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Boo!

Markets retreat as fear gauge jumps

October 30, 2009 – Stock markets got volatile with a vengeance last week, as a selling trend gained momentum, culminating in last Friday’s triple-digit drops on the major market indexes. The Chicago Board Options Exchange’s Volatility Index (VIX), meanwhile, spiked 22%, to more than 30, on Friday, the highest level since July. The VIX is known as the “fear gauge,” because it serves as a barometer of near-term investor expectations for the market by tracking the cost of using options to hedge against declines in the S&P 500 Composite Index.

S&P/TSX Composite Index



S&P 500 Composite Index



CBOE Volatility Index



The moves seem almost counterintuitive, given that the third-quarter gross domestic product reading for the US came in at a strong 3.5%. But that’s already old news for markets, which had already discounted a strong third-quarter GDP number and which are now weighing potential values for the next two quarters.

The US economy returned, as expected, into positive territory with a 3.4% jump in consumer spending, supported in turn by a hefty 22% increase in durable goods sales. The big “but” here is that the massive contribution to GDP from this surge in consumer spending was spurred by the “cash-for-clunkers” rebate program – a “stimulus” measure that has now expired.

It appears that the markets believe, as we do, that most of the positive news on GDP can be pegged to pinpoint stimulus programs. Not only cash for clunkers that gave a shot in the arm to the auto industry, but government grants earmarked to first time home buyers that boosted housing demand and prices, albeit ever so short lived.

When you think about it, if you are looking to stimulate confidence with government largesse, you want to hit the big ticket segments of the market. Consumers need to borrow money for cars and homes, so stimulating those sectors effectively multiplies the impact across the economy.

We also think that this explains why Canada’s GDP numbers were not nearly as robust as those in the US. While our governments stimulated the economy, in percentage terms, it was not nearly as significant as the US programs. Nor did our governments pinpoint the money to the extent that we saw in US.

The implication here is that our numbers may provide a truer picture of the actual health of the North American economy. If so, then more stimulus money will likely be needed. Finance Minister Flaherty suggested as much last week, because from where he sits, private sector demand has been sluggish.

We are seeing this on both sides of the border as US consumer spending dropped 0.6% in September, as after-tax real disposable income dropped 0.1%, the fourth consecutive monthly decline.

That also plays into the inventory figure, which showed only a slower rate of contraction in the third quarter, not an outright recovery. Remember that factories basically shut down in the first half of the year. The current resumption of production is essentially growth off a zero base as production sputters back to life to meet existing domestic demand. But as we said, that demand isn’t showing signs of growing, and probably won’t, as long as unemployment remains close to 10%.

Private residential investment rose over 23% in the third quarter, but that also was stimulated by the imminent expiry of an \$8,000 tax credit for first-time home buyers. Once that tax credit ends in November, residential real estate could well slump again.

And there is the possible unintended consequences of stimulus spending. Consumers may sit on their wallets if they think that by waiting, they may be able to take advantage of new government incentives. But that’s a story for another day.

What we know now is that cash-for-clunkers, the home buyer's tax credit, and various other US stimulus programs highlight the essentially very short-term effects of such activity on the broader economy. What we also know is the long-term impact such programs have on the massive budget deficit and national debt burden spawned by an erroneous belief that government is good at anything other than transferring wealth and taking a cut.

To another point, the market is discounting any glimmers of hope in the US residential real estate market, because there is the real risk of an imminent collapse in the commercial real estate market. These concerns were partially responsible for the downdraft in US equity markets last week, as real estate billionaire Wilbur L. Ross, Jr. voiced his opinion that the US commercial real estate market is at the beginning of a "huge crash."

He said that all the markers of real estate value are declining in tandem, including occupancy rates and rental rates, while capitalization rates – the returns investors expect – are rising. Third-quarter US office vacancy rates hit a five-year high of nearly 17%, and shopping centre vacancies rose to their highest levels since 1992.

Left-wing billionaire George Soros also opined that some "bloodletting" is on the way for commercial real estate, adding that he believes a "double dip" recession might follow in the next 24 months. And Harvard University prof Martin Feldstein (chairman of the Reagan Administration's council of economic advisors from 1982 to 1984) added his two cents' worth, reiterating his warning of the risk of a double-dip slowdown in 2010.

The still fragile financial sector took a hit on these new fears, amplified by the threat of the bankruptcy of commercial lender CIT Group Inc. Carl Icahn, one of CIT's largest creditors and until now a vociferous critic of its restructuring plan, agreed with Goldman Sachs to support the current plan for pre-packaged bankruptcy proceedings and to extend CIT a \$1 billion line of credit. In addition, a flurry of window dressing for some financial companies whose year-ends fall on Oct. 31 may have contributed to last week's volatility.

The US dollar also can take some of the blame. Firming of the greenback against a basket of currencies put pressure on dollar-denominated commodity stocks, most visibly oil and gold, as well as on stocks of global companies that so far have benefitted from stronger foreign currencies.

In Canada, gross domestic product in August fell 0.1% month over month, diminishing hopes for a strong third-quarter recovery and throwing doubt on the Bank of Canada's most recent forecast of 2% GDP growth for the third quarter.

The rally in the US greenback weighed on Canadian resource issues, as shares of companies like Suncor Energy Inc. and Barrick Gold Corp. suffered heavy losses on declining prices for gold and oil.

October's Halloween surprise saw the S&P/TSX Composite Index lose 4.1% week over week at Friday's close. Toronto's benchmark posted a 4.2% loss on the month, but remained 21% ahead for the year to date.

In New York, the Dow Jones Industrial Average retreated for the second straight week, closing down 2.6% week over week, but remaining just about flat on the month. The venerable Dow Industrials are still ahead nearly 11% for the year to date.

And the broad-based S&P 500 Composite Index of large-cap US stocks shed 4% on the week, dropping 1.9% on the month, but remaining 14.7 ahead for the year to date.

Stock markets are going through a natural period of volatility after a powerful post-bear rally lasting seven months. Whether it cascades into a classic 10% correction remains to be seen. Caution is still warranted. ■

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