BREWIN DOLPHIN

MARKET STRATEGY

INVESTMENT RESEARCH

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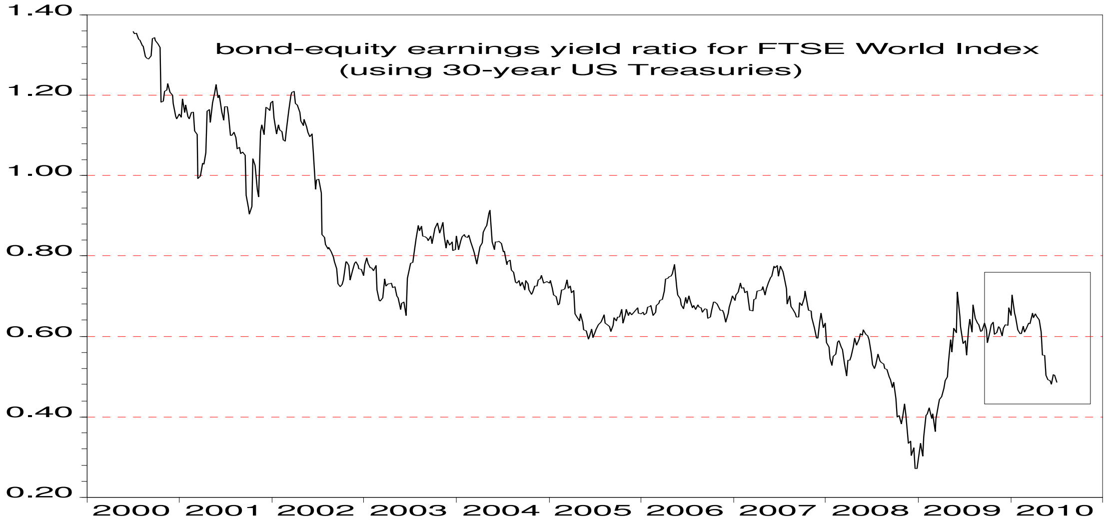
Equity markets are oversold, offer value and are in a strong position to rebound.



Source: DATASTREAM

Equity markets are oversold across a number of technical indicators. The extent of the condition varies according to the indicator but overall it suggests that the downside for markets is limited from here and that a rebound is due – one with a bit more energy than last month's feeble effort. The obverse, or flip side of this, is worth noting, namely that the US Treasury market is overbought. A bout of profit-taking should thus lead to some rotation back into equities.

The FTSE All-World Index is down nearly 15 percent from this year's April peak. As the chart above shows, this has enhanced the valuation for equity markets, as measured by the bond-equity earnings yield ratio and using as the comparator the yield on US Treasuries. However, as the top chart on the next page shows, the bond-equity earnings yield ratio, using as the comparator the yield on US dollar 'investment-grade' corporate bonds, is at its lowest for over two decades. On this metric the valuation for equity markets is seriously compelling.

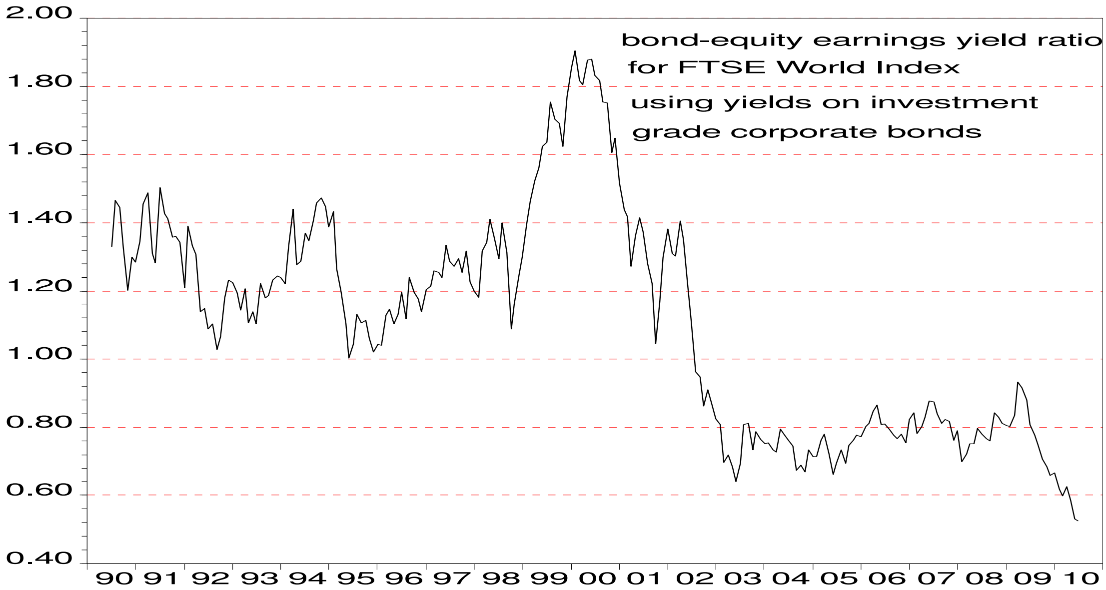
But you have to believe the earnings story in which the top line is now complimenting the cost cutting and restructuring effort that has been feeding through to the bottom line. As the lower chart on the next page indicates, the recovery has been surprisingly strong – just look at that climb – and in our view, unsustainably so. In recent weeks the earnings revisions ratio (red line) has fallen back as fewer companies have seen their mean earnings estimates revised up and more companies have seen their mean earnings estimates revised down. However, this is partly what the correction in equity markets has been about.

This loss of earnings momentum parallels what has been happening in the context of the bigger picture. As the latest from Consensus Economics Inc shows, the upgrading of forecasts for GDP growth in the developed economies has stalled after more or less constant upward revisions to the forecasts – month-in-month-out – over the past year. However, this loss of momentum in the macro news flow is a 'typically' cyclical phenomenon. Also one very important part of the general backdrop for equity markets is that, while interest rates are going up elsewhere, neither the Federal Reserve, nor the European Central Bank, nor the Bank of Japan, nor the Bank of England are likely to put them up any time soon.

The sovereign debt crisis, the related problems with banks, Europe's fiscal austerity and, elsewhere, central bank normalization, have all brought the prospect of a double dip more closely into focus. To repeat, it's what the correction in equity markets has been all about and they are now oversold, attractively valued and in a strong position to rebound on any good earnings news flow.

Next week, US companies start reporting on their second quarter earnings. It will be of interest to see how the big internationals distinguish their operating environments between the developed and the developing economies. Emerging Asia-Pacific and Latin America have played a lead role in the cyclical upswing and Europe has lagged. The markets are likely to be acutely sensitive to the way companies offer guidance on the outlook in light of the loss of momentum underlying the recovery in the global economy.

A 'decent' earnings season would help set to rest some of the apprehension that has weighed on equity markets and make our year-end target for the FTSE 100 of 5500 (formed before the end of last year) look like something to go for.



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IMPORTANT NOTES