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Market Tactics

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INVESTMENT RESEARCH
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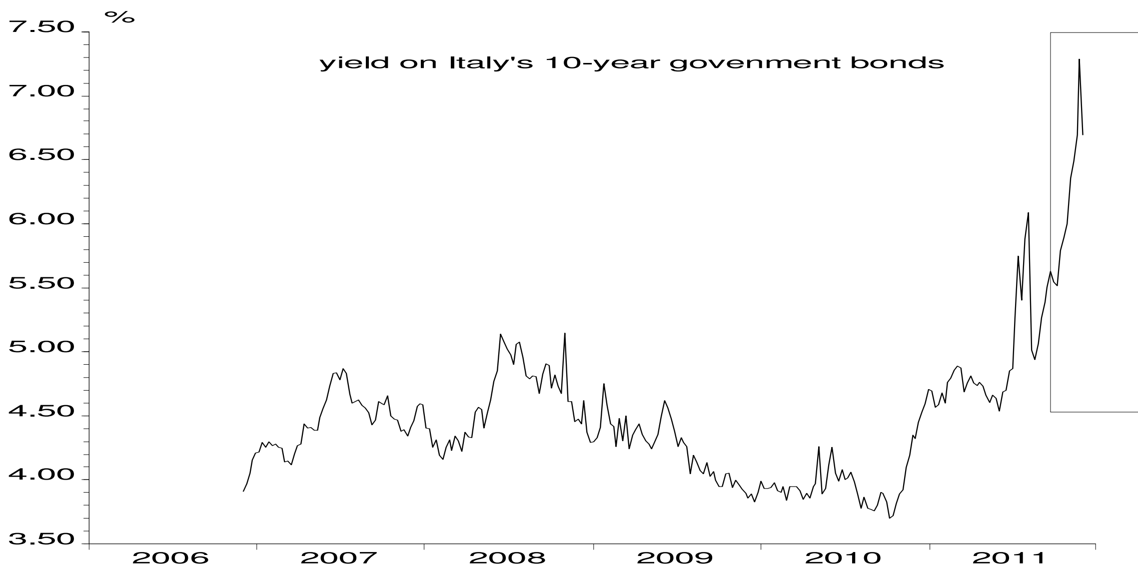
The Lady's not for turning and the markets think she will rule.



Italy's bond market sure likes Mr Monti's 30 billion euro austerity budget. The yield in the chart is Friday's close but at the time of writing, yields had dropped nearly 50 basis points more and by this Friday they could be 100 or 150 bps lower.

That's because Mrs Merkel has made her mind up and, like that other lady, she's not for turning! The root of the problem needs tackling with nothing short of a transfer of fiscal sovereignty to the federal level. For Mrs Merkel, and the markets, here lies what is critical to credibly resolving the issue of eurozone debt sustainability and to ensuring budget discipline.

Mr Sarkozy has yet to be convinced. He acknowledges the need to be tough on fiscal discipline but doesn't like the idea of losing sovereignty over the budget process. Of course he has also got his eye on an election and on political rivals who do not wish to cede sovereignty in any way shape or form. So Mrs Merkel has her work cut out for her ahead of Friday's EU summit in Brussels.

She does have her allies though. Indeed, it was the Dutch who put forward the idea of commissioner for budgetary discipline with responsibility for oversight of national budgets and powers to sanction for breaches in complying with the rules on fiscal governance. When the Dutch Prime Minister and his Finance Minister outlined their scheme in the Financial Times several months ago it included the ultimate sanction of expulsion from the eurozone. Having seen how swiftly and ruthlessly markets can deal with wayward sovereigns, what eurozone government would wish to incur such a sanction?

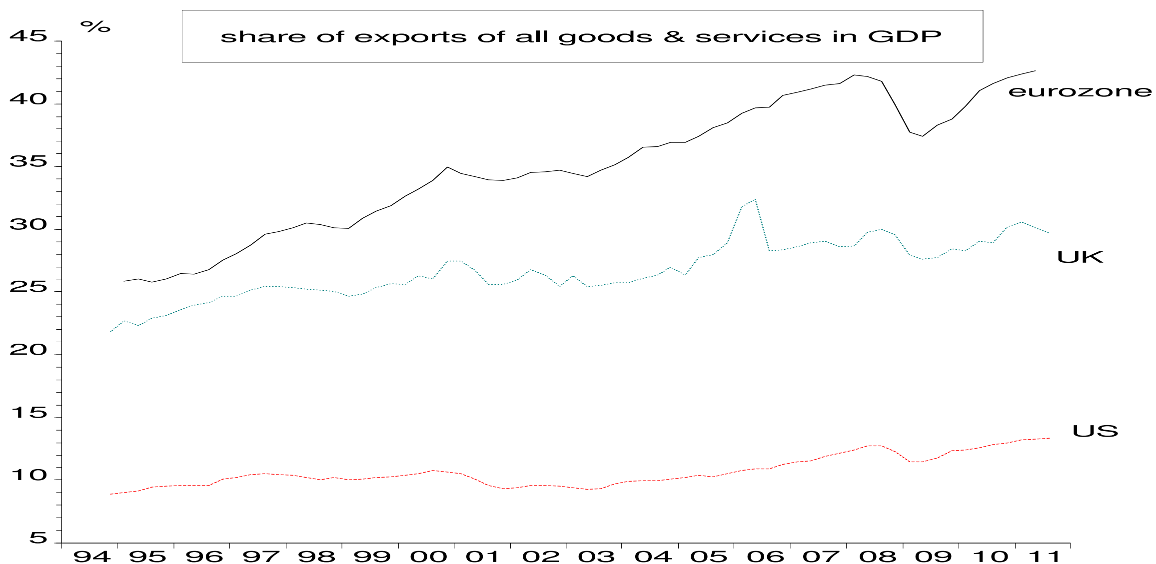
Eurozone leaders know the time has come. Olli Rehn, EU Economic and Monetary Affairs Commissioner could not have stated it more succinctly with his 10-day warning last week to policymakers on the need to complete and conclude the crisis response to the eurozone. It is either fiscal integration or a break-up of the Eurozone and if Mrs Merkel succeeds at Friday's EU summit meeting, much could fall into place.

Last week ECB President, Mario Draghi, indicated that the ECB would be prepared to be more responsive to the crisis as the quid pro quo for a 'fiscal compact'. Ideas have been circulating including expanding the Securities Market programme and channelling funds for sovereign loans through the IMF. Also, attracting funds from the bigger emerging markets through the IMF is still a prospect. A fiscal compact would be likely to make China and Brazil for example more disposed to supporting lending programmes via the IMF and could turn what is still a prospect into a reality.

Having been blindsided by the eurozone sovereign debt crisis, a change in sentiment might also encourage the markets to focus on some of what it has been going on elsewhere, like in the US where employment is growing, albeit slowly and modestly, but without any sign of faltering. Capacity utilization is rising across industry. Outstanding bank loans to commercial and industrial companies are rising.

If Congress passes legislation allowing both unemployment benefits and the employee payroll tax cuts to be extended into next year, this will be very positive for sentiment. There is promising talk on a deal to extend them but both are due to expire at the end of this month and this would seriously hit consumer spending, growth and jobs at a time when the eurozone's crisis is slowing global trade. America's policymakers just won't let it happen.

As for the slowdown in global trade, the US will feel the pinch. But America is still a relatively closed economy. While the share of exports in US output has risen over time, this is currently no more than 14 percent of US GDP, that is, about half of what it is for the UK and about a third of what it is for the eurozone. Global demand will affect the US the economy but it remains still largely driven by domestic demand which is regaining momentum – and not losing it. Has the consensus pushed up those one-in-three odds of recession for next year? No! If anything, the odds have diminished.



But momentum is being lost – in the developing world. While China will feel the impact on global trade of Europe's likely recession, the loss of momentum is not all down to the eurozone. Until recently, central banks including China's were also tightening policy and aggressively in some cases. Also, rising inflation, due in part to higher commodity prices earlier in the year, was squeezing real income growth everywhere including in the developed world.

Now central banks in the developing economies are starting to loosen monetary policy. Brazil has cut interest rates three times, most recently last week, and China has started to loosen by cutting reserve requirement ratios for the banks. Given the growing and sizeable contribution of the developing world to the global economy, the scope available for conventional policy stimulus is positive for equity markets.

As for the eurozone, this Friday could be 'make or break'. The markets are hopeful of the former. If Mrs Merkel gets her way with fiscal integration, market sentiment will be dramatically transformed. To say that equity markets, especially the banks, will have something to celebrate understates it. Fuelling the risk-on trade will be a big exit out of bond markets – and we don't mean Italy's.

IMPORTANT NOTES

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