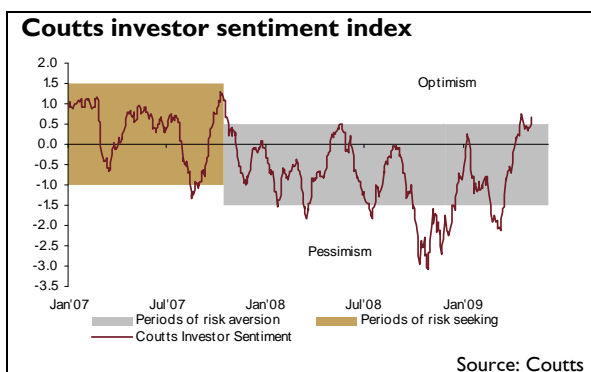


Rally drivers required

On Wednesday, the S&P 500 broke decisively above the 900 level (closing at 919). That took it – and many other developed markets – back into positive territory for the first time this year. The current rally, which started in early March, has now lifted the S&P by 36%, making it the second significant rebound of this bear market (after the one at the end of 2008). As noted in previous *Daily Themes*, it is very hard to distinguish a short-term technical rebound from the start of a new, sustainable bull market. Here, we review the current picture in terms of investor sentiment and economic news flow to assess what could drive the rally higher.

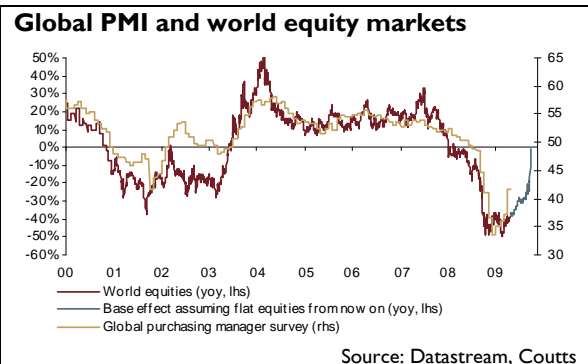
Looking at the two months of the current market rebound, we can split this period into two phases. In the 'initial relief' phase during the first month, markets rebounded from very oversold levels, with investors such as hedge funds covering their short positions. That coincided with our proprietary indicator improving from its capitulation levels on 9th March, only one day after the S&P 500 made its low, back to a neutral level on 6th April.



In the rally's second phase, the market progressed further on evidence of slower economic contraction – or 'green shoots'. That tallied with investor sentiment moving into optimistic territory and oscillating around +0.5 over the past few weeks.

If it should break higher (and move out of the grey range in the graph above, which is associated with risk aversion) for the first time in 18 months, that could herald a key change in investors' attitude, with a move towards increased risk appetite.

For it to do so, however, investors will need supporting evidence that the economy is on the path to recovery, not just a slower contraction (see *Daily Themes*, 'Green shoots of slower contraction, not recovery', 23rd April 2009). Global purchasing managers' indices (PMIs) illustrate the point well. Often cited as a green shoot, they have rebounded from their extreme lows of December 2009. Yet this rebound can only be interpreted as the global economy not falling into a depression: at 41.8, it is still at levels consistent with continued recession.



Equity markets have been efficiently discounting the PMIs' news for the past ten years (see graph above). The past few months have been no different, as markets rallied on relief that the global economy was not entering a depression. Looking forward, however, for markets to hold their current levels – let alone make further progress – they will need to be fuelled by more positive good news, such as the PMIs heading towards 50, a level that historically has been consistent with positive growth. Sadly, we aren't there yet. So, unless investors are willing to take a recovery for granted, equity markets could face some headwinds in the short term.

Carl Astorri
+ 44 20 7753 1612

Richard Batley
+ 44 20 7753 1576

Jean-Maurice Ladure
+ 44 20 7753 1469

Henry Lancaster
+ 44 20 7957 2426

Issued by Coutts & Co, which is authorised and regulated by the Financial Services Authority. Coutts & Co is registered in England No. 36695. Registered office: 440 Strand, London WC2R 0QS.

The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance should not be taken as a guide to future performance. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down.

The information in this document is not intended as an offer or solicitation to buy or sell securities or any other investment or banking product, nor does it constitute a personal recommendation. The information is believed to be correct but cannot be guaranteed. Any opinion or forecast constitutes our judgement as at the date of issue and is subject to change without notice. Any Coutts company, or a connected company, its clients and officers may have a position or engage in transactions in any of the securities mentioned.

The analysis contained in this document has been procured, and may have been acted upon, by Coutts & Co and connected companies for their own purposes, and the results are being made available to you on this understanding. To the extent permitted by law and without being inconsistent with any applicable regulation, neither Coutts & Co nor any connected company accepts responsibility for any direct or indirect or consequential loss suffered by you or any other person as a result of your acting, or deciding not to act, in reliance upon such analysis.

Not all products and services offered by the individual Coutts companies are available in all jurisdictions, and some products and services may be available only through particular Coutts companies.

None of the overseas Coutts companies or offices is an Authorised Person subject to the rules and regulations made under the Financial Services and Markets Act 2000 for the protection of investors and depositors, and compensation under the Financial Services Compensation Scheme will not be available in respect of business transacted with them.