GMAG INSIGHT SERIES

Global Multi-Asset Group – Monthly Investment Outlook

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Returns – Changes over January 2010, %

	Equity Market*	Bonds*	Exchange Rates+
Global	-3.6	0.8	n/a
US	-3.5	1.6	0.3
Eurozone	-3.6	0.5	-1.9
Japan	-0.8	0.0	-1.2
UK	-4.1	0.6	0.6
Emg. Mkts	-4.4	-0.1	n/a
Hong Kong	-6.4	-0.2	-0.1

*Total return
+ Change in nominal trade-weighted indices
Sources: Thomson Datastream, MSCI, J.P. Morgan

- **Debate within the major developed central banks may increase, but we do not expect any significant tightening in 2010. China has begun to normalise policy, which will be an ongoing process for several months**
- **The OECD will undergo a sub-par economic recovery; the manufacturing recovery continues according to survey data, however, there are signs of peaking in the services data**
- **Market sentiment has been challenged by potential changes to banking regulations, the onset of Chinese policy normalisation and escalating concerns over sovereign risk, but equity valuations relative to cash and bonds are attractive**
- **Within our balanced portfolios, we remain overweight equities vs bonds, with preference for Japan, Asia, emerging markets and Sweden. We are neutral the US and UK and underweight Europe ex UK and Australia**

Policy Outlook

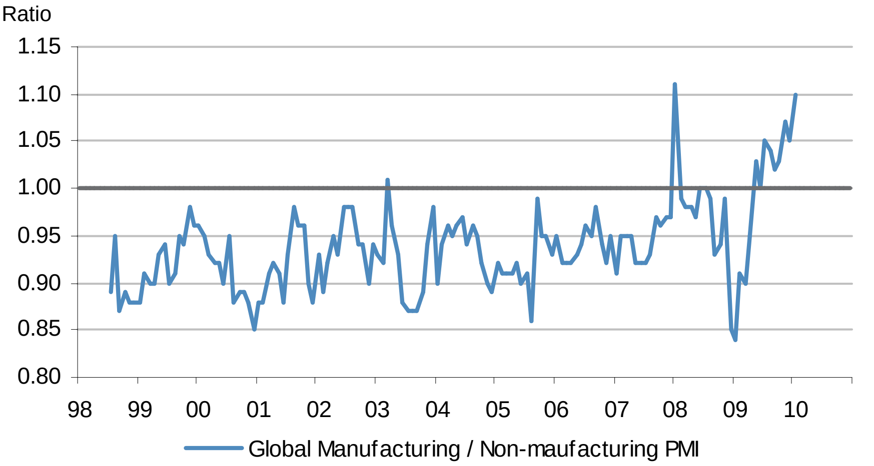
Differences between, and even within, central banks are increasing, in acknowledgement that economies are at different stages of recovery and are therefore facing different pressures. With real GDP growing 10.7% y/y in Q4 2009, the Chinese authorities have begun normalising policy, though arguably, it remains accommodative. During January they increased bill yields twice and have raised the reserve requirement ratio by 50bps, though it remains below the pre-crisis level. There were also announcements of clamp-downs on new lending – probably not that surprising given the pace of credit extension so far in 2010. Although lending practices are highly seasonal in China (largely frontloaded, especially ahead of Chinese New Year), the announcement of these measures comes after almost RMB 1.5 trillion had been extended in credit this year already and when the entire quota for lending in 2010 is RMB 7.5 trillion. To put this in perspective, the annual GDP of Malaysia had been lent out by the Chinese banking system during January. As inflation rises, and exports recover, we expect further, and ultimately much more aggressive, policy tightening measures as we approach mid year.

Chart of the Month

Our COTM shows the ratio of the global manufacturing and non-manufacturing PMI surveys. Having bottomed in January 2009, the series is now close to the all-time high. This suggests that strength in the manufacturing index has been outstripping the services index for sometime, reflecting the savagery of the inventory drawdown in Q4 2008 and subsequent recovery.

Sources: MacData, J.P. Morgan Asset Management Global Multi-Asset Group

Global services PMI data lagging manufacturing counterpart



Consensus economic forecasts

Real GDP	2009	2010
US	-2.4	2.7
Eurozone	-3.9	1.2
Japan	-5.3	1.4
UK	-4.8	1.2
China	8.7	9.5

Source: Bloomberg

Consensus headline consumer price inflation forecasts

CPI	2009	2010
US	-0.4	2.1
Eurozone	0.3	1.3
Japan	-1.4	-1.3
UK	2.2	2.5
China	-0.7	2.3

Source: Bloomberg

Bond Yields (as at 29 January 2010)

	2 Yrs %	10 yrs %	10-2 yrs bp
US	1.14	3.84	277
Europe	1.33	3.39	208
Japan	0.15	1.30	117
UK	1.32	4.02	265
China	1.65	3.64	139

Sources: Bloomberg, J.P. Morgan Asset Management

Policy Outlook cont/…

The last FOMC meeting was, on average, taken as relatively benign, though it is clear that the debate within the Fed will become less consensual as the year progresses. There was a slight change to the language, with the Fed assessing the outlook for the "pace of economic recovery" (compared to "economic activity" before) to "moderate" from "weak". The noisiest news on the FOMC statement, though, was the hawkish dissent from Thomas Hoenig on keeping the phrase "extended period" in the statement with regards to the Federal Funds Rate. The Kansas Fed President's reasoning was that "economic and financial conditions had changed sufficiently that the expectation of exceptionally low levels of the Federal Funds Rate for an extended period was no longer warranted". While this does not suggest that the debate has shifted markedly within the FOMC, it probably does mean that there will be more of a debate in the future. Fed watching is taking on several of the characteristics of Kremlinology and the market is likely to become evermore sensitive to subtle nuances of opinion. We remain of the view that the primary players in the Fed will be slow to raise rates, preferring to err on the side of caution. Markets are discounting around 60bps of tightening over the next year, which seems slightly exaggerated to us.

At its latest policy meeting, the Bank of England opted to keep the door open for further quantitative easing measures. The statement put out by the UK central bank noted that the downturn had "probably impaired supply capacity… the fall in output means that a substantial margin of under-utilised resources is likely to remain". This suggests that the Bank is allowing for some permanent reduction in economic capacity. Readers may recall that it was the Bank of England policymakers who were particularly vexed in recent years at the difficulty of measuring the economy's capacity because of the inflow of migrant workers. This led to extensive debate at the time regarding capacity constraints and consequent inflation pressures. One wonders if admission that capacity has been reduced will lead to an equally vexing debate in the MPC about capacity constraints leading to inflationary pressures in the months to come.

Eurozone policy makers are grappling with the sorry state of the so-called PIGS (Portugal, Ireland, Greece and Spain). Greece is the test case, but the resolution to the problem is unlikely to come through the ECB. It is further evidence though of the multi-tiered momentum of the eurozone. Although markets have moderated expectations of ECB tightening, from 110bps at the start of the year to around 70bps now, it is hard to see the ECB raising rates in 2010 given limited inflationary pressures and clearly what will be a punishing adjustment for some of the peripheral nations.

Economic Outlook

Our base case scenario looks for a sub-par recovery this year in the developed countries. These recoveries are unlikely to be homogeneous across countries or even regions. China reported that it grew 10.7% y/y during the fourth quarter, with growth having troughed at 6.1% in Q1 2009; retail sales also came in better than expected. Evidently, the authorities in China seem comfortable enough to start to withdraw some of the super-accommodative policy. The US economy appears to be experiencing an almost classic recovery in terms of trajectory, having expanded at an annualised rate of 5.7% during the last quarter. The UK, meanwhile, was only able to post a meagre 0.1% q/q growth rate in the same period. Should global growth remain reasonably strong, the UK may do better in the coming quarters if we assume a delayed positive impact on exports from currency weakness.

At the risk of being alarmist, we are concerned that the recovery could be approaching a turning point, though the evidence is not at all conclusive yet. The latest release of the US ISM manufacturing index, for example, was far stronger

Currency markets (as at 29 January 2010)

	$ rate	REER*	5yr avg
US	-	85.5	85.4
Euro zone	1.39	119.7	124.5
Japan	90.3	83.7	75.2
UK	1.60	83.0	92.0
China	6.83	107.7	105.8

*Real Effective Exchange Rate Index
Sources: Bloomberg, Thomson Datastream, JP Morgan, J.P. Morgan Asset Management

Forward PE ratios

	Current	5-yr avg	Diff %
World	14.2	13.7	3.7
US	14.4	14.4	0.2
Euro zone	12.8	12.1	5.7
Japan	19.2	17.9	10.7
UK	12.0	11.7	4.4
Hong Kong	16.7	16.0	4.8
Brazil	13.3	9.1	46.3
China	13.9	13.3	3.8
India	17.5	15.9	9.8
Russia	8.4	9.1	-8.3

Sources: Thomson Datastream, MSCI, J.P. Morgan Asset Management

Dividend Yield

	Current	5-yr avg	Cash Rate*
US	1.9	2.0	0.25
Euro zone	3.1	3.2	0.55
Japan	1.7	1.5	0.25
UK	3.5	3.8	0.62
Hong Kong	2.6	3.0	0.13
Brazil	2.9	3.4	8.65
China	1.9	2.2	1.91
India	0.9	1.2	4.62
Russia	1.4	1.7	6.01

*3-month interbank rates, except for Brazil where overnight Selic rate used. Data as at 2010
Sources: Thomson Datastream, MSCI, Bloomberg, J.P. Morgan Asset Management

Economic Outlook cont/…

than expectations, rising to the highest level since September 2004. The non-manufacturing survey, though, remains only just in expansionary territory. In Europe, the composite PMI survey fell back slightly in January. Other European indicators have also showed some weakness, with the ZEW survey markedly softer than consensus, driven by a decline in the forward-looking component of the survey. The OECD's leading economic indicators for the G4 economies have continued to improve. However, while the year-on-year changes in the indices remain positive and rising, a more dynamic (and arguably noisier) measure, which looks at the six-month annualised rate of change, suggests that all of the series bar Japan may have topped out.

Overall, evidence of a marked softening in the forward-looking indicators is inconclusive. And we note that developed market services PMI indices may well have peaked, though manufacturing indices are generally still rising. This may reflect two things; first, it is the result of recovery from a savage inventory cycle; and second, that demand for manufactured goods from abroad (and in particular emerging markets) may be helping the manufacturing cycle, but the *relative* weakness of the services sector is representative of still soft domestic consumption. Additionally, we identify the weakness in money growth as a continuing source of concern for the growth outlook. Broad money growth in the US, eurozone and Japan shows no signs of revival. Even Chinese broad money growth has declined on a six-month annualised basis from a peak of 36.9% to 19.9% now, while in the US and eurozone it is now contracting 2% and 1%, respectively. It suggests that a stronger near-term growth profile could easily give way to a weaker profile later in 2010 and into 2011. If this scenario gains credence, then investors will start to stress test the durability of their 2011 earnings estimates.

Earnings and valuations

Expectations have come a long way, with aggregated bottom-up forecasts for global earnings growth in 2010 of 28.3% and 20.0% in 2011 and a cumulative 56% increase between 2009 and 2011 for S&P 500 earnings. The 2010 numbers will benefit from sizeable base effects coming from the financials, consumer discretionary and energy sectors, but earnings quality and prospects for sales and revenue growth should be the focus of attention after very aggressive cost cutting last year, especially in the US. The fourth quarter US corporate earnings season, which is underway, has progressed reasonably well so far, though this has failed to rally markets. So far, 74% of the reported companies have beaten estimates (and more than half of these have done so by more than 10%), but this is below the 80% run rate in the third quarter. The good news is that far more companies have reported better revenues: 56% so far compared with only 44% in Q3. The other important theme that could impact markets centres around the timing of the upturn. Strong economic activity and better-than-expected earnings paint a picture of rampant underlying profits growth in H1 2010. At some stage, there is likely to be concern that this cannot be repeated in H2 2010 or 2011. The consequence could be higher expectations for this year at the expense of 2011 as analysts bring forward their numbers. Such a scenario could unsettle markets, but after they have priced in a better 2010 outlook. As such, we remain somewhat sceptical at this stage that earnings growth of 21% will be attainable next year.

Our measures of earnings momentum have clearly peaked, with higher momentum now compared to six months ago in only 17 out of the 24 markets we monitor, and in only 8eight markets compared to last month. Nevertheless, analysts are continuing to upgrade their numbers, with Spain and Italy the only markets where there are more downgrades to estimates than upgrades.

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Earnings and valuations cont/…

Our composite valuation indicators (CVI), which look at valuations around a medium-term trend, suggest that most market valuations are around neutral. The sell-off during January has cheapened equities slightly on these metrics with our global equities CVI declining from 0.37 to 0.26 (where 0 is neutral). Equity valuations against history do not look outstandingly cheap. Indeed, the ten-year cyclically-adjusted P/E ratio for the US is now 20x, which is 0.25 standard deviations above its post-Second World War average.

However, compared to bonds and cash, equities remain the asset class of choice. 78% of FTSE 100 companies offer a higher dividend yield than the UK real bond yield. Although this figure declines to 63% in Europe ex UK, it is still well above the 10-year average of 58%. Furthermore, our aggregated bottom-up analysts' estimates suggest that US equities have a risk premium of 5.7% over 10-year Treasuries, which, while lower than the peaks, remains attractive.

Markets

After a good start to the year, risk assets have floundered, marred by concerns over Greek sovereign debt, pending banking regulatory change and the start of the withdrawal of monetary stimulus in China. Ultimately, none of these factors should have been a surprise to investors, and all three - sovereign default risk, regulatory change and policy tightening – will be general themes that rumble throughout 2010. Volatility will be the relative winner in an environment of uncertainty, and we have already seen the Vix index increase from its January low of 17.6 to 26.1.

Investor sentiment is likely to be schizophrenic this year and periodically challenged as to the outlook for risky assets. Survey data suggested that there was an air of optimism among investors at the beginning of this year, which, in spite of fairly robust corporate earnings newsflow, gave way fairly quickly to profit taking and risk aversion catalysed by the above factors. The path of least resistance for markets was upwards for much of 2009 when hopes were being rebuilt and central banks endorsed risk-taking, but a lot of good news is now already priced into markets. If the data are persistently strong, then it is likely to bring forward policy tightening (or at the very least fears of policy tightening); too weak and investors will rightly question whether there is fundamental strength to this recovery. The patchy data releases are indicative that the flow of news will not be uniform this year; the same is likely to be true of the path of asset prices.

This is not unprecedented however. Based on the work of Rogoff and Reinhart, we looked at equity market performance of 12 banking crisis-hit economies. Our analysis showed that in the year following the crisis, on average equity markets rallied 78%. What is particularly interesting for us now is what happens to markets after that, which is that they tend to move sideways in a range, albeit a fairly wide, and certainly tradeable range, for some years. On balance, we remain overweight equities and expect them to outperform bonds, though we are cognisant of these lessons of history. Within our balanced portfolios we are overweight cyclical markets, with equity positions maintained in emerging markets, which remain the primary growth area. We are also overweight Hong Kong, Japan and Sweden, while we have moved to neutral in UK and US and stay underweight in Europe ex UK and Australia.

About GMAG

The Global Multi-Asset Group is a 40-strong team of portfolio managers, investment specialists, analysts and strategists based mainly in London and New York, which is dedicated to developing and managing multi-asset and multi-country strategies, using JPMorgan Asset Management's global expertise across core and alternative asset classes. GMAG is responsible for managing assets totalling over US$31bn, including traditional balanced portfolios, fund of funds, convertible bonds and total return funds and specialised TAA mandates.

Responsibility for overall asset allocation lies with the Global Strategy Team, a group of senior investors with an average investment experience of 25 years.

Neill Nuttall is Chief Investment Officer of the Global Multi-Asset Group.

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