



# BREWIN DOLPHIN

## MARKET STRATEGY

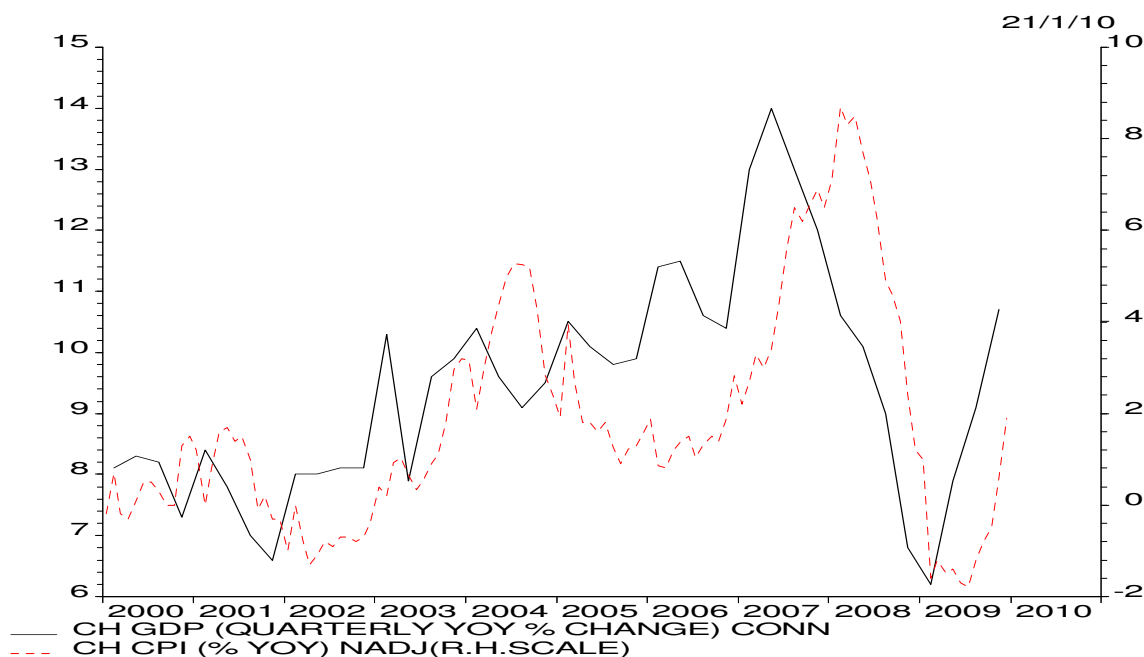
INVESTMENT RESEARCH

22 January 2010

Mike Lenhoff – Chief Strategist

Tel: 0845 213 3360; e-mail: [mike.lenhoff@brewin.co.uk](mailto:mike.lenhoff@brewin.co.uk)

### *Reaction time for equity markets.*

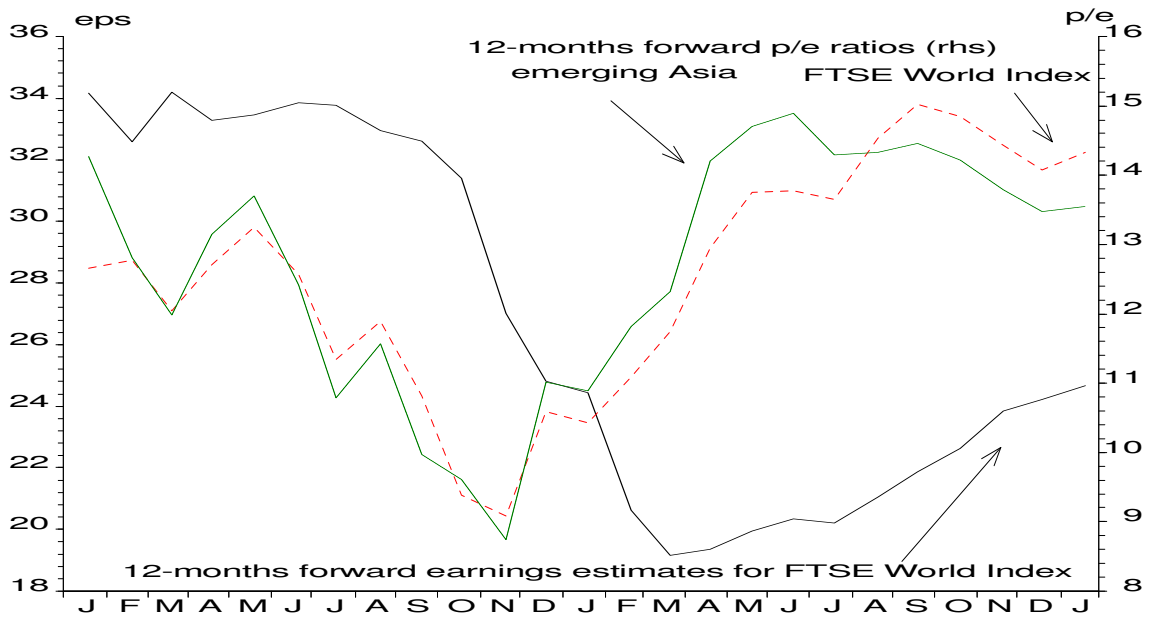


China's V-shaped acceleration in growth from the slowdown that took place in the latter half of 2008 and into the first quarter of 2009 has been accompanied by a rapid pick-up in inflation, making the modest measures introduced so far to restrain bank lending and drain liquidity not only justified, but also likely to be taken further. However, economic growth is not only coming through more strongly than expected in China but also throughout emerging Asia. Consensus forecasts for GDP growth for India, South Korea, Taiwan and Hong Kong are continuing to be revised up.

Attention is thus likely to focus on the directional change in central bank policy that is starting in China and under pressure to start elsewhere in the region (notably South Korea and Taiwan) sooner rather than later. This is the downside for equity markets. The upside, though, is earnings, which are being revised up too. Although perspective 12-months forward growth rates for corporate earnings may appear to be peaking in places, with economic growth for the emerging Asia-Pacific regional economy surprising on the upside, the same is likely for earnings.

These points apply more generally. Last June's consensus forecast of 2 percent global growth in 2010 has been revised up to 3 percent (according to Consensus Economics Inc) and, as the following chart shows, the twelve month's forward earnings estimate for the FTSE World Index (solid line) has continued to be revised up as well. Also valuations have not altered very greatly over the past months. Those for emerging Asia are not vastly dissimilar to those for the FTSE World Index – which is dominated by the major equity markets. As implied by the prospective p/e ratios, equity markets have done no more than 'price in' the earnings upgrades.

On earnings, the 2009 fourth quarter reporting season is under way in the US and there is an interesting development. The fourth quarter of 2008 marked the low point for the corporate recession so the year-on-year comparisons will look extraordinarily good but leaving this aside, it is worth noting where the surprises are beginning to appear.

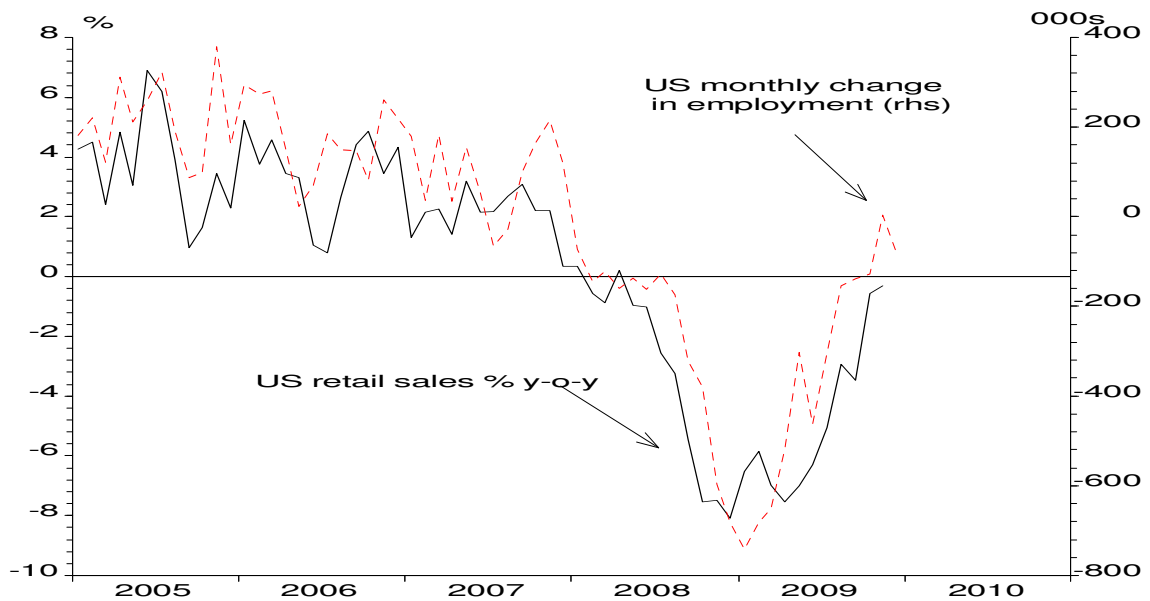


Source: DATASTREAM

It is still very early days, with much less than a fifth of the S&P 500 having reported, but so far companies in the Consumer Discretionary sector have all surprised on the upside. This positive news flow could be significant for here, in the Consumer Discretionary sector of the equity market might lie an encouraging sign for the economy.

One of the big surprises to come out of the US over the past months has been the faster than expected rate at which joblessness has diminished. There is, as a result, a widely held view that employment will start growing again by the spring of this year. As the chart below shows, the trends in retail sales growth (solid line) and in the monthly Non-Farm Payrolls (dotted line) are more or less coincident and heading in the same direction.

If earnings for the Consumer Discretionary sector are coming in better than expected this could be partly because job losses are not quite as bad as expected. There is no denying that joblessness is bad but, if the rate at which jobs are being lost continues to surprise on the upside, then so may consumer spending, and, with this, the US economy and corporate earnings. Yes, the downside to consumer spending is the slowing real wage growth but, if jobs are being created and the housing market continues to recover, so should consumer confidence.



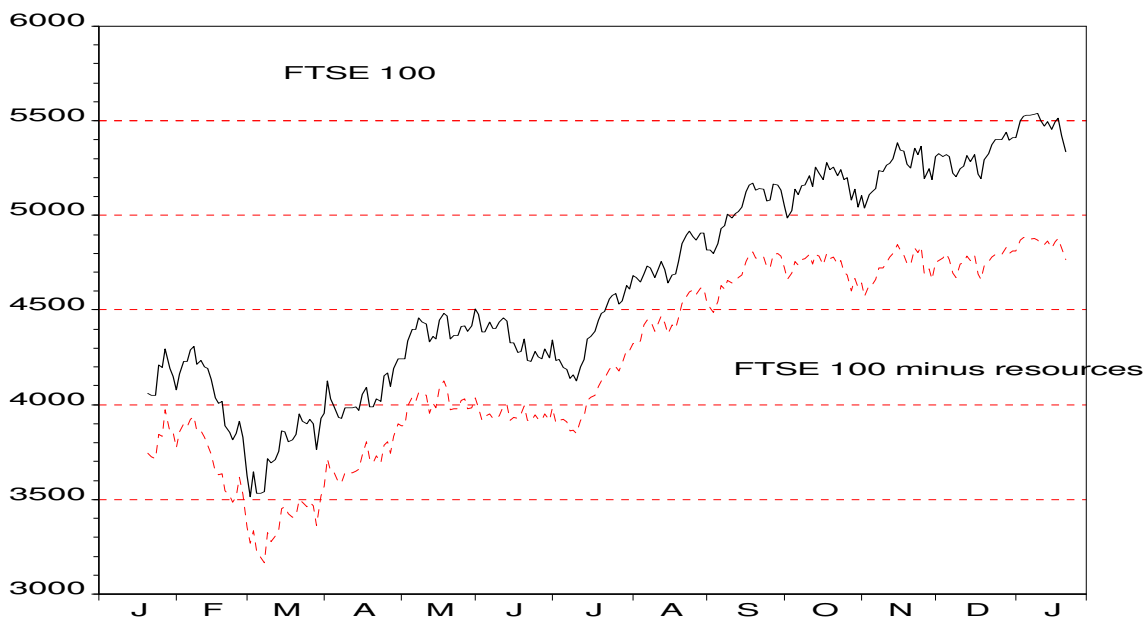
Source: DATASTREAM

Equity markets have climbed far higher than many expected and a bout of profit-taking is due anyway. In looking at the potential downside, there are three developments the markets may choose to focus on. One is the directional change in monetary policy that is getting started in China. Certainly, this is influencing sentiment towards the resources sectors of the equity markets – mining especially – and it may also concentrate the mind on the likely prospects for monetary policy not only elsewhere in the Asia-Pacific regional economy but also in the US.

Second, although the leading economic indicators for the developed economies continue to point upwards – Japan excepted – there has been a slight loss in the momentum underlying the economic news flow in the major economies. A simple tally of the economic data and surveys shows in aggregate that, over the past weeks, the reports that have come in stronger than expected have fallen well short of those that have been weaker than expected. As it happens, there has been a loss of such momentum for a number of months now but this may reflect nothing more than overly buoyant expectation levels after months in which the news flow momentum had been improving. Alternatively, it may reflect a loss of momentum underlying the recovery in the major economies. If investors are looking for profits they may well focus on this.

Third, President Obama’s latest proposals to ban proprietary trading by the banks and prevent them from engaging on their own account with hedge funds and private equity groups, has already jolted the equity markets. These proposals have a long way to go. Their implementation may not even see the light of day but they might, nevertheless, continue to affect sentiment towards banks – not just US banks.

As the chart below shows suggests, much of the rise in the FTSE 100 has been due to the resources (Mining and Oil & Gas) so there is room for quite a bit of profit-taking here. The Resource sector represents about a third of the FTSE 100’s market capitalization. Add in the banks and we are talking about 47 percent of the Index that is directly vulnerable to more selling arising on worries over the developments described above.



Source: DATASTREAM

## IMPORTANT NOTES

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