

## High anxiety over Europe

### *Third-quarter earnings season waits in the wings*

October 7, 2011 – Some encouraging news on job creation in both the US and Canada, along with signs that the eurozone may be ready to bail out its big banks in the event of a Greek sovereign default, helped give stocks a mid-week boost last week. And after dipping into bear market territory, that was welcome news for investors, whose stock portfolios have taken a beating through most of 2011.

The US employment market went from zero to hero in the space of a month. From recording no job creation at all in August, the US Labor Department's non-farm payroll report surged by 103,000 in September, exceeding the consensus estimate of 60,000. Interesting how 103,000 new jobs is considered a surge when it takes nearly 250,000 new jobs per month just to keep the unemployment rate at neutral. If nothing else, it demonstrates just how low expectations are among investors. And for the record, we really should net out the 45,000 striking Verizon telco workers who went back to work, in which case, the "surging" number actually came in at consensus. Still, it provided some positive news for an economy that many had thought was on the verge of contraction.

Last week the Chairman of the US Federal Reserve Board, Ben Bernanke, telegraphed to the market that he still believes the US economy is teetering on the brink. In remarks made to the Congressional Joint Economic Committee, Bernanke said that the US economic recovery is "close to faltering, urging the White House and Congress to work on policies that will shrink the size of the US deficit in the longer term without wielding the axe too vigorously in the near term." The market took that as a sign that the Fed was willing to stand alone if necessary, and would take further action to stimulate the economy. Can anyone say "QE3"? Although on that note, Bernanke told congress that the Fed has "no immediate plans to do anything like that."

Bernanke's comments also revealed the extent to which the Fed is concerned with the state of the US residential real estate market. Saying, "Addressing the housing market is very, very important," Bernanke stressed that making it easier to refinance household mortgages is a critical aspect of reviving the burnt-out housing market. Developing a strategy for the government-owned mortgage corporations, Fannie Mae and Freddie Mac, which together hold billions of dollars' worth of underwater loans, should be high on the list of government priorities, according to Bernanke. The Fed's own recent efforts in the housing area have included its "Operation Twist," by which it will tilt its portfolio towards long-dated Treasury bonds and increase its holdings of mortgage bonds. (note:

some estimates already put the Fed's portfolio of mortgage bonds at or near \$2 trillion), all with the aim of cutting long-term interest rates.

Mr. Bernanke may have good reasons to be concerned about the strength of the US economy. While manufacturing showed some slight improvement in September, new order books remained worryingly unfilled in the period. The widely-watched manufacturing Purchasing Managers Index published monthly by the Institute for Supply Management showed slight growth in the manufacturing economy for September, climbing to 51.6 from 50.6 in August. The August reading was perilously close to the growth/no-growth threshold of 50, so September's increase was indeed encouraging. But the new orders component of the index continued to show contraction, remaining unchanged from the previous month, at 49.6. The decline in new orders confirms earlier reported declines in both durable and non-durable goods orders in July.

Not to wonkishly belabor the point, but manufacturing is faltering around the world. We note for example, J. P. Morgan's index of global manufacturing slipped below the 50 growth threshold in September, falling to 49.9, as new orders dried up. In Europe, the situation became even more dire, as the Markit PMI fell to 49.3 for September, down from 50.7 in August.

Amidst all this global gloom, let's take a minute to reflect on the Canadian story. Oddly, it's not too bad, all things considered. According to Statistics Canada, a net 60,900 more people were employed in September than in August. As in the US, this number, too, was skewed by a large number of those previously counted as "unemployed" coming back into the job market – in Canada's case, teachers going back to school. The education sector accounted for about two thirds of the September jobs number. The country's unemployment rate inched down to 7.1% from 7.4% in August.

Canadian manufacturing also stood out amidst the general global gloom. The RBC Canadian Manufacturing Purchasing Managers' Index for September climbed to 55.0, up from 54.9 in August. It was the highest reading since April, and "reflected further expansions of both output and new orders," according to an RBC press release.

It's unlikely that Canada will remain insulated for long from the larger global economic headwinds that threaten to slow or stall a recovery. A fact not lost on currency traders as the Canadian dollar has slipped some 10% and currently rests at \$US0.9625.

Those headwinds we refer to are especially pronounced in Europe, where the European Central Bank left its benchmark interest rate unchanged this past week, at 1.5% for the third consecutive month. That raised a lot of eyebrows, considering the perilous state of the European economy compounded by the systemic threat of the sovereign debt crisis.

At least the ECB moved to backstop Europe's financial institutions with low-rate loans for up to 13 months. In addition, the ECB will also purchase some US \$53 billion in "covered" bonds backed by mortgages and other assets. This bank rescue is seen as a critical step in ensuring that bank lending doesn't freeze completely in the

(understandable) absence of private investment. In the meantime, Fitch Ratings cut Italy's debt to A+ from AA, joining both Moody's Investors Services and Standard & Poor's, which had already previously downgraded Italy's debt.

Unlike the ECB, the Bank of England, however, decided to expand its asset purchase program, implementing a second round of quantitative easing in an effort to keep rates down and stimulate consumer demand.

The major North American stock market indexes gave up some gains in Friday's session, as concerns about the European debt crisis overcame a bout of mid-week optimism brought on by some mildly positive data on US jobs and manufacturing. The largely ham-handed response to the eurozone crisis continues to take the steam out of any rally, even though the US indexes ended higher for the week.

Toronto's benchmark S&P/TSX Composite Index flagged enough in Friday's session, led by commodity-related stocks, to push the index into a hairline 0.3% loss week over week. Despite Friday's late-day downdraft, New York's Dow Jones Industrial Average ended with a 1.7% week-over-week advance, while the S&P 500 Composite Index posted a 2.1% gain on the week.

The eurozone crisis continues to be the key driver for markets, but over the next couple of weeks, third-quarter earnings season, and earnings guidance and warnings for the next quarter, are likely to compete for investors' attention. And given the low expectations that are permeating the investor psyche, that may well provide a floor for equity prices and provide the oomph for a pre-Christmas rally. ■

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