

MARKET INSIGHTS

December 2009 Equities: overweight



Tom Elliott
Vice President
Global Strategist
Investment Marketing

Equities: overweight

The following paper looks at why many investors have missed out on the stock market rally of the last six months, arguing that until the late summer they had justifiable reasons. However, although several risks remain, the arguments in favour of running an overweight position in equities in multi-asset portfolios now appear compelling. Equities are currently supported by loose monetary policy, corporate earnings growth and high dividends. Therefore, for investors who are still underweight equities in their portfolios, it may not be too late to rectify these positions and benefit from further stock market upside in 2010.

Summary

Investors were right to be wary of the sustainability of the stock market rally in the spring and early summer. Risks included a further banking crisis and a global depression. These risks only receded over the summer, when second-quarter GDP data showed an economic recovery in Germany, France and Japan, leading indicators in other OECD countries turned upwards, and Chinese economic growth accelerated. As VIX (the Chicago Board Options Exchange Volatility Index) fell to more normal levels and three-month Libor spreads over policy rates began to be eliminated in the late summer, investor risk aversion fell and the justification for being out of equities weakened.

We are not out of the woods yet. There continues to be a risk of a double dip recession, induced perhaps through policy error (premature monetary and/or fiscal tightening). However, our base case is that the next 18 months will be marked by slow growth (not a return to recession), and by low core inflation. Against that background, a low interest rate environment will continue to support income-generating risk assets, such as equities.

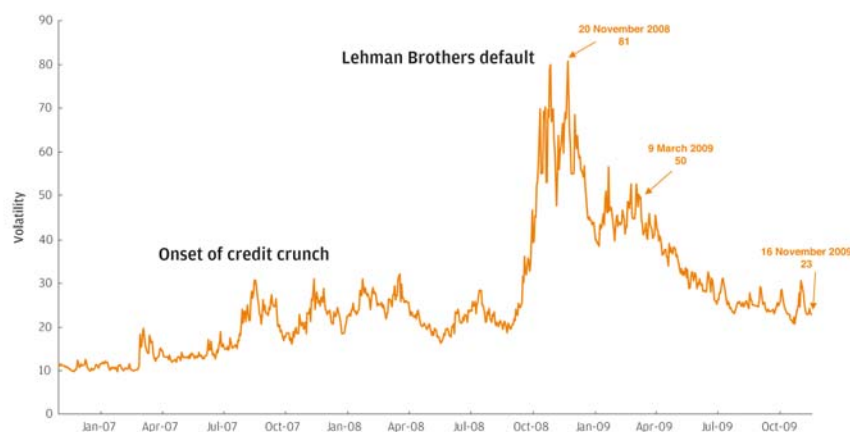
Why many investors remain underweight equities

At the height of the credit crunch a joke was going around, referring to the increased level of risk associated with corporate paper: 'Bonds are the new equities, equities are the new options and your options are running today's 3.30pm horse race!'

After a decade in which the developed stock markets had failed to make any gain, ending in a vicious sell-off against a background of very high volatility, it is no wonder that in early 2009 investing in equities was becoming equated to betting on horse races.

A suggestion that clients go overweight equities in March 2009 would have been a very high risk suggestion, given fears that the global recession may turn into a depression. **Exhibit one** shows that market volatility was much higher than it is today (eg: the VIX, which is a measure of anticipated volatility on the S&P 500, was at 50 on 9 March, still well above pre-credit crunch levels). In addition, the market appeared to be dominated by short sellers, an unsettling feature.

Exhibit one – VIX



Source: Bloomberg, J.P. Morgan. Data as at 16/11/09

Furthermore, banks did not trust each other to repay money, as demonstrated by the wide spreads on three-month dollar Libor over central bank policy rates until the late summer which we see in **exhibit two**. The chart for three month sterling Libor is similar, while euro Libor rates corrected relatively early. If banks believed that there was continuing counterparty risk well into the summer, (ie, the risk of another bank blow-up, with all the chaos to financial markets that that would have entailed), why should we, as investors, have believed otherwise?

Therefore, an overweight call in the first few months of the rally would have been a high risk strategy that could not have been supported by fundamental analysis.

Exhibit two – US interbank rates %



Source: FactSet, J.P. Morgan. Data as at 30/10/09.

As the summer - and the rally - progressed, institutional investors reacted to improving economic data by increasing their exposure to equities. Japan, Germany and France recorded growth during the second quarter, while leading indicators rose sharply across OECD countries. Surprisingly strong second-quarter corporate earnings did much to help nudge institutional investors into equities, even though the positive results had been achieved through cost cutting rather than top-line sales growth. The result was seen in the Merrill Lynch Fund Managers' Survey¹, which showed by October a net 38% of respondents from around the world were overweight equities by mid October, the highest level for two years.

However, private investors have lagged their institutional counterparts and have hesitated to go overweight equities. Instead, many are waiting until the market 'pulls back' a little, in what is a classic behavioural trap. This is the temptation to see a discount as offering 'value' if markets fall by, say 10%, irrespective of where the starting point was. But while 'buying on the dips' may often lead to missing rallies that have already started, the habit - exercised en-mass by investors - should provide support for the market, as a whole, when those dips occur.

One piece of data illustrates the private client's defensiveness well: US industry data² shows that flows into bond funds exceeded those into equity funds for 20 straight months to September, in contrast to 2007 when equity fund sales were stronger than bond funds.

This thinking has come at a large opportunity cost for those investors who will shortly be calculating calendar 2009 returns. The MSCI Europe Index is up 23% in the year to October in euro terms and the FTSE 100 up 18% in sterling terms. These stock market returns are in sharp contrast to the relatively modest gains to be had from cash or government bond markets, with EMU government bonds up just 4.5% over the same period and UK Gilts up 0.9% in local currency terms³.

¹ Source: Bank of America Securities – Merrill Lynch Research.

² Source: Dalbar Inc.

³ Source: Market returns year to date from FTSE, MSCI, JPMorgan Global Bond Index.

The arguments in favour of equities

Equities have performed very strongly since March 2009. However, there are still many reasons to believe that the rally has a lot further to go. Five key factors highlight the continued attractiveness of equities as we head into 2010:

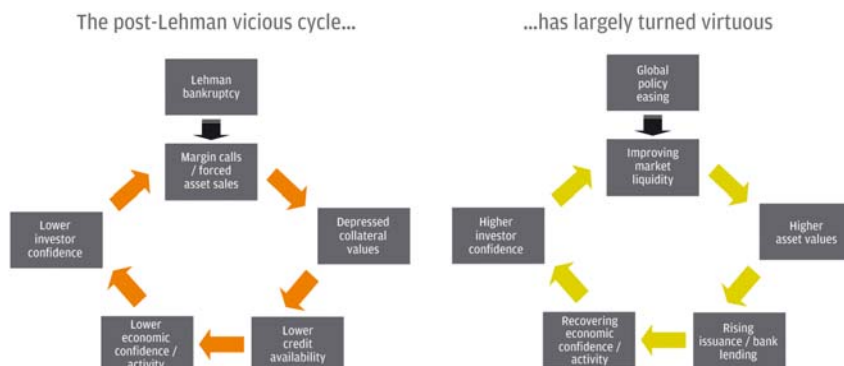
- The risk of a renewed run of bank failures has receded
- Economic recovery
- Valuations are fair, dividends offer support
- Investor risk appetite is improving
- Loose monetary policy to continue

The risk of a renewed run of bank failures has receded

Without a functioning banking system, there can be no sustainable recovery. Without wishing to tempt fate, it seems fair to suggest that the worst of the subprime mortgage debacle and banking crisis is behind us, thanks to massive fiscal and monetary policy easing. The banking system is now in repair. **Exhibit three** shows the vicious cycle that the credit crunch created after Lehman Brothers collapsed, with falling asset prices forcing asset sales, which further reduced prices. This has now been replaced by a virtuous cycle triggered by very loose fiscal and monetary policy.

Furthermore a drop in three month Libor in all the major currencies, to levels comparable to the relevant central bank policy rate, suggests that banks now have enough liquidity in their reserves and/or no longer fear counterparty default, so reducing a key risk. Indeed the improvement in confidence within the banking sector, that we have seen over the last six months, has been the key to the economic recovery and to the improvement in investor sentiment.

Exhibit three - From negative to positive



Source: J.P. Morgan

Economic recovery: weak, but capable of delivering corporate earnings growth

All of the major economies except the UK recorded growth during the third quarter of 2009, while for Germany, France and Japan the recovery began in the second quarter. The emerging markets have seen notably strong recoveries, with China reporting robust GDP growth over the year to September of 8.9%. The UK has disappointed, with third quarter GDP showing a further quarter on quarter contraction in the economy making it the longest recession since statistical records started to be used (at least 50 years ago).

Exhibit four - GDP forecasts for 2009 and 2010

	Real GDP growth %			CPI Inflation %		
	2009	2010	2011	2009	2010	2011
US	-2.4	2.6	3	-0.4	2	2.3
Eurozone	-3.8	1.1	na	0.3	1.4	na
Germany	-4.9	1.5	na	0.3	1	na
France	-2.1	1.2	1.8	na	na	na
UK	-4.4	1.1	1.9	2.1	2.1	1.7
Japan	-5.7	1.2	1.3	-1.2	-1.2	-0.4
China	8.3	9.5	8.7	-0.6	2.7	3

Source: Consensus Estimates from Bloomberg as at 17/11/09.

Exhibit four, above, shows that private sector economists remain doubtful that a sharp recovery in the developed economies will take place. But equally they do not expect a return to recessionary conditions (indeed, 2.6% forecasted GDP growth in 2010 for the US is not far from the 2.9% average long-term GDP growth rate). Inflation is also forecasted to be low, suggesting low interest rates will continue.

Why might this recovery be weaker than previous recoveries from recessions? After an initial wave of pent up demand and inventory rebuilding, the recovery will be dependent on the consumer, but it is not clear that the consumer is ready. Households are over-indebted, and a deleveraging of household balance sheets - with savings built up and debt paid off - is likely to be an ongoing theme over the next year or more. Meanwhile, cuts in public spending and tax increases - as governments tighten fiscal policy from next year - will also impact on consumer spending. Consumer spending makes up about two thirds of GDP in most developed economies (a little higher in the US, a little lower in Germany), and so is a key part of any sustained recovery.

Another important contributor to economic growth is investment spending. This is a much smaller share of GDP than consumption, but historically more volatile. It is divided into government and private sector-led spending. The outlook for both is not good. Increases in government investment spending are likely to reverse over the next year or two as governments reign in very large deficits, while private investment by companies is hampered by banks' ongoing reluctance to increase their lending. So while demand and output will both return to growth, a quick return to the year-in, year-out global GDP growth rates of around 4.5% that characterised the middle years of this decade is unlikely.

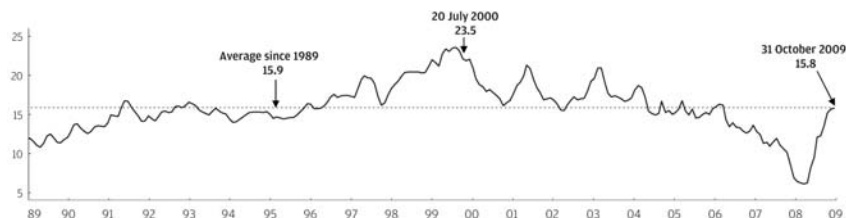
An increase in output - as demand recovers - will be reflected in an increase in sales. The impact on company profits will be greater because of the gearing effect of the fixed costs in a companies' cost structure. Hence small changes in total output in an economy can lead to a big change in profits, particularly when emerging from a recession.

Corporate earnings are not only being supported by the economic upturn. Cost cutting has been an important theme of the last 12 months, with many economies seeing a rise in unemployment as companies raced to trim their cost base in line with falling order books. Indeed operating margins in the US are currently at the highest level for more than a decade. Cost cutting often results in productivity gains that can be 'banked' for some years, boosting earnings in the early years of the next cycle. Hence forward corporate earnings growth will benefit not just from improved top line growth, but from higher productivity. These factors have helped to deliver better than expected corporate earnings since the summer.

Valuations are fair, dividends offer support

In the upturn of an economic cycle, earnings and valuations become very difficult to quantify. For instance, if a company has made a loss, due to the recession perhaps, its price/earnings ratio (P/E) is negative and it is not a useful measure. If it is a large constituent of a market index, in terms of market capitalisation, its inclusion or exclusion in a market index P/E may have a meaningful impact. Meanwhile the 'P' of a P/E ratio is the price which is looking ahead to future earnings. These future earnings are notoriously difficult to predict at the best of times and still harder at an inflection point in the business cycle. However, we must use what is available to come to some sort of conclusion, and as **Exhibit 5** shows historic P/E multiples are at long term averages and do not appear stretched. Indeed the rally of 2003 begun at similar P/E ratios to those existing today.

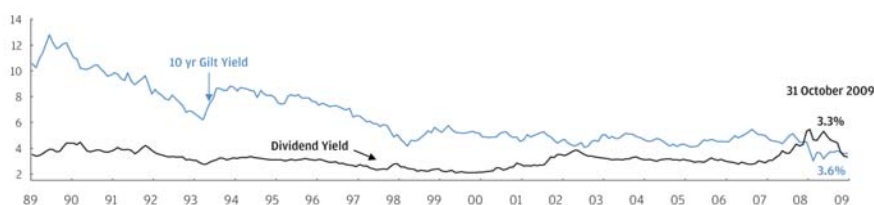
Exhibit five - UK P/E



Source: Bloomberg, J.P. Morgan, FactSet Aggregates Composite Index for historic. Data is on a monthly frequency.

Meanwhile, **Exhibit six** shows local dividend yields are close to government bond market yields. This means that investors are getting, for free, the protection that a share will give against inflation. Dividends may be cut further, but most analysts would agree that the worst is probably behind us with corporate earnings beginning to recover. Stock market dividends are even more attractive when compared to bank account cash rates, which are barely above zero percent for most retail investors in the major currency areas. For those investors who have parked money in bonds, or bank account cash, equities still look good value.

Exhibit six - UK dividends



Source: Bloomberg, J.P. Morgan, FactSet Aggregates Composite Index for dividend yield, data is on a monthly frequency.

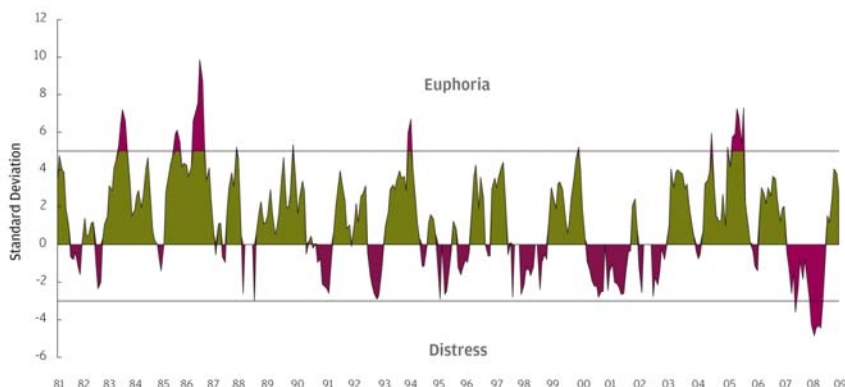
Dividends are not just useful for income seeking investors. Reinvested, they can form a valuable part of a long-term investor's total return. Even for the non-income seeking investor, research has shown that the reinvestment of dividends has a powerful effect on long-term returns. Dimson, Marsh and Staunton, in their 2009 Global Investment Returns year book, demonstrate this. They estimate that a portfolio of US equities, with dividends reinvested, would have grown to almost 100 times the value it would have attained if the investor had spent the dividends⁴. Other studies show that over the long-term high dividend paying stocks, that give increasing dividends, tend to outperform low dividend payers and high payers with stable dividends.

⁴ Source: Dimson, Marsh and Staunton, Global Investment returns Yearbook 2009; London Business School/ Credit Suisse Research Institute 2009

Investor risk appetite is improving

Along with improved growth and corporate earnings prospects, investors are more willing to buy risk assets, such as equities, than at any time since the summer of 2007. **Exhibit seven** shows investor preference for risk, or for defensive assets, relative to cash since 1981. Anything over zero is a preference for risk assets, such as equities. It is perhaps reassuring to see we are not in 'euphoric' territory.

Exhibit seven - Risk appetite



Source: Credit Suisse, J.P. Morgan. The Credit Suisse Appetite Indicator compares aggregated risk-adjusted returns across 64 markets (both equity and fixed income). It compares six month excess returns over cash with 12 month volatility for each asset, and plots the resulting score on the vertical (Y) axis. Data as at 31/10/09.

The fall in the VIX index of anticipated volatility on the S&P 500 (in **Exhibit one**) tells a similar story, with the current level of 23 showing a far greater confidence in the US stock market by investors than at any time since the credit crunch began. This seems fair, since a return to the days of a single digit VIX number would suggest too much complacency in the market.

Loose monetary policy to continue

Low interest rate policies from central banks have made money cheap, while quantitative easing in its variety of different forms has meant that there is plenty of liquidity, currently being held by banks and financial institutions. This has helped support risk assets, such as equities, since the holders of cash are getting very little through keeping it on deposit on the money markets.

Exhibit eight - Market interest rates and forecasts

	Policy rates Actual Nov 2009	Consensus estimates for December 2010
US	0.25	1.25
Eurozone	1	1.5
UK	0.5	1.25
Switzerland	0.25	1.5
Japan	0.1	0.1
China	4.5	4.75

Source: Bloomberg for central bank policy rates and consensus forecast as at 17/11/09.

These low rates are likely to persist. The markets were taken by surprise when Australia raised interest rates in October, making it the first of the developed economies to do so. Norway and Israel followed, but rate increases from major central banks are likely to be relatively slow, in order to ensure that a second recession is avoided.

Exhibit eight shows that while policy rates will rise next year, they will remain at historically low levels. The Bank of England may be the first one to raise rates, followed by the European Central Bank, while the US Federal Reserve appears to be happy to delay normalising interest rates so long as there is the possibility that raising rates too fast will induce an economic downturn.

The risks

- Near-term consolidation and fears of a double dip recession
- What if the bond market is right?

Near-term consolidation and fears of a double dip recession

The last bull market began in March 2003. After a strong performance for the rest of the year, led by high beta stocks, concern over a 'double dip' recession in the US then set in. This haunted developed stock markets for the whole of 2004 and the major markets traded within a narrow range for a prolonged period. A double dip was avoided and the rally gained renewed momentum in 2005.

This pattern may be repeated, as investors wait for conclusive evidence that the recent improvement seen in economic data is sustainable and will lead to a sustained increase in output. With bank lending still expensive and in short supply to small businesses in most G7 countries, and household deleveraging likely to be a medium-term theme, stock markets may stall for a period until investors gain reassurance. There is also the fear of policy error, with the

possibility of central banks tightening monetary policy too fast, too soon and/ or governments tightening fiscal policy prematurely in order to tackle budget deficits. But as long as the cost of money continues to be at historic low levels, fear of policy error is unlikely to create a severe correction to asset prices.

What if the bond market is right?

What if we do get a double dip recession? For some analysts, current low bond yields suggest that this is a distinct possibility.

It is not clear that the low bond yields of today are indeed a result of market fears of low economic growth. It may be that yields are low because of strong demand. Central banks engaged in quantitative easing (QE) programmes have absorbed large amounts of bonds, while private individuals are purchasing government bonds as they rebuild their savings.

However, if the bond market is 'right', and the recovery is feeble, stock markets will react poorly, with growth-biased sectors particularly hit. An investor who is interested in buying equities today, but fears this outcome as an outlying risk, may gain some protection through focusing on defensive sectors. Particularly given the high dividends currently on offer from sectors such as utilities, telecoms, oil & gas and media.

Investors who fear this outcome as a central case should retain, or return to, a preference for government bonds.

Summary

Investors were right to be wary of the sustainability of the stock market rally in the spring and early summer. Risks included a further banking crisis and a global depression. These risks only receded over the summer, when second quarter GDP showed an economic recovery in Germany, France and Japan, leading indicators in other leading OECD countries turned upwards, and Chinese economic growth accelerated. As VIX fell to more normal levels and three month LIBOR spreads over policy rates began to be eliminated in the late summer, investor risk fell and the justification for being out of equities has weakened.

We are not out of the woods yet. There continues to be a risk of a double dip recession, induced perhaps through policy error (premature monetary and /or fiscal tightening). However, it seems from consensus estimates (**in exhibit four**) that 2010 and much of 2011 will be marked by sub-trend GDP growth (not a return to recession), and by low core inflation. Against that background, a low interest rate environment will continue to support income-generating risk assets, such as equities.

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