BREWIN DOLPHIN

MARKET STRATEGY

INVESTMENT RESEARCH

21 May 2010

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

What's really bugging Wall Street?

Source: DATASTREAM

While the sovereign debt crisis may be overwhelming the politicians, whose response has been failing to impress, there is another issue to which Wall Street may be reacting. We'll pick this up in a moment.

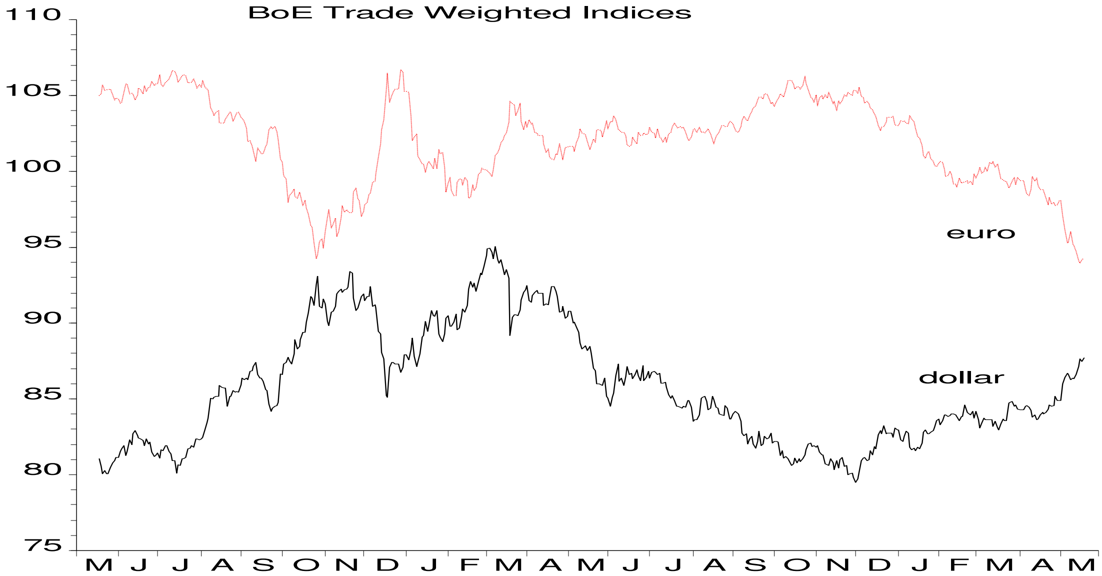
In commenting on the general backdrop for equity markets recently **(*Hysteria – it's back!* 12 May 2010)** attention was drawn to their technical condition. While the sell-off from their April peak had taken them into an extended oversold condition on Relative Strength Indicators, the feature highlighted in the note was that this was less the case with other overbought/oversold indicators. The example used to illustrate the point was that for the UK equity market and is reproduced above.

As shown, the dip into oversold territory was relatively modest. This cast doubt on the prospect that a strong rebound lay ahead and that an ideal buying opportunity had been presented. Equity markets have since fallen back and taken out the low point reached two weeks ago. A rebound of sorts may follow but we still have our doubts that a genuine buying opportunity has arrived.

So what about Wall Street? Fundamentals are more supportive for the equity market than expected. The story behind the recovery in profitability is no longer just about cost cutting and restructuring. Revenue is growing. Moreover, jobs are now being created thus increasing the likelihood of and confidence in a sustainable economic expansion. Forecasts for GDP growth are continuing to be revised up. Thanks to this and also to the strength of the recovery thus far, America's own budget deficit is expected to be nowhere near as bad as forecast initially.

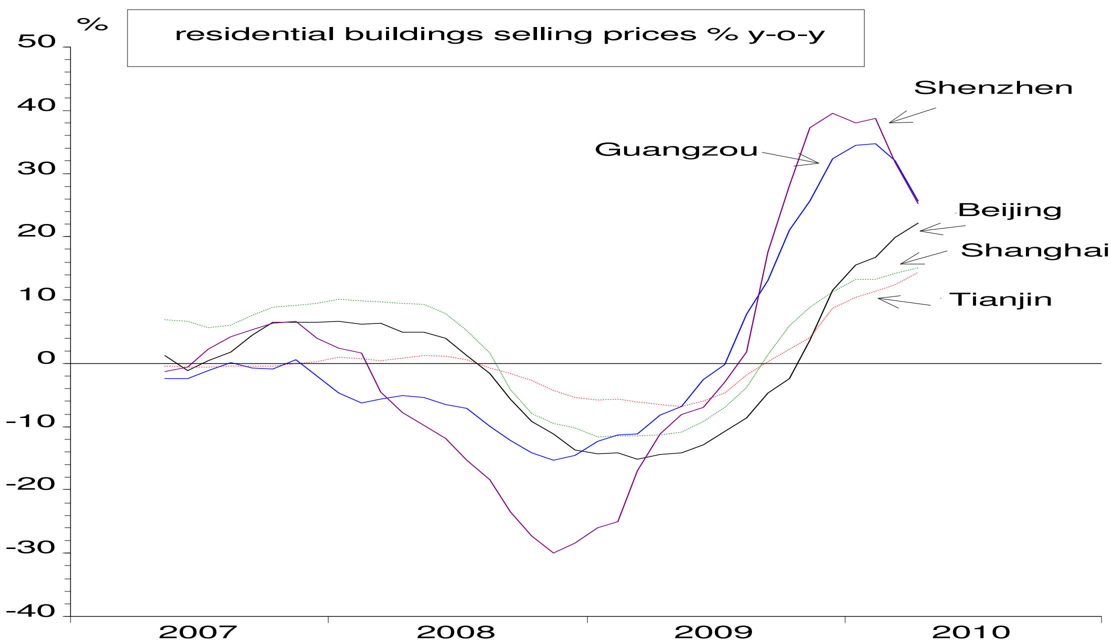
On earnings for the S&P 500, about a third of the 40 percent or so derived overseas comes from Europe but some two-thirds originate in areas of the global economy that are growing faster than the eurozone and the UK. Furthermore, expectations for growth outside of Europe are still being revised up according to the latest from Consensus Economics Inc. On the face of it then, the news flow for the US equity market remains positive and, on that basis, valuations are attractive.

Yet Wall Street's thoughts might lie elsewhere – like with the deflationary impulse that the eurozone's sovereign debt crisis exports to the US via the exchange rate appreciation in the dollar. As the chart of the trade weighted indices shows, the dollar may not be near the level it reached in March 2009 but it has been working its way towards it. If you're a bear of the euro you're probably thinking that, with each step the dollar takes towards higher levels, the much less competitive dollar priced goods and services become, thus affecting S&P 500's earnings – domestic as well as overseas.



Source: DATASTREAM

Also, the dollar's climb takes the renminbi with it, which means that China's growth gets hit too. Indeed, that goes for any dollar-related currency. This puts the squeeze on the Asia-Pacific economy for which the interest rate cycle is on the turn. Although China has not raised interest rates it has been curbing bank lending and attempting to micromanage a cooling down of the economy. From the behaviour of the Shanghai Composite, the authorities appear to be succeeding with their efforts, which are also starting to become apparent in the housing market, as the chart below shows. House prices have actually fallen for the past couple of months (month-on-month) in a few major cities.



Source: DATASTREAM

In reflecting on where we've come from, it was the dollar bloc (notably the US and China) that led the way in the global recovery. With the rise in the dollar a risk now is that its contribution to the global upswing lessens and that this in turn results in a loss of the earnings 'momentum' behind the rapid upward revisions to global earnings expectations. The downside is that it spoils what has been very positive news flow for equity markets.

Commodity prices may now be reflecting the disinflationary/deflationary impact of the strengthening dollar. The London Metal Exchange Price Index is down nearly 20 percent from its recent post-March ’09 high.

More disturbingly, the latest reading on US consumer prices for April shows that core inflation has dropped to its lowest rate since the early 1960s. Having dropped to just below 1 percent, core inflation is not a million miles from the threshold that separates disinflation from outright deflation. This could easily convince the Fed to keep interest rates where they are for the indefinite future and while equity markets might like this, it’s the prospect of deflation they won’t like.

Source: DATASTREAM

The FTSE All-World Index is down some 12 percent from its April peak. That’s not a big correction for what might really be on the cards. Sure, the sovereign debt crisis affects sentiment as does the policy mismanagement but the ‘big deal’ might lie in the consequences described above and to which equity markets may already be reacting. As discussed at the outset, the markets are not oversold enough to make us think this is ‘the’ buying opportunity. But the markets are working on it and we suspect it lies further down.

IMPORTANT NOTES

The information contained in this report represents an impartial assessment of the value or prospects of the subject matter. Graphs, performance data etc are as at the close of business on the day preceding the date of the note. The information contained in this report has been taken from sources disclosed in this presentation and is believed to be reliable and accurate but, without further investigation, cannot be warranted as to accuracy or completeness. The opinions expressed in this document are not the views held throughout Brewin Dolphin Ltd. No Director, representative or employee of Brewin Dolphin Ltd. accepts liability for any direct or consequential loss arising from the use of this document or its contents. We or a connected person may have positions in, or options on, the securities mentioned herein or may buy, sell or offer to make a purchase or sale of such securities from time to time. In addition, we reserve the right to act as principal or agent with regard to the sale or purchase of any security mentioned in this document. For further information, please refer to our conflicts policy, which is available on request or can be accessed via our website at www.brewindolphin.co.uk. The value of your investment or any income from it may fall and you may get back less than you invested. Past performance is not a guide to future performance. If you are in any doubt concerning the suitability of these investments for your portfolio you should seek the advice of a qualified investment adviser. Brewin Dolphin Ltd, a member of the London Stock Exchange, authorised and regulated by the Financial Services Authority. Registered office: 12 Smithfield Street London EC1A 9BD. Registered in England and Wales no 2135876.