The equity market will climb a wall of worry

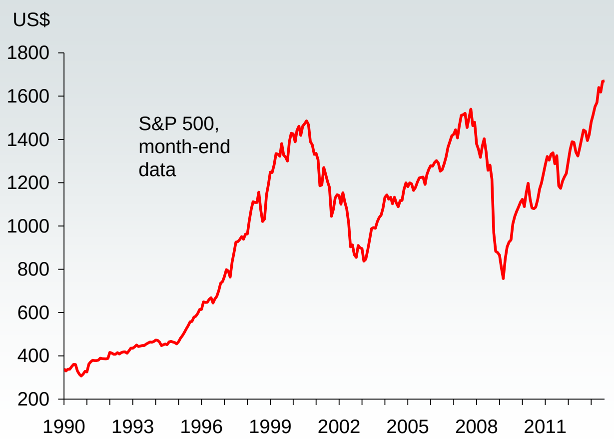
The equity market has had a tough few months due to a combination of concerns, including fears that a US-led attack on Syria might lead to a wider Middle East conflict and threaten oil supplies. Of greater concern for equities are worries that a turn in the US monetary policy cycle could eventually kill off the US recovery. However with valuation not looking like a barrier to further gains, this four-and-a-half year equity bull market will in all likelihood climb the wall of worry and set another new high before the year is out.

A combination of risk factors mean the equity market has had a tough end to the summer

The equity market has had a tough end to the summer. After hitting a record high on 2 August, the S&P 500 slipped 5% over the following three weeks despite US activity data coming out consistently above market expectations. The market has become a little more turbulent but volatility remains below the level seen last year, and far below the level seen during the global financial crisis. So far in September the S&P 500 appears to be stabilising, bouncing off the 150-day moving average just as it did following last summer's sell-off (which was driven by Eurozone break-up fears).

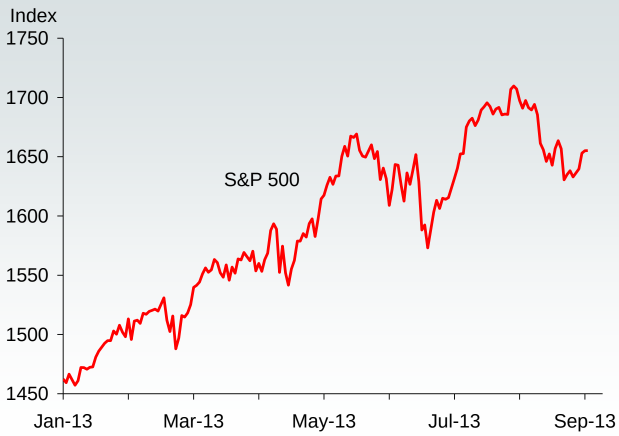
It is not valuation that is holding the market back. The PE of the S&P 500 at 17 is in line with its average since 1946. Rather a combination of factors mean that this four-and-a-half year bull market will, like those before it, have to climb a wall of worry to make further progress from here. The main risks are: the threat of a US attack on Syria turning into a war in the Middle East; the Fed starting to turn the US monetary policy cycle after an unprecedented period of loose policy; uncertainty over who will be the next Fed chairman; an imminent German election that could bring in its wake yet another round of speculation about the Eurozone's future; the long-awaited "third arrow" of Shinzo Abe's Japanese reform programme; and another destructive conflict over the US budget and Treasury debt limit that could result in a government shutdown or even a temporary default. And that is ignoring likely policy upheavals in China, India, Brazil, Indonesia, Turkey and other crisis-ridden emerging economies.

US: Stockmarket - long term



Source: Haver Analytics

US: Stockmarket - short term



Source: Haver Analytics

Fears that an attack on Syria will spread seem easiest to dismiss

Each of these concerns seems likely to blow over eventually, enabling confidence to return to the equity market. Nevertheless, it is useful to consider how much of a threat each poses to the global economy, and hence to financial markets. Fears that an attack on Syria will spread seem easiest to dismiss. After all, war in the Middle East is effectively a continuation of the permanent status quo. Parts of the Middle East have been at war almost continuously for at least 50 years, and ruinous fighting will probably continue for many more. Neither the global oil supply nor the balance of power between Sunni and Shi'ite Muslims is likely to be significantly affected by whatever action the US may or may not take. Before military action is even concluded, financial markets will probably enjoy a relief rally, as they often have after military engagements in the Middle East.

Washington will be the main source of uncertainty between now and mid-October

The main source of financial and economic uncertainty this autumn does not stem from Syria, Germany or Japan but from a combination of three events in Washington: the impact of QE tapering, which is expected to be announced by the Fed on 18 September; the naming of a new Fed chairman around the same time; and a Congressional vote on Treasury debt limits due by mid-October.

Last week's US (non-farm) employment growth figure for July was 169,000, below the consensus expectation of 180,000 but not weak enough to stir serious worries about whether tapering will prove dangerously premature. Once the FOMC meeting in September is out of the way, attention will quickly shift to the Fed succession and the debt ceiling vote. The appointment of Larry Summers now seems a foregone conclusion, but a worrying question remains. Why has President Obama apparently decided to back a candidate who will face furious opposition from both parties in Congress and whose views on monetary policy appear to be dangerously hawkish? A bullish answer is that Summers may be proposing more radical combinations of monetary and fiscal policy stimulus than Ben Bernanke was willing to contemplate. A bearish interpretation is that Obama believes a financial crisis is inevitable and is impressed, post-Lehman, with Summers' fire-fighting skills. Whatever Obama's true motivation, the Fed appointment will make investors nervous until it is finally settled and fully explained.

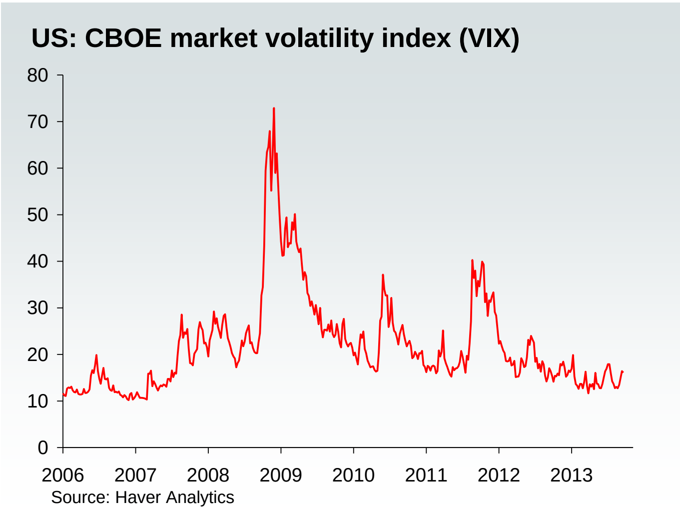
The vote on the debt ceiling was not expected until November or December but the White House has brought forward the deadline to mid-October. This may reflect confidence about striking a deal with Congress, as Republican leaders back off earlier threats to shut down the government or trigger a Treasury default. Alternatively, the White House may fear that the US economy will soon face a crisis and wants to trigger an early budget confrontation, so as to blame Republicans for whatever economic disappointments lie ahead. Either way, the fiscal uncertainty will be resolved by mid-October. And the equity market should then be free to rally into the year end.

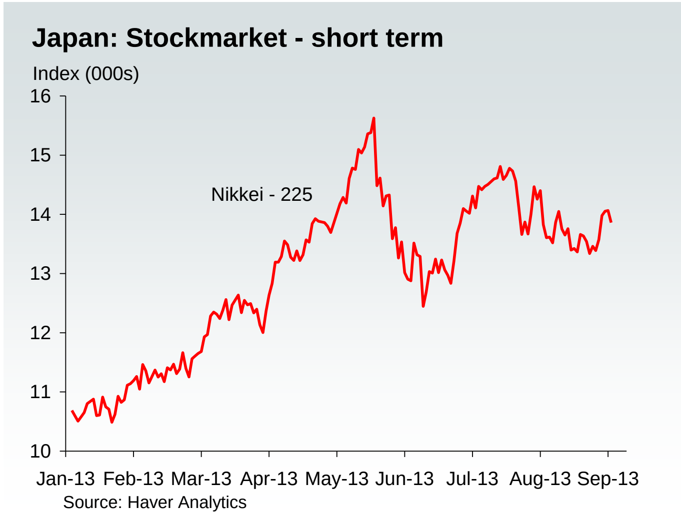
The German elections won't result in a major change of approach to the euro crisis

The outcome of the German election on 22 September seems all but a forgone conclusion. Bulls once hoped this election would usher in a period of more collaborative German leadership. Conversely, bears predicted financial and political crises once the new German government was revealed to be no less stubborn than the old one in blocking compromises on bank bailouts and fiscal targets. Recently, however, both positive and negative expectations have been deflated by the blandness of the German campaign, combined with a slight improvement in the Eurozone's economic conditions.

Japanese policy outlook is more uncertain than German

Shinzo Abe, the newish prime minister, could use the new Diet session starting in a few weeks to announce significant structural reforms, backed up by further monetary and fiscal stimulus. Japan might then experience a sustained supply-side recovery, driven by reform, and probably a continuation of the bull market that began last November, rather than a temporary policy-induced boost. On the other hand, Abe could lose his nerve and fail to deliver structural reform. In that case Japan would see GDP sink back to its tepid potential growth rate of around 0.8%, and most investors would revert to ignoring Japan, much as they have for the past decade.





Watch out for…

- President Obama's attempts to build political support in the US for an attack on Syria
- An annoucement on the pace and timing of tapering following the Fed's meeting on17-18 September and the naming of a new Fed chairman around the same time.
- Results of German election on 22 September.
- The vote on the debt ceiling in to mid-October.

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