Macro Strat
Strategy Update: Moves on S&P 500 and 10yr Treasury overdone 5 August 2011

Big moves in recent sessions and overnight have seen the targets of 2.50% on the US 10yr Treasury and 1,200 points on the S&P 500 that we put out to clients on June 7, hit. (See *"Macro Strat: The expected path of S&P 500 and 10yr Treasury yield, illustrated"* dated June 7, 2011) The call was based on a lagged impact of slowing US money growth early in the year and the potential impact that the end of QE2 could have on the economy and hence, financial markets.

The market has turned decidedly bearish, following the sledgehammer that hit Wall Street overnight. Money market rates have fallen below zero, as a rotation from EUR money funds materialized. Rates on the 1-month T-Bill rose from 0.01% at the start of July to 0.16% before falling back to near zero now. Risks around the debt ceiling being capped were overblown. The real risk is *more* debt.

The ECB's resolve will be tested by rising yields of Italian and Spanish bonds in coming weeks. The ECB has tapped the brakes too hard from a policy perspective, and this is resulting in a crash in money supply growth and hence, causing funding issues for these sovereigns at present. The BOJ and SNB have upped the ante with more QE of their own this week, and BOE data shows that M2 money supply growth has accelerated smartly since the start of the year. This may result in a wave of monetary inflation from the major financial centres in coming months.

In the US, M2 sa annualized money supply growth has accelerated to levels of 8-9% since the start of June after being range bound between 4-5% from Jan to late May. The current money growth can be described as "QE3 by other means." It will keep the Fed weary of another round of QE right away. With money supply growth accelerating, we may see a decided improvement in headline US economic data in Q3 and Q4. Coupled with strong earnings results seen recently, this is bullish for US stocks despite the recent poor economic data. Price inflation momentum will stay to the topside. This will see the attraction of stocks relative to fixed income securities improve. Our view that CPI inflation will break above 4% y/y into h2/h1 2012 holds. This type of price inflation will also begin to weigh on Treasury securities, particularly with yields on the 10yr around levels of 2.40%.

Tactical view:

Fixed income: Recent rally on 10yr Treasury overdone. Cyclically, economic conditions are not as poor as markets are pricing. Value to start putting out short lines on the US 10yr around present yields of 2.40%. Yields could rebound very strongly in h2 2011. A rebound of the yield to 3.50% going into h1 2012 is the baseline scenario.

Equities: S&P 500 has fallen 10.8% in the past two weeks, to 1200 points at present. The market is substantially more bearish than can be justified cyclically. A strong rebound in h2 is expected. Position to take advantage of a rally that tests the highs of 2011 at 1,360 points. Potential for new highs for 2011 exists, but this is not the baseline.

Strategically, we continue to hold the view for a secular bull market on stocks and a bear market for Treasuries over the next decade. Recent market moves offer value to establish trades that will profit off these long-term trends.

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