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## **Markets power up** *But skeptics worry*

*May 8, 2009* – Some encouraging signs that the global recession may be easing have reignited the commodity markets and as a result have renewed investor interest in the Canadian dollar. That same interest has also been powering Canadian equities to fresh year-to-date highs almost every week since the March low. Canada's resource-heavy S&P/TSX Composite Index has advanced 35% from its March low of 7,479.96, and as of this week's close has cracked the 10,000 level.

Frankly, we thought it would take just a little bit longer, but who are we to quibble if the market's starting to feel frisky?

And the fact is there appear to be plenty of reasons for investors' sudden sense of optimism. First and foremost, residential real estate. In the US, the National Association of Realtors reported that its Pending Home Sales Index rose 3.2% in March, the second consecutive monthly advance. Separately, the US Commerce Department reported that construction spending rose 0.3% in March, the first increase in six months.

All US residential real estate data have been watched closely for any sign that the market is bottoming. It's in residential real estate mortgages, after all, that the whole mess began, and it's here that it will be resolved. So the uptick in sales is significant in a lot of ways. Not only does it indicate that the market has reached a bottom, but it also indicates that buyers are returning in large enough numbers to affect sales volumes. And that means by extension that consumer confidence is rising.

First-time buyers are taking advantage of a conjunction of a number of positive factors to make that all-important first-home purchase. US mortgage interest rates are at very low levels, with the average 30-year fixed-rate mortgage still below 5%, according to Freddie Mac's weekly survey. Prices have declined substantially, giving added impetus to affordability. And credit has become easier as banks, flush with fresh injections of capital, are strong-armed into lending by the Fed.

That's not to say real estate markets are about to see an "overnight" recovery. Sustained strength depends on at the very least a return to supply/demand balance. And that's not going to happen until the huge overhang of unsold inventory (much of it in the form of foreclosed property) is worked off. Of course, any significant drawdown in inventory depends on a recovery in the labor market. That's going to take some time, as US non-

farm payrolls fell another 539,000 in April, while the unemployment rate rose to 8.9%. That's in keeping with our outlook for a 10% unemployment rate sometime later this year. Still, there's a note of optimism in the trend. The April numbers were considerably better than expected, decelerating from the 708,000 jobs lost in March.

Both stock and commodity markets shrugged off the considerable longer-term risks still inherent in the readings for residential real estate and employment, focusing instead on the anticipated trend, as markets are fond of doing. And the trends are headed in the right direction for now, at least as far as the markets are concerned. For example, following hard on the heels of a fourth consecutive monthly advance in US Institute for Supply Management's manufacturing index for April, the nonmanufacturing, or service, index rose to 43.7 from 40.8 in March. Both indexes reported significant strength in the new orders component, suggesting that severity of the US contraction may be easing.

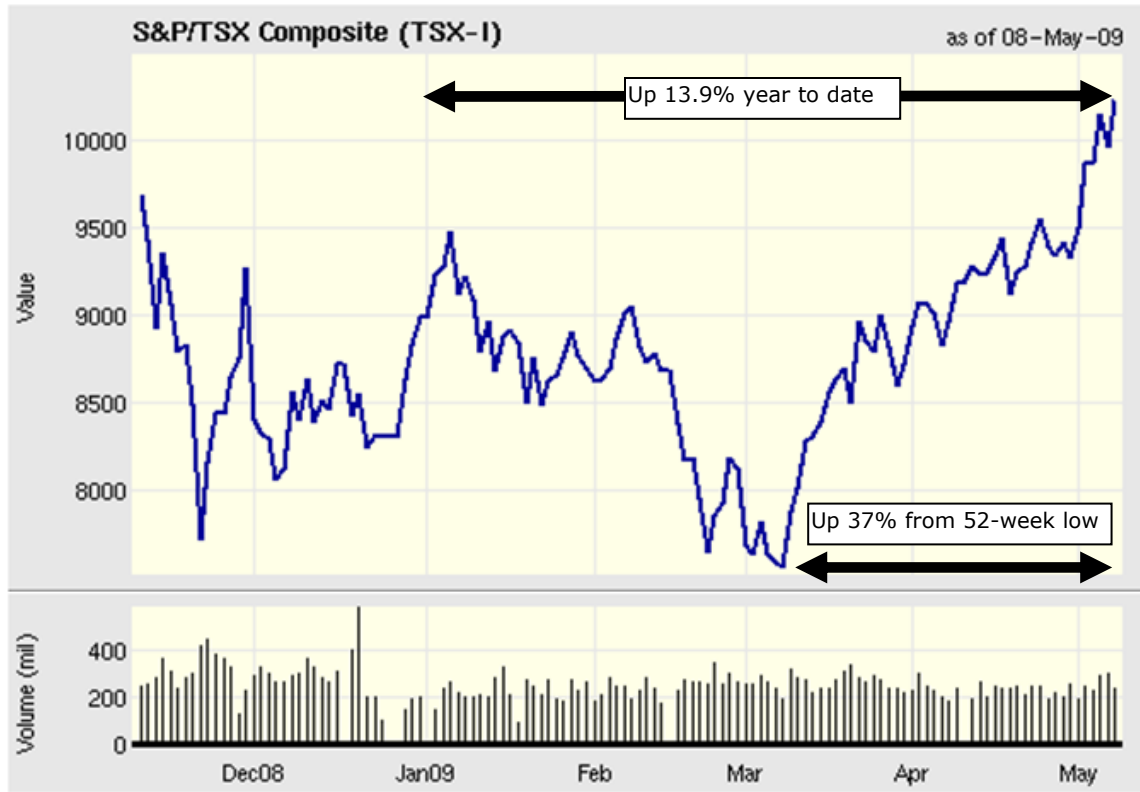
The stock market also shrugged off last week's results of the US federal government's "stress" tests for the country's 19 largest banks. The government ordered 10 banks, including Bank of America, Wells Fargo, and Citigroup, to raise a combined US\$74.6 billion in capital to shore up balance sheets against potential future losses. The stress tests were widely criticized as being overly simplistic, politically motivated, and ultimately detrimental to the very recovery they're allegedly designed to promote. That's all true, of course, and may be a big reason why the markets ignored the results of the stress tests.

Canadian equity markets have especially enjoyed this rally, owing to the large representation of commodity-related issues in the market's main benchmark indexes. Climbing oil and gas prices have led a broad-based rally in Canadian resource stocks, while providing additional support to the loonie, which ended Friday's trading session at US\$0.8679, up from about US\$0.80 a little over two weeks ago.

In a television interview last week, Bank of Canada Governor Mark Carney said that with business inventories being slashed both here and in the US, Canada's economic recovery will develop in "full force" early next year. With its target overnight rate set to remain close to zero for the foreseeable future, the BoC has ruled out pure money printing (quantitative easing), a move that further strengthened the loonie, assisted by a positive jobs report that saw an increase of 36,000, while the unemployment rate remained unchanged at 8%.

As a result, the S&P/TSX Composite Index ended last week with a 7.8% week-over-week advance, continuing a series of weekly gains that was interrupted only last week with a slim loss. The Toronto benchmark is ahead 13.9% for the year to date.

## Wall of worry?



The Dow Jones Industrial Average gained 4.4% on the week, while the S&P 500 Composite Index advanced 5.9%, as both indexes continued their powerful surge since bottoming in March. The Dow Industrials are still underwater by 2.3% for the year to date. But the more broadly based S&P 500 blue-chip index is now 2.8% in positive territory, for the first time since early January.

Analysts have been left scratching their heads at the size and strength of the spring rally, as each subsequent weekly advance by the big indexes converts more bears into bulls. Earnings fundamentals have improved, volume has risen, and new highs are consistently outnumbering new lows. However, there's a high degree of skepticism that the current rally is sustainable. It's said that bull markets "climb a wall of worry." While we're not prepared to declare the birth of a bull just yet, we'll certainly agree about the "wall of worry." ■

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