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Eurozone troubles weigh on markets

Investors ready for hair-trigger flight to safety

April 30, 2010 – The sound and fury emanating from Europe last week concerning the Greek debt crisis pretty much drowned out some pretty good economic and business news from North America. And as fears of a European debt-crisis contagion peaked through the week, investor anxiety spread through stock markets, driving the major North American indexes to a weekly loss, but keeping monthly readings in the black.

The flack really started flying after rating agency Standard & Poor's cut Greek government debt to junk status last Tuesday, followed by ratings downgrades to both Spain and Portugal (but not yet to junk status). The risk of a Greek debt default climbed commensurately, as the estimated cost of a joint bailout package orchestrated by the European Union and the rest of the industrialized world through the International Monetary Fund climbed to US$150 billion over the projected three-year package. That is three times the amount originally pledged just a few weeks ago.

The debt relief for Greece, which is politically hugely unpopular in Germany, comes with stringent requirements for the Greek government to implement deeper austerity measures, which are, of course, politically hugely unpopular in Greece. Resistance by the public service bureaucracy to cuts to its deeply entrenched entitlements are likely to impede progress in implementing the austerity measures demanded as a condition for the EU/IMF bailout.

Further delays will, of course, result in more debt downgrades and the distinct possibility of similar downgrades to the sovereign debt of Spain, Portugal, and Italy. Investors are even casting a wary eye on UK debt, where the size of protection against default through credit default swaps (CDSs) has nearly doubled since the beginning of the year. That alone doesn't indicate a UK sovereign debt crisis, but it does indicate a higher level of concern.

Will Greece remain solvent? It seems increasingly likely that the Greek rescue package will come through at the eleventh hour. The next week will tell the tale. But it remains to be seen whether Spain, Portugal, and Italy will be the recipients of similar largesse. That uncertainty is also likely to keep markets on edge for the next few months.

While the fate of the Greeks hangs in the balance, the economic recovery in both Canada and the US gained more traction.

Canada's gross domestic product (GDP) grew for the sixth consecutive month in February, supported by growing manufacturing output. GDP grew 0.3% from January, for a 1.8% year-over-year advance. The goods-producing sector continued to show broad strength, with 14 of the 21 manufacturing groups tracked by Statistics Canada showing growth. The services sector lagged, however, posting only 0.1% month-over-month growth.

The strength of February output suggests that Canada's first quarter GDP could show growth of more than 5.5%, with the trend continuing into the second quarter. The Canadian dollar hovers near parity, as a result of a confluence of robust economic growth, a healthy fiscal position (February's budget deficit was the smallest in a year), a "flight to quality" while the Greek debt crisis unfolds, and lofty commodity prices.

The strong loonie has once again appeared as a factor for the Bank of Canada, as Bank Governor Mark Carney last week specifically identified persistent dollar strength as a "risk" to economic activity. The Bank's dollar "jawboning" may contain hints that it is prepared to intervene and use its various monetary tools to prevent a strong dollar for derailing the Canadian recovery.

Preliminary figures show that US GDP grew 3.2% annualized in the first quarter, down from the 5.6% recorded in the fourth quarter of 2009, but still a respectable pace. A revival in consumer spending, which grew 3.6%, provided most of the lift, aided by inventory replenishment. US consumer confidence is gathering strength, as the New York-based Conference Board's confidence index rose to 57.9 in April, from 52.3 in March.

Adding some confirmation to those data, credit card company Visa Inc.'s fiscal second-quarter earnings climbed 33%, as payments volume increased 13% year over year. That provides more evidence of credit-based consumer spending and a sustained turnaround in the hard-hit credit card business.

The US Federal Reserve Board, meanwhile, stayed the course on interest rates last week, leaving its key federal funds rate near zero and reiterating that rates are expected to stay low for "an extended period." It predicted only moderate growth for the US economy, and said that inflation is "likely to be subdued for some time." In sum, not an outstanding US outlook, but not bad either.

The Greek debt crisis outweighed everything else and made for some very choppy sessions last week. Still, Toronto's S&P/TSX Composite Index ended the week with only a marginal 0.2% loss, for a gain of 1.4% on the month, as resources, particularly gold and energy, helped counterbalance nervousness about the financials.

In the US, the Dow Jones Industrial Average slipped 1.8% on the week, the first weekly loss in the past eight, as financial stocks felt the headwinds of the Greek debt troubles and government lawsuits and investigations of Goldman Sachs. For the month, however, the DJIA came in with a 1.4% gain, as first-quarter earnings season largely exceeded expectations. Similarly, the S&P 500 Composite Index fell 2.5% for the week, but posted a 1.5% advance for April.

Exhibiting some of its characteristics as a safe-haven metal, gold closed at US$1,181/oz., up more than US$20 on the week, touching a four-month high. Oil, on the other hand, closed the week at US$86.15 for a barrel of light sweet crude, up about US$2 on the week.

Markets are very likely at the point of high anxiety where investors are more likely to stand aside or flee to safe havens at any hint of trouble. Equity market advances are therefore likely to be very hard won, while declines can occur very quickly. And gold may surge past its record US$1,200 before retreating again.■

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