BREWIN DOLPHIN

Market Strategy

INVESTMENT RESEARCH

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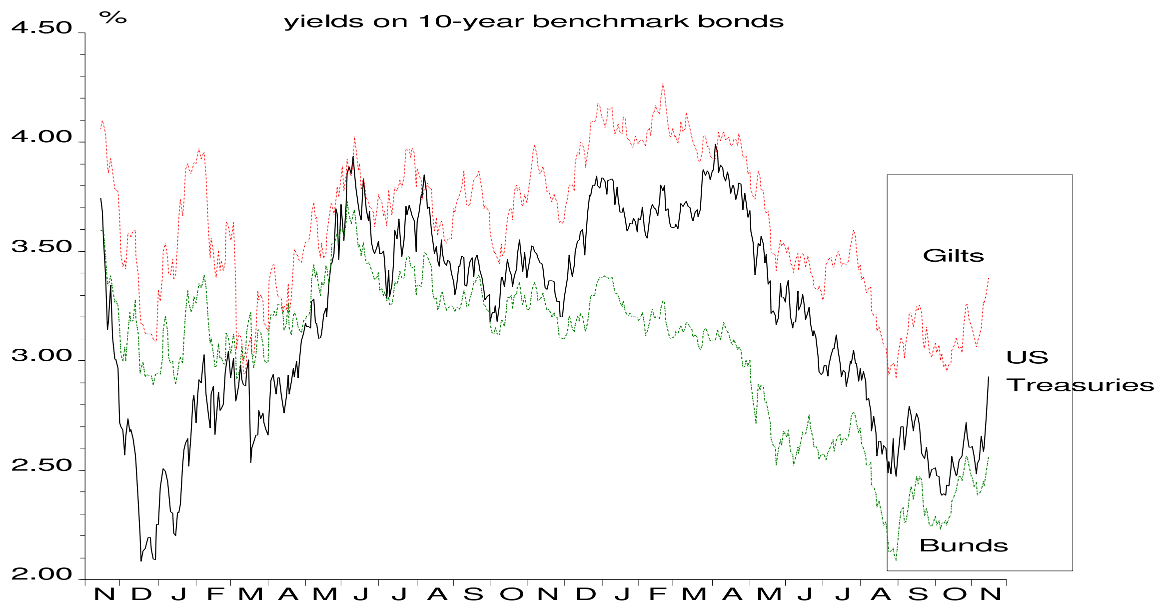
Some not so good news for equities.



Ireland's got everybody worried – except, maybe, the Irish. Pressure is growing from the EU and the ECB to force the government into accepting financial assistance as the backstop for the banks, to forestall a default, to limit contagion in peripheral bond markets and pressure on the eurozone, including pressure that might inhibit the conduct of the ECB's operations.

Both the Irish prime minister and the finance minister insist no help is required on the fiscal front just yet. Understandably, the government does not wish to give up its preferential corporate tax system, which EU financial assistance might require. Both the EU and the ECB know that the Irish government's resistance only delays the inevitable and rattles the bond markets which doubt the government's ability to ride things out.

There is enough to rattle equity markets too, like developments in China where the authorities have some way to go before they can feel confident about taming inflation. Aside from higher interest rates the renminbi could play a more pivotal role in policy tightening.

A more purposeful, though still controlled, rise in the renminbi would restrain export growth but it would also help curb the excessive bank lending and inflationary pressure which result partially from a policy mix that is creating lots of domestic money against the constant stream of hot money inflows. Policy tightening through a faster adjustment than at present in the renminbi might usefully augment the reliance to date on selective controls, reserve requirement ratios and interest rates. More sterilization for the hot money inflows would put interest rates under upward pressure but it might also serve to choke them off.

Second, a more earnest appreciation in the renminbi would help dampen mounting inflationary pressures by lessening the cost of imports and intensifying the pressure on domestic producers to price

competitively. That might hurt profitability and jobs but any reduction in inflation would also boost real incomes and spending.

For equity markets the key is that policy tightening restrains growth and China isn't alone in tightening. Central banks throughout the developing world have been tightening and also exchange rates have been appreciating. This combination points to a loss of economic momentum in the developing world. Given that the developing world accounts for about 30 percent of global GDP – or some 45 percent of it in purchasing power parity terms – and nearly 70 percent of world growth in recent years, it also points to a loss of recovery momentum in the global economy as well as to a loss of momentum in global earnings.

Equally if not more critical for equity markets now is the rise in US Treasury yields across the curve. This is in spite of the Fed's intention to buy 105 billion dollars worth of Treasuries each month for the next 8 months and suggests the bond market is focusing on the reflation the Fed is after, namely a strengthening economy that will improve the prospects for jobs and modestly raise inflation expectations in an effort to achieve price stability.

Equity markets have defied any expectation of profit-taking – a serious bout that is – but then they have enjoyed plenty of good news, like the prospect of QE, better than expected earnings and a lot of support from corporate activity. Valuations have been attractive too compared to bonds.

But yields in the US Treasury market, as well as other major bond markets, are rising and this coupled with the thought of a loss of global economic momentum, and with this a loss of global earnings momentum, are not so good. A bout of profit-taking has been over due for a while yet equity markets have hung on doggedly to their gains of the past months. If rising bond yields and a loss of earnings momentum won't do the trick you wonder what else can.

IMPORTANT NOTES

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