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Market Tactics

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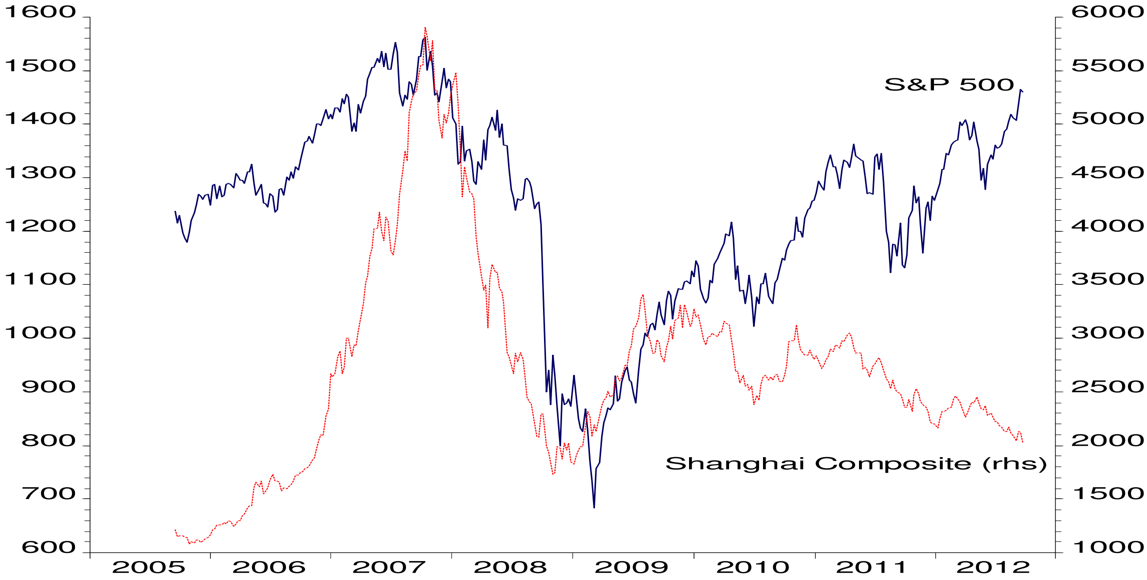
Wall Street's underlying 'risk-on' trend.



Source: DATASTREAM

Writing in last Friday's **Insight** column of the Financial Times, Gillian Tett picked up on the Fed's latest initiative on QE3 ***(Beware the high costs and psychology of America's QE3)*** and on why several Fed Governors (and non-voting FOMC members) were less than supportive of it. She encouraged those wishing to celebrate the market action to read the speech given last week by Richard Fisher, head of the Dallas Fed and one such non-voting member – and I did.

In his talk, which was 'bold' and well worth the read, Fisher focused on uncertainty as the key in preventing monetary policy from being as effective as might be expected and thus questioned the merits of more stimulus if companies are not responding to the Fed's policy initiatives already. To quote Fisher: '... you cannot have consumption and growth in final demand without income growth; you cannot grow income without job creation; you cannot create jobs unless those who have the capacity to hire people – private sector employers – go out and hire.'

If uncertainty inhibits what would otherwise be the response to easy monetary policy, what good can more QE do? Fisher cites evidence, which applies as much to medium-size and small businesses as to large companies, as indicating that monetary policy is not an issue and that even if interest rates could be cut, this would not induce firms to alter their investment intentions.

Moreover, the concerns are broadly shared across the corporate spectrum. As Fisher put it: '… With the disaster that [US] fiscal policy has become and with the uncertainty prevailing over the economic condition of both Europe and China … it is no small wonder that businesses are at sixes and sevens in committing to expansion of the kind … to propel job creation.'

There is no doubting the uncertainty. Sir Mervyn's 'black cloud' stretches far and wide. But with one exception, much is being done about it. The introduction by the European Central Bank of a formal framework for supporting bond markets is subduing the crisis and its destabilising influence. China's landing remains an uncertainty but it is also easy to forget that the authorities are targeting slower growth and that policy is intentionally geared to stabilising rather than stimulating the economy. The last thing the authorities want is to hand over to a new leadership an economy heading for the rocks or heating up again. While the balance is fine, the objective is clear. Less clear is the outcome, an uncertainty reflected in the equity market.

But at least there is a sense of direction with the Chinese, which is more than can be said of the US Congress. As Fisher put it, Congress fights, bickers and sails about aimlessly. It was doing just this last summer in squabbling over the budget ceiling. Back then, President Obama challenged Congress to '... stop the circus and ... do something to help the economy'.

The latest Bank of America monthly fund managers' survey found that more than a third of respondents saw US fiscal policy as the biggest tail risk. A third – and only a third – saw the eurozone as the biggest tail risk but this was well down from what it was in the last survey, when nearly half of the respondents saw it as the biggest tail risk.

This makes Wall Street's behaviour all the more interesting, or puzzling. Despite the overriding concerns of businesses large and small, the equity market has surprised right across the board. Both the S&P mid and small cap indices have climbed to new all-time highs and the S&P 500, the large cap index, has reached new post-financial crisis highs. The Dow is less than 4 percent from its all-time peak.

Significantly, that strength is not new. The bullish pattern of rising highs and lows for the S&P 500 has been in place for some while, as has a similar pattern for the S&P600I, the small cap index. The underlying trends have been firmly upwards, that is one of 'risk on', and they look set to continue.

No doubt the Fed has had much to do with this. It sees the high unemployment rate as cyclically and not structurally influenced and thus responsive, at least in principle, to faster growth. That is the justification for its stimulus in the context of price stability. Given its latest economic projections, price stability is what the Fed expects.

Earnings have had much to do with it. Despite the loss of momentum, they are still climbing to record highs.

Wall Street refuses to give up. Maybe it expects the fiscal cliff of spending cuts and tax increases to be postponed. Or Obama to be re-elected! The prediction market Intrade shows the chances of the latter as having climbed to just over 70 percent. According to Strategas Research Partners, the US equity market has tended to do well the year following the re-election of a Democrat President.

It is surprising that other equity markets, which have been volatile, have also been so resilient in the face of so much pressure from all the uncertainties. In one way or another, the activity of the major central banks is supporting growth and/or financial stability. Being discounting mechanisms, equity markets could now be expecting this to lead to an eventual reflation of aggregate demand.

So maybe the second liners offer a lead. Not just in the US but in the UK too. The FTSE 250, an index of mid-sized companies far more allied to the domestic economy than the FTSE 100, has reached a new high of the year. That's not bad going considering the UK economy is still in recession.