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European debt troubles weigh on markets *But tech stocks help buoy Toronto index*

December 18, 2009 – Year-end fiscal troubles among some of the weaker members of the European Union gave a boost to the US dollar last week, and let some of the air out of the loonie’s expansion towards par with the greenback. Following hard on the heels of Dubai’s *de facto* debt default a couple of weeks ago and last week’s nationalization of a regional (and small, with assets of US\$63 only billion) bank by Austria, European debt woes serve as a grim reminder that the stresses of the global financial crises have not yet been fully relieved.

Reacting to concerns that Greece’s public finances are threatening to spiral out of control, and that the government and entrenched bureaucracy are unable to overcome stiff domestic opposition to any program of fiscal austerity, two major rating agencies downgraded Greek sovereign debt, most recently Standard & Poor’s, which last week cut its debt rating to BBB+, while warning of the potential for further downgrades.

That had the effect not only of increasing premiums on Greek debt, but also of drawing attention to the plight of other vulnerable eurozone countries in fiscal difficulty, including Portugal, Ireland, Italy, and Spain. (These states have collectively come to be called the “PIIGS”.) Along with Greece, these countries face stiff competitive headwinds in the global economy, owing to swollen and unresponsive bureaucracies and severely deteriorating fiscal pictures weighed on by ballooning debt levels.

After a lengthy run of strength against the US dollar, the euro got hammered last week, falling 1.3% against the dollar on Thursday. Investors decided very quickly that discretion was the better part of valor, and put European stocks on the auction block. The FTSE 100, the DAX, and the CAC 40 all came under selling pressure last week as investors suddenly rediscovered their love for the greenback as a “safe haven” currency.

That didn’t stop the contagion from spreading to North American markets, however. The major US and Canadian indexes also sold off last week, as speculation on the timing of a rate hike by the US Federal Reserve Board caused some anxiety on Wall Street. The tide of liquidity that has floated markets (and, some say, caused various asset bubbles to form in lieu of inflation) for the past year and a half or so is slowly beginning to recede. That, too, has given new life to the beleaguered greenback.

Traders were further buoyed by economic data that show a subdued, but sustainable, US rebound in the making. US housing starts, for example, grew again in November in all parts of the country, for a total increase of 8.9%, following a dropoff in October. In a sign that US factories are starting to roll again, industrial production rose 0.8% in November from October's level. And capacity utilization rose to 71.3% from 70.6% in October.

Along with a 1.8% jump in the US producer price index in November, and a 1.8% jump in the all-items consumer price index for November, these data points also tend to spotlight a shift to inflation worries, which leads again to speculation about the "when" and the "how much" of the Fed's next rate move. For now, however, the Fed is maintaining the status quo.

In announcing no change to its target benchmark overnight rate of 0% to 0.25% last week, the Fed pointed out that economic activity has picked up and that "deterioration in the labor market is abating." Analysts pored over the Fed's statement for any indication that its policy is shifting, even subtly. Other than an acknowledgement that conditions are slowly improving, there was none. But starting now, the game of Fed tea-leaf reading is going to become a full-time occupation in the econo-sphere.

In Canada, it's a similar story of gradual recovery, though perhaps a bit more robust than in the US. Canadian factory sales rose 2% in October, topping guesstimates and adding to positive news in housing (national home sales rose 73% in November) and recent improvements in the labor market and consumer demand, as average individual spending through the holiday season is expected to rise to \$891, topping last year's \$884.

Although the Canadian all-items consumer price index climbed 1% in November, the Bank of Canada is unlikely to begin on a path to normalizing rates before its self-imposed deadline of June 2010, and for the same reasons as the Fed: the economic recovery is simply too fragile to risk throwing interest-rate sand into the slow-moving gears.

The S&P/TSX Composite Index rose just shy of 1% on the week, as investor optimism over positive earnings results from Research in Motion helped boost a resurgent tech sector and offset weakness in commodity-based issues, arising from the stronger US dollar.

In New York, the roller coaster of late December volatility asserted itself as expected, and the big indexes ended the week with moderate losses from the previous week's close. The Dow Jones Industrial Average slid -1.4% on the week, while the S&P 500 Composite slipped -0.4%. Much of the volatility can be attributed to seasonally lower volumes, presumably as traders take time to get out to TJ Maxx and make their contribution to consumer demand in advance of the holidays.

Bucking the trend, however, as in Toronto, is the Nasdaq Composite Index, which gained 1% on the week, as technology stocks like RIM and Oracle maintained their uptrend towards the end of the year.

Finally, I'd like to take this opportunity to wish everyone the best of the holiday season, and a healthy and prosperous New Year. ■

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