

## **Storm season ahead**

*Periods of rising volatility possible*

*August 28, 2009* – Stock markets appeared headed for a second consecutive monthly advance in August, posting relatively strong gains on steadily declining volumes through the dog days of summer. The bullishness that has characterized equity markets since the March low has been reason enough for a turnaround in sentiment. Indeed, positive sentiment has been rising steadily, according to the Investors Intelligence Advisors Sentiment Index, as the number of bullish stock advisors tracked by the index jumped to 51.6% last week, while the number of bearish advisors dipped to 19.8%, just below the 20% threshold many observers believe is a sign of a market top.

The big indexes have risen steadily in parallel with sentiment, but – and there’s always a “but” – without a convincing 10% correction to let some gas out of the bag. And with indexes already trading mostly near the top end of annual forecasts made six months ago – which many then thought overly optimistic – the stage could be set for a classic “October surprise,” before resuming the uptrend towards the end of the year and going into 2010.

Investors should take note that stock market volatility is very likely to make a comeback when traders come back to their desks after lazing about on the beach these past few weeks.

This is not to say that investors should be alarmed. Quite the contrary. Data coming from the bean counters last week bolsters our position that the recession is over and that corporate earnings should begin to breathe on their own, once the paddles of cost cutting and inventory reduction have been removed. That, of course, requires an upturn in revenues, and some spending data fresh last week provided some hope on this account.

First and foremost, the US Commerce Department reported last week that new home sales rose 9.6% in July, the fourth consecutive monthly increase, and the fastest pace of sales since last September. In addition, the benchmark Standard & Poor’s/Case-Shiller US National Home Price Index posted its first quarterly increase in three years in the May to June period, rising 1.4% quarter over quarter, and about 15% annually. Although delinquent mortgages and foreclosures still plague sunbelt regions, it appears as though the housing market is reviving. And that’s bodes well for consumer spending.

Consumer sentiment rose in August, as the New York-based Conference Board's Consumer Confidence Index rose to 54.1 from 47.4 in July. It's still a far cry from the 90+ reading required to indicate a healthy economy, but at least the trend is up.

And US consumer spending rose 0.2% in July, although the personal income level remained essentially unchanged. The savings rate declined marginally to 4.2% from 4.5% in June, but was still up considerably from the 2.6% rate recorded a year ago. Many economists believe that consumer spending still has a long way to go to recovery, owing to high unemployment, virtually no income growth, and depleted personal balance sheets. The summer blip in spending could be attributed to various government stimulus programs, such as the popular "cash for clunkers," which made the news even here in Canada, where we don't have a "cash for clunkers" cash giveaway, for which we might want to spare a moment of thanks.

That program, incidentally has been now been discontinued, because it was on its way to bankrupting the US Treasury. This goes to the insane profligacy of the US "stimulus" package, which as we've argued in these notes, consists more of political pork barrelling than anything else. Together with declining tax revenues and the imposition of a costly national healthcare program, soaring government spending is set to contribute to an *additional* US\$9 trillion of national debt over the next decade – and these numbers come right from the White House budget office. They do things big in the States! No wonder people are bringing rotten tomatoes to rowdy "town hall" meetings convened by reluctant Congressmen.

Back in the real world, US durable goods orders posted their largest increase in two years, climbing 4.9%, for the third monthly advance in the past four months. Durable goods data are important, because they indicate the general state of health in the big-ticket manufacturing sector – those items expected to last at least three years, such as washing machines and cars. Again, that supports a rise in underlying consumer sentiment.

Similarly, in Canada, the Ottawa-based Conference Board said last week its consumer confidence index rose to 88.4, an increase of 5.5 points, and the highest level in 12 months.

If there were a confidence index for Canadian banks, it would probably be off the meter. The six big Canadian released their second-quarter financial results last week, and the news was, in most cases, better than analysts had expected. The banks' capital markets businesses combined with strong spring mortgage season and improving margins on business loans to give quarterly earnings a hefty boost over year-ago levels. Improving credit trends and loan loss provisions (except for Canadian Imperial Bank of Commerce, where provisions for loan losses jumped \$344 million over a year ago), put the icing on the cake.

Contrast this with the US bank story, which saw the Federal Deposit Insurance Corporation add 111 lenders to its list of problem banks last week, now totalling 416.

Very simply, these are financial institutions at high risk of insolvency. It's not a pretty picture, and clearly, the US banking system is still far from healthy – at least in comparison with its rosy-cheeked Canadian cousin.

We've said that a recovering financial sector is a necessary precondition for an overall economic recovery. That's happening in Canada now. It's going to take a bit longer south of the border.

Toronto's benchmark S&P/TSX Composite Index did its own little happy dance last week, gaining 1.4% from the previous week's close, as the financials subindex advanced 4% on those snappy bank earnings.

The Dow Jones Industrial Average, however, ended a volatile week of trading a scant 0.4% higher than the week before, while the S&P 500 Composite ended just a hair above the flatline, up only 0.2%. August as a whole is likely to show blockbuster monthly gains.

But going into September, markets are increasingly likely to emulate the weather: stormy. ■

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