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Market Strategy

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INVESTMENT RESEARCH
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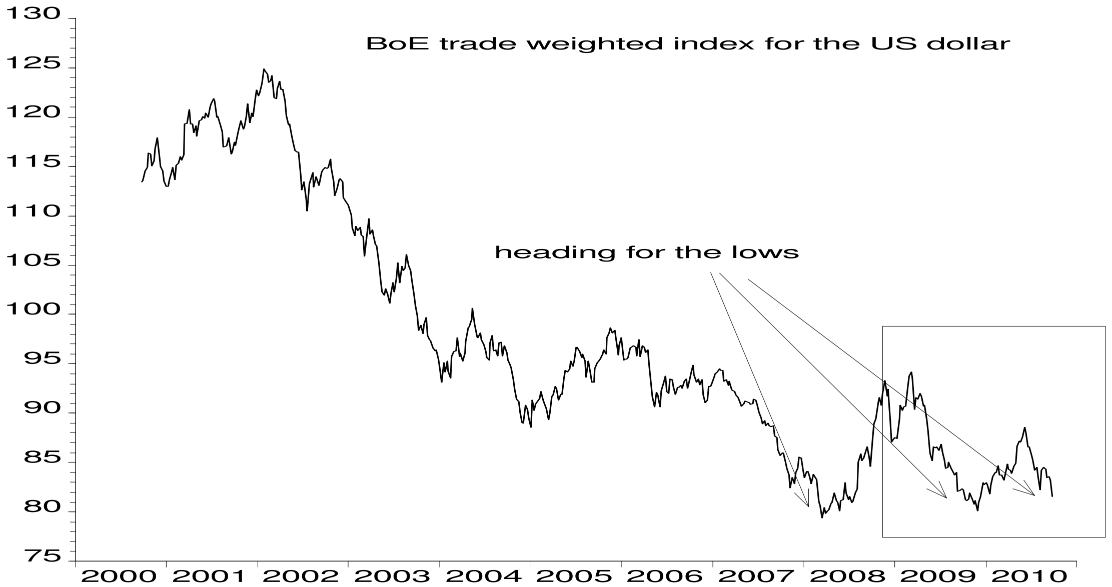
Fed won't need more QE – rebounding equity markets and a weakening dollar will do the job.



Source: DATASTREAM

If equity markets continue to rebound, as we expect, central banks are likely to view this as a welcome sign of reflation and indicative of a recovery that is progressing towards a sustained expansion.

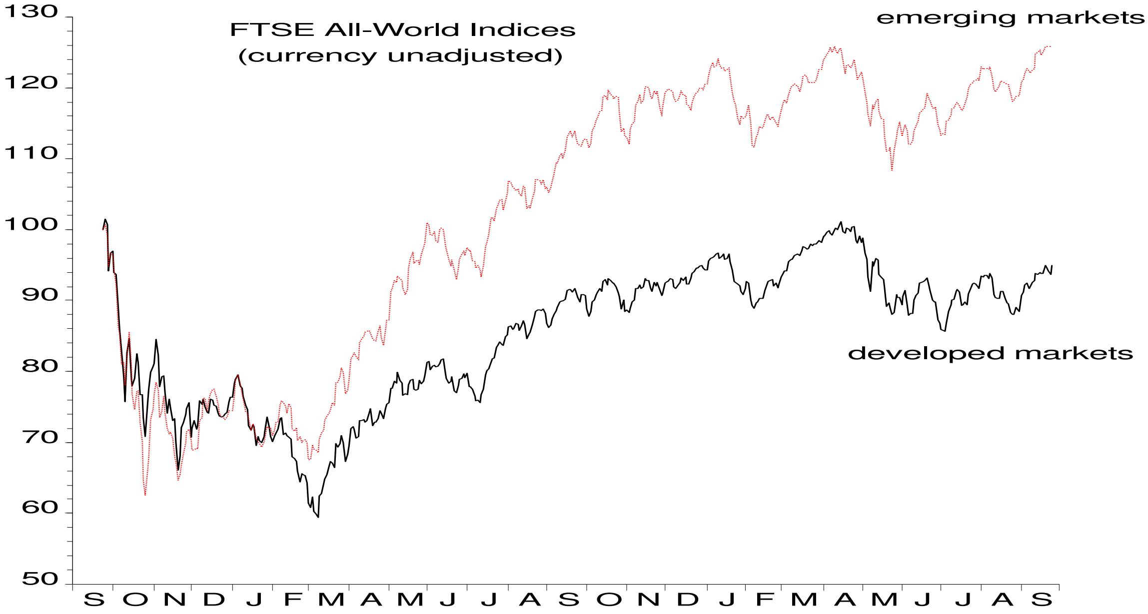
And if the US dollar continues to depreciate, the Fed won't have to worry about more QE. It's not just against the major currencies that the dollar is weakening; it is also against the minor ones where, for the most part, forecasts for GDP growth are continuing to be revised up. This is particularly helpful for the S&P 500 which, like the FTSE 100, has a sizable proportion of revenues generated from the developing world – though not as sizable (Bond markets take their cue from developed economies, equities from the developing, 24 September 2010).

A weakening dollar is also good for US companies with little or no direct exposure overseas. Apart from the exporters and overseas earners, it will help domestic output of goods and services as US consumers turn to import substitutes. A weakening dollar is good for profitability all round, which in turn is good for investment and jobs and probably a surer way of creating both than having to rely on QE.

Also, the reflationary implications of a weakening dollar extend far and wide by helping to boost commodity prices. Of course this is good and bad – good, that is, for producers and maybe not so good for consumers.

Importantly though, a weakening dollar is likely to translate not just into harder commodity prices but more generally into inflation expectations and this together with a weaker dollar and the stimulus the latter provides for the US economy are likely to make the Fed feel happier. This is because the combination is likely to alleviate the concern the FOMC has about underlying inflation being at levels somewhat below those it judges '...consistent over the long run with its mandate to promote maximum employment and price stability'.

Also, the BoE aside, the other major central banks might not mind a bit of inflation. Rather than raising interest rates or tightening monetary policy, as many of the central banks in the developing world are doing, the major central banks may just choose to keep existing policies on hold for the time being and forget about more QE.



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IMPORTANT NOTES