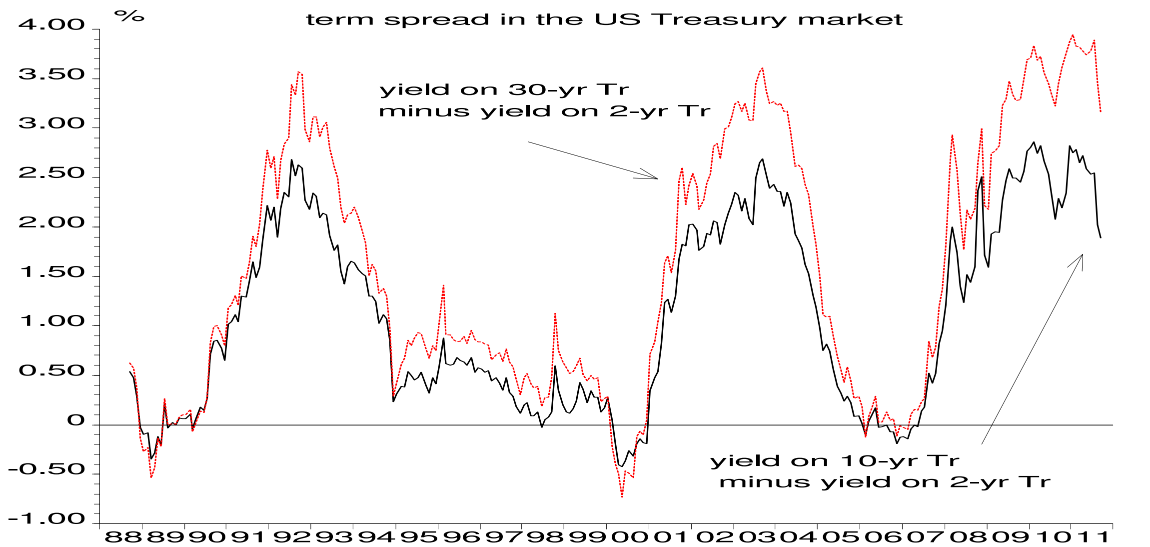
BREWIN DOLPHIN

Market Tactics

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

INVESTMENT RESEARCH
19 September 2011

Inaction by Eurozone's Finance Ministers gets a thumbs down



Source: DATASTREAM

Actions may speak louder than words but, as the week gets underway, equity markets are giving inaction the thumbs down.

'Membership in a monetary union is an opportunity, but also a heavy burden' said the German Finance Minister over the weekend. For Greece, the latter part of the sentiment is, if anything, an understatement and, as for an opportunity, Mr Schaeuble must be joking. Greece is not alone in finding that bit hard to swallow. Germany does too! As do the Finns and probably the Dutch, which is exactly why last weekend's gathering of eurozone Finance Ministers has yet again led nowhere but to more disappointment.

Was anyone really going to listen to Mr Geithner's call for expanding the EFSF by leveraging off the ECB and for eurozone Finance Ministers to follow the US example of introducing a fiscal stimulus? Did they like being told the way it is, notably that their financial challenges have left a lot to be desired?

Not that they would have wanted to hear it from Mr Trichet either. His sharp but still diplomatic touch bore criticism too when he put it thus; '… the problems are not words, the problems are deeds.'

If action speaks louder than words we might see some of it this week elsewhere. Eurozone Finance Ministers seem bent on driving the Eurozone into recession and towards deflation but the Fed is not going there, at least not if it can help it. And neither is the Bank of England.

While the Fed is about as reflationist as they come for a central bank, the MPC may be veering towards Adam Posen's way. Being the lone MPC member behind augmenting the Bank's QE programme, Mr Posen indicated last week that the economy might require £100 billion in reserve assets and not the £50 billion he has consistently been calling for. We will know more when the Minutes for September's MPC meeting are released on Wednesday.

For its part, the Fed's two-day session which starts tomorrow, will be devoted to reviewing the pros and cons of the options available for more monetary stimulus. A recent note (Focusing US fiscal and monetary policy on where it counts, 5 September 2011) concluded that the Fed would be favourably disposed to restructuring its balance sheet in favour of more long dated US Treasuries.

Not only might this help in addressing one of the more persistent influences behind the US economy's weakness, notably the depressed housing market, but in lowering bond prices it may also boost asset values all round thus helping to induce wealth effects in aggregate spending. Although term spreads have narrowed already by virtue of the global flight to quality, they remain sizeable thus giving the FOMC plenty to go for. We suspect that the dovish axis, which includes the Fed Chairman, will tip the balance of the FOMC towards this option and possibly a cut in the interest rate charged on reserves.

Returning to the policy front, what's missing is a forthright and cohesive commitment by politicians to dealing with the difficulties of debt sustainability for the eurozone. Yet the surest way of demonstrating this is for the member countries to put quickly into place much of what has been discussed already, that is a framework for fiscal and budgetary governance along with the expanded role for the European Financial Stability Facility. Here would be action that speaks louder than words.

For equity markets, inaction merely fosters an environment where the risk attached to earnings visibility is rising steadily. As a result investors are grappling with the valuations that should apply. The higher risk premiums demanded are reflected in higher earnings yields, in equity markets that remain unsettled and in lower yields in quality bond markets.

Equity markets have been discounting a lot of bad news including the prospect for little or no earnings growth looking ahead into next year. For investors whose patience is being tried by inaction, it has been a joyless time, but at least patience is being rewarded by attractive dividend yields.