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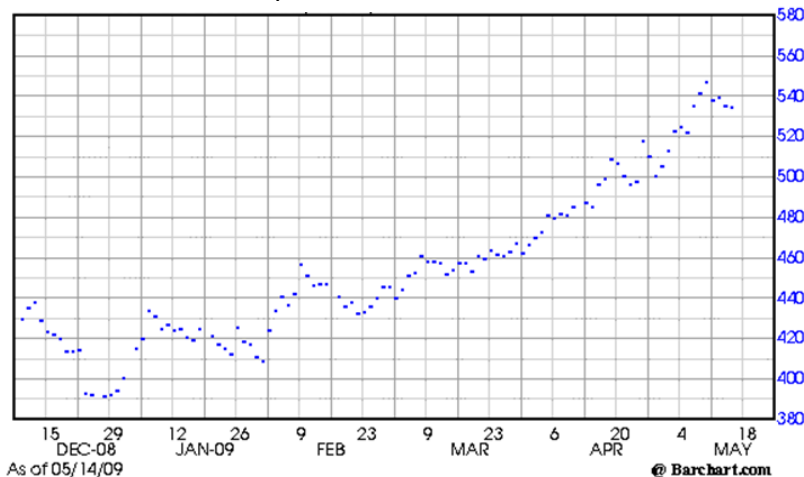
Curbed enthusiasm

Market pullbacks provide second chance

May 15, 2009 – As expected, at least in these comments, investors decided to take some profits off the table last week, following a powerful two-month rally that saw the S&P/TSX Composite Index climb some 37% from its March low, and decisively break the 10,000 mark on May 8. Last week's retreat saw the benchmark index slide back to close Friday at 9,763, a loss of 4.6% on the week. Investors' early enthusiasm about all those "green shoots" we've been hearing about waned a bit, as the hard realities of flaccid earnings expectations for the rest of the year took hold.

Canadian stocks have benefitted substantially from the recovery in commodity prices, particularly in base metals, as can be seen in the accompanying graph of the CRB Metals Sub-Index.

CRB Metals Sub-Index, 6 months



Courtesy Commodity Research Bureau

Base metals prices have reacted largely to an accumulation binge in China. While the North American and European economic outlooks remain dim for this quarter and the next, China appears to be showing signs of a rebound. April's purchasing managers manufacturing index rose to 51.4, signalling an expansion in the manufacturing sector for the first time in nine months. (For most purchasing managers indexes, 50 marks the threshold between growth and contraction.) And in Japan, industrial production rose 1.6% in March, the first such increase in 10 months, while Korea posted its second

consecutive monthly gain in production, growing at a 4.8% pace in March, after a 7.1% advance in February.

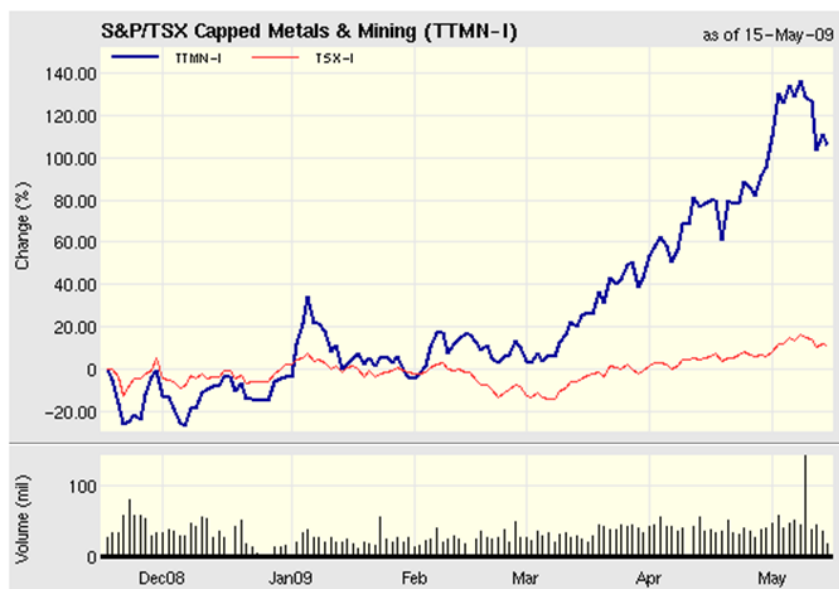
The budding recovery in Asia has stimulated demand for base metals, especially copper. Strong Chinese buying has drawn down London Metals Exchange stocks by 25% since late February, as the State Reserve Bureau restocks inventories that were depleted in the boom through the past decade.

So far, the recovery in China's economy has been supported by an aggressive stimulus policy combined with central bank easing. Capital spending rose 33.9% year over year in April, the fastest pace in five years, as those stimulus funds made their way into the economy. However, the picture darkened somewhat as exports fell 22.6% year over year in April, and the central bank warned that until private sector demand revives in a big way, government spending alone is not enough to provide a firm foundation for recovery. A full recovery isn't expected until 2011.

Meanwhile, however, key commodity imports continue to surge in China, mainly to support fixed-asset infrastructure investment. Imports of iron ore, for example, rose 33% in April, while crude oil shipments advanced 13.7%.

The effect on the Canadian metals and mining sector compared with the broad-based index has been striking, as seen in the accompanying graph. (Note also the close correlation of the metals and mining index with the CRB Metals Sub-Index shown in the graph above.) This is another indication that the recession has turned and that the stock market has indeed bottomed out.

S&P/TSX Capped Metals & Mining Subindex vs. S&P/TSX Composite Index, 6 months



Courtesy Globeinvestor.com

Base metals stocks typically recover first and fast in a recessionary end-game. And it's no different this time. Prices for base metals and for shares of base metals mining companies are signalling an end to the protracted slump in global industrial production within the next couple of months.

In the US, the slump in industrial production also showed signs of easing, if not of immediate recovery. Output from factories, mines, and utilities dipped 0.5% in April, better than the 1.7% drop recorded in March. Inventories have been slashed, and there are early signs that production is starting to roll again, if only to meet existing demand.

Consumer prices fell 0.7% (unadjusted) year over year in April, the biggest drop in prices in 54 years. However, a deflation does not appear imminent. Most of the decline in the consumer price index was attributed to declining energy prices through the month. Core inflation, which excludes food and energy components, actually rose 1.9%, the fourth consecutive monthly advance.

Another note on the plus side of the ledger came from consumer sentiment. The Reuters/University of Michigan consumer sentiment index climbed to 67.9 in early May, up from 63.1 at the end of April, and from a low of 55.3 last November.

All of these green shoots have played to investors' fresh enthusiasm for risk, and particularly for equities. However, earnings have yet to catch the enthusiasm. First-quarter earnings for S&P 500 stocks have exceeded estimates and "guidance," it's true, but almost everyone acknowledges the low-balling numbers game that took place to make this outcome possible. However, profits are still down more than 30% year over year, and the numbers game that helped propel some of the big US financials to better-than-expected first-quarter financials isn't likely to be repeated in this quarter.

The return to more subdued earnings expectations is likely to play out in somewhat less enthusiastic trading than we've seen since March. That may already have started this past week, as the major North American indexes all lost ground. Toronto's S&P/TSX Composite Index lost 4.6% on the week. New York's Dow Jones Industrial Average dropped 3.6% while the S&P 500 Composite Index retreated 5%.

That curbed enthusiasm may well lead to a partial retracement of the spring rally over the coming weeks. For those who were less eager to buy at the March lows, that retracement will present a second chance. ■

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