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Central banks' intervention ignites market surge

December 2, 2011 – Relief rallies come and go. But last Wednesday's was a doozy, as investors cheered the big Western central banks' coordinated effort to keep eurozone and other vulnerable banks liquid. Stock markets in the US were further buoyed by a successful "Black Friday" shopping weekend combined with evidence of renewed job growth. And better-than-expected third-quarter Canadian economic growth helped along by resurgent commodity prices helped power a single-day 4% surge Canada's benchmark stock index.

Faced with a growing US dollar funding crisis among European and some Japanese banks, the US Federal Reserve Board, the Bank of Canada, the Bank of England, the Bank of Japan, the Swiss National Bank and the European Central Bank announced a plan that allows central banks to swap their domestic currencies for US dollars on an emergency basis at a reduced rate. The central banks then are able to lend those US dollars to banks and other institutions that need short-term cash absent other normal sources of short-term funds.

The fact that the world's leading central banks stepped in to provide an emergency source of funding to keep the big European banks operating was enough to spur some of the biggest single-day stock market rallies since 2009. Understandably, because now that it's in place, that backstop of liquidity isn't going away anytime soon, moral hazard be damned.

The essential problem still hasn't gone away, as the punditocracy was quick to point out last week. Greek, Italian, Portuguese, and Irish sovereign debt still fouls the balance sheets of European banks, and sooner or later, someone's going to have to take a "haircut" on the worst of that paper. Markets don't really care one way or the other how the junk debt is covered, just so long as it is, and preferably as close to par as possible. That's clearly not going to happen, of course, so the next best thing is to have as many taxpayers of as many of the world's richer nations as possible foot the bill. And that's the stage where the euro sovereign debt crisis is now.

As in 2008, when excessive private risk became socialized in the US following the collapse of investment banker Lehman Bros., so too now excessive sovereign risk in the eurozone is slowly but surely also becoming socialized, first through Europe, but increasingly on a global basis. The ever deeper involvement of the International

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Monetary Fund, the leading Western central banks, and the growing financial hegemony in the eurozone of Germany as the region's remaining solid fisc attest to this.

The European Central Bank is under intense pressure to increase purchases of toxic sovereign debt and issue joint Eurobonds to stabilize yields and thus financial conditions through the eurozone while political issues are hammered out. But German Chancellor Angel Merkel has been adamant in opposing any immediate, massive ECB "quantitative easing" without full budgetary and fiscal oversight of eurozone members. The devil is in the details, of course, and one man's full fiscal oversight is another's loss of sovereignty. So far, the ECB has resisted any escalation of bond buying, while ECB President Mario Draghi exhorted eurozone members to work hard to create a "new fiscal compact."

The mid-week market surge reflected investors' hopes that the central banks' intervention last week would kick-start those serious negotiations for a tighter eurozone fiscal union ahead of a key meeting of leaders on Dec. 9. But time is running out, and both political and economic options are dwindling by the day.

Japan, some of whose banks are beneficiaries of last week's emergency currency swap arrangements, may also be on the verge of a sovereign debt crisis. The International Monetary Fund warned last week that any spike in Japanese bond yields could render Japanese debt unsustainable, and could result in the withdrawal of liquidity from global capital markets as bond yields rise elsewhere.

In the US, meanwhile, markets got an extra boost from the consumer spending front, as November's "Black Friday" shopping weekend appears to have been a resounding success. In fact, Black Friday, the day that US retailers' income statements finally show a profit (i.e., go into the black) seems to have turned into a chaotic shopping spree at most larger destinations, despite the best efforts of pepper-spray-wielding matrons and outnumbered security guards. The day saw a 16.4% increase in sales from the same day last year. Sales for Cyber Monday, the online equivalent of Black Friday, minus the pepper spray and elbows, rose 22% from the previous year. The big jump from 2010 sales speaks to increased consumer confidence going into year-end.

That sense of confidence also got a boost as the US Labor Department reported that payrolls increased by 122,000 positions in November with most strength in the private sector, while the unemployment rate dropped to 8.6%, the lowest in two and a half years. In addition, the Fed reported "moderate" growth in 11 of its 12 districts in November, supported by growth in manufacturing and consumer spending.

In fact, manufacturing grew in both the US and Canada in November, in sharp contrast to contractions in most other regions around the world. The RBC Canadian Manufacturing Purchasing Managers' Index posted a reading of 53.3 in November, while the US Institute for Supply Management's Manufacturing Index rose to 52.7. Any reading above 50 indicates growth in the sector. Canada's gross domestic product grew at a 3.5% annual pace in the third quarter as manufacturing and energy exports led growth. While the surge

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comes off a second quarter that saw a very slight contraction, and is thus not expected to continue at this pace, it does indicate that a recession is not imminent here.

In an indication of a growing economic disconnect between North America and other regions, manufacturing most everywhere else is contracting. Markit's Eurozone PMI fell to 46.4 in November from 47.1 the previous month, while HSBC China PMI dropped to 47.7, a 32-month low. So concerned is China about the slowdown in its economy that its central bank is easing bank reserve requirements for the first time in nearly three years, a sign of loosening monetary policy and an indication that the government is focusing on attempting to avoid a "hard landing" and restoring growth.

After that eye-popping mid-week advance, stock markets hung fire for the rest of the week, as initial enthusiasm over the central banks' intervention failed to carry momentum into a sustainable rally. But at least the big indexes didn't immediately slide back to their pre-bounce levels and finished the week virtually flat.

Toronto's benchmark S&P/TSX Composite Index gained 5.3% week over week after that 471 point surge on Wednesday. For all of November, then, the S&P/TSX nearly broke even, losing only -0.4% month over month, while still remaining underwater -9.2% for the year to date.

New York's Dow Jones Industrial Average also finished ahead on the week, advancing 7.0%. For all of November, the DJIA gained 0.8% and remains ahead 4.0% year to date.

The broader-based S&P 500 Composite Index rose 7.4% on the week. That gain helped the index nearly break even on the month of November, finishing the month with a hairline -0.5% loss. Year to date, the S&P 500 is now down only -0.8%.

The fundamentals of North American businesses remain relatively strong, a fact obscured by the incipient panic that's ignited by every daily word and deed from the eurozone. The risk-off trade in North American equities has undoubtedly created value in many sectors, while pushing valuations in non-cyclical defensive stocks to levels that probably are unsustainable. Any hint of resolve by the eurozone governments to exorcise the debt demon could see a surge in stock indexes that would eclipse last Wednesday's runup. The risk, naturally, is that such a hint may not be forthcoming anytime soon, leaving markets to wallow in uncertainty for awhile longer.■

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