Weekly Market Analysis 16 November 2009

Market Overview

European equity markets appeared to depart from their recent consolidation phase, moving higher for much of the week, retesting the 12-month peaks reached in mid-October. The third quarter earnings reporting season has started to draw to a close and has been characterised by few results materially adrift from expectations. Economic data releases during the week were generally encouraging, with the Euro Area exiting recession in the third quarter and UK unemployment seemingly moderating. Within equity markets, the basic resources sector (+5.8%) led the pack once more, followed by strong gains for real estate (+4.7%) and the banks sector (+4.3%). On the downside, the auto sector was the worst performer, gaining just 1% after weakness in one of the German majors. Oil and gas (+1%), food and beverages (+1.3%) and telecoms (+1.5%) were also relative laggards. On a country level, most national bourses rose between 2-3%. The German DAX (+3.6%) was the best performer; the Swiss SMI (+0.7%) the worst.

Currencies

Both the UK pound and the euro were little changed versus the dollar over the course of the week. The dollar had initially weakened versus both currencies after the Group of 20 (G-20) finance officials pledged to maintain stimulus measures, encouraging investors to move towards higher yielding assets funded with dollar loans. However, a perceived dovish statement by the Bank of England when it released its inflation report, led to weakness in the pound, after it suggested that inflation would remain below target for most of the next three years at market rates. Mervyn King, the Governor of the Bank of England, also commented that a weaker currency should help the UK economy. The euro also lost some ground late in the week after a retreat in US stocks and other risk assets discouraged demand for high-yield. By the close of trade on Friday, sterling was little changed on the week at $1.667 (having closed the previous week at $1.661), while the euro was also largely flat on the week at $1.490 (versus $1.484).

Commodities

The price of oil rose early on in the week after the dollar weakened against a number of currencies (following the news flow from the G-20) and as tropical storm Ida entered the Gulf of Mexico, disrupting more than a quarter of the area’s oil and gas production. This led to price moving above the $80/barrel level during trading on Tuesday. However, the price of crude then fell back again on Thursday after data from the US Department of Energy showed that there was a larger than expected increase in inventories. Inventories of crude climbed 1.76 million barrels during the previous week to 337.7 million, adding to concern a slow recovery from recession will keep pressure on fuel use. A turn in direction from the US dollar versus the euro on the same day also added pressure to the commodity as its appeal as an alternative investment slid. By the close of trade on Friday, a barrel of oil was trading at $76.35, a four-week low, having ended the previous week at $77.43.

The price of gold, while only a little changed by the end of week, managed to reach a new all-time high in trading on Thursday, touching $1123/oz. The price of bullion had moved passed the $1100/oz mark early in the week as the dollar weakened, but then (like oil) pulled back as the US currency found its feet again. The price of the metal is continuing to benefit from low US rates which helps to push investors into gold as an alternative investment to the dollar, the prospect of stimulus induced inflation for which it is seen as a hedge, and improved demand from central banks for physical gold as they diversify from paper currencies. Gold was trading at $1118/oz by the end of trade on Friday, having closed the previous week at $1095/oz.

Economic Commentary

Friday's Euro Area GDP release showed that recession ended in the third quarter, with a 0.4% gain. Although this was below both consensus (0.5%) and our economists expectations (0.6%), it was the first positive quarterly move since the first quarter of 2008. According to the country split, all three large member countries reported gains (Germany +0.7%; France +0.3%; Italy +0.6%). The only countries still reporting a contraction were Spain (-0.3%), Greece (-0.3%) and Cyprus (-1.4%). Available data from member countries and comments from the statistical offices suggest that a gain in net exports and a build up in inventories were the main driver for the recovery. With quite solid momentum in the activity indicators during the third quarter, our economists we expect the recovery in the euro area to continue into the end of the year and through 2010.

Euro area industrial production increased by 0.3% month over month in September. This was below the consensus expectation for a 0.5% gain and our economists 0.6% forecast. However, with a upward revision of the August reading (from 0.9% to 1.2%), the September level of industrial output is in line with expectations. Reflecting five consecutive monthly gains, industrial production in the third quarter increased by 2.2% on average. This is the strongest quarterly gain in the history of the time series, following the sharp contraction in previous quarters.

UK unemployment registered its 20th consecutive monthly rise, bringing the overall unemployment rate up from 7.7%, to 7.8% and the youth unemployment rate up to an all-time high of 19.8%. However, the total increase in those claiming benefits (12,900) was the smallest in 18 months, representing the third consecutive monthly decline in the rate of increase. Indeed, October's number is well below the February 2009 peak of 136,600 suggesting that the worst may have already passed. Our economists note that the labour market usually lags the economy by 6 months, suggesting a further leveling off in 2010.

Third quarter German GDP increased by 0.7% quarter over quarter (QQ), while the second quarter's reading was revised up to 0.4%, form 0.3% previously. This was roughly in line with the consensus view of a gain by 0.8% and our economists 0.9% forecast. According to the statistical office, increasing exports and an increase in capital expenditure contributed to the third quarter gain. Furthermore, increasing inventories provided an additional contribution. In contrast, private consumption fell, probably reflecting the correction of the boom in expenditures for cars, caused by the scrapping bonus. Our economists note that after the free fall around the turn of the year, third quarter data back up the view of German economic recovery.

The German ZEW business expectations index dropped from 56 to 51.1 in November, a weaker than expected result (consensus 55). This is the second consecutive decline in the index and is likely to have been driven by a combination of the stronger euro, increasing oil prices and falling equity prices. However, it is important to note that business expectations are still 0.7 standard deviations above the long-term average, pointing to expansion in economic activity. Not only that, but the assessment of the current business situation improved for the sixth consecutive month and Citi's combined ZEW index increased from –8.1 in Oct to -7.2 in Nov, the highest reading since June 2008.

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