

## The not so merry month of May

### *Stocks retreat as economic fundamentals fade*

*May June 3, 2011* – The Internet company mini-mania might be reaching a peak. What other conclusion can you draw when Internet companies with not much more than an interesting business model and a pretty website come to market looking for equity financing – and get it instantly. To the tune of hundreds of millions of dollars? And while all that hoopla is going on, stock markets lose ground, the economy fades, and the outlook dims. Something definitely wrong with that picture.

Internet deal billboard and coupon distributor Groupon Inc. filed for an initial public offering this past week. Okay, maybe that's not so strange. What's strange is the speculation about how much the company is seeking with its offering. Reports have circulated that Groupon is looking for between US\$750 million and US\$1 billion. That would value the company at around US\$20 billion given. Pretty rich for a company that lost US\$413 million last year and another US\$114 million in the first quarter of this year. But get this: Revenues climbed to US\$645 million in the quarter! That's a lot of coupons. Groupon should be making money – or at the very least breaking even.

Same story a couple of weeks ago with LinkedIn Corp., which came to market wearing not much more than a big smile. The career-oriented social network company posted net income of only US\$15 million in all of 2010, on revenue of US\$243 million. The IPO at US\$45 per share disappeared in a flash. No matter. Crazy investors quickly bid up the price to US\$94 before coming to their senses. LinkedIn recently changed hands around US\$77.

Now we hear that Zynga Inc., a maker of games (including, yes, poker) for the social network site Facebook, is also ready to file for an IPO this month. Financials aren't public yet, but the company is reported to have net income of about US\$400 million in 2010, on revenue of US\$850 million. We'll see.

And, speaking of Facebook Inc., the mightiest of the social network sites is busy pumping up the market for a possible gazillion-dollar IPO early next year.

There is more than a little of the “triumph of hope over experience” feeling about all this. While first-class passengers up on the Internet deck break open the bubbly, things aren't quite as rosy down in the engine room. Hewlett-Packard Co. and Cisco Systems Inc., two rather large high-tech hardware outfits you might have heard of, have been having a

tough time getting up a head of steam. In fact, earnings estimates and guidance keep getting revised – downwards.

Unfortunately, that's not the only thing getting revised down.

US factories, which had been humming along nicely for quite some time now, sputtered in May. The Institute for Supply Management's manufacturing index plunged to 53.5 last month, from a reading of 60.4 in April. A level of 50 is considered the threshold between growth and contraction in the sector. May's reading was the lowest in two years.

Home prices south of the border dropped 4.2% in the first quarter of the year, according to the S&P/Case-Shiller home price index. The index has posted declines for eight straight months, raising the spectre of a double-dip real estate crash in the US. This is really, really bad news, because residential real estate is really the cornerstone of so much of America's wealth. Steeply declining home equity not only curbs consumer spending on household goods but also puts an increasing number of homeowners underwater with their mortgages, when properties are worth less than the mortgages on them.

And that reverberates through the entire economy. Already, consumers are feeling the effects. The New York-based Conference Board reported this past week that its closely-watched confidence index dropped to 60.8 in May, from 66.0 in April. That's already being reflected in job-creation numbers, as only 54,000 new non-farm jobs were created in May, far less than the 150,000 that had been expected. Unemployment notched up to 9.1% from 9.0% in April.

To top it all off, ratings agency Moody's Investors Service warned of a possible review of America's prized Aaa credit rating unless the US debt limit crisis is resolved. Unless Congress raises the debt limit, the government will exhaust its borrowing authority by Aug. 2, according to Treasury Secretary Timothy Geithner. No fear there. One thing governments are good at is printing more money.

US Treasury yields, meanwhile, dropped last week, with 10-year notes falling below 3%, indicating increasing concern about the health of the economy. Although the current round of quantitative easing is slated to come to an end this month, the Fed has given no indication of any plans for a third round (QE3), despite deteriorating economic fundamentals.

As goes the US, so goes Canada. The new RBC Canadian Manufacturing Purchasing Managers' Index, which debuted just his past Thursday, fell to 54.8 in May from 56.3 in April, joining a general global decline on the assembly lines. The Bank of Canada wisely kept its target overnight bank lending rate at 1.0%. It also said that "some" of the current monetary policy stimulus will "eventually" be withdrawn. That caused a bit of a media flap for awhile, for no really good reason, when you consider the BoC prefaced its remark with the proviso that such stimulus would be "eventually" withdrawn "to the extent that the expansion continues and the current material excess supply in the economy is gradually absorbed." Ho-hum.

Despite the razzle-dazzle IPOs from the social network, stock markets maintained their trek south last week, continuing the trend from May. Indeed, May wasn't a very merry month for stocks at all, as all of the big indexes posted declines.

Toronto's S&P/TSX Composite Index slipped 2.0% for the week, extending the 1.0% loss posted for the entire month of May. To the end of May, however, Toronto's benchmark remained ahead 2.7% for the year to date.

New York's Dow Jones Industrial Average closed last week with a weekly loss of 2.3%, also extending May's month-over-month loss of 1.9%. For the year to date to the end of May, the DJIA remained well ahead, however, up 8.6%.

The S&P 500 Composite Index dropped 1.9% on the week, following a 2.1% month over month retreat in May. For the year to date to the end of May, the S&P 500 still recorded a gain of 7.0%.

The Internet IPO balloon might not yet have finished inflating. After all, there's still Facebook and Twitter to contend with. But expectations have almost certainly been driven beyond "reasonable." And an overextended balloon can pop at anytime. Declining stock markets might just be getting the pin ready.■

**Please [visit](#) our website for more timely information on the markets, financial planning, and new products from R.N. Croft Financial Group Inc.**

[www.croftgroup.com](http://www.croftgroup.com)