 9 Months of 2003)



Source: Macdonald & Associates.

C) Return on VC Investments

Macdonald & Associates has published return data for the Canadian VC industry for 2002. This is only the second time such data has been made available for Canada. Overall, Canadian VC returns have not compared favourably to those of the U.S. (Table 2). Canadian VC firms have shared the pain of the high-tech downturn with their U.S. counterparts, without having benefited to the same extent from the high-tech boom. For the one-year and three-year periods, Canadian VCs experienced negative returns that were comparable to those of U.S. VCs. However, while U.S. VCs provided 20%+ internal rates of return over five-year and eight-year investment horizons, Canadian firms posted a –3.1% five-year return and a 6.1% return over eight years. Furthermore, comparisons with public market indices (e.g. NASDAQ, TSE 300 and S&P 500) are not particularly advantageous. Over the 5-year and 10-year horizons, the Canadian VC industry lagged behind these indices, even without adjusting for risk.

Table 2: Investment Returns for Periods Ending 12/31/2002 (%)

	Period in Years			
	1	**3**	**5**	**8***
Venture Capital				
Canada	-25.0	-9.6	-3.1	6.1
U.S. **	-23.3	-6.8	28.3	26.3
Public Markets				
TSE 300	-12.4	-6.3	1.3	7.7
S&P 500	-22.1	-14.6	-0.6	10.3
NASDAQ	-31.5	-31.0	-3.2	7.4

Sources: Canadian Venture Capital Association, National Venture Capital Association.

* For the U.S. 10-year returns are used.
** U.S. returns are provided net of management fees and carried interest (e.g. share of profit earned by general partners). For Canada gross returns are provided.

CANADIAN FIXED INCOME

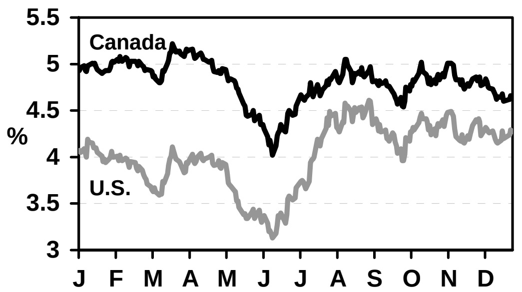
Overview

High quality bonds traded sideways throughout most of 2003, except for a remarkable run-up during the second quarter and a matching decline during the third quarter. In Canada net issuance of corporate debt, which has generally increased sharply since the mid-1990s, fell conspicuously in 2002 and remained relatively low in 2003. Globally the big fixed income story of 2003 was the significant tightening in spreads for lower quality (high yield) bonds. The demand for riskier assets was supported by record low interest rates, an easing of geopolitical tensions after the Iraq war, and signs of a strong economic recovery in the United States.

A) Sovereign Bonds

Modest year-end to year-end movements in Canada and U.S. government bonds belied some dramatic price moves during 2003 (Figure 6). After trading sideways during the fourth quarter of 2002 and the first quarter of 2003, U.S. government bonds made a strong advance after the Iraq war, pushing yields to record lows by mid-June on expectations of Federal Reserve purchases to loosen monetary conditions. In the following two months to mid-August, however, bonds retraced sharply after it

Figure 6: Yields on 10-Year Government Bonds, 2003



Sources: Bank of Canada, Federal Reserve.

became apparent that the Federal Reserve would not pursue this policy. Bond prices recovered somewhat in September, but were relatively steady throughout the fourth quarter of 2003.

B) Corporate Bonds

a) Investment Grade Debt

Canadian corporate bond issuance (company debt instruments with a maturity over one year) has sharply declined from the heights of 2001. Corporate bond offerings picked up in the first quarter of 2003, however, as issuers took advantage of falling yields to raise relatively low cost capital (Table 3). The recovery was interrupted as new financings failed to keep pace with debt retirements during the summer months, but resumed in the fourth quarter.

Corporate bonds appreciated in price somewhat more than sovereigns during the year, reducing spreads (Figure 7). Of note, however, is the fact that U.S. corporates strengthened more during the first two months of the year and then weakened more during July.

b) High Yield Debt

The main story in the global corporate debt market is the remarkable outperformance of high yield debt (HYD) or “junk bonds” relative to the rest of the corporate universe since October 2002. These are bonds rated Ba1 or less by Moody’s Investors Service and/or BB+ or less by Standard & Poor’s. Since bonds with these relatively low ratings are considered higher risk, they offer higher yields to investors. Merrill Lynch’s global high yield bond index returned a remarkable 28.2% in 2003. U.S.-based companies constitute more than 88% of the global high yield index as other countries, including Canada, have relatively undeveloped HYD markets.

Table 3: Net New Bond Issuance (C$ millions)

	Gov’t of Canada	Provincial	Municipal	Corporate
1996	**33,364**	**3,831**	**153**	**21,209**
1997	**18,439**	**3,061**	**197**	**39,502**
1998	**9,895**	**7,860**	**-16**	**34,085**
1999	**2,214**	**5,127**	**-200**	**37,969**
2000	**-4,958**	**748**	**-474**	**21,768**
2001	**-16,622**	**6,955**	**125**	**60,985**
2002	**-8,498**	**-465**	**455**	**6,073**
2003 Q1	**676**	**-4,735**	**-379**	**7,715**
2003 Q2	**-3,200**	**-2,854**	**780**	**16**
2003 Q3	**-4,006**	**2,471**	**239**	**190**

Source: Bank of Canada.

Figure 7: Spreads on Corporates, 2003

Source: Merrill Lynch.

The demand for global high yield apparently reflected diminishing risk aversion and improving default rates. In early 2003 Moody’s forecast a decline of the global speculative grade default rate from 2002’s 8.3% to 6.9%. By the end of 2003, Standard & Poor’s reported that default rate was

4.57%, the lowest since 1999 and well below the long-term average of 5.17%. Defaults are expected to stay low in 2004 thanks to a recovering global economy, favourable financing conditions and rising profits. In addition, with the decline in the equity market in recent years, businesses have been increasingly focused on minimizing downside risks. As fixed claimants on an issuer's cash flow, bondholders have gained the benefit of this new focus in management.

Canadian firms tapped the high yield market on several occasions in 2003, but as usual the majority of the issues were denominated in U.S. dollars (Table 4). During 2003 several Canadian paper and forest companies went south of the border for debt capital to take advantage of a declining U.S. dollar. June saw a flurry of bond issue announcements as companies from a variety of industries scrambled to refinance at low yields. The bulk of the deals were privately placed, and many were associated with note exchanges or restructurings. For example, Acetex privately placed U.S.$75 million of 10 7/8% bonds due August 2009 in order to repay part of the indebtedness of AT Plastics as part of Acetex's acquisition of that company. As part of its restructuring, Saskatchewan Wheat Pool exchanged $105 million in bank debt and $300 million in medium term notes into two new notes, yielding 8% and 9%, both of which expire in 2008. The end of the year saw a renaissance in the domestic high yield market as Shaw, Sherritt International, and Hudson's Bay Company completed successful public issues. On November 13, for example, Shaw Communications announced that its offering of 7.5% senior unsecured notes due 2013 had been increased from $250 million to $350 million as a result of strong demand.

Table 4: Notable High Yield Issues by Canadian Firms in 2004

Issuer	Placement	Amount ($ millions)	Date
U.S. dollar			
Tembec	Private	100	March 14
NorskeCanada	Private	150	May 15
Fairfax Financial	Private	300	June 5
IPSCO	Private	200	June 13
Rogers Cable	Private	350	June 16
Abitibi	Public	500	June 18
Gerdau Ameristeel	Private	405	June 27
Cascades	Private	100	June 30
Baytex Energy	Private	150	July 9
Acetex	Private	75	August 5
Canadian dollar			
Sask Wheat Pool	Private	300	March 14
Shaw Communications	Public	350	Nov 13
Sherritt International	Public	300	Dec 4
Hudson's Bay Co.	Public	120	Dec 10

Source: System for Electronic Document Analysis and Retrieval.

Telecommunications companies were particularly strong performers among HYD issuers. The sector was hard hit by the high tech downturn. Large debt loads that had been incurred became difficult to service for many telecom companies, and their bonds fell to distressed levels. Eventually the carriers were able to cut back expenditures enough that HYD investors became more comfortable with their ability to generate the cash flow necessary to service their debts.

PUBLIC EQUITY MARKETS

Overview

Global equity markets rebounded in 2003, registering gains for the first time in four years. A short campaign in Iraq, improving investor and consumer confidence and low interest rates were credited with fuelling optimism for a U.S.-led global economic recovery. The following sections discuss equity market performance, initial public offering (IPO) activity and income trusts.

A) Equity Market Performance in 2003

During the first quarter of 2003 North American equity markets fell amid global geopolitical uncertainties (Figures 8 and 9). Investor confidence waned as the focus shifted from improving corporate earnings to geopolitical news, and as a result, markets approached October 2002 lows. On March 13 stock markets in North America and Europe rose after reports indicated that U.S. officials were in surrender negotiations with key members of the Iraqi regime. The Dow Jones Industrial Average (DJIA) rose 3.57%, its largest daily gain year-to-date. Markets also bounced back strongly in Europe. The Toronto Stock Exchange (S&P/TSX) Composite Index rose 1.1% that day. Britain's leading shares soared to their best one-day gain since October 1987, surging 6.1%, recovering from the eight-year low hit on March 12, 2003.

Figure 8: Performance of S&P/TSX Composite and Venture Indices (2003)

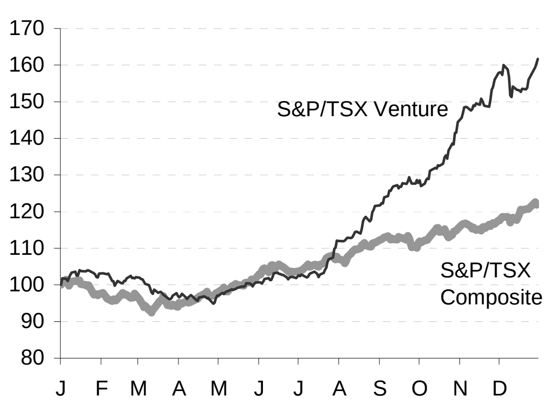
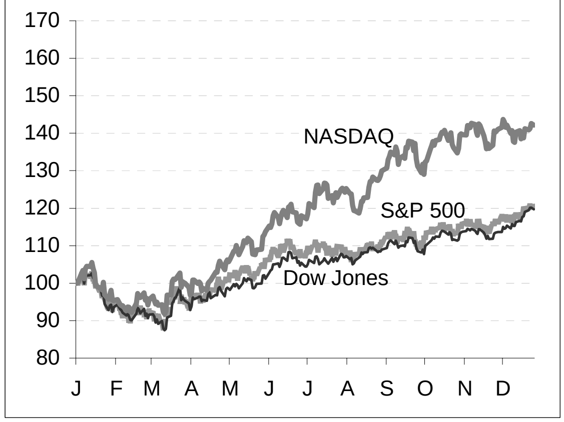


Figure 9: Performance of U.S. indices (2003)

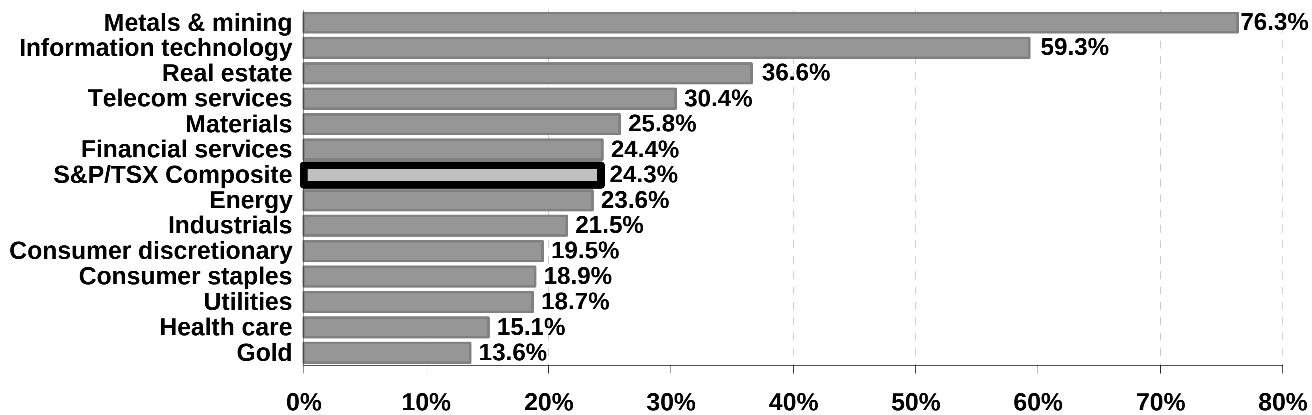


There were moderate retracements when the rumoured surrender talks were followed by the invasion of Iraq on March 20. Overall, however, markets were firm, retaining much of the advance achieved in the preceding weeks. As the war progressed and the outcome became clear, markets pushed forward. North American equity markets rocketed higher during the second quarter; the S&P 500 rallied 15%, the benchmark's largest gain since a 21% jump in the fourth quarter of 1998. Similarly, the DJIA climbed 12% and the NASDAQ Composite Index rose 21%, their strongest performances in more than four years. The S&P/TSX Composite Index did not fare as well, but still managed to post a quarterly gain of 10%.

Global equity markets continued to rally through the second half of the year. The blackout that affected large parts of Ontario and the northeastern U.S. had limited economic impact. In the U.S., strong economic data fuelled optimism that an economic recovery was underway. Investor confidence strengthened after taking a beating in 2002 following corporate scandals such as Enron and WorldCom.

However, the rise of equity markets was tempered briefly in late September, when OPEC surprised the markets by agreeing to cut output, fuelling concerns that rising energy costs could slow the pace of a U.S. economic recovery. In the U.S. the DJIA gave up 2%, and the NASDAQ Composite Index was hardest hit, losing more than 3%, with weak sales forecasts coming out of the tech sector adding to the decline. The S&P/TSX Composite Index took a light hit, losing less than 1%. European and Asian markets also gave up some ground.

Figure 10: TSX Performance by Sector in 2003 (Year-Over-Year Change)



Source: The Globe and Mail.

Global equity markets ended 2003 on a positive note, closing near multi-year highs and posting positive returns for the first time since 1999 (Table 5). Canada's benchmark index ended the year posting a 24.3% gain, while the blue-chip DJIA gained 25.3%.

Table 5: Global Equity Index Returns (%)

	1999	2000	2001	2002	2003
NASDAQ	86.0	-39.3	- 21.1	- 31.5	50.0
DJIA	25.2	- 6.2	- 7.1	- 16.8	25.3
S&P 500	19.5	-10.1	- 13.0	- 23.3	26.4
S&P/TSX	29.7	6.2	- 13.9	- 13.9	24.3
Hang Seng	68.8	-11.0	- 24.5	- 18.2	34.9
Nikkei	36.8	-27.2	- 23.5	- 18.6	24.5
FTSE	17.8	-10.2	- 16.2	- 24.5	13.6

Major European and Asian markets also achieved positive returns. In terms of sectoral performance, all of the TSX's 13 sub-groups were higher by year-end (Figure 10). The strongest performers were stocks in the TSX's Metals and Mining sub-index, gaining 76.3% after leading the S&P/TSX Composite Index decline in 2002.

Another notable development was that Canadian investors showed renewed enthusiasm for high tech shares by pouring funds back into the sector. After suffering a 60% loss in 2002, the TSX's Information Technology sub-index rebounded, posting a 59.3% gain, surpassing even the NASDAQ Composite Index's 50% recovery in 2003. Telecommunications suppliers Nortel Networks and Research In Motion were among the big winners. Despite the run-up in tech shares, traditional valuation measures for the S&P/TSX Composite Index, such as the price/earnings ratio, remained relatively flat at around 28 times, which would suggest that earnings recovered on stronger demand as the global economy began to turn.

After leading all sub-indexes higher in 2002, the gold index was the worst performer of the year, posting a 13.6% gain, despite the fact the price of the precious metal gained 20%.

B) Primary Market

Canada's IPO market was down approximately 20% in 2003 from 2002, but still well above the poor performance of 2001. There were 56 new offerings in 2003 worth C$4.6 billion, compared to C$5.8 billion in 2002. However, the great majority of IPO activity in Canada for the year was not in traditional IPOs but in the income trust sector (Table 6).

Table 6: IPO Dollars Raised by Domestic Companies on Domestic Exchanges (C$ billions)

Year	Canada	U.S.
1993	4.9	58.1
1994	3.5	35.8
1995	3.1	38
1996	3.4	57.7
1997	5.2	50.5
1998	3	55.6
1999	4.4	93.5
2000	5.4	82.9
2001	1.6	51.5
2002	5.8	41.7
2003	4.6	24.5

Sources: Investment Dealers Association of Canada, Reuters, Bloomberg.

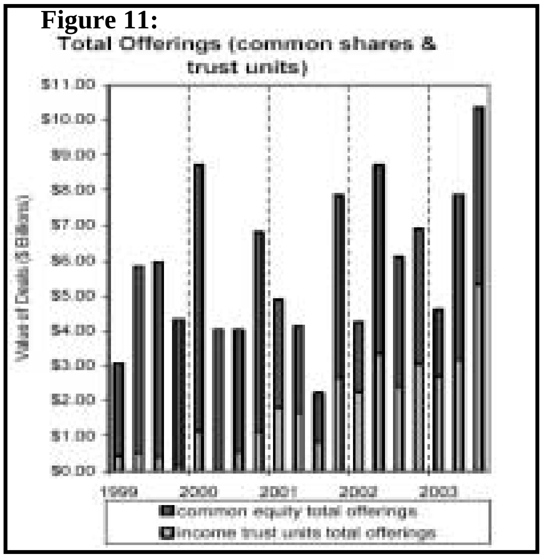
Despite the rebound in equity markets, the year 2003 will go down in U.S. history as one of the slowest periods for IPOs. Though deal flow was relatively unchanged, the amount of capital raised was down by more than 40%. However, market commentators anticipate a turnaround in IPO activity in 2004, building on the momentum of a strong December, when around 30% of total IPO capital raised was in the final month of the year. Market watchers are also encouraged by the rather large flow of quality deals in registration with the U.S. Securities and Exchange Commission.

C) Income Trusts

In Canada the income trust market continued to grow dramatically in 2003, albeit at a slower pace than in 2002, in an environment of continued low interest rates, but no longer of low equity market returns. In the past two years income trusts accounted for most Canadian IPO activity: 83.6% in 2003 and 86.6% in 2002 of total capital raised (Figure 11). The gross value of income trust IPOs fell to C$3.8 billion in 2003 from C$5.0 billion in 2002. In terms of total issuance, income trusts had their strongest showing ever in the third quarter with just over C$5.3 billion, eclipsing total common equity issuance for the quarter and representing a substantial increase in secondary offerings by income trusts. Helping the sector to record levels in the third quarter was the Yellow Pages Income Fund, offering the second-largest income trust IPO ever at $935 million.

To date interest in the asset class has been limited mostly to retail investors and to mutual funds serving the retail market. These investors are seeking high and relatively stable income streams in a context of low interest rates and dividend payouts. Pension funds have generally stayed out of the asset class, reflecting concerns about the risk of unlimited unitholder liability, which has also kept income trusts off Canada's benchmark S&P/TSX Composite Index.

Figure 11:



DERIVATIVES

Overview

The remarkable growth in the global derivatives market continued throughout the first half of 2003, fuelled by an increasing demand across a variety of enterprises for a more quantitative approach to risk management. The currency derivative market was especially active in 2003 as volatile currency movements encouraged non-financial players to enter the market and hedge their exchange rate risk. Trading in derivatives listed on global exchanges was strong early in the year but waned during the third quarter as the players who provide liquidity to the market by facilitating trading ("market makers") backed away after suffering some losses related to a steep, unexpected rise in bond yields during the summer.

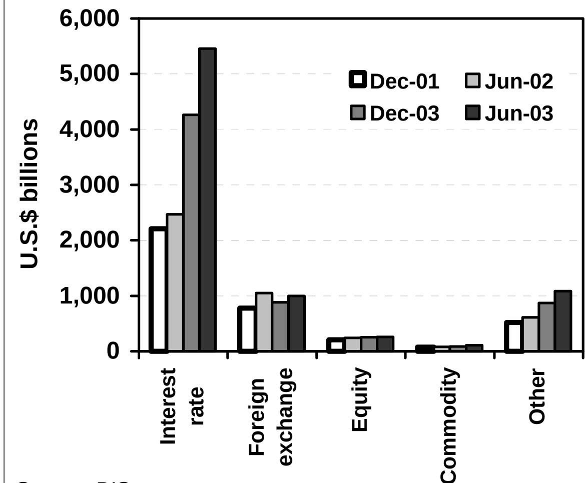
A) Over-the-Counter Derivatives

Financial derivatives are either listed on a financial exchange or are over-the-counter (OTC—i.e., arranged between two parties). The global OTC derivative market, which is considerably larger than the exchange-traded market, has been growing rapidly for the past 20 years, a trend that continued during 2003 (Figure 12) according to the semi-annual data collected by the Bank for International Settlements (BIS). The International Swaps and Derivatives Association (ISDA) and the U.S. Office of the Comptroller of the Currency (OCC) have confirmed the rapid expansion of the OTC market. The ISDA reported a 22% increase in the global stock of OTC contracts in the first half of 2003, while the OCC reported a 17% rise in commercial bank holdings of derivatives contracts (most of which are OTC). Currency options were the most dynamic sub-segment, expanding by 42%. Some of the smaller currency markets expanded even more rapidly, with options involving the pound sterling, the Swiss franc and the Canadian dollar growing by 74%, 92% and 152% respectively. The accelerating downward trend in the U.S. dollar apparently prompted non-financial customers to seek protection, as holdings of currency options by such users rose by 91% in the BIS' most recent review period.

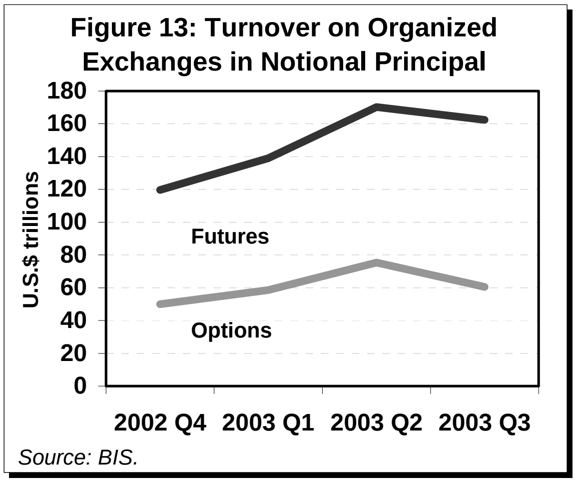
B) Exchange-Traded Derivatives

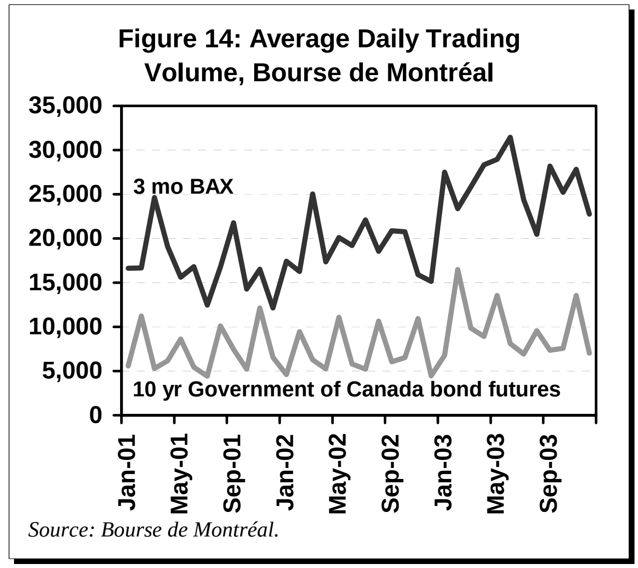
During the first half of 2003 global exchange-traded activity grew even more than OTC business (Figure 13). But during the third quarter the aggregate turnover of exchange-traded financial derivatives contracts monitored by the BIS fell by 9% to U.S.$223 trillion, as turnover in interest rate contracts fell following a pronounced drop in money market contracts on U.S. exchanges. This was generally attributed to the upward pressure on the yields of U.S. fixed income assets in July and August and a slackening in the pace of mortgage refinancing in the U.S.

Figure 12: Gross Market Value of Global OTC Derivative Contracts



Source: BIS.





C) Canada

In Canada the market for exchange-traded derivatives is smaller than the OTC market and takes place on the Bourse de Montréal. Since the Bourse de Montréal became fully automated two years ago, it has seen an 40% increase in average daily volume such that at the present time about 70,000 contracts and $30 billion in value are traded daily on the exchange. Trading volumes were fairly steady in 2003 as average daily trading volumes in 3-month bankers' acceptances (BAX) and 10-year Government of Canada bond futures remained rangebound (Figure 14). The Bourse de Montréal has become a player in the U.S. equity options market by joining with the Boston Stock Exchange and Interactive Brokers to form the Boston Option Exchange, the launch of which was approved by the U.S. Securities and Exchange Commission on January 14, 2004.

FOREIGN EXCHANGE

Overview

The Canadian dollar appreciated strongly throughout 2003, reaching decade highs in December. General U.S. dollar weakness in 2003 allowed the Canadian dollar to equal or better the performance of other major currencies, although the Canadian dollar did not keep pace with the Australian dollar. Despite the Canadian dollar's relative strength, data suggest that it continued to trade below purchasing power parity in 2003.

A) Canadian Dollar Performance

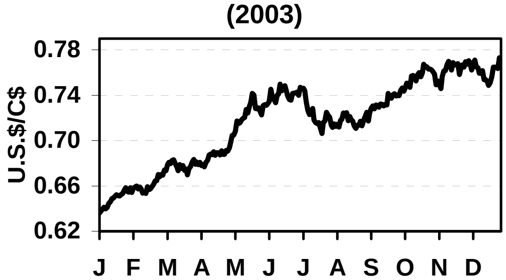
From January 1 to December 31, 2003, the Canadian dollar increased 21%, attaining levels last seen in August 1993. After experiencing rangebound trading between 62 and 64 cents U.S. during the second half of 2002, the Canadian dollar joined most other major currencies in making strong gains against the U.S. dollar from January through to mid-May 2003 (Figure 15) as concerns related to the war in Iraq weighed on the U.S. currency. The Canadian dollar relinquished some of its gains from mid-

Table 7: Five-Year Bond Yields in 2003 (%)			
	Canada	U.S.	Spread (basis points)
January	4.27	3.02	125
February	4.18	2.69	149
March	4.47	2.78	169
April	4.18	2.85	133
May	3.72	2.3	142
June	3.55	2.46	109
July	3.76	3.38	38
August	3.97	3.46	51
September	3.86	2.85	101
October	4.07	3.27	80
November	4.07	3.38	69
December	3.91	3.25	66

Source: Bank of Canada, Federal Reserve.

May to July, dipping back toward 70 cents U.S. However, by August the Canadian dollar resumed its strengthening path above 74 cents U.S. before settling into rangebound trading between 74.5 and 77 cents U.S. for most of the fourth quarter of 2003. The highest close of the year came on December 30 when a fresh 10-year high of 77.26 cents U.S. was set.

Figure 15: Daily Exchange Rates (2003)



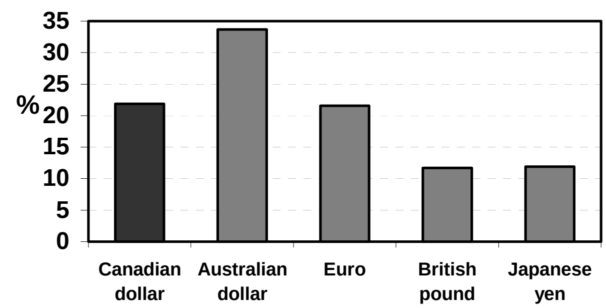
Source: Bank of Canada.

Most analysts explain the appreciation of the Canadian dollar largely in terms of general U.S. dollar weakness, which may represent a concrete response to large U.S. current account deficits that have averaged over 4% of gross domestic product (GDP) since 2000. Other likely sources of upward momentum in the Canadian dollar include the increase in commodity prices, the positive differential in Canada-U.S. short-term interest rates (Table 7), Canada's record of low and stable inflation, fiscal and current account surpluses, and declining federal government debt and net foreign debt as a share of GDP.

B) Canadian Dollar Performance Compared to Other Major Currencies

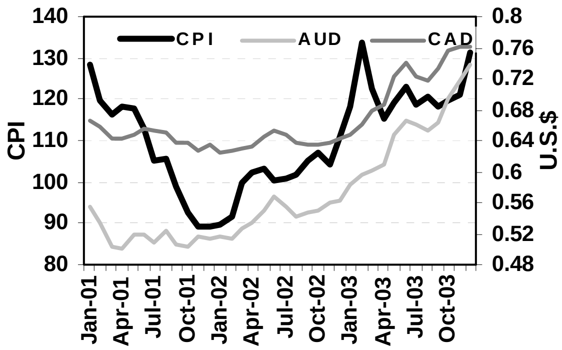
In 2002 the Canadian dollar did not appreciate against the U.S. dollar at the same pace as other major currencies such as the yen and euro. However, in 2003 the Canadian dollar performed on par with the euro and outperformed the British pound and Japanese yen, although it advanced somewhat less than the Australian dollar, to which it is often compared (Figure 16). The Australian dollar's ascent in 2003, like that of the Canada dollar, was partially linked to the increase in commodity prices, as both economies are to some extent resource-based (Figure 17). Of note is the yen's strengthening, despite being held back

Figure 16: Performance vs U.S.$ in 2003



Source: Bank of Canada.

Figure 17: Commodity Price Index and Canadian & Australian Dollar



Source: Bank of Canada.

during 2003 by the Japanese government's massive intervention in the market.

C) Outlook for 2004

In mid-December the major Canadian banks issued differing forecasts for the Canadian dollar over 2004. Three of the five major banks forecast a gradual rise in the value of the loonie, but at the time of writing this article almost every forecasted figure had already been exceeded (Table 8). CIBC, however, issued a bearish forecast for the Canadian dollar.

Table 8: Forecast Canada-U.S. Exchange Rate in 2004				
	Q1	Q2	Q3	Q4
BMO	0.752	0.750	0.750	0.750
CIBC	0.800	0.769	0.749	0.741
Scotia	0.769	0.781	0.794	0.800
TD	0.745	0.760	0.765	0.770
RBC	0.776	0.784	0.792	0.800

D) Purchasing Power Parity

Based on the Organisation for Economic Co-operation and Development's (OECD's) 2002/2003 data on purchasing power parity (Table 9), which compares the price of a representative basket of consumer goods and services among OECD countries, one could make the case that while the Canadian dollar is undervalued, it is less undervalued against the U.S. dollar than it was in 2002. A basket of goods and services that cost U.S.$100 in the U.S. could have been purchased for U.S.$81 in Canada during August 2002, when the monthly average for the Canadian dollar was U.S.$0.6380. The same data from November 2003 shows that a basket of goods and services that cost U.S.$100 in the U.S. could have been purchased for U.S.$97 in Canada.

Table 9: Comparative Price Levels (Canada = 100)		
	August 2002	November 2003
Japan	175	155
United States	124	103
Mexico	89	70
United Kingdom	129	113
France	116	116
Germany	116	115

Source: OECD.

MUTUAL FUNDS

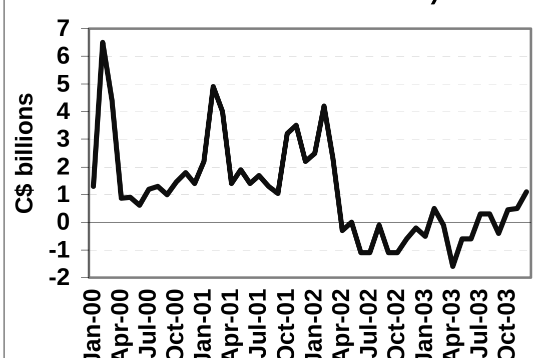
Overview

After a difficult start, the Canadian mutual fund industry ended 2003 on a high note as stock markets regained lost ground and investor optimism returned. The stock market recovery of 2003 had a particularly beneficial impact on equity funds, which had fared badly in 2002. On a less positive note, 2003 may be remembered as a year of mutual fund scandals in the U.S., where trading abuses have tarnished the reputation of the mutual fund industry.

A) Fund Growth

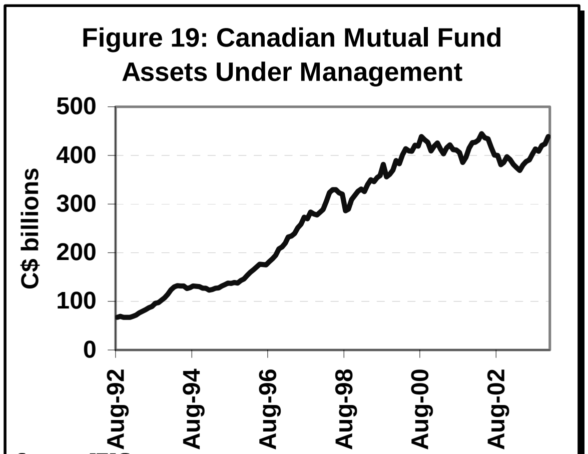
In many respects, the first three quarters of 2003 were difficult for the mutual fund industry in Canada, as net sales (excluding reinvested distributions) were negative for the year as a whole. The industry recorded a net withdrawal of approximately $650 million in 2003, the first since 1991. However, the industry closed out 2003 on a strong note as net sales were $513 million in November and $1.1 billion in December (Figure 18).

Figure 18: Net Sales (Excluding Reinvested Distributions)

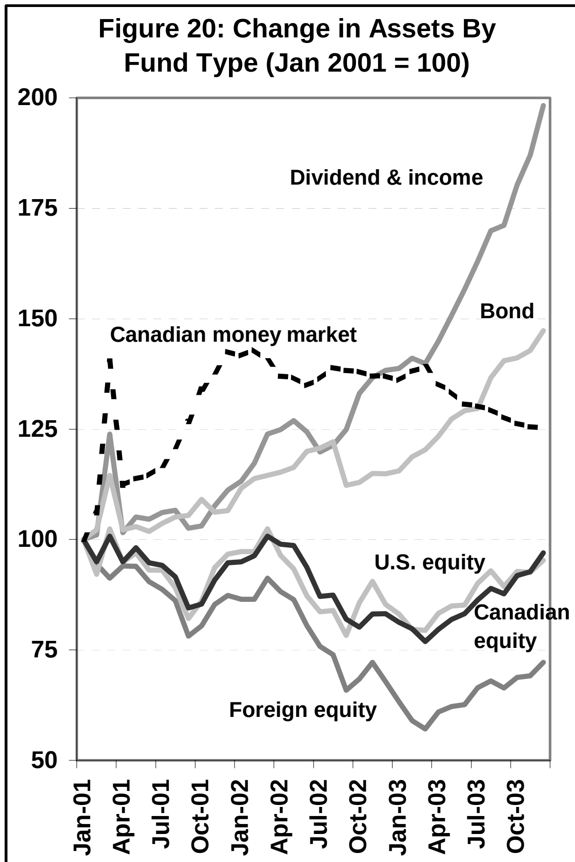


Source: Investment Funds Institute of Canada (IFIC).

When including reinvested distributions, gross sales were actually positive for 2003, so that assets under management increased to $439 billion, the second highest figure ever for the industry (Figure 19). Total assets under management increased 3.6% in December and are 12.1% higher compared to a year earlier.



Source: IFIC.



Source: IFIC.

B) Fund Assets

With the exception of money market funds, all categories of mutual funds recorded increases in assets in 2003. With the resurgence of the stock market in the last three quarters of 2003, equity funds became more appealing to investors as valuations improved. The result was an increase in equity and dividend fund assets in the last nine months of 2003 (Figure 20), after remaining relatively flat in the previous six months. Despite soaring equity markets, bond funds still managed to increase their assets, benefiting from the safe haven appeal of government bonds. On the other hand, money markets were clearly negatively affected by the performance of equities. The best performers of the year were "dividend and income" funds and "bond and income" funds, which increased by 43.3% and 28.2% respectively (Table 10).

Table 10: Assets by Fund Type

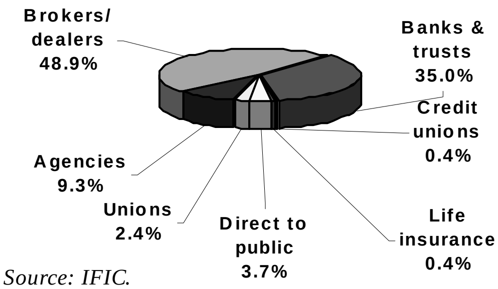
	December 2003 ($ 000s)	Year-to-Year Change
Canadian equity	100,070,612	16.5%
U.S. equity	31,453,710	11.7%
Foreign equity	87,159,540	6.4%
Dividend & income	39,060,692	43.3%
Balanced	74,539,017	14.3%
Mortgage	5,868,087	5.2%
Bond & income	40,657,464	28.2%
Money market	52,107,071	-8.6%
Other	7,948,729	-3.7%
Total	438,864,922	

Source: IFIC.

C) Fund Companies

All of the top 10 fund companies in Canada (Table 11) saw increases in assets in 2003. RBC Asset Management Inc. displaced Investors Group in the number one spot with a 20.3% increase in assets over the previous year. C.I. Mutual Funds Inc., which acquired Synergy Mutual Funds and Skylon Capital Corp. in 2003, saw its assets increase by 16.1%. However, CIBC Asset Management recorded a 50.1% increase in assets, the largest among the top 10 fund companies, earning the company a place in the top five. Mutual fund dealers and the banks continue to be the primary players in the industry, managing over 80% of assets (Figure 21). Many of the large dealers continue to snap up smaller fund companies.

Figure 21: Assets By Manager Member Type (December 2003)



Source: IFIC.

Table 11: Top 10 Fund Companies by Assets

	Dec-2003 ($ 000s)	Change from Dec-2002
RBC Asset Management Inc.	41,086,477	20.3%
Investors Group	40,904,159	8.8%
AIM Trimark Investments	38,037,244	12.2%
CIBC Asset Management	37,591,786	50.1%
Mackenzie Financial Corporation	33,590,707	9.4%
C.I. Mutual Funds Inc.	32,279,322	16.1%
TD Asset Management Inc.	31,989,854	10.9%
Fidelity Investments Canada Ltd.	30,010,164	7.7%
AGF Management Limited	23,976,646	4.4%
Franklin Templeton Investments	18,055,901	9.8%

Source: IFIC.