

## **Third-quarter stealth rally**

### *Markets overcome currency, monetary, and fiscal anxieties*

*October 1, 2010* – For investors, September is often the cruelest month. Not this time though. Stock markets rallied through September, capping three months of gains through an at-times volatile summer market. Market advances came in fits and starts, overcoming intense investor anxieties about, well, anything at all. Yet eurozone sovereign debt troubles, the fading US recovery combined with eye-glazing chatter about the dreaded triple-D (deflationary double-dip), and growing global currency friction failed to put a damper on what turned out to be an unexpected third-quarter stealth rally.

Investors turned a blind eye to deteriorating US economic data, and instead started high-fiving the US Federal Reserve Board's announcement that it would implement another round of quantitative easing, if necessary. That intention was further bolstered on Friday by William Dudley, President of the New York Fed. He said that the current outlook for inflation and employment remains "unacceptable," adding that the Fed has "the tools that can provide additional stimulus at cost that do not appear to be prohibitive." As for the likelihood of using those "tools," Mr. Dudley all but confirmed that the Fed would reinstate asset purchases next month, unless things improve radically for normalizing both inflation, which is widely perceived to be too low, and the unemployment rate, which at around 9.6% is too high.

That put a buzz in stock markets last week, as the imminent arrival of a fresh wave of newly-minted money is about to wash over the financial markets. Whether all this money-printing actually works or not is still a subject of heated debate in the econosphere, with the division along predictable lines: the neo-Keynesians on the left and the neo-monetarists on the right. We apply the prefix "neo" to these schools, because both original theories have been eroded somewhat by actual events over the past couple of decades. Yet old habits die hard. At the moment, the neo-Keynesians prevail, but their influence may soon fade as the consequences of their work – massive fiscal deficits, rising longer-term inflation, higher taxes, and slow growth – become apparent to a restive electorate. The winds of change are already blowing in Europe and will soon scour the tattered remnants of the Democrats' neo-Keynesian agenda out of Washington as well.

Speaking of theories, there are plenty to go around about why the price of gold is climbing to record highs. At over US\$1,300 per ounce, gold is once again behaving as a classic crisis hedge and store of value. The weakness of the US dollar against a basket of major currencies is one reason that's frequently trotted out for gold's smart advance through the third quarter. Another is strong demand from rural India's farmers just

coming off a prosperous harvest. Another is the potential for the dreaded deflationary double-dip. Another is the potential for rising inflation in the not-too-distant future as the US monetary base is set to expand yet again. Then, of course, there's the ever-present speculative buying that bets on any and all of these factors. To some degree, all of it goes into the stew that is refined as the London gold fix at noon GMT each day.

But the biggest factor of all right now may be the devaluation of global currencies. Although Dominique Strauss-Kahn, head of the IMF, downplayed the risks of an all-out global currency war – in which countries actively intervene in currency markets to prevent domestic currencies from appreciating against trade rivals' currencies – the reality is that the currency war has been underway for some time, with the US leading the way. It's no secret that latent protectionism lurks in the US Congress, whether Democrat or Republican. And Treasury Secretary Geithner has been under intense pressure for well over a year to let the greenback weaken to protect domestic industries. Hence all the carping about China's "currency manipulation" and recent proposed legislation by Congress in an attempt to penalize what it sees as China's unfairly devalued currency.

Japan has already intervened in currency markets, for the first time in six years, selling the Chinese yuan in an effort to kick-start exports and support domestic growth. Grumbling from other Asian and Latin American countries about the US and China spiked into outright warnings of a currency war by Brazil's finance minister last Monday.

Over in the eurozone, the rift between the core and periphery widened even further last week. Germany, the region's largest economy, continues to show strength, as exports surge and unemployment declines. Germany's unemployment rate fell to 7.5%, the lowest rate in more than 18 years, lifting consumer sentiment to a three-year high. On the other hand, concerns about Ireland's banking system flared again last week, as the Irish government sought to persuade investors that it would and could bail out troubled Anglo Irish Bank Corp. without dipping into the European Union's emergency reserve fund. That put other peripheral eurozone nations like Portugal and Spain back under the microscope last week, and contributed to a flight to safety – including to gold.

Equity investors remained seemingly oblivious to the assorted "currency wars" and "flights to safety" taking place elsewhere. Instead, investors gradually drove up stock prices, albeit on low summertime volumes and quiet implied volatility.

Toronto's S&P/TSX Composite Index saw steady advances through the third quarter, with boosts from gold and improving base metals prices, like copper. As of Sept. 30, the S&P/TSX Composite gained 3.8% for the month, 9.5% in the third quarter, and 5.3% for the year to date. The index thus ended last week with a 1.3% weekly advance.

In New York, the Dow Jones Industrial Average posted a 7.7% advance in September over the previous month's close, a 10.4% quarter-over-quarter gain, for a 3.5% year-to-date advance. For the week, the DJIA climbed a hairline 0.3% over the previous week's close.

And the S&P 500 Composite Index similarly gained 8.9% month over month in September, for an 10.7% quarter-over-quarter advance. Year to date, the S&P 500 is now ahead 2.3%. Last week, though, the index dipped just slightly below breakeven, closing on Friday with a shallow 0.2% week-over-week loss.

Stock markets keep advancing, but only by inches (centimeters in Canada), as investors focus increasingly on fundamentals against a backdrop of widely divergent growth rates between the developed and emerging world, an increasingly tense global trade environment, and a giant question mark hovering over the eurozone. But then, stock markets always did “climb a wall of worry.” ■

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