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UK equity market update



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The introduction of the ECB's long-term refinancing operation (LTRO) in December initially went unnoticed, but subsequently changed the dynamic of the market. At the start of the year it became apparent that the tail risk of an implosion in the banking system had been greatly reduced. This has allowed the market to look forward more positively, albeit that sovereign risk still remains.

However, it is the strength of economic activity in the US that is behind the recovery in the UK market from its October 2011 lows. Economists at Credit Suisse believe that US growth is currently running at over 3%, the strongest pace since Q2 2010. If this were to continue, consensus earnings estimates will be looking rather conservative.

According to Deutsche Bank, the earnings revisions ratio, which peaked in June 2010 looks to have bottomed in November 2011. This could prove to be a trap ahead of the results season, but it has already fallen by 90% of the decline seen between 2007 and 2009 and has been a useful indicator in calling the turn in markets and sectors.

Although it is the US data that is turning, many UK equities are beneficiaries of this. Most of the global industrial sectors are starting to perform better and while they might still be seeing more downgrades than upgrades, it is at a far slower and increasingly better rate than the market. Those companies exposed to weaker domestic demand are struggling.

However, things are playing out in a remarkably similar way to the last downturn in 2008. During 2008, cyclicals bottomed against defensives at exactly the point at which the earnings of cyclicals peaked against defensives. In other words, all the underperformance of cyclicals typically occurs ahead of the downgrades. So perhaps it should come as no surprise that we're starting to see recoveries in chemicals, industrials and basic resources amongst others.

However, it is not going to be a straight repetition of 2008-9; we are not looking for a wholesale rotation from defensives into cyclicals. There are bound to be cyclicals that are negatively impacted by weaker European growth, which can still surprise on the downside. Balance sheet strength is more important this time, with yield and dividend growth as important as earnings momentum.

There have been a number of profit warnings already this year, including from companies such as Tesco and Invensys, but the better mood in the market engendered by the LTRO and outlook for US growth has, in the short term, seen buyers return to the market. This should continue at least until the end of February when LTRO 2 is announced.

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