BREWIN DOLPHIN

MARKET STRATEGY

INVESTMENT RESEARCH

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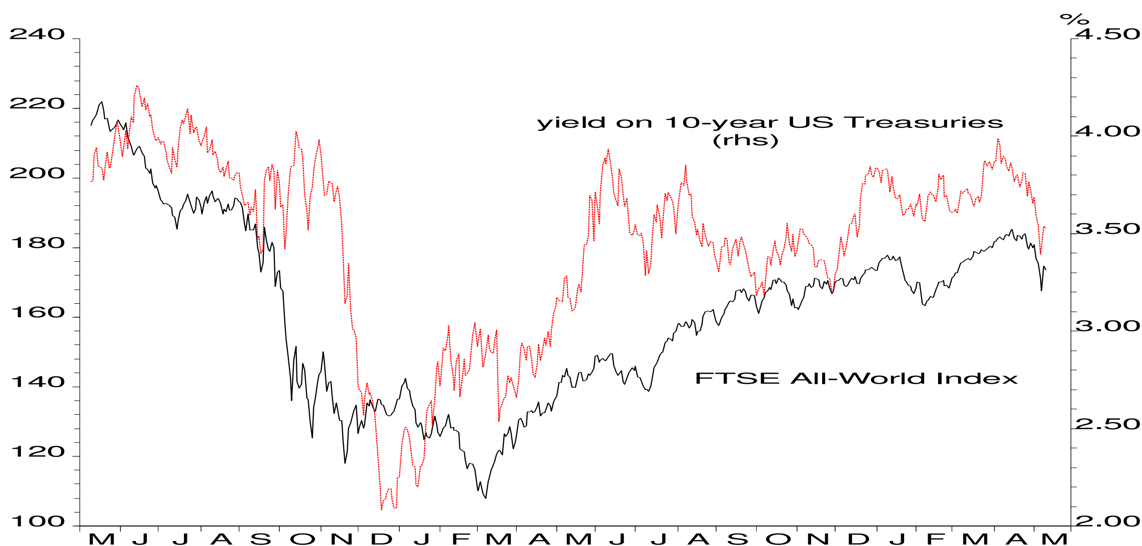
Hysteria – it's back!



Source: DATASTREAM

Would the eurozone's public debt crisis have been a game changer for equity markets? It might have been – and it might still! Certainly, if it transferred back to the private sector via the banks, which then couldn't or wouldn't lend, the forces of contraction and deflation could be unleashed all over again, thus taking the evolution of a crisis full circle to where it started. By providing a substantial loan facility along with plenty of liquidity, the collaborative (EU, IMF and ECB) effort behind the eurozone's stabilization package is intended to see this does not happen and that contagion is arrested.

However, there is no escaping the eurozone's burdensome fiscal problem. Fiscal consolidation – it's easier said than done. That is especially so for an economy that has yet to leave recession behind. Just ask Greece. Spain and Portugal, which are likely to be next in line for any take up of the new loan facility offered by the eurozone's stabilization programme, have announced further measures to cut their respective budget deficits. And the pressure will be maintained. Not only will arduous conditions be attached to any loan but also the terms of any agreement will be subject to constant surveillance. For the eurozone, severe fiscal austerity, even if confined to the few, risks restraining recovery and inhibiting the development of a sustainable expansion.

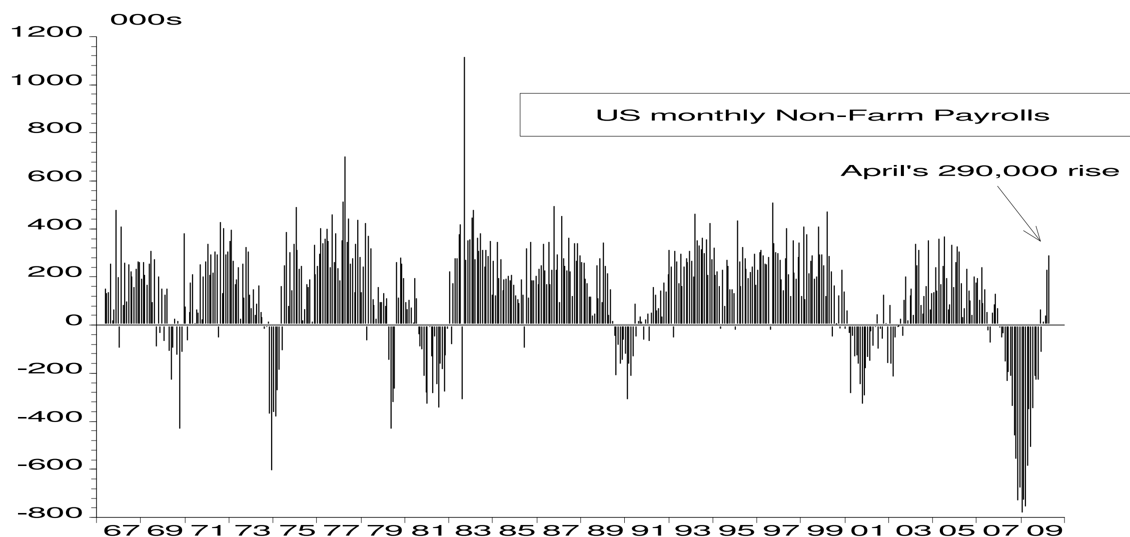
Meanwhile, away from the eurozone, the light has been brightening thus bringing the divide between the leaders and laggards in the cycle more sharply into focus. This is particularly so for the US, where this year's budget deficit is likely to be nowhere near as bad as expected. The US Administration had forecast it would reach 10.6 percent of GDP for 2010 but the deficit is on course to come in well below this. It is already 8 percent lower for the first half of this fiscal year than in the corresponding period last year. US corporate profitability is recovering far more swiftly than expected generating jobs at a faster clip than expected and the combination is good news for tax receipts.

Less cheerful is the rise in the US rate of unemployment. This suggests that government expenditures may take more time to fall away, but the rise is an oddity that is more a reflection of the US economy's strength rather than any weakness (differences in labour market surveys which report the data also account for it). Formerly discouraged workers who had left the labour force are being encouraged by the economy's more promising outlook to return to the labour force in search of work. As the following chart shows, the labour force participation rate is rising but so are the Non-farm Payrolls – at the moment they're

just not rising at the rate required to absorb the growing pool of aspirant workers. However, as shown later, the Non-Farm Payrolls have already climbed to a level consistent with previous expansions. This will ease the pressure on government spending and mean that the surprises in the budget deficit could be upside. No sovereign debt crisis here.

However, there are two points equity markets have yet to get a fix on. First, the list of central banks raising interest rates is growing. If that list extends to central banks that are tightening but not raising interest rates, it includes China. Aside from the US, the Asia-Pacific economy, led by China, has been contributing greatly to the global upswing. Tightening throughout the regional economy is likely to moderate this contribution. The significance for equity markets is that this will also take away some of the earnings 'momentum' behind the rapid upward revisions to global earnings expectations. The earnings growth will still be there but the loss of momentum could take the shine off the earnings news flow and that could affect sentiment towards equity markets.

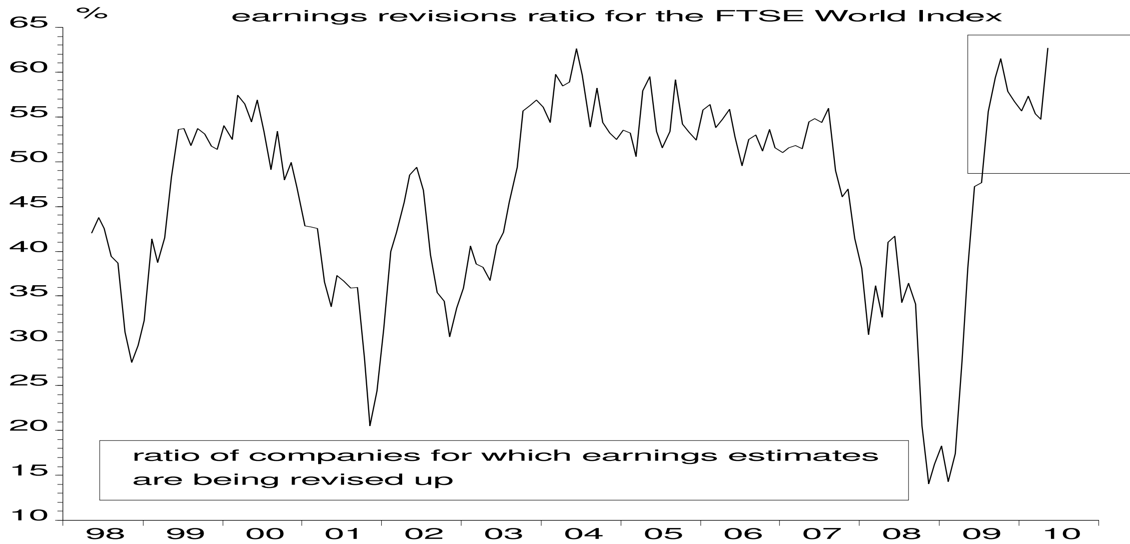
Second, two things aren't happening. The bond market vigilantes are nowhere in sight and, importantly, the growing list of central banks raising interest rates does not include the Federal Reserve. Not only is the Fed not tightening but its message has helped to keep those bond market vigilantes corralled. This is likely to change in the next few months.



As the chart above shows, the Non-Farm Payrolls have climbed to a level that is well into the range of monthly job creation seen during previous recoveries and sustained expansions. This suggests that, before long, the Fed will have to re-craft its message and alter its 'extended period' language to accommodate a policy change that may start with one or the other or a combination of the Fed's balance sheet, reverse repos or the paying of interest on reserves. This is when the bond market vigilantes are likely to cut loose and set in motion a reaction in equity markets.

It has been difficult to avoid blowing hot and cold on equity markets this year. On the one hand, companies are delivering stronger than expected results. The global economic recovery is finally coming through into their top line growth. Earnings estimates are still being upgraded, as the following chart shows, and valuations remain attractive. On the other hand, and as noted already, more central banks are tightening. Those that aren't will most likely get a start on this shortly, like the Bank of Canada – and later the Fed.

Our year-end FTSE 100 forecast of 5500, which was formed at the end of last year when the index was close to 5300, was intended to reflect our limited expectation of how well the equity markets could do against a change in the interest rate cycle. Volatility is proving to be a bit of a feature this year and, while our target implies that a buying opportunity is on offer, we are also looking at more swings and roundabouts ahead and possibly a better buying opportunity.



Also, while on Relative Strength Indicators, the FTSE 100 did look deeply oversold by the time it fell below its 200-day moving average, this has been less the case on other overbought/oversold indicators, such as the one shown below and for which the record has not been bad. As the chart shows, the recent sell-off did not take the UK equity market deep enough into oversold territory to make us think a strong rebound lies ahead.

So we are back to feeling cautious. At its last meeting, the Asset Allocation Committee reduced further its underweight position for the eurozone equity market. It also reduced the equity weighting to emerging markets – the position remains overweight though less than before – but left the US overweight. However, the overall balance of the asset allocation was given a more of a defensive tilt – with a bit more cash for that buying opportunity!

IMPORTANT NOTES

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