

Markets retreat

Another bear or a classic buying opportunity?

August 5, 2011 – For awhile these past couple of weeks, the “debt ceiling crisis” in Washington dominated media attention. The show unfolded with the clockwork precision of kabuki theatre, replete with furrowed-brow *bon mots* by legions of pundits seeking sound bites interlaced with inane “man-in-the-street” type comments from bewildered taxpayers collared by marauding camera crews.

But theater it was, and always will be, when politicians gather in the limelight, huffing and puffing, full of sound and fury, signifying nothing. We pointed out several weeks ago in these notes that there never was any doubt that the US debt ceiling would be raised at the eleventh hour, and it was. Unfortunately, Washington’s summer stock provided a serious distraction from the very real crisis unfolding in Europe. And that landed on markets last week like a rotten tomato thrown from the cheap seats.

It’s impossible to tell what will trigger a market rout. Last week’s stampede for the exits from equity and commodity markets around the world coincided with the resolution of the US debt ceiling show, increasing signs of a global economic slowdown, and the failure of the European Union to contain or even slow down the debt contagion spreading through the eurozone.

“Contagion” may be the wrong metaphor. Instead, it might be more useful to liken the European debt crisis to the famously slow lava flows from Sicily’s Mt. Etna, which move at much less than walking speed, but destroy everything in their path nonetheless. Now picture the European Union as a Sicilian farmer attempting to divert the implacable lava with a piece of plywood and a couple of two-by-fours.

For instance, the prior week’s band-aid fix to forestall Greek sovereign bankruptcy was quickly eclipsed as Spain and Italy lumbered into the emergency room for triage. The European Central Bank had just announced a resumption of its sovereign-bond purchase program (quantitative easing, by another name), but badly misread the consequences of its exclusion of Spanish and Italian debt from that program, focusing instead on stocking up on worthless paper issued by Ireland and Portugal.

Bond markets reacted predictably, selling off Italian and Spanish bonds, pushing up yields to levels unsustainable for sovereign debt of the third and fourth-largest economies in the eurozone. The yield on 10-year Italian government bonds rose to 6.2% last week, a 14-year high. Lenders, it seems, are not entirely convinced that either Spain or Italy can

get their respective fiscal houses into order in a timely manner, putting their ability to pay up at risk.

Neither Spain nor Italy are “peripheral” eurozone members. And Italy, with GDP 50% larger and debt at more than two and a half times the size of Spain’s, is very simply beyond the power of the European Union’s current emergency fund to bail out. If it gets to that stage, Italy may, in fact, be altogether beyond the power of the EU to rescue.

Bond investors (mostly the behemoth financial institutions) quickly set sail for safer harbours and landed at the mouth of the Rhine, shoveling up piles of German bunds (government bonds) they found there. That demand contributed to rising prices (and lower yields) for bunds, widening the yield spread between German and Italian debt even further, to 370 basis points.

As the eurozone entered the life-or-death phase of its existence as a monetary union, the world’s investors were beset by yet more unnerving news. This time, on the fundamentals. Growth, it seems, is flagging everywhere.

In the US, the Institute for Supply Management’s manufacturing index for July fell to 50.9 from 55.3 in June. A reading of 50 marks the threshold between growth and contraction, so July’s reading comes perilously close to shrinkage in the manufacturing economy. And in fact, the ISM’s measure of new orders did drop below the threshold, to 49.2. A similar reading for the services sector dipped to 52.7 in July from 53.3 in June.

The ISM surveys pretty much echo the US economy as a whole. In the second quarter, US GDP grew at a pallid 1.3% annual rate, following a near-stall of 0.4% in the first quarter. Still, the US economy added 117,000 jobs in July, up from 46,000 in June. While not enough to shoot the lights out, the job creation numbers outstripped most consensus estimates for the month. The unemployment rate, however, edged down only slightly, to 9.1%.

But the output retreat isn’t unique to the US. Everywhere around the world, manufacturing gauges have been falling into contraction or near-contraction. Europe’s manufacturing index fell to a near-threshold 50.4, while the UK’s index at 49.1 indicated contraction. In China, the official manufacturing index (always suspect) dropped to 50.7, while the more reliable HSBC PMI dropped to 49.3. China’s reading is particularly worrisome, because it confirms other signs of slowdown in the world’s second-largest economy, and joins a general declining trend in most other emerging markets.

Stock markets declined steeply on the week as the fear factor took its toll. The S&P/TSX Composite Index retreated 6.0% week-over-week, mainly on a slide in commodities, led by crude oil, which dropped to near US\$85 per barrel, before recovering to US\$87 by Friday’s close.

In New York, the Dow Jones Industrial average lost 5.7% on the week, and the S&P 500 Composite retreated 7.2% on fears that a faltering US economy would depress earnings through the second half.

And it could get worse before it gets better! After the markets closed on Friday, Standard & Poor's cut the US credit rating to AA+ plus from AAA. Despite the fact it was a widely expected move, it could have wide-ranging consequences.

The most significant issue is how a rating change may impact interest rates. If the US government has to pay a higher rate to borrow across US\$14.4 trillion in debt, that will take money away from other government programs.

It could also affect the cost of consumer loans. Since US bonds are considered risk-free investments, other borrowers – i.e., corporate loans, consumer loans, mortgages – typically pay rates that are priced off the risk-free rate. If there is an increase in the risk-free rate, all other loans rise accordingly.

There could be implications for global stock markets. Although, given last week's performance, any short-term reaction will likely be muted. Medium and longer-term may be a different story. US politicians are clearly antsy about the downgrade and fear a voter backlash. Not that we should expect anything else...like, say, doing what is best for the country. In the end, the risk of political backlash may be enough to force leaders into taking a stronger stance against the deficit. Given the fragility of the US economy, this may not be the best time to rein in spending.

Some analysts think that it will draw into question the value of the US dollar as a safe haven investment. These analysts point to the move towards other "more stable" currencies like the Australian dollar, Swiss franc, and to a lesser extent, the Canadian dollar

All of these things are possible. But from our vantage point not likely. We could get a sell-off next week, but longer term we cannot believe that anyone will forego US bonds just because they are rated AA+. Furthermore, S&P is the only rating agency to actually issue a downgrade. Both Moody's and Fitch maintained their highest credit rating for US debt.

I also doubt that there is any real risk that the US dollar will lose its status as the world's reserve currency. By definition, a reserve currency must be liquid. And in this game, only the euro comes close to the depth of liquidity available in US dollars. Does anyone seriously think the euro is a better reserve currency? Make no mistake, if we get a serious selloff in the markets, investors will rush to buy US dollars.

Another factor to consider if you are seeking direction is to look at the CBOE Volatility Index (VIX), which closed at 32 (up 35%) last week (see Chart 1 below). The VIX is our favorite fear gauge, and to look at it, one would have to assume that a bear is crashing

around in the woods, telling us that it is time to abandon hope, sell stocks, and move into cash, which yields...nothing!

The problem with that logic is that volatility is typically viewed as a contrarian sentiment indicator. Which is to say, spikes in the VIX tend to coincide with market bottoms.

Chart 1: CBOE Volatility Index (VIX)



No question we have moved into correction territory, which incidentally had been predicted by a number of pretty smart analysts. And now, some of those same players have been touting the selloff as a classic buying opportunity. Credit Suisse Group AG and HSBC Holdings Plc, for example, are looking for a significant stock rebound in the second half advising clients to buy in anticipation of a rally in the S&P 500 of as much as 16% from current levels by the end of the year.

With nearly all S&P 500 companies having reported quarterly financials, both corporate revenue and earnings are up 13% from the same period a year ago, according to Yardeni Research. What's more, the S&P 500 forward price/earnings ratio is around 13, below the long-term average of 16. A number of analysts have raised earnings estimates for the S&P 500. Strong earnings and estimates often combine with low (oversold?) prices for a potentially good buying opportunity.■

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