

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 Euro zone 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 (Year To Date down 39%), Spain (Year To Date 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% Year To Date. 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 have 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.

.....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. In 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 second half 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 me, 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 projections are accurate. My 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.

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.

US weighting downgraded to Neutral

Recent US economic statistics and the sharp decline in world stockmarkets since early May have unnerved equity investors. Although US profits have rebounded smartly over the past year,

investors are concerned that this recovery is unsustainable given the high and rising level of both government and consumer debt. Confidence, of CEOs and consumers alike, is the key, and right now that confidence is being tested by another wave of negative headlines. My instinct is that the better trend in the economy and markets will continue as companies start hiring and investing, but we have to recognize that the risks around this appear to be going up. At the same time, American equities have outperformed Europe on a Year To Date basis, and on a technical / trading view, European equities look relatively cheap. On the other hand, the potential rewards for owning equities are also increasing, with the free cash flow yield now approaching 8% for the S&P500 ex-financials, and the risk premium offered for buying US equities versus bonds now at levels almost matching the extremes reached during the depths of the crisis last year. Overall, a neutral weighting seems warranted.

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

Until the current enormous uncertainty over the fiscal, growth and earnings outlook eases, I have downgraded my equity weighting to Neutral. I believe that markets are likely to remain choppy for the next few weeks until the growth debate outlined above is settled. I 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 U.S. 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, I believe that the "core" markets of the US, Europe Ex UK and the UK all warrant a neutral ranking. I 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. I 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; 3) a renewed focus on global macro fears will again highlight Japan's fiscal weaknesses and tight monetary conditions.

Asset Allocation – in order of preference

Emerging Markets	– Overweight (Unchanged)
Eastern Europe	– Neutral
Latin America	– Neutral
Asia	– Overweight
Middle East	– Neutral
Africa	– Overweight

NB This table refers to regional weights within the EM asset allocation

For emerging markets, the primary risk over the next 12 months remains inflationary pressures. Developing world growth trends remain robust. However, the timing of further interest rate increases may be softened by the current worries over global growth trends. The extent of emerging interest rate hikes during this year are likely to be not more than 25% of the total easing in interest rates seen during the global credit crunch. Policymakers are seeking to normalize interest rates rather than to implement aggressive tightening. Another key risk is posed by a

stronger US Dollar. When the US Dollar is weakening, emerging markets tend to do well and when the US Dollar is strengthening, this has traditionally hurt emerging markets' relative attractiveness versus US equities. Emerging markets need to demonstrate that the risks outlined above will not torpedo their ability to meet or exceed profits' growth forecasts. The fact that earnings momentum (as measured by earning upgrades / earnings downgrades) remains robust in both Asia and Latin America is encouraging. However, the drop in Emerging Europe's earnings momentum in June to 0.75x is a cause for concern. Any earnings disappointments in emerging markets are likely to be punished heavily by investors.

Asia – Overweight (Unchanged)

China remains the key to Asian markets' performance in 2010, and a policy surprise and / or growth shock in 2010 remains the biggest risk for investors. Investor anxiety over Chinese monetary tightening continues to overshadow Chinese equities. However, Chinese share prices already discount much bad news. Meanwhile, Beijing is now making visible progress on its top priority of curbing rising property prices. On a long term view, China's growth outlook remains attractive. Also, of importance is the fact that in China a) debt is low relative to G7 levels and b) bank provisions for bad debts are relatively good. My view is that the Chinese authorities will continue to steer a pragmatic course and will avoid the perils of aggressive tightening to monetary policy. Given strong domestic demand, negative real interest rates and rising inflation in a number of Asian countries, the most pressing issue in 2H 10 is how soon and how far central banks raise interest rates. The key to Asia's continued strong equity performance is its ability to outshine the advanced economies in terms of both GDP and profits growth over the next 3 years. Investors will want reassurance that Asian equities can deliver on 2010 profits' forecasts.

Europe Ex UK – Neutral (Unchanged)

The European Sovereign Debt crisis continues to traumatise investors. There is the capacity for further macro effects in the future (especially through Eurozone fiscal retrenchment in 2011-12 and a weaker Euro). However, there is also uncertainty with regards the outlook for European new loan growth and potential balance sheet problems for the weaker Spanish and German banks. In this regard, the release of the EU's stress test results at the end of July are potentially significant. Despite strong second quarter corporate profits, investors remain nervous, particularly of earnings downgrades for European banks and financial institutions. However, earnings momentum in June continued to increase and is a robust 1.81x in Absolute terms. Given the robust data from both the European Purchasing Managers' Index and German Ifo corporate sentiment surveys, and the likely beneficial impact of a weaker Euro on exports, Europe Ex-UK equities may offer cheap and attractive investment opportunities.

UK – Neutral (Unchanged)

On the economic front, the housing market remains a key factor affecting future growth trends. It is therefore of concern that the Halifax House Price Index fell 0.4% in May and has seen negative prices in three out of the first five months of 2010. This appears to be due to greater supply of houses for sale. In the long term, greater transaction volume is an important step towards normalisation in the UK property market. However, in the near term, this may impact consumer sentiment. On the policy front, the austerity budget has generally been well received by investors. It has been sufficient to retain the UK's AAA credit rating. However, uncertainty remains. The announced spending cuts represent the tightest fiscal policy adjustment in 40 years. To reduce Britain's record deficit of close to 12% of GDP is going to be tough, requiring difficult and

unpopular policy decisions. Overall, for now I am comfortable to maintain my Neutral investment weighting for UK equities.

USA –Neutral (downgraded from overweight)

Recent US economic statistics and the sharp decline in world stockmarkets since early May have unnerved equity investors. Although US profits have rebounded smartly over the past year, investors are concerned that this recovery is unsustainable given the high and rising level of both government and consumer debt. In particular, the recent data showing that the labour force shrank by 652,000 in June is of genuine concern. 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 sidewise 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. Confidence, of CEOs and consumers alike, is the key, and right now that confidence is being tested by another wave of negative headlines. My instinct is that the better trend in the economy will continue as companies start hiring and investing, but we have to recognize that the risks around this appear to be going up. At the same time, American equities have outperformed Europe on a Year To Date basis, and on a technical / trading view, European equities look relatively cheap. On the other hand, the potential rewards for owning equities are also increasing, with the free cash flow yield now approaching 8% for the S&P500 ex-financials, and the risk premium offered for buying US equities versus bonds now at levels almost matching the extremes reached during the depths of the crisis last year. Overall, a neutral weighting seems warranted.

Japan- Underweight (downgraded from Overweight)

I 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; 3) a renewed focus on global macro fears will again highlight Japan's fiscal weaknesses and tight monetary conditions. Japan remains a clear value play. However, with earnings momentum blunted and rising doubts about the global growth trends, it is hard to see a compelling catalyst to unlock this value in the near term. Meanwhile policy uncertainties persist over the direction of the new government.

Edmund Brandt writes in his capacity as global equity strategist and investment director. His views are based on a 12 month time horizon and reflect the input from various investment teams within JPMAM. His opinions may therefore diverge from the GMAG team outlook, which is based on a 3-6 month time horizon and reflects the investment strategy of our Global Multi Asset Group.

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