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A case of nerves

Markets sell off in a week of jittery trading

June 19, 2009 – After powering up rallies of 35% to 40% since their March lows, stock markets retreated last week as investors took some profits off the table. No particular “X” factor precipitated the decline, which saw Toronto’s benchmark S&P/TSX Composite Index shed 578 points (5.4%) by Thursday’s close before recovering a bit on Friday. South of the border, the broad-based S&P 500 Composite Index of large-cap stocks retreated 3.8% in the same period.

Put it down to a sudden case of nerves as uncertainty surged in economic data, in political announcements, and in geopolitical tension.

First, there was some off-putting economic data from the Federal Reserve Bank of New York early in the week. Its Empire State Index indicated that regional manufacturing contracted more than had been expected, falling to -9.4 in June from -4.6 in May. A negative reading signals shrinkage in the sector. The Index is widely watched as a barometer of the overall state of US manufacturing, and may have raised investors’ concerns about the duration of the economic slump.

The top-line number really doesn’t tell the whole tale, however. The survey also showed that executive optimism about the manufacturing outlook jumped to 47.8 from 43.8 the previous month. The continuing drawdown in inventories and production slump has really set the stage for a recovery in output as demand eventually overtakes dwindling stockpiles.

That may take some time, though, as the Federal Reserve reported later in the week that US industrial production slumped 1.1% month over month in May, while capacity utilization dropped to 68.3%. Producer prices fell an annual 5% in May, the sharpest drop in 60 years.

Another concern for markets last week was a report by the US Treasury Department that foreign demand for US financial assets slackened somewhat in April. Not only did Japan, China, and Russia cut back on their holdings of US Treasuries, the four core developing nations – Brazil, Russia, India, and China (BRIC) – met in Russia to complain once more of their lack of influence in the global economy, even while holding vast amounts of US dollar-denominated assets. Russia again pushed for an alternative reserve mechanism to reduce dependence on the greenback for stabilizing the value of domestic currencies.

Though the BRIC meeting may have consisted more of form than substance, the message to international markets was undeniable. Concern over the weakness in the US dollar and anxiety about the effects of America's \$11 trillion (and growing) total national debt cannot be denied. While it's true that the US government is not likely to go bankrupt, owing to its unlimited powers of taxation and ability to create money, its profligate fiscal and monetary actions do have consequences on future growth, as taxes *must* rise and spending *must* fall to meet both growing current needs and immense future unfunded liabilities.

However, while these issues are of great import, it's unlikely that they'll hold the attention of the market for any longer than the next earnings release, unemployment report, or inflation announcement.

Indeed, last week's US inflation numbers indicated little change, once the dampening effects of volatile food and energy prices are removed from the equation. Year-over-year, the consumer price index was down 1.3% in May, mostly a consequence of the steep decline in energy prices over the period. For the month, however, prices gained 0.1% over April. Removing energy and food prices from the mix (the so-called "core" price index) yields a 1.8% positive rate of annual inflation and a positive 0.2% month-over-month increase. It's widely believed that the US Federal Reserve Board has an implicit core inflation target of 2%, so the May core inflation figure is pretty much spot on the Fed's implicit target.

In Canada, consumer prices also defied the deflation threat and rose in May. The all-items inflation rate rose 0.2% month-over-month, for a 0.1% year-over-year increase. Excluding energy costs and other volatile items, the year-over-year core rate rose to 2% in May, matching the Bank of Canada's target 2% rate.

At the moment, neither inflation nor deflation appears to be of any great concern in the near term. In Canada, that led to some more firming in the Canadian dollar along with some softness in the bond market, as the prospects increased for an interest-rate hike before the end of the Bank of Canada's self-imposed no-hike period in June 2010. In the US, the inflation/deflation threshold was still thin enough that Treasury yields slipped modestly, adding more downside pressure to the US dollar.

What gave markets their biggest shock last week, however, was the release of the Obama Administration's blueprint for regulatory reform. The document outlined a host of changes to the financial regulatory structure, including giving the Fed sweeping new powers of discretionary intervention in businesses it deems "too big to fail" or those that might put the financial system at risk. Under the rules, almost any business could thus be swept up in the government's regulatory net.

While many (perhaps most) on the left-hand side of the political spectrum applaud those efforts at levelling the boom-bust cycle of a free-market economy, history tells us that such massive interventions do not work. Instead, they tend to lead to huge distortions in investment, an exponential increase in moral hazard, and a wide-open field for political

interference and corruption. Tellingly, the government's own rules and laws on housing and mortgages that laid the foundation for the sub-prime mortgage meltdown remain untouched and unmentioned in President Obama's plans (except to state that they were, of course, blameless).

Going into the weekend, traders were left wondering not only about economic and political uncertainties but also about growing geopolitical tensions in the Pacific, as North Korea threatened to launch a missile over Japan towards Hawaii, and US Navy ships prepared to intercept a North Korean vessel believed to be carrying nuclear weapons material.

After a hectic week of trading, which included a fair amount of option rollover before the quadruple witching hour (the simultaneous expiry every quarter of stock options and futures, and stock index options and futures) on Friday as well as some anxiety about second-quarter earnings releases due out in a couple of weeks, the S&P/TSX Composite Index closed Friday with a week-over-week loss of 3.4%. The Dow Jones Industrial Average dropped 3% on the week, while the S&P 500 Composite retreated 2.6%.

We had expected some retracement in the indexes after such a powerful rally. There may be more to come as a consolidation phase kicks in. How long it might last is anyone's guess, but we still believe that at this stage, significant pullbacks can be used as buying opportunities. ■

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