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Bank of Canada wants us all to just behave

December 11, 2009 – Canada’s central bank produced a couple of classic Obama-style finger-wagging exhortations last week. Stepping into full nanny-state mode, the Bank of Canada warned, in equal measure, consumers of the folly of going too deeply into debt and equity markets of becoming too exuberant. And here you thought the Bank of Canada’s mandate was to aim for price stability through sound monetary policy. Apparently its mandate has expanded somewhat to include pulpit-pounding sermons on the sins of debt and greed, presumably to a citizenry too stupid to manage its own affairs and a market too blinkered by greed and too unfettered by all-seeing higher powers to agree on value through a free exchange of shares between buyer and seller.

In its semi-annual Financial System Review released last week, the BoC said, “While indicators point in different directions, various measures, such as forward price-earnings ratios, suggest that equity prices may have increased more than warranted in the context of an expected slow recovery.”

Bemused observers wondered whether Canada’s most important financial policy-making institution had gone just a tad too far, despite peppering its statement with all sorts of qualifiers. After all, while private-sector analysts can and do argue 24/7 about whether the market is over- or undervalued, they can’t actually *do* anything about it. The Bank of Canada, as an agency of the federal government, *can*. And therein lies the danger of any of these types of judgments from the BoC.

If the central bank perceives that its mandate has widened to control not only inflation but also market movements that it sees becoming too “exuberant,” then investors will rightly be suspicious about the Bank’s aims, intentions, and tactics going forward. Will the dead hand of government henceforth be the invisible third party to any stock market transaction? Will it consider this or that trade “unwarranted” at the agreed price? Will every subsequent trade at a higher price bring on the threat of an interest rate hike or, what’s worse, more sermons?

The BoC also turned its attention to household debt. It warned that Canada’s rising household debt – mostly mortgages at historically low rates – poses the biggest risk to the country’s financial system, saying, “Households need to assess their ability to service

these debt obligations over their entire maturity, taking into account likely changes in both income and interest rates.”

While this may seem to be “Financial Planning 101,” and an area best left to individuals, their lenders, and their financial planners, the BoC thinks it should weigh in with a little bit of scolding for those tempted to borrow beyond their means. We wonder whether the Bank will now also offer to balance individuals’ monthly accounts, just to be sure they’re not crossing the debt-service-ratio threshold.

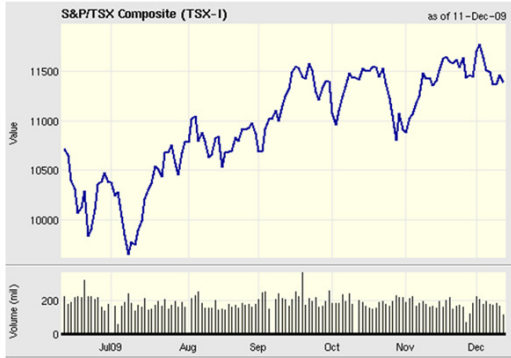
In a larger sense, of course, the BoC’s concerns may be well-founded. Trouble is, the Bank is largely the author of our own misfortunes, whether overbought stock markets or overleveraged homeowners. That’s because there’s no *deus ex machina* that sets interest rate policy in this country apart from the selfsame Bank of Canada.

The Bank may argue that it’s at the mercy of larger international financial forces, primarily the giant one south of the border – and it is. To a large degree, the BoC must slavishly follow policy set at a little outfit called the US Federal Reserve Board. It’s been doing just that these past couple of years, essentially letting go all restraints on money supply short of quantitative easing, which some would argue is taking place anyway in everything but name.

Interest rates near zero, which the BoC confirmed again in its last week’s rate announcement, are bound to result in certain very specific types of behaviour by consumers and by investors. It’s unavoidable. For the BoC – and indeed other central banks around the world who joined in the sermon last week – to warn us all about the dangers of debt and overheated markets seems more than a little disingenuous, considering that it was the architect of the current monetary environment in the first place.

For those fond of hidden agendas and deeper meanings, it could be argued that the BoC and other central banks are not really expanding their mandates in order to act as Chief Financial Planners. In reality, they may just subtly be setting the stage for a spate of interest rate hikes next year. In other words, they’re saying, don’t be surprised when equity markets dip and variable-rate mortgages have to be painfully re-set after rates rise next year. And those rate hikes may come earlier in the year than expected.

Stock markets, as irrationally exuberant as the grand poobahs of government might deem them to be, have already been discounting some sort of wider monetary policy action early next year. A look at the charts shows that the big North American indexes have been moving “sideways” in the last quarter of this year, unable to pierce upside resistance or downside support in any meaningful way. And a look at the MSCI World Index shows the pattern isn’t limited to North American stocks.



CourtesyCTVglobemedia



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MSCI World Index



CourtesyBloomberg LP

The lagging macro-economic evidence continues to point to at least a muted recovery, as last week's release of October trade figures attests. Canada's merchandise trade balance is back in surplus after six months of deficit. Driven by growing US consumption, Canadian export volumes grew 3% in October. Imports fell slightly, owing to lower import prices, while import volume actually grew.

The US trade deficit narrowed considerably in October, indicating an increasingly entrenched comeback in global trade. While exports posted strong growth, domestic energy demand fell 12%, weighing heavily on import growth.

On the consumer demand front, US retail sales have held up surprisingly well, despite the 10% unemployment rate. Spending rose 1.3% in November setting the stage for a positive holiday shopping season and a further improvement in personal consumption growth from the 2.9% advance posted in the third quarter.

Stock investors kept their fondness for the game of musical chairs, and when the music stopped last week, left only a few players without a seat.

Toronto's S&P/TSX Composite Index slipped 0.8% over the week, on softening commodity prices, as resource stocks followed oil's slide to below US\$70 per barrel from around US\$78 last week, and by gold's retreat to US\$1,116 an ounce from US\$1220.

New York's blue-chip Dow Jones Industrial Average advanced 0.8% on the week, as the US House of Representatives approved a bill increasing regulation of the financial services industry, decreasing the Fed's powers, and creating yet another regulatory agency to oversee the financial industry. Strong readings in retail sales and consumer sentiment offset anxieties over burgeoning government intervention in the private economy and prevented the DJIA from slipping into the red.

Similarly, the broader S&P 500 Composite Index ended the week with neither a big advance nor steep retreat, closing flat in week-over-week terms.

A stock market retreat now and for the next few weeks into the early New Year would not be surprising, given the astonishing bull run since March, growing wariness over imminent tightening of monetary policy, and increasing turmoil in debt markets over vulnerable sovereign debt in places like Dubai, Greece, Spain, and Ireland. Whether markets are overvalued or not is still an open question for most investors. However, for the real inside dope, we could always ask the Bank of Canada. ■

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