

## Grinding down

### *Stocks lose ground on euro turmoil, recession fears*

*December 16, 2011* – Canadian stocks fell off the proverbial cliff in last week’s trading, as investors raced to abandon resource issues. The selloff followed an increasingly dim outlook for global economic growth going into the first half of 2012, as yet another emergency summit of European leaders over the previous week again failed to produce any firm resolution of the eurozone’s fiscal implosion.

Most, if not all, of the current market turmoil can be traced to the fuss over how to cure the eurozone’s fiscal mess. With nothing to show for yet another crisis summit on Dec. 9 except a vague agreement to talk about a plan for unspecified austerity measures within an undefined “fiscal compact,” markets remained skeptical of any near-term fix for Europe’s manifold structural problems.

Rating agency Moody’s Investor’s Services, said that the eurozone communiqué “offers few new measures, and does not change our view that risks to the cohesion of the euro area continue to rise.” The agency added that unless credit market conditions stabilize in the very near future, its “ratings of all EU sovereigns will need to be revisited,” something it expects to complete in the first quarter of 2012.

In the same vein, the other big rating agency, Standard & Poor’s, is widely expected to downgrade France’s triple-A credit rating along with a general review of all eurozone sovereign debt.

A debt downgrade implies higher rates on European sovereign refinancing going into the first quarter. And that puts added pressure on peripheral eurozone countries already facing a mountain of de facto unrepayable debt. But it also calls into question the ability of Italy, the area’s third-largest economy, to service its debt at unsustainably elevated rates, which is a much bigger problem looming for the eurozone and the European Union as a whole. In addition, already –stressed banks will have to mark down their European bond holdings creating further losses and making credit market stability even more elusive. The problem is further compounded by faltering economic growth in most every member of the eurozone save Germany. A higher rate structure overlaid on a general eurozone recession will only add to the fiscal stresses that now threaten to crack the euro area apart at the seams.

European leaders meanwhile continue to bicker about possible solutions to the crisis. Germany continues to resist expanding the size of eurozone's permanent bailout fund to more than its current €500 billion, and rejects the idea of eurozone bonds, favoring instead a closer fiscal union with budgetary oversight and penalties with teeth for transgressors. German Chancellor Angela Merkel admitted such a plan could take years.

Unfortunately, the eurozone doesn't have years. As the euro fell 3% last week, dropping below US\$1.30, European Central Bank president Mario Draghi called on leaders to "swiftly implement all those decisions that have been taken to put the euro area economy back on course." That included pledges by EU nations to provide the International Monetary Fund with €200 billion to backstop a bailout of larger economies like Italy and Spain. So far, that pledge has gone nowhere, as Germany resists upping its contribution without similar pledges from non-euro IMF members like the US and the UK, both of which continue to reject such advances. (The US Fed is already supplying US dollar liquidity to European banks through emergency low-interest loans.) The calls to "socialize" European toxic debt worldwide thus continue to grow louder on the pretext that failure to do so would lead to global financial catastrophe. Nothing like the threat of a good catastrophe to focus the mind – and get a few trillion bucks flowing your way.

Whether or not securities markets are pricing in "catastrophe" at this point is an open question. Canadian stock markets were certainly none too happy last week, focusing on the implications of ebbing eurozone growth on the fortunes of Canada's resource sector. A recession in Europe will have an outsized impact on China's growth rate, as Europe is now the biggest market for China's exports. Amongst other domestic issues facing China's economy, declining exports will reduce manufacturing and thus demand for raw materials – of which Canada is a major supplier. The vicious circle is complete, and the stocks of Canada's resource companies, which comprise nearly 50% of the value of the S&P/TSX Composite Index, take a hit, as earnings expectations or cranked down.

Adding insult to injury, Statistics Canada reported last week that Canadian manufacturing sales fell 0.8% in October following three consecutive months of expansion. About two thirds of Canadian manufacturing reported lower sales, with petroleum and aerospace products leading the way. Still, analysts were quick to point out that the \$48.7 billion in factory sales in October were the second highest of the year.

Bank of Canada governor Mark Carney issued yet another warning to Canadians about household debt, which climbed to an average of 150% of personal disposable income in the third quarter. Hardly surprising given the near-record low level of interest rates. Still Mr. Carney frets that "debt fueled household expenditure" could leave Canadians vulnerable to external financial shocks – code for a eurozone crackup.

On a brighter note, the Organisation for Economic Co-operation and Development last week said its composite leading indicator for Canada showed a slowing pace of decline, even as the CLI for most other member states pointed to severe slowdowns elsewhere and recession in the eurozone.

Meanwhile, US stocks also fell last week, as the Federal Reserve Board stuck to its near-zero rate policy, but avoided any mention of easing long-term rates through additional purchases of securities. The Fed said that while modest US expansion continues, “strains in the global financial markets continue to pose significant downside risks to the economic outlook.” US consumer price inflation stayed at an annual 3.4% in November, owing to a decline in energy prices. Core prices, however, which include volatile food and energy, rose to 2.2%, the highest since October 2008.

Despite the risk overhang from Europe, then, the US economy is displaying signs of continuing recovery, with growing bank credit and commercial loan demand picking up the slack from a still-moribund housing market as a source of growth. In addition, claims for jobless benefits keep falling to new lows, while the unemployment rate dropped to 8.6%, the lowest for two and a half years.

Regardless, the European theatre commands investors’ attention these days, and this past week was no exception. Commodity prices continued trending down as recession anxiety grips the markets. Gold futures dipped below US\$1,600 per ounce and crude oil futures slipped to US\$93 per barrel during the week. Toronto’s S&P/TSX Composite Index closed down -3.3% on the week as a result. In the US, the Dow Jones Industrial Average lost -2.6% week-over-week, while the S&P 500 Composite dropped -2.8%, as investors continued to focus on eurozone troubles – something they’ll still be doing well into next year.■

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