BREWIN DOLPHIN

MARKET STRATEGY

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

INVESTMENT RESEARCH

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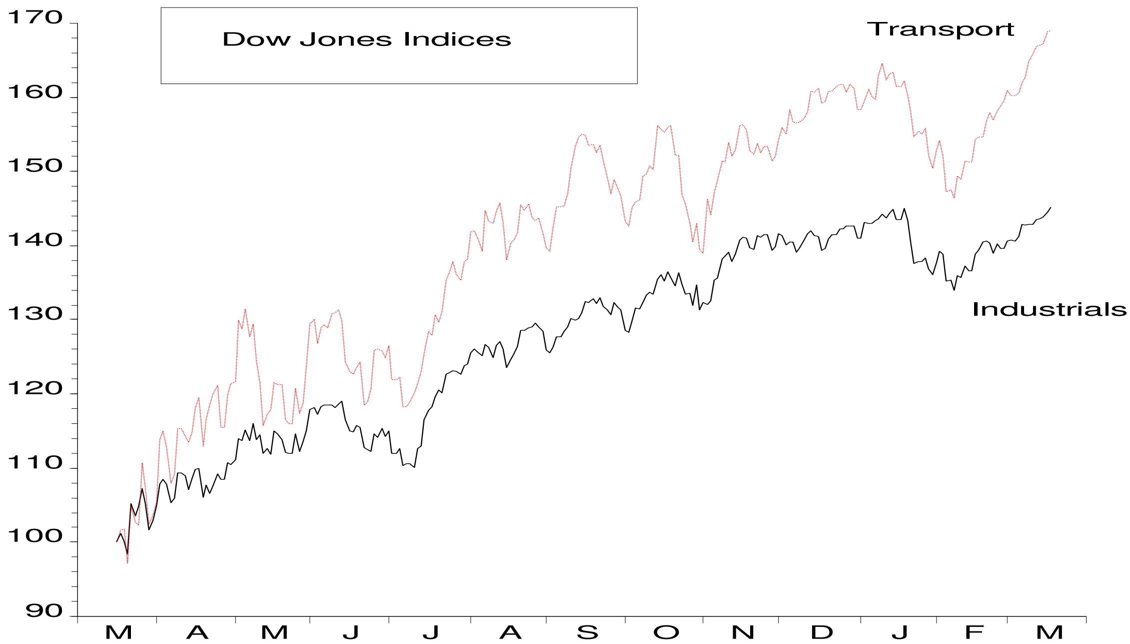
New post-March '09 high for the Dow – another bullish signal.



Source: DATASTREAM

Managing expectations is no easy task but, in a sense, this is what the Fed is doing and it will do more of this when the time comes to wean markets off its message. It won't say 'economic conditions no longer warrant exceptionally low levels of the federal funds rate for an extended period'. It will say what it's saying now, like '... the labour market is stabilizing' or '... Business spending on equipment and software has risen significantly'. In other words it will start talking up the economy. Sure it might still say it intends to '... employ its policy tools to promote recovery and price stability', but this goes without saying and, as the months roll on, it is likely to make less of these statements and more of the other.

But while it talks up the economy, the Fed also needs to be mindful of the Treasury market because the last thing it wants is give the bond market the heebie-jeebies – at least not until it reckons the recovery is well and truly sustainable. Hence the 'extended period' message. However, the bond markets are savvy and, with profitability improving and business spending picking up – this usually leads employment – the Fed can only go on playing this game for so long. For now, the Treasury market is happy to play along.

Then again, the calmness of the Treasury market may reflect a different sentiment. Maybe it just doesn't trust the recovery. Maybe it reckons that the impact of the financial crisis has yet to run its course, that in time, the economy might still succumb to potentially contractionary and deflationary forces – a bit like Japan.

If so, this sentiment is not shared by the other bond markets where little sense of apprehension is evident. For example, yields on corporate and emerging market debt have fallen to new lows for the cycle and credit spreads have continued narrowing.

Equity markets have been climbing the wall of worry amid no shortage of comment on the sustainability of the recovery, sovereign debt issues, central bank tightening or, indeed, policy errors. None of this has stopped the S&P 500, Nasdaq, and now the Dow, as well as the FTSE 100 and now the DJ Stoxx Europe 600 ex UK from reaching new post-March '09 highs.

In a recent note, attention was drawn to new relative highs for the US mid caps (New relative highs for mid caps – a bullish sign 8 March 2010). The comment was that this provided a lead on the equity market and, because of the cyclical exposure of the mid caps, a lead on the US recovery coming through to the domestic economy – meaning that the jobs are coming. More jobs mean more consumer spending and hence more top and bottom line growth for companies.

Yesterday the Dow Jones Index closed at a post-March '09 high. Having lagged the rises in the S&P 500 and Nasdaq, the Dow's closing high is significant. While it may not be representative of the US equity market, the Dow is nevertheless symbolic of the financial leadership that Wall Street still provides. In this context, the Dow's new post-March '09 high is a boost for sentiment.

Has the US equity market risen on thin air? I don't think so. We know that earnings are not only surprising on the upside but also that revenues are starting to do this too. Top line growth is beginning to contribute to the bottom line. The upgrading of the earnings estimates means that valuations remain sensible. Also, and to return to where we started, the Fed still judges that exceptionally low interest rates are warranted for an extended period, thus helping bond markets to behave well. It all sounds too good to be true – but then that's part of the wall of worry too.

Relative strength indicators show that the rise to new highs for the equity markets has pushed them into overbought conditions and some, like the S&P 500 and Nasdaq, are verging on the extreme. Thus far, the markets have been reluctant to yield to any profit-taking but it would be astonishing if they didn't. However, both the fundamentals and market dynamics suggest that any buying opportunity that arises is, like January's sell-off, likely to come and go – that is, if it arises at all!

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IMPORTANT NOTES