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Sideways

Two months of nothing much

February 26, 2010 – For the past couple of months, North American stock markets have basically gone nowhere. And for the past five months, they've traded in a fairly narrow range, rallying on light volume interspersed with heavy-volume selloffs. For technicians, that describes more of a bear-market pattern than a bullish trend. And yet the Chicago Board Options Exchange's volatility index (VIX), commonly known as the "fear" index," has been trending down recently – an indication implied volatility is declining.

That's not surprising really given a directionless market. If it can be said that the VIX has even slight predictive value for near-term stock market movement, then right now, options traders see no particular reason to pay increased options premiums for downside protection as they did in late January, before the big equity indexes started sliding. That's not to say it can't happen, of course, but at the moment it all seems pretty quiet. Generally, a significant decline in the VIX is a precursor for a major move – up or down – in the underlying stock market. At which point VIX can spike almost instantaneously as can be seen on the accompanying chart that tracks the performance of the VIX against the movement in the S&P 500 Composite Index.

CBOE Volatility Index vs. S&P 500 Composite Index

The directionless market could be the result of so much external "noise" besetting investors these days. To the point that investors may be ignoring macro issues, focusing instead on what really counts…earnings. And so far, investors like what they see.

With most of the S&P 500 companies' fourth quarter earnings now in, adjusted earnings per share are up 215.5% from the fourth quarter of 2008. In addition, net income is up 178.3%. And some 73% of earnings reports were "positive surprises," coming in ahead of consensus estimates.

In Canada, fourth-quarter operating profits for Canadian corporations rose 7.9% from the previous quarter. Though year-over-year earnings are still down from fourth-quarter 2008 levels. The increase marked the second consecutive quarter of earnings growth after the recession bottomed out last year. Profits increased broadly in every sector, according to Statistics Canada, led by a 19.7% quarter-over-quarter surge in the financial sector.

That trend, at least, appears on track to continue into the first quarter of this year, as both National Bank of Canada and Canadian Imperial Bank of Commerce exceeded estimates and raised expectations for the sector as a whole. National Bank tripled its first-quarter earnings from the same period a year ago, while CIBC, which faced some serious problems last year, posted a 344% year-over-year increase.

This is a particularly good sign for the Canadian economy as a whole, as banks are expected to report a significantly smaller portfolio of troubled loans and a larger book of lending business. Watch for the federal government to begin phasing out many of its emergency bank-support measures in Thursday's federal budget, in conjunction with continuing measures by the Bank of Canada to "normalize" monetary policy. Although a hike in the Bank's target overnight lending rate is not in the cards until after June 30 (according to the BoC), an upturn in commercial bank lending often presages a policy rate increase.

Not so in the US, where the labor market is still under a great deal of stress. Unemployment hovers stubbornly at 10%, and unit labor costs continue to be disinflationary. There is no particular wage-pressure in sight, despite a rising rate of capacity utilization.

Even more significant, bank lending remains suppressed as gun-shy banks keep a tight grip on all that liquidity the Fed has injected. Bankers remain fearful of high loan losses in a still fragile real estate market. Particular emphasis is being placed on the potential problems looming in commercial real estate, which may explain why the US banking system is sitting on over US $1 trillion in reserves. Then there is the political wildcard, which is the uncertainty about the extent to which the Obama administration will extend increased regulatory costs into the financial sector beyond those institutions that the government has already bailed out.

A sudden turnaround in commercial and industrial lending over the next two quarters will, of course, have the Fed singing from a whole new song sheet. But that's not likely to happen. So apart from already well-telegraphed plans to withdraw excessive monetary accommodation through market mechanisms (last week's increase in the discount rate, for example), don't expect even a minute hike in the fed funds rate until the third quarter of the year at the earliest.

Meanwhile, the uptrend in US corporate earnings surprises is likely to continue, as revenue growth and improving margins flow down to more robust earnings gains in coming quarters. The Fed reported that the total industry capacity utilization rate in January stood at 72.6%, up from 71.9% in December, and still a long way from the 80.6% average from 1972 to 2009, implying plenty of upside for earnings through this year and next.

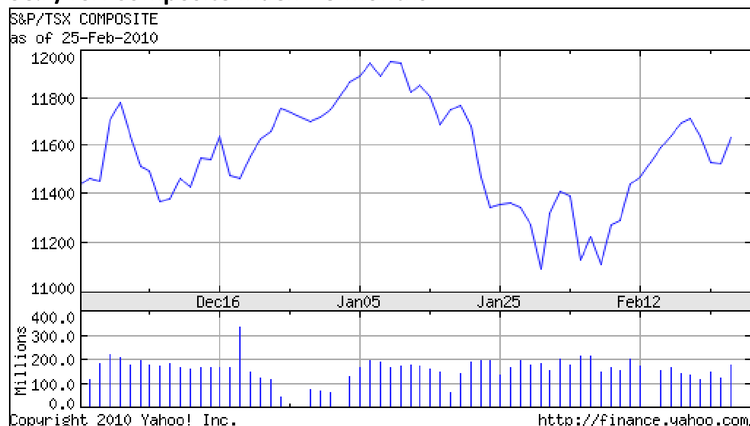
Against this backdrop, investors grew hesitant and nervous on reports of climbing US jobless claims in the previous week, a 2.9% decline in "core" durable goods orders, a near-10-point plunge in the Conference Board's consumer confidence index in February, and drops in both prices of homes and sales of new homes. Even a late-day report that the US economy rose at an annualized 5.9% in the fourth quarter wasn't enough to impress investors, who had already discounted a strong GDP number for the end of 2009.

The Greek tragedy unfolding in the euro-zone remains only distant concern at this stage, viewed by North American investors largely as a faraway regional fiscal issue that can only benefit the US dollar as the euro comes under increasing downward pressure. In the process that can only bolster the greenback's status as a safe-haven currency, despite gigantic fiscal problems also looming for the US.

However, suggestions by US regulators to "investigate" the role Goldman Sachs and others may have played in various off-balance-sheet sovereign currency and bond transactions for the governments of Greece, Spain, and other nations fond of dodgy accounting may eventually spook investors into another run on the financial sector. For now, however, stock investors simply remain wary, with most of the action taking place in the rarefied and high-risk world of international bond, currency, and credit default swap trading.

At the end of February, developed world stock markets stayed slightly in the red for the year to date, though most had gained some ground lost since the end of January. In other words, January and February saw a lot of "sound and fury, signifying nothing."

S&P/TSX Composite Index – 3 months



The S&P/TSX Composite Index lost –0.7% on the week, but gained 4.8% month over month from January, and closed February with a loss of –1.0% year to date.

The Dow Jones Industrial Average ended the week with a –0.7% loss, advancing 2.6% on the month, but posting a –1.0% loss for the year to date. Similarly, the S&P 500 Composite ended the week off –0.5%, gaining 2.9% on the month, but remaining –1.0% in the red for the year to date.

By contrast, Frankfurt's DAX blue chip index has lost 6.0% year to date and edged down another 0.2% month over month in February, as weak economic recovery is further impeded and weighed down by the distraction of the Greek, Spanish, Portuguese, and Italian fiscal and debt crises, which have shaken the European monetary unit, the euro, to its very foundations.

Gold, meanwhile ended February at a spot price of US$1,116 per ounce, not far from where it closed at the end of last year at US$1,096. Similarly, Brent crude oil closed February at US$79.68 per barrel, not too far ahead of last year's close of US$77.85.

The Canadian dollar also left February at US$0.9500, largely unchanged from last year's close at US$0.9555.

For the past two months, then, markets have gone pretty much "sideways," losing some ground, gaining some ground, but not seeing any decisive moves either way. As we've said in our previous comments, this is characteristic of markets following a strong bullish phase such as we saw through 2009. It's likely to be "sideways" for some months yet.■

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