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## **Risk aversion?**

### *Markets touch highs, then sell off*

*November 20, 2009* – Are investors becoming risk-averse as the year-end approaches? It's possible, but it's still too early to say. After hitting new year-to-date highs last week, North American stock markets eased back, and closed the week with only relatively modest week-over-week gains. A week crowded with international monetary politicking, fresh attacks on the “independence” of the US Federal Reserve Board in the US Congress, and some less-than-rosy economic data left investors understandably anxious, with fingers hovering nervously over the “sell” button.

At the US-China summit in Beijing last week, US President Barack Obama urged the Chinese government to allow the yuan to appreciate against the US dollar. Dominique Strauss-Kahn, the managing director of the International Monetary Fund, echoed that request in a separate visit. And Bank of Canada Governor Mark Carney, in New York to address the Foreign Policy Association, called for freer exchange rate movements, without singling out China or other US dollar hoarders, like Thailand and Malaysia. Exchange-rate imbalances risk “sub-optimal” recovery, he said, and in the past have led to just the kind of global financial crises that we're experiencing now. To level out the imbalances, Mr. Carney urges a regime of international monetary cooperation under which countries would reduce their US dollar foreign exchange reserves and allow their currencies to appreciate. In addition, while China must focus on expanding domestic demand for growth, the US must return to a more normal savings rate and boost exports.

The problem is that the Chinese yuan is pegged to the US dollar, and the Chinese central bank manages the yuan heavily in order to keep the peg in place and prevent the yuan from appreciating. As a consequence, China's foreign exchange reserves have ballooned to US\$2.27 trillion, fully 45% of China's gross domestic product.

China has been understandably reluctant to cave in to international pressure to allow its currency to appreciate. Chinese president Hu Jintao has kept a polite but intractable silence on the issue of China's monetary policy. The cheap yuan provides lifeblood to China's export-dependent economy, now growing at an annual rate of more than 8%, on its way back to a 10% rate. Any increase in the relative strength of the yuan against the US dollar would immediately make Chinese exports more expensive on the world market, an unappealing prospect with China's exports only now beginning to recover after a 20% slump in the past year.

Other Chinese financial officials have not been as reticent about policy as the president. Yao Jin, a spokesman for the Chinese Ministry of Commerce defended China's exchange-rate policy, arguing that it is in fact good for the global economy, allowing Chinese companies to plan ahead with greater confidence in the long-term stability of the currency. Chinese officials also point to the continuing weakness of the US dollar as a consequence of the profligacy of the US government and the only tepid recovery of the US economy. A stronger yuan, they point out, would slow or stop China's domestic recovery with knock-on effects for the entire world.

Well, that may be overstating things a bit, but it's doubtlessly true that China and other nations have a bone to pick with US dollar policy, which it seems, is all talk and no action, as the US struggles to find a workable fiscal and monetary policy that lies somewhere between barely adequate and downright awful.

To that end, reports surfaced last week that the Fed is taking steps to more closely monitor the asset bases of the largest US banks. According to a report from Bloomberg last week, the Fed is redoubling its efforts to ensure that financial giants like Goldman Sachs Group Inc., JPMorgan Chase & Co., and Morgan Stanley have enough capital in the coffers to underpin the risks they take.

Curious minds might ask what the Fed and other financial regulators have been doing all this time, while shovelling billions of dollars at the banks and buying up all that junk debt. Have they not been keeping a close eye on capital and leverage ratios? Isn't this what pushed the US financial system to the edge of the abyss in the first place?

Leaving aside the rhetorical questions about the ability and competence of government to regulate anything at any time, it does seem more than a little curious that these reports are surfacing at just this time. Talk of asset "bubbles," fuelled by zero interest rates and an orgy of money printing, has been bubbling for a few weeks now, taking on a fresh urgency against the backdrop of rising exchange-rate friction. Enhanced vigilance over banks' capital bases and leverage ratios could well mark increasing concern over the growing risk of a major downturn in asset prices.

While the US banks were being scrutinized (still? again?) for their ability to withstand plunging global markets, the Fed itself was being subjected to the third degree by a Congressional committee. In fact, the House Financial Services Committee voted by an overwhelming majority to approve a measure that would give the Government Accountability Office the power to audit interest rate and lending decisions. The legislation containing the measure has a long way to go before becoming law, and may never make it past the House and Senate. However, such is the mood of Congress that an influential committee – dominated by liberal Democrats – would overwhelmingly approve a measure sponsored by Ron Paul, the Libertarian congressman from Texas, who openly advocates the dismantling of the Fed altogether! Strange times indeed.

On the hard data front, the US economy is still struggling to show some sustainability for the 3.5% GDP growth it posted in the third quarter. So far, the handoff to the fourth

quarter appears to be flagging. A key index tracked by the Fed showed that manufacturing activity slowed sharply in October, as US factory production rose only 0.1% in the month. Capacity utilization remained flat, at 67.6%, following two consecutive monthly increases. While producer prices, excluding food and energy, rose 0.3% in October, they remain down 1.9% year over year. The US economy is still sputtering in first gear, prompting Fed Chairman Ben Bernanke to warn that concerns over economic fragility is “likely to warrant exceptionally low levels of the federal-funds rate for an extended period.” How that played in China’s central bank is anyone’s guess, but it likely didn’t provide any further incentive for the Chinese to allow the yuan to float.

It’s not playing all that well on Wall Street either, as the Dow Jones Industrial Average ended the week ahead just 0.5% from the previous Friday’s close, following a three-day slide from the year’s high-water mark. The S&P 500 Composite Index lost 0.2% on the week, as investors showed signs of becoming more risk averse.

And one of the most significant signals of a return to risk aversion was the 0.02% yield on 3-month US Treasuries, a yield that had actually climbed back from negative territory Thursday afternoon. A willingness to accept zero or negative return on US Treasury instruments, which are still considered “risk-free,” often indicates a turn to risk aversion.

The S&P/TSX Composite Index, on the other hand, advanced 1.5% on the week, after touching a 52-week high on Wednesday. A selloff in the latter part of the week took some of the edge off, as energy issues lagged as the price of crude oil slipped below US\$77 per barrel. But metals and mining, led by gold, up to US\$1,146 per ounce, and copper, up to US\$3.10 per pound, helped keep the TSX afloat last week.

A return to caution in stock markets may well be in the cards, manifesting in some further selloffs as year-end portfolio rebalancing and institutional window-dressing kicks in. But can we say that investors have become truly “risk averse”? The CBOE Volatility Index (VIX), known as the fear gauge, hasn’t shown any particular signals of rising implied volatility, closing Friday at 22, still well down from around 30 at the beginning of November. The VIX will bear close watching over the next couple of weeks for any confirmation of a general trend to risk aversion. ■

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