MARKET INSIGHTS

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A soft patch, not a perfect storm

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Introduction

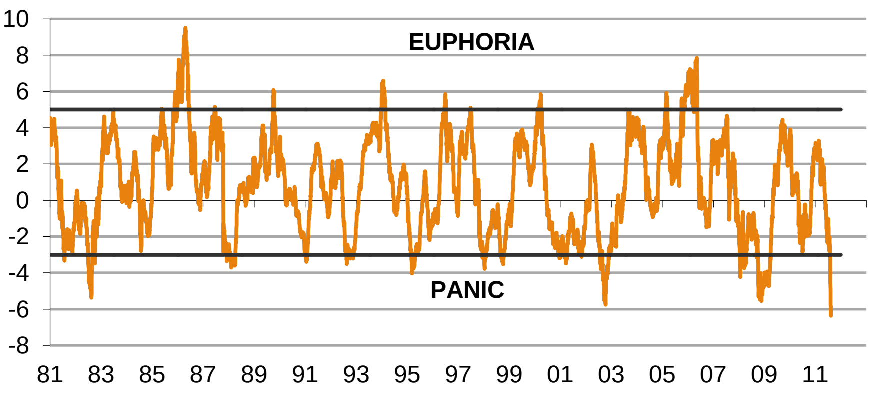
Investor fear has resulted in heavy losses in global equity markets in recent weeks, pushing risk appetite indicators to extreme lows. Katherine Santiago evaluates the drivers of the market falls, assesses the economic backdrop and looks at the implications for portfolio construction.

Investor risk appetite – the most extreme risk aversion

Over the past few weeks, markets have been highly volatile and fear-driven. What has been surprising has been the breadth of the selling and the speed of the declines. Indicators of market fear have been pushed to extremes, with the Credit Suisse risk appetite index dropping to the lowest level since its inception in the early 1980s. As with the market declines, the pace of the drop in the risk measure has been particularly remarkable.

When the Credit Suisse measure is at panic levels, this has historically been a buy signal. The extreme fear of the market may therefore be a contrarian signal to stick with risk assets.

Exhibit 1 – **Credit Suisse measure is at its most risk averse**
Investment risk appetite indicator*



Sources: Credit Suisse. Data up to 11 August 2011
* Note: The Credit Suisse risk appetite indicator compares risk-adjusted returns across 64 equity and fixed income markets. The index aggregates six-month excess returns over cash compared with 12-month volatility.

J.P.Morgan
Asset Management

Mid-cycle slowdown, not double dip

The most dramatic news of recent weeks has perhaps not been the US downgrade but the poor second-quarter GDP reading and the downward revision to the historical numbers. Economists use historical numbers to formulate their future growth expectations, so downward revisions also put downward pressure on expectations.

Some analysts have argued that the US economy will stall and head back into recession when growth falls below 2%. While growth is now at these levels, our central case remains that we are in a mid-cycle slowdown, rather than headed for a double dip.

Monetary policy remains largely stimulative

Monetary policy remains stimulative in most major economies – the exception has been China, where policy has been tight, but now may be loosening again. Given the extent of the stimulus provided so far, there are questions over how much more support can be provided, and it is unlikely that policy will provide the market tailwind that it has done. Nonetheless, accommodative policy continues to underwrite the cycle.

Margins may prove more resilient than expected

With the economic backdrop weak, investors will be questioning whether equity markets can deliver positive performance without economic growth. The key will be corporate earnings. It is not going to be as easy as it has been for companies to keep growing earnings; however, margins may prove more resilient than analysts currently expect. Consensus thinking believes that margins will compress back towards their long-term mean. However, the current cycle is different from previous cycles due to the high levels of spare capacity and the limited pricing power of labour as a result of persistently high unemployment. Therefore, margin compression may take longer, providing support for earnings.

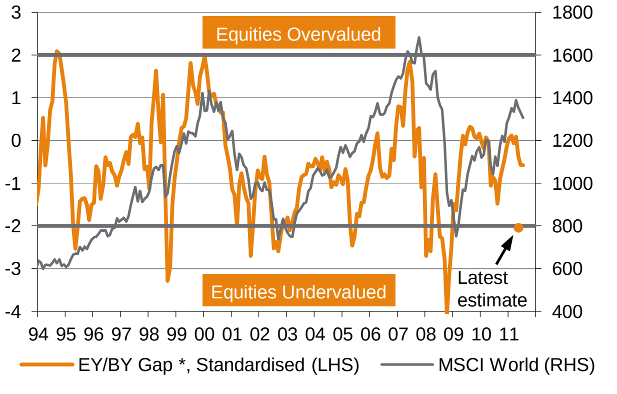
On the revenue side, much depends on how long the current market panic lasts. If it proves to be a short, sharp market decline, lasting a few weeks, the revenue impact will be limited. However, if it continues for longer, consumer sentiment has the potential to deteriorate rapidly, weighing on revenues.

The driver of equity market performance may not be actual earnings, but the extent to which earnings continue to beat analyst expectations. The nervousness among investors means that earnings disappointments have the potential to have a more significant effect than whether or not earnings are growing. Nonetheless, given our expectations of margin resilience, we continue to view earnings as supportive.

Equity valuations are supportive

Even before the falls of the past few weeks, equities were not expensive. Now, valuations look very reasonable, with equities appearing attractive, particularly relative to bonds. In August, equity versus bond valuations have moved to extremes, with equities beginning to look undervalued.

Exhibit 2 – **Equities are attractive relative to bonds**
Equity Yield: Bond Yield Gap*, Standard Deviations

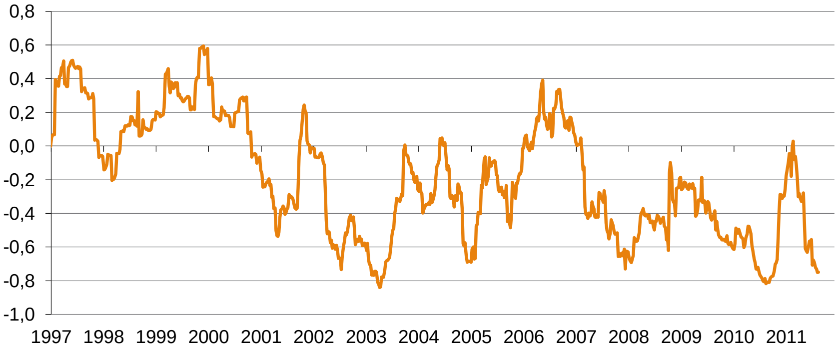


Sources: Thomson Datastream, J.P. Morgan Asset Management Global Multi-Asset Group. Monthly data up to end July 2011, with estimate for 11 August 2011.
*Note: The global earnings-bond yield gap measures the difference between the earnings yield and the nominal bond yield. The series has been standardised over three years. Data up to July 2011. This information reflects JPMAM's opinion and is subject to change. LHS: left hand scale.

Fixed income duration may help to mitigate risk

Correlations of equity and bond returns have been negative since the market panic began. Even at current extremely low yields, and despite the US downgrade, government bonds continue to be sought for their safe haven status. Given the significant divergence between equities and bonds, extending fixed income duration may be one way to mitigate portfolio risk.

Exhibit 3 – **Correlation of equity/bond returns: The case for duration**
Correlation of US Equity and bond returns, rolling 25-weeks



Sources: Thomson Datastream, J.P.Morgan Asset Management. Data up to 12 August 2011.

Conclusion

It is easy for investors to become caught up in panic, but it is important to take investment decisions based on fundamentals, rather than on sentiment. Given our view that we are in a mid-cycle slowdown not a double-dip recession, and with policy stimulus continuing to provide support, we remain positive on equities. Valuations are attractive, and company margins may prove more resilient than analysts currently expect. To mitigate portfolio risk, investors may wish to consider adding some fixed income duration.

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