BREWIN DOLPHIN

Market Strategy

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

INVESTMENT RESEARCH
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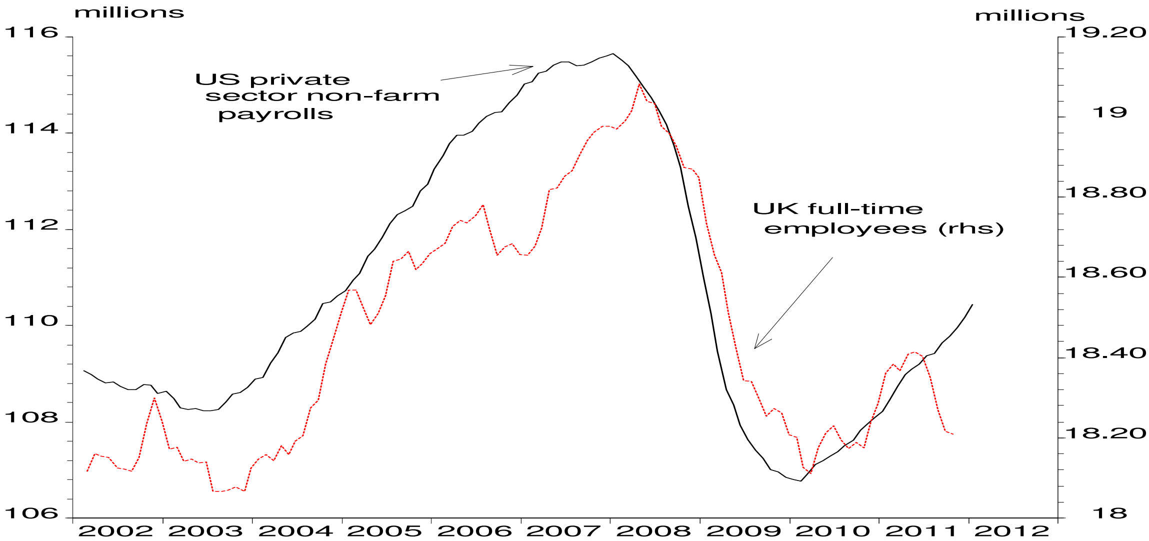
A justifiable re-rating for equity markets even as earnings lose momentum



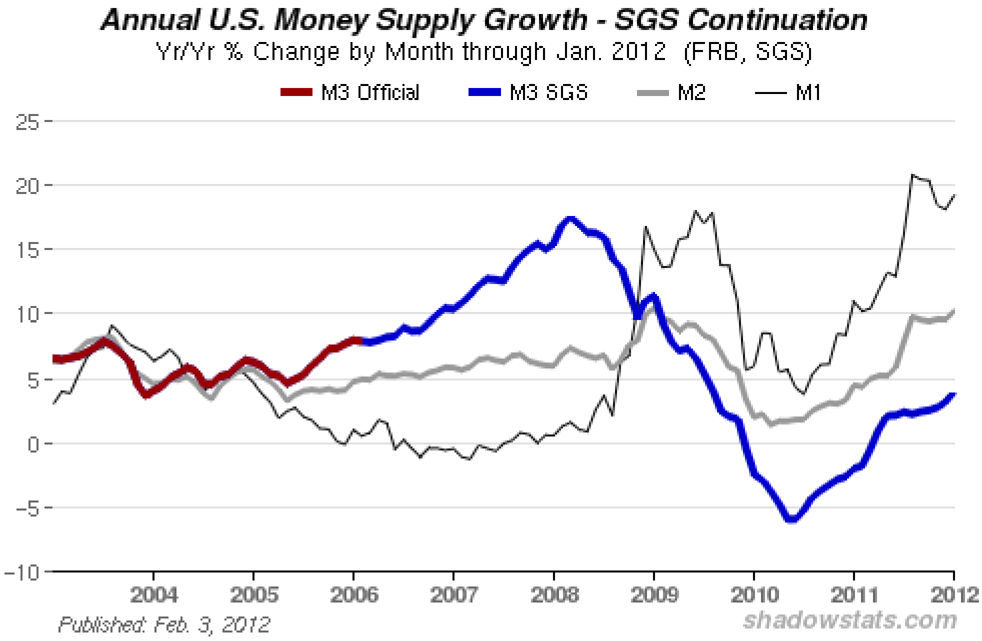
Source: DATASTREAM

Good news for equity markets! Yesterday's Super Bowl champs, that is. Or should this have been anticipated with the Dow's rise to new post-financial crisis highs? The New York Giants, who defeated the New England Patriots, came from the old National Football Conference of the National Football League (NFL). The Patriots came from the old American Football Conference. A win by a team from the former division is supposed to be good for the US equity market. The record for this Super Bowl Indicator – an 80 percent success rate is attributed to it – is probably as good, and maybe better, than anyone else's.

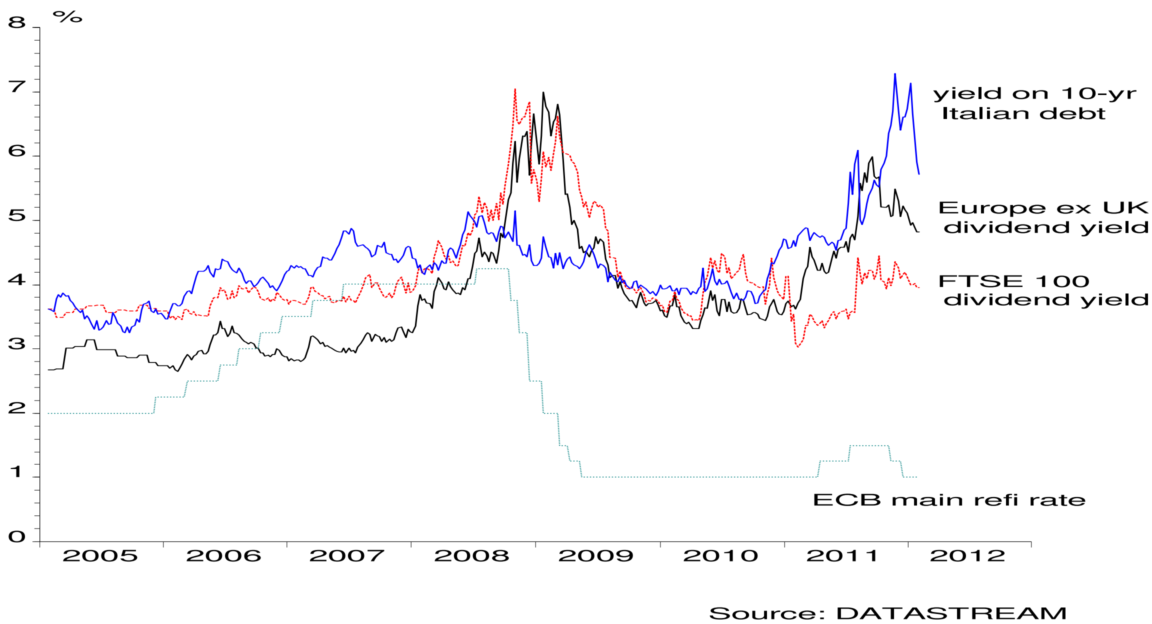
However, for non-NFL fans there is still good news for Wall Street. While the Fed Chairman's sentiment about a 'frustratingly slow' recovery is no doubt widely shared, not only is the economy growing but also the recovery is proving to be sustainable. What better economic indicator of this than employment and, for monetarists, broad money supply. Employment is growing more strongly than expected – aside from last Friday's Non-Farm Payrolls, the latest revisions to the series for 2011 show that more jobs were created than estimated – and broad money supply growth is beginning to pick up again after the loss of momentum for much of last year.

Compare that combination to the UK position where employment, as measured by full time employees, is falling and where broad money supply is static at best (M4 is actually declining and M4 ex Intermediate Other Financial Corporations is no higher today than it was a year ago) and you wonder what the Fed Chairman is talking about. Yes, it's all relative. The Greeks must look at America with envy. And as for the UK, it likely means that the Bank of England's MPC will announce more quantitative easing on Thursday.

Not long ago the judgment reflected in bond and equity markets was that the eurozone sovereign debt crisis had put at risk the stability of the global financial system and with this the stability of the global economy. Recent action, such as the shift towards the higher beta areas of risk assets suggests the judgement has changed.



Indeed, not only have yields in quality bond markets stabilisd but a few of the eurozone's distressed sovereign debt markets – notably those for Italy and Spain – have made up some of their lost ground. With money at one percent for the three-year loans the ECB is making available through its Long-Term Refinancing Operation (LTRO) – the second of two is coming at the end of this month – there are great carry trades here. They are available too in equity markets too where yields are high and where dividends are likely to grow.

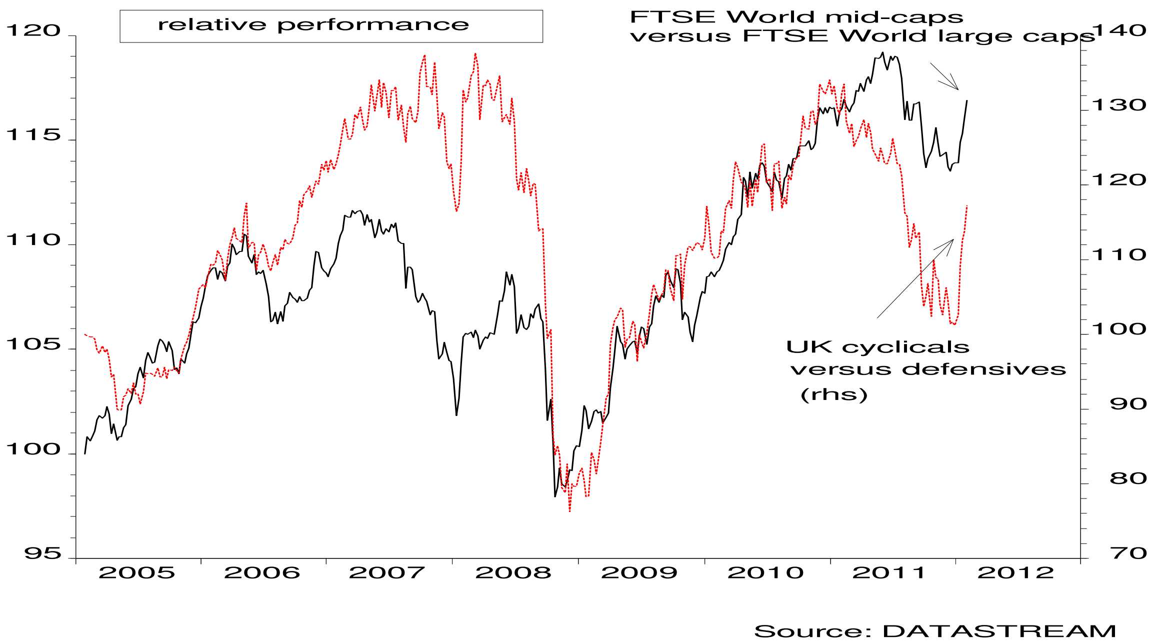


For equity markets, it is not just their underlying tone that has improved. The New Year has also seen small and mid-caps outperform large caps, cyclicals outperform defensives and developing markets outperform developed. Accompanying this shift towards more 'beta' has been a re-rating of the valuations attached to equity markets at a time when earnings momentum is fading. Looking at the corporate results and the lower beats-to-misses ratios compared to the corresponding period a year ago begs the question whether the re-rating is justified.

We think it is. First and as indicated, the momentum the US economy has been regaining looks sustainable. Second, while the developing world is losing momentum, central banks are responding by easing policy and have plenty of scope to continue doing this, through conventional means. Third, a more constructive phase for policy makers is underway in Europe. For a start, the ECB took a giant step towards subduing the banking crisis. Its message in introducing its three-year LTRO and extending the range of acceptable collateral was that the survival and functioning of the eurozone banking system were beyond question.

EU leaders, meanwhile, have indicated their readiness to sign up to an Intergovernmental Treaty that will bind them (25 of them) into a fiscal framework setting out the rules and governance (along with an enforcement mechanism for eurozone members) behind the eventual path to sovereign debt sustainability.

This will be a giant step too. It will not resolve the difficulties confronting Europe in the short term but in place will be the discipline, including its surveillance, by which the crisis can be tackled over the medium and longer term. The so-called 'fiscal compact' needs to be ratified by a minimum of 12 eurozone governments and, provided this happens, it will come into force at the start of next year.



Risks for the outlook remain including a hard landing for China. Higher oil prices – and a hard landing for all of us – are a risk. Meanwhile, today is supposed to be crunch time for Greece in responding to the terms of the second bailout and like the markets, we await the outcome.

On the face of it though, another banking crisis now seems less likely and the sovereign debt crisis may at last be on the road to resolution. The risks appear to have been greatly diminished as has the degree of the uncertainty in the outlook for earnings that prevailed until now.

On that view, a re-rating is justified, as is being a little less risk averse, though markets may be up with events. The S&P 500 is overbought on its Relative Strength Indicator, which suggests caution. Then again, bullish trends look that way.