

# Global equities worth a look

Market sentiment has swung considerably since the darkest days of early March. There is a definite argument in favour of equities at this point, notes **Peter Hensman**.

The change in market thinking has been such that the prospect of a US interest rate increase was priced into the Fed funds futures market for the tail end of 2009. In equity markets, sentiment is stuck between the irreconcilable concerns that monetary policy might be tightened, while there are few genuine signs that the underlying economy has done anything other than stop declining as rapidly as it had been. Given that the rate of contraction in activity was possibly the fastest since the Great Depression, it is hardly a noteworthy achievement to have succeeded in slowing the rate of descent.

There has been some continuation of the improvements in economic data from earlier this year. In the US, the manufacturing sector survey from the Institute of Supply Management for May rose to a level consistent with positive growth, the highest level on this index since December 2007. Similar surveys in economies such as China and India suggest that rather than having simply managed to return to sluggish growth, these countries are expanding robustly.

Yet, most data remain patchy at best. The health of the US employment market, as reflected in the non-farm payroll data, is questionable. It was the release of the employment figures for May that was the immediate catalyst for the bond market moving to price in the prospect of interest rate increases before the end of 2009. The data were, however, anything but strong. The report showed that "only" 345,000 jobs were lost in May. This figure was lower than the consensus expectation of 520,000 redundancies and the average decline in employment of 640,000 in the prior six months, but was still worse than the 325,000 peak for job losses in 2001. Furthermore, this low point in the 2001 downturn came in the uncertain backdrop of the October following 9/11 attacks.

This less-than-impressive improvement

in economic data is evident across most sectors and economies. German factory orders rose 3.7 per cent in March and April combined, following a near 40 per cent decline in the preceding six months. As with the US employment data, this is hardly evidence of a significant upturn in fortunes. Chinese data offer some indication of a greater improvement, as domestic investment spending continues to grow rapidly. Fixed asset urban investment is reported to have increased 33 per cent year on year in the year to May, the strongest in five years, and many cite the sharp acceleration in bank lending as an indication of how successfully the Chinese approach enables the authorities to have much greater control over the rate of expansion.


Yet, even in China, the case that the economy has resumed its past growth path is not clear. Electricity production in the year to May reportedly declined by three per cent. This decline may indicate a shift in the sectors that are leading economic activity away from those that are more power intensive. It equally raises some doubts about the quality of other real economy data. Certainly, the evidence of the squeeze on China from the external environment is evident in the trade numbers that show that the value of Chinese exports fell 26 per cent in the 12 months to May.

What is clear is that market conditions have improved. Even the high-yield bond market in Europe, which was lagging behind other markets, has seen issuance return. Rights issues have almost become commonplace in the equity markets. Not all are aimed at balance sheet repair; some are now raising cash on a speculative basis to take advantage of acquisition opportunities/distressed asset prices that have arisen during the earlier market turmoil. One example of the turn in sentiment is the unexpectedly convincing election result for

the Congress Party in India, which is likely to set in train a raft of IPOs and fundraisings as companies take advantage of market conditions and the enthusiasm of investors for a strong fundamental investment story.

This leaves open the question of what is next for markets that appear to have run well ahead of any improvement in economic data, especially as the divergence in performance between the more economically sensitive sectors and those that typically produce more stable earnings has been even more exaggerated than the rise in the broader indexes suggests.

Certainly, the strength and rapidity of the rally leaves some scope for a setback in markets. However, given that much of the worst of the market travails was the result of illiquid conditions and that the authorities are clearly more cognisant of the risk of liquidity deteriorating once again, a quick return to the lows from the early part of the year seems unlikely. Equally, the rise in US long bond yields is now reaching the point where mortgage rates are being forced higher, threatening to undermine the tentative signs of stabilisation in the housing market.

In addition, the June/July period is likely to show some very weak CPI-measured inflation figures, based on the y-o-y comparison to the peak of the oil price in 2008 and the general absence of pricing power that emerges when labour markets are weak. The prospect of some further policy easing in the US, on the grounds that there remains a significant deflation threat and that the policy could be targeted to underpin the housing market, seems real. With equity valuations still reasonable even after the recent rally and the authorities likely to respond swiftly to any significant threat to continued market/economic improvement, the risk reward balance for equities still looks favourable. 

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