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Investment Director's Bulletin

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May 2012

World equity markets suffer from April showers

After a strong start to 2012, global stock markets corrected in April, with the MSCI World Index falling 1.5% in local currency terms. Among G7 markets, there was sharp polarisation in the month, with the UK, USA and Canada each dropping less than 1%, while France, Japan and Italy fell more than 5%. Emerging markets outperformed their developed counterparts in the month, with the MSCI Emerging Markets Index sliding down only 0.6% in local currency terms. The best performing emerging markets in April were China (up 3.5%), South Africa (up 1.7%) and Mexico (up 1.0%).

The key drivers of the pull back in world equity markets were mixed economic data and negative political news, which heightened concerns that the fundamental risks to equities remain material. These risks are weaker-than-forecast US growth, a hard economic landing in China, failure to agree a long-term sustainable structure for the eurozone, and a deeper and longer-than-expected recession in Europe.

Is the eurozone at a turning point?

Although investors have been fretting over the risks, it is the eurozone sovereign debt crisis that has once again demanded the most attention. European politics appear to be at a turning point, as the combination of fiscal tightening, high unemployment in southern Europe and a low/no growth outlook provoked a backlash against current policy. The collapse of the Dutch government over spending cuts, the defeat of Nicolas Sarkozy in the French presidential election and the Greek election result, where the parties supporting austerity did not win a parliamentary majority, reflected growing frustration across the eurozone.

Markets are both cautious and confused about what happens next. While the fiscal compact is flawed and a possible growth compact is alluring, investors are uneasy about future French policy. However, the storm clouds of uncertainty are darkest over Greece and Spain. In Greece, the political limbo following an inconclusive general election, a surge in support for the radical leftist party, Syriza, which opposes key parts of the fiscal compact, and the need to agree reforms in order to receive further bailout money have significantly increased the risk that Greece may be forced to leave the eurozone.

Meanwhile, investors fear that Spain is becoming trapped in a vicious debt circle, with biting unemployment above 20%, stringent fiscal tightening to meet the requirements of the eurozone's fiscal compact, and a deepening recession leading to higher bad debts for the banks, which in turn will require the government to step in to recapitalise the banking system, leading to a further bout of fiscal tightening and ever higher unemployment. Therefore, the announcement that the Spanish government will take a 45% stake in Bankia, the third largest Spanish bank by assets, and will push the banking sector to increase provisions for all property loans from 7% to a possible 30% is potentially significant. This is Madrid's fourth attempt since 2008 to strengthen the banks. If this reform does definitively recapitalise the Spanish banking industry, it could be a major event for both Spain and the eurozone. Investors will be watching developments closely.

UK and Europe ex UK equities downgraded to underweight

There is no quick or sweeping solution to these problems. The most likely scenario is a mixture of incremental steps by the Spanish government (which may be criticised by investors as too small and too slow), combined with renewed efforts by eurozone governments to agree a multinational solution. These negotiations are likely to take months, while the risk of euro rupture has increased. Given this backdrop, the outlook for growth in Europe remains very uncertain. The UK and Spain are now in a technical recession (defined as two consecutive quarters of negative growth) and leading indicators are signaling modest contraction in European Union (EU) activity over the summer.

Although earnings momentum in both the UK and continental Europe improved modestly in April (see below) this could well reverse in the face of negative economic and political events. While the UK continues to benefit from greater monetary and currency flexibility than the eurozone, the EU is the UK's biggest trading partner and fiscal austerity looks set to bite deeper in the second half of 2012. As a result, the outlook for both UK and European equities has materially worsened over the past month. While dividend yields and price-to-earnings ratio (PER) valuations remain attractive, both political and economic risks have increased. Until there is better clarity here, and I have greater confidence about the earnings outlook on a 12-month time horizon, I have downgraded both the UK and Europe ex UK to underweight in a global equity portfolio.

Double-dip recession: UK and Spain take the lead, will the US follow?

After a strong start to the year, global manufacturing is cooling off. This slowdown is not due to weak demand or a spike in commodity prices. It is rather the fading of the one-off Asian rebound from the 2011 natural disasters in Thailand and Japan, together with a slowing in inventory building. However, underlying GDP growth trends remain lacklustre and with the UK now in a technical recession and the eurozone set to follow, investors are nervous about whether the US is also headed for a double dip.

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US economic data in April has been noticeably softer in tone. The biggest negative has been the increase in unemployment claims. However, purchasing managers' index data remains positive, signaling further expansion over the coming months. In addition, there are signs that the housing industry, a key source of economic weakness, is now turning a corner. US existing house sales are increasing; 30-year fixed-rate mortgage rates are at a record low, while affordability is now at a multi-year high. A sustainable, modest recovery in housing may thus be on the way.

Overall, investors are still giving the US economy the benefit of the doubt and this seems fair. I still expect US GDP growth in 2012 to be circa 2.5%. US GDP and consumer spending (both real and nominal) are now well above the pre-crisis peak of 2008. This is significant for two reasons; first, it shows that the US recovery is both real and ongoing; and, second, it stands in sharp contrast to both the UK and the eurozone, where key economic indicators are still materially below 2008 levels in absolute terms. For 2012, global GDP growth of 3.5% seems realistic and would be mildly supportive for corporate earnings.

First-quarter earnings results were stronger than expected in the US and Europe

Corporate earnings for the first quarter of 2012 have been better than forecast in both Europe and the US. In the US, 406 companies from the S&P 500 index have now reported. Earnings per share (EPS) have risen 7.8% year on year. Excluding Apple, the aggregate growth rate is 5.4%. Revenues for the S&P 500 are estimated to have increased 5% in the first quarter. This is a good result, confirming US profit margins have remained resilient, despite the hike in commodity input costs. For 2012 as a whole, aggregate EPS is forecast to grow 8% for the S&P 500 index. This is down from 10% growth forecast on 1 January.

Earnings momentum (ie earnings upgrades versus downgrades, where 1.0x is neutral) improved for all major regions in April. Reflecting the strong corporate profits season, US earnings momentum surged to 1.3x (versus 0.85x last month). Encouragingly, Japan saw its earnings momentum reach 1.1x (versus 0.9x last month). Meanwhile, the ratio for both the UK and Europe ex UK improved slightly, to 1.0x in April. However, given the problems and uncertainties outlined above, this may well fall back over the summer. Of note is that emerging markets saw earnings momentum unchanged month on month, at 0.8x. Emerging Europe showed the best momentum (rising from 0.8x in March to 1.0x in April) and Latin America showed the worst momentum (falling from 0.9x last month to 0.8x now). Overall, the first-quarter reporting season and earnings momentum data are modestly positive for global equities. However, in the near term, this good news is being counteracted by renewed anxiety over both recession in Europe and a settlement for the eurozone sovereign debt crisis.

Asset allocation summary: Overweight equities on a 12-month view

At the moment, the majority of investors seem to be confused and cautious, rather than actively bullish or bearish. Investors remain wary of aggressively increasing asset allocation in equities. This reflects in part that we are at a different stage of the earnings cycle than in 2009, when asset allocators bought equities in anticipation of a recovery in earnings. Today, US profitability is above the long-term trend with second-quarter profits likely to remain under pressure from macro factors. Investor risk tolerance also remains fragile. Asset allocators are currently tactically overweight higher risk assets, including equities. However, strategically, equities are likely to remain vulnerable to abrupt short-term changes in newsflow, especially with regards the eurozone sovereign debt crisis.

Nevertheless, the fundamental support for an overweight position in equities is strengthening, with economic data improving, central banks signaling further supportive action and equity valuations still looking cheap. I favour US, Asian and emerging market equities. I am also overweight in Japan, reflecting the strong cyclical recovery in earnings that is likely over the next 12 months, combined with very cheap equity valuations. While both UK and Europe ex UK equities have high dividend yields and low PER valuations, attractive stock characteristics are not currently driving European equity prices. Until there is greater clarity over the political and economic issues, an underweight position is justified.

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 emerging market asset allocation.

It is important to reiterate that emerging growth is both healthy and a key engine for global growth. For example, South Korea's real first-quarter 2012 GDP was 11.0% above its 2008 peak. Globalisation continues to benefit the emerging economies at the expense of the G7 nations. The three long-term drivers of globalisation are free movement of people, information and capital. Of these, only the latter may be under threat due to increasing government regulation of banks and pension funds. The key to emerging market equity returns in 2012 will be the delivery of stronger growth in earnings, shareholder returns and dividends than the G7 nations. The continued success of the BRIC nations, particularly China, is key to this. I am keeping a close eye on earnings momentum data.

Volatility in emerging markets is likely to remain high as investors react to inflation and growth newsflow, and as perceived country risk changes. Emerging markets also remain vulnerable to a US dollar rally. Historically, there is a high negative correlation between a stronger US dollar and emerging market equity performance. Overall, valuations now discount much bad news. For emerging markets there is a well established price-to-book ratio (PBR) trading range. Historically, emerging markets have been a strong buy when PBRs fall below 1.5x and have become vulnerable to selling in the range of 2.5 to 3.0x. On this basis, PBRs still look cheap at around 1.8x. I would focus on the BRIC markets, which have historically outperformed other emerging market countries in a market recovery phase. In order of preference, I currently rank the BRIC nations as follows; China, Brazil, Russia and India.

Asia – overweight (unchanged)

For 2012, China and India will be the key to Asian equity returns. While growth rates will slow this year, China and India are expected to post impressive GDP growth of circa 7.5% to 8.0% and 6% to 7% respectively. The prospect of superior growth in earnings and dividends at attractive valuations is my primary reason for being overweight in Asia. Across the region, our fund managers continue to favour companies that are exposed to Asian consumption as opposed to export-related stocks. We expect China to ease monetary policy in the months ahead and to achieve a soft economic landing in 2012.

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In the first quarter, China's domestic economy continued to show signs of healthy growth. Consumer confidence surveys continued to recover and employment figures remained firm. While recent earnings newsflow has been negative, on the assumption that further monetary easing is implemented in the second quarter earnings may now be close to their cyclical trough. Current Chinese equity valuations are very cheap. The biggest potential negative is that monetary easing is too slow and GDP growth falls sharply in the second quarter. However, in a year of political leadership change, the authorities are likely to veer towards a strong growth policy as a means of dampening any potential social unrest. Given China's strong fiscal position, there is scope for material additional infrastructure and social spending to boost 2012 growth trends.

US – overweight (unchanged)

US economic data in April was noticeably softer in tone. The biggest negative was the increase in unemployment claims. However, the purchasing managers' index data remained positive, signaling further expansion over the coming months. In addition, there are signs that the housing industry, a key source of economic weakness, is now turning a corner. Overall, investors are still giving the US economy the benefit of the doubt and this seems fair. I still expect US GDP growth in 2012 to be circa 2.5%. US GDP and consumer spending (both real and nominal) are now well above the pre-crisis peak of 2008. This is significant for two reasons; first, it shows that US recovery is both real and ongoing; and, second, it stands in sharp contrast to both the UK and the eurozone, where key economic indicators are still materially below 2008 levels in absolute terms. Overall, US economic growth looks moderately supportive for corporate earnings in 2012. The key to US equity returns over the next 12 months will be US corporate profits and how resilient profit margins prove to be. I maintain an overweight position in US equities.

Japan – overweight (unchanged)

Japan remains out of favour with asset allocators. However, Japanese equities are looking attractive on a 12-month time horizon. Earnings momentum has rebounded from its trough and looks set to improve robustly in 2012. Although 2011 GDP growth was -0.7%, economic growth is now recovering from the effects of the Tohoku earthquake and the flooding of Japanese factories in Thailand. As a result, both economic and earnings growth over the next 12 months is likely to be the highest among G7 nations. In addition, March's Tankan business sentiment survey confirmed a lift in the corporate outlook, which is expected to be confirmed by robust industrial production data for the second quarter. Meanwhile, valuations are very cheap, with the Topix index trading near 1.0x PBR. While Japan's long-term structural outlook remains bleak, the cyclical outlook looks upbeat due to pent up demand and infrastructure rebuilding. In the past 20-year bear market, Japan has experienced five rallies, where the index has risen by more than 35%.

UK - underweight (downgraded from neutral)

Recent GDP data confirmed that the UK is now in a technical recession, suffering two consecutive quarters of negative growth, a cumulative -0.5% since the third quarter of 2011. However, it is an odd recession, given that over the same period, unemployment has improved and export volumes have increased, despite the eurozone being the UK's largest trading partner. Looking ahead, although earnings momentum in the UK improved modestly in April, this could well reverse in the face of negative economic and political events. While the UK continues to benefit from greater monetary and currency flexibility than the eurozone, it will not be immune to a full-blooded recession in the eurozone. In addition, UK fiscal austerity looks likely to bite deeper in the second half of 2012. As a result, the outlook for UK equities has materially worsened over the past month. While dividend yields and PER valuations remain attractive, both political and economic risks have increased. Until there is better clarity, I have downgraded the UK to underweight.

Europe ex UK - underweight (downgraded from neutral)

European politics appear to be at a turning point, as the combination of fiscal tightening, high unemployment in southern Europe and a low/no growth outlook have provoked a backlash against current policy. Markets are both cautious and confused about what happens next. While the fiscal compact is flawed and a possible growth compact is alluring, investors are uneasy about future French policy. However, the storm clouds of uncertainty are darkest over Greece and Spain. In Greece, the political limbo following an inconclusive general election, a surge in support for the radical leftist party, Syriza, which opposes key parts of the fiscal compact, and the need to agree reforms in order to receive further bailout money have significantly increased the risk that Greece may be forced to leave the eurozone. The most likely scenario is a mixture of incremental steps by specific governments, combined with renewed efforts by eurozone governments to agree a multinational solution. These negotiations are likely to take months, while the risk of euro rupture has increased. Given this backdrop, the outlook for growth in Europe remains very uncertain. Spain is now in recession (defined as two consecutive quarters of negative growth) and leading indicators are signaling modest contraction in EU activity over the summer. As a result, the outlook for European equities has materially worsened over the past month. While Europe ex UK equities have high dividend yields and low PER valuations, attractive stock characteristics are not currently driving European equity prices. Until there is greater clarity over the current political and economic issues, an underweight position is justified.

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 J.P. Morgan Asset Management. 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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