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Second Quarter 2010

At the end of June, the old stock market saying “sell in May and go away” seemed like bankable advice, with most stock markets posting double-digit losses since their late April peak. But then they rallied better than 5% in the first week of July, their biggest rally in a year. Volatility is back.

My favourite new jargon this quarter is “Flash Crash”, coined to describe the May 6, 2010, stock market meltdown (high frequency traders use so called “Flash” orders that can be displayed for up to 500 milliseconds). In a lightning descent that seemed to last maybe 10 minutes, the Dow Jones Industrial Average’s decline grew to 9.8% at the worst, and 3.2% by the end of the day, on 19 billion trades, many executed in milliseconds. Bizarre quotations and bizarre transactions, only some of which were later cancelled by the authorities, abounded. For example, on some electronic markets, shares of Procter and Gamble tumbled by \$22.79 or 37%, at one point, to \$39.37 (but not on the New York Stock Exchange which after a 5% decline, switched P&G to trading by slow humans who, unlike computers, had some non-artificial intelligence).

The “Flash Crash” brought back memories of “Black Monday”, October 19, 1987, when the Dow crashed 20% in a day. The “Flash Crash” was at first attributed to a “Fat Finger” or a mistake in data entry. On examination it appears now that both the “Flash Crash” and “Black Monday” were led by a wave of futures selling. The slide in futures caused stocks to fall, leading to even more selling of futures. Intense selling pressure led buyers to pull out, creating an air pocket in stocks.

One point of difference is that Exchange Traded Funds (ETFs) didn’t exist in 1987. As the Wall Street Journal’s Scott Patterson reported (May 18, 2010):

Heavy selling of ETFs spread losses to other parts of the stock market like a virus. The value of many ETFs actually fell to pennies. About two-thirds of all securities that had cancelled trades Thursday were ETFs, according to Index Universe.com... In today’s market, quantitative, computer-based strategies that trade baskets of stocks based on historical relationships can propagate a trend in one part of the market to another almost instantaneously!

“Black Monday” and the “Flash Crash” were both preceded by a year of strongly rising stock prices. But this spring macro-economic concerns were again rising. Credit Default Swaps today are implying a 55% probability that Greece will default in the next 5 years and an over 20% probability that Portugal, Ireland, Spain and Italy will.

Focus on more serious fiscal challenges in Europe have put a bid under the U.S. dollar. Briefly at parity with the Canadian dollar in April, it rose to \$1.06 Cdn. in May after the “Flash Crash”. Also for government guaranteed bonds. Ten year U.S. treasury yields went from 4% in April to less than 3% in late June. Government bond prices are now priced for near-depression, not recession (but let’s not rule anything out) despite the precariousness of the U.S. government’s fiscal health. It is ironic to some (e.g. bond guru Bill Gross of Pimco, see his July letter “Alphabet Soup”) that, when fearful, investors pile into the perceived safety of the U.S. dollar and U.S. government bonds.

Corporate balance sheets may be in their best shape in decades, and many companies are boosting dividends. In my April letter I described our investment strategy of emphasizing dividends on stocks, which are competitive with bond yields, and of emphasizing particularly rising dividends. Another way to think of the return on stocks is the earnings yield. Barron’s (July 3) recently pointed out “ that the gap between the earnings yield on the S&P 500 -- earnings divided by the index’s value -- of 8% is five percent points above the 3% yield on the 10 year Treasury note... historically, when the gap has been this wide, the average one year return on the S&P has been 26.1%. The last time the gap was so wide was in the late 1970s.”

The S&P 500 is now where it was in 1998. Perhaps investors prefer government bonds with miniscule yields because after two crashes and several minicrashes, they are worried that, for risk versus reward, there is a “fat left tail” to the bell curve (that is, a small but larger than normal probability of a significantly negative outcome).

In my January letter, after months of rising stock prices, I observed that when the “risk trade” is on, investors “hurry” into stocks, emerging markets, copper, the Canadian dollar, and oil. During the Olympics my 4 year old and I called “Go Canada”. On the July 1st weekend, when I started to muse about this letter, the market had had a rough couple of months. The “risk trade” was off. Young Matthew and I were learning the national anthem. Go Canada had become Ohhh Canada.

Sincerely,
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Portfolio Manager

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