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Market Tactics

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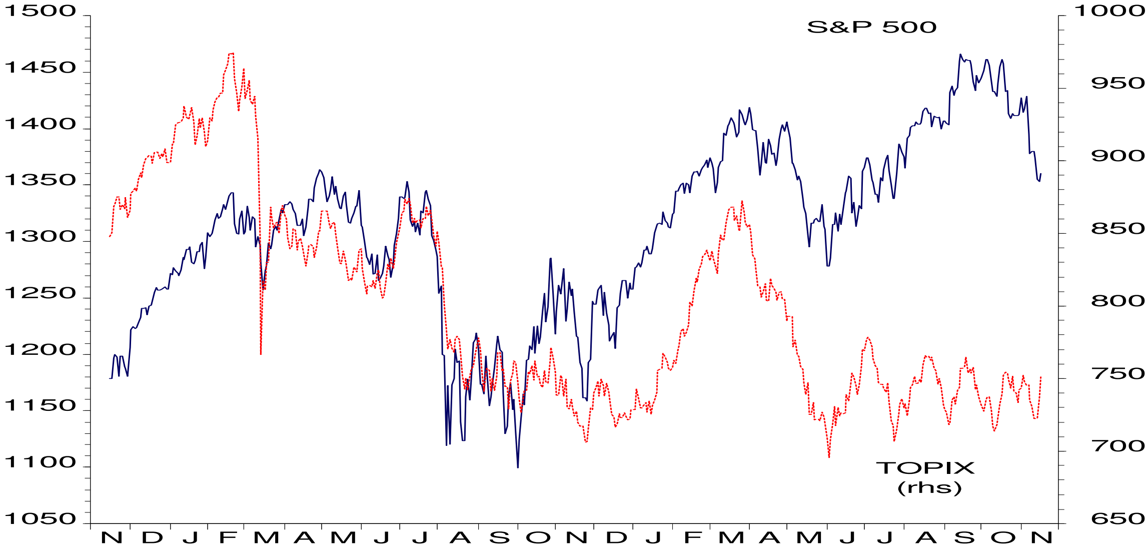
Shakeout leaves equity markets oversold and ready for good news.



Source: DATASTREAM

With one exception, equity markets now look oversold. They just need good news.

President Obama's meeting last Friday with Congressional leaders marked the start of the negotiations over how to proceed on budget cuts to avert the fiscal cliff. The line is that the Republicans are willing to concede on tax changes that result in greater government revenues provided these are accompanied by appropriate spending cuts.

However, such a deal is unlikely to be the 'grand bargain' needed for fiscal consolidation. While closing various tax loop holes or tax breaks seems to be on the cards, it is not yet clear that Obama, whose re-election gave him confidence to persevere with his position of higher tax rates for the wealthy, is prepared to put the latter behind him.

The President's position on this has been a sticking point with Republicans and a fundamental difference that could take the economy over the cliff. Until last week, equity markets had not really counted on anything other than an agreement before year-end to avoid the prospect of recession but that thought was put in doubt by the President's insistence on higher tax rates.

It was part of what lay behind the shakeout in equity markets – except for Japan, where the traffic went the other way.

In Japan, an election has now been called for 16 December. The expectation is that the Liberal Democratic Party (LDP) led by former Prime Minister Abe Shinzo, will be elected on a platform aimed at ridding the economy of deflation, creating minimal nominal GDP growth of 3 percent and revising the mandate of the

Bank of Japan's terms to allow for the printing of 'unlimited yen'. Sounds great! Certainly, the forex market took it to heart and the yen continued to weaken.

On China, October's house prices reported over the weekend showed that the recovery in the residential property market for new homes remains in tact. Also, the latest OECD composite index of leading indicators continues to point, for the fourth month running, to an adjustment to slower growth that has run its course. Thus, in handing over the reigns to China's leaders-in-waiting, the retiring leadership is not handing over an economy that is heading for the rocks.

It is premature to judge how reformist or not China's new leaders will be but, on the face of it, the overall balance appears to be reformist. According to Reuters, the two key figures, the next president and head of state, Xi Jinping, and the next premier, Li Keqiang, are considered to be all-round reformists. Two other members of the Politburo's Standing Committee are viewed as being financial reformers with a good understanding of economic issues. A fifth is thought to be a 'cautious reformer', leaving two others who are seen as being conservative.

Whatever the chemistry of the new Politburo Standing Committee, it is likely there will be continuity of policies consistent with the goals set out in China's current 5-year plan, which runs to 2015. There remains plenty of scope for conventional monetary and fiscal policy to be used to stabilise the economy.

Moving on to the eurozone, the Eurogroup of finance ministers meets tomorrow, along with the IMF in Brussels, to resolve differences over Greece's austerity programme and the associated time line. It is to be hoped that agreement on the way forward can be reached so that Greece can at last be granted approval for the next tranche of loans.

Spain will undergo something of a test next Sunday with the referendum over Catalonia's independence. The polls show that support for independence has lessened and that the referendum is unlikely to succeed. Such an outcome would likely bring cheer to the Spanish Prime Minister; it would likely subdue concern about the risk of political instability and so help the bond market.

Back to the fiscal cliff and to a poll out last week that showed that if Washington fails to strike a deal, the Republicans would be blamed. That same poll showed that more Republican than Democrat supporters thought the resulting tax increases and spending cuts would not only have a major impact on the economy but also a major impact on their own financial position.

Republican voters might not hold Congressional Republicans responsible for the fiscal cliff, as the survey showed, but it is doubtful they would happily ignore the impact on their personal finances. The mid-term elections are some two years away and if the economy did go over the cliff, it could still be in recession or barely recovering at the time. Moreover, the Democrats could point to Republicans as being the cause of the high unemployment. All this is enough reason to encourage Congressional Republicans to draw a line under any intransigence in negotiating a deal.

The US and European equity markets look oversold, so good news could extend their very spirited start to the week. The developments in the Middle East, Gaza in particular and Israel's readiness to use troops to defend itself against rocket and missile attacks are worrying. But as discussed in previous notes, resolving the fiscal cliff could provide a powerful antidote to the loss of momentum throughout the global economy and its impact on corporate earnings. The message from President Obama is that he and Congressional leaders are confident a deal will be struck that avoids the fiscal cliff. It may not be the 'grand bargain' but if a deal lessens the uncertainty that has inhibited growth, equity markets should rebound strongly.