

Markets sink on Euro turmoil

Slowing growth adds to jitters

November 4, 2011 – A summit meeting of the Group of 20 leaders in the south of France this past week failed to quell investor jitters. A week of enhanced Euro-weirdness saw the big stock indexes slide steeply earlier in the week, never really fully to recover lost ground. And investors remained on edge as the US Federal Reserve Board lowered US growth forecasts, while keeping its finger on the trigger for yet another round of security purchases.

Amid the usual political pomp, posturing, and photo opportunities (what on earth could they all be smiling about?), the non-European G20 members resisted renewed attempts by the European colleagues to expand the role of the International Monetary Fund (IMF) in helping to bail out the eurozone by buying toxic debt from the European Financial Stability Fund (EFSF). At least for now. The efforts by European leaders to ensure that the rest of the world feels their pain is gradually taking on momentum, and has every appearance of becoming a fresh mechanism for them to find political cover for their own massive fiscal incompetence. Still, the Australians, Canadians, and Americans insisted that the Europeans “get their own house in order.”

That won't be easy. After all, the EFSF last week revoked a planned €3 billion bond issue, because there were no takers. Not only is it embarrassing, but it's also disquieting that investor anxiety has precluded, if only briefly, the main Euro bailout machine, backed by €780 billion in sovereign guarantees from the likes of France and Germany, from fulfilling its function – that is, to borrow on behalf of the fiscally homeless, like Ireland and Greece, to whom no sane investor is willing to lend money.

Greece has already *de facto* defaulted on its sovereign debt. The only question that remains is who takes the loss. In a strange way, Greece is already out of the picture, as it has no hope of covering its current debts. Under the terms of the proposed bailout, public debt as a percentage of GDP would decline to 120% in a few years, still deeply in fiscal trouble territory – roughly where Italy finds itself now. The country is basically bankrupt, deep in economic recession, with no one prepared to work, no one to tax, no one willing to pay tax, and no one willing to lend money.

For Greece, the options are limited. It must either accept a bailout and the accompanying ignominy of externally imposed fiscal control, and thus relinquish sovereignty, or it must exit the eurozone and thus admit to default. The government teeters perpetually on the edge of collapse (as we've seen this past week), and the voting public is unwilling to

accept austerity (naturally, because that would imply a far lower standard of living than most have become accustomed to). But the threshold of Eurozone patience has probably already been crossed. And eurozone leaders France and Germany have made it clear that their intention is to defend the euro – with or without Greece.

Meanwhile, the new president of the European Central Bank, Mario Draghi, the former governor of the Bank of Italy, announced a 25-basis-point rate cut, while warning of a “mild recession” in the eurozone. The eurozone is very probably already in a contraction this quarter, and it remains to be seen just how “mild” a contraction it will be, as manufacturing slumps and unemployment climbs. Clearly, Mr. Draghi feels the eurozone inflation rate of 3% will be dragged down by slowing economic growth. If not, then the ECB has entered a new era of disingenuousness, taking it far from its mandate of price stability and low inflation, to something more like the US Federal Reserve, where controlling inflation is but one of its many and conflicting mandates.

The G20 meeting made at least one concrete decision: confirming Bank of Canada Governor Mark Carney as head of the Financial Stability Board, with new powers to regulate the world’s largest financial institutions. Presumably, and unfortunately, that doesn’t include the largest of them all: fiscally reckless governments. Mr. Carney replaces Mario Draghi (yes, the new president of the ECB) in the part-time position. (The central bankers club is a very small one.)

The US central bank essentially made no change to its basic monetary policy last week, leaving the benchmark federal funds rate unchanged at between 0% and 0.25%. It also left unchanged its plans regarding purchases of mortgage-back securities and the so-called “Operation Twist,” by which Fed lengthens the maturity of its bond portfolio.

What the Fed did change, however, was its economic growth outlook. It expects US GDP to grow between 2.5% and 2.9% in 2012, while it predicts that unemployment will remain elevated at between 8.5% and 8.7%. There was also much hedging of bets with talk of “significant downside risks,” concerns about “strains” in financial markets, and other oleaginous baffleb of this sort.

The US economic slowdown is beginning to bite, as manufacturing came close to stalling completely in October, while expansion in the services sector slowed just a notch. The Institute for Supply Management’s (ISM) manufacturing index fell to 50.8 in October, just slightly above the 50 mark, which is the threshold between expansion and contraction. The ISM service sector index edged down slightly, to 52.9 in October from 53.0 in September. Still, 80,000 new jobs were created in October, while the jobless rate inched down to 9.0% from 9.1%. Job creation is still far from what’s considered optimal growth (150,000 new jobs created per month), but the trend is in the right direction.

In Canada, new job growth came to a shuddering halt in October, as the jobs market actually contracted by 54,000 positions. That put paid to any hopes that September’s red-hot growth would become a trend. Job losses were highest in the manufacturing sector, where output has slowed to a crawl (up only 0.8% in the past year). And that doesn’t

bode well for GDP growth in coming months, also dashing any hopes that August's 0.3% month-over-month GDP growth pace will continue into the fourth quarter.

The unsettling eurozone political crisis combined with a lackluster US employment picture to tip investors into a selling mode last week.

Toronto's S&P/TSX Composite Index retreated 0.9% on the week as investors, having already priced in positive third-quarter earnings, began discounting rather less robust earnings going into the fourth quarter. The index advanced 5.4% month over month in October, but remained down -8.9% year to date to the end of the month.

New York's Dow Jones Industrial Average was hit even harder, declining 2.0% on the week, ending October's 9.5% month-over-month rally. For the year to date to the end of October, the Dow Industrials had posted a 3.3% gain. The S&P 500 Composite Index likewise retreated 2.4% on the week, ending a month-long string of weekly gains that saw the index rally 10.8% in October. Year to date, the S&P 500 remained down -0.3% to the end of October.■

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