

## Stressed out

### *Eurozone crisis stretches investors' nerves*

*November 25, 2011* – Anxiety levels in the halls of power ratcheted up a degree or two last week, if the sudden call for “stress tests” on the big North American banks is any indication. Bond markets applied their own stress tests to European sovereign debt and found it wanting, as the squabble over the role of the European Central Bank between the French and German leaders became increasingly strident. If all that wasn’t enough to stress you out, the big stock indexes lost ground for another week on growing fears of a contraction in US economic growth.

Word of new stress tests on the largest US banks came from the Federal Reserve Board last week. The Fed wants to know how the banks’ loan portfolios would perform in the event of a severe recession. In the “emperor-has-no-clothes” department, it can’t be reassuring to those in the business of advocating increasing state intervention in everything that despite the myriad new regulations implemented on top of the tons of existing ones by the Obama administration since the *last* banking crisis (you know, the one in 2008) that has virtually nationalized the US financial industry, nothing has changed.

Even though multiple government US agencies, boards, and departments, including the Fed, now have vast and unprecedented new powers over the financial sector, they *still* have no idea whether the biggest banks – and there are really only a handful of them – could survive a euro-induced market meltdown. No surprise there. They barely know what’s going on in two of the largest *government*-run lending agencies, Fannie Mae and Freddie Mac, both of which are deeply in the hole.

Never one to avoid a good bandwagon when he sees one, Canada’s Finance Minister Jim Flaherty tabled a proposed new law that would give the government even more power over Canadian banks. The *Investment Canada Act* would not only give the government veto power over foreign investment in Canadian banks but over Canadian banks’ foreign investments. Possibly also how many tellers should attend a retail branch counter during lunch hours. We jest, of course, but only a little.

As for stress tests on Canadian banks, the Office of the Superintendent of Financial Institutions isn’t talking. Canadian banks have very little direct exposure to the eurozone basket cases, a bit more to the United Kingdom, but still not enough to present a significant danger. Still, it’s a good bet that the OSFI is conducting some sort of tests for the worst-case scenario of a complete euro crack-up.

Meanwhile, markets displayed ever deeper investor skepticism over eurozone governments' ability to even find the barn door, never mind lock it after the horse has galloped away.

Germany's Bundesbank was left holding nearly half of the €6 billion in bonds it had offered up for auction, owing to a lack of bidders. Italy managed to sell all of its bonds, but only at the cost of a record 6.5% yield over six months, while 10-year bonds again spiked to yield 7.3% (considered to be the point of no return) on Friday. Portugal's sovereign debt rating was cut to BB+ junk status by rating agency Fitch, just a notch above Moody's Ba2 junk rating. Oddly, as of last week, Standard & Poor's still rated Portuguese sovereign debt as investment grade. And French debt, while still rated triple-A, trades with a risk premium that suggests something slightly less gold-plated, as 10-year bonds yielded 3.7% on Friday.

Stressed to the max, French and German leaders bickered over whether or not the European Central Bank ought to be the lender of last resort, the magic money-printing machine, and the repository for toxic debt. Angela Merkel, the German Chancellor, whose political fortunes hang by a thread, banged her gavel and said the mandate of the ECB to maintain price stability "cannot, absolutely cannot, be changed." François Baroin, France's finance minister, disagreed, saying that intervention by the ECB would be "the best response to avoid contagion," pointing to similar actions by the Federal Reserve, the Bank of England, and the Swiss National Bank – none of which, incidentally, are members of the eurozone, a fact perhaps forgotten by Minister Baroin in all the excitement. Still, the three national leaders of Germany, Italy, and France met on Thursday and announced plans for yet another proposal to renegotiate European Union treaties to allow for closer economic integration and greater fiscal oversight.

Bank of Canada Governor Mark Carney weighed in with reassurances that the Bank of Canada would stick to its inflation-fighting mandate and keep interest rates at near historic lows, propositions that those of the Monetarist and Austrian schools of economics see as manifestly contradictory. In his speech to business mavens in Montreal, Mr. Carney also said of the euro crisis that "acute strains persist." And in what for a central banker passes for near panic, he added, "At this point, the crisis appears barely contained."

While fears of a eurozone implosion, a US recession, and a global slowdown drive Canadian markets lower given the Canadian stock market's broad exposure to resources, earnings for Canadian firms trading on the TSX were actually up 34% year over year in the third quarter. Sales were up some 17.8% for most of the 256 members of the S&P/TSX Composite. Third-quarter sales and earnings for S&P 500 companies similarly surprised to the upside.

The US economy expanded at a 2% pace in the third quarter, instead of the 2.5% that had been initially reported. According to the Department of Commerce, corporate profits rose 7.9% year over year in the third quarter. And the labor market appears to be stabilizing as the pace of layoffs slows and new jobs come on stream, albeit slowly. Consumer

spending is still on the rise, but at a slower pace, edging up 0.1% in October over September. Great hopes are pinned on the holiday shopping season that began with Black Friday last week, as the Thomson Reuters/University of Michigan consumer sentiment index rose four points in November.

All this continues to be cold comfort to stressed investors who steadfastly maintained the “risk-on” trade last week. All the big indexes ended the week in the red, even in New York, where a truncated three-and-a-half day trading week was punctuated by Thanksgiving Day festivities.

Toronto’s S&P/TSX Composite Index fell -3.6% on the week, while New York’s Dow Jones Industrial Average lost -4.85 on the week. Similarly, the S&P 500 Composite Index lost -4.7% week over week.

Whether or not you believe the current market malaise is a “counter-trend correction” or not, the fact remains that the eurozone stress test is still with us, and isn’t about to let up anytime soon.■

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