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What is going on in equity markets?

Equity markets with no direction – for the moment.

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Equity markets seemingly have no direction at the moment – it is clearly range trading. It seems as if the market is chasing news; one moment a new theme leads the market in one direction, the next moment another theme has taken over and leads it in the opposite direction. We believe that 2 longer lasting themes are in the making and will affect the equity market for the next 6 months or so.

Basel III

Sunday this week the next release of the important Basel III proposal on future regulation for the financial sector will be released. In this release we should expect more clear guidelines as to how much more capital banks will need to hold in the future. This is very important obviously – but due to various reasons. First of all if banks are to hold more capital obviously lending will drop from current levels as more capital is to be hold. Since especially small- and medium sized businesses is currently having a difficult time getting access to credit and this segment is where the most part of the job creation is going on the recovery will weaken. Furthermore the price of a bank like any other stock depends on the expected future earnings and if banks are required to hold more capital earnings will obviously get hit as they are not able to generate the same amount of earnings from fewer loans; there are after all an upper limit as to how much prices on loans can increase.

During this weak a number was leaked as to how much you should expect the increase in Tier1 and Tier2 capital ratio would be – going from 8% to 16%. This is a very drastic change. Fundamentally this would require European banks to raise billions of EUR; for German banks only The Federal Association of German Banks, BdB, estimated that the total number for the 10 biggest banks would turn into 105 bln. EUR. We do not expect the capital ratio requirement to be 16% because it would for sure devastate the European banking sector for a long time, but rather around a 12% capital ratio. This would still be sufficient in order to achieve a stable banking sector going forward given that the current definitions of Tier1 and Tier2 stands.

It actually does not matter what the number comes out at, but rather this will for sure be a theme within equities that will run for a long time. The whole financial sector will undergo a change and in general we find it very hard to assume that the current return on equity (ROE) would stand. It will obviously go lower leading prices of especially banks lower as well. But in a broader perspective the whole way of especially corporate finance in Europe will change as well. Corporates will need to find another way of financing than using the bank which is the most common way of financing used today in Europe. We would most likely see a shift towards the American way using bond markets as complementary to using bank financing.

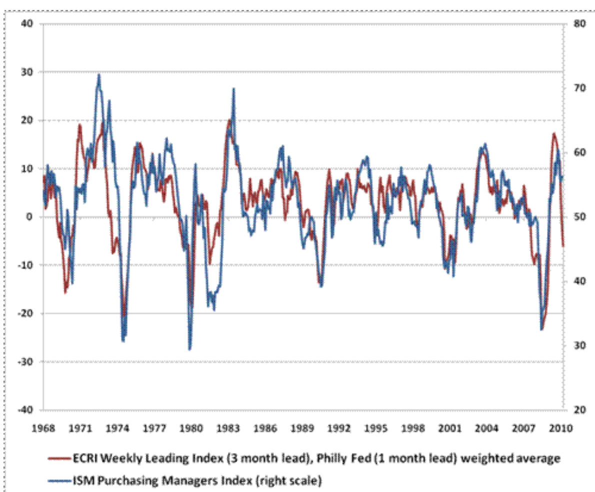
Equity market getting into the recognition window.

Over the course of the market cycle, one of the primary areas of risk for equities is typically the "recognition window" where economic activity begins to deviate from the upward trend that is priced into the market, and investors begin to recognize that an economic downturn is, in fact, likely. The typical lead times between deterioration in reliable measures such as the ECRI weekly leading index and deterioration in coincident economic activity tend to be on the range of 13-26 weeks.

For most economic indicators, we are not there yet. This is why I believe that the much earlier deterioration in economic measures is not encouraging, but it also opens up the possibility that we may see some misleading 'improvement' in the data in the next few weeks before we get into the more typical window of deterioration.

The tone of economic data does not turn all at once. There are leading indicators, coincident indicators, and lagging indicators. Once leading indicators have clearly deteriorated, it takes a while for coincident indicators to follow. During the interim, small positive surprises in coincident indicators are unreliable and in my view this is where we are now also in terms of perception of the economic recovery in equity markets. In my view investors have clearly abandoned the concern about further economic weakness prematurely.

To clarify what I believe will be the trend going forward, the graph below presents the historical relationship between the ECRI Weekly Leading Index (growth rate), the Philadelphia Fed Index (2 month smoothing), and the ISM Purchasing Managers Index (manufacturing). Movements in the ECRI leading index tend to precede movements in the PMI by about 13 weeks. Similarly, the Philadelphia Fed index tends to lead the PMI, but only by a month, on average. Based on the ECRI and Philadelphia Fed data, however, the prospect of continuing strength in the PMI is not good.



Look closely at the graph above, however, and you'll note that it would be wrong to assume the PMI will follow the ECRI and Philly Fed data with exact precision. Observe, for example, that if you look at the downturn in early 2008, the ECRI and Philly Fed index gave a timely warning, but the ISM data held near the 50 level for several months longer than usual before finally plunging. In the intervening period, the S&P 500 lost 20%.

So to recap slightly I believe equity markets will be heading south for a while, but the trend is not by any means going to be straight forward. Rather the bear market rallies will be significant and at times you could be tempted to think that we have entered a bull market.

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