BREWIN DOLPHIN

Market Strategy

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

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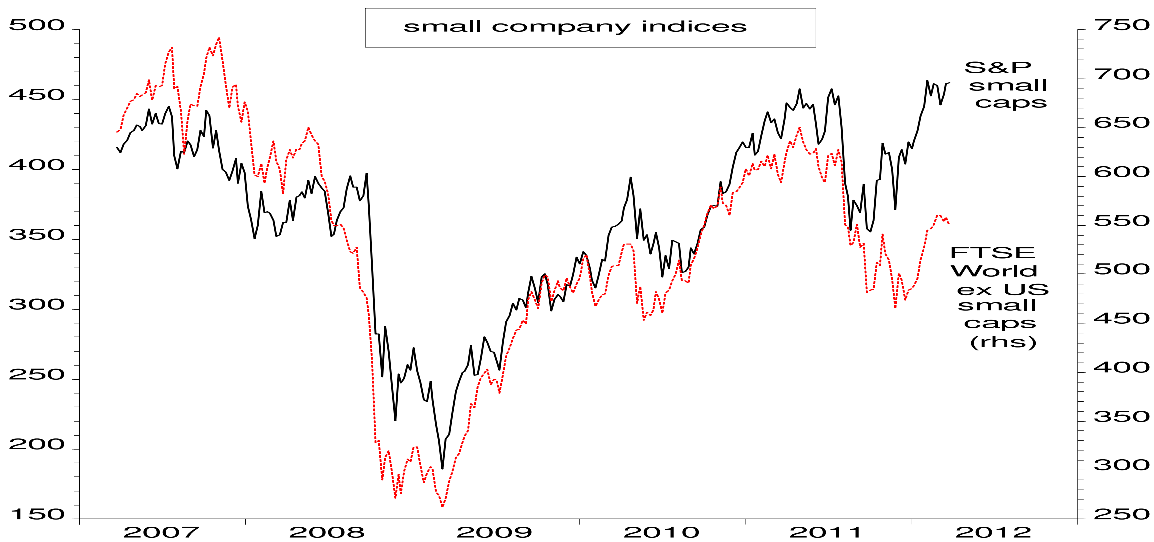
Wall Street's breadth reflects Main Street's recovery.



This year's action on Wall Street is not just impressive; it is spectacular! We are not talking just about the S&P 500's climb to a new post-Lehman crisis high but about the breadth of the equity market and the performance of the second liners and smaller companies. The rise by the S&P mid caps to new record highs has not gone unnoticed. Nor has the rise in the S&P mid cap index. The index has climbed to within a whisker of the record set last year. The interesting feature though is that the US equity market is on its own in demonstrating such breadth. Neither the FTSE World ex US mid cap index nor the small cap index is any where near its former peak.

It is not stretching the imagination to say that the US equity market's breadth reflects the transfer of the recovery in the US economy from the corporate sector to the personal sector by way of employment. The firm upward trend of job creation is a convincing sign of the sustainable expansion the economy now looks to be establishing.

For the corporate sector this transfer may spell some erosion in margin growth because of the resulting loss in productivity gains reaped previously and now also the associated rise in unit labour cost growth. But the good news is that more jobs mean more spending, which is likely now that consumer confidence is on the rebound, and a better tone to the housing market. Not only does this give breadth to the economy's expansion but it also provides for greater breadth in earnings, which is good news for those second liners and smaller companies with sales more aligned to the domestic economy than say for the larger international blue chips.

Another feature which points to the growing likelihood of a sustainable and broadening expansion is the trend in broad money supply and bank credit referred to in previous notes. The trend of aggregate US commercial bank credit has been upward for some months but in recent months the largest single component of commercial bank credit, notably real estate loans, has turned upwards too. If this proves to

be more than just a two or three month wonder, the markets will conclude that the US economy has entered a new phase of the cycle.

This will mean one thing and one thing only for the bond market! The conclusion will be that the Fed will need to get cracking on its exit strategy. As Lawrence Summers writing in this morning's Financial Times put it, this need be no more than the use of 'contingent commitments', that is, an articulation of intent behind prospective action in Fed policy.

Yet a difference of views is emerging already among Fed officials on the wisdom of maintaining the FOMC's super easy monetary policy. The greater breadth to the economy's expansion suggests that prolonging Fed policy as is may not only be inappropriate but may also encourage the corporate sector to make up for the loss in margin growth through price increases.

Jeffrey Lacker, a voting member of the FOMC chose not to go along with the commitment to the extended period message at the January's FOMC meeting. More recently, James Bullard, a non-voting member, has been explicit in raising doubts about the wisdom of prolonging the Fed's easy policy; 'overcommitting to the ultra-easy policy could well have detrimental consequences for the US, and by extension, the global economy.' Dennis Lockhart, another voting FOMC member, and Richard Fisher, a non-voting member, believe that the Fed has gone far enough with policy easing. Meanwhile, the Fed Chairman and others appear intent on retaining policy as is to ensure that the recent drop in the rate of unemployment is not only sustained but sent decisively on its way to achieving the Fed's longer term target of 5 to 6 percent.

None of this is to say that the Fed is falling behind the curve. But with rising commodity prices and better economic news flow for the US economy, it may not take much for the bond market to get worked up about latent inflationary pressures. Even the slightest thought of the Fed being caught out on an exit strategy could induce an unwelcome reaction in equity markets as well as in the bond markets.

Anything like this should find support in what is a strong and bullish technical position for Wall Street reflective of improving economic fundamentals. We are talking then about a period of consolidation after what has been an unexpectedly energetic charge into 2012 – a breather mixed with rebounds in between minor bouts of profit-taking – and then onwards and upwards.

IMPORTANT NOTES

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