It appears as though the warm summer that most have been anticipating is finally upon us as temperatures here in the Okanagan and most of Western Canada are now reflecting the late spring/early summer heat. As the mercury moves higher, unfortunately, the same cannot be said about the equity markets. Indeed over the past few weeks, global markets have once again been riddled with another round of selling pressure. This has led to a spike in volatility and a reemergence of the “perma-bear” crowd with their ultra-negative prognostications.

The primary cause of this can be attributed to recent events that have unfolded in the Euro zone including the unexpected outcome in the French presidential race, the troubled Greek parliamentary elections, as well as fears that the Spanish banking system is in need of support (re-capitalization). To quickly recap; the victory of the anti-austerity candidates in the French elections has brought into question not only the appetite for fiscal discipline and much needed reforms in areas of Europe, but also the ability to get deficits and debt levels under control. As for Spain, it now finds itself in a position where its banks require a capital infusion (read; need more money) in an environment where unemployment is skyrocketing and negative economic growth and rising inflation are the prevailing trends. In economics textbooks this is known as a deflationary environment and quite simply central bankers worst nightmare.

As pressures have begun to build over the past few weeks, bond yields in the Euro region have moved higher (recall: higher yields reflect a lack of confidence in the issuing country) with Spanish bonds moving upwards of 6%. Italian bond yields have followed their Spanish counterpart and have also moved considerably higher. To put this into perspective, Canadian & US government issued 10 year bonds are trading with yields of approximately 2%!! Clearly, investors are finding comfort in North America and avoiding Europe en masse. As a result, many are feeling that we are on the verge of another serious market correction similar to that of last summer when equity markets fell 15-20% peak to trough. Now, although anything is possible, we do not feel the likelihood of such an event will occur.

As recently stated by Raymond James Strategist Andy Maclean, “Last year Europe was cracking at the seams under the combined weight of a banking crisis and real prospect of default that threatened the Euro as a currency and the entire economic union. Since then, several policies have been enacted serving as backstops and to assist in lessening the strains on the system. First of all the banking system has been recapitalized and provided with ample short term “money” from the LTRO. That the banking system continues to function is a major departure from last year.
We can see this by looking at the inter-bank lending market (the market in which banks lend funds to one another; left graph below) as well as the market for US dollars. The second departure from last year is there is no imminent threat of widespread sovereign defaults (right graph). While Greece has debt payments of about 500 million Euros this month, authorities say they have sufficient resources to pay even if European central banks withhold bailout funds.”

The main takeaway from the French elections is that confidence in the Eurozone as an economic region is fading. As evidence, many are pointing to the success of fringe parties, both left and right, who either want to renegotiate bailout terms or exit the union altogether. But this success of fringe parties we feel is more a reflection of voter dissatisfaction over austerity and the economy, rather than loss of confidence in the region. Even in Greece, the majority of the population (70%) wants to remain with the Euro. While the Greeks may want to lessen the focus on austerity and concentrate on growth, no party has been given a mandate to govern let alone exit the Euro (Greeks will most likely have to return to the polls next month). Despite the rhetoric over the need to renegotiate bailout terms established last year and the rapid change of governments over the past few months, things are pretty much status quo in Europe as far as the political landscape is concerned.

Bottom line is that while risks remain elevated, they are nowhere as bad as last year. Once election rhetoric calms (after next month’s French Parliamentary and Greek elections) attention should return to focusing on budgets, debt and growth. As that happens, we expect market volatility to subside.

Digging deeper into North America, the spillover from Europe is undeniably having an impact on our equity markets. Topping out in early May at 12,332, we have seen the TSX Composite Index fall approximately 6% (as of Tuesday May 15, 2012), which by our pencil, this is a “normal” market correction. Certain sectors within the composite are experiencing sharper pullbacks including the energy complex (oil & natural gas), materials stocks and precious metals related securities. These sectors have been some of the leading segments of the market when the uptrend had been in place. We believe this falls into the stereotypical “risk on, risk-off” trade that you hear so often in market commentaries. When investors feel confident in the markets, they are flocking to perceived “riskier” assets, yet selling these same investments when pessimism sets in. Look no further than the U.S. dollar, bonds, money market funds etc. and you can see how quickly sentiment changes.
As stated in past commentaries, within our toolbox of indicators that we follow, sentiment serves as an invaluable gauge. Not surprisingly, the current “feeling” of the investing public is that of extreme negativity. Look no further than the headline news; “Market Meltdown Coming”, “Its 2008 All Over Again”, “Batten down the Hatches”, “Sell in May and Go Away.” For some the fear or thought of another serious market correction may be too much to take. Certainly, I can feel for these individuals as the market environment we have experienced over the past few years has not been for the faint of heart at times. That’s why we believe it is important to ALWAYS review your objectives, time horizon and goals during emotionally challenged times. And let’s face it – remaining objective in an emotionally charged market environment is nearly impossible for most investors. Consequently, they make the wrong investment decision at the exact wrong time. Our technical tools and analysis keep us objective and instill the discipline to make those tough investment decisions.

Speaking to timing, I once again offer the following chart that I so often reference during my conversations with investors at times like this. One doesn’t have to dig too deep to conclude where most investor’s thoughts are at this time.

In summary, the evidence based on our indicators strongly suggests a market rebound is due sometime this week. Currently, the markets are deeply oversold and when readings of such extremes are so dominant, the market generally moves in the opposite direction. Although we do not like to experience corrections (much like our clients), we have to remain cognizant of the fact that these are part of overall market cycle and are to be expected. If our thought process does not play out as expected and further downside action is seen, we will re-address our outlook and determine our game plan going forward. At that time, we will notify our clients.

Once again, we want to thank you for your continued support and trust in allowing us to manage your financial affairs.

Sincerely,

Craig White

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