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Markets on track for correction

Bear staying in hibernation

February 5, 2010 – Are we back to a bear market? From its 52-week high in early January, the S&P/TSX Composite has dropped 7%. The S&P 500 Composite Index is down 9%, and the Dow Jones Industrial Average has retreated 8%. No, it's not bear market territory yet. But markets are getting close to what's generally defined as a correction – a 10% drop from a recent high.

A correction has been in the cards for awhile now. After all, powered by near-zero interest rates, drunken-sailor spending of taxpayer money, and overtime money printing by central banks, stock markets around the world spent the better part of last year surging up from the bear market bottom, gaining 30%, 40%, 50%, and more without interruption since last March. That's a heckuva ride, but it was bound to run out of steam sooner or later.

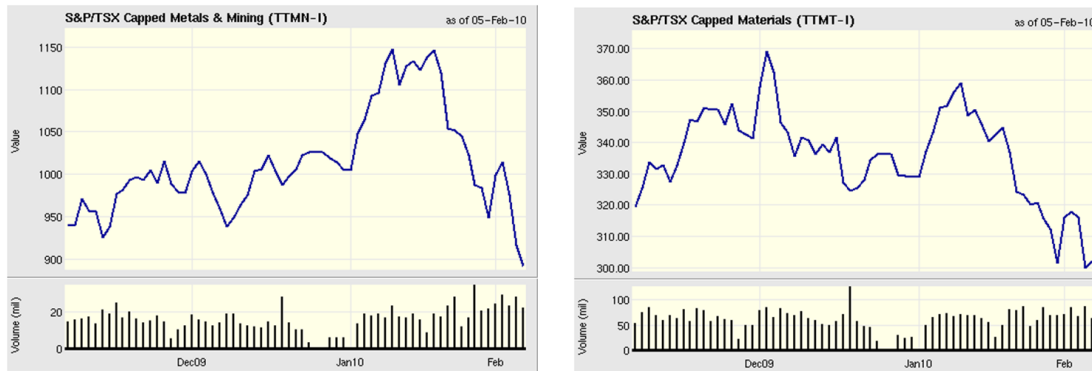
It began with a small change in tone in central bank rate communications over the past few weeks. That ever-so-subtle change signalled a shift in central bank intentions, from a focus on furnishing liquidity and stimulating credit, to a sudden interest in the troubling levels of runaway national debt, black-hole fiscal deficits, and the threat of asset bubbles. To investors, that implies rising interest rates sometime down the road (most central banks have given broad hints about rate increases after June 30), and rising rates are anathema to stocks. Higher rates imply costlier financing for businesses, just when the economy appears on the verge of recovery, and as businesses begin to contemplate increasing capital spending budgets.

Throw in moves by China's central government planners to curb bank lending in an effort to control galloping real estate prices and climbing consumer price levels, and you give investors even more motivation to hit the "sell" button. That's been painfully obvious in when you look at resource issues, which are so much driven by general commodity price levels, which have dropped precipitously as speculative long commodity positions (particularly in large, liquid markets like copper) begin to unravel in a gathering avalanche of bearish sentiment.

And what better place to look than right here in Canada, a resource-based stock market if ever there was one. The S&P/TSX Capped Materials Index has collapsed 16% since its

52 week high in early December. The S&P/TSX Capped Metals & Mining Index is down 21% since early January. Both are now deep down into “correction” country.

Down...



The euro-shambles crisis, as thrilling as it might be to watch from a safe distance, is something of a red herring. Sovereign debt and currency crises make for wonderfully hyperbolic headlines and much furrowed-brow reporting by the talking heads on business news channels, but their broader ramifications for global markets is often obscure, and talk of “contagion” is premature to say the least.

This is not to say that the PIIGS-inspired (Portugal, Italy, Ireland, Greece, and Spain) fiscal problems roiling the euro-zone are not serious. They are. For the euro-zone. And in the very worst case, intractable domestic political impediments to bringing national fiscal houses into order may lead to a calamitous collapse of the euro experiment entirely. The heart of the problem is that the euro-zone is a 16-member monetary union, and except for limits on fiscal debt and deficits and so on – most of which are casually ignored – the affiliation is not a political one.

A “United States of Europe” it manifestly is not, and, as we’ve repeatedly pointed out in these comments over the years, nationalistic tendencies are never far from the surface in Europe, well-intentioned monetary unions notwithstanding. For how long will German taxpayers stand for being Europe’s rich uncle, bailing out profligate relations like Greece and Portugal (let alone Spain) even while shoring up their own swaying financial house? We’d hazard a guess and say, “not for too long.”

How the euro-mess gets sorted out is anyone’s guess. It’s worth noting that the debt problems among Europe’s weak sisters are not a particularly big surprise – except maybe to the media. The precarious state of European national accounts has always been there for everyone to see, and over the past year or so, many observers have noted the inevitability of the current result. But it’s not the end of the world. And probably not even the end of the euro.

If investors believed the euro-mess were a threat to the global financial system, you’d expect the price of gold – the ultimate crisis hedge – to be probing new highs about now. Instead, the yellow metal is being sold off, and funds are flowing torrentially into US

dollar Treasury assets, strengthening the US dollar. Nearby contract gold futures dropped another 4.4% last Thursday, the largest percentage decline in 14 months. To date, the precious metal has retreated 12% from its December high of US\$1,214 per ounce.

Crude oil likewise dropped below US\$70 per barrel as huge inventories continue to hang over the market (95 days' supply compared with an average of 86 days), OPEC capacity increases, and demand remains soft. Oil futures are down nearly 8% this year, while copper, often referred to as "Dr. Copper" for its predictive value, is down 14%, also on rising stockpiles with no concomitant increase in demand.

Rather than a rebirth of the financial crisis from the womb of the euro-zone debt dilemma, it's more likely that last week's market slides represent a natural retrenchment after a long, unbroken market rally. Economic data points from the US last week still point to a recovery slowly – very slowly – gathering momentum, rather than slipping back into recession. The Institute for Supply Management's key manufacturing index rose to 58.4 in January, up from a revised 54.9 in December. And the US unemployment rate unexpectedly declined to 9.7% as manufacturers resumed hiring and increasing both hours worked and pay levels.

Corporate profits are also on the rise, with reported fourth-quarter operating earnings for S&P 500 companies up 47% annualized so far, the first advance after nine consecutive quarterly declines. Revenues are expected to rise only 0.9% from the year-ago quarter, but that still beats four consecutive quarters of double-digit slides.

In Canada, the jobless rate fell to 8.3%, its lowest level in nine months, as some 43,000 new jobs were created, raising hopes for a gradual recovery in the labor market.

The S&P/TSX Composite rose 1.2% week over week, as gold prices firmed somewhat, while the Dow Jones Industrial Average and the S&P 500 Composite Index fell just a hair below breakeven, losing 0.6% and 0.7% respectively. Overall, though, the "corrective" trend continued, as it probably will for the next few weeks. At the very least, we can expect some heightened volatility, as the Chicago Board Options Exchange's volatility index (VIX) spiked up to 26 at week's end, up from around 17 in mid-January, implying a growing level of investor concern over market risk.

All in all, a needed and expected correction is in play. But it's unlikely at this stage to transform into a bear. ■

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