

Up!
But can it last?

July 3, 2009 – Investors enjoyed up markets through the second quarter, as the March bear market low faded into blessed memory. Toronto’s benchmark S&P/TSX Composite Index rallied strongly through April and May before losing steam in June. Double-ditto for US markets, which cooled off in June, too, as investors began to take profits in a market that increasingly came to be driven by sentiment. As a bonus, the overused “green shoots” metaphor very quickly became a cliché and seems to have faded into richly deserved business buzzword oblivion, for which we can all be grateful.

Canadian gross domestic product posted a -0.1% monthly contraction in April, bringing the year-over-year slide in output to -3.0% . The news wasn’t surprising, and pretty much matched consensus estimates. However, it was tough to put a positive spin on the GDP data, because April’s falling output number was the ninth consecutive monthly decline, even though the rate of contraction eased somewhat from the -0.3% monthly drop recorded in March.

The goods-producing sector was again the hardest hit, with manufacturing, mining, and energy producing the worst output results. In fact, factories produced 1% less in April than they did in March, for a 13.8% year-over-year decline. A stronger Canadian dollar and weak domestic and external demand continued to weigh heavily on manufacturing, and appear poised to continue acting as an anchor through May and into June.

Though mining and energy output suffered a 0.7% contraction in April, a turnaround in commodity prices through May and June augurs well for the resource sectors as higher prices are likely to spur increases in production for the second quarter overall. Of course, some risk continues to hang over commodity prices, given that much of the rally through the second quarter was stimulated by Chinese stockpiling, and not by a sudden improvement in global fundamentals. The energy sector, especially natural gas, remains vulnerable to heavy supply overhang and slack demand, which are likely to keep a lid on prices for the rest of the year.

It’s very likely that in Canada, at least, the worst of the recession is behind us. The pace of contraction in the second quarter will slow to about -2% , approaching flatline in the third quarter, and posting modest growth in the fourth. That also implies steady, but not spectacular, advances for Canadian equities to the end of the year.

In the US, a shortened week of anemic trading on low volume preceded the July 4 Independence Day long weekend. For traders still at their desks in the first week of the traditional summer holiday season, the week was capped by a couple of seemingly contradictory data points, which didn't really seem to interest anyone all that much.

The Institute for Supply Management's manufacturing purchasing managers index notched up another advance, to 44.8 in June from 42.8 in May. Any reading above 50 indicates economic expansion; any reading below, economic contraction. So, while the manufacturing economy is still in recession, the pace of contraction has slowed, and has been for several months now. The Commerce Dept. confirmed the trend with its report that US factory orders rose 1.2% in May, the largest increase in about a year.

The US employment picture, however, did not brighten any in June, as employment fell by another 467,000 jobs, raising the unemployment rate to 9.5%, while average hourly earnings rose a meagre 0.7% annualized, the slowest pace in 45 years. The US Conference Board's index of consumer confidence slipped for the first time in four months, dropping to 49.3 in June from 54.8 in May, as employment concerns once again became a source of anxiety for households.

That raised concerns (again) that economic recovery would be delayed until 2010, based on the very logical assumption that high unemployment translates into dampened consumer spending, which is said to be the single largest contributor to US GDP. Any recovery absent vigorous consumer spending and predicated only on structural efficiencies and replenishing inventories to meet current needs without a concurrent real increase in demand would be "anemic" indeed. Hence the fear of a "jobless" recovery.

In Europe, the European Central Bank left its key interest rate unchanged at 1% as it characterized inflationary pressures as "low" – an understatement, considering that consumer prices in the 16-nations sharing the euro fell 0.1% in June, down from 0% in May. Lower energy costs and general economic weakness (i.e., no spending) get the blame for June's dip into deflation territory. That's understandable, considering eurozone unemployment jumped to a 10-year high of 9.5% in May. Meanwhile, rating agency Moody's Investors Services followed Standard & Poor's lead earlier in the month, and knocked a notch off of Ireland's AAA credit rating, blaming the country's excessive debt load for the reassessment. Ireland joins Spain and Greece in the negative credit outlook category.

In the stock market performance derby, foreign markets took the prize, especially emerging markets. The MSCI Emerging Markets Index posted a second-quarter gain of 33.6%, for an overall 34.3% advance in the first half, led by a kind of buy-anything exuberance in Brazil, India, and China.

North American stock markets ended last week with significant losses. With the Canada Day holiday interrupting Toronto's week and Independence Day truncating New York's, markets capped a week of uninspired trading with steep drops on Thursday following the gloomy June US employment report. Toronto's S&P/TSX Composite Index lost 1% week over week, while the Dow Jones Industrial Average dropped 1.9% and the S&P 500 Composite Index ended the week down 2.4%.

For the second quarter, however, the major indexes posted strong gains, with the S&P/TSX Composite ahead 19% from the previous quarter's close, while the DJIA advanced 11% and the S&P 500 gained 16.7%. That put the S&P/TSX ahead 15% for the year to date to June 30, while the S&P 500 inched 1.7% into the green for the same period. Despite a valiant effort to break breakeven for the year to date in mid-June, the DJIA failed to maintain upward momentum and retreated to close June with a year-to-date loss of 3.8%.



In US bond markets, Treasuries posted a 3% decline for the quarter, according to the Merrill Lynch Treasury Master Index, and a 4.4% loss for the first half of the year. The yield on the 10-year Treasury note rose to 3.52% at the end of June, from 2.69% at the end of March. Corporate bonds, meanwhile, rallied as thawing credit markets enticed investors back to riskier debt.

Second-quarter earnings season is getting under way. Third-quarter market action will hinge on whether the market now sees those results as a glass half empty or half full. We lean towards the half-full side of the argument, and believe that equity markets are more apt to grind out gains in the second half, albeit slowly, than they are to revert to another bearish trend. ■

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