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Market Strategy

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A deal not quite done – but the bet is on!

Source: DATASTREAM

'We have to sacrifice a lot so as not to sacrifice everything'. That sounds like the rallying cry behind a war for freedom. It was one among many of the pleas from Greece's leaders over the weekend. Coming from the former Prime Minister, George Papandreou, whose father and grandfather, were prime ministers of Greece themselves, it was one of the more emotive calls to parliament to back the law that will enact the austerity measures behind a second bailout. Parliament listened!

Is it a done deal? Not quite since Eurozone finance ministers meet on Wednesday to pin down Greece's coalition government to a final agreement on details for 325 million euros worth of deficit reduction and written endorsement from all coalition leaders on implementation of the conditions for the second bailout. Also, following this, parliamentary approval is required for the contributions by eurozone members to Greece's loan.

However, lawmakers in Greece have chosen to go for it knowing the hardship and burden the Greeks must bear for the indefinite future. It is difficult to imagine that Greece will not now be granted access to a second bailout. The betting must be that it will.

Bond and equity markets are likely to read this as another positive development in helping to diminish further the risk of contagion and subduing the eurozone's financial crisis. For the banks it is likely to be seen as a green light for carry trades in the eurozone's higher yielding bond markets (e.g., Italian and Spanish debt markets) and all the more reason to borrow big time at this month's (29 February) three-year Long-Term Refinancing Operation (LTRO).

In helping to underpin the 'high yielders' in debt markets, this latest development should also help push the risk trade into equity markets. We have been saying that Wall Street looks overbought but also that a bullish phase can make equity markets look technically extended for a while. Both the Dow and Nasdaq have

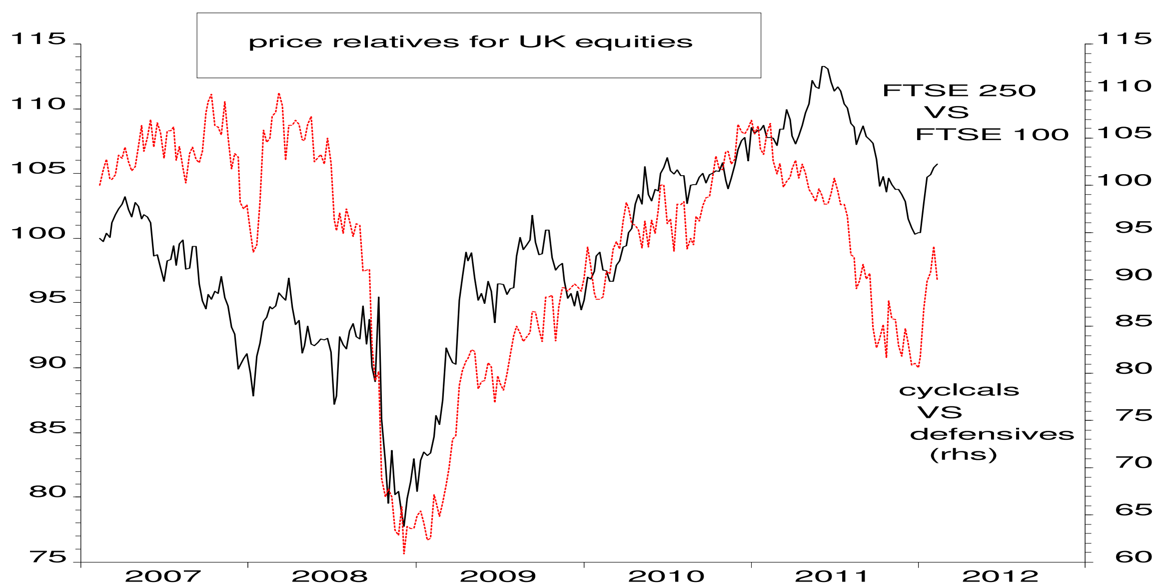
climbed to new post-financial crisis highs and the S&P 500 is not so very far from doing so. It would not be surprising now if the FTSE 100 managed to push up and through its own post-financial crisis high of 6091 of a year ago.

Earnings are supportive – not great maybe, but not bad! The US is the easiest example to draw on because of the access to the beat and misses on earnings. Thus far, with over 70 percent of the S&P 500 having reported its fourth quarter results, the ratio of beats-to-misses has climbed from something just shy of 2 to 1 to something a little better, like 2.4 to 1. Importantly, the earnings estimates have been revised up since the start of the reporting season.

From China, this morning's Financial Times reported that the banks have been instructed by the China Banking Regulatory Commission to roll over certain outstanding loans to local governments and extend repayment dates for several years, thus lessening the risk of a hard landing.

Yes, it may be all buying time. But who isn't buying time in an effort to help the economy? Having just extended its 'extended period' message on interest rates, the Fed is buying time by making sure that the recovery, the prospects for which are looking up, is sustainable. The ECB is buying time through its three-year LTROs hoping to remove what has been a hugely destabilising influence on the economy. The Bank of England is buying time: the Monetary Policy Committee's recent decision to expand its quantitative easing programme by another £50 billion is about reflating aggregate demand and boosting broad money supply growth in recognition that, without the extra effort, '... it was more likely than not that inflation would undershoot the 2% target over the medium term.' It all needs time and money.

Yet for equity markets a more constructive backdrop is emerging compared to a few short months ago, which lessens risk premiums and justifies the re-rating discussed previously ***(A justifiable re-rating for equity markets even as earnings lose momentum)***. Lastly, none of this says anything of the corporate activity that is picking up and which also offers more ammo for equity markets to move onwards.



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MPORTANT NOTES

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