

That sinking feeling

Markets retreat as data disappoint

July 16, 2010 – The good news was that a key indicator of Canada’s economic health rose more than expected in June, painting a picture of a narrowing output gap and sustained economic recovery. Elsewhere, however, the news wasn’t so good. Investor sentiment turned bearish again, and stock markets retreated on the week, following two weeks of advances.

Statistics Canada reported Friday that its composite leading index rose 1% in June, while consensus estimates had put the advance at 0.7%. Manufacturing and new orders for durable goods both provided some oomph, but both housing sales and new housing starts are declining, and that has cast a shadow over an otherwise upbeat report.

The Conference Board of Canada, an Ottawa-based economic think-tank, said in its Summer Report that Canada has already seen its best growth this year. In other words, consumer spending, which drove the surge in GDP growth in the first half of the year, is on track to slow down as income-growth lags. Government stimulus spending, another key support for the first-half GDP surge, is already being phased out as political pressure increases on governments to rein in runaway deficits – or face the dreaded Greek disease.

The problem facing the Bank of Canada next week is whether to raise its benchmark target overnight rate another 25 basis points, to 0.75% from 0.50%. The Bank has been unusually coy about its outlook, avoiding telegraphing any signals about the need for a continuing series of rate hikes. The Bank is, of course, cognizant of the fact that bond markets have not been pricing in anything of the kind, even though Canada’s robust economic recovery, complete with classic job growth, would suggest the need to start tightening the monetary screws back towards something approaching “normal.”

The consensus expects another 25 basis point hike in the bank rate, and there’s no reason to think that the BoC will back away from its program at this stage. Later in the year, however, it may take a break because of what’s coming down the pike from abroad, mainly from the US.

There, the news isn’t so good.

Uncertainties about US corporate earnings, a widening trade gap, crumbling consumer confidence, falling price levels, sagging retail sales, and a struggling real estate market

are all contributing to a deepening sense of unease about the sustainability of the US recovery.

The US earnings season hit a sour note by the end of last week, after tepid results from General Electric Co., Bank of America Corp., and Citigroup Inc. tested investors' willingness to keep betting on the banking sector. Investors' nerves were stretched even further as the Dodd-Frank financial reform bill got Congressional approval from Democratic majorities in Congress and now needs only President Obama's signature to become law.

The law is expected to add heavily to the already massive regulatory cost-burden carried by financial institutions, and with its conferral of open-ended rule-making authority to a host of agencies is likely to dampen the growth outlook for the entire sector for years to come. It doesn't stop there, of course, because the knock-on effects of regulatory overkill will be felt everywhere, from farmers attempting to hedge crops with derivatives to small businesses trying to access credit.

The US trade deficit widened by 4.8% in May, to US\$42.3 billion, mostly as a result of growing imports from China outpacing only a slim increase exports. The gap is the widest since November 2008. Although growing imports suggest strong consumer demand, it does not augur well for domestic producers. And that's why many US economic growth estimates for the second half were hastily revised downwards last week.

Consumer confidence also took a hit last week, with the Thomson Reuters/University of Michigan index of consumer sentiment sliding to its lowest level since last August. The survey indicated growing pessimism over the job outlook and the risk of a contraction in consumer spending. Retail sales are already showing signs of slowing, with June sales falling 0.5% from May, for a second straight month of decline. But business inventories kept rising in May, raising the risk of an inventory glut if sales keep trending down. It's too early to say whether this is a trend that will end badly, but it was enough to weigh markets last week.

Prices continued to fall in June as well, as the headline (all items) US consumer price index dropped 0.1% month over month from May, for an annual rate of 1.1%. Core prices, which exclude food and energy, remained unchanged at 0.9% year over year.

With the housing market struggling and another million or so foreclosures on the way, according to some estimates, the potential deflationary trend has caught the Fed's attention. And while the Fed has acknowledged a lower-growth environment in the second half, it's unclear how it will respond given that rates are already near zero. The usual tools of quantitative easing and bond purchases to create more money are obvious steps, but there's only so much the Fed can do if the global environment turns south.

Commodity prices dropped in sympathy, and Toronto's S&P/TSX Composite Index gave up all of its gains from earlier in the week, to close at just about the breakeven level for the week.

Not so south of the border, where the Dow Jones Industrial Average lost 1.0% on the week, while the broader S&P 500 Composite Index, which includes all the big financials, dropped 2.9%.

We've cautioned in these notes about the potential for increased market volatility over the summer months, and with the CBOE Volatility Index (VIX) staying stubbornly just below 30, we see no reason to amend our outlook for now.■

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