

## **The fat finger of fate**

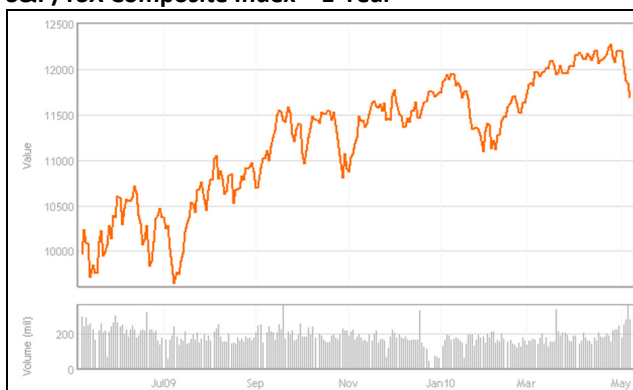
*Sellers push the panic button*

*May 7, 2010* – Last week’s steep stock market plunge left investors wrung out, analysts baffled, and politicians with a whole new reason to thump tubs and sputter with manufactured indignation. A combination of the unfolding euro/Greek debt crisis and some apparent anomalous trading system behaviour in New York led to a sweaty few minutes in global markets last Thursday as the Dow Jones Industrial Average plummeted nearly 1,000 points before bouncing back almost immediately. Ditto for Toronto’s S&P/TSX benchmark and every other benchmark around the world. As the old saying goes, “We hate to tell, but we told you so.”

As we’ve opined in these notes for some time now, equity markets have enjoyed a strong post-recession bull market rally for over a year, without a pause for a correction – thus paradoxically increasing the risk of one with each passing day. Sentiment indicators have been ringing alarm bells recently, warning of an imminent topping of the bullish sentiment that has been driving the markets to date.

In our concluding remarks in our April 30 notes, we observed, “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.”

**S&P/TSX Composite Index – 1-Year**



*Courtesy CTVglobemedia*

As astute observers have noted through the ages, markets exhibit strong herd or swarming tendencies. This time, it took the relentless drumbeat of Greek fiscal “contagion” to spook the herd into a stampede for the exits. Yes, last Thursday’s selloff actually began in Asia and Europe – well ahead of the market rout in New York, as investors switched out of risky positions in favour of the alleged safety of US-dollar-denominated assets.

The 45-minute market collapse in New York appears to have been the result of an erroneous trade order, possibly from Citigroup, where “billion” was inadvertently substituted for “million” on somebody’s order ticket – hence the term “fat fingered” mistake. A sale of that size would automatically cascade into market-wide sell orders as the assorted financial black boxes of “high-frequency” traders kicked in at certain volume, price, or momentum criteria. There’s your *real* contagion! But it doesn’t really matter whether “black boxes” were involved or not. Market blowoffs occur regularly and always have, a phenomenon well documented back to the days of the quill pen. It’s a function of human psychology – not some fat-fingered Princeton-trained “quants” black boxes.

The markets declined very quickly last week, and gold did indeed finish the week above US\$1,200, as the precious metal displays now trades on its historic characteristics as the ultimate store of value.

The odd part about all this – and something that adds at least a little weight to the argument that this episode is really all about a much-needed market correction and not “the end of the world as we know it” – is that the Greek “crisis” is in reality a political one. Greece, after all, comprises just 2% of the European Union economy. It’s a relative drop in the bucket in global terms. A default by Greece on its sovereign bonds would not be the end of the world. Other countries – think Latin America and Asia – have done just that within living memory. Venezuela – the Zimbabwe of Latin America – is even now rapidly spiralling down to that very fate.

The banks with most exposure to Greek debt are European, and these banks are decidedly vulnerable, as the cost of insuring them against credit risk soared last week. The question then becomes enormously political for the Europeans, because French and German taxpayers for the most part will end up both guaranteeing Greek debt through the EU/IMF bailout plan and recapitalizing (that is, bailing out) European banks whose holdings of Greek debt threaten to overwhelm their balance sheets. The political heat may become so unbearable that Greece may well be ejected from the eurozone (stringent fiscal conditions attached to the EU/IMF loans will never be met given the popular mood of enraged entitlement and neo-Marxist sentiment now on display in Athens and throughout Greece), or there may be a sudden change in Greece’s government, which could lead to Greece recusing itself from the eurozone.

The deafening roar of media hype about Greece and its “contagion” drowned out some pretty significant economic metrics here at home. Statistics Canada reported that 108,700 new jobs had been created in April, far outpacing consensus estimates of 25,000, while the unemployment rate fell to 8.1% from 8.2% in March.

In the U.S. employers added 290,000 new jobs in April, 100,000 more than anticipated. The unemployment rate edged up to 9.9%. US productivity also clocked in at 3.6% for the first quarter, still high by historical standards, but down from the 6% to 7% gains posted last year. In addition, the US Federal Reserve reported that consumer credit rose again in March, by US\$2 billion, an indication that borrowing is on the rise as consumer confidence returns despite rising employment.

Rate-hike expectations have also diminished in Canada as investors factored in worries about spreading contraction in credit growth, as the London Interbank Offered Rate (Libor) climbed to 0.43% from 0.29% over the past month.

The S&P/TSX Composite recorded a 4.2% week-over-week loss by the time the dust had settled at Friday's close. And the Toronto benchmark is also now just marginally in the red for the year to date.

New York's Dow Jones Industrial Average posted its worst week since October 2008, falling 5.7% week over week, while the S&P 500 Composite Index declined 6.4%, its worst weekly loss since March 2009. Neither the Dow Industrial nor the S&P 500 are in official correction territory (down 10% from a high), though the S&P 500 is down 9% from its high.

But that is likely just the beginning. It won't take much more high anxiety for the big indexes to register the long-awaited correction. Typical corrections retrace as much as 50% of the previous rally, and this rally has been going virtually non-stop since the first quarter of 2009. ■

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