BREWIN DOLPHIN

Market Tactics

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INVESTMENT RESEARCH

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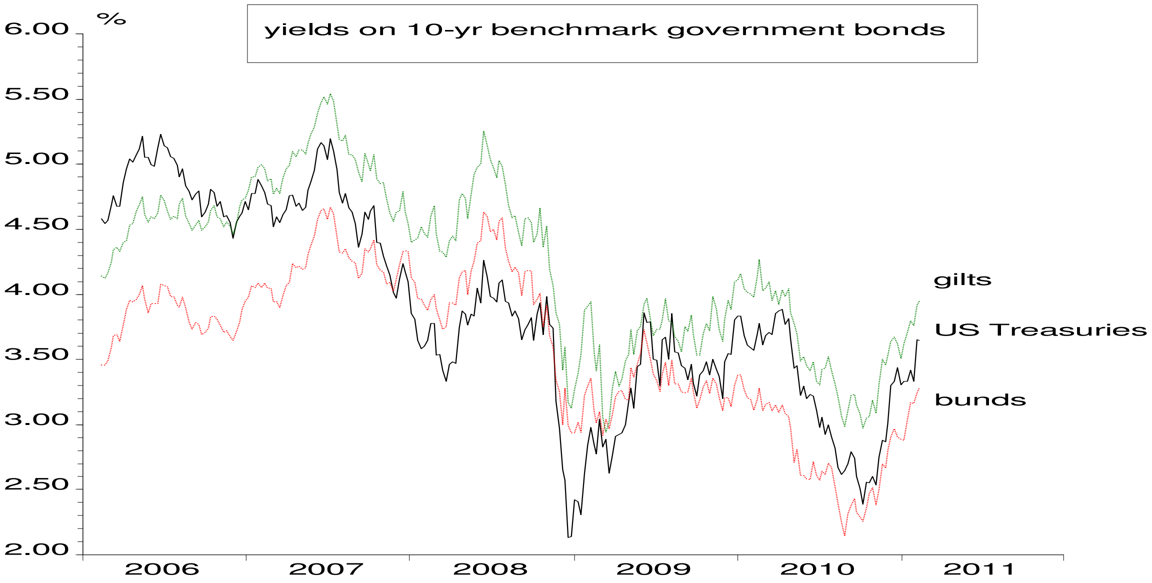
People power on the rise - along with inflation and bond yields.



Source: DATASTREAM

Mubarak's resignation is the triumph of a people's challenge. Now for the hard part as the army leads Egypt along an uncertain and possibly confrontational path to constitutional reform and free and fair elections. As the man in the suit said, 'one does not grow a new government overnight'. The army, i.e., the supreme council, has indicated it will retain authority for 6 months or until a general election can be held.

Equity markets greeted the people's victory with the thumbs up. For commodity markets it also meant some letting off of steam which may ease concern about the outlook for inflation. But the prevailing pressures are upward and the question remains; are emergency settings for interest rates still warranted?

Government bond markets don't think so. Tactically, the bond markets look oversold and, while a buyer's moment may have arrived, this week's inflation news out of China, the US and the UK is likely to make a damp squib out of any attempt at a rebound. If anything, yields can be expected to resume their upward trend considering that the outlook for the global economy is improving.

Expectations for US growth have risen sharply over the past few months. The Fed has probably revised up its own forecast for GDP growth this year as January's FOMC Minutes, due on Wednesday, are likely to show. China continues to grow more strongly than expected despite central bank tightening. Indeed, this applies to much of the developing world. Elsewhere in the developed world Germany has been surprising by its strength and last week the Bank of France revised up its forecast of French GDP growth for the first quarter of this year to a pace not seen since before the financial crisis.

This improving picture of the global economy underlies commodity markets, as does the persistence of weather related supply shocks such as China's drought and the influence on wheat prices. This better picture underlies bond and equity markets which have their sights on a sustainable expansion now that the reflation of aggregate demand is coming through in the global economy.

Less of a risk is the deflation that might have been associated with the cataclysmic shock of the financial crisis. If anything, inflation expectations are easily primed against the backdrop of a global economy that is visibly strengthening. Hardship remains and while the recovery in the developed world may need its nurturing, the emergency for which the current historically low levels for interest rates were set would seem to be no longer.

For the bond markets the message is that the time has come for central banks to make a start at moving away from the emergency settings and for a little while, our view has been not only that the BoE and the ECB will be the early starters but also that bond yields will head higher. For a longer while, the Group's recommendation has been that, as an asset class, bonds deserve to be underweighted.

Equity markets are focusing on the earnings story associated with the strengthening outlook. Focusing on the US corporate scene, about 85 percent of the S&P 500 will have reported by the end of this week. Although the current round has not been brilliant in terms of earnings surprises it has been satisfactory with a 'beats to misses' ratio of 3 to 1. Earnings for the quarter have been revised up (to 36 percent growth from 32 percent at the start of the quarter) and so have revenues (to 8 percent growth from 6 percent).

Moreover, the distribution of the earnings surprises across sectors supports the view that the cyclical upswing in the US economy is gaining momentum, a feature endorsed by the contribution of consumer spending to last quarter's GDP growth. As for tomorrow's US retail sales figures, they, like January's non-farm payrolls, may say more about the weather than anything else. However, the fundamentals support our recommendation not only to overweight equities but to overweight developed markets and notably the US (among others). Its underlying trend is unlikely to alter ahead of any change in Fed policy.

Source: DATASTREAM

IMPORTANT NOTES