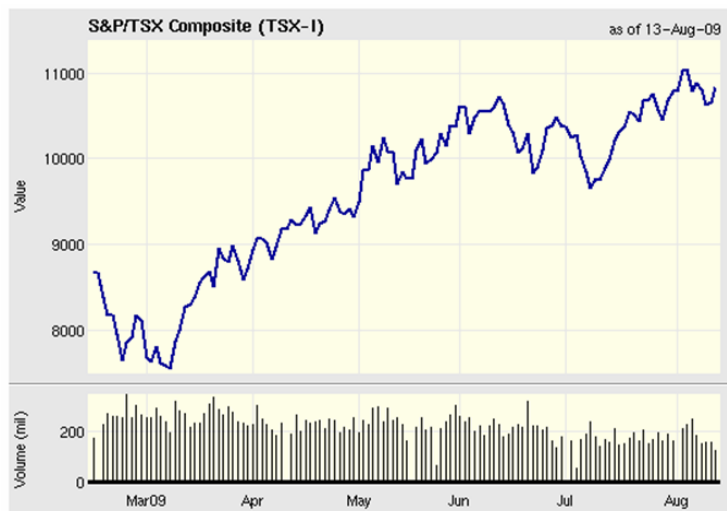


## **Worry-wart market**

*Testing 12-month resistance levels*

*August 14, 2009* – There’s an old market maxim that says bull markets climb a wall of worry. That little bit of market wisdom basically reflects the fact that historically, bull markets tend to begin almost when no one is looking, preoccupied as people are with the gloom and doom of the present moment. It goes to the natural tendency of human beings to check the rear-view mirror for an indication of where things might be going. But the road ahead is never quite the same as the road behind – as the markets’ decidedly bullish behaviour since March has demonstrated.

The accompanying graph of the S&P/TSX Composite Index tells the story.



The upward trajectory of Toronto’s benchmark index has been replicated pretty much the world over. But note the gradual decline in volumes. There’s not a lot of strength there, which often tends to indicate a rally without conviction. It faltered once in early July, but interest hasn’t really picked up since then, which might presage another correction ahead, now that second quarter earnings season is over and markets begin the work of estimating earnings for the next two quarters.

There’s a worry-wart theory making the rounds that the market’s bullishness over the past five months is a function of government stimulus and bailout programs, combined with astoundingly easy monetary policy. These interventions, according to the theory,

prevented a catastrophic financial collapse, thawed out credit markets, and set the stage for a recovery. Coming off deeply oversold conditions, stocks rebounded strongly in anticipation of improving earnings. But until house prices in the US turn up and consumers begin spending again, a recovery cannot fully take hold, at least according to this argument. What stands in the way is a secular shift to savings from consumption, as a general “de-leveraging” takes place.

While there is some merit to this standpoint, it does tend to play down the significant benefits of reduced debt ratios and higher savings rates in an economy, not the least of which is a growing investment rate. Still, the trend in stocks seems reasonably well established, notwithstanding the occasional expected pullback. But it will be awhile yet before the trickle of sidelined cash coming back into equities turns into a torrent. In the meantime, the smart money is ignoring the wall of worry and staying positioned to harvest the proverbial “low-hanging fruit” – the powerful gains typically made during the early days of a nascent bull.

As expected, US productivity – output per hour worked - surged in the second quarter, rising an annualized 6.4%. Much of the gain in productivity went to corporate bottom lines, resulting in the generally better-than-expected second-quarter earnings results. Rising productivity is often a harbinger of rising economic growth. That could be offset by persistently large job losses, of course, but last month’s employment report indicated a slowing in the pace of job cuts.

Companies are running as lean as they can get without shutting down altogether. Productivity increases generally increase living standards all around. However, it’s unlikely that this blistering pace can be sustained. Eventually – probably sooner than later – growing demand will force companies to resume hiring. Job growth could expand very quickly as the economy recovers, because prior cuts have been deep and aggressive.

In the eurozone, both Germany and France recorded economic growth in the second quarter, following four consecutive quarters of contraction. Because Germany and France are the economic powerhouses of the shared-currency euro zone, the news fuelled optimism in both bond and stock markets that the deepest European recession in 60 years has ended.

Developing Asian economies apparently have ignored the wall of worry, scaling it completely while posting vigorous growth. China reported last week that industrial output rose 10.8% year-over-year in July, the third consecutive monthly increase. In addition, exports rose 5.2% month-over-month in July, following a 4.5% advance in June. Imports rose 3.5% in July, while retail sales surged 15.2%.

India, Asia’s other developing giant, saw industrial production surge 7.8% in June, the fastest pace in 16 months.

With aggregate stimulus of about US\$1 trillion and aggressive monetary easing, the region is experiencing a rapid return to growth as domestic demand springs back to life.

That continues to lend support to the argument that emerging markets will lead developed markets out of the recession.

Markets have been testing resistance levels around the world, as Hong Kong's Hang Seng Index, Bombay's Sensex, and Singapore's Straits Times Index all achieved new 12-month highs in early August.

After a week of triple digit gyrations, the S&P/TSX Composite showed every indication of testing that resistance zone around the 11,000 level, as the price of oil around US\$71 per barrel after the International Energy Agency raised its forecast for 2009-10 oil demand. And the price of copper rose to US\$6,422 per tonne, the highest in over 10 months, on positive news of industrial strength in Asia, economic growth in Europe, and word from the US Federal Reserve that the US economy is beginning to stabilize.

Similarly, the Dow Jones Industrial Average dipped and surged around the 9,400 mark, while the S&P 500 Composite Index strove towards a close at 1,020, a level last seen in October 2008.

Markets are climbing a wall of worry. They have been since touching the bear market low in March. It's been five months. At some point more investors will overcome their anxieties and start to believe that the five-month rally is something more than a bear trap, at which point the next real bull market will begin. There's no way to time or anticipate that point, other than to believe it will happen sooner and faster than anyone expects. It always does. ■

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