BREWIN DOLPHIN

Market Tactics

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INVESTMENT RESEARCH

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Equity markets await key figures but look for more upside.

Source: DATASTREAM

Equity markets have recovered a little more than half of what they lost since peaking in February. Having also worked through their oversold conditions they are in a strong position to rebound further on any good news. While the markets are not likely to lose sight of the developments in Japan and the Middle East and North Africa, they appear to be re-focusing on fundamentals, which remain positive, ahead of what is a busy week for economic news.

Key among this week's features is the US Non-Farm Payroll report. We have drawn attention before to the employment components of the US ISM surveys, both of which show improving business sentiment towards job creation. This is particularly so in manufacturing where the employment index has now reached a high not seen since the early 1970s but, importantly, both surveys point not only to the prospect of good numbers ahead for jobs but also to an area of the economy that could start surprising on the upside.

While the latter sentiment has yet to register in the US Treasury market which reflects a degree of caution at the longer end of the curve, yields at the short end have climbed more rapidly suggesting the bond market is beginning to anticipate a Fed policy change. Yields on 2-year Treasuries are a mere 10 bps from their February high rather than the 30 or so they were in the middle of this month.

Also, the trend of implied inflation as reflected in the Treasury market remains up and, significantly, the March (final) Thomson Reuters/University of Michigan Survey released at the end of last week confirmed the pick up in medium term as well as short term inflation expectations. The longer oil prices remain at their elevated levels the more likely it is that they fuel inflation expectations and push yields up. A recent Reuters poll showed that analysts expect oil prices to remain above $100 per barrel through all of this year and all of next year.

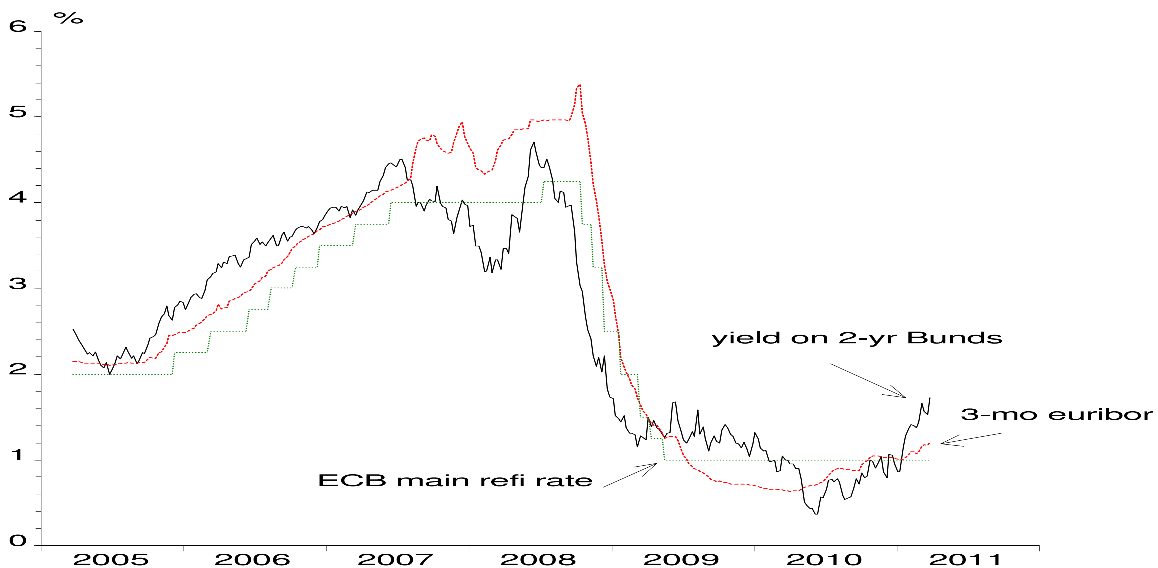
Combine this with the FOMC's last statement and more recent comments from a number of Fed officials and the end to the Fed's QE2 programme looks more certain in an uncertain world. While the bond market

might not like this, equity markets should welcome the growing conviction within the Fed that the economy no longer needs QE.

Elsewhere the Japanese equity market starts the week with a slight loss of momentum. The government estimates that the direct cost of the damage from the earthquake and tsunami could be some 6 percent of GDP, the lion's share of which will be borne by the government. The Bank of Japan has been impressively responsive in its provision of liquidity to the financial system. However, it has also demonstrated the defect that has not only consumed it for so long but also burdened the economy with the deflationary malaise it has been unable to shake. Thus far, the BoJ's governor has discouraged the thought of participating in the reconstruction programme through buying government debt. This would tarnish the BoJ's credibility, hurt the yen and raise inflation expectations.

A supplementary budget for the reconstruction programme is expected to be announced soon. The options for financing the reconstruction are being explored and include tax increases. This seems the least desirable option considering the state of the economy.

More desirable is a statement by the BoJ to the effect that it acknowledges the need to reflate aggregate demand and will engage in a big buying programme of government debt to fund reconstruction. If anything, the economy needs a weaker yen. Moreover, inflation expectations could help stimulate spending. Without this policy initiative it is doubtful that the equity market will offer anything more than the tactical buying opportunity we spoke of last week – and it might not even offer that.



Despite a disappointing conclusion to last week's EU summit meeting and the deferral till June of the decisions needed for 'economic governance' and crisis resolution procedures, at least one important area of policy seems to be decided. As the chart shows, yields on 2-year Bunds have now climbed to levels not seen since June 2009. That was when yields were on the way down. Now they are on the way up. The Bund market is convinced of the intention by the ECB to raise interest rates at its April 7 meeting and we think it will.

IMPORTANT NOTES

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