

- Recent statements by central banks suggest a commitment to secure the recovery and point to the possibility of additional quantitative easing measures
- Recent data question whether the corporate sector will take up the baton of growth from the public sector. We think it will eventually, but stick with our thesis of a sub-par economic recovery in 2010/11
- Corporate profits growth has been stellar, with upgrades to 2010 earnings. This raises doubts that 2011 estimates could prove too optimistic. Yet, despite this, equity valuations remain supportive
- We have moved overweight stocks vs. bonds and within our balanced portfolios favour the UK, US and the emerging markets. We have moved underweight in Europe, while continuing to underweight Japan and Australia

#### Returns – Changes over July 2010, %

	Equity Markets*	Bonds*	Exchange Rates+
Global	5.8	0.5	n/a
US	7.0	0.7	-3.9
Eurozone	5.3	1.0	3.1
Japan	1.4	0.4	-0.5
UK	7.1	-0.3	0.4
Emg. Mkts	6.2	4.4	n/a
Hong Kong	5.5	n/a	-1.2

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

#### Policy Outlook

A robust rebound in markets during July was helped by the comments made by Fed Chairman Ben Bernanke during his semi-annual testimony to Congress (formerly known as the Humphrey Hawkins testimony). Mr Bernanke indicated concern about the robustness of the US business cycle and intimated that the Fed stood ready to take additional action to secure the recovery.

These comments have enabled US bond yields to fall further during July, with two-year yields touching record lows of 51bp in early August and ten-year yields approaching 2.8%. This has been a source of concern for some investors who were looking for yields to rise, as evidence that the recovery is continuing. However, our sense is that the recent fall in yields may be due to declining expectations of higher policy rates over the coming months. According to the Credit Suisse measure of forward rates, markets are pricing in rate hikes of less than 20bp over the next 12 months in the US, down from 100bp as recently as April, and hikes of 40bp for the eurozone.

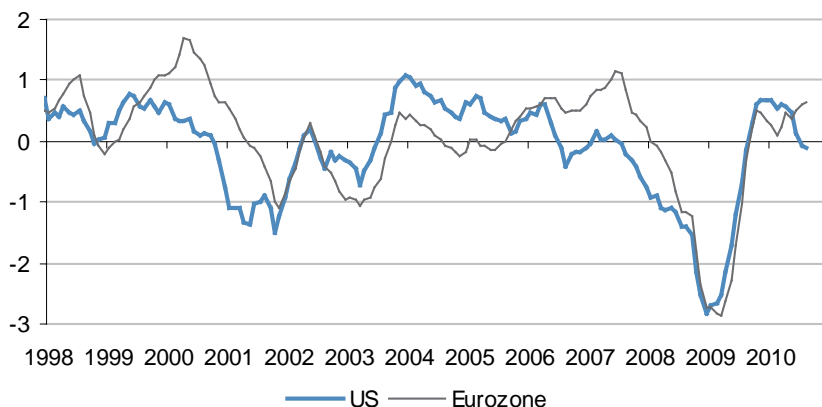
#### Chart of the Month

Our COTM shows our Global Currency Team's proprietary leading economic indicator for the US and eurozone. The LEI is a composite of key data series that are timely and demonstrate leading indicator qualities vis-à-vis prospective economic growth. The chart shows the recent divergence between the two regions, with the data suggesting that US growth could fall back below trend by year end.

Source: J.P. Morgan Asset Management Global Currency Team

#### Leading Indicators – pointing to regional divergence

Standard deviations



**Consensus economic forecasts**

Real GDP	2010	2011
US	3.1	2.9
Eurozone	1.2	1.3
Japan	3.4	1.7
UK	1.2	2.0
China	10.0	8.9

Source: Bloomberg

**Consensus headline consumer price inflation forecasts**

CPI	2010	2011
US	1.6	1.6
Eurozone	1.5	1.6
Japan	-1.0	-0.2
UK	3.1	2.5
China	3.0	3.5

Source: Bloomberg

**Bond Yields (as at 30 July 2010)**

	2 Yrs %	10 yrs %	10-2 yrs bp
US	0.55	2.91	236
Europe	0.78	2.67	189
Japan	0.16	1.07	91
UK	0.78	3.33	255
China	2.25	3.29	104

Sources: Bloomberg, J.P. Morgan Asset Management

**Policy Outlook cont/...**

Any commitment by central banks to “do what it takes” to secure the recovery could return us to a similar investment environment to that in 2009, where markets are influenced by the transmission mechanism underpinning quantitative easing (QE). Under conditions where the credit transmission mechanism has broken down, this QE framework highlights the importance of sustaining asset prices, both as a means of maintaining wealth and as a means reducing the cost of capital – ultimately aiming to encourage investment and avoid increased private-sector savings. The upshot is that central banks will implicitly need to target risk appetite. Yet with house prices starting to falter in both the US and the UK any further sign of economic weakness, or renewed equity market declines, could trigger a further bout of QE on both sides of the Atlantic.

Recent evidence of slowing activity has led to a shift in emphasis by the Chinese authorities. The response to weaker real GDP growth data for Q2, as well as other signs that China’s economy is finally cooling, has led to a shift in investor emphasis from fears of further tightening towards potential policy loosening. At present, our estimate of Chinese monetary conditions suggests that policy is restrictive and suggests that the trend towards a slowdown of the economy could extend into 2011. This should herald a peak in the inflation cycle, which usually lags the economic cycle by 1-2 quarters. Consequently, the economic slowdown could mean that the focus of policy in China could shift away from tighter monetary policy back towards renewed accommodation by the turn of the year.

Our measures suggest that monetary conditions have tightened in the US, China and Japan with all measures slightly restrictive. This appears counter intuitive, given that interest rates are close to zero in the US and Japan, while Chinese real interest rates are negative. However, currencies have appreciated and real interest rates have risen in both the US and Japan, while excess monetary growth has weakened to the point where it is no longer supportive of future growth. All this suggests that monetary policy is unlikely to be tightened in the OECD during 2010 and probably not in 2011 either.

It is notable that monetary conditions are most accommodative in the eurozone. Our proprietary indicator suggests that policy is very stimulative – and this may have encouraged ECB President Trichet in justifying no change in policy at the recent policy meeting. Indeed, the contrast between monetary conditions in the eurozone and the US is striking, with European conditions looking extremely accommodative, while those in the US look restrictive.

**Economic Outlook**

Investors remain concerned about the recent soft economic data, especially the disappointing US Employment Report in early August. Our global growth indicator (which comprises ten forward indicators that gauge activity in the developed and emerging economies) has continued to drop for the seventh consecutive month, suggesting that activity probably peaked in the middle of 2010. Official leading indicators in the largest developed economies (US, eurozone, UK and Japan) have all seen slowing annualised growth over the past 8-9 months, while China’s LEI has been slowing since June 2009. Our currency team’s proprietary leading indicators (LEIs) corroborate the official data and suggest that economic activity will retreat back to below trend rates of growth in the next 1-2 quarters in the US, UK and Japan. The exception is the eurozone, which continues to hold up with its LEI suggesting that growth will remain above trend in the second half.

This resilience in Europe has also been reflected by the Citigroup Economic Surprise indices, which continue to show positive surprises in both the eurozone

**Currency markets (as at 30 July 2010)**

	\$ rate	REER*	5yr avg
US	-	84.9	84.9
Euro zone	1.31	115.7	124.3
Japan	86.5	85.2	75.3
UK	1.57	82.8	90.2
China	6.77	117.0	107.7

\*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	12.0	13.5	-10.9
US	12.3	14.1	-12.5
Euro zone	11.1	11.9	-6.6
Japan	14.0	17.9	-21.7
UK	10.0	11.3	-11.9
Hong Kong	15.5	15.9	-2.7
Brazil	9.9	9.5	4.2
China	12.4	13.5	-8.4
India	16.3	16.2	0.6
Russia	6.0	8.9	-33.1

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

**Dividend Yield**

	Current	5-yr avg	Cash Rate*
US	2.1	2.1	0.45
Euro zone	3.3	3.3	0.90
Japan	1.9	1.6	0.38
UK	3.6	3.8	0.75
Hong Kong	2.8	3.0	0.36
Brazil	2.7	3.2	10.66
China	2.3	2.1	2.45
India	1.0	1.1	6.65
Russia	1.8	1.7	5.11

\*3-month interbank rates, except for Brazil where overnight Selic rate used. Data as at 30 July 2010  
Sources: Thomson Datastream, MSCI, Bloomberg, J.P. Morgan Asset Management

**Economic Outlook cont/...**

and the UK. While the G10 aggregate measure has retreated from a five-year high, it is still in positive territory. However, economic surprises have deteriorated in the US, where there are worrying signs that the expiry of fiscal stimulus has led to a slump in demand. Our interpretation remains that real GDP growth probably peaked in H1 2010 and will decelerate in 2010/11. We therefore stick with our long-standing thesis of a sub-par economic recovery in 2010/11.

A move towards fiscal retrenchment will likely exacerbate any slowdown. US economic growth will be hindered by the reversal of the fiscal stimulus – and that is before any tightening measures are put in place. This effect will be more marked in Europe, where retrenchment has been earlier and stronger. The key question is whether there will be a recovery in *private*-sector demand to offset the decline in *public*-sector demand in the next 12-18 months. The answer to this will determine whether there is to be a successful rebalancing of activity that enables OECD countries to alleviate their fiscal stress. If so, then such an outcome would be positive for risk assets. Failure for either monetary policy to take up the slack, or for private-sector activity to revive fully, would threaten a shift back into recession, which could be disastrous for equities and eurozone periphery bond markets.

**Earnings and valuations**

There is little evidence to suggest that corporate profits are slowing. The Q2 reporting season has been very strong. With about 430 of the S&P 500 companies having reported, equivalent to nearly 90% of market cap, the degree of earnings “beats” is the third highest on record. Excluding financials, reported earnings are 5.1% higher than expected, while revenues have been in line with expectations. Aggregate index earnings are up 5.4% from expectations at the start of the reporting season. However, the one minor blemish is that 2011 earnings have been revised downwards, albeit very slightly, led by materials, energy and utilities.

Bottom-up global earnings growth forecasts for 2010 have inched up slightly, from 34% at the end of June to 35% currently. However, the consensus now expects 17% growth in 2011, down from 19%. This change in the profile of 2010/11 earnings growth probably reflects a combination of upgrades to 2010 from these stellar results and base effects that are a drag on 2011 growth. Nevertheless, we are just beginning to see the first signs that 2011 earnings are being *reduced* in some cyclical sectors (such as autos). We have been very alert to the prospect of downgrades to 2011 earnings and the growing evidence of a soft patch for global economic growth coupled with better-than-expected Q2 results suggests that the going will become that much harder in the Q3 and Q4 earnings seasons.

Earnings momentum (defined as the ratio of analysts’ upgrades to downgrades) has increased in 12 of the 24 markets we track compared to the past three months, while it has improved in just 8/24 markets over the past six months. While earnings momentum is topping out in some markets, analysts’ upgrades still outnumber downgrades in 16 of the 24 markets we track.

There are inbuilt valuation supports for equities for longer-term value investors. At the end of July, the S&P 500 index traded on a forward PE ratio of 12.3x, based on IBES consensus earnings growth of 38% in 2010 and 15% in 2011. This compares with a long-term average of 15.2x. Yet applying a 10% “haircut” to 2011 earnings takes the multiple to 13.1x – still 14% below the long-term average. Indeed, using our handicap for 2011 consensus earnings and also derating the market back to one standard deviation below its long-term average suggests an

### About GMAG

The Global Multi-Asset Group is a 42-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 J.P. Morgan Asset Management's global expertise across core and alternative asset classes. GMAG is responsible for managing assets totalling over US\$29bn, 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 26 years.

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### Earnings and valuations cont/...

index level of about 970 for the S&P. Compared to bonds and cash, equities remain the asset class of choice, with the equity risk premium trading in excess of 6% in the US, Europe and Japan – near extremes and well above long-term averages.

### Markets

The rebound in markets probably owes itself to the combination of indices becoming very oversold, being indicative of poor sentiment, together with an apparent change of tack by central banks. Recent economic data increasingly question whether the corporate sector will take up the baton of growth from the public sector and increase investment and employment. Nevertheless, recent remarks by central bankers suggest that they are prepared, effectively, to underwrite investor risk appetite to stabilise asset prices. So far, it has been the *possibility* rather than the *reality* of monetary easing that has boosted markets. Yet despite this, the short end of the US bond market continues to price in a less palatable outcome, with record low yields around 0.5% and suggesting that a harder landing scenario remains a viable tail risk.

Nevertheless, we continue to believe that markets are likely to remain choppy until the uncertainty over the current soft patch in activity is resolved. But in the meantime, any policy intention to bolster risk appetite means that, at the margin, directional bets have become more attractive. This makes us happier to take directional positions in markets and we have increased our stocks vs. bonds exposure. We currently have an overweight position in stocks vs. bonds and are targeting slightly higher levels of overall portfolio risk. Within our balanced portfolios we favour the UK, US and the emerging markets. We have moved back to underweight in Europe, while continuing to underweight Japan and Australia.

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