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A stock market gift

Maintaining momentum on growing US confidence

December 24, 2010 – Stock markets closed the night before Christmas with another weekly gain – a little gift for the holidays. Despite dark mutterings from the International Monetary Fund about Canada's economy, despite warnings from all and sundry about Ireland and Greece and Portugal, and despite surging commodity prices, stocks have been on a roll, vindicating all those who've been fully invested and attracting a growing tide of bond-market refugees. This time, it looks like the stock market is filling its role as a leading indicator, sending signals of gathering momentum for the US economy in 2011.

Doesn't matter to the International Monetary Fund, however, which last week issued its own dire warnings about Canada's high level of household debt. If you sense an echo here, you're not mistaken. You'll recall that a couple of weeks ago, the Bank of Canada issued its own warnings about the unbelievable tendency of Canadians to binge-borrow when the central bank's interest rate is at 1%. Assorted deep-thinkers have weighed in on this "crisis" ever since, as even the big banks clamor for tighter lending rules.

The IMF said that with Canada's high household debt, a cooling housing market, and waning fiscal stimulus, "risks are tilted to the downside, with a key risk that the global recovery stalls." On the other hand – and there's always another hand – the IMF qualified, hedged, and watered down its warning so as to have the impact of distilled water by adding, "In the absence of a double-dip recession in the United States and/or a new rapid deterioration of global financial conditions from renewed sovereign credit strains, Canada should enjoy a comfortable, *if not exuberant*, rate of growth in the near term." [Emphasis added.] As is so often the case, the IMF's hedging conditional backtracking didn't make the headlines in the business press.

Is the US headed for a double-dip recession? The current consensus is "not likely!" A view, by the way, that we have shared in these pages throughout 2010. Each successive report on monthly consumer spending (which accounts for 70% of economic activity) improves on the preceding month. Most recently, household purchases in November rose 0.4% month over month, following a 0.7% gain in October. It was the fifth straight monthly increase.

What we are witnessing is a virtuous circle of climbing stock prices and higher incomes leading to rising consumer confidence. In fact, the ThomsonReuters/University of Michigan consumer sentiment index rose to 74.5 in December; a six-month high. Add to the rosier retail sales picture the previously-reported upswing in factory production, rising

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exports, and a shrinking US trade deficit, and you have a recipe that points more to gathering economic recovery than a double-dip recession.

In Europe, the warnings and ratings downgrades are flying thick and fast as rating agencies fall over each other to inform investors of the rising risk of holding sovereign debt of peripheral eurozone nations like Ireland, Portugal, and Greece. As agencies like Moody's, Fitch, and S&P lower ratings of deadbeat sovereigns to near-junk status, it's clear that the message is getting across. Not only has the European Union stepped up to the plate to backstop their debt with assorted bond guarantees, but governments are imposing fiscal austerity measures for the first time in years in an effort to balance their books, reassure their larger eurozone partners, and rekindle waning investor interest. Nothing like a touch of market discipline to focus the mind.

In the United Kingdom, economic growth continues to be subdued, with third-quarter GDP growth revised downward, to only 0.7% from an early estimate of 0.8% from the previous quarter. Adding insult to injury, the government borrowed more in November than in any previous month *ever*. Flaccid economic growth combined with public spending cuts and inevitably rising taxes do not augur well for the UK's growth in 2011.

Again, no matter. London's FTSE 100 Index ended Thursday's session at its highest level in two years. Same with North American markets, emerging markets and even the eurozone.

Commodities have also been climbing to levels not seen for a couple of years. Crude oil, for example, jumped to US$91 per barrel on Thursday, its highest level in over two years as cold weather in the US leads to surging demand and puts a big dent in US oil inventories. With red-hot growth in emerging nations, global demand is expected to grow 2.9% in 2011, according to the International Energy Agency. And a flood of new investment money, including surging derivatives, is adding even more impetus to the price of crude. Other notable commodities much in the news owing to ever-rising prices include gold, copper, corn, sugar – virtually the entire complex, in other words.

The question yet to be answered, is how much of this good news story has already been priced into global markets? If stocks are really a leading indicator, are we close to the tipping point where risk outweighs the potential. Bottom line; can you invest with confidence in 2011?

Whether the remarkable resurgence of risk-appetite in recent months can be attributed to a growing confidence in US economic recovery or simply as the inevitable result of vast injections of fresh money through the US Federal Reserve Board's reflationary efforts – or a combination of both – remains to be seen.

Whatever the reason, stock markets last week maintained their December momentum. Toronto's S&P/TSX Composite Index closed Thursday with a 1.3% advance from the previous Friday's close, and with only a half-day trading session on Friday, was on track to post a full-week advance.

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In New York, the Dow Jones Industrial Average closed the week on Thursday with a 0.7% week-over-week gain on reduced volumes ahead of the Christmas holiday, while the S&P 500 Composite Index advanced 1.0%.

Stocks are on track to finish the fourth quarter with significant quarterly gains, topping off 2010 with annual gains of 10%+. Even if stocks pull back in January, it may be only a prelude to the next leg up in what is now a two-year bull market. And that next leg could be, as they say, "an upside surprise."

And with that, I'd like to wish all our readers a happy holiday and a healthy and prosperous New Year.■

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