

MARKET STRATEGY

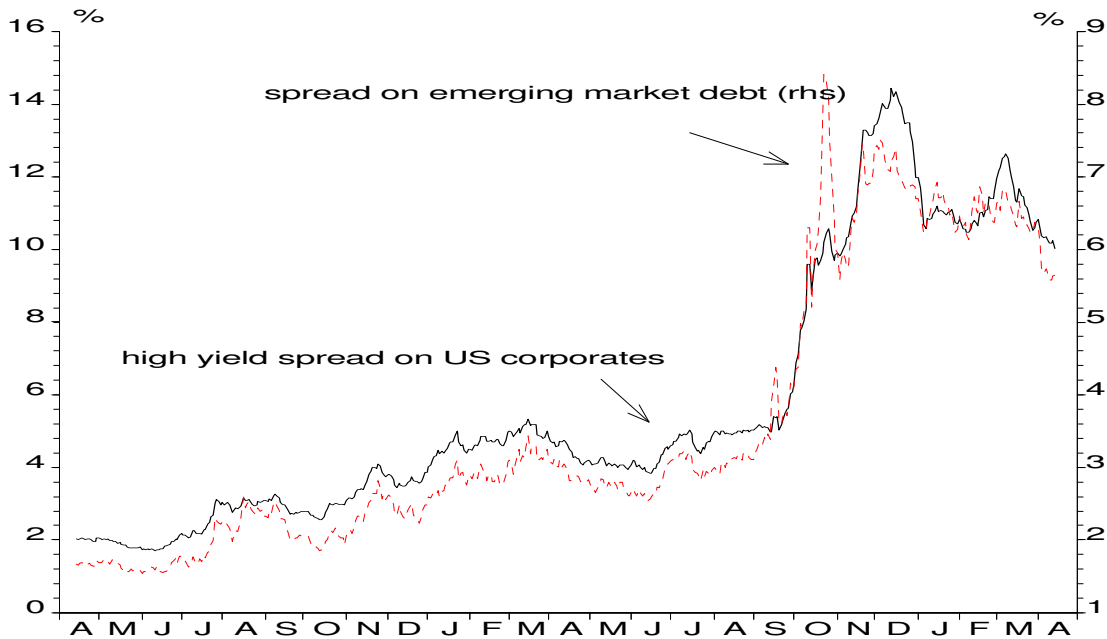
INVESTMENT RESEARCH

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Re-pricing risk - for a sustainable recovery?



Source: DATASTREAM

In commenting on Wall Street's recent performance in an interview with the Financial Times (April 16 2009), the chief executive of the NYSE Euronext expressed doubts over whether investors had regained confidence in the fundamentals of the market and questioned whether the rebound from the March low was 'real', i.e., in the sense of whether it could be trusted.

Certainly the news flow remains bad, even allowing (as reported in the Fed's Beige Book), for the 'moderation in the pace of decline' in the US economy. Also, the rebound since the March low has been primarily driven by financials - Life Insurance, Banks, Real Estate - areas of the markets that had become oversold.

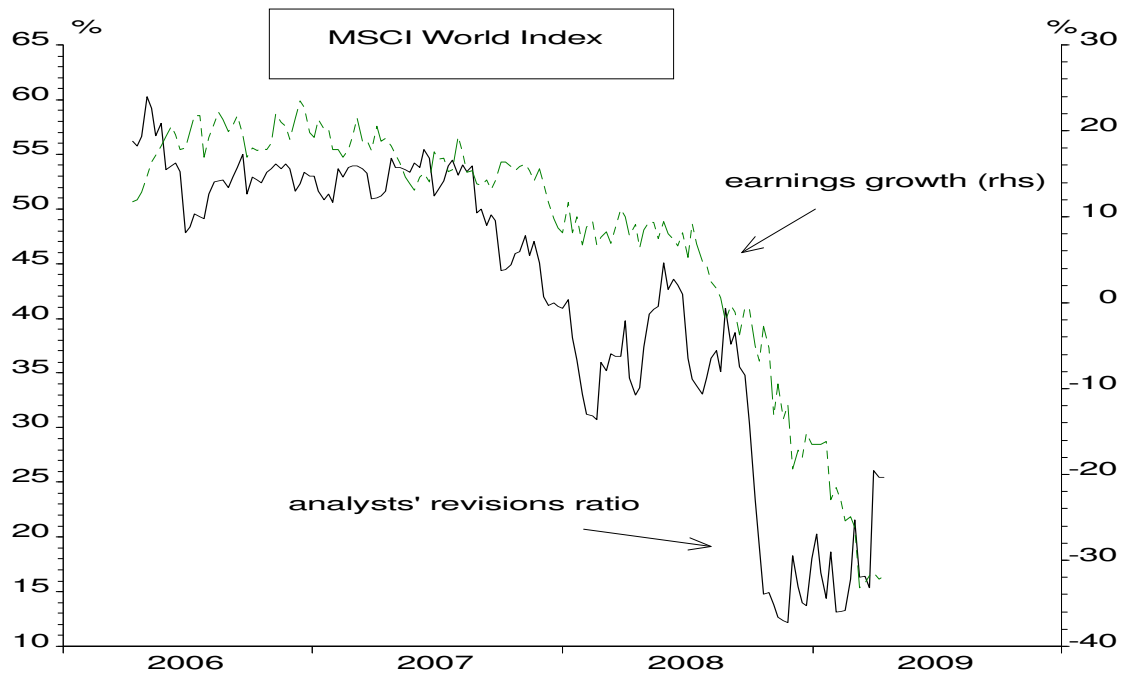
However, there are times when investors have to take their cue from the markets and this may be one of them. I think there are three promising developments which suggest that the start of a recovery is on the cards, possibly for later this year.

First, if there is more conviction about in the prospect of an economic recovery and a pick up in profitability, you would expect risk premiums to fall and for this to register in the bond markets through a narrowing of the spreads. This has been happening, as we've been pointing out, but to take this further, you might also expect to find no better test of this conviction than at the riskier end of the debt markets.

As the chart shows the spreads for high yield, or below investment grade, US corporate debt and also emerging market debt have narrowed considerably. Whether these spreads continue to narrow will be determined not only by whether the conviction in the recovery grows but also by whether the conviction in a fully fledged expansion develops. You can hang about and wait for the news flow to improve, or you can take your lead from the bond markets, which have a record of sensing the winds of change.

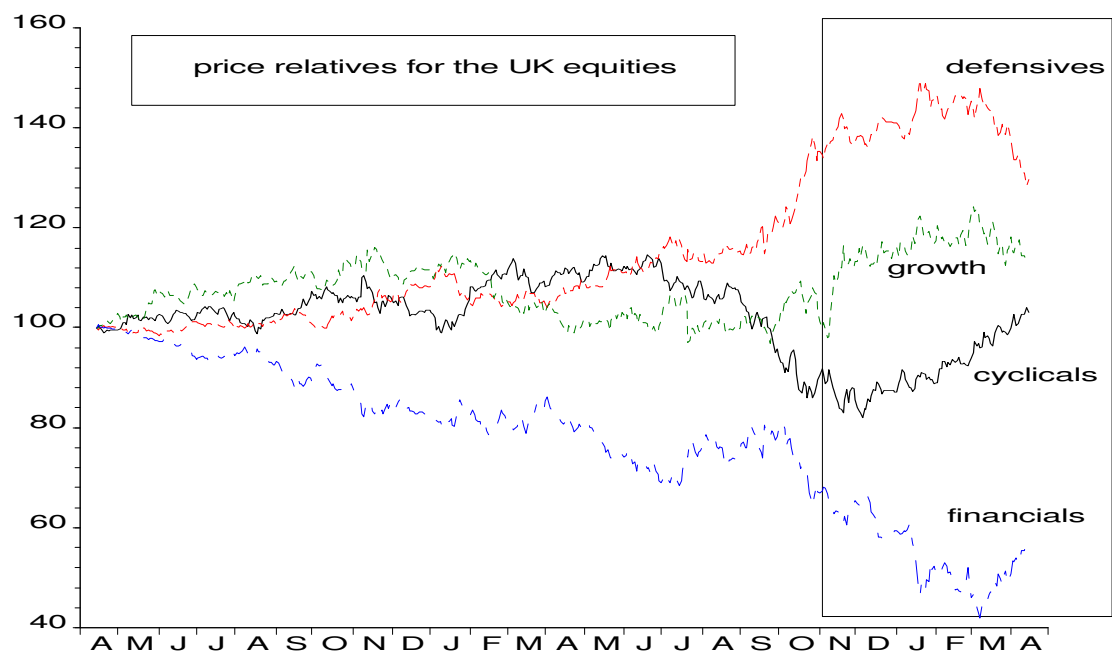
Second, with the first quarter earnings season under way in the US, it is worth drawing attention to another development. This is the improving trend in the analysts' earnings revision ratio for the constituents of the MSCI World Index. As the chart below shows, although earnings for the MSCI World

Index are continuing to decline (dotted line, rhs), the proportion of companies with improving 12-month forward mean estimates (solid line) is on the rise and has been for several months, suggesting not only that the worst of the downgrades in the earnings estimates lies behind us but also that earnings could start surprising on the upside in the coming quarters.

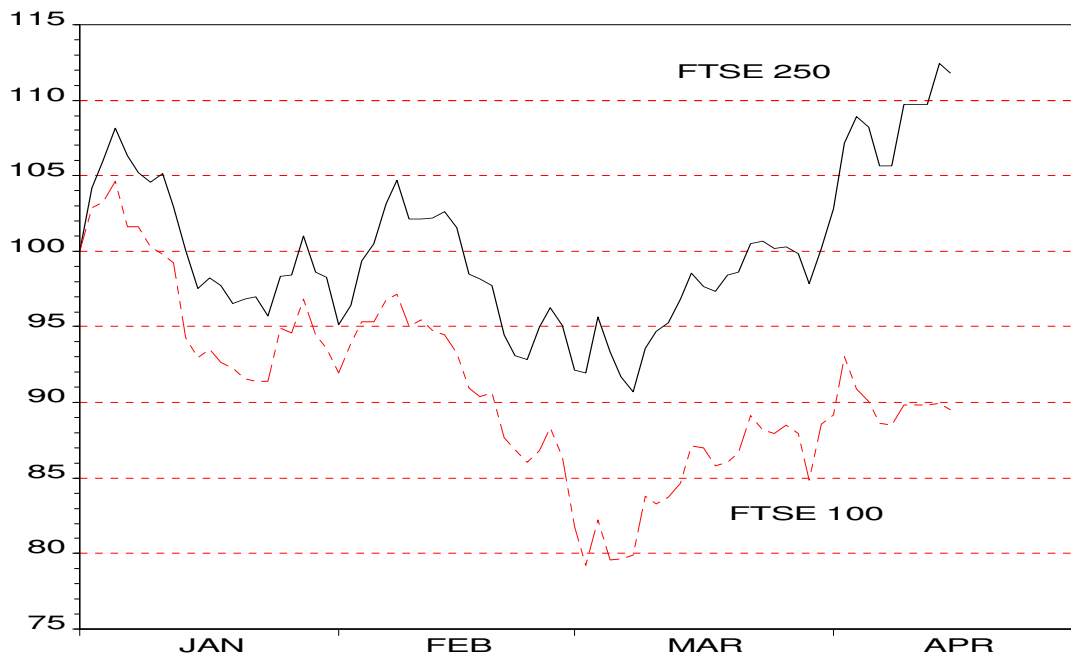


Source: DATASTREAM

Third, and looking at the UK, it is worth noting the sector dynamics that have been in play for several months in the equity market. We have been commenting on this for a while. As the chart below shows, cyclicals have been outperforming the market for more than four months. This development is due not just to the commodity cyclicals but also to the better tone for the consumer cyclicals, which reached their relative low back in the summer of last year. The outperformance of the FTSE 250 so far this year - see the chart on next page - is directly related to these developments as well as being allied to the loss of momentum in the defensives.



Source: DATASTREAM



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This rotation in the equity market away from defensives may now be a bit overdone. In terms of sector strategy our own recommendations include being up to weight in cyclicals but still being overweight defensives, though much less so than before. Defensives still offer plenty of value and reliable dividend growth ([see Sector Strategy Debrief – April 2009](#)).

However, the improvement in the relative performance of the cyclicals and, more recently, the financials along with the narrowing of the spreads in the bond markets suggests that risk is being re-priced once again. This time the re-pricing is in anticipation of the success that policy makers everywhere will have with their attempt to reflate the global economy. The improvement in the consensus earnings revisions ratio may also be a collective vote of confidence in the better prospects for growth and profitability that lie ahead.

We expect the signs of economic recovery to begin to show through by year-end and while we think the recovery will prove sustainable the markets will be the better judge of this. Any further fall in risk premiums will continue to be reflected in a further narrowing of the yield spreads in bond markets and the reflation trade in equity markets with a move to more 'beta' will develop.

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