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Market Tactics

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INVESTMENT RESEARCH
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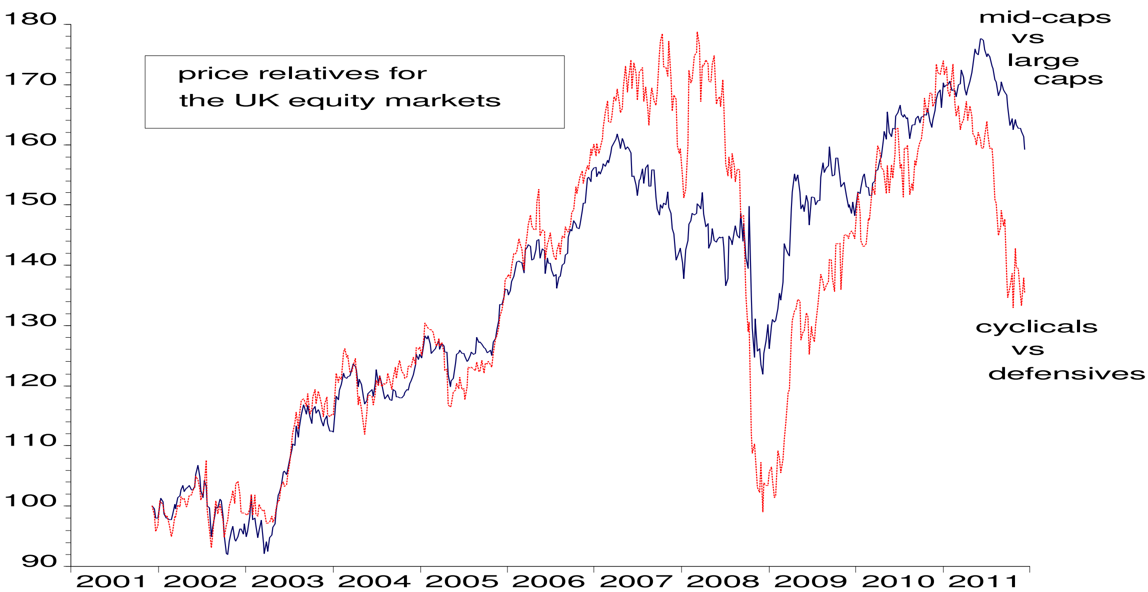
A eurozone deal – now markets await the detail.



Source: DATASTREAM

Perhaps the detail of it was never a likely prospect at last Friday's EU summit. However, to give the eurozone's fiscal compact credibility, not only with the markets but also with the ECB, the process of adjustment and timeline towards the rules on fiscal governance need to be spelled out. Where ratios of budget deficits and debt to GDP exceed those stipulated, what is the adjustment process that applies before automatic sanctions kick in?

Part of this is implicit in the terms and conditions agreed already in the bailouts for Greece, Ireland and Portugal but not for such members of the eurozone as France, Spain and Italy which are expected to end this year with budget deficit to GDP ratios in excess of 3 percent. Until a comprehensive process of adjustment is specified, the risk is that markets take the view that the fiscal compact is incomplete and lacking in credibility. The risk is also that the ECB sees it that way too and remains hard-nosed about what it is ready or not to do.

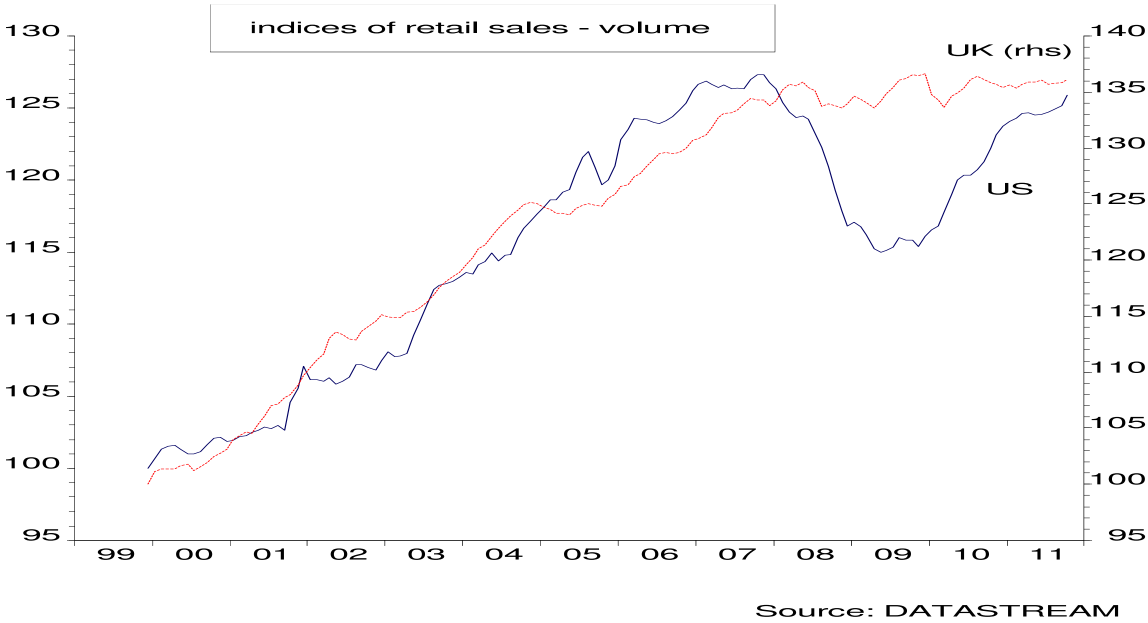
Hopefully this will form part of the detail to be put in place by March 2012. According to the European Commission President, Mr Barossa, the EC will be 'acting to ensure swift preparation of the treaty that is fully compatible with European Union law and which also preserves the role of the European Institutions'.

What has been agreed is that the original Stability and Growth Pact (S&GP) is to become a binding fiscal framework with sanctions on any breach of the rules governing the Pact. The framework will be grounded in an intergovernmental treaty (that will sit along side the EU Treaty that Mr Cameron refused to sign up to). The European Stability Mechanism (ESM) is to become operational at the beginning of July next year but the European Financial Stability Facility (EFSF) is still expected to run to mid-2013. The two combined are to be limited to 500 billion euros, although this may be subject to revision.

EU governments also agreed to provide loans to the IMF of up to 200 billion euros mainly in support of the eurozone economies. Of this, some 150 billion euros is to come from eurozone members. This readiness to extend resources to the IMF could encourage contributions from the developing world, a route down which China, Brazil and others may be prepared to go in their support, albeit indirectly, for the eurozone.

Shifting scene, figures on retail sales are due for the US and the UK this week. The chart below shows retail sales in real terms for the US and the UK. For the former, retail sales in volume terms are nearly back to their previous cyclical peak. In the UK the volume of retail sales have held up impressively well these past few years.

However, considering that the UK economy is falling on hard times and that employment is beginning to turn downwards again (labour market figures are also out for the UK this week), you wonder whether even a sideways trend for retail sales can be maintained next year. The contrast lies with the US where, with the trend of employment firmly upwards, retail sales are likely to be heading for new cycle peaks.



Equity markets have worked through their oversold condition and need good news to sustain the momentum as they await the detail on the eurozone's fiscal framework. Meanwhile the estimates for corporate earnings are being downgraded. Mid-caps are underperforming large caps. In the UK, the second liners tend to be hugely sensitive to the swings and roundabouts of the cycle and where they go in terms of relative performance against the large caps, so go the cyclicals in terms of relative performance against the defensives. In terms of sector strategy, a defensive positioning remains appropriate.