Investment Director's Bulletin

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Global economic recovery to continue in 2010

As we embark on our investment journey through 2010, a good starting point is to review the consensus economic forecasts for the next 12 months, as reported by Bloomberg. For 2010, GDP is expected to grow by 2.6% in America. This is well above the growth rates forecast for Europe and Japan, but is lower than the historic US trend growth rate. By contrast GDP in the eurozone is expected to increase by a lacklustre 1.2% and UK GDP is anticipated to grow by 1.2%. Analysts are looking for Japan to remain in a low growth environment, with forecast GDP of 1.2%. Of note is that China is expected to achieve impressive GDP growth in 2010 of 9.4%.

For me, one of the key drivers of investor sentiment this year will be positive / negative surprises to these consensus growth forecasts. On this basis, forecasts for both the eurozone, the UK and Japan seem cautious and make very conservative assumptions for the recovery in both exports and capital investment. My instinct is therefore that there is upside potential to these forecasts. By contrast, the US GDP forecast looks to be less obviously either too conservative or too aggressive. December's weaker than expected non-farm payroll data is a warning that recovery in the US is unlikely to be in a straight line. Nonetheless, the combination of very loose monetary policy, Mr Obama's commitment to further fiscal stimulus and bank balance sheet rebuilding means that economic recovery looks set to continue in 2010.

Finally, we have China. In many ways both the most interesting and the most important forecast is for Chinese growth of 9.4%. While this figure is both high in absolute terms and relative to the G7 nations, recent data suggests that in the first half, Chinese growth could be even stronger than anticipated. In December, Chinese exports rose by 17.7% year on year, well ahead of the modest consensus increase. Of equal significance is that imports grew by a dramatic 55.9%. This is an impressive sign of both strong domestic demand and increased raw materials volumes, which are likely to be a leading indicator for further strong exports during the first quarter. Given recent comments by China's President, Hu Jintao, that China will continue to pursue "moderately loose" monetary policies and a "pro-active" fiscal policy, the likelihood is that China's economy sees heroic growth at both the corporate and GDP level during the first half followed by a possibly abrupt slowdown in the second half as administrative measures to curb excessive exuberance start to bite.

Overall, I believe that global growth will continue to recover during 2010, with risks to growth remaining on the downside for developed countries and on the upside for emerging economies.

For the G7 nations, I still see a double dip downturn as a bigger risk than inflation during 2010, although assuming current monetary and fiscal policy continue, it should be possible to avoid both these problems. For the emerging markets, managing sharply rebounding domestic and export growth will be the major challenge.

Investors await confirmation that company profit growth is still strong

While the economic environment is always important for stock markets, it is corporate earnings that will be the key driver of equity prices. As investors prepare for the earnings results season for the last quarter of 2009, a streak of wariness has crept in. Recent company profit growth data has noticeably slowed over the past few weeks. This has been relatively modest in the US, UK and eurozone, but has been more material in emerging markets, where company profit growth has come back in both Asia, Eastern Europe and Latin America. While my instinct is that this is just a temporary lull, due partly to the Christmas holiday season and partly due to pre-results caution from analysts afraid of being wrong-footed, markets are unlikely to move sustainably higher until they receive reassurance that company profit recovery is on track.

As important as the strength of profits over the last three months will be companies' guidance for the year ahead. In particular, I will be monitoring closely both operating margins (for signs of continued improvement) and sales (for clear evidence of positive growth). For company profit recovery to be sustainable in 2010-11, sales growth is vital to take profits growth to the next stage. Currently, the picture remains very mixed in the G7 markets. However, I am reassured by the current state of low inventories. Especially in Europe (both in the eurozone and the UK) companies remain cautious and therefore restocking of inventories is still only tentative. My instinct is that inventory rebuilding has the potential to both a) provide upside surprises to profits over the next six months and b) endure longer than analysts expect.

While nervous, I remain overweight emerging markets

Emerging markets are currently the most challenging call for asset allocators. In the immortal words of the Clash song: "should I stay or should I go?". Returns in 2009 have been so strong, with the MSCI Emerging Market index soaring 62% in local currency terms, and the BRICs by a truly impressive 72%, that some analysts are fretting over an emerging market (EM) asset bubble that will ultimately lead to disaster. Clearly, current prices already reflect much good news. Valuations are no longer cheap and to be frank, emerging markets make me nervous, but it still seems too early to talk of an EM asset bubble. Providing profit increases do not disappoint expectations and dividend growth is strong, there is still realistic scope for further price gains.

Overall, I think it is still too early to reduce exposure. Given the strong growth dynamic in emerging nations, interest rate increases are likely to be an issue for emerging markets sooner than for G7 countries. Analysts are forecasting interest rates will go up in a number of countries during the first half, including Korea, India and Brazil. How this impacts equity prices is yet to be seen. With China now looking to tighten policy to damp its over-charged recovery, the key question is whether growth forecasts in the key BRIC markets are over-optimistic. If company profits disappoint, emerging markets look vulnerable. Also emerging markets would also be likely to underperform if the US Dollar has a sustained period of recovery. Emerging markets are likely to experience a roller-coaster ride in 2010.

Asset allocation summary – overweight equities

Asia – Overweight (unchanged)

Overall, I believe that global economic growth will continue to recover during 2010, with risks to growth remaining on the downside for developed countries and on the upside for emerging economies. Given this environment, and that that the major central banks are likely to err towards a late exit from loose monetary policy rather than an early exit, the cost of holding cash is likely to remain high. While I remain a nervous bull, this does not seem the time to take money off the table. I therefore remain overweight in equities with a bias towards quality companies, particularly if investors are worried about a double-dip downturn for G7 nations and rising interest rates in emerging markets. Therefore companies with strong cash flows, attractive dividend yields, credible management and fortress balance sheets are likely to do well. Within equities, I continue to be overweight emerging markets (although I favour a global approach over regional / country strategies) and for G7 markets, I maintain a modest preference for Europe ex UK versus the US and UK.

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

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

Given the pace of recovery in China and India and other emerging markets, any signs that inflation is making a comeback will be a worry for investors. Within emerging markets, the likelihood of (moderate) interest rate increases in 2010 looks most advanced in Korea, India and China, although it is also worth monitoring Taiwan, Brazil and Turkey. The biggest threat to emerging market equities next year would be if frothy domestic demand, buoyant economic growth and renewed inflationary pressures provokes aggressive interest rate rises. This would be likely to spell "Game Over" for emerging markets outperformance. The other key risk would be a sustained recovery in the US Dollar, which would hurt emerging markets relative attractiveness versus US equities and also commodity producing countries. We remain overweight emerging equity markets but note that risks of overheating and interest rate rises are increasing. Also, valuations on the whole are no longer cheap. In terms of EM asset allocation, we have upgraded Eastern Europe to overweight. This is driven by the cheap valuations in Russia and Turkey, relative to other emerging regions.

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. However, given strong domestic demand and rebounding exports in a number of Asian countries, the most likely issue is that interest rates rise during the first half in Korea, India and elsewhere. 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 three years. Investors will want reassurance that Asian equities can deliver on 2010 profit forecasts. Asian valuations are no longer cheap but still seem to have further upside potential, if investors believe that company profit expectations are realisable.

Europe ex UK – overweight (unchanged)

The strength of the GDP recovery in the eurozone has surprised investors and suggests that 2010 GDP forecasts may be too low. Industrial production rebounded strongly during the third quarter for not only France and Germany, but Italy, too. 2010 Bloomberg consensus forecasts are for eurozone GDP growth of 1.2%. Yet if corporate sentiment surveys prove correct, then a much stronger recovery is likely. This is a potentially powerful engine for positive sales and profits surprises over the next few months. Given investors are obsessively focussed on short-term news-flow and company profit data, this should ensure that equity prices continue to have an upward bias. Meanwhile, European stocks are still good value compared to US equities.

USA – neutral (unchanged)

While US aggregate operating margins have proved resilient, due to proactive cost-cutting by American firms, for 2010 the key risk is that US firms struggle to grow sales, as consumption, property prices and the construction sector all remain weak. If growth disappoints, then US equities may underperform both European and emerging market equities. I maintain a moderate pro-quality bias and believe it is still too early to be defensively positioned. Even with the recent rally, the spread between cheap and expensive stocks remains historically high and therefore favours a value style bias. Overall, I continue to prefer Europe ex UK among the core markets.

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Japan – neutral (unchanged)
Japan is unloved and out of favour with investors. Japan remains a value play relative to global equities. However, given recent signs that company profit growth is rolling over, I am waiting for clear signs that profits growth remain healthy before upgrading to overweight. Japan offers an interesting opportunity for contrarian investors.

UK – underweight (unchanged)
In the short term, the current cyclical recovery may continue to surprise on the upside. However, for 2010-11, despite a high proportion of company profits earned internationally, the key risk is that UK firms see profits growth curbed due to a mixture of weak consumption, higher taxes and government spending cuts. The fiscal outlook and household debt finances look truly grim, even after December's Pre-Budget Report. The UK and California are the two developed economies with the worst budget deficit problems in 2010. Solving these will be both urgent and painful. This may curb the extent of a recovery in GDP growth during 2010-11. So too will the consumer debt mountain, which has been estimated (including mortgages) at £30,450 per capita. This represents over 12 months of aggregate wages, which will be a very significant headwind for retail sales over the coming months. However, recent trends in the property market suggest prices are now rising, but remain fragile, as supply is abnormally low. If sustained, this is key to allowing the banks to rebuild their balance sheets and write off credit losses.

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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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