Markets advance in May

Shrug off concerns over rising yields, falling dollar...for now

May 29, 2009 – As we stated in these notes quite some time ago, Chrysler and GM have been *de facto* bankrupt wards of the state for many years now, whose characteristics as "investments" for any kind of portfolio (except perhaps hedge fund shorts) have long been a sham for anyone with eyes to see. If you for some reason still hold GM bonds or shares in your retirement plan, you can kiss your "investment" good-bye.

It should come as no surprise that Chrysler and GM have ended up as "government enterprises" – a classic oxymoron if ever there was one. However, what "should be" and what really "is" are two different things. The fact is that thousands of bondholders with some $27 billion in GM debt, and with access to precisely the same financial information over the past few years as everyone else, now face the prospect of losing their investments almost entirely.

GM followed Chrysler into US Chapter 11 bankruptcy protection (and under the Companies' Creditors Arrangement Act in Canada) on Monday. The process is simply a legal formality that will allow GM to "restructure" itself into a quasi-government agency, much like Fannie Mae or Freddie Mac in the US or a Crown Corporation in Canada.

When all is said and done, the $30 billion in financing from the US government will be turned into a 60% equity stake in GM. In Canada, the federal and Ontario governments are ponying up $10 billion in financing, which also will be converted to a 12% equity stake. None of this taxpayer-funded largesse will ever be repaid, of course, and will disappear forever into the deep, dark pool of fiscal deficits that will plague governments for the next decade or so – or at least until they monetize their way out of it.

And there's the rub. The bailouts of Chrysler and GM are just one piece of the larger fiscal puzzle. That puzzle is still in the process of being solved, as last week, both US Treasury yields and mortgage rates jumped to their highest levels since last November. That has investors worried that the US government's efforts to stimulate the economy will result in an oversupply of US Treasurys. Soft demand pushes up yields and depresses prices. And higher yields are just what the government doesn't want, as it attempts to keep mortgage rates low and put a floor under the US housing market. A scenario of climbing yields could prolong the recession or dampen the strength of any recovery.

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Last week's sudden surge in rates could see the Fed advance its planned purchases of Treasury bonds before its open market committee meets again on June 24. While rising yields can be an early indicator of an economic revival, they might also be indicating new anxieties about the potential for corrosive inflationary effects of the Obama administration's large-scale borrowing to finance its multi-trillion-dollar stimulus packages.

Although Canada's Finance Minister Jim Flaherty announced that the federal deficit estimates have been upped to the $50 billion range, a result also of aggressive stimulus and bailout packages, Canada's situation is not nearly as perilous as it is south of the border. True, CIBC and Royal Bank reported losses for the first quarter, but Toronto-Dominion, Bank of Nova Scotia, Bank of Montreal, and National Bank all reported net profits, generally in line with expectations. Capital ratios remained robust and all have taken steps to cut costs. That's diametrically opposite of the wreckage-strewn financial landscape south of the border.

The Canadian dollar climbed past US$0.91 on continuing US dollar weakness. But a surge in crude oil to US$66 per barrel, gold to US$978 an ounce, and silver to US$16.51 an ounce, and continued Chinese stockpiling of base metals added strength, as the loonie is seen as a commodity-related currency.

Equity markets have so far shrugged off credit market concerns and have focused instead on the thawing of credit markets, the depletion of inventories, and the bottoming out of the real estate market. Which is not to say that equity investors won't do a sudden about-face in June and take alarm at rising interest rates and the ever-falling greenback.

For now, the strength in commodities has helped push Toronto's benchmark S&P/TSX Composite Index to a 10.1% month-over-month advance in May, as the index closed last week with a 4% weekly gain. The TSX is now up 39% from its March low and is ahead 15% year to date.

New York's Dow Jones Industrial Average gained 4% month-over-month in May, the third consecutive monthly advance. Marking a 2.7% advance on the week, the DJIA is up 32% from its March low, but is still down 3.1% for the year to date.

The broad-based S&P 500 Composite Index ended May with a 5.3% monthly gain, as it closed last week with a 3.6% advance. The S&P 500 is now up 38% from its March low and is ahead 1.8% year to date.

Plenty of observers, including us, have expected a retracement in equity markets after such a powerful rally. Of course, the market does what it wants, and never what or when you expect. Still, the summer doldrums are imminent, and we still expect that cooling off cycle to happen.

When we said, "It's buying time again," back in our Jan. 2 comments, we felt that the market was close to or at a bottom. The bottom actually came in March, from which point

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the major market indexes have advanced like gangbusters. We still think it's buying time, and any market pullbacks in coming weeks will present opportunities to continue selective rebalancing of portfolios back towards equities.■

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