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On course for a March gain

Sinking ships don't faze markets

March 26, 2010 – A sinking South Korean naval vessel sent the big North American markets for a choppy ride on Friday, but markets stayed comfortably afloat for the week overall. Even the steeply listing euro and the “tween-decks” squabbling among members of the eurozone over the fate of their Greek co-currency compatriot wasn’t enough to rock New York’s boat for long.

An explosion that ripped a hole into the hull of a South Korean navy ship on routine patrol near North Korean waters caused the ship to sink a few hours later, with the loss of a number of lives. Complete details had not been confirmed. But the incident was enough to give stock markets a mild case of the jitters during Friday’s trading session, given the fragile state of relations between North Korea and South Korea (and just about everyone else, of course). The concern, always, is that a deterioration of the 50-year standoff between the nuclear-armed communist North and the democratic South could escalate into an armed conflict in the region, drawing in the U.S., Japan, China, and Russia. But those fears never really gelled.

By close of trading on Friday, things had settled down somewhat as the incident did not immediately escalate into a shooting war.

Meanwhile, on the other side of the world, the eurozone was engaged in attempting to keep another kind of ship afloat. As predicted in these notes some time ago, the European Union, led by France and Germany, has concocted some sort of a rescue package for Greece’s near-bankrupt government that involves last-resort bilateral loans from EU members along with unspecified support from the International Monetary Fund should Greece be locked out of credit markets completely.

Greek authorities, having exhausted attempts to blame their own financial profligacy on everything from unspecified “speculators” in credit default swaps to German banks and exporters, have now appeared to throw their fate entirely on the kindness of strangers. Unwilling, and perhaps unable, to impose the kind of fiscal discipline necessary to restore sovereign creditworthiness, Greece and its sympathetic EU allies France, Italy, and Spain have managed to talk the entire 16-member currency zone into the mother of all moral hazards.

Because, after all, how likely is it that Greece will *not* avail itself of the bailout now so tantalizingly within reach? That particular probability has dwindled to near zero. (Think AIG, Bank of America, Goldman Sachs, GM, et al and the moral hazard created by the Troubled Asset Relief Program in the US.) It's just so much easier to pluck the low-hanging fruit of US\$408 billion in EU and IMF funds (so generously provided by U.S., German, and French taxpayers) than it is to apply fiscal discipline and pay the irritatingly high risk premiums demanded by an "unreasonable" bond market and those pesky CDS "speculators."

After initially dumping all over the proposed package, and incidentally causing a bout of global stock market turmoil on Thursday, European Central Bank president Jean-Claude Trichet later saw the light and endorsed the plan, no doubt after some fairly vigorous arm-twisting from his political masters.

By the time the dust had started to settle, markets had regained some of their equilibrium. And the big European bourses in fact renewed their climb to near two-year highs, even though the euro continued under pressure.

Investors didn't have to look far for a reason to invest. The widely followed Markit Economics euro-area manufacturing purchasing managers index rose to 55.5 in March from 53.7 in February, the fastest growth since 2007. And manufacturing has been gathering steam, especially in Germany, as export orders come flooding in the doors. The lower euro has a lot to do with that, of course, having slipped 11% against the US dollar as the Greek fiscal drama unfolded with the clockwork precision of a Sophoclean tragedy over the past four months. Although business confidence is on the rise throughout the region, full-bore economic recovery is still a long way off, as persistently high unemployment keeps a lid on consumer demand.

In North American markets, meanwhile, investor focus began to shift to debt markets, as concerns about the US deficit manifested in slack demand for US Treasury notes last week. With the yield on 10-year US Treasuries climbing to 3.9% on tepid demand at auction, investors began to sense impending trouble for the housing market should yields continue to rise. That's because the mortgage market keys off the 10-year yields. And the US Federal Reserve's plans to soon begin unwinding support for the mortgage market heightened concern that the fragile housing market would suffer another setback.

Even worse, a jump in 10-year Treasury yields beyond 4% could augur for some setbacks in the stock market as the cost of business financing increases commensurately – with the implicit hit to earnings growth. Throw in the growing prospect of central bank rate hikes starting at the end of the second quarter, and you've got the makings of some high anxiety for equity investors over the coming months.

In Canada, the prospects for a rate increase also rose, as Bank of Canada Governor Mark Carney emphasized in a speech last week that the BoC's pledge to hold the target overnight rate at 0.25% was "expressly conditional" on what happens to inflation. And inflation has been rising lately, with the core price index advancing at a recent 2% annual

rate. That shouldn't be too surprising, given that Canada's economy is recovering robustly. Statistics Canada's index of leading economic indicators grew 0.8% in February, the ninth consecutive monthly increase.

Stock markets are on track to end March with some strong gains, despite troubled European waters and sinking Korean ships. But those gains have been hard-won, with advances coming against some pretty powerful headwinds. The pattern continued again last week as the S&P/TSX Composite Index ended the week just about flat, closing last Friday ahead only about 10 points from the previous Friday's close. Ditto for the S&P 500 Composite Index. Only the Dow Jones Industrial Average showed some strength, advancing 1% on the week, as the big industrial stocks, with innate defense against a rising rate structure, gained momentum. ■

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