

## Markets rally in July

*But remain vulnerable to swings in sentiment*

*July 30, 2010* – As the pace of economic growth slows in both Canada and the US, the dire warnings are coming thick and fast. The bearish contingent of the econo-sphere continued to beat the drums for a double-dip recession, while a senior member of the US Federal Reserve Board’s Open Market Committee warned, “The US is closer to a Japanese-style outcome [deflation] than at any time in recent history.” Investors, meanwhile, marched to the beat of a different drummer, as buyers outnumbered sellers through July, propelling stock indexes to some of their largest monthly gains in a year. No dips there, double or otherwise.

Attention focused on the US economy, still the world’s largest by any metric you’d care to mention. There, the pace of economic growth lost some steam, with second-quarter real gross domestic product (that is, adjusted for inflation and seasonal factors) rose at a 2.4% annualized rate quarter over quarter, compared with an upwardly revised 3.7% rate in the first quarter.

Still, the second-quarter growth was not far off the consensus estimate of 2.5%. Weakness in the consumer spending component was thought to be a culprit, rising only 1.6% in the quarter, along with a climbing trade deficit, as imports surged over 28% compared with a 10% increase for exports. The weakness in consumer and business demand has led to speculation of a very weak handoff to third-quarter growth, with, say some of the more bearish analysts, the potential increasing for a so-called “double-dip” recession – another quarter or two of contraction.

Meanwhile, James Bullard, a voting member of the Fed’s Board of Governors and the President of the Federal Reserve Bank of St. Louis, warned in the speech last week of the dangers of a Japanese-style deflation should another negative shock hit the US economy. Most media reports focused on this, highly conditional, part of his rather lengthy comments, including possible Fed actions in the event of a prolonged deflationary episode. That makes for strong, dramatic headlines.

What does not make for high drama, however, is what Mr. Bullard said about what’s most likely to happen. Here’s what he said: “The most likely possibility from where we sit today is that the recovery will continue through the fall, inflation will start to move up, and this issue will all go away.” Note he didn’t say that was the Fed’s most fervent wish or some wild, speculative fancy – he said it was “*the most likely possibility.*” There’s your real headline.

There's no doubt that things will be slowing down in the second half. We've warned as much in these notes, along with a large contingent of our fellow prognosticators in the econo-sphere. But a double-dip is unlikely, as US business investment, up nearly 22% in the second quarter, is expected to continue to support the recovery, and translate eventually into sustained job growth.

In other parts of the world, no one is talking about deflation. Quite the contrary. Heading off inflation is the big story, and last week India joined China, Brazil, and other emerging economic hothouses in tightening monetary policy with a central bank rate increase. With its wholesale price index roaring away at 10.55% in June, the Reserve Bank of India raised its policy rate 50 basis points, to 4.50%, much too little too late, according to some critics. By comparison, Brazil's central bank rate sits at 10.75%.

The contrast between the emerging and developed worlds is quite striking in terms of growth, inflation, and monetary policy. And with the emerging world on the verge of a tightening cycle, the red-hot pace of growth, particularly in Asia, is likely to lose some momentum in the second half. As a sidebar, it appears China has now surpassed Japan as the world's second-largest economy, and expanded at an annual rate of 11.1% in the first half. Even so, risks abound for China, particularly in the banking sector, where there is serious risk of large loan losses arising from some 1.55 trillion yuan of badly collateralized loans.

And speaking of badly collateralized loans, the euro got a lift on positive news from Germany, where unemployment fell to 7.6%, the lowest rate in two years, as consumer and business sentiment surged in July. In another sign that some of the economic pall over the sovereign debt crisis is lifting in Europe, borrowing costs for some of the worst eurozone basket cases, like Spain, Greece, Portugal, and Ireland, have fallen with spreads between German bunds and bonds of those peripheral nations narrowing from recent record highs.

And Canada? Last week's GDP report for May showed a slowdown in output, with strong gains in the goods producing sector, led by oil and gas extraction, offsetting contraction in the services sector, for an overall 0.1% month over month increase. No surprise there, really, as a slowing second quarter was widely expected from the 6.0% growth recorded in the first. And that's a trend that is likely to continue into the second half.

Stock markets rallied in July, overcoming the gyrations generated in May and June by the eurozone debt crisis. For the month, the S&P/TSX Composite Index gained 3.7%, although performance was dampened somewhat by subdued commodity prices. For the week, the index remained virtually unchanged from the previous week's close.

The Dow Jones Industrial Average powered to a month-over-month advance of 7.1%, as solid earnings and an easing of the eurozone crisis restored at least some appetite for riskier assets. The DJIA closed the week with a hairline 0.4% advance over the previous

week's close. The S&P 500 Composite Index matched the Dow Industrials, rallying 6.9% month over month in July, and ending last week just shy of breakeven on the week.

Gold has lost some of its luster, closing July at US\$1,181.40 per ounce, as the fear factor ebbs, stock markets stabilize, and gold mania fades. Indeed, the amount of gold held by funds like the SPDR Gold Shares has dropped from record highs at the end of June, while the number of open gold futures contracts on Comex has fallen 8%. Meanwhile, crude oil for September delivery closed July at US\$78.95 per barrel, virtually unchanged for the week, and just slightly higher on the month.

Stock markets, though perhaps somewhat more stable than in May and June, are still vulnerable to bouts of volatility and quickly changing sentiment, and will continue to be through August and into September. It's no time for complacency. ■

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