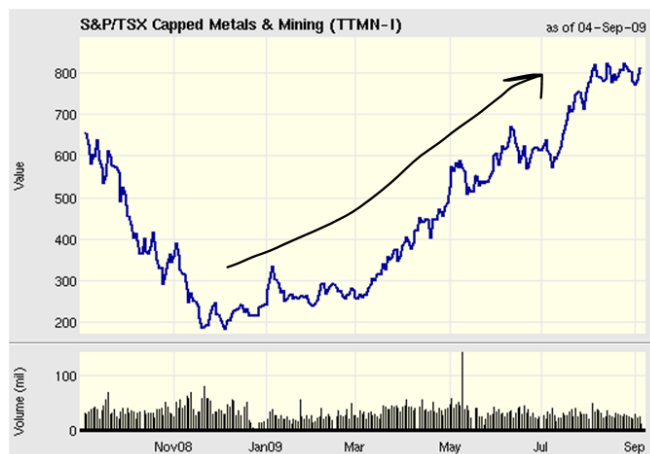


Global economy on the mend *But markets getting nervous*

September 4, 2009 – Have you enjoyed your 21% return since the beginning of the year? Because that's how much Toronto's S&P/TSX Composite Index has advanced year to date. Counting from the March bear market low, the TSX has gained 47%. That's pretty strong stuff in anyone's books. And investors participating in the bull rally through index-tracking exchange-traded funds have every reason to pat themselves on the back. Of course, just as you've done that, the markets will administer some punishment.

The Toronto benchmark's handsome returns so far can be attributed to a happy coincidence. Think of it as rocks and paper. The Toronto stock market is dominated by resource and financial issues. And both these sectors have prospered in Canada.

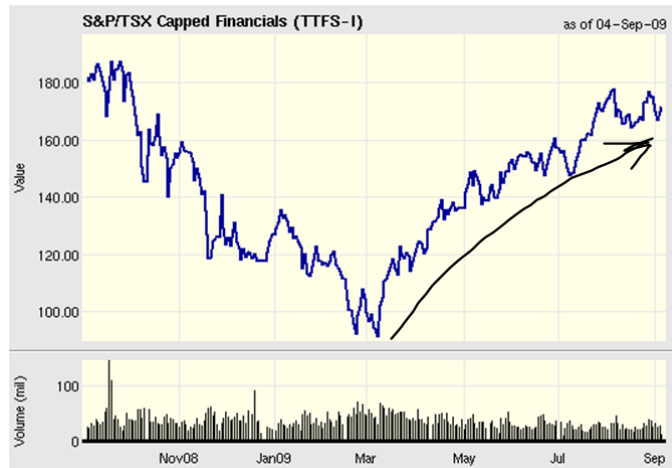
Over the past few months, commodities have recovered smartly. China's stockpiling of key commodities at low prices against a potentially sharp revival in domestic demand strapped booster rockets to everything from copper and iron ore to crude oil and petroleum distillates (a fancy term for gasoline). Canadian mining, exploration, and development companies took off as a result (see the accompanying graph).



Courtesy CTVGlobemedia

And Canadian bank stocks, too, have rallied robustly from post-Apocalyptic lows earlier this year, when it became clear that Canadian banks really were not in the same kind of danger facing the big US players. With Canadian banks' second-quarter earnings coming

in largely better than expected, the thrill of recovery gained even more momentum (see the accompanying graph).



Courtesy CTVGlobemedia

But Canadian markets' outsized recovery has a darker side. The Canadian dollar has soared against the US dollar, partly a function of the weakness of the US dollar against most world currencies, but partly also a function of the loonie's commodity base.

A strong loonie is not exactly welcomed with open arms by Canada's exporters and manufacturers, which have already been hammered by the US recession and the collapse of General Motors and Chrysler. Canada's merchandise trade balance went into deficit in the second quarter, tied to a 21% drop in export volumes.

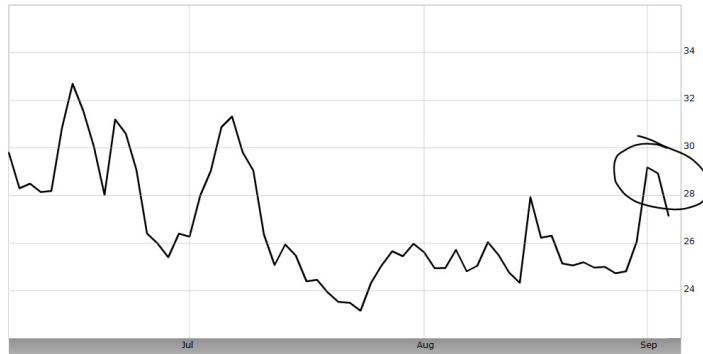
However, in the near term, the loonie may well ease back from its arm-wrestling with the greenback. The commodity surge shows signs of running out of gas, and any retreat will put pressure on all commodity-based currencies.

Gold also is signalling that all may not be quite right with the markets. The precious metal flirted with the US\$1,000 per ounce level for most of last week, but without the usual correlations from stocks (usually a positive correlation) or the US dollar (usually a negative correlation). This has many observers worried that gold is acting as a safe haven in anticipation of an imminent stock market correction.

Something that adds weight to this argument is the sudden rise in the CBOE Volatility Index (VIX), which tracks prices paid for options on the S&P 500 Composite Index. The VIX tends to move inversely with the S&P 500, and thus has come to be known as the "fear index" – a spike in the VIX index could indicate a defensive options trend in anticipation of a market decline. Last week, the VIX popped up to nearly 30, before retreating somewhat. It's an unusual move following several weeks of relative calm at consistent closing levels below 30.

The VIX isn't a failsafe indicator, but sudden sharp increases such as we saw last week, should at least put investors on the alert for the potential of an imminent stock market downturn.

CBOE Volatility Index (VIX)



Courtesy Bloomberg LP.

Even while markets are starting to signal heightened volatility in the weeks to come, the global economy showed increasing signs of recovery with the release of assorted purchasing managers' indexes (PMI) for August last week.

Most notably, the US Institute of Supply Management's manufacturing PMI rose to 52.9 in August, up from 48.9 in July. Any reading above 50 is considered expansionary, and the August index indicated growth for the first time since January 2008. According to the ISM, new orders accounted for most of the strength in the index, as companies began to replace depleted inventories to meet new demand.

Manufacturing activity also expanded globally, as manufacturing indexes in China, India, and Australia all posted readings above 50. In addition, the rate of contraction in the eurozone eased again, where the PMI manufacturing index climbed to 48.2 in August, up from 46.3 in July. The European Central bank promised to keep its lending rates low (currently 1%) until the economy is growing solidly again.

To this end, the finance honchos of the Group of 20 nations met in London over the Labor Day weekend to chat about when (or if) current fiscal stimulus and monetary easing should be ended. Going into the weekend, the consensus seemed to be...not anytime soon.

So even as the global economy gathers steam, with promises of continuing easy money and stimulus largesse, stock markets wavered last week, fluttering nervously back from recent highs. The S&P/TSX Composite Index closed Friday above 11,000, but ended the week flat overall, with barely a change from the previous Friday's close. After posting an 8.2% year-to-date gain as of Aug. 31, New York's Dow Jones Industrial Average retreated 1.1% on the week. Similarly, the broader S&P 500 Composite Index dipped 1.2% on the week, after closing August with a 13% year-to-date advance.

Last week, we issued a warning of a stormy market season ahead, with periods of intense volatility. We see no reason to change that forecast. ■

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