No Inflation, No Bear Market

Tomorrow, Thursday August 3, the European Central Bank ought to push the cost of money to 3%. All in all, monetary conditions remain accommodative. Stocks should recover in a scenario of adequate earnings, low inflation and moderate growth.

By Vincenzo Sciarretta

The stock market plunge that materialized in May had some of the typical features of a temporary correction. "First and foremost," says **Teun Draaisma** of Morgan Stanley "sentiment changed from outright complacent in April to close-to-capitulation in mid-June." It is worth noting that retail investors panicked, setting off a stampede as far as the last 10 years are concerned. Only in September 2001 did equity fund redemptions exceed the May and June outflows in the Euro-zone. In Germany and Spain redemptions were greater than in September 2001. European savers dumped their positions. According to a report by **Ryan Kloster** of Lehman Brothers, "historically such sell-offs have created buying opportunities." In fact, he argues, global equity markets have outperformed on a one- and three-month forward basis after periods of sharp net selling.

No Inflation

Tomorrow, August 3, "we assess a very high 95% probability for an ECB (European Central Bank ed. note) 25 basis points rate hike," affirms **Matthew Sharratt** of Bank of America. This move, consisting in raising the cost of money to 3%, is widely expected since explosive money and credit growth coupled with good economic performance, support the case for additional monetary normalization. Further, the ECB stated in its July meeting that they would "exercise strong vigilance," a code phrase for imminent action and consistent with the decision to reschedule the August 3 meeting from a teleconference to a physical meeting in Frankfurt.

After this action, prevailing expectations and futures markets have been leaning toward a gradual withdrawing of monetary accommodation that leads the refi rate to 3.25% by year-end. Some expect more, namely 3.50%, and some less, namely 3.00%. But the fact is that money markets do not even discount a return to the 3.75-4% "neutral zone."

Whilst the rest of the world is on inflation alert, the ECB seems in no hurry to remove its accommodative disposition. "Inflation seems not to be a big problem in Europe," comments **Peter Hoeller**, the OECD's head of Euro-zone studies. "Headline inflation remains at 2.5%, under the impetus of oil prices, and above the ECB's close-to-but-below 2.0% target. However, core inflation has been declining since 2002 and expectations are pretty

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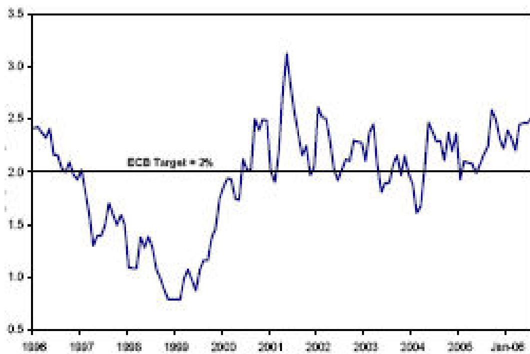
stable. I can envision a scenario where inflation moves toward 2% again. The dissimilarities with the US situation are centred on the fact that the US economy shows much more dynamism and lower unemployment, and on the fact that in Europe there is still plenty of spare

Eurostoxx 50: recovering its poise

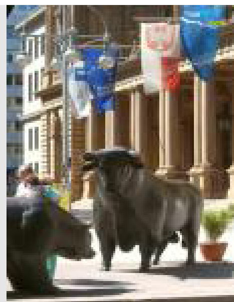
Source:Bloomberg



Source:Eurostat
Headline inflation is above ECB's target, but core inflation has been declining since 2002

capacity. In other words, the region can absorb much stronger demand for some time without worsening underlying inflation. We would suggest that the ECB normalizes interest rates, but in a gradual way."

Good value at the right price



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If professionals are correct that inflation is not such a big problem in Europe, then stock market valuations should be interesting since low inflation and low interest rates make a certain level of earnings quite valuable (for a different point of view read Marc Faber's interview). "Price/earnings multiples are not excessive in relation to the low interest rates that prevail in Europe," claims **Florent Bronès** of BNP Paribas who is in-line with many colleagues. Stocks may be the main beneficiary of the current state of affairs, enjoying a combination of low inflation and moderate growth.

In addition, according to **Ian Scott** of Lehman Brothers, "the European earnings season appears fairly robust." Mr. Scott writes in a report dated July 31: "based on 89 out of Europe's top 300 companies for which we have data, the positive-to-negative surprise ratio has decreased from 2.6:1 last quarter, to 2.2:1. The picture is consistent with still strong, though slowing earnings momentum." Mr. Bronès of Bnp Paribas agrees, "the corporate sector continues to produce excellent earnings." In fact, since wages in most multinational companies can only grow within the limits induced by the opening up of Eastern Europe and the competition of Asia, any pickup in demand goes straight to the bottom line. Moreover, a stable euro is now in the process of relieving pricing pressures. Instead of tightening monetary conditions, the European Central Bank is just gently withdrawing the stimulus and M3 money supply is still running at 8.5%, not exactly a constraint. If the European bull market is to be aborted, the causes will have to be external. A widely recognized menace indicated by the analysts is a slowdown in the US, deteriorating into a recession on account of tightening monetary policy and a collapse in real estate. "Otherwise markets are going up," says Bronès. "Equities are cheap compared to bonds; we are likely to experience another wave of mergers, acquisitions and buy-backs and rising dividends, and this scheme is presaging that stocks will continue to recover from the nasty break they suffered in May and go up, say, by 10%."

In conclusion, geopolitical tensions could coincide with a new corrective leg in the usual weak September-October period, to be followed by the classical year-end rally. This, of course, is if analysts are right.

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