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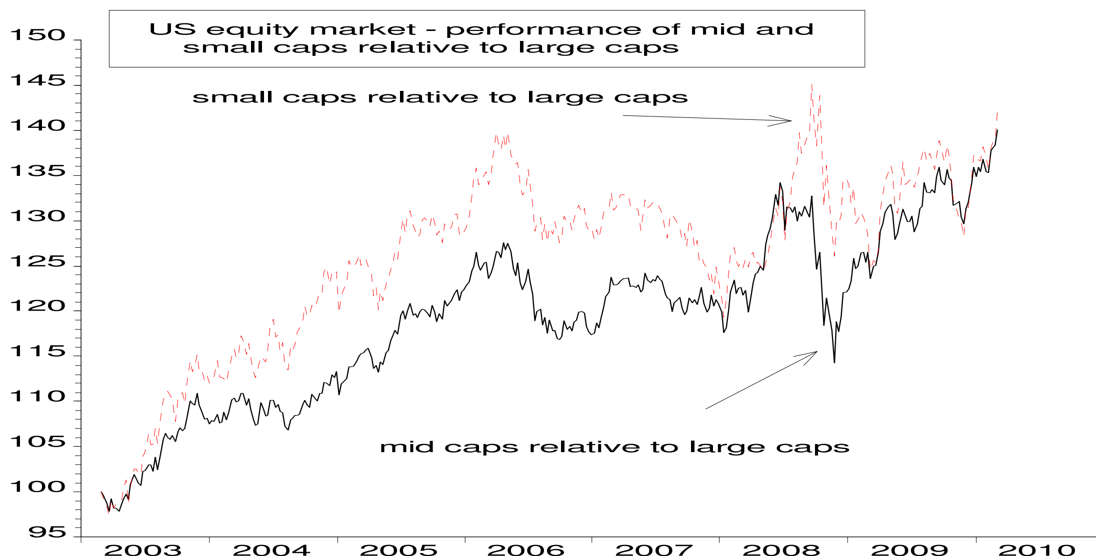
New relative highs for mid caps – a bullish sign.



Source: DATASTREAM

Greece and sovereign debt have been receiving lots of attention but one of the more interesting and less fussed about developments is depicted in the chart, which shows the performance of the mid and small caps relative to the large caps for the US equity market. Over the past few weeks, the mid caps have shot up to new relative highs. While the small caps are not far from new relative highs, they have still risen to new relative highs for the year. These are probably the most bullish signs around for equity markets.

Generally – not always – second liners and smaller companies tend to be more cyclically geared and, because of this, higher beta situations. Also, they tend to be more exposed to the domestic economy than the large blue chips. The rise to new relative highs for the US mid caps reflects the conviction that the recovery is coming through to the domestic economy. The job numbers may not yet show this but the US equity market reckons the jobs are coming, which means more consumer spending and more good news ahead for the corporate sector. Certainly, things are beginning to look that way.

For a start, expectations for GDP growth have been revised rapidly upwards for the US economy. According to Consensus Economics Inc., forecasters expect US GDP to grow by nearly half a point more in 2010 than they did at the end of last year. For Japan, the eurozone and the UK, consensus forecasts for GDP growth for this year are no higher than they were at the end of 2009.

Importantly though, much of the upward revision in the consensus forecasts for US GDP growth for this year appears to come from a more favourable outlook for consumer spending. Driving this is a more favourable outlook for employment. Indeed, the ISM (Institute for Supply Management) Surveys for the US show that employment is among the components to have registered the biggest gains over recent months.

Also, the story is not just about better than expected growth in US corporate earnings; it's about where the surprises are coming from because no longer are they due just to cost cutting and restructuring; the US recovery is beginning to come through to top line growth for companies, as the fourth quarter's results now show.

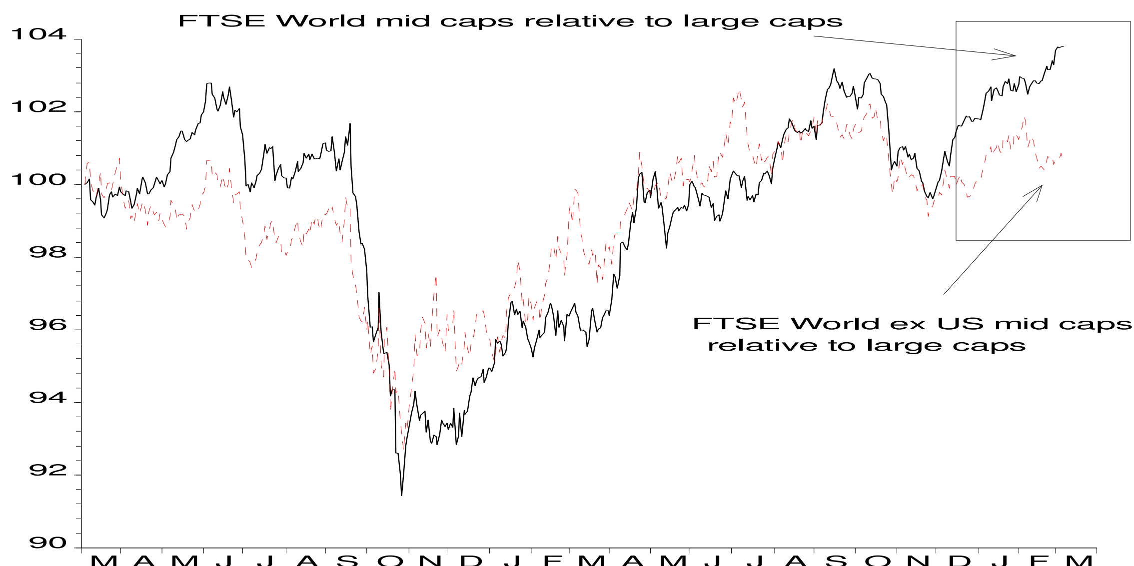
But what is really worth noting is the distribution of the earnings surprises. The ratio of ‘beats to misses’ has been highest for the Technology sector of the US equity market but, after that, it has been best for the Consumer Discretionary sector by a long shot. This suggests there is unexpected strength coming through in consumer spending, which is good news for an economy dependent on the consumer for some 70 percent of its GDP. Not only does this add to the conviction in the cyclical upswing but it also points to a better outlook for domestic earners.

Finally, there is the Fed’s reassurance, which is good for confidence and the (global) economy. Even when US employment starts growing again, it will still take some doing, as well as some while, before the Fed feels inclined to alter its message on interest rates. As it keeps on saying, economic conditions – including low rates of resource utilization, subdued inflation trends and stable inflation expectations – are likely to warrant exceptionally low levels of the federal funds rate for an extended period. This should help keep yields in the Treasury market from rising that much on the good news for the economy.

Thus far, the new relative high for the mid caps is unique to the US, as the chart below indicates. While there is likely to be some catching up in other equity markets, the US experience has yet to be repeated in the eurozone, the UK, Japan and even in developing Asia, which has been at the forefront of the upswing in the cycle.

For now though, the rise to new relative highs in the US mid caps is a vote of confidence in the Obama stimulus and the Fed’s ultra-easy monetary policy. It suggests that the jobs are coming and that more top and bottom line growth lies ahead.

After their impressive comeback from the January sell-off, equity markets look a touch overbought on relative strength indicators and some profit-taking is likely, but the lead by the mid caps to new relative highs in the US suggests that the bull market that began in March of last year remains intact.



IMPORTANT NOTES

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