

## Closing the books on a volatile year

*Equities lag, fixed-income advances, risk reigns*

*December 30, 2011* – Equity investors may be forgiven for saying “good riddance” to 2011. Investors suffered through gut-wrenching market gyrations through most of the second half of the year as the one-two punch of the devastating Japanese earthquake and the European sovereign debt debacle topped the list of events that weighed on markets. The big US indexes ended mixed for the year. Unfortunately, Canada’s resource-heavy market was pretty much nibbled to death by ducks as commodity prices trended steadily downward after peaking in late April.

Which of these trends is likely to continue into 2012? Probably all of them. Broad economic and financial trends are no respecters of arbitrary calendrical divisions, like New Year’s Eve. So we don’t have to gaze too deeply into the crystal ball to predict that the eurozone debt problem will continue to be the main preoccupation of financial markets well into 2012.

Indeed, it’s become like an engrossing soap opera – a series of unbelievable events, driven by an almost cartoonish cast of characters, in a seemingly never-ending series of cliff-hanger endings. You really couldn’t make this stuff up! The good news (if you can call it that) is that the eurozone problem will eventually be resolved without a complete crack-up of the euro. Some sort of complicated two-tier monetary system will most probably be implemented as euro members work towards a tighter fiscal union to ensure stricter financial discipline among member states.

The immediate concerns over European bank liquidity are being addressed both overtly and covertly. Overtly, through European Union, European Central Bank, and International Monetary Fund intervention, including an increase in the European bailout fund and, sooner or later, a mandate for the ECB to purchase more debt and perhaps issue its own. Covertly, through US dollar swap arrangements between the Fed and other central banks, ostensibly to ensure a sufficiency of US dollar liquidity to cash-starved European banks, but ultimately, as we’ve observed in these notes, to serve as an international sluiceway to globally socialize eurozone toxic debt. The process is already underway, and will continue through 2012.

Meanwhile, European economic growth has stalled out in the fourth quarter of 2011 and will very probably contract in the first half of 2012. A recession in Europe has broader global implications, especially among emerging nations like China and Brazil, a large portion of whose exports flow into Europe every year. A symptom of recession, of

course, is weaker demand for the kinds of consumer goods produced by emerging nations, which will have knock-on effects on their GDP growth rates in 2012.

China is already wrestling with a slower pace of growth and the only question now is whether the country will experience a “hard” landing (defined for China as annual GDP growth rate below 7%) or a “soft” landing. The jury is still out on that one, and with a change in Chinese political leadership in the offing, it’s really futile to attempt any sort of prediction. Still, we would hazard a guess that Chinese demand for raw materials is likely to be constrained by a softer international trade environment, though it might find some support through stockpiling of selected commodities.

One thing that won’t slacken is the increasing size of China’s international investment through state-owned or controlled entities. Canada’s energy and mining sectors are prime targets for Chinese takeover, and it remains to be seen for how long Canadian provincial and federal governments will allow shadowy foreign state-owned enterprises to lock up vast tracts of Alberta’s oilsands or mines in BC, Quebec, and Newfoundland. Recall the fuss over BHP Billiton’s ultimately unsuccessful efforts to take over Potash Corp. of Saskatchewan, and BHP is a private resource company, traded on global stock exchanges.

The trouble is that the expected slowdown in global growth is increasing the risk of continued underperformance by the Canadian stock market. Heavily weighted to both resources and financial issues, Toronto’s TSX has, through 2011, sailed straight into the headwinds generated by declining commodity prices and the risk-off trade afflicting global financial stocks in general. That trend is likely to continue as well, for as long as the global slow-growth no-growth trend exerts downside pressure on raw materials and the eurozone financial system faces the threat of a liquidity freeze.

The US economy, however, is growing. That’s good for Canada, of course, as the US is our largest trading partner by far, notwithstanding the meme that has taken hold in some quarters of the government, business media, and the econo-sphere that growing trade with, say, China will offset Canada’s huge trade reliance on US markets. Perhaps, if a massive tectonic plate slip in the Pacific suddenly butts China up against Vancouver Island. Until then, for Canada, the US is the only game in town.

It is, therefore, encouraging to see that US consumer confidence hit an eight-month high in late December as reported by the New York-based Conference Board. That upbeat report can be traced to improvements in the labor market as applications for unemployment benefits in December plunged to their lowest level in three years. Another facet of the consumer revival is a budding recovery in the all-important US housing market. While prices remain low, sales volumes have been climbing, as has new home construction, driven by lower long-term mortgage rates – in turn a result of recent efforts by the Fed to up its purchase of mortgage securities to force down rates.

In a separate report last week, the Federal Reserve Bank of Richmond reported increasing manufacturing activity in the Atlantic region for December, following a lackluster November.

The divergence in US economic growth from Europe and Asia is striking. It's a theme that will continue through 2012, as the US once again shows that it's a mistake to underestimate its economic resilience.

Risks remain hovering, however. And they're big ones. A political blow-up of some kind in the eurozone is the main one casting a shadow over estimates, predictions, and forecasts. The other one is a ratcheting up of tension in the Middle East, primarily from Iran, which spent much of last week telling anyone who would listen how "easy" it would be to block the Strait of Hormuz, through which much of European and Asian oil supply flows. The US has already said it would not tolerate any blockade of the Strait, and sent a carrier group through the channel last week to deliver a pointed message to the mullahs. They got the message. Still, there's a risk that the price of oil could spike well above US\$100 per barrel if tensions in the region increase, and that would have a decidedly negative impact on economic growth.

For 2011, then, the performance wrap-up is mixed.

Toronto's S&P/TSX Composite Index advanced 0.2% week over week in the final few days of trading in the year. That shallow advance wasn't enough to overcome a -2.0% loss for the month, a -2.8% loss in the fourth quarter from the third quarter, and an overall -11.1% retreat for the year.

The Dow Jones Industrial Average lost a bit of steam in the final week of the year, closing with a small -0.6% week over week retreat. However, that didn't detract from its 14% surge for the month, its 11.9% advance for the fourth quarter, and an overall 5.5% gain for the year.

The S&P 500 Composite Index also dropped -0.6% for the week, but managed a 0.8% gain for December for an 11.1% surge in the fourth quarter. For the year, however, the S&P dipped just slightly below the waterline, with a hairline loss of -0.1%.

Nymex Light sweet West Texas crude oil ended the year up 8.2%, with a powerful 25% rally in the fourth quarter. For the month, though, crude dropped -1.4%, and ended the year at US\$98.94 per barrel, retreating 0.7% on the week.

Comex gold ended the year at US\$1,564 per ounce, down -2.6% on the week, -10.4% for the month, and off -3.6% for the fourth quarter. For the year, however, gold is still ahead 10% overall, making it one of the best-performing assets for the year.

The other top-performing asset class, of course, was fixed-income. The DEX Universe Bond Index had posted a gain of 9.6% for 2011.

Happy New Year to all! ■

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