

Markets bounce sharply off lows

But summer volatility may not be over

July 9, 2010 – The late Sir John Templeton, the grandfather of value investing, famously said that the best time to invest is at the point of maximum pessimism. We’re not sure whether that point has been reached, but a sufficient number of investors thought so, and went on a buying spree last week. So much so, in fact, that the S&P 500 Composite Index posted its strongest weekly advance in 12 months, after sliding into correction territory from April’s high.

Bearish sentiment has been carrying the day in stock market action, with a heavy global fear factor spurring on a flight to safety through the second quarter. The yet-to-be resolved eurozone debt crisis and its potential ramifications on global recovery led the gloom parade, along with Chinese government efforts to cool red-hot growth, the still-struggling US labor market, and a flattening yield curves as short-term rates rise while longer-term rates stand still. All macro events that spooked investors into lightening up on equities, boosting the price of gold, and putting some backbone into the US dollar through demand for the “safe haven” of US Treasuries. It all added up to a truly crummy second quarter in stock markets – and no equity investor anywhere was immune to the volatility markets displayed in the April to June period.

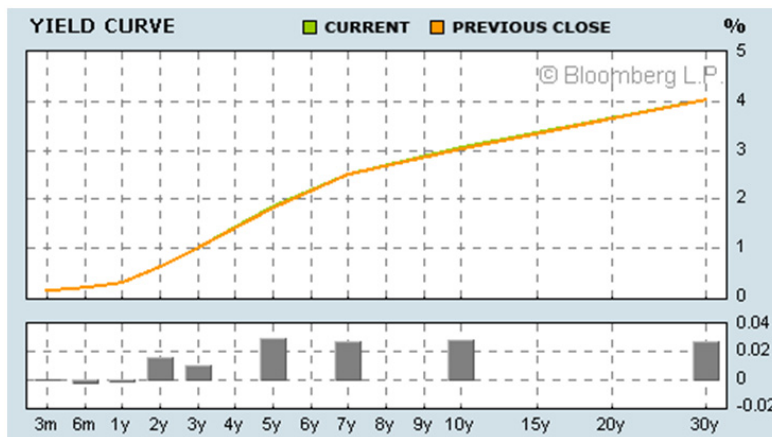
But sure enough, no sooner had the pages of the business media filled with dire predictions of a “double-dip” recession than the markets confound everyone with a powerful rally.

Well almost everyone. In previous commentaries we said that investors would be focusing on macro events until earnings season returned to full swing. We also pointed out that the macro news is not particularly positive, but the outlook for earnings is pretty bright. Last week was all about the market shifting focus from macro events to the upcoming earnings season.

Some suggest that the size and speed underlying the rally was surprising. Although it shouldn’t have been, given the depths of the June swoon, and the fact that fears of a “double-dip” were probably overdone. The question is, does it continue?

From our vantage point, the earnings numbers should keep the markets from being sidetracked by macro events. The underlying economic fundamentals, while slowing somewhat from the first quarter, are not flashing warning signs of a contraction.

Manufacturing indexes the world over are still indicating expansion, though at a less torrid pace. Global trade has surged as Asian economies return inexorably to pre-recession export levels. And although the yield curves have flattened, they remain positive (see accompanying graph) and are not yet anywhere near the levels that have previously signaled the onset of a recession. (A negatively sloped yield curve – where short-term rates are higher than long-term rates – has been a reliable leading indicator of economic slowdown).



So earnings should be driving the market over the next quarter, and because of that, it would be useful to dissect the upcoming season, if for no other reason than to avoid any more shocks to your pocketbook.

Second-quarter earnings are not expected to be as robust as the first quarter. Consensus estimates have been in the order of 20% and 25% year-over-year earnings growth in S&P 500 stocks for the second quarter. Profit warnings through the second quarter have been at a record low, even though pessimism has reached new highs, setting the stage for surprise upside stock market moves in the third and fourth quarters.

A couple of other bits of news helped boost investors’ animal spirits as well. The announcement by the European Commission that the results of stress tests of 91 European banks would be released on July 23 gave investors some hope for a way to quantify European banks’ exposure to PIIGS (Portugal, Italy, Iceland, Greece, Spain) debt. Although there has been some suspicions – mostly from US analysts – that the European stress tests were not as onerous as the ones applied to US banks.

The Agricultural Bank of China also got some attention last week with what was widely touted to be one of the largest initial public offerings in history. With shares listed in Hong Kong and Shanghai, the Chinese government bank is expected to raise more than US\$20 billion. The intense interest by large investors, including sovereign wealth funds, in a notoriously opaque Chinese government organization speaks more, perhaps, about those investors’ faith in the ability of the Chinese government to “run” things than in the usual fundamental analysis that attends IPOs of private companies in more open markets.

Still, that's never stopped investors from being burned badly in less-than-savory foreign markets – Venezuela and Congo being two recent examples.

In Canada, job gains surprised just about everyone last week, with Statistics Canada's announcement on Friday that the economy had created 93,200 jobs in June, with the bulk of growth coming from private sector full-time jobs in the service industries. Over the past five months, an average of 53,000 jobs have been created every month, giving some empirical weight to an argument for sustainable recovery. The unemployment rate dropped to 7.9% from 8.1% the previous month.

The jobs numbers gave monetary hawks more ammunition for their argument that the Bank of Canada now has a free hand to continue normalizing rates, as accelerating job creation suggests economic growth that has evolved beyond the "fragility" stage. In short, these statistics almost guarantee another 25 basis point rate hike by the Bank of Canada at its next meeting.

That view, along with advances in copper and oil, put some oomph into the Canadian dollar, which rose sharply, to US\$0.9674. The S&P/TSX Composite Index rallied commensurately on the week, closing Friday with a 3.3% week over week gain.

New York's Dow Jones Industrial Average surged 5.3% on the week, for its strongest weekly gain since July 2009. And the S&P 500 Composite Index closed with a 4.2% week-over-week advance ahead of what is expected to be a strong earnings season.

It is probably premature to label the stock market bounce from last week's lows as the end of the correction or the resumption of a bull market. Fact is, there's still plenty of summer left...and plenty of volatility.■

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