HEMISPHERE CAPITAL MANAGEMENT

Reflections
November 2007

THE MIGHTY LOONIE

Since the start of 2007, the Canadian dollar has strengthened upwards of 20% against the U.S. dollar. When the loonie hit parity in September, Canadians paused for a modest (typically Canadian) celebration. During early November, our dollar continued its climb eventually spiking to $1.09, a level not seen since the 1870's. From its low five years ago, the loonie has experienced a 65% gain. The mighty loonie seems to have given Canadians a new sense of confidence.

In our wildest projections we would not have forecasted this. Within the context of financial history, this is unprecedented. To have the currency valuations of two major trading partners move so dramatically during such a brief period is an extremely rare or "black swan" event (in reference to the recently published book by Nassim Taleb called *The Black Swan - The Impact of the Highly Improbable* that is making its rounds with investment professionals like ourselves).

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So what is the cause of the amazing strength of our currency? It is a combination of U.S. dollar weakness (primary reason), Canadian dollar strength and outright financial speculation.

Although the loonie has been a clear standout, most other major currencies have also made strong gains against the U.S. dollar. Recently, the U.S. dollar hit a record low against the euro and a 26 year low against the British pound. U.S. dollar weakness also translated into a recent 28 year high in the price of gold.

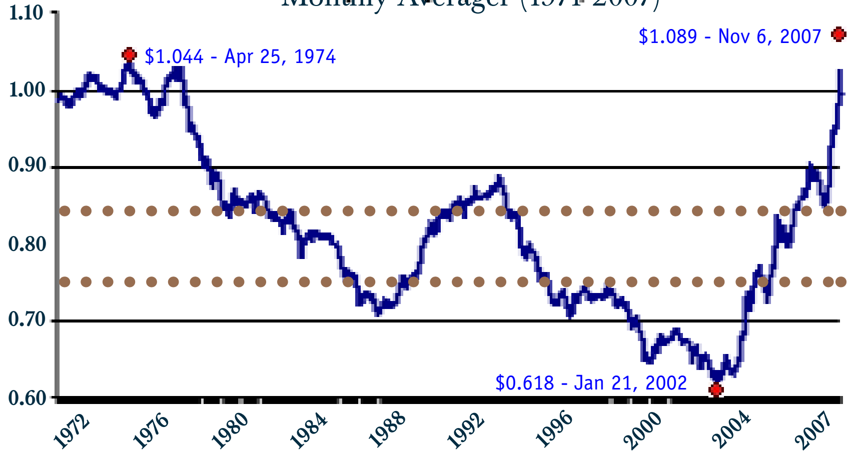
Fueled by the chronic U.S. twin deficits, the forces behind the U.S. dollar weakness have been building for some time. Americans continue to buy far more from the world than the world buys from the U.S. (trade deficit). The commencement of the "war on terror" early this decade dramatically increased U.S. government spending, pushing the nation back into its traditional large Federal deficit position. Both of these deficits require huge foreign capital inflows, which like a dark cloud overhangs the greenback.

The U.S. dollar has been "pushed over the edge" by the subprime mortgage crisis. Rising mortgage delinquencies and defaults have created a major downturn in the U.S. housing market and a credit crisis. This in turn has generated billions of dollars of write-offs in the U.S. banking industry making deterioration in U.S. economic growth virtually inevitable. With rising negative sentiment towards the U.S. dollar, there is concern that dollar weakness could become self-reinforcing. As the U.S. dollars slides against other major currencies, most notably the euro, speculation grows that large currency reserve countries (China, Japan, Russia and Middle East oil producers) may sell their U.S. dollar holdings to diversify to other reserve assets. This further weakens the greenback.

Concerns related to U.S. economic growth, prompted the U.S. Federal Reserve to lower short-term interest rates twice in the last two months. Unfortunately, these moves have put additional downward pressure on the greenback. While U.S. short-term rates are falling, most major central banks, including the Bank of Canada, the Bank of England and the European Central Bank, have been more inclined to raise short-term interest rates.

In contrast, underlying sentiment towards the Canadian dollar is mainly positive. Economic fundamentals appear much better in Canada relative to the U.S. High commodity prices have boosted demand for Canadian natural resources. Canada has a healthy (but declining) trade surplus and successive Federal governments have been running fiscal surpluses. Canadian consumer expenditures remain healthy and our financial system is not encountering the mortgage crisis found south of the border.

Canadian Dollar in Terms of the U.S Dollar
Monthly Averager (1971-2007)



The third reason for the strength in our currency relates to currency speculation. Within the world financial markets, the Canadian dollar is a minor player. This means a modest pick-up in speculative interest in the loonie can translate into significant currency swings. Currency speculators are connecting their bullish outlook for commodities with a strong demand for the loonie.

The strength in our dollar has been a bonanza for Canadian travelers and cross-border shoppers. Unfortunately, the reverse is true for Canadian manufacturers, our tourism industry and our retailers. For Canadian exporters, every penny the loonie rises above parity generates $1.5 billion in lost revenues. Undoubtedly, our trade surplus will decline and eventually employment will be hurt in our manufacturing sector.

For Canadian investors, the rise in our dollar has hurt the investment returns for all U.S. and foreign securities. Although the EAFE (Europe, Austral-Asia and Far East) index has appreciated approx. 14% year to date, this has resulted in a net loss of 6% in Canadian dollar returns. Any portfolio diversification outside of Canada has been a "lead weight" on Canadian dollar portfolio performance. Despite this situation, investors should remain globally diversified. As always infinancial markets, these short-term aberations will correct themselves over any long run period of investing.

So what is in store for our loonie? Currency markets have a tendency to over-shoot both in terms of absolute level and duration. As long as financial market participants believe in further weakness in the U.S. economy and/or the possibility of further short-term rate cuts in the U.S., prospects for the greenback will remain gloomy. However, from our perspective it appears that pessimism levels have become extreme. This implies that there is bound to be a sizeable rally in the U.S. dollar in the near term.

The Canadian economy is still inextricably linked to the U.S. Our two currencies are tied to a greater degree than most Canadians would like to believe. Ultimately, it is very difficult for the value of the loonie to diverge too far from the value of the $U.S.

Since 1971 when the Canadian dollar was allowed to freely trade in international currency markets (prior to this the dollar was fixed in a range relative to the U.S. dollar), the Canadian dollar has tended to have a range in the $0.75 to $0.85 level vs the U.S. dollar. In the 1970's during a high commodity era our dollar traded well above this range, while in the 1990's (a low commodity price era) our dollar traded below this range.

It would appear that we are heading into a sustained period where the norm for our dollar is to trade above the $0.85 level. The absolute level above this range will be dictated by the strength of commodity prices. If oil prices drop well below $90 a barrel and/or metal prices weaken significantly, our currency will trend towards this $0.85 range.