

## **Macro anxieties**

### *Markets dip for second straight week*

*October 2, 2009* – The Canadian economy did not register any growth at all in July. That had the econo-sphere in the Mother of All Flaps last week, as the tepid performance took just about all observers by surprise. And that resulted in a flurry of retrenchments, retractions, and rethinking about overall third-quarter growth and the outlook for the fourth quarter. Suffice it to say that there was no joy at King and Bay in Muddy York last week.

The zero growth posted in July, following June's 0.1% rise, came as key contributors to Canada's gross domestic product data logged declines in the month. Mining – a major contributor to Canada's resource based economy and markets – was hammered, dropped 1.5% in July, the ninth consecutive monthly decline.

But other key sectors joined in the pain. Construction, for example, took a breather in July. But that's expected to come back as stimulus pork begins to build transitways in Toronto and fill a few potholes in Montreal. The glimmerings of a revival in the housing market is likely to get contractors strapping on their tool belts again – home prices increased 1.6% in July, the third consecutive monthly increase.

Utilities took a big hit as an exceptionally cool summer resulted in much-reduced air conditioning usage. Combined with lower factory demand as the recession bottomed, utilities cranked out a whole lot less power, and thus contributed less to the GDP.

One bright spot in Canada's July GDP report was manufacturing. Though driven down by the strength of the loonie and the collapse in exports to the US during the past year, manufacturing output actually grew in July. Not enough to cover new sales, mind you, as inventory drawdown still covered much of that, but enough to register on the radar. That's a good sign for coming months, as production will need to get in gear to start filling those empty inventory pallets on the warehouse floor.

As for Mr. and Mrs. Consumer? The Ottawa-based Conference Board of Canada reported last week that its consumer confidence index rose 2.5 points in September, logging its seventh consecutive increase. When asked, more consumers said they are likely to make a major purchase in coming months. They were also more optimistic about the employment outlook than last month. However, July retail sales data were disappointing, with sales dropping 0.6% from June, and down 4.9% from a year ago. Unemployment

stood at 8.4% in the second quarter and looks to come in just south of 9% for the third quarter.

July's GDP number could well turn out to be something of an anomaly – and sort of misfired match on the recovery fuse. Fundamentally, the Canadian economy is in exceptionally good shape compared with its developed country peers. Increasingly, it appears that Canada's sound banking system and strong fiscal health going into the recession last year saved the day. It will provide the bedrock for a sustainable recovery next year. Indeed, the International Monetary Fund predicts now that Canada's economy will grow 2.1% next year, up from its previous forecast for 1.6% expansion. That's better than any of the other members of the original G-7 group of industrial nations.

In the US, there was much nail-biting about the fragility of any economic recovery, about continuing unemployment, about the pressure on the US dollar, about deflation, and about whether there will be any nails left to bite.

The recovery from recession seemed as tenuous as ever, as US factory orders dropped 0.8% in August, a sharp reversal from July's 1.4% increase. Orders for durable goods – things like cars and refrigerators – dropped 2.6%, and that's bad news, because durable goods make up 47% of all factory demand. The Institute for Supply Management said that its manufacturing purchasing managers index indicated expansion, with a reading of 52.6 in September. But that was down from 52.9 in August. (Any reading over 50 indicates expansion in the manufacturing economy, according to the ISM.)

The US unemployment rate weighed in at 9.8%, the highest since 1983, and up from 9.7% in August. The acceleration in job losses had been widely predicted, as a phenomenon typical of the early stages of an economic recovery. In other words, things might be improving, but nobody knows about it. In fact, the Chairman of the US Federal Reserve Board, Ben Bernanke, said last week that while most forecasters are predicting a return to economic growth in 2010, it won't be "so rapid as to substantially lower the unemployment rate." This may well be the first official acknowledgement that the US is headed towards a classic "jobless recovery" next year.

Meanwhile policymakers, ex-policymakers, and policy pundits debated when and how monetary accommodation should be removed. Fed Vice Chairman Donald Kohn said last week that tightening should begin even before there are evident signs of job growth and shrinking capacity. And Jeffrey Lacker, prez of the Federal Reserve Bank of Richmond, echoed those sentiments, harkening back to a late-September speech by Fed Governor Kevin Warsh, who said "policy will likely need to begin normalization before it is obvious that it is necessary, possibly with greater force than is customary." Even former Fed Chairman Alan Greenspan weighed in, saying the Fed cannot afford to "get behind the curve" by waiting too long to start reining in monetary stimulus.

You'd think they'd all been prepped from the same playbook, because it sure sounds like the Fed is gearing up to stop the money presses and start raising rates in 2010.

On top of all this, Chairman Ben has to deal with the troublesome and persistent weakness in the greenback. Various G-7 finance chiefs, who meet this weekend in Istanbul, have been making noises for a “strong dollar” – a necessary condition for a strong recovery among most G-7 members. Implicit in their pleas is a warning to the Obama Administration that it must put its increasingly messy financial house in order, lest its decade-long multi-trillion dollar deficits erode the greenback’s role as a reserve currency over the longer term.

Against this backdrop, stock markets went to the sell side for the second straight week. All the major North American indexes lost ground week over week. The S&P/TSX Composite Index slid 2.3%, while both the Dow Jones Industrial Average and the S&P 500 Composite dropped 1.8%.

But quarterly and year-to-date gains remain comfortably positive.

From the end of August, the S&P/TSX Composite rose 4.8%, posting a third-quarter gain of 9.8%, and putting it ahead 26.8% year to date.

The Dow Jones Industrial Average advanced 2.3% from the August close, giving it a 15% third-quarter gain – the best third quarter since 1939 – for an 11% increase for the year to date.

The S&P 500 Composite Index closed September with a 3.5% month over month advance, pushing it to a 15% gain for the quarter, and leaving it 17% ahead for the year to date.

The current round of selling is symptomatic of a market that’s become momentum-driven. Gains from March lows have been roughly between 50% and 60%. A round of really serious profit taking is overdue. ■

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