October rally

More behind stock gains than eurozone pseudo-solution

October 28, 2011 – Since their early-October lows, global stock indexes have seen strong advances. The upside action hews closely to an historic seasonal pattern that sees stocks generally advance from October to about April. Last week's pseudo-solution to the European sovereign debt crisis helped give the big North American indexes a triple-digit boost on Thursday. But the real engine for North American stocks, at least, is more likely to be found in largely positive third-quarter earnings reports, intimations of improving GDP growth, and more talk from various US Federal Reserve officials about boosting economic growth.

Mark Carney, the governor of the Bank of Canada, alluded to financial conditions in both the eurozone and in the US, in comments accompanying the release of the BoC's October *Monetary Policy Report*. That's pretty much the bible on the government's outlook for economic growth and financial conditions both in Canada and abroad. And in this edition, the BoC is pretty downbeat. In his comments, Carney said, "The global economy has slowed markedly," citing the realization of several downside risks identified in the previous report. He added, "The combination of ongoing deleveraging by banks and households, increased fiscal austerity and declining confidence is expected to restrain growth across the advanced economies." All in all, a pretty gloomy outlook.

It gets worse. Carney says the BoC projects a "brief" recession for the euro area, and then adds that the sovereign debt crisis there will be "contained," a base-case scenario that is "clearly subject to downside risks." Again, pretty gloomy, and not a terribly strong vote of confidence in the Europeans actually to solve that crisis.

Eurozone leaders last week seemed to do everything in their power to add some heft to the challenge of those "downside" risks by announcing a detail-free "deal" worth something in the order of €1.4 trillion to bail out Greece and re-capitalize European banks, while including a 50% voluntary writedown ("haircut") of toxic debt held by Greece's private creditors (that is, European banks). It's unclear whether any part of this arrangement will actually come to pass, of course, because detail is notable by its absence. Already rating agency Fitch has weighed in with an opinion that a 50% haircut on Greek debt constitutes default.

So any suggestion of a "relief rally" in equity markets is probably premature. As Scotia Capital economists Derek Holt and Karen Cordes point out in their "Daily Note" on Friday, "…this will not be a straight line trajectory for the risk trade, as volatility plays remain attractive." In other words, don't look for stock markets to keep rising steadily just yet. We agree. Hold off on the celebrations, because the wrangling in the eurozone is far from finished. Let's not forget that the debt crisis has already infected Italy, where Parliament is hammering out austerity programs, literally, as members assault each other in a form of "debate by other means." Spain, too, is waiting in the wings, alms bowl in hand, hoping for a little of that bailout largesse.

Trouble is, there's no one left to borrow from, except those ultimate suckers, the taxpayers in wealthier European countries like France and Germany. And oh yes, add to that the taxpayers in Canada, the US, and other members of the International Monetary Fund, who will again foot some part of the bill for fiscal irresponsibility, bad investment decisions, and moral hazard outside their own borders.

Rumors that China, the third-largest member of the IMF, might somehow come to the eurozone's rescue smack more of desperation than anything else. The Chinese may well be induced to sop up some toxic debt through purchases of bonds from the European bailout fund, but only on terms (most likely involving trade issues) that would be unpalatable to most European countries.

In the meantime, Mr. Carney's prediction for a brief recession in the eurozone is already coming to pass. A key factory index continued to show contraction in the eurozone manufacturing sector in October. The Markit Eurozone PMI Composite Output Index fell to 47.2 in the month, down about two points from September's 49.1 reading for the third consecutive monthly reading below the growth/contraction threshold of 50. Germany's positive reading of 51.2 was not enough to offset the drag from France and other eurozone members already experiencing manufacturing contraction.

Across the pond, however, things aren't looking quite as grim. The BoC acknowledged that the outlook for Canada has weakened owing to troubles elsewhere in the world. But there's no hint of recession in store for either Canada or the US – just a slower growth rate. Indeed, Canadian retail sales rose 0.5% month over month in August, while home resale prices rose to record levels. Consumer confidence eroded in October, however, as the Ottawa-based Conference Board of Canada's consumer confidence index fell to its lowest level since May 2009.

In the US, there was some small reason to be optimistic and the economy posted the fastest growth in 12 months, with output expanding at an annual 2.5% rate in the third quarter of the year. Consumer spending helped drive growth, rising at a rate of 2.4%, while business spending increased at an annual 16.3% in the quarter as companies invested heavily in plant, equipment, and information technology. The trend appears on pace to continue in the fourth quarter, as September retail sales expanded 1.1% month over month, the fastest growth in seven months, while consumer spending rose 0.6% month over month in September. Still, the New York-based Conference Board's index of consumer confidence dropped to its lowest level in two and a half years, suggesting that US households haven't stopped fretting over high unemployment rates, high debt levels, and low home prices.

On that last point, markets may have picked up on some statements made early in the week by New York Fed president William Dudley and Fed governor Daniel Tarullo calling for further action to spur economic growth, including – wait for it! – more purchases of securities. Yes, a couple of powerful Fed inner-circle officials are calling outright for another round of quantitative easing (QE3) to support the mortgage market by buying mortgage securities and pushing rates down.

Markets love easy money almost as much as they love earnings surprises. So any hint that both are in the offing is bound to have a positive effect on investors' outlooks. As of this past Friday, with 323 of the Standard & Poor's 500 biggest blue-chip US companies reporting third-quarter earnings, the news was generally better than expected, with 252 firms reporting higher earnings per share and 60 reporting lower EPS. More telling, and of more interest to the market, is the rate of positive earnings surprises – that is, companies reporting better-than-expected profitability. So far, about 70% of companies have reported positive earnings surprises, while 20% have posted negative surprises. The remaining 10% have been bang on target.

So with some glimmers of light in a gloomy economic landscape, and some pleasant third-quarter earnings news, North American stock markets advanced again on the week, on track for a month of gains.

Toronto's benchmark S&P/TSX Composite Index rose 4.8% week over week, as the loonie approached parity with the US dollar again, and commodity prices advanced for the third consecutive week, as measured by the Thomson Reuters/Jeffries CRB Index. As of Friday's close, for the month to date, the S&P/TSX has gained 7.7%.

The Dow Jones Industrial Average of 30 blue-chip industrial stocks rallied for the fifth straight week, logging a 3.6% advance on the week, gaining 12% month to date as of Friday's close. The broader S&P 500 Composite Index did even better, advancing 3.9% week over week, for a 13.5% month-to-date gain.■

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