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## **Markets' growing appetite for risk** *Premature exuberance?*

*June 12, 2009* – Despite the recent reversion to risk by investors, the recession, it seems, is still very much with us. Stock markets, commodity markets, and yields on key debt instruments have rallied like it's 1999, oblivious to dire warnings from a variety of deep thinkers in the econo-sphere that the sustainability of current rallies is highly doubtful, given the still-distressing unemployment picture and the vast amount of slack in the economy.

In Canada, Statistics Canada, the agency chiefly responsible for tracking and reporting on such things, revealed that about only 69% of available industrial capacity was being used in the first three months of the year. That was down from about 75% in the fourth quarter of last year, and was the lowest reading on record. StatsCan says that in the transportation sector, first-quarter capacity use fell to 42.5%, as two of the largest players in the auto sector – Chrysler and General Motors – complete their transition to government pork barrels.

No question about it. Canadian manufacturing is feeling the pinch (actually more of crushing vise-grip) of dwindling demand both here and abroad and a resurgent Canadian dollar, which has added further insult to injury by squeezing out any remaining solace Canadian manufacturers might have found in exchange-rate-related export pricing advantage.

Canadian trade numbers released last week by StatsCan confirmed observers' worst expectations about the depth and breadth of the economic downturn. Any hopes of a sustained Canadian trade surplus were cruelly dashed, as Canadian trade slipped back into deficit in April, albeit by only a rather slim \$179 million. The April deficit was the third in the past five months, as the exports shrank 5%, led by steep declines in industrial equipment and materials, while imports fell 1.5%.

As much as assorted economic seers, prognosticators, and theorists might have speculated during the heady years of globalization, Canada is in no way, shape, or form “decoupled” from the US. And despite valiant attempts by the current US administration to erect trade barriers in the form of “Buy America” policies for recipients of stimulus funding, Canada remains America's largest trading partner, with some 72% of our total exports making their way, somehow, through the ever “thickening” border.

In the US, the trade picture darkened again in April, as its deficit in international goods and services widened to US\$29 billion from US\$28.5 billion in March. A 2.3% decline in exports outpaced a 1.4% slide in imports, blindsiding many econo-bloggers who had expected to see a glimmer of hope in even a small uptick in trade volumes.

On the plus side of the ledger, however, consumer confidence rose in June according to a widely followed Reuters/University of Michigan Survey. Its index rose to 69 from 68.7 in May, the highest level since last September. However, the US Commerce Department reported that retail sales increased 0.5% in May, but said most of that increase was a result of higher gasoline prices. Take out spending at the local Exxon station, and that retail sales number drops to a 0.2% monthly increase – nothing to write home about, but at least it's a move in the right direction.

So while consumer sentiment may be showing signs of life, retail sales have yet to feel any significant impact of that allegedly brimming confidence. As long as American consumers continue to groan under a near 10% unemployment rate, heavy debt loads, depressed housing values, and ravaged equity portfolios, a prolonged bout of shopping for various doodads and knick-knacks at the local Target store is unlikely just yet. Personal balance sheet cleanup and an intense focus on saving are the orders of the day.

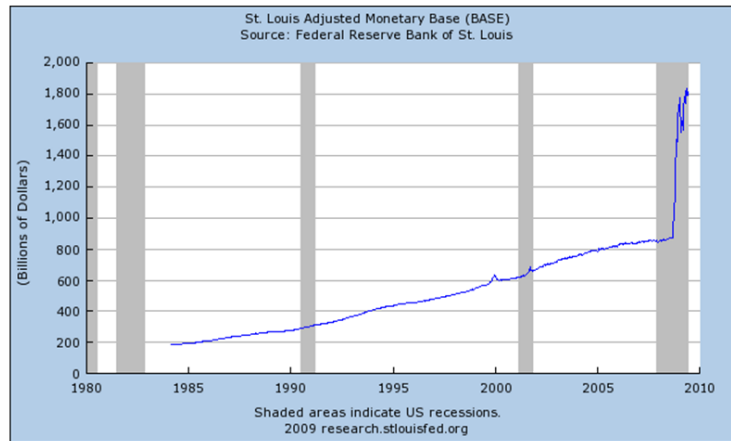
Bank of Canada Governor Mark Carney also warned of engaging in premature exuberance. In remarks at the International Forum of the Americas in Montreal last week, Carney said, “We shouldn’t overplay at this stage the green shoots.” (See also our remarks in our June 5 commentary, entitled “Herbicide.”) He pointed out that private sector demand has weakened so much over the past year that a strong recovery is unlikely, let alone imminent. He added that while global trade carnage may be bottoming, there is “still more to come” in the way of inventory and labor adjustments. That’s central bankerese for more unemployment and inventory shrinkage ahead.

Still, Mr. Carney remains convinced that we are likely to see a return to modest economic growth in the third quarter in the US, China, and Japan. European Central Bank officials see no such revival in their corner of the world until the middle of next year.

Meanwhile, the debate continues to rage in the econo-sphere about whether rising bond yields and rallying markets are a good sign or a bad sign. There are persuasive arguments on both sides of the aisle on this one, and it would be easy to dismiss the entire foofaraw as a storm in a teacup if only the stakes weren’t so stratospherically high.

On the one side, there are those who argue that massive global government stimulus, inventory drawdowns, and high unemployment have set the stage for the recovery. Consequently, investors have found a renewed appetite for risk in equities and commodities. Central bankers see rising long-term bond yields as a sign of this growing optimism. The staggering growth in money supply, they argue, is necessary to keep the wheels spinning, and potential inflation will be mopped up by the economic slack. The danger, if it exists, lies in a relapse into deflation. And this suggests that rates will remain low for a considerable period yet.

On the other side, there are those who argue that the exponential growth in money supply is already a problem and is being manifested in those same market rallies, which are finely attuned to any change in inflationary potential. Critics like economist Arthur Laffer of the “Laffer Curve” fame, argue that it may already be too late to put the brakes on the inflationary effects of the largest percentage increase in the monetary base in 50 years (see graph below). The 12-month growth rate of M1 (a measure of money in circulation) is around 15%, the fastest pace in 50 years, and potentially more inflationary than the 1970s, when the prime rate soared to 21.5%. Mr. Laffer is not hopeful that the US Federal Reserve has the will or the independence to shrink the money supply drastically anytime soon, a move that, while necessary, would raise rates, leading to a double-dip recession and a bond market crash. However, the alternative, he fears, is a devastating inflationary period ahead.



*Courtesy: Federal Reserve Bank of St. Louis*

On this one, it’s tough to wiggle out and say “the truth lies somewhere between the two.” There seems to be no viable middle ground. We can only hope the former argument prevails. In the meantime, it might be an idea to maintain a safety component involving at least some exposure to hard assets like gold. This approach makes sense anyway, as the Canadian resource sector is likely to benefit from any sustained revival in commodities. If that approach also works as a portfolio hedge against future inflationary problems, all the better.

Toronto stocks ended marginally higher on the week, closing Friday 0.7% ahead of the previous week’s close. Friday’s slide in energy stocks was not enough to completely erode gains made through the week.

In New York, the S&P 500 Composite Index gained 0.7% on the week, closing Friday 5% ahead for the year to date. The Dow Jones Industrial Average was also ahead 0.4% for the week, climbing 0.3% into positive territory for the year to date. It was a kind of “green letter day” for the Dow Industrials, because Friday’s close marked the first time this year the Average has closed above break-even for the year to date. It also marked the first full week of trading with new Dow Industrial components Cisco Systems and Travelers replacing General Motors and Citigroup respectively, undoubtedly resulting in a flurry of index and portfolio rebalancing through the week. ■

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