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Playing defense

Anxieties grow over eurozone, Korea

May 28, 2010 – Last week, Ford Motor Co. decided to stop manufacturing the venerable Mercury line. The 71-year-old brand joins several other Ford divisional divestments since 2006, when new CEO Alan Mulally took over. These include Jaguar, Land Rover, and Volvo. Could be that's why Ford gained a buck and a half in last week's trading. And also why it has nearly doubled in price over the past year, after spurning the seductive offers of federal government bailouts – the only domestic US automaker to do so.

Now, while General Motors Corp. and Chrysler Corp. are well-pickled deep inside a government barrel, Ford still has a free hand to produce profits for its shareholders instead of pork for politicians. That's the difference between an enterprise operating without the clammy hand of government interference and one with a de facto head office in Washington (or Ottawa).

Of course, we use the phrase “government interference” very tightly here, because automakers, like all businesses, are shackled by innumerable regulations, edicts, mandates, oversights, and other more subtle, but no less onerous interference, that it's a wonder anyone makes any money at all! And, of course, Ford, like all large businesses, is no stranger to other types of government siren songs, including favourable tax breaks and other trade or commercial inducements dangled by local and state governments as enticement to locate factories or offices in their home city or state.

Still, what's left of the invisible hand of “capitalism” in the US manages, somehow, to allocate capital and resources efficiently enough to keep the US perched in its position as the world's largest economy. And all without President Obama personally deciding how many size nine brown loafers will be manufactured this week (with the proviso, of course, that the US healthcare sector, like Canada's, is already heading in that direction).

While a business can – and must! – undertake swift and deep cost-cutting measures to keep its books balanced (and its shareholders and creditors happy), governments cannot. Their only recourse is to print or loot their way out of trouble. Which is precisely what's happening in Europe these days (see: crisis, Greece, just about anywhere), and what is very likely to befall the UK and the US in the not-too-distant future. But printing money (i.e., monetizing the debt through inflation) and raising taxes while cutting services is exactly what governments have always known how to do best. When the patricians and

free citizens of ancient Rome, for example, had been bled dry for tax, coin-clipping became a favoured pastime of Roman emperors seeking extra revenue to keep their far-flung armies clothed and fed – and themselves in power. Students of economic history know this, but each generation must, unfortunately, learn this lesson anew. President Obama is about to learn this lesson, as well. But he’s a fast learner. (Prime Minister Stephen Harper is an economist by trade, and so already knows how to cook the books.)

Wall Street, it is said, is “spooked” by the Greek crisis, as the Dow Jones Industrial Average ratcheted up to a 52-week high of 11,309, and then plummeted to a 13% correction, all within the space of eight trading days from April 26 to May 6. As the three-month London Interbank Offered Rate (Libor) climbed again last week, to 0.54%, money managers began to fear repeat of the credit squeeze that characterized the depths of the recession. Libor is a measure of the rate that banks charge each other for short-term loans – at the depth of the credit crisis in 2008, that rate surged to 5.5%. So even while European banks are busily hoarding cash, rather than lending it out, the Libor premium is a long way from indicating a total freeze.

It’s going to take a really nasty chain of events to replicate the conditions of 2008 – something that central banks and governments everywhere are not willing to revisit anytime soon. Though Spain is fast following Greece on the road to perdition (Fitch Ratings downgraded Spanish government debt to AA from triple-A), the freshly-minted EU/IMF debt bailout contraption stands ready to invoke the mother of all moral hazards. Even though Spain, Ireland, and Italy have all supposedly undertaken deep “austerity” measures to bring national accounts back into line, many observers believe that the trillion-dollar backstop won’t be enough. And that suggests an even larger flood of fresh liquidity, in Europe at least, to supplement the actions already taken over the past year or two to keep the EU banking system afloat.

And that’s pretty much what stock markets are discounting at the moment. With many equity market indexes having travelled through at least a 10% correction, and plenty of market doomsayers, like a troupe of cowed medieval monks, yet again ringing in “the end of the world as we know it,” contrarians are starting to at least hint that maybe, just maybe, the whole thing has gotten a little overcooked and that equity markets will begin to surprise on the upside if the EU crisis appears to remain euro-centric.

The macro outlook for growth remains positive virtually everywhere – even in Europe. First-quarter US GDP was revised to 3%, as growth in first-quarter corporate profits at 5.5% slowed somewhat from fourth-quarter growth rate of 8%. Consumer and business spending were also slightly lower in the first quarter than originally estimated, but considerably higher than reported in the fourth quarter. Although job creation is improving, unemployment and high debt loads continue to weigh on overall GDP growth. Canada’s GDP logged a robust 6.1% annualized growth rate in the first quarter.

So although the big North American equity indexes looked to be heading for a down month, for the week, at least, things weren’t so bad. Toronto’s S&P/TSX Composite Index actually gained 1.3% week over week, overcoming softer-than-expected bank

earnings reports. New York's Dow Jones Industrial Average closed just a hair below breakeven on the week, while the S&P 500 Composite Index eked out a tiny gain. Surprisingly, global markets overall gained on the week, as the MSCI World Index climbed about 1% week over week.

There could be a message in that last piece of data, given that Germany's premier automaker, Daimler AG, reported that its luxury car unit Mercedes-Benz said it expected higher-than-estimated second-quarter operating profit, buoyed by strong sales growth, especially in China. If people the world over are buying more German luxury cars, how bad can things be? Well, things can always turn bad in a hurry, once ham-handed politicians start trying to "fix" things – and both the eurozone crisis and the growing tensions in the Korean Peninsula could conjoin into a perfect storm of ham-handedness. At this juncture, there's simply no way to tell, which is why so many investors are busy playing defense. ■

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