

The continuing rally *But pace likely to slow as momentum eases*

August 7, 2009 – Toronto’s benchmark S&P/TSX Composite Index last week breached the 11,000 mark for the first time since October 2008, when it looked very much as if the financial world was coming to an end. Likewise, the two big US benchmark indexes climbed to levels last seen in the fall of 2008.

The week’s trading capped a remarkable global equity market rally that has seen stock market indexes around the world surge 40%, 50%, or more from their March 2009 lows. In part, that’s an indication of a dramatic about-face in risk aversion as the threat of a global financial catastrophe was swept away under a tidal wave of fiscal stimulus and monetary easing.

The reversion of corporate yields to historical norms over the past eight months has given stocks the kick they needed to get up off the ground. Spreads are still wide, but that’s because yields on risk-free government paper are nearly invisible, owing to aggressive rate slashing moves by central banks.

With confidence coming back to the market and the risk premium shrinking, stock valuations have soared, and some would argue that they’ve soared well beyond fair valuations based on the most recent earnings reports. That’s not really too surprising, because earnings are still at cyclic lows, even though more than half of reported second-quarter earnings have exceeded consensus estimates. For now, bottom-up consensus estimates are for a 35% year-over-year decline in TSX earnings for the third quarter and a 42% advance in the fourth.

In keeping with a typical recession-ending market, investors are slowly abandoning defensive sectors, like utilities and consumer staples, and moving into more cyclical sectors like materials, energy, and industrials. Financials too are seeing a lot of strength.

A look at the performance of the TSX subindexes since the beginning of March tells the tale. The Metals and Minerals subindex, for instance, has climbed 197%, while Financial Services is up 72% and Energy is ahead 39%. Utilities, meanwhile, have gained 6%, while Consumer Staples have advanced only 3% in the period.

Canada’s stock markets even took in stride a rather nasty employment report last week, which saw the economy lose a net 45,000 jobs in July. With many people simply giving

up looking for work, the labor force shrank by 53,500 people. That does raise some questions about the strength of any economic recovery in the third and fourth quarters – a shrinking labor force simply isn't commensurate with a robust growth scenario and adds weight to the argument that Canadian GDP growth may lag the US in the second half of the year. Overall, the unemployment rate remained unchanged at 8.6% as a result.

US payrolls shrank less than expected in July, with 247,000 jobs lost, compared with 443,000 in June and 303,000 in May. The unemployment rate dropped to 9.4%, but, as in Canada, only because discouraged job seekers gave up the hunt. US job losses are expected to increase again in coming months, despite a return to GDP growth, and unemployment is likely to climb above 10% before all is said and done.

In Europe, fresh evidence emerged that the deep recession wreaking havoc in the eurozone and the UK may be ending. The British services sector purchasing managers index posted a reading of 53 in July, the highest in 17 months, and the third consecutive monthly reading above 50. Any reading above 50 indicates expansion. And in the eurozone, Markit Economics' closely followed composite output index rose to 47 from 44.6 in June, indicating a significant slowing in the pace of economic contraction.

Still, eurozone producer prices fell at a 6.6% year-over-year rate in June, painting a picture of low demand and an absence of pricing power. The European Central Bank left its official interest rate at 1%, predicting only a weak economic recovery through the remainder of the year. Likewise, the Bank of England raised its bond buying program by a larger-than-expected amount, suggesting the BoE is not yet satisfied that its policy of quantitative easing has had the desired effect of stimulating new bank lending.

Despite these conflicting signals, stock markets continued their winning ways last week. The S&P/TSX Composite Index gained nearly 1% week-over-week, despite jawboning about the strength of the Canadian dollar by Finance Minister Jim Flaherty earlier in the week. The loonie continues to fly high against the weaker US dollar, as commodity and stock market gains continue to keep Canadian stocks aloft.

Despite soft US consumer spending data released earlier in the week, the Dow Jones Industrial Average advanced 2.2% on the week, while the S&P 500 Composite Index gained 2.3%.

While the recovery in financial sector stocks is an encouraging sign of an imminent return of economic growth, it's hard to see how the pace of the equity markets' advance can be sustained at this point. Stock market gains from here on are likely to become increasingly hard won, as momentum eases and advances come in small increments. ■

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