

## **Positives and negatives**

### *Stock markets recover week's losses*

*June 26, 2009* – The fragility of market sentiment was front and centre early in the week as equity markets took steep losses on Monday. Observers were quick to jump on a gloomy economic release from The World Bank on the same day as the “trigger” for Monday’s bout of selling. We don’t think it’s all that simple.

After all, markets rallied again through the week, recovering most of Monday’s retreat. Toronto’s benchmark S&P/TSX Composite Index fully recovered from its Monday loss and proceeded gain even more ground lost since its year-to-date peak on June 11.

The World Bank revised downward its estimate for global output this year, saying it expects a 2.9% contraction, down from its 1.7% guesstimate a couple of months ago. Focusing on what it believes are unresolved problems in the banking sector and its projections for a continuing deterioration in world trade, the World Bank warned of more potential financial problems arising out of constricted capital flows to emerging nations.

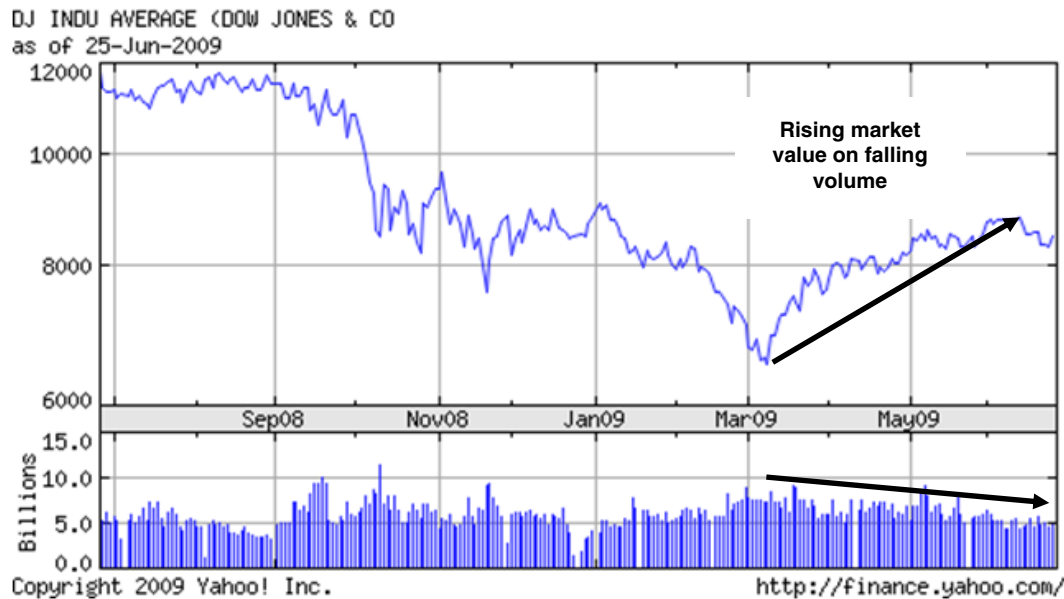
While it’s hard to believe that any one economic forecast would have such an immediately dampening effect on the markets, it’s not totally out of the question either. Markets are, after all, a prime example of groupthink. And equity markets have been on a tear since touching a bear-market low back in March, advancing anywhere up to 40% from that trough and touching year-to-date highs just a couple of weeks ago.

But notice the trend in volume during that period – it’s been on a steady decline (see the arrows in the accompanying graph of the Dow Jones Industrial Average). Price advances on declining volumes generally indicate weakening demand and don’t really portend a sustainable rally.

In other words, markets have been advancing on the fumes of momentum, driven by initial optimism that massive government deficit spending (also known as “stimulus”) along with massive central bank money creation will head off a deflationary collapse. And, indeed, judging from steady improvements in broad economic data and confidence indicators, they appear to have done just that.

But momentum-driven markets inevitably succumb to a retreat as investors become increasingly anxious about the sustainability of the rally and look for the best opportunity to lock in profits. The forward price-earnings ratio of the S&P 500 Composite Index has

moved back up to around 14, its long-term average, from around 10 back in March, an indication that prices have outrun fundamental valuation for now. Hence the decline since June 11.



So it's a tad misleading to lay the blame for a selloff completely at The World Bank's doorstep. If you think about it, it's unlikely that investors, either individual or institutional, will all suddenly decide to act on just one of the myriad of economic reports released by major financial players every day. When was the last time you did that yourself? How likely are you to say, "Hey, The World Bank just issued another report, and I think that *this* time they're going to be right. Sell everything!" Probably not very likely. Instead, The World Bank's report, already largely discounted, was simply one of many factors weighing on investors' predisposition to sell at this particular time.

The Organisation for Economic Co-operation and Development (OECD) issued an economic outlook last week as well, revising its estimate for 2009 GDP in its 30 member nations upwards, to an aggregate contraction of  $-4.1\%$  from a previous  $-4.3\%$ . It was the first upwards revision in two years. The OECD also predicted an anemic recovery of  $0.7\%$  GDP growth in 2010, up from its previous no-growth scenario.

In its report, the OECD says that "it looks as if the worst scenario has been avoided and that OECD economies are now nearing the bottom." It goes on to say that world trade is showing signs of life again, as Brazil, India, and China have largely already emerged from the recession, and are on track for a return to growth in 2010 as industrial production gets back into gear.

It says Japan and the euro area are basically basket cases and will remain so through 2010, as exports slide, unemployment reins in consumer spending, and unused capacity keeps prices under downward pressure. In fact, Japanese consumer prices dropped an annual  $1.1\%$  in May, raising the spectre of another deflationary spiral of shrinking profits,

falling wages, and declining consumer spending. Euro area prices saw no increase in May.

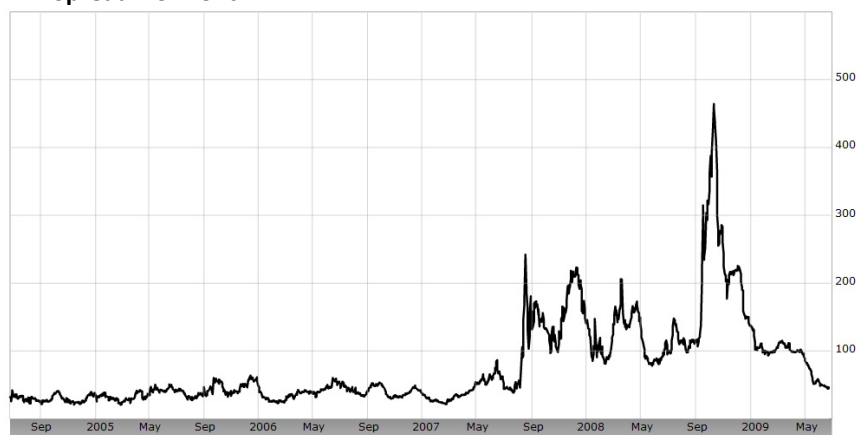
For the US, the OECD expects GDP to shrink 2.8% for all of 2009, revised upward from its -4% estimate in March. It's expecting the US economy to expand 0.9% next year. The Canadian economy is expected to shrink 2.6% this year and grow 0.7% in 2010.

There were more signs last week that the recession is indeed bottoming in North America. US durable goods orders posted their best performance since December 2007, climbing 1.8% in May, the second consecutive monthly increase. And in a sign that business investment is beginning to stir, orders for capital goods, excluding defense orders, rose 4.8%.

Consumer sentiment in the US also rose for the fourth straight month in June, while consumer spending gained 0.3% and incomes rose 1.4%, the biggest increase in a year. These increases came despite a hike in the US household savings rate, to 6.9%, the highest in 15 years, as households clean up personal balance sheets and pay down debt. Some observers have expressed concern that a rapidly rising savings rate could hinder economic recovery by suppressing consumer spending, though most do not believe it will extend the recession.

The US Federal Reserve Board kept its key federal funds target rate unchanged last week, between 0% and 0.25%, saying that inflation remains subdued and that "substantial resource slack is likely to dampen cost pressures." It also added that conditions in financial markets have improved in recent months, a view that's confirmed by the declining 3-month T-bill/Eurodollar (TED) spread. Widely used as indicator of credit risk, the TED spread is a measure of the difference between 3-month US Treasury bill futures contracts and the 3-month Eurodollar futures contracts. The accompanying graph illustrates the extent to which credit risk has shrunk since the height of the financial crisis last fall.

**TED Spread – 3-month**



Courtesy: Bloomberg LLP

Stock markets ended the week just about flat, having recovered earlier losses. The S&P/TSX Composite closed Friday 0.7% ahead of last Friday's close. The Dow Jones Industrial Average edged down 0.8%, while the S&P 500 Composite Index closed just a hair below breakeven on the week, with a loss of 0.1%.

Looking at the pros and cons, we'd still have to say that on balance the positives now slightly outweigh the negatives. Against this backdrop of a generally improving macroeconomic environment, markets are unlikely to test March lows, though some increased volatility may be the order of the day through the summer months as earnings season brings fundamentals back into sharper focus. ■

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