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Canada's sweet spot

Loonie touches parity, stocks edge up

April 9, 2010 – There's no doubt about it now. The Canadian economy is well into recovery mode, as the outlook for the labor market improved, the loonie rose against most major currencies, and the stock market continued trending higher.

Statistics Canada's March Labour Force Survey released last week showed that some 18,000 new jobs were created in the month, with most of those in the private sector. Although much of the growth has been in the service sector, employment growth in the cyclical goods-producing sector will gain momentum as manufacturing begins to expand on higher demand. For now, an average monthly gain of 22,000 full-time jobs since last August paints a picture of vigorous underlying strength in Canada's economy.

That's contributed to the strength of the Canadian dollar lately. Last week, the loonie reached parity with the US dollar, before easing off later in the week. The Canadian dollar also advanced strongly against the euro, the British pound, and the Japanese yen, mostly because Canada's economic and fiscal positions are perceived as being in far better shape than the aforementioned countries.

The US and the UK have loaded up on debt to the extent that fiscal deficits now threaten to dampen economic growth over the longer term. The problem is readily apparent in the yields on 10-year US Treasury notes, which have risen to nearly 4%. That's an indication that investors are demanding a higher premium for taking on the risk of funding those gargantuan US deficits – currently about US\$1.3 trillion, or more than 10% of US GDP.

US Federal Reserve Chairman Ben Bernanke last week spoke again of the dangers of rising deficits, warning that unless the Obama administration acts now on spending and taxes, higher rates could jeopardize the economic recovery. What's not so clear is what the Fed's policy on rates is likely to be.

At the moment, the Fed is committed to keep rates where they are for an extended period. But public pronouncements by various Fed governors reveal a deeper division. Some, including the Obama administration's appointee, believe the Fed should keep rates low for most of this year, and possibly into 2011, in the face of high unemployment, tepid recovery, and decelerating underlying inflation. Other Fed governors have been calling

for the Fed to begin moving the fed funds rate higher now, in order to avert a low-interest-fuelled asset bubble.

The eurozone has its own problems, as the Greek fiscal crisis continues to distract from a slightly improving economic picture in France and Germany, the largest members of the 16-nation currency union. A recovery is slowly taking hold, as factories start to notch up production, with an assist from government stimulus programs and growing foreign demand. But persistent troubles with fiscal basket cases Greece, Spain, and Portugal have made the European Central Bank (ECB) cautious about removing stimulus measures or raising policy rates.

Believing that discretion is the better part of valour, the ECB left its benchmark lending rate unchanged at 1% last week. And no wonder. As ratings agency Fitch Ratings cut Greek debt to BBB-minus, a level just above a junk rating, Greek bonds plunged as yields on two-year bonds rose to 7.45%, 651 basis points above comparable German bunds, following requests from the country's four largest banks for emergency liquidity funds. As predicted in these notes, the EU/IMF debt bailout contraption, whatever it finally turns out to be, is proving to be an irresistible lure for the Greek government, which continues to blame investors for not buying its bonds without commensurate compensation for the risk undertaken.

The eurozone is firmly placed between the proverbial rock and hard place. Give in to Greek demands for a bailout or face a Greek debt default, which would be closely followed by debt defaults by Spain and Portugal. But once you bail out Greece, you'll have to bail out Spain and Portugal, perhaps Italy as well. Until the crisis comes to a head, the euro will remain under selling pressure.

And so the Canadian dollar benefits as investors seek a safe haven in the relatively calm waters of the Canadian economy. But the main driver of the loonie's strength to date has been the resurgent price of crude oil in anticipation of increasing demand on global economic recovery. Even if oil prices level off, owing to OPEC's current production slack and the enormous US supply overhang, the Canadian dollar is likely to continue to draw strength from the relative yield advantage of Canadian government debt over US debt.

Canadian stocks edged up again last week on that positive employment report and on improved commodity prices (except for oil, which slipped just slightly to US\$84.92 per barrel). The S&P/TSX Composite eked out a week-over-week gain of just 0.2% after recovering from a steep slide on Thursday.

Similarly, the Dow Jones Industrial Average recovered ground lost mid-week after a gloomy consumer credit report, briefly climbing above 11,000 before retreating again to close Friday with a 0.6% weekly gain. The more broadly based S&P 500 Composite posted a healthier 1.4% advance for the week, in anticipation of positive first-quarter earnings reports, due to begin next week. ■

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