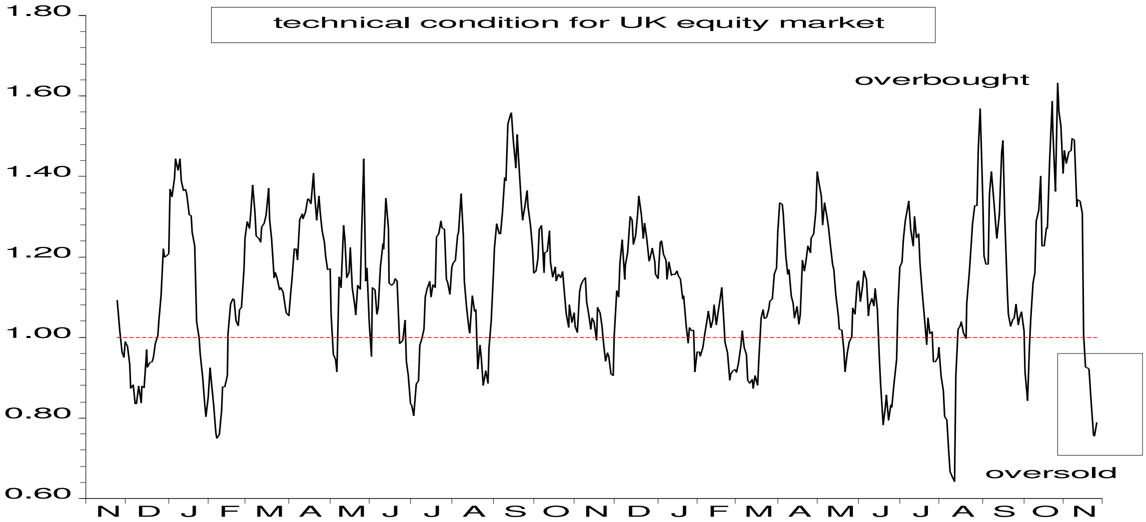
Market Tactics

Mike Lenhoff – Chief Strategist
Tel: 0845 213 3360; e-mail: mike.lenhoff@brewin.co.uk

INVESTMENT RESEARCH
28 November 2011

Equity markets are oversold and starved of good news flow.



Source: DATASTREAM

Did the euro get the thumbs down from last week's failed bund auction? Wolfgang Munchau writing in this morning's Financial Times described the eurozone as '... now subject to a run by global investors.' No doubt others share his sentiment that it is doomed to '... break up very soon.' Well, cometh the hour, cometh the man, or rather in the eurozone, cometh Mrs Merkel!

Mrs Merkel may reign but she does not rule, yet! She will get her chance though if she means what she says about the need for a fiscal union along with the rigour of German budget discipline. But to facilitate this will require urgent treaty change which she will have to drive through at next week's EU summit in Brussels. On the agenda will be proposals from Germany and France for amendments to the EU's Lisbon Treaty in relation to enforcing budget discipline and strict fiscal governance for the eurozone.

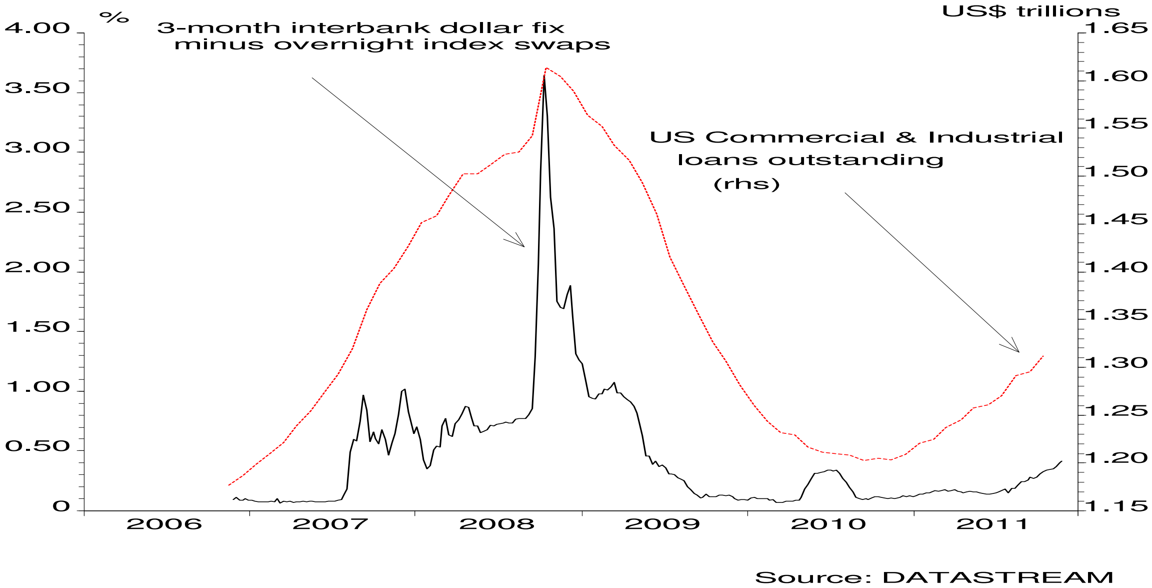
Agreement may not be easy. In view of the need to respond boldly, convincingly and urgently, Germany and France are exploring options intended to accelerate the process of fiscal integration. According to Reuters, the idea of a more 'manageable' Stability Union consisting only of eurozone members is one of these while another idea focuses on a separate agreement outside the EU Treaty involving a core of 8 to 10 eurozone members as a means of 'seeding' fiscal integration. These are radical initiatives from those who want the euro to survive. They may well be a means of applying pressure on all EU members to get serious.

Enforcement with a sense of purpose may be a first step towards saving the euro as well as a first step towards eurobonds. Mrs Merkel objects to eurobonds – as well as to an enlarged 'lender of last resort' role for the ECB – on the grounds that the issue of debt sustainability needs tackling first but the quid pro quo for accelerating fiscal integration could be Germany's acquiescence to eurobonds and a broader role for the ECB.

In terms of economic news, the US non-farm payrolls will be the main focus of attention. The consensus is looking for a November gain in the headline figure of 120,000 and of 145,000 in private sector payrolls. The economy has been re-gaining momentum recently and the weekly jobless claims have improved thus pointing to better employment prospects and possibly a surprise that might be on the upside.

One interesting feature against the backdrop of mounting stress in the interbank markets is the recovery in credit outstanding for Commercial and Industrial (C&I) companies. As the chart shows, the spread between the 3-month dollar fix and the overnight index swaps has widened over the past months but the trend for C&I loans outstanding has remained firmly upwards.

That recovery in the non-financial side of the corporate sector of the economy, particularly among the smaller and mid-sized companies to which much of the outstanding lending applies suggests that the risks of recession looking into next year have not increased and that better employment prospects might even lie ahead.



In the UK Mr Osborne will deliver his Autumn Statement tomorrow. While the talk is of the credit easing programme he wishes to introduce for small companies, plans for direct investment in infrastructure by pension funds as well as more spending on infrastructure and other things, what the Chancellor will not do is throw caution to the wind, meaning fiscal austerity is still here to stay.

Finally, equity markets are oversold enough to expect a decent rebound on any catalyst. The chart at the top of the preceding page is for the UK equity market and shows the extent of the technical condition. The news as reported by Italian media that the IMF would make a large loan available to Italy so as to give Mr Monti time for implementing budget reforms ahead of any debt refinancing was clearly welcome but it was denied this morning by the IMF.

Still, the reaction by equity markets illustrates how responsive they are likely to be to any positive news. If Mrs Merkel can get her way on fiscal integration, equity markets could be easily supported by a swing out of bond markets. Indeed, if any of this week's news is better than expected, especially those US non-farm payrolls, equity markets should enjoy a decent rebound though, at this stage, it is unlikely to be much more.