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Market Strategy

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INVESTMENT RESEARCH

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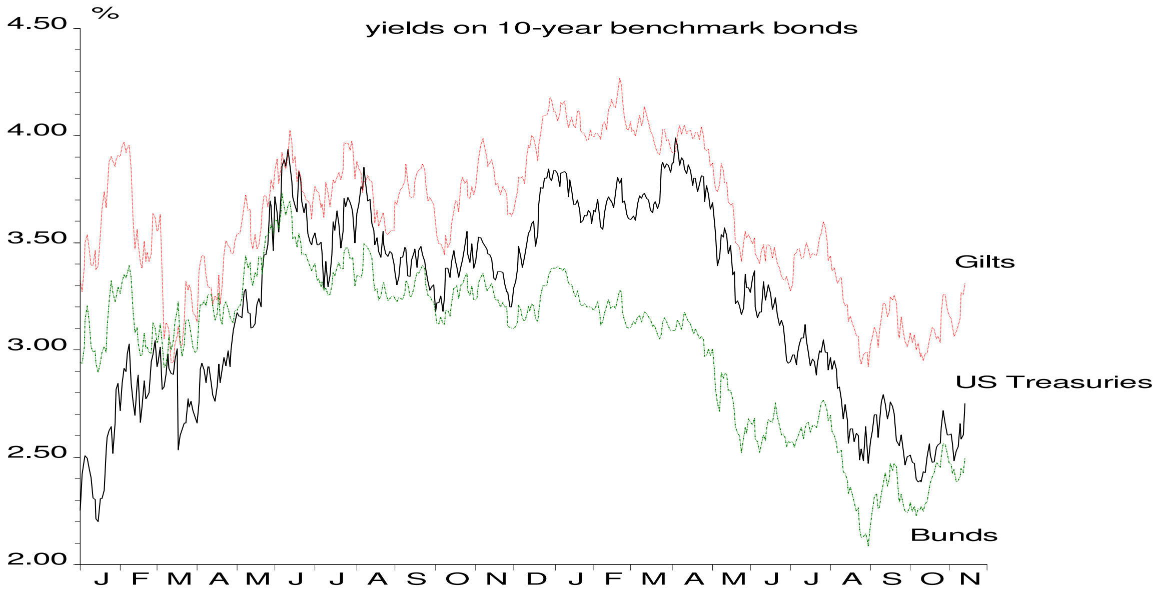
Bond and equity markets re-focus their sights.



Source: DATASTREAM

Much of what has driven markets over the past months now lies behind them, like the Fed's QE program, G20 as well as the US earnings season, which has pretty well run its course. So the week starts with the markets set to re-focus their sights on other developments.

One is the pressure that is growing to force Ireland into accepting EU financial assistance as the backstop for the banks, to forestall a default and to limit contagion in peripheral bond markets. Both the Irish Prime minister and the Finance Minister insist no help is required but EU officials have learned that this kind of talk just won't do. Markets will doubt the Government's ability to ride things out and will reckon that sooner or later, and probably sooner, it will bow to EU pressure.

Another focal point is China's expected response to bank lending, renewed speculative activity, particularly in the equity market, and accelerating inflation. As a means of curbing hot money inflows as well as the rise in domestic inflation, a more purposeful, but still controlled, appreciation might now be considered.

A third and critical feature is the rise in US Treasury yields across the curve. This is happening in spite of the Fed's intention to buy 105 billion dollars worth of Treasuries each month for the next 8 months. It suggests that the bond market is focusing on the reflation – the employment and price stability – the Fed is hoping to achieve through expansion of the monetary base by some 30 percent over the next 8 months. Indeed, other major bond markets may be reflecting on this too. As the chart shows, yields on gilts and bunds are rising as well.

Equity markets have been reluctant to give up any ground but after their fine performance over the past few months, any further progress might now be inhibited by rising US Treasury yields. Technically, equity markets look ready for a bout of profit-taking.

IMPORTANT NOTES