Market Tactics

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

INVESTMENT RESEARCH

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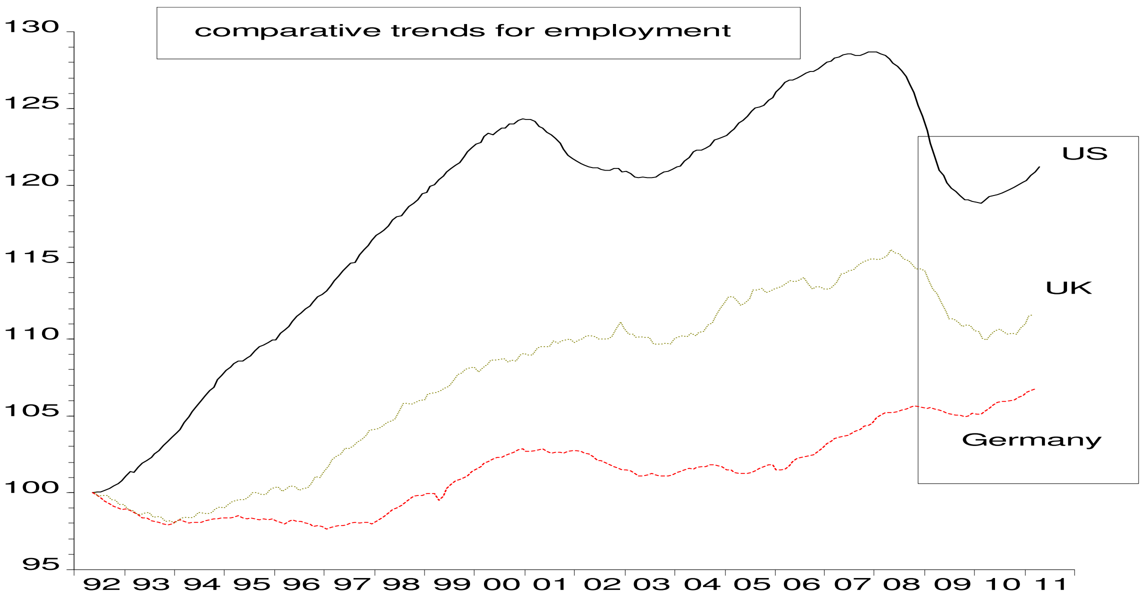
Markets focus on short term loss of momentum.



Source: DATASTREAM

With their sights set clearly on a loss of recovery momentum underlying the global economy, equity markets look set for more profit-taking following the latest flash reading on China's Manufacturing Purchasing Managers' Survey. This showed that the economy is continuing to slow. China's PMI was also followed this morning by the eurozone's manufacturing and service sector purchasing managers' surveys and both of these disappointed. So the bond markets start the week with little need for a lead on where to go next.

Bond markets have done well to get where they have but they know from April's FOMC minutes that the Fed has now agreed an outline of how it will implement its eventual exit strategy. They know too that QE2 will end in June. And, with the exception of Japan, they know that inflation is not only above target for the major central banks but also heading firmly upwards. Surely, none of this is good for them!

That is, unless, of course, the attempted reflation of aggregate demand is doomed to end in failure. But this is unlikely and it helps to look at what may be possibly the most persuasive case in support of the outlook for a sustainable expansion.

As the chart shows, the trend for US private sector non-farm payrolls looks to be decisively on the upswing. The employment trend for Germany is simply astonishing. Its climb to new and higher levels points to growth ahead not just for the economy but also help, more broadly, for the Eurozone. Even the UK economy, which is saddled by fiscal austerity, appears not to have lost totally its capacity to create full time jobs.

Job creation is surely the strongest reason for thinking that the reflationary effort has not gone just into commodity prices. Clearly, the developing world's hugely significant contribution to the global recovery has had much to do with boosting corporate profitability. In Germany's case this is in spite of a euro that is nowhere near as competitive an exchange rate as the dollar.

For jobs though we are not talking just about the big internationals but also about smaller and medium size companies. Not only do they tend to be more closely geared to the domestic economy but they are also the bed rock of job creation. With the latter now underway, here then is the compelling reason for believing that the reflationary effort undertaken by the developed economies is working to secure a sustainable expansion.

It suggests that Japan's bond friendly environment of deflation is unlikely to be replicated. It also suggests that while a loss of momentum from higher commodity prices and tightening monetary policies in the developing economies is to be expected, the fundamental underpinning for a sustainable expansion and support for equity markets is present for the bond markets to see too.