

## Herbicide

### *Officials warn of danger to economic “green shoots”*

*June 5, 2009* – According to assorted financial and political leaders, all those tender economic “green shoots” we’ve been hearing so much about could easily be trampled in coming months by soaring deficits, the plunging US dollar, and excessive quantitative easing. That would delay the nascent economic recovery as surely as if the moribund General Motors Corp. suddenly morphed into a “Transformer” and thundered down Wall Street crushing all in its path.

Come to think of it, GM *has* transformed into an unkillable alien life-form, which now threatens to feed on taxpayers in Canada and the US for generations to come. But that’s another story.

Given last week’s Canadian job market report from Statistics Canada, it’s tough to believe there are any green shoots at all. Some 42,000 jobs disappeared in May, pushing the national unemployment rate to 8.4%. Most of the 0.4 percentage point jump from April’s 8% rate was attributed to the loss of manufacturing jobs in Ontario, where unemployment now runs at 9.4%. Indeed industrial production dropped like a stone in the first quarter, shrinking 16.5% as the export sector got hammered again.

We don’t know whether Canada’s first-quarter gross domestic product reading could be considered a “green shoot” insofar as it was less awful than had been expected. StatsCan reported that first-quarter output shrank “only” 5.4% annualized from the previous quarter, somewhat less than the consensus estimate of a 6% contraction. A 26% plunge in business investment combined with a 30% drop in exports and a 38% decline in imports put paid to the notion that inventory weakness was largely responsible for the appalling decline in GDP. A 25% drop in corporate profits added to the toxic first-quarter brew. The fact that no one really thought the first-quarter GDP number was all that “appalling” is in itself an indication of the extent to which the market has thrown in the towel.

If there’s any shoot of any color at all here, it’s in the fact that the economic contraction was showing signs of levelling off in slightly firming monthly GDP figures. Additionally, a Harris/Decima poll indicated some that Canadian consumer confidence was improving.

In the US, where conditions are far worse than in Canada, green shoots have started popping up in a really encouraging way. In May, the pace of layoffs eased, as employers cut 345,000 jobs, the lowest number of monthly job losses since last September, and the fourth

consecutive month of declining layoffs. However, the unemployment rate spiked to 9.4%, the highest it's been for 25 years. Typically, unemployment remains elevated even after a recession has officially ended, and we see no reason to believe that it will be any different this time. The US unemployment rate could still rise to 10% or more this year.

Other signs of a gradual end to the recession came from an improvement in the US Institute for Supply Management's (ISM) May manufacturing purchasing managers' index (PMI). The manufacturing PMI rose to 42.8 in May from 40.1 in April, continuing an uptrend after bottoming at 32.9 last December. Any reading below 50 is considered recessionary, while any reading above is considered expansionary. While still indicating a contraction in the manufacturing economy, the pace of shrinkage has slowed. And notably, a key subindex, the new orders index, climbed above 50 for the first time since last November. This goes to the drastic cuts in inventories over the past few months, which as we've been pointing out in these comments, suggests a revival in production to meet both existing and new demand. The climbing new orders index in May bears this out, as growing new orders are a leading indicator of rising production.

Likewise, the ISM non-manufacturing PMI rose to 44 in May, also indicating that the contraction in the service sector of the economy is slowing. This is critical, of course, because non-manufacturing businesses now comprise some 90% of the US economy.

Overall, US productivity rose 1.6% in the first quarter, indicating some further pain for the labor market in months to come, even while a recovery gets under way.

In the real estate market, more signs of life appeared, a new single-family home construction rose in April and pending sales of existing housing rose 6.7%, marking the third straight monthly increase.

Counterbalancing these glimmers of good news, central bankers in the US and Canada issued some pretty dire warnings about the potentially toxic effects of current market conditions and fiscal policies on the economic green shoots now struggling to grow.

Keeping Canada's benchmark target overnight rate at 0.25%, the central bank warned that although financial conditions and commodity prices have improved, the coincident rise in the value of the Canadian dollar against the US dollar "could fully offset these positive factors" if it proves to be persistent. A stronger loonie, in other words, will crush the green shoots of economic recovery. It went on to say, in the bank's magnificently understated style that "the outlook is subject to considerable uncertainty."

In the US, Ben Bernanke, the Chairman of the Federal Reserve Board, warned that the large US federal budget deficits could offset growth – thus negating their intended "stimulus" effect. In Congressional testimony, Bernanke said, "Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy economic growth." The budget deficit is projected at US\$1.85 trillion this year, or 13% of GDP. President Barack Obama has pledged to cut the deficit in half by the end of his first term, though how this can be done without *both*

raising taxes and cutting spending is hard to envisage. Of course, there's always the option of monetization. But that has rather serious implications for both inflation and the value of US debt.

Treasury Secretary Timothy Geithner felt the outliers of this interesting little conundrum last weekend in his first official visit to China. Speaking before an audience of politicians, financial academics, and students, Geithner insisted that the trillions of dollars that China holds in US assets are safe and sound, reaffirming his faith in a strong US dollar. His reply that "Chinese assets are very safe" drew loud laughter from the audience, much to the chagrin of both Geithner and Chinese Vice Premier Wang Qishan, who later in the day attempted to downplay the reaction with some of the usual bafflegab about "dialogue." But the damage had been done and the truth told in gales of laughter.

China's continuing stockpiling of commodities such as oil and copper only adds another bit of circumstantial evidence to the case for the coming Obama-inflato-mania. Even German Chancellor Angel Merkel departed from the political convention of not criticising central banks, and sternly rebuked the US Fed for its profligate ways, suggesting that the much-vaunted independence of central bankers has been largely a sham. A call for tighter money is unusual for a politician, and indicates that anxiety about the consequences of the flood of quantitative easing has migrated beyond the blogosphere.

Stock markets pretty much ignored the selloff of GM's Opel, Saturn, and Hummer divisions last week (to Magna International, Penske Automotive Group, and Sichuan Tengshong Heavy Industrial Machinery respectively), and closed generally higher on rising energy and materials stocks.

Toronto's S&P/TSX Composite advanced 1% week over week, kept aloft by the financials even as the energy and gold issues faded in Friday's trading in the face of declining oil and gold prices.

In the US, the Dow Jones Industrial Average gained 3.1% week over week, as growing optimism over all those green shoots in the economy translated into a buying binge. Similarly the S&P 500 Composite advanced 2.3% on the week.

For now, investors have put aside concerns about fiscal profligacy, towering national debt-to-GDP ratios, the falling dollar, and rising long-term yields, focusing instead on an imminent return to corporate profit growth as production lines get set to re-engage.

Not ones to fight a trend, or the Fed, we'll enjoy salutary effects the rally has had on our equity positions for as long as it lasts. We remain vigilant, however, and await fresh buying opportunities on any pullbacks. ■

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