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Is it a 'V' or is it a 'W'?

You may remember the old line, "Is it a bird, is it a plan? No it's Superman." Well we have had a superhero bounce back in world stock markets from the very sharp falls of January and February. The question now is, are we in a 'V' shaped recovery or the second leg of a 'W' shaped movement that will see the markets re-test their recent lows.

A daily observation of the movements in the UK stock market will show that it is heavily influenced by the daily direction of the US market. From 8 am in the morning until the US market opens at 9.30 EST, which is 2.30 BST in our time zone, the UK market seems to be driven more by the direction of the US Stock Market Futures contract than by events in our own economy. Then from 2.30 until our market closes at 4.30 our stock market seems to be dragged up and down by the actual movement of the US market.

Much of the reason for this is crowd mentality and a part of it is, no doubt, the high proportion of the larger UK companies whose earnings are derived from overseas and particularly in US\$. And yet, eventually, the growth or fall of profits of an individual company will eventually be reflected in their share price and it is the total of all these share prices that make a market and from which the indices are derived.

So back to our question, is it a 'V' or is it a 'W'? To try to answer this we can look at the mass of data and opinion that is available on the US market and then we can consider how that relates to our stock market..

We start with technical (chart) analysts. Although he still maintains that stock markets are witnessing nothing more than a bear market rally, Richard Russell, doyen of newsletter writers and author of the 50-year old Dow Theory Letters, said on Friday 10th April, "I was wrong. It looks as though this rally has legs. Lowry's Selling Pressure Index has stopped rising and now appears to be topping out. At the same time, Lowry's Buying Power Index is in a rising trend. The look of the Lowry's chart suggests that the [short-term] direction of least resistance is up."

From London, David Fuller of Fullermoney said, "... consistent and persistent trends, such as we have seen over the last five weeks, are often important trends. This continues to look like the first psychological perception stage of a new bull market. Lows are rising over time, indicating that demand has the upper hand, but most people do not believe in the market's recovery. Consequently, the perception is of high risk, while it is actually low, given all the cash available to fuel an additional advance.

To balance that, the analysis of corporate earnings in the US makes gloomy reading and many commentators are suggesting that the poor earnings news will eventually drag the US market down.

Pulling it all together, BCA Research commented on the US: "Now the focus has shifted to whether or not positive second half of the year growth will provide the base for a solid recovery next year. There is plenty of fiscal and monetary stimulus in the pipeline, but the headwinds and risks highlight that the recovery will be fragile. Much will depend on the apparent success or failure of the bank stress tests and the Treasury's plan to relieve banks of their legacy assets. Both are wild cards that could reverse the recent improvement in investor sentiment. Moreover, consumer fundamentals remain grim due to high debt levels, falling home prices and massive payroll cuts. "Bottom line: A bottoming in growth suggests that we have seen the lows in the equity market, but a sustainable uptrend may take time to develop and could be very choppy."

Much the same could be said about the UK as many of our problems are similar and the Government response on the Banks has similarities too. However, we are aware that the outlook for corporate earnings is very murky. On balance we believe that Government stimulus will work over time but we would be surprised if there was a fast response. There is much to be worked out and the general personal and corporate reduction in overall debt levels taking place in developed economies is going to remain a very long term drag.

To sum up. The stock market may be in a 'V' or it may be in a 'W'. We cannot tell. There are favourable signs that support the 9th March low as the bottom of a V. There are unfavourable signs that suggest this is a W and that after this rally another downward leg lies in our path.

Our current strategy remains to be fully invested in bonds (fixed interest), to be slightly underweight in equities and not to hold property. Cash balances are therefore high, available to be invested when markets either weaken or take the third leg of the W. We suspect the stock market has an upward bias in the near term. We also believe that Gilts are richly priced but higher-grade corporate bonds are desirable. We remain ready to change direction if necessary.

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