



BREWIN DOLPHIN

MARKET STRATEGY

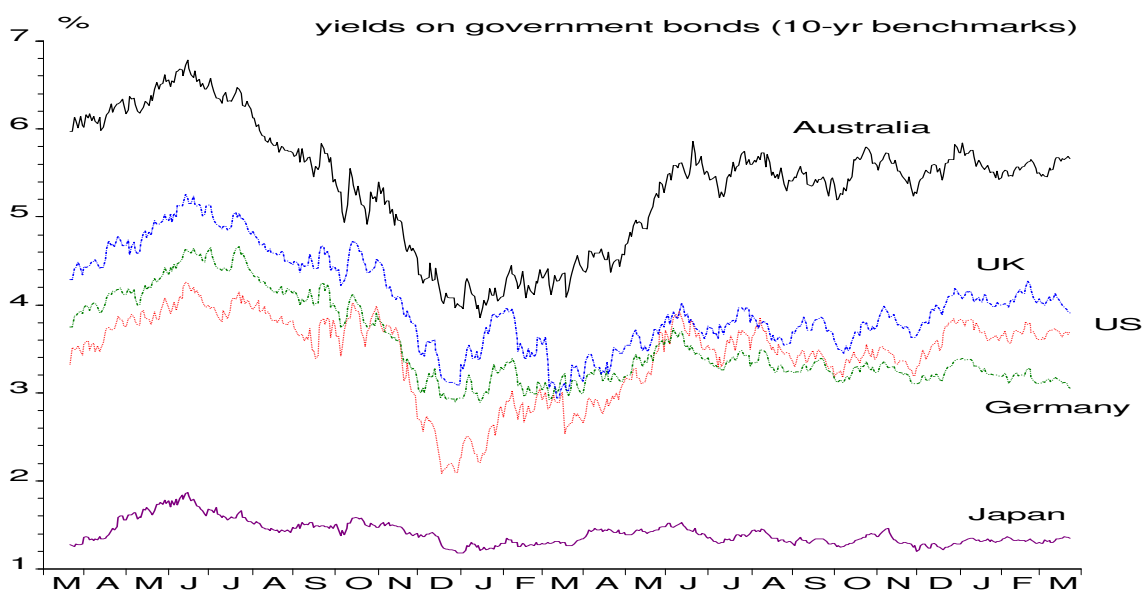
INVESTMENT RESEARCH

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Government bond markets help equity markets to new post-March '09 highs.



Source: DATASTREAM

Germany digs its heels in and the European Union's odyssey with Greece continues but it's all a side show for equity markets which have been moving to new post March '09 highs, a feature not only associated primarily with developed markets but also one that is not just down to the US. The FTSE 100 and, depending on your choice of index, Europe ex UK have climbed to new highs too. Of the bigger markets Japan remains the laggard. It has rallied along with the majors but has failed to participate in the move to new post March '09 highs.

One among several reasons why equity markets are doing well may be down to the government bond markets, which are behaving rather better than might have been imagined. This is considering the recovery coming through in the global economy and concerns by some about inflation or inflation expectations as implied by the 'break-evens'. Not even talk about central bank exit strategies or indeed the tightening now under way in the Asia-Pacific (ex Japan) economy is unsettling the bond markets. Nor are they disturbed by the warnings from the credit rating agencies, the most recent of which came from Moody's last week when it said that the US and the UK had moved substantially closer to losing their AAA credit ratings. This was for reasons to do with the cost of servicing their debt. But who cared? US Treasuries and gilts were not the slightest bit fazed.

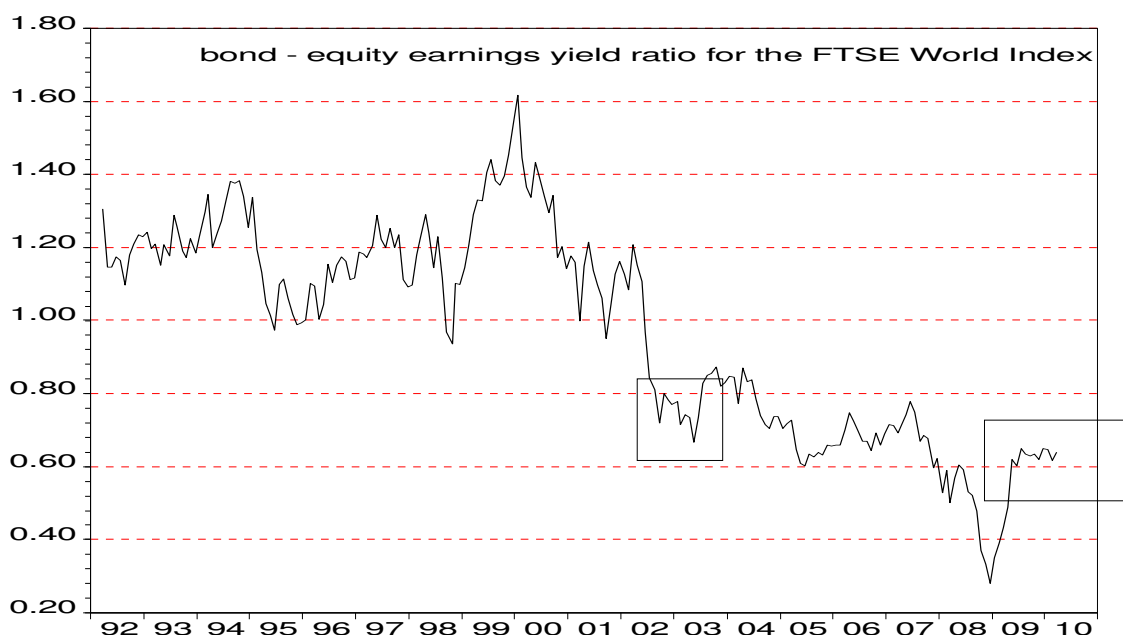
As the chart above shows, from about last June onwards, government bond markets have traded more or less sideways. In the US the stability is no doubt down to the Fed's message on interest rates – that is, its 'exceptionally low for an extended period' message. But even where interest rates are rising, as in the case of Australia – the Reserve Bank of Australia has pushed rates up four times since last October and indicated there is more tightening to come – the bond market has exhibited an impressive degree of stability. In the UK yields on gilts have fallen quite

a way from their February peak. In the eurozone, yields on German Bunds have dropped below a key threshold level and are not all that far from their pre-March '09 lows.

That the bond markets remain so well behaved is another reason why equity markets have been reaching new post March '09 highs. Better or stable bond markets coupled with earnings upgrades help valuations for equity markets and this enhance their appeal. As the chart below shows, the bond-equity earnings yield ratio for the FTSE World Index shows that equity markets are more favourably valued now than they were at the start of the last bull market – and this is even after a 78 percent rise in the Index in dollar terms (65 percent in sterling) from their March '09 lows.

We said a few times before that the US indices especially are overbought on Relative Strength Indicators. In fact the more they rise the more overbought they look but then that's bull markets for you. If they don't want to correct just yet who's going to argue?

Two key changes were made to our UK sector strategy recently. Mining was downgraded to in line and Food Producers upgraded to overweight. The former was on the view that the excitement in commodity prices was likely to be over for the time being. The latter followed our long held view that Asia and the United States will continue to lead the upswing in the cycle and that Sterling's weakness will help overseas earners. The Food Producers fit the bill. They are big overseas earners not only through their exposure to the US but also to emerging markets, which are the key engine for sales growth.



Source: DATASTREAM

IMPORTANT NOTES

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