

GUIDE TO THE MARKETS

Market review & theme September 2010

MSCI World Index total return

August 2010

-1.3% in EUR

-1.9% in GBP

-3.7% in USD

-6.7% in JPY

Part 1: Review of markets in August 2010

August saw the major government bond markets outperform developed equity markets, as investors continued to worry over the prospect of a double-dip recession in the US, a possible slowdown in China and ongoing stress in peripheral eurozone bond markets. The MSCI World Index fell 3.4% while the JPMorgan Global Bond index rose 2.1%, both in local currency terms.

Of the major stock markets the UK fell least, helped by its relatively defensive blue chip stocks. Indeed, the FTSE 350 High Yield index actually rose 1.2%. Japan was the worst performer, hit by poor domestic economic data and by a strengthening yen. By style, growth slightly outperformed value while large cap outperformed small cap. The emerging markets index outperformed the developed index, down 1.4%. All performance data is from MSCI, in local currency terms.

Economic data in August was mixed. Weak housing market and employment numbers in the US coincided with a downgrading of second quarter GDP estimates, from 2.4% growth at an annualised rate to 1.6%. However, industrial production and manufacturing output data for July were both strong. While analysts debated whether the US is in a 'soft patch' or entering a double-dip recession, the US Federal Reserve chairman, Ben Bernanke, pledged to ensure he will do all he can to preserve the recovery. This was interpreted by some as a promise of further quantitative easing, should the need arise.

Meanwhile in Germany second quarter GDP growth came in at 9.0% at an annualised rate, a post-unification record and easily the fastest growth of the major developed countries over the period. Strong investment spending, particularly in construction, and a surge in exports (up 8% in value over the quarter) were the main drivers. The Ifo index of German business confidence rose to its highest level in more than two years in August.

China overtook Japan as the second largest economy in the world, in dollar terms, a title that Japan had since 1968 when it took it from West Germany. Fear of inflation in China, and of policy error resulting from attempts to curb inflation, persisted after July CPI inflation came in at 3.3%, up from 2.9% in June. However a slowdown in Chinese GDP growth was recorded in second quarter data which showed the economy grew at 10.3% year on year, down from 11.9% in the first quarter.

Corporate news included the continuation of generally good second quarter earnings in the US and Europe, with some dividend policies reinstated. BHP Billiton made a hostile USD 39 billion bid for the Canadian fertiliser company Potash Corp, this is the largest bid offer of the year so far. McDonalds issued a RMB 200 million (USD 29 million) bond, making it the first non-Chinese company to raise funds in renminbi.

CONTENT

Part 1: Review of markets

Part 2: Market Theme:

The best defence

Part 3: Index charts

- US equities and bonds
- European equities and bonds
- UK equities and bonds
- Japanese equities and bonds
- Emerging markets equities and bonds

The major government bond markets rallied, with the ten-year US Treasury yield falling 44bp to 2.47%, its lowest since January 2009. UK and German ten-year government bond yields both fell to record lows, with investors buying partly in response to a steady rise in yields in peripheral eurozone markets.

On the currency markets the yen hit a 15-year high against the dollar and a nine-year high against the euro towards the end of August, ending 9.8% up against the dollar and 20.1% up against the euro since the start of the year.

% Total returns from markets over August

Asset	Sterling	US dollar	Yen	Euro
Equities (MSCI)				
World	-1.9	-3.7	-6.7	-1.3
US	-2.6	-4.4	-7.4	-2.0
Europe ex UK	-2.7	-4.5	-7.5	-2.1
UK	-0.1	-2.0	-5.0	0.5
Japan	-0.4	-2.3	-5.3	0.2
Pacific ex Japan	-0.1	-1.9	-5.0	0.5
Latin America	-0.3	-2.2	-5.2	0.3
Emerging Markets	0.0	-1.9	-5.0	0.5
Bonds				
World	4.1	2.1	-1.0	4.7
US	4.0	2.1	-1.1	4.6
Japan	5.9	3.9	0.7	6.5
UK	4.6	2.6	-0.6	5.2
EMU Aggregates	1.8	-0.1	-3.2	2.5
Currencies				
Sterling	na	-1.9	-4.9	0.6
US dollar	1.9	na	-3.1	2.5
Yen	5.2	3.2	na	5.8
Euro	-0.6	-2.4	-5.5	na

Source: JPMorgan GBI Index, MSCI, FactSet, J.P. Morgan.

Part 2: Market theme

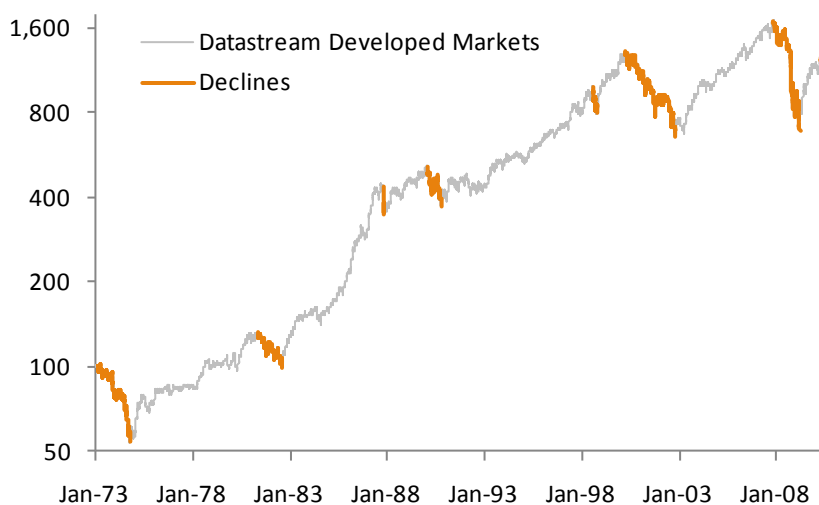
The best defence

Most investors know that when markets are rising it is best to hold cyclical stocks and when markets are declining the preference is for non-cyclicals. But they may not be as knowledgeable about what sectors or industries fall into each category. It is not as easy as just assuming that the consumer staples and utilities sectors are non-cyclical or defensive. For example, during the downturn in 1990 utilities stocks performed worse than the broad market (in this case, they fell 31% versus a decline of 28% for the Datastream Developed Markets Index). Moreover, there can be wide variation in the performance of the industries that make up a sector. Analysing eight episodes over the last 37 years when the broad stock market declined by more than 10% (see Exhibit 1), we identify those industries¹ which offer the most consistently defensive returns in down markets. In a follow-up paper, we will look at the best cyclical options.

Even the most naturally defensive sector, **consumer staples**, has not always produced top quartile returns (that is, returns in the top 25%) during every period we studied. From January 1973 through October 1974, several industries had returns in the bottom quartile, and in other periods returns were just average. Within consumer staples, the industries that have most consistently been in the top rank include food retailers and brewers. The reason for this is that even when earnings are falling or economic growth is weak, people will always need to buy food and will continue to drink alcohol. A list of the top defensive industries is given on page 5.

Exhibit 1: Market corrections

10% or greater decline



- There have been eight episodes of greater than 10% declines in developed world equity markets over the last 37 years.
- Returns during the most recent dip in the market since April have ranged from 6% to 16%.

Note: Log scale. Source: J.P. Morgan.

¹Stocks in MSCI indices are categorized according to the Global Industry Classification Standard (GICS), which organizes stocks into sectors, industry groups, industries, and sub-industries. We are using the Industry Classification Benchmark (ICB) system for this analysis because there is more history available than for GICS, which only has data from 1990. The categories, however, are broadly similar.

The next most defensive sector is **utilities**, which has been in the top for five out of eight episodes. It is the truly basic utilities, such as water utilities, that have provided the most consistent returns. Less traditional industries, such as alternative energy, have occasionally generated bottom quartile results. The utilities sector is not as reliable as it was in the past, however, as more and more functions that were once heavily regulated by governments have been liberalized and become subject to market forces. Of the five industries making up the sector, only two have outperformed since April (conventional electricity and gas distribution). During previous downturns, almost all sectors held up well compared to the market.

Telecom services has almost become a utility again, in the way it was when telecom operators were often controlled by the state. After shares had been more widely distributed to the market, valuations exploded during the technology bubble, leading to disastrous returns in the subsequent market collapse. Fixed line telecom companies have now learned to manage declining usage, while mobile telephones offer either steady income in saturated, developed markets, or enticing growth in emerging ones.

The **healthcare** sector overall has outperformed the index in five out of eight episodes (the current downturn is an example of when it has performed relatively poorly). There is also great dispersion at the industry level. One of the more reliable industries has been pharmaceuticals, whereas biotech has twice generated returns at the bottom of the range, reflecting the risks and rewards of the industry. The healthcare sector also suffers from regulatory risk, perhaps explaining some of the volatility in the returns for healthcare providers currently.

None of the remaining sectors are clear choices for investors looking to build defensive portfolios. There are, however, some industries that outshine others. In the **energy** sector, the integrated oil & gas companies have sufficiently diverse sources of revenue to allow them to accommodate the decline in demand that accompanies lower GDP growth rates. They have done less well recently, most likely due to the extreme volatility in oil prices over the last few years.

Gold mining stocks benefit from the safe haven status of gold during periods of anxiety, though they are often more volatile than the gold price itself. Within **industrials**, trucking companies have become much more reliable performers than they were in the past. **Consumer discretionary** stocks are almost by definition not defensive, but restaurants have held up surprisingly well. Perhaps this reflects the changing nature of modern society — either the determination to provide oneself small luxuries (even if it means frequenting cheaper restaurants), or the difficulty for families of meeting around the dinner table at a fixed time when both parents may work and the children are involved in extracurricular activities.

Please see table overleaf.

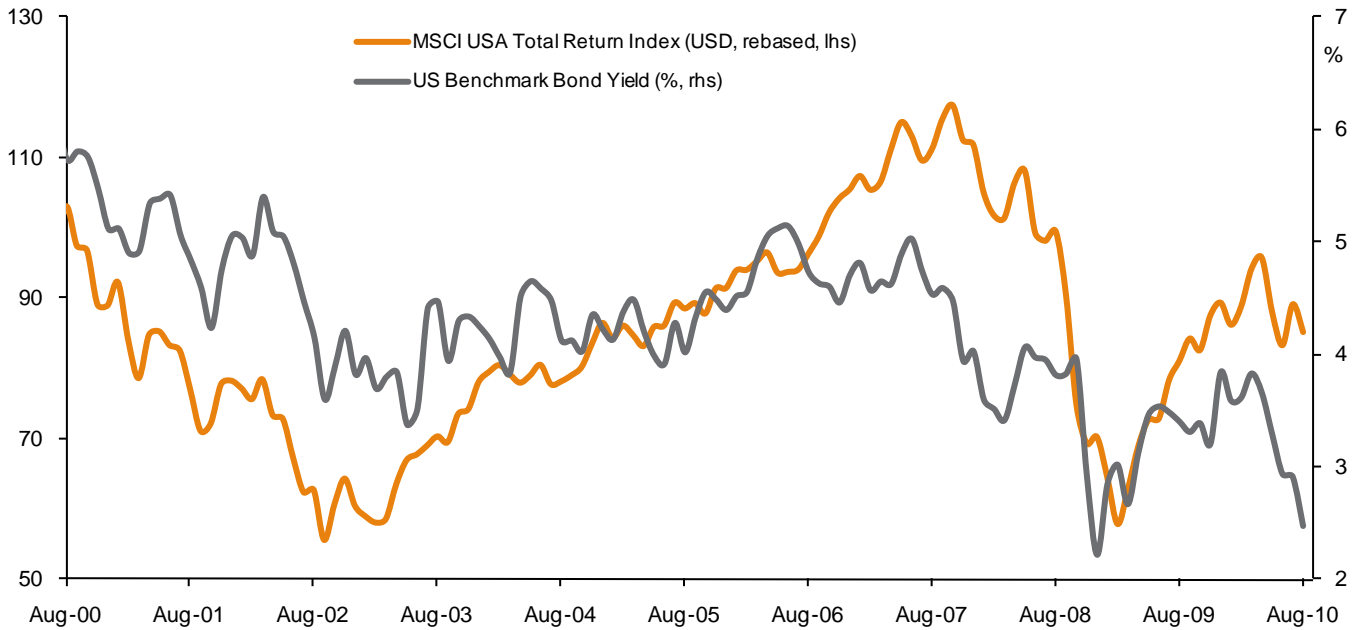
Top defensive industries over last eight downturns

Industry	Relative Return*
Tobacco†	52%
Gold Mining†	46%
Household Products (Nondurable)†	39%
Medical Supplies	34%
Drug Retailers	33%
Water	31%
Food Products†	30%
Brewers†	28%
Railroads†	25%
Soft Drinks†	24%
Medical Equipment	23%
Pharmaceuticals†	23%
Integrated Oil & Gas	22%
Conventional Electricity†	20%
Multi-Utilities	19%
Trucking†	18%
Food Retailers & Wholesalers†	18%
Travel & Tourism†	17%
Restaurants & Bars†	13%
Pipelines†	12%
Fixed Line Telecommunications†	9%

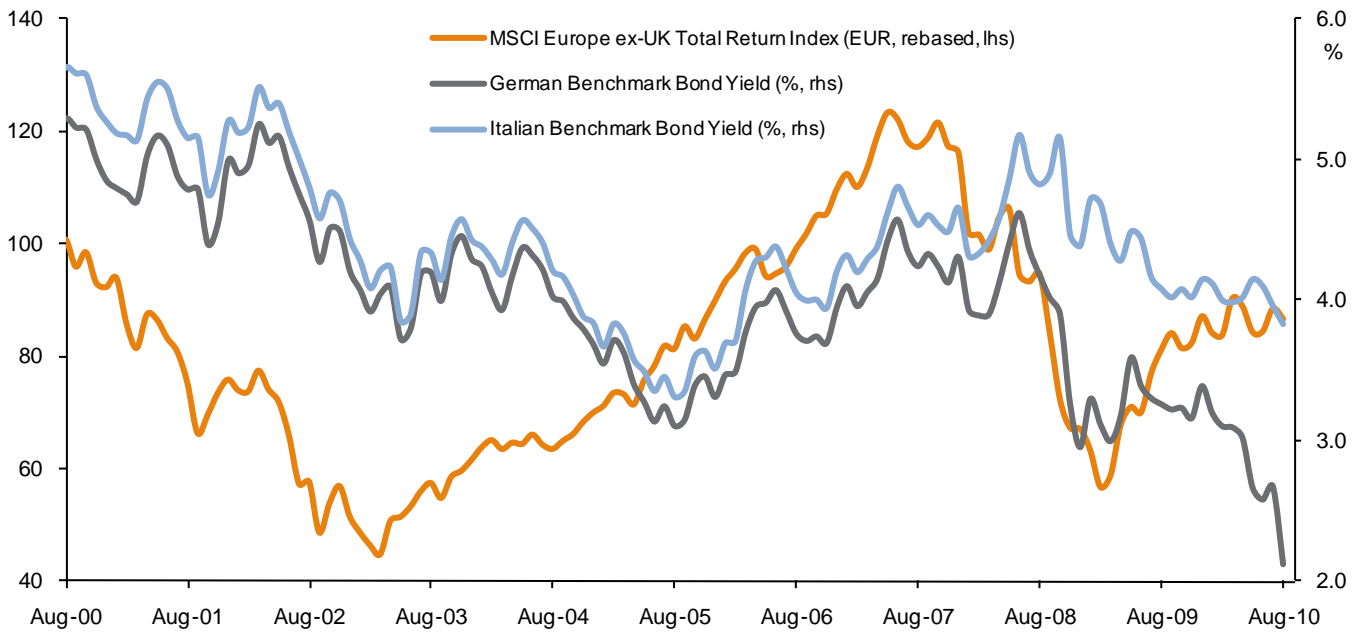
† In top quartile since 15 April 2010, most recent high of index. *Average return relative to index over eight episodes studied. Source: Datastream, J.P. Morgan.

Part 3: Index and yield charts

US equities and bonds

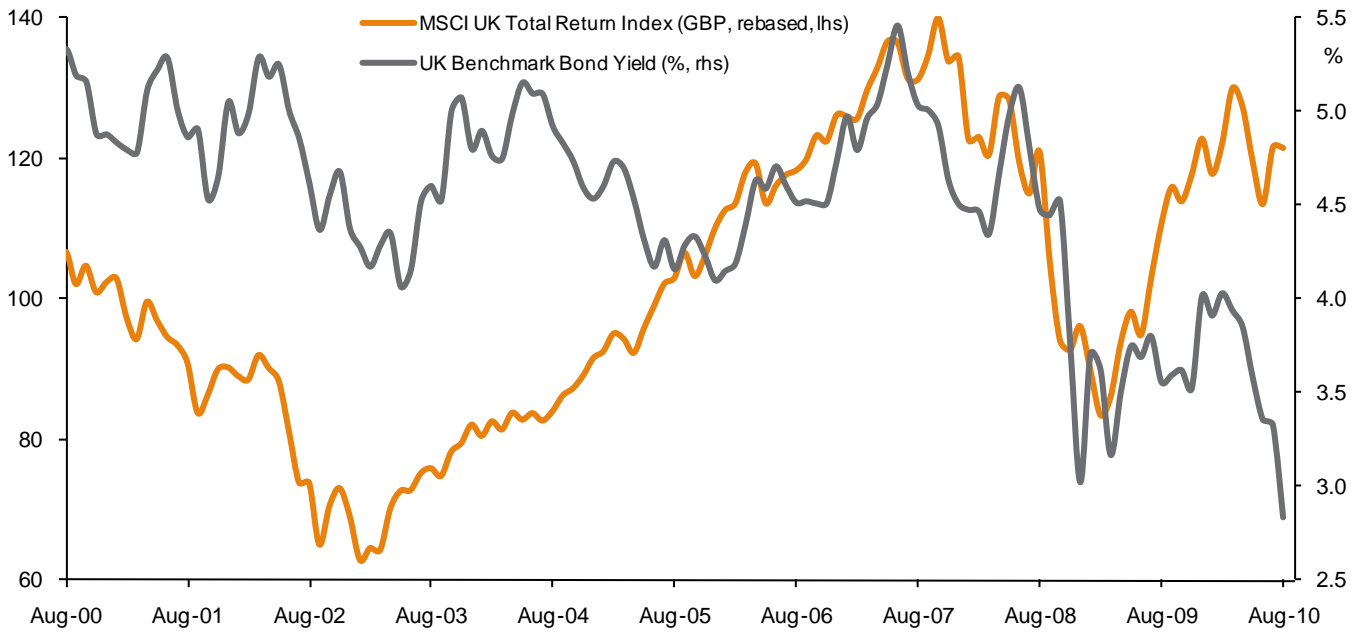


European equities and bonds

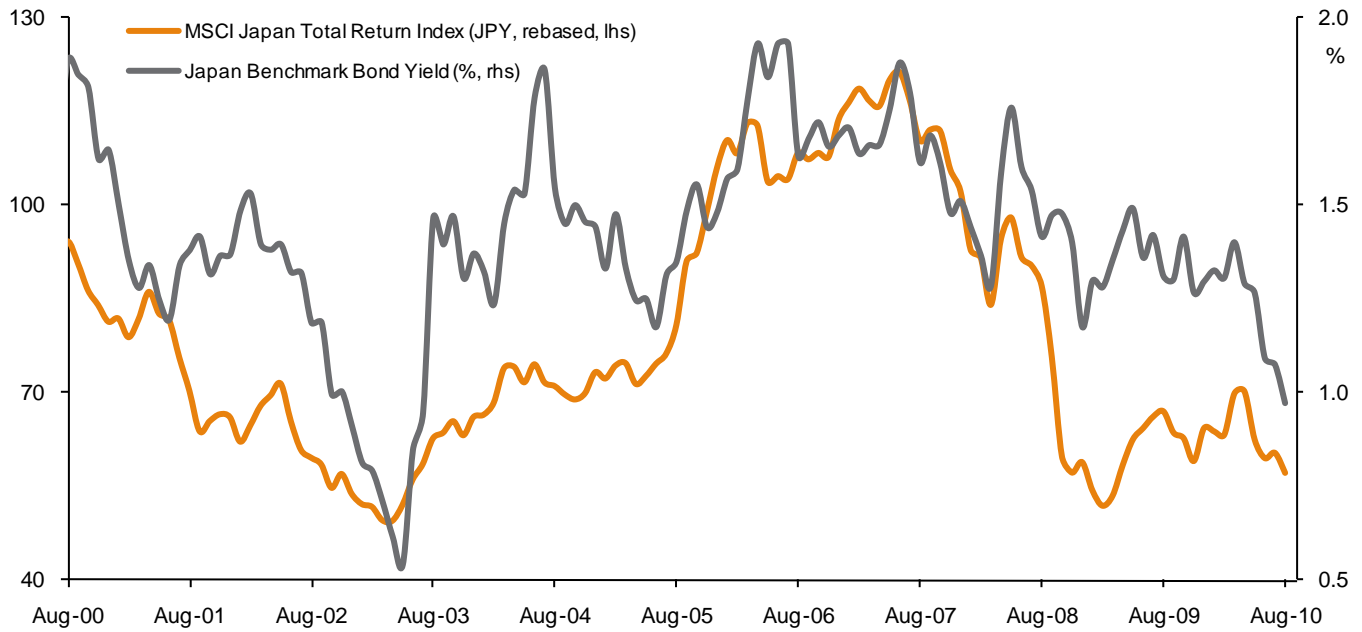


Source: MSCI, Bloomberg, 31 August 2010

UK equities and bonds

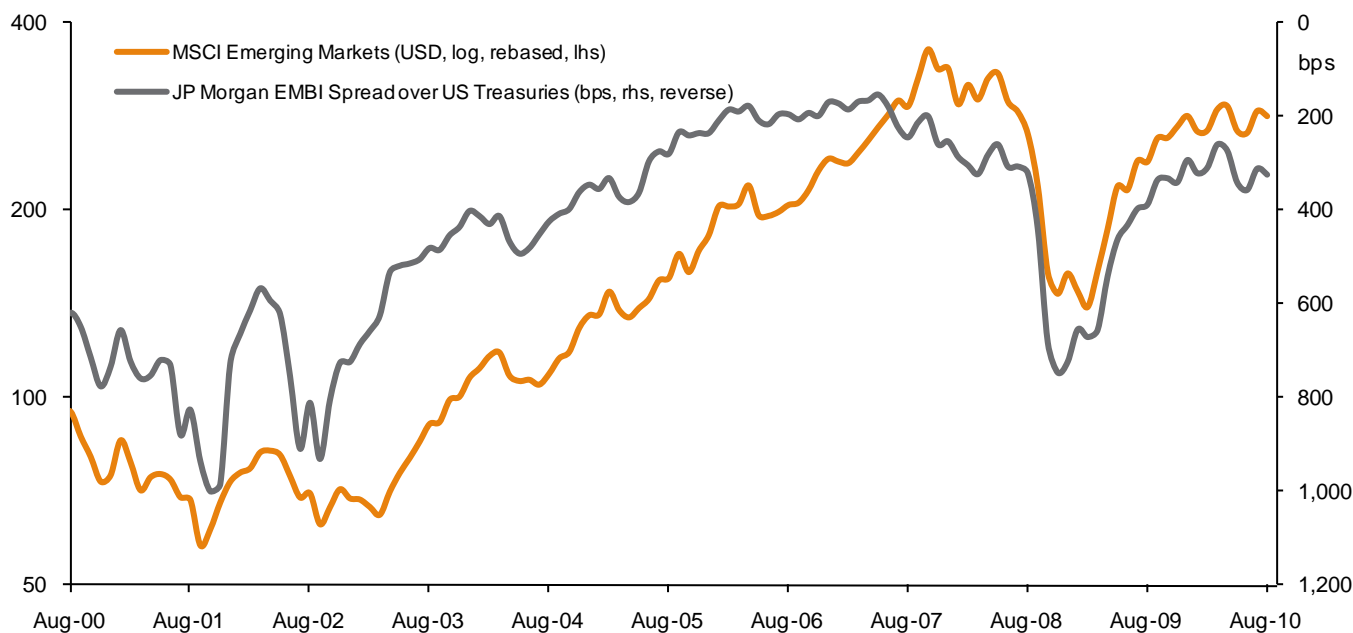


Japanese equities and bonds



Source: MSCI, Bloomberg, 31 August 2010

Emerging markets equities and bonds



Source: MSCI, Bloomberg, 31 August 2010

For any enquiries about this document, please contact: Tom Elliott – tom.cb.elliott@jpmorgan.com

Dan Morris – daniel.m.morris@jpmorgan.com

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