



CROFT
FINANCIAL
GROUP

INVESTMENT COUNSELLORS-PORTFOLIO MANAGERS

Flagging markets

Correction in process

July 10, 2009 – The benchmark Reuters/Jefferies CRB Commodities Index has slipped about 13% since June 11 as crude oil continued its long selloff last week. Prices for light sweet crude have plunged 16% since hitting an intra-day high of US\$73.38 per barrel on June 30.

The reason can be derived from a report by the US Energy Department that indicated oil stockpiles of gasoline and distillates grew more than expected as the recession continues to suppress demand in the US.

US consumers, already stressed to the limit with high debt, and unemployment approaching double-digit rates, have essentially taken the pedal off the metal and are leaving the cars in the garage, so to speak.

Consumers' apparently would rather spend their Obama-bucks from Washington's stimulus packages on repairing household balance sheets and fattening up the piggy banks rather than on extended road trips to strip-mall land.

Commercial transportation is down as well, as is airline travel. People and goods just aren't moving around as much as expected, and, of course, are not using as much fuel as a consequence.

Crude oil prices had been bid up in early June on optimistic expectations of an early end to the recession and a speedy recovery in demand. Combined with energetic stockpile-building by China, oil prices soared to US\$74 per barrel in June giving rise to much

REUTERS/JEFFERIES CRB INDEX, 6 MONTHS



LIGHT CRUDE OIL, 3 MONTHS



hand-wringing from the political classes about “greedy speculators” and the need to establish even more controls, regulations, and impediments over trading activity.

Indeed, the US Commodity Futures Trading Commission floated a new set of proposed trading rules designed to limit the amount of money any single trader can bet on any one commodity. Left-leaning political hacks from far and wide, including Gordon Brown, the Prime Minister of Great Britain, Nicolas Sarkozy, the President of France, US President Barack Obama, and the US Senate, joined the chorus in calling for such curbs. It’s a fair bet that some trading restrictions will be implemented, because “greedy speculators” have always made an appetizing and highly visible target in tough times.

In truth, of course, speculators simply attempt to guess which of the numerous supply/demand “fundamental” narratives is the correct one and place their bets accordingly. Speculators in the aggregate lose as often as they win. It’s a zero-sum game in which there’s a losing bet for every winner. But Marxist-type political interference in markets always looks at only one half of the equation, the upside, and conveniently ignores the downside.

Because of the zero-sum nature of speculative activity, speculators provide a valuable service to the market: liquidity. Ironically, attempts to curb speculative activity will only reduce liquidity, *increase* market volatility, raise the risk level by increasing hedging costs, while dampening trade, exploration and development in the process, all of which is the diametric opposite of the hand-wringers’ intended effect.

The tension among fundamentals, meanwhile, won’t change. The Organization of Petroleum Exporting Countries won’t close its doors. The Canadian oil sands won’t disappear. Stockpiling by China and the US won’t stop. US consumers will get back behind the wheel when they feel more comfortable with their household budgets.

Very simply, the laws of supply and demand cannot be repealed.

All of which brings us back to last week’s market activity. Stock market indexes have been steadily sliding from their early June highs, and saw no reason to stop last week.

In Canada, a climbing jobless rate combined with falling commodity prices and a deteriorating trade picture conspired to keep the S&P/TSX Composite Index under downward price pressure for most of the week.

S&P/TSX COMPOSITE INDEX, 5-DAY



Statistics Canada reported on Friday that the Canadian unemployment rate climbed to 8.6% in June from 8.4% in May, as job losses among full-time workers was offset by gains in part-time employment and a sharp increase in self-employment.

Additionally, the unimpeded slide in commodity prices took its toll on Canadian resource stocks. The May trade report revealed a growing merchandise trade deficit, reflecting shrinking global demand and the ravages of a strong currency. And a report from the Export Development Corp. predicted that the sluggish world economy would keep Canadian exports constrained, especially in the resource sector.

As a consequence of all this unrelenting pressure, the S&P/TSX Composite Index lost 5.2% week-over-week as of the close on Friday, July 10.

The story wasn't much better south of the border, where a waning appetite for risky assets pulled stock indexes down again for another weekly loss. The Reuters/University of Michigan index of consumer sentiment dropped in July for the first time in four months, as job losses mount.

So despite the fact that General Motors emerged from bankruptcy as a shiny new entity, owned mostly by the US and Canadian governments, investors focused more on the first raft of quarterly earnings reports, and were not particularly amused. Corporate profitability still currently hinges on cost cutting efforts rather than a broad increase in sales. And a return to robust consumer demand still seems a long way off. Shares were priced accordingly as investors rediscovered fear and trotted back into Treasuries, which saw a surge of buying and concomitantly falling yields. Yields on 10-year US Treasuries closed the week at 3.30%, falling from 3.46% earlier in the week and way down from 3.95% on June 10.

The Dow Jones Industrial Average gave up 1.6% on the week, posting its fourth consecutive weekly loss. Ditto for the S&P 500 Composite, which dropped 1.9% on the week.

The S&P/TSX Composite has now retraced 9% from its June 11 high, while the S&P 500 is down 7%. A 10% slide from a previous high is considered a "correction." At that point, technically speaking, markets will encounter a fairly strong support level. Unless some unexpected market-shaking event intrudes (and it's still not out of the question at this stage), we should see a consolidation phase before the next leg up in anticipation of earnings recovery later this year and into 2010. ■

Please [click here](#) to visit our website for more timely information on the markets, financial planning, and new products from R.N. Croft Financial Group Inc.

www.croftgroup.com