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MARKET STRATEGY

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INVESTMENT RESEARCH

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A rebound in equity markets – but it could soon exhaust itself.

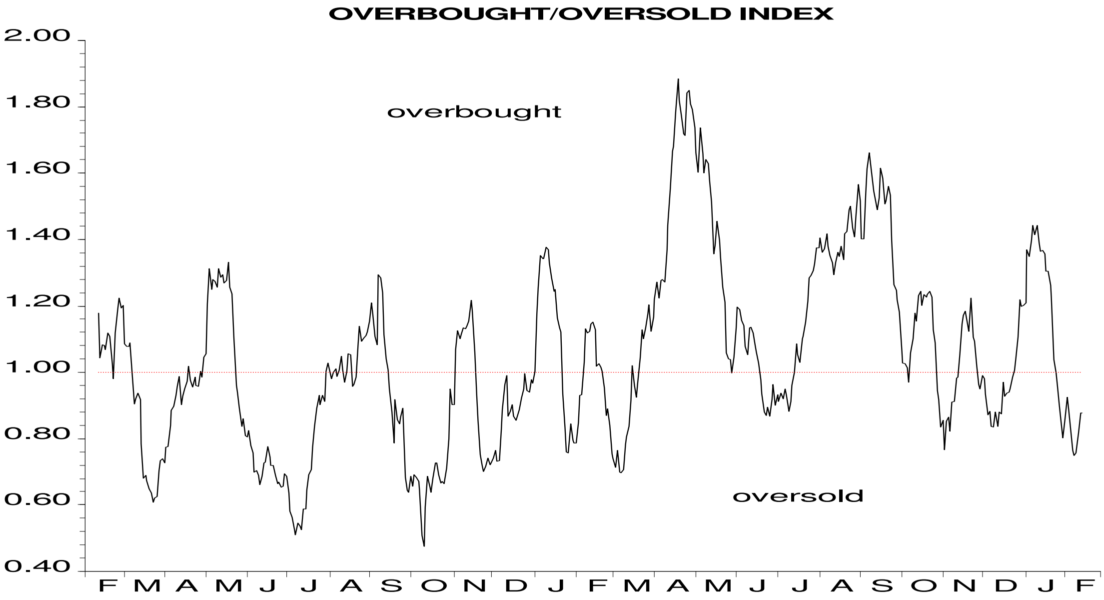
Source: DATASTREAM

An eight percent plus sell-off from the FTSE 100's January peak is a decent enough correction at one go and it would not be unreasonable to expect a rebound, but the index as well as other leading indices look vulnerable to further profit-taking. While the relative strength indicator (say the 14-day RSI) suggests the FTSE 100 is oversold, various other overbought/oversold indicators, such as the one shown overleaf for the UK equity market, does not register anything like an extended oversold condition. That could suggest that any attempt to rally might be exhausted rapidly.

Also, concern about sovereign debt, notably though not exclusively within the European Union, appears to be coming through to the high yielding end of the market for corporate debt, an area of the bond markets that tends to be acutely sensitive to the winds of change. As the lower chart on the next page shows, the spread has been widening over the past few weeks. Considering where these spreads have come from and the extent of the collapse seen over the past year or so, the recent move is nothing to fret over – yet – but it bears watching for the lead it might provide on the outlook for the global economy and the merits of the recovery that is under way.

In terms of broad sector dynamics, the Financials, led by the Banks, have continued to underperform, thus sustaining a trend that has been developing for a while. Cyclicals, led by Mining, have made little relative progress since the start of the year. Meanwhile, Growth led by Technology, and Defensives led by Tobacco and Electricity, have been outperforming.

On the issue of sovereign debt, any helpful clarification from EU Finance Ministers on assistance for Greece is likely to be well received by the markets and could mitigate some of the concern, but they – the markets – are also starting to focus on China's gradual but determined approach to policy normalisation. They are also likely to get a fix on the Fed's exit strategy. A first step is expected to be a rise, shortly, in the discount rate, thus opening up the spread with the Federal Funds rate. Although the Fed Chairman has indicated that such a move should be viewed in the same light as the phasing out of various lending facilities, the markets are, nonetheless, likely to reflect on what will come next. Against a backdrop where expectations for GDP growth continue to be revised up, the FOMC's message that '... economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period', could begin to look a little stale.



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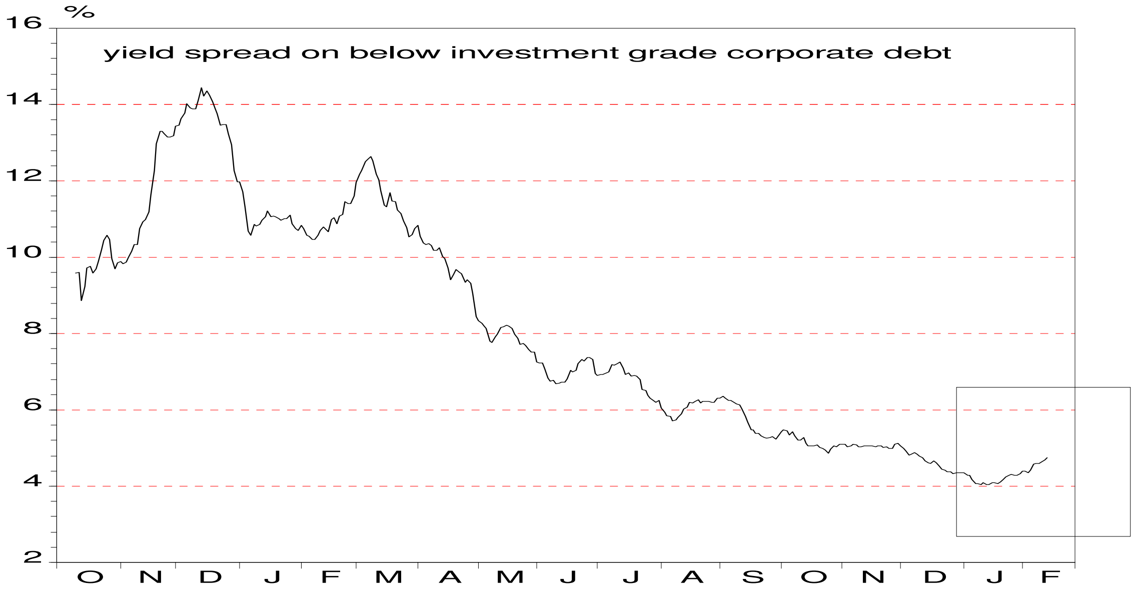

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IMPORTANT NOTES