BREWIN DOLPHIN

MARKET STRATEGY

INVESTMENT RESEARCH

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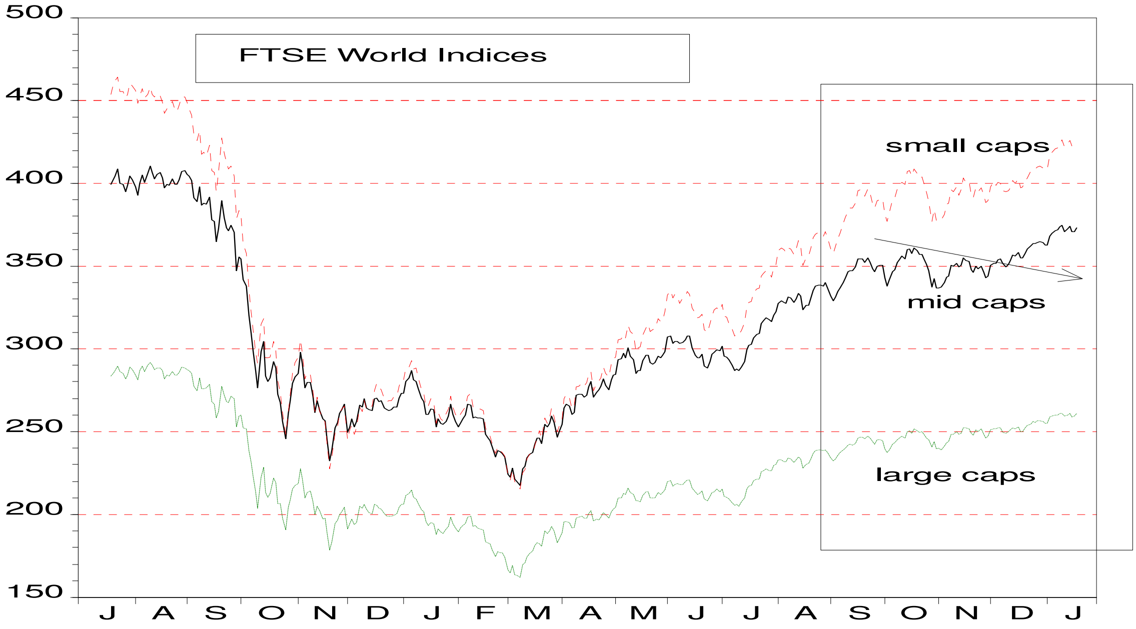
Mid caps regain momentum in equity markets – a bullish sign?



Source: DATASTREAM

Late last summer and in the early autumn I started commenting on what looked like a significant development for equity markets, namely a loss of market leadership. Briefly, not only had the financials, which had been leading the markets' recovery, lost momentum but also no other major sector had taken over the lead. The observation that the markets were 'leaderless' was particularly relevant in the UK – where the equity market is dominated by a large cyclical (Mining), a couple of large defensives (Oil & Gas, Pharmaceuticals) and a large financial (Banks), all with lots of international exposure.

Towards the end of the year attention was also drawn to the loss of momentum in the second liners, a feature judged to be indicative of a loss of breadth in equity markets. By then the Miners had taken up the running in terms of sector leadership but I still thought that the underlying tone of equity markets had changed and that it was right to be cautious.

Well, the point has yet to be made. My 2010 year-end FTSE 100 target was reached on the very first day we all got back to work in the New Year. Yikes!! So what now?

Whether strong seasonal or turn-of-the-year effects alone have helped push up world equity markets remains to be seen but the interesting feature, shown in the chart, relates to the mid caps (and the small caps) which have regained momentum. Once again they are outperforming the large caps, as the chart over leaf shows, suggesting, once again, a lowering of risk aversion thresholds.

It is not unusual for second liners to lead a bullish phase in market activity. The second liners led the markets' recovery from the dot com bust that got under way in the spring of 2003 and they also led the recovery from the March 2009 lows – along with the financials. Thus, a decisive break through that resistance in the chart could be quite a bullish signal, which might encourage investors to clamber on board the momentum band wagon. In terms of the FTSE 100, we could be talking about a level of 6000 or higher by year end. However, a failure to get through the resistance could also mean that what lies behind the move in equity markets is the turn-of-the-year-effect, which may be running its course. This would then be another reason for caution.

That said, equity markets are reluctant to give up any ground and the bit they do – when they do – is seized on as an opportunity by ready buyers. Also, any caution on the markets needs to be viewed in the context of fundamentals that are still supportive. Equity markets may not be cheap but they are not dear either. Earnings estimates are continuing to be upgraded on the back of more confidence in the outlook for global growth. Indeed, consensus forecasts for GDP growth continue to be revised up. And while this suggests that the major central banks are expected to get a start later in the year on altering their policy settings to something less 'easy', we're still likely to be talking about interest rates remaining exceptionally low even if they rise by 50 or 100 basis points.

As for the policy initiatives by China's central bank, equity markets appear to be taking the view that a shift to something only modestly less accommodating is welcome on the grounds that first, the intention is to take the heat out of the more steamy or speculative areas of the economy and that second, the overall thrust of policy remains directed towards sustaining the expansion of domestic demand. What equity markets are not doing, at least not yet, is focusing on the directional change in monetary policy that is likely to become more apparent as the year progresses.

So I suspect we will just have to keep an eye on the chart and go with the flow on this one. From the looks of it, we'll know which way to go soon enough!

Source: DATASTREAM

IMPORTANT NOTES