

The gales of November

Markets gyrate through volatile week

November 26, 2010 – November is a stormy month, in the weather as well as in the markets. And true to form, the eurozone debt crisis and rising tensions in the Korean Peninsula once again sent global markets gyrating through a volatile week of trading. The contentious bailout of Ireland’s big banks and rising concern about Portugal’s debt situation added to investors’ anxieties. And hot money flows charged around the world looking for safer havens, the haven of choice being the U.S. dollar, which has gained strength steadily through the past four turbulent weeks. That, along with pressure on commodities over concerns about tightening monetary policy in China, stopped the Canadian dollar’s long march to parity.

The U.S. stock markets were closed on Thursday and part of Friday so that traders could observe Thanksgiving Day, and perhaps take advantage of some holiday shopping on what has come to be known as “Black Friday,” the day when U.S. retailers finally get their books into the black. That didn’t stop markets from sliding on Friday, however, as rating agency Standard & Poor’s cut the debt ratings on Irish banks, some to junk status, and North Korea again fired some artillery in a “training” session.

As the cost of insuring the debt of other vulnerable peripheral eurozone nations like Portugal rose last week, European financial authorities considered various ways to save Irish banks and contain the contagion. Mounting political pressure, especially from eurozone powerhouse Germany, suggests that senior holders of Irish bank debt (i.e., those at the very top of the payment pyramid) may be offered a swap for new bonds, forcing them to take a “haircut” on the value of their positions. (The advantage of this approach is that a losing some hair is better than losing your head.) A debt-equity swap may also be considered. Either way, senior bondholders will very likely be forced to share in the loss, as Irish banks recapitalize after several years of risky lending behavior that has now come unravelled, similar to that of the big U.S. banks in 2008.

Eurozone finance ministers were burning the midnight oil in an effort to cobble together some sort of semi-palatable rescue package before markets reopen on Monday. Meanwhile, very, very nervous investors had pushed the average yield on 10-year peripheral-country sovereign bonds to 7.56% by Friday afternoon, pricing in an overall increase in systemic risk. That’s just a fancy way of saying that going forward, senior debtholders can no longer be assured of being made whole in the event of default. In the meantime, deposits keep flying out the doors, windows, cracks, and crevices of just about every Irish bank, adding to the general sense of fear prevailing in euro credit markets.

Euro-fears also infected stock markets around the world, with stocks in resource and commodity sectors especially hard hit as investors lost their appetite for risk. With the flight back to U.S. Treasury bonds as a safe haven, commodity prices have ebbed nearly 6% this month, as measured by the ThomsonReuters Jeffries/CRB Commodity Index. Conversely, the U.S. Dollar Index has risen by the same amount in the same period. Some of that can be attributed to persistent concerns that Chinese monetary authorities will soon act to choke off a growing inflationary threat by tightening monetary policy further. Any move by China to subdue its economic growth will very probably also weigh on its demand for raw materials, thus putting downward pressure on the price many commodities.

These headline-grabbing global macro-economic trends often tend to overshadow more positive news closer to home, news that often is more likely to support equity values in the longer term. For example, lost in the eurozone circus was a report from the U.S. Department of Commerce that third-quarter after-tax earnings rose 3.2% from the second quarter, for a year-over-year gain of 28.2%. Furthermore, that earnings growth came largely from increased sales and lower labor costs.

At the same time, the Commerce Dept. revised its estimate for third-quarter gross domestic product, raising it to 2.5% from an earlier 2%, as consumer spending rose 2.8% in the quarter, up from an earlier report of 2.6%. Retailers are keeping their fingers crossed that the trend to the upside continues, as early indications were that Black Friday this year was likely to considerably exceed last year's holiday-shopping kickoff.

In Canada, too, the consumer-spending trend appears to be gathering steam, as Statistics Canada reported a 0.6% increase in total retail sales from August, for a 3.3% year-over-year gain. Although strong auto sales led the way, gains were posted in all general merchandise sectors as well.

In the meantime, Canadian inflation surged to an annual rate of 2.4% for the all-items consumer price index in October (up from 1.9% in September), while core prices, which strip out volatile prices like energy and food, rose at a 1.8% annual rate (up from 1.5% in September). While those higher rates of inflation are expected to ebb in coming months as the effects of U.S. quantitative easing wear off, the rate of change in Canadian prices is getting closer to the Bank of Canada's mid-point 2% inflation target. However, subdued economic growth for the next couple of quarters is likely to keep the BoC sidelined from any hikes to its target overnight rate for another two quarters, leaving the Canadian bond market a grace period of a few months yet.

North American stock markets lost ground on the week, as many U.S. traders were absent on Thursday and Friday. Canadian stocks lost ground as the loonie weakened against the greenback, closing Friday at US\$0.98, and commodity prices softened. Eurozone debt problems and North Korean sabre-rattling ramped up market jitters significantly. And the S&P/TSX Composite Index retreated 0.5% week-over-week as a result. South of the border, the Dow Jones Industrial Average dropped 1.0% week-over-week, while the S&P 500 Composite lost 0.9%, on those same market jitters.

Is this the start of a bearish trend? Probably not. Stock markets frequently sell off in November only to rally again before year-end. This time, the sell-off has been exacerbated by broader geo-political events, but barring something catastrophic, global growth trends (higher in emerging markets, lower in developed ones) are not likely to be derailed, even though risks arising from continuing imbalances remain high.■

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