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SEC sues Goldman Sachs, takes markets on a wild ride

April 16, 2010 – Stock markets took the proverbial roller coaster ride last week, as investors reacted to accusations of fraud against US banking giant Goldman Sachs Group Inc. by the US Securities and Exchange Commission. Financial stocks took a beating late in the week just about everywhere, as regulatory risk popped up again on traders' screens from London to New York to Toronto.



Charts courtesy Yahoo! Inc.

Goldman Sachs shares plunged some 13% on Friday, taking down Berkshire Hathaway Inc. in the process. That's because the famous holding company run by the quotable Warren Buffett holds US\$5 billion in Goldman warrants, purchased back in September 2008. The SEC civil-fraud lawsuit centres on some relationships with hedge funds that the SEC says were undisclosed in Goldman-issued collateralized debt obligations (derived from US subprime mortgages), which were sold in early 2007.

That got investors all antsy about the possibility of other such suits in the regulators' pipeline as the hunt for patsys, fall guys, and blame-takers in general continues in political capitals around the world.

The Goldman story got all the media attention at the end of the last week, but there were a few other items – perhaps of even greater consequence – that went into market calculations during the week.

First of all, the US trade deficit widened in February, to US\$39.7 billion, after narrowing somewhat in January. Analysts pointed to a US\$3 billion jump in imports from January as the main driver of the widening deficit. On the plus side of the ledger, though, growing

exports helped push the US trade surplus with Asia to US\$2.2 billion, while the deficit with China narrowed to US\$16.5 billion from January's US\$18.3 billion.

Then, the Thomson Reuters/University of Michigan consumer confidence index dropped to 80.7 in April from 82.4 in March, a dip that took analysts by surprise. The survey indicated that consumers in general still feel a high level of unease about the prospects for wage increases and employment prospects.

Headline consumer prices, meanwhile, measured by the all-items consumer price index, showed a 0.1% increase from March, for a 2.3% year-over-year gain. Core rates, which exclude the volatile food and energy components, showed no change from March, for a year-over-year increase of only 1.1%, well below what is believed to be the US Federal Reserve Board's implied 2% target core rate. (The Fed does not officially target inflation the way the Bank of Canada does.)

Fed Chairman Ben Bernanke told a Congressional committee last week that the threat of inflation picking up anytime soon was low, even while he remained cautiously optimistic about the outlook for the economy. All this comes in advance of the Fed's rate policy meeting later this month. And while observers expect the Fed to maintain its ultra-low rate policy, they are waiting to see whether it will continue to keep rates low "for an extended period." Any change in that language could be a signal of changing Fed intentions over the next few months.

Inflation rates that are too quiet cause concern for investors, owing to the threat of a slide into a deflationary period, which is typically symptomatic of a slow- or no-growth economic environment.

Counterbalancing these concerns, however, was some encouraging data on US consumer spending. Retail sales jumped 1.6% in March, for a third straight month, while both January and February sales data were revised upwards. This is definitely good news, as so much of the US economy depends on consumer spending – and in turn exerts a gravitational pull on Canadian manufacturing and exports.

And the Fed reported that factory output surged again in March, climbing 0.9% on strong demand for durable goods. That helped push capacity utilization to 73.2%, up from February's 69.5%, as inventory restocking and growing new order books continued to support the manufacturing recovery. Its so-called beige book survey of regional economic conditions also painted a picture of steadily improving activity, with growing factory output contributing to improving manufacturing employment numbers.

In Canada, all eyes will be on the Bank of Canada's rate policy announcement, due out on Thursday, following BoC Governor Mark Carney's scheduled statement on Tuesday. The question is whether the Bank will telegraph a rate hike in June, earlier than its self-imposed June 30 cutoff date. With core inflation surpassing the Bank's target 2% threshold in February, many observers have argued for an early rate hike based on a yield

spread of more than 170 points between Canada two-year bonds and the Bank's target overnight rate.

After that roller coaster week of trading, markets ended generally flat on the week, on high volumes. Toronto's S&P/TSX Composite Index dropped 0.9% from the previous week's close, as financials slipped and crude oil, gold, and the Canadian dollar all lost ground.

The Dow Jones Industrials broke even on the week, closing just 0.2% above the waterline, in anticipation of strong first-quarter results from industrial bellwether General Electric. The broader S&P 500 Composite Index closed just 0.2% below the waterline for the week, as anxiety about the financial sector continued to weigh on the benchmark until Friday's close.

It's unlikely that the Goldman Sachs imbroglio will trigger a bout of selling, though a correction is probably overdue. What's more likely to get investors pulling the trigger is even the smallest change in the Fed's interest rate intentions. ■

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