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No cars from Oprah

Tepid growth weighs on US markets

May 27, 2011 – One thing you would not have heard about on Oprah Winfrey's final syndicated daytime TV show this past week was any mention of US gross domestic product. Of course, that subject very rarely, if ever, came up for discussion. Too bad, because there was plenty of angst and hand-wringing about the tepid rate of US first-quarter GDP growth. The question, to put it in daytime tabloid TV terms, is whether the US economy needs intervention or rehab.

The answer is that it's getting both. The US economy grew a paltry 1.8% in the first quarter of the year, a sharp comedown from the 3.1% expansion recorded in the last quarter of 2010. Braced by the Federal Reserve Board's second round of quantitative easing (that is, money creation through vast purchases of new US Treasury debt), and a federal funds rate officially near 0%, consensus economic forecasts (insofar as such a thing is possible, given the number of "other hands" economists have) called for GDP growth of roughly 2.5% to 3.5% in the first quarter. The Fed's continuing "intervention," while possibly averting an even worse GDP reading, appeared to have no identifiable impact on growth.

Curbed enthusiasm in consumer spending is said to be the main culprit in first quarter's underwhelming growth. What really curbed things, though, was that spike in gas prices. More discretionary money went into gas tanks, leaving less for all those other doodads people like to buy.

Industrial production also slowed somewhat as the Japanese earthquake threw pretty much the entire interlocked global supply chain into disarray for a time. The effects of that are still echoing in the global economy, particularly in the developed world (yes, Canada too), where the outlook for stronger second-quarter growth has also dimmed considerably.

The emerging world is wrestling with its own problems of rising inflation, undervalued currencies, and in many cases, overheating economies (China is a prime example of this triple threat). A couple of big fund managers recently significantly – and very publicly – reduced their funds' exposure to emerging market equities. It's always dangerous to draw broad conclusions from only a couple of specific cases, but the message seems to be the emerging market stocks have had their run, and sentiment will soon sour, as inflation remains a problem and growth strains the limits of capacity.

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No such problem in the US or Canada. Consumer prices in the Great White North continued to rise at an annual 3.3% rate in April. Take out price increases for food and gas, however, and the "core" rate of inflation rose at an annual rate of 1.6%, down slightly from the 1.7% recorded in March. Because it's the core rate that concerns the Bank of Canada most, right now it's an even bet as to whether the BoC will raise rates or not in July. The Bank's own most recent target estimate of 1.4% for second-quarter core inflation remains below actual readings. On the other hand (see note on economists' hands, above), retail sales seem to be flagging, with March sales remaining unchanged from February but with sales volume declining. With such wishy-washy data coming in, and especially with further tepid US readings expected in the second quarter, the Bank of Canada is under no particular pressure to raise its target overnight rate. But at this stage, who knows? Economists have many hands, and the Bank of Canada is heavily populated with the breed.

In Europe, the unraveling of the eurozone continues, albeit at a glacial pace. European banks are stuck with US$143 billion in junk Greek government debt that no one wants. They'll take more than a "haircut" if Greek debt is restructured (that is, if Greece essentially declares itself bankrupt and unable to pay creditors). The Greek government is still selling off assets and cutting spending in an effort to lure back interest from the bond market. Meanwhile, "hidden" debt keeps being uncovered in Spain, which is rapidly joining Greece on the road to ruin. Portugal and Ireland? Same story, different language. European Union politicians and central bankers remain at an impasse, as stronger governments, like Germany, increasingly resist further bailouts. A "reprofiling" (i.e., a rescheduling of payments) of Greek debt, in which private-sector creditors would join eurozone taxpayers in taking a hefty loss, is the latest scheme making the rounds. Whatever the plot, this is one story with no happy ending whatsoever.

The Canadian stock market once again rallied on the week, as a weaker US dollar and strength in commodity prices drove mining shares higher. That strength overcame softness in the financial sector (the other big noise in the Canadian stock market) after the big banks generally disappointed with lower-than-expected quarterly earnings reports. The S&P/TSX Composite Index advanced 1.1% on the week, as a result.

The less than glowing economic data south of the border weighed on Wall Street again last week, as the Dow Jones Industrial Average retreated 0.6% on the week, while the S&P 500 Composite Index dropped 0.2%. Both the big US market gauges have now lost ground for four consecutive weeks in a descending pattern of lower highs and lower lows.

If the pattern continues, markets could be in for a bumpy ride this summer. And we can't even count on Oprah to give everyone a new car.■

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