J.P.Morgan
Asset Management

Investment Insights

Global Outlook for 2H 2010

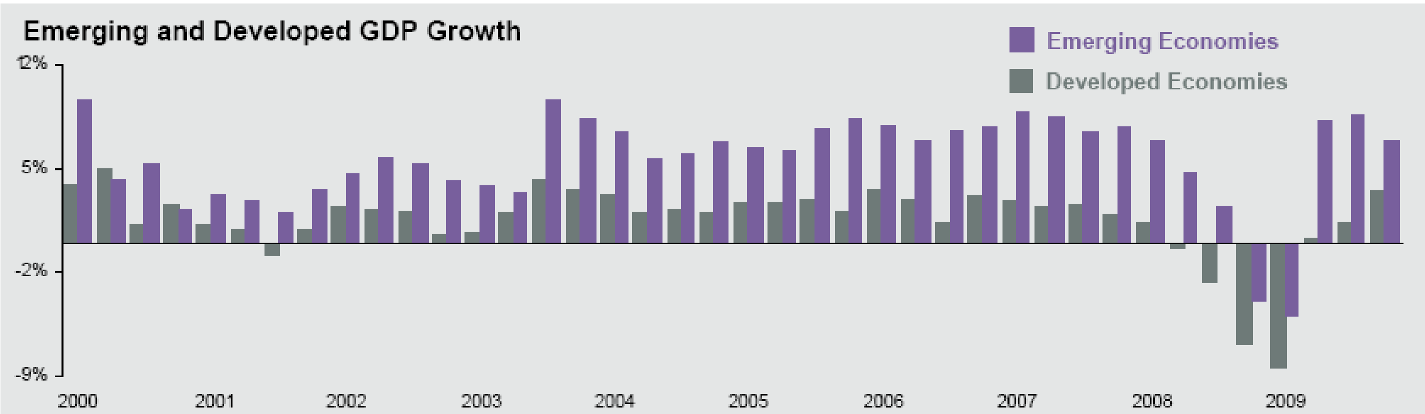
July 2010

A difficult first half for global equities

June was another difficult month for global stockmarkets. The MSCI World Index fell 4.2% in local currency terms, bringing a dismal first half to a close. Year-to-date, the MSCI World index is down 7.1% in local currency terms. While the US, UK and Japan all fell essentially in line with global benchmark, the Eurozone did materially worse, correcting by 9.3%. However, it is important to note how polarised performance was between the Euro nations in 1H'10. The countries perceived as having the highest risk of sovereign debt default saw their equities fall furthest: Greece (YTD down 39%), Spain (YTD down 21%) and Portugal (down 13%). By contrast, the Eurozone countries seen as having lower economic risks outperformed their peers strongly: Germany fell only 1%, while both the Netherlands and Belgium actually rose by around 1% YTD. Of note is that both France (down 9%) and Italy (down 15%) saw their stockmarkets hit harder than expected. Among emerging nations, the MSCI Emerging Markets Index corrected by a modest 1% during June and 4% in 1H'10. However, as before, there was great divergence between the winners and losers. Over the past six months, Brazil, Russia (ADR/GDRs) and Taiwan all fell by at least 12%. Conversely Chile, Indonesia, the Philippines, Thailand and Turkey all rose by over 5%.

The risks of a double dip recession have risen

Recent FIFA World Cup matches highlighted the difficulties of forecasting the future in a fickle and uncertain world. In its World Cup Special, one of the major British newspapers confidently predicted that the semi-finals would be between Brazil, Argentina, England and Spain, thereby achieving a 75% inaccuracy level! Unfortunately, forecasting investor returns so far this year has been equally challenging. Despite accommodative G7 monetary policy, negative real interest rates in most OECD countries and strong 1Q'10 earnings results worldwide, equities have underperformed both bonds and cash in the first half. Primarily, this is because 1) investors have been mauled by the sovereign debt crisis in the Eurozone; 2) OECD fiscal tightening could overwhelm private sector recovery; 3) there are renewed worries about bank regulation and stability; and 4) uncertainty over the future pace of economic growth in the US and China has risen. Overall, investors are now more afraid of a global double dip recession than six months ago. As a result, investors are in risk aversion mode, prioritizing capital preservation over capital growth.



Source: J.P. Morgan Global Economics Research, IMF, J.P. Morgan Asset Management. Data are as of Apr 2010. 2010 and 2011 data are estimates as provided by the IMF.

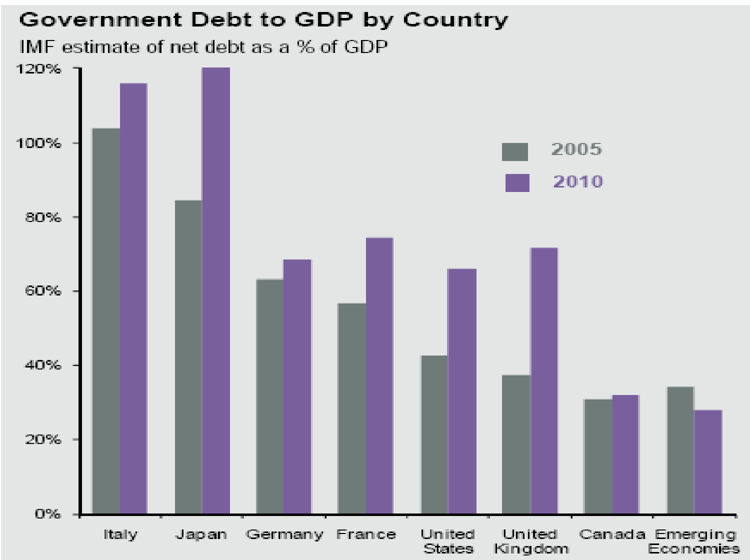
Investor uncertainty and risk aversion are unlikely to fall swiftly

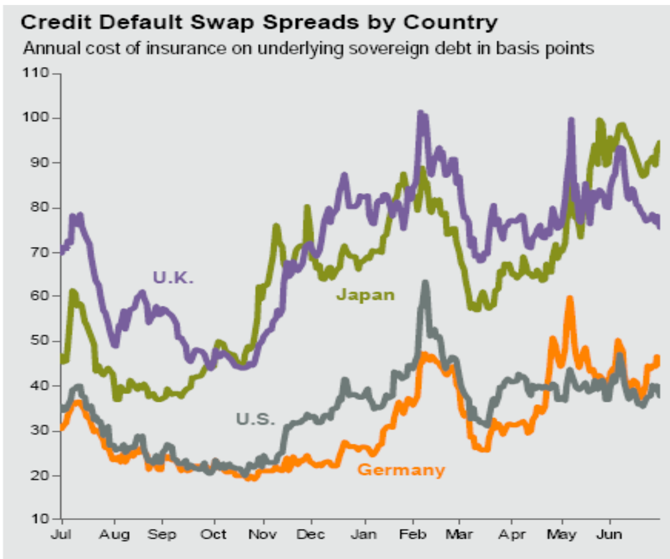
Unfortunately, these key risks to global stockmarkets are unlikely to be overcome either easily or swiftly. Recent statistics have generally been at the weak end of market expectations. I n particular, the recent US data showing that the labour force shrank by 652,000 in June is of genuine concern. This can't be wholly explained by the end of temporary employment for the US Census. In addition, the 30% plunge in May pending house sales following the expiry of the US homebuyers' tax credit needs to be monitored closely. If the US property market trends sideways for a while, this need not derail personal spending. However another bout of falling house prices is likely to have a knock-on impact for both consumption and domestic orientated US businesses. GDP forecasts for both 2010 and 2011 are now being trimmed, and this is likely to pose a headwind for both earnings momentum and profits growth in both the 2H'10 and 2011. Leading economic indicators for both America and China continue to stall, although they have yet to signal economic contraction. A major fear is that the ongoing growth slowdown in China could end in a hard, not a soft landing. The key issue for investors is whether we are currently in a soft patch within an ongoing economic recovery or whether we are about to see a double dip recession.

Asset allocators are currently polarized. While optimists cite cheap equity valuations, oversold technical indicators and continued earnings recovery, pessimists fear that we will see a full blown economic downturn, led by fiscal tightening, further falls in US property prices, weak G7 consumption and a potential hard landing in China. For us, the picture is less clear than it was a month ago. In particular, uncertainty over the outlook for US growth trends has risen and is a key swing factor.

The outlook for earnings looks healthy for 3Q'10, but uncertain for 2011

During June, earnings momentum (defined as earnings upgrades/earnings downgrades) remained strong in the US, Europe, Asia and Latin America. Of note, however were divergent trends between regions. In Europe ex-UK and Asia ex-Japan, earnings momentum remains positive reaching 1.81 upgrades for every downgrade in Europe ex-UK and 1.45x in Asia ex-Japan. In the US, earnings momentum moved sideways and in Japan and the UK, earnings momentum weakened, although were still healthy in absolute terms, at 1.96x and 1.84x respectively. Given the macro fears over the Eurozone, the continued strong showing of core Europe's outlook for profits is noteworthy. The weaker euro seems to be key, boosting profit forecasts for exports, notably in Germany. Equally interesting is the weakening earnings momentum in Japan, which dropped from 2.24x in May to 1.96x in June. Given earnings momentum is the key to the investment case for Japan, this is a worry. Another area of concern is Emerging Europe, where the earnings momentum ratio has now fallen to 0.75x, i.e. downgrades now outnumber upgrades. Overall, investors want reassurance that these projection s are accurate. Our instinct is that earnings forecasts have some further upside potential for this year. However 2011 earnings' risk is likely to lie on the downside. The key uncertainty here remains over 1) sales growth potential and 2) the willingness of the US consumer to spend freely.





Source: IMF Fiscal Monitor, Thomson Reuters, FactSet, J.P. Morgan Asset Management. Data are as of June 2010.

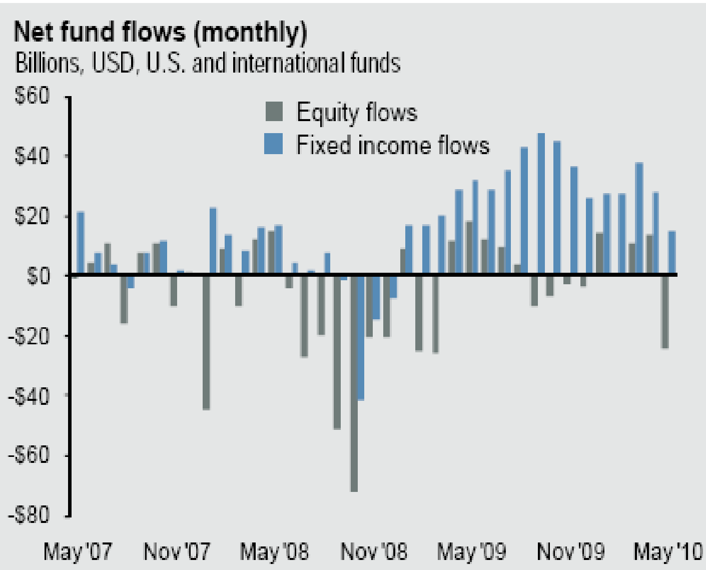
Are current equity valuations really cheap?

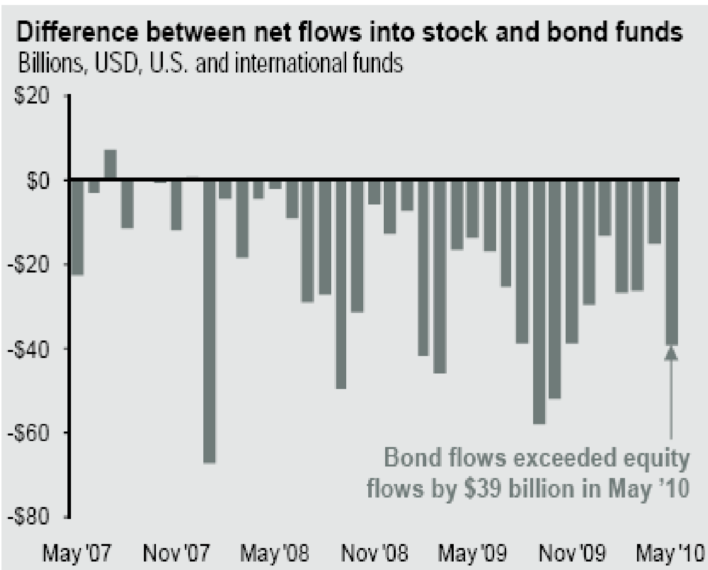
On published data, equities look attractive at current price levels. In particular, equity risk premia versus bond yields are historically high and appear to be pricing in much bad news. In Europe, Japan, the UK and US, equity risk premia are all currently above 6%. In addition, dividend yields are higher than government bond yields in all major markets bar the US and Canada. Europe ex-UK dividend yields look especially attractive at 3.8%. Judged on PERs, valuations currently look comfortable rather than compelling, although all regions are trading towards the low end of historic ranges. However, risk aversion and equity volatility are likely to stay high in the near term. For that to change, investors need reassurance that: 1) earnings growth will remain robust in 2H'10; 2) PER valuations are realistic; 3) currently high dividend yields do not get cut; and 4) high equity risk premiums are not a value trap.

Asset allocation: Neutral on equities until there is greater investment certainty

Until the current enormous uncertainty over the fiscal, growth and earnings outlook eases, we have downgraded the equity weighting to neutral. We believe that markets are likely to remain choppy for the next few weeks until the growth debate outlined above is settled. We remain cautiously optimistic about the current global economic recovery and believe earnings momentum remains robust. In addition, the stimulative impact of negative real interest rates in most major economies should not be underestimated. However, continued asset price declines, whether they are in European sovereign bonds, global equities or US residential real estate, are material threats to global growth. While risk aversion remains investors' overriding impulse, global stockmarkets will continue to struggle against powerful headwinds.

Within equities, we believe that the "core" markets of the US, Europe ex-UK and the UK all warrant a neutral ranking. We continue to rank Emerging Markets and Asia as overweight. This is primarily because the outlook for earnings growth remains at a premium to the G7 prospects and investors will continue to seek robust sources of profits growth. We have downgraded Japan from overweight to underweight. This reflects a combination of a) a noticeable weakening in earnings momentum during June although the absolute level (at 1.96x) remains strong; 2) Japan's attractiveness to investors is principally as a geared play on global economic recovery. This is now more ambiguous; and 3) a renewed focus on global macro fears will again highlight Japan's fiscal weaknesses and tight monetary conditions.





Source: Investment Company Institute, J.P. Morgan Asset Management. Data include flows through May 2010 and exclude ETFs. International equity flows are inclusive of emerging market, global equity and regional equity flows.