Equities soar on hopes of 6% base rate

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TRADERS celebrated the fifth anniversary of the world crash in equities with a mighty party last week. Despite the ensuing hangovers, the London stock market recorded a rise of 105 points with the FT-SE Index of 100 leading stocks closing at 2669.7.

As one market-maker baldly put it: 'Every country is in recession. All countries are into lower interest rates. That's good news for world stock markets.'

The market as measured by the FT-SE 100 has risen by 7 per cent since the start of the year, but is still some 70 points below its all-time high achieved two days after the General Election in April.

Trading volumes soared, peaking just short of 700 million shares traded last Wednesday. This was welcome news to most London dealers, but did not come early enough to save the 50 people who lost their jobs at the London office of Japanese securities house Nomura last Tuesday.

The Government's about-turns on the coal pit closures and the economy went down well with the stock market. Despite Prime Minister John Major's denial yesterday that he is embarking on a 'dash for growth' financed by increased public spending, equity analysts believe that less concentration on inflation and more on growth and jobs should lead to considerably lower interest rates and benefit companies' earnings.

According to stockbroker Kleinwort Benson: 'The Government's successive U-turns are undoubtedly bullish for UK equities and the market is no longer a "hold". The Prime Minister's political future appears to hang on Maastricht passing through the Commons.

'But whether Major's latest shifts in economic policy are sufficient to secure his position as Prime Minister probably matters little to the market. Any successor would no doubt follow the same policies.'

Kleinwort believes the FT-SE 100 could rise to 2800 by the end of the year, even if there is no improvement in corporate earnings. In 1993, the broker is looking for a significant recovery in corporate profits and warns that its current estimate of 10 per cent growth in earnings could be too low. FT-SE should reach the 3000 mark in the latter part of next year, forecasts Kleinwort.

It is clearly not the time to try and buck market sentiment. Market-makers who decided to mark prices down at Friday's opening, following four consecutive days of rises, found little opportunity to fill outstanding positions as — once again — a trickle of sellers was overtaken by a flood of buyers.

Further evidence that the mood is turning truly bullish came from the newly constructed FT-SE mid-250 Index, which tracks second-line stocks. Early in the week, its progress lagged behind the 100 share index, but as buyers built up a head of steam and first-line stock sellers dried up, the 250 index recorded double the gains of FT-SE.

The market also displayed a clear switch in sentiment when it came to sector selection.

Safe stocks such as water and electricity companies, which outperformed during the summer sterling crisis, were among the worst performing sectors last week. Traditional cyclical industries, such as building materials, construction and motors, outperformed the market by 5 per cent-plus last week.

The Government's new emphasis on recovery — and particularly on capital spending — clearly increases the attractions of the building sector, while the possibility that the Chancellor will allow inflation to creep up detracts from high-yielding utility stocks.

Both the electricity generators and the regional electricity companies have come under heavier selling pressure as doubts over future contracts with British Coal have increased. News that these contracts have been further delayed is certain to see such pressure intensifying this week.

But domestic political factors seem to be restricted to a few specific stocks. The market already appears to have factored in most developments on the broad political front. Chancellor Norman Lamont's speech at the Mansion House this Thursday and his Autumn Statement, a fortnight later, will be listened to with interest, rather than awe.

Even Bill Clinton's expected victory over George Bush in the US presidential election on 3 November is no longer likely to unsettle equity investors. On Wall Street, the Clinton factor has sent bonds tumbling, but the Dow Jones Industrial Average climbed slowly above the 3200 mark last week with volumes of stock traded rising above 200 million a day.

Lamont is preparing his Mansion House address against a background of falling interest rates across Europe. Italy announced a 1 per cent cut in its discount rate to 14 per cent, which comes into effect tomorrow. The Bank of Italy's Governor, Carlo Ciampi, yesterday warned that the devaluation of the lira — down by 14 per cent since May — had been overdone and that the currency would have to rise before rejoining the European exchange rate mechanism.

Meanwhile, the Bundesbank has prepared the way for a further cut in its rates. This may come as early as Thursday's meeting of the bank's council, although certain regional members are still making hawkish noises about easing policy too quickly.

Gerard Lyons, chief economist at DKB International, believes that if the Bundesbank were to announce a half point cut in the Lombard rate on Thursday, it would pave the way for Lamont to announce a 1 percentage point cut in UK base rates the morning after his Mansion House speech.

Lyons expects little in terms of new detail on monetary policy in the speech but says that this is unlikely to worry a market that expects further cuts in interest rates.

He argues: 'The message will be reinforced by this week's data, with a poor CBI survey and weak building society net new commitments providing the latest evidence of a deepening recession.

'Markets are already discounting 6.5 per cent base rates by the year-end.' Lyons forecasts that the equity market is 'heading for the magic 3000 by the end of this year'.

SG Warburg Securities forecasts a year-end base rate of 7 per cent and takes a far more cautious view of the market, forecasting the FT-SE at 2750 by end-1992 and at 2900 by end-1993.

Warburg says: 'Rates may be falling more quickly than we originally expected, but near-term fundamentals remain grim, with the full benefit of any reflationary moves possibly not emerging until 1994. Some of the recent star performers thus look obvious targets for selling into further strengths as base rates fall.'

Midland Montagu's Roger Bootle says: 'The speed of recent economic events defies belief.' Nevertheless, he welcomes the Government's change of direction and argues that base rates could come down to 5 per cent by next spring.

Economists at NatWest take a more sanguine view: 'The handling of the pit closures issue has added crass misjudgment to discretion as the key characteristics of the Government's present approach to policy.

'That this combination has not proved lethal, and that the financial markets have not panicked, may just reflect the fact that the markets have already had shock treatment and a certain resilience born of bitter experience has become ingrained.'

FT-SE 100 April-October 1992