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Market Strategy

INVESTMENT RESEARCH
2 July 2012

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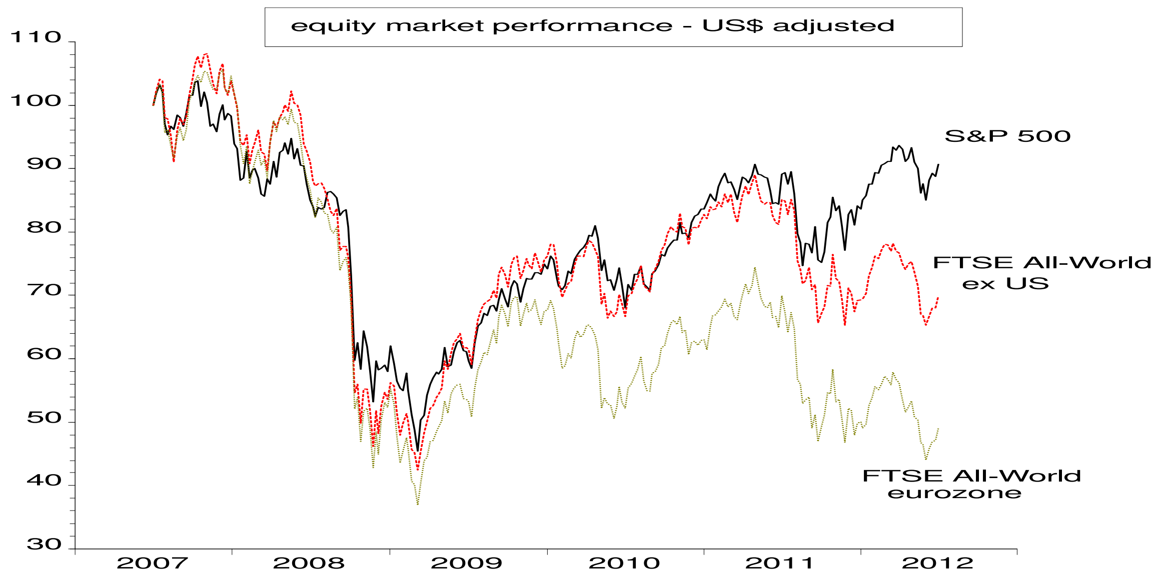
Eurozone leaders answer the call to action.



Source: DATASTREAM

Eurozone leaders have yet to produce the 'fix' for the sovereign crisis. But if they can now deliver on their Euro Area Summit Statement, which affirmed the need to 'break the vicious circle between banks and sovereigns', last week's summit could be a watershed for the eurozone. To summarise briefly, it was agreed that:

- The European Commission presents proposals for the establishment of a single supervisory mechanism for the banks and that the proposals be considered as a matter of urgency by the end of 2012.
- When such a mechanism is established, involving the ECB, the banks in the eurozone could be recapitalised directly by the European Stability Mechanism (ESM).
- For the Spanish banks, financial assistance be provided first by the European Financial Stability Facility (EFSF) and then by the ESM when it becomes available but without the latter gaining seniority status (in the case of the Spanish banks).
- Support through the EFSF/ESM is to be available to help stabilise markets, notably bond markets, for countries complying with their budget rules and reforms.

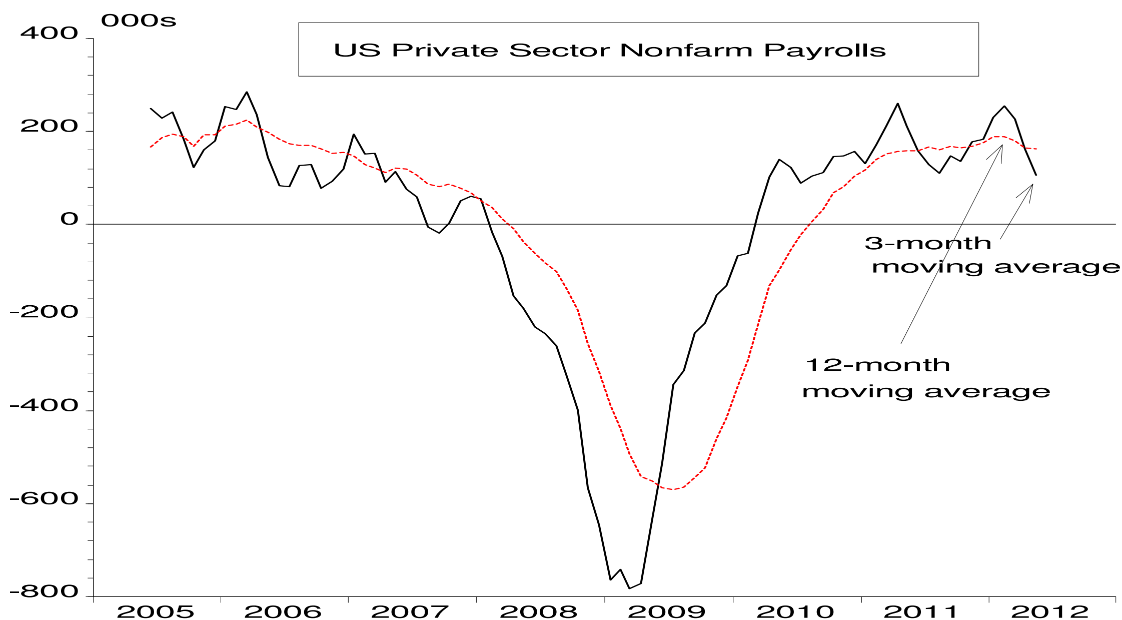
In addition, the European Council is now to produce interim and final reports before the end of this year containing a 'specific and time-bound road map for the achievement of full financial and fiscal integration as outlined last week, ahead of the Summit, by the President of the European Council. This is also to include an examination of what can be accommodated within the boundaries of current Treaties and what would require Treaty changes.

This is real progress and not just more kicking the can down the road. While it would be expecting too much for what was agreed to lift the 'black cloud of uncertainty', the Summit demonstrated a newly found

earnestness for dealing with the crisis. That should put equity markets in better spirits and enable them to focus on this week's economic news and central bank meetings.

On the latter, expectations are primed for action by the Bank of England (BoE) and the European Central Bank. For the BoE, the balance is now likely to be tipped in favour of extending its quantitative easing programme by another £50 billion when the Monetary Policy Committee meets on Thursday. The ECB also meets on Thursday and is expected to deliver a quarter point cut in interest rates. While the latter's decision may be framed in the context of price stability, the markets are likely to see it as a cooperative response to a constructive summit outcome and indicative of further action for a stagnant economy.

On economic news, China's official PMI for manufacturing, released on the weekend, indicates that the sector is now more or less bordering on the threshold between expansion and contraction. The ISM surveys for the US are likely to confirm that the economy is still growing but continuing to lose momentum. However, the key to what the Fed will do will come with Friday's employment figures.



Source: DATASTREAM

Since peaking in January, the US monthly Nonfarm Payrolls have shown that fewer and fewer jobs have been created. This is not the first such loss of momentum for employment during this recovery but it has come against a backdrop of uncertainty over the US election, the tightening of fiscal policy next year and Europe's black cloud of uncertainty. While FOMC members are not all on side just yet for any further easing, the Fed will not stand by and watch the momentum in the labour market erode much further.

Moreover, as it knows, US companies are due to start reporting their second quarter results in a few week's time and expectations are being revised down in view of the economy's loss of momentum and the prevailing uncertainties.

According to Thomson Reuters, the ratio of negative to positive pre-announcements for the second quarter is at its weakest showing since the third quarter of 2001. Expectations were for second quarter earnings growth for the S&P 500 of 9.2 percent back at the start of April. That slipped to 8.8 percent at the start of May and then 7.4 percent at the start of June. This month starts with expectations having been revised further downward to below 6 percent. Not only that, if the Financial sector, which will benefit by an easy comparison to the second quarter of last year, is stripped out of the calculation, Thomson Reuters estimate that second quarter earnings growth for the S&P 500 will be negative.

This is not good news for jobs and nor is it for equity markets. But the action by eurozone leaders to stop kicking the can down the road should help to improve market sentiment. It certainly provides for a better mindset by which to handle the bad news. Moreover, the markets know that the Fed is not one for hanging about and that it remains predisposed to adding more stimulus with the unemployment rate as high as it is. That comfort combined with this week's central banking easing by the ECB and the BoE could harden the tone underlying equity markets and help drive Wall Street to new post-financial crisis highs sooner rather than later. That said, it is the eurozone that would be likely to outperform.

IMPORTANT NOTES

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