

## **Mr. Bear comes calling**

### *Perilous third quarter for equities*

*September 30, 2011* – After weeks of speculation, parliamentarians in Berlin last week voted to increase German taxpayers’ exposure to worthless Greek sovereign debt by approving a near-doubling of the lending capacity of the eurozone bailout fund. Stock markets around the world rallied early in the week in giddy anticipation of the vote, while happy eurozoners metaphorically high-fived and chest-bumped each other all over the place on the result. All that relief is likely to be as short-lived as it is misplaced.

As pointed out repeatedly in these notes and in other journals of sober economic thought, the fundamental structural problems that led to the current euro-crisis have hardly even been addressed, let alone solved. At the heart of the problem is the absence of any political mechanism that ensures compliance with the fiscal discipline that member countries of the eurozone swear with a solemn oath to uphold – and that most immediately break.

The unfortunately mis-named “troika” of Europe Union, European Central Bank, and International Monetary Fund auditors charged with examining (really, “re-examining”) the Greek government’s financial records were faced with assorted stick-wielding state “workers” at various government offices, and were last week prevented, at least temporarily, from carrying out their duties. (“Troika,” of course, is the term attached to extra-legal panels of three Communist party faithful that were convened to hasten the execution of political prisoners during the bloody era of Stalinist purges in the Soviet Union. No wonder the Greeks don’t want anything called a “troika” poking into their business!) The “troika” had already been driven out of Greece once before, and are able to stay now only because the next tranche of European bailout money depends on their auditorial presence there. It’s a heck of a way to run a country, a currency union, or a trade zone!

Rushing in flying squads of auditors is no substitute for workable – and enforceable – fiscal controls. Absent such controls, richer countries in the union will be trapped in an endless loop of backstopping worthless sovereign debt, no matter which way it’s sliced and diced. (You may recall what happened not too long ago when high-risk sub-prime US mortgage debt was “securitized” and transformed by a lot of financial legerdemain into triple-A rated assets.) Greece will undergo a “controlled” default. Can Portugal be far behind? And after Portugal?

It is a truth, universally acknowledged, that national fiscal control works only when parochial interests are subsumed to a larger political entity led by its strongest elements. As the revival of a continent-spanning Bismarckian Prussian empire is highly unlikely, the days of the eurozone, and perhaps of the European Union itself, at least as now constituted, are numbered.

Anyone who still believes in the continuing viability of the “European experiment” must now be seen much as those who argue that proof of the essential seaworthiness of the ill-fated ocean liner *Titanic* was thwarted only by the fact of its sinking.

While the Greek tragedy played out more as *opéra buffa* in all its glorious farce in the European theatre, investors still took time last week to consider some of the more mundane aspects of economic life. Some of those aspects didn’t look particularly promising for the economic growth, and thus threw a bucket of cold water on Tuesday’s relief rally.

In the US, the New York-based Conference Board’s consumer confidence index remained nearly static in September, at 45.4, up only slightly from the 45.2 posted in August. No surprise there, given that unemployment remains stuck above 9%, while the housing market is showing only a pallid recovery, with the 20-city S&P/Case-Shiller Home Price Index rising only 0.9% in July from June. And just to add that extra piece of evidence that not all is quite right on the home front, orders for durable goods (like fridges and cars) edged down 0.1% in August after a 4.3% jump in July.

One glimmer of light on an otherwise dark horizon was an increase in non-defense capital goods orders, which rose 1.1% in August, after a dismal 0.2% performance in July. The August increase suggests a greater willingness by business to start deploying some of that balance sheet cash hoard in something other than share buybacks. If the trend continues – and it’s still a big “if” – it could signal an upside surprise in the pace of GDP growth in the final months of this year. And if the Fed’s recent “twist” operation to reconfigure its Treasury holdings to the long end of the maturity spectrum indeed results in the removal of at least some interest rate risk from the market, it could goose the mortgage market into some semblance of life as well. That would do a lot to improve consumer sentiment.

In Canada, signs and portents indicated only marginal improvements. Prices for manufactured goods rose unexpectedly in August, by 0.5% from July, owing mainly to higher prices for vehicles, and the decline in the value of the loonie against the greenback through August. Like their US counterparts, Canadian consumers seemed only slightly more confident in September as the Conference Board of Canada’s index of consumer confidence rose to 75 from 74.7 in August. Wage growth remained flaccid, as non-farm weekly earnings grew at an annual pace of only 2.2% in July, the slowest since January 2010.

While this agglomeration of small datapoints doesn’t appear to be cause for either alarm or rejoicing, we note that copper, the bellwether industrial metal, has pretty much fallen off the table this month, as prices for December futures contracts plunged 25%, closing

September at US\$3.15 per pound, for an overall loss of 27% on the quarter. That's considered a bear market. And since copper is used in everything, it's often seen as a leading indicator of broader economic activity, and thus something of a crystal ball for stock market performance. Adding weight to the argument is crude oil's retreat, as November futures closed September at US\$78.62 per barrel, dropping 11% on the month for a 17% retreat overall in the third quarter. If you buy into that theory, then it really is time to batten down the hatches.

Of course any "battening down" would ideally have been done back in April, at market highs. But hindsight is always 20-20. Equity markets have been on a downslope since then, with third-quarter retreats pushing most into true bear-market territory – that is, at least a 20% drop from recent highs.

As such, the big North American indexes are all in the red for month, quarter, and year-to-date periods. Last week saw something of a rally early in the week, as euro-sclerosis got a dose of Warfarin, but that began to wear off almost as soon as it was administered. End-of-quarter portfolio fiddling by funds and institutions added to the general volatility.

Toronto's benchmark S&P/TSX Composite Index advanced 1.4% week over week at Friday's close. However, the index was down -9.0% month over month, -12.6% quarter over quarter, and -13.5% year to date.

New York's Dow Jones Industrial Average finished the week with a 1.3% advance from the previous week's close. But the Average was down -6.0% from the previous month, -12.1% from the previous quarter, and -5.7% for the year to date.

And for the week, the broad-based S&P 500 Composite Index was the odd man out, retreating 0.4% on the week. Month over month, the S&P 500 dropped -7.1% from August's close, and retreated -14.3% from the previous quarter. Year to date, the index is down -10.0%.

We'd like nothing better than to pronounce comfortable market vapidity like, "It's always darkest before the dawn." Yet with the terrible uncertainties of the eurozone hanging over the global financial markets, and with economies sputtering to stall-pace almost everywhere, we're not yet entirely convinced that it's gotten as dark as it's going to get. So our hatches, at least, remain battened. ■

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