

Expressions of risk

Some positive news amidst the gloom

April 9, 2009 – Last week’s stock market rally capped a fifth straight week of advances in the equity market rally since the new lows in early March. That has many analysts wondering when the party will end. They’re not necessarily just a bunch of professional gloomsters either, although there are still plenty of those about, too.

As the first-quarter earnings season gets underway, stock markets ended a truncated week of trading on a high note, racking up, for the most part, a fifth consecutive week of gains. Investors especially liked financial stocks again after Wells Fargo announced on Wednesday that it expects record-setting net income in the first quarter of US\$3 billion, or US\$0.55 per share. That coincided with a report in *The New York Times* that the 19 largest US banks subject to the federal government’s stress test are on track to get a passing grade when the feds announce results at the end of the month, after earnings announcements are in.

In fact, Wells Fargo’s earnings guidance was pretty good news, as was the *Times*’ report. Together, they could be an early sign that the free-fall in the financial sector has been arrested, thanks to the massive assumption of risk on behalf of taxpayers by the US federal government and its key money-printing operation, the Federal Reserve Board. The same can be said of Canadian treasury and monetary efforts, though on a much smaller scale, of course. Taxpayers in Europe, too, have underwritten the massive risk of the financial sector thanks to aggressive fiscal and monetary interventions by the Bank of England and the European Central Bank.

Some key economic metrics are also starting to show signs of, if not a turnaround, at least a slowing of the economic decline. At the top of the list is that deep cuts in production and massive drawdowns in inventory in the fourth quarter of 2008 and in the first months of this year may be reaching an equilibrium point. The Institute for Supply Management (ISM), which surveys manufacturing conditions monthly, reported that manufacturers’ inventories shrank at a faster pace in March than in February, with only 9% of firms reporting increases compared with 19% the previous month. With empty warehouses now barely meeting existing demand, the stage is set for an increase in output. And that could occur rapidly if consumer demand shows signs of reviving. But that’s big “if.”

Unemployment continues to rise everywhere, as the wrenching adjustments of the disappearing “wealth effect” (driven by a cascade of real estate deleveraging) over the past year work through the broader economy. Rising unemployment is expected to continue through this year and into 2010, dampening expectations of a revival in

consumer spending anytime soon. Still, the injection of trillions of dollars of “stimulus” into the economy via massive government spending programs (which, incidentally augur also for a coming “decade of deficits”) is likely to bear a little fruit beginning the second half of this year, as some of that cash actually makes its way into designated projects.

For investors, this may be a boon in the shorter term, anywhere up to five years or so, as early monetary inflation works relatively invisibly on equity values. Beyond that, it’s anyone’s guess, and much hinges on central bankers’ ability to predict and stanch growing inflationary expectations in the future through the traditional tools of inflation targeting (raising interest rates). Alas, their record is not a good one.

For now, though, there are more rays of hope emerging that the recession is at least no longer gaining momentum. We see such signs in the inventory stabilization we mentioned earlier. We see it in rising exports, as both Canada and the US posted export increases in February. We see it in rebounding new home construction in both Canada and the US in February, despite (or perhaps because of) still-declining house prices. And we see it in gradually rising commodity prices, especially in base metals like copper – for which April and May futures contracts closed last week above US\$2 per pound – as inventories continue to fall. For now, crude oil remains just below US\$50 per barrel with US stockpiles at 16-year highs, and on track to expand even more.

On balance, markets have expressed a renewed appetite for risk over the past few weeks, pushing emerging market indexes to strong gains this year. The MSCI Emerging Markets Index, for example, is up 7.6% year to date, as component indexes like Russia’s, have advanced as much as 28% in 2009.

Contrast this with the broad US indexes, which remain mired deep in the red in year-to-date terms. As of Friday’s close, the Dow Jones Industrial Average was down 7.9% year to date, while the S&P 500 Composite Index is off 5.2%. Toronto’s S&P/TSX Composite Index, however, is now ahead 2.2% for the year to date, benefitting from strength in both financial and resource sectors.

Still, for now, the trend has been in the right direction. Last week, the DJIA closed the week with a 0.8% advance, while the S&P 500 rose 1.7%. The S&P/TSX gained 1.3% on the week.

Some of this exuberance is bound to wear off as more first-quarter earnings reports give markets a bit of a reality check. Risk is still high, despite investors’ growing interest in acquiring a bit more of it. US outstanding commercial paper expanded by US\$56.9 billion, to US\$1.53 trillion, last week, the first signs, perhaps, that the Fed’s efforts to thaw credit markets is working. However, wide corporate yield spreads are still signalling a significant expression of risk on the part of lenders. Until those risk concerns are allayed, equity markets will remain volatile and unpredictable. ■

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