



BREWIN DOLPHIN

Market Strategy

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INVESTMENT RESEARCH

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Bernanke and Geithner get tough about QE ahead of G20.



Source: DATASTREAM

Having hit a series low for the dollar on the Bank of England's trade weighted index last week, the pressure is growing to put the finer points on tackling global trade imbalances and pursuing 'market determined' exchange rates at this Thursday and Friday's G20 meeting in Korea.

Frictions are also growing. Both the Fed Chairman and the US Treasury Secretary found themselves defending policy over the weekend. There were no shortage of critics (Germany, China and Brazil for a start) of the Fed's new QE program but Mr Bernanke rightly explained its purpose, namely to 'provide additional stimulus to help the economy recover and to avoid potentially additional disinflation'.

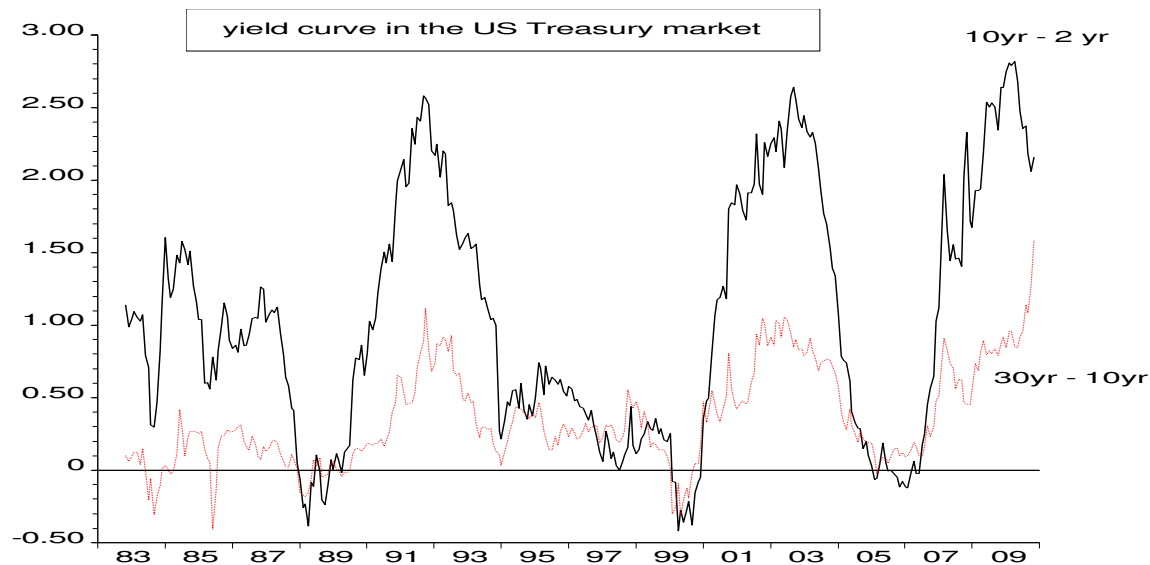
Meanwhile Mr Geithner had to fend off criticism too from those who claimed that the US was deliberately weakening the dollar. As he had to tell them, current US policy aims to strengthen the US economy and, normally, this would be associated with a stronger – not weaker – dollar.

With equity markets in fine form, having ended last week on an upbeat supported by positive economic news, they start this week still looking technically overbought so you sort of wonder; isn't anyone out there going to take their profits?

But profit-taking there has been – in the bond market. Yields at the long end of the US Treasury market have been rising and are now some 70 basis points above their August lows. Although the Fed does not intend to purchase much in the way of 30-year Treasuries this is not likely why the yields are rising.

As Mr Bernanke puts it, the Fed is not out to create 'super-normal' inflation but to influence expectations in a manner consistent with its dual mandate. Now that the Fed will be purchasing about 75 percent of the US budget deficit reflected in consensus forecasts for 2011, the bond market may be in the initial stages of buying into this (the 75 percent includes the monthly reinvestment of principal payments from its now passé credit easing program so not all of this is monetizing the deficit or involve printing money).

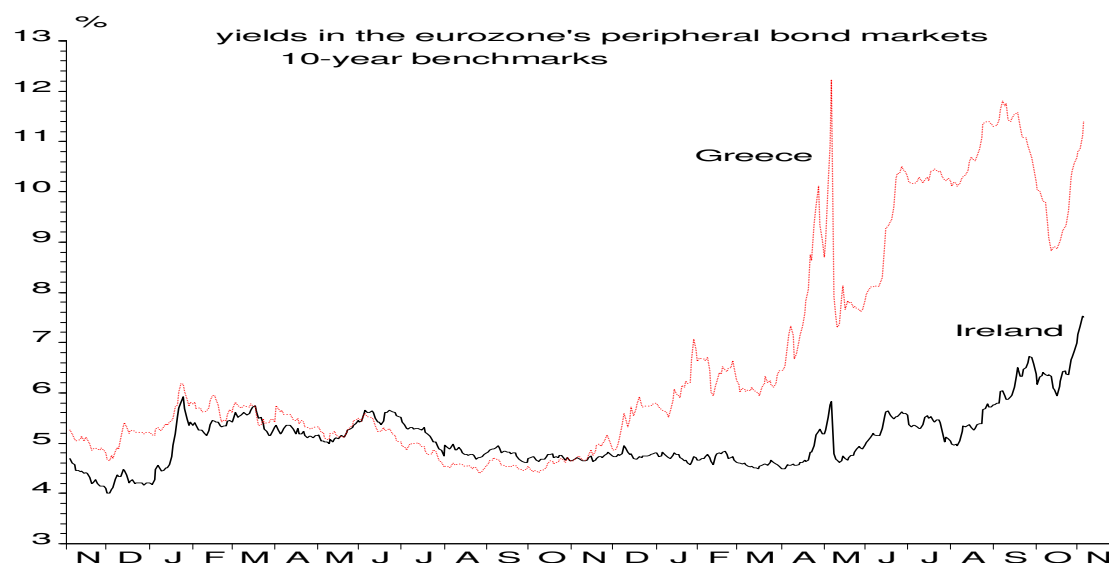
Debt monetization has been widely considered inflationary in the past. As the chart below shows, this view may now be gaining ground. The 10 to 30 year area of the yield curve is more upward sloping than at anytime over the past few decades suggesting a focus that is not just on inflation but more broadly on the prospect of reflation, which itself denotes the rise in aggregate demand – from both prices and quantities – and the rise in jobs that the Fed wishes to see.



Source: DATASTREAM

From the point of view of the US corporate sector, the weak dollar is good for US corporate earnings, which are recovering strongly thanks to the growing contribution to sales from the developing economies. But from the latter's viewpoint, the US is exporting or transferring the disinflation the Fed is hoping to mitigate through QE and this is the downside for US corporate earnings. The equity market has not been on to any of this, partly because the earnings reported to date have been better than expected, partly because investors have been single minded in their quest for risk taking and partly because the response from the developing world in the form of the imposition of capital controls has been relatively limited to date.

Also, with the eurozone's sovereign debt crisis having receded into the background a while ago the recent rise in yields in peripheral bond markets and the widening of spreads have been blissfully ignored. The markets could easily re-focus on this once the G20 meetings in Korea have been concluded. With the US earnings season is drawing to a close too – by the end of this week over 90 percent of the companies in the S&P 500 will have reported – there will be one less source of positive news to occupy the markets. We still can't help feeling a bit cautious.



Source: DATASTREAM

IMPORTANT NOTES

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