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- European commitment to fiscal austerity is slipping in the wake of political upsets and elections. An increased focus on growth would be positive, but risks upsetting bond markets.
- The ECB and Fed seem reluctant to engage in further stimulus but may be forced to react if European politics spark more severe market deterioration.
- Our regime work shows ongoing divergence in the global economy, with an equal share of economies in inflationary and disinflationary regimes. The US remains in the inflationary regime it has inhabited for the past four months, but its data have begun a period of technically-driven weakness.
- Valuations remain reasonable for equities and generally unattractive for bonds. The best risk-adjusted value in fixed income markets is to be found in the credit space.
- We retain our neutral stock/bond position but, with equity markets no longer overbought following the recent correction, are looking to go back overweight medium term. Within our balanced portfolios, we still favour the US and Japan and now also Hong Kong and Canada. We are underweight in Europe ex UK, UK, Australia and neutral in emerging markets.

### Returns – Changes over April 2012, %

	Equity Markets*	Bonds*	Exchange Rates+
Global	-1.5	0.7	n/a
US	-0.6	1.5	-1.1
Eurozone	-3.3	-0.1	-1.4
Japan	-6.1	0.6	3.1
UK	-0.3	0.4	1.9
Emg. Mkts	-0.5	1.9	n/a
Hong Kong	0.7	n/a	-0.3

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

### Policy Outlook

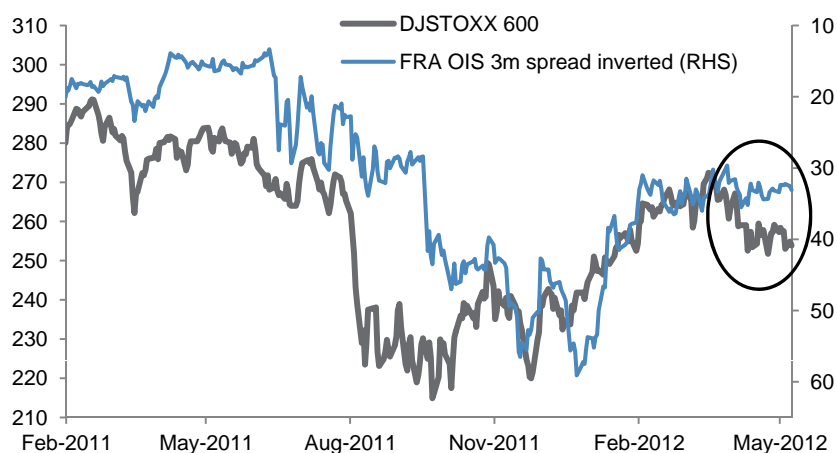
European politics seem to be at a turning point. The beginning of May saw a number of elections across Europe, with the results pointing towards looser fiscal policy. France has elected a new socialist president, who campaigned on a policy shift from austerity to growth. Greece has had inconclusive general election results, in which the two large austerity-supporting parties have failed to gain a majority, significantly increasing the risk that Greece may be forced to leave the eurozone. In the UK, the coalition parties fared badly in local elections and this will at least partly be seen as a negative vote by the public on the government's austerity drive. And a few weeks ago the Dutch government collapsed during negotiations over budget cuts.

### Chart of the Month

Our chart of the month shows the US dollar FRA-OIS spread, which has been a good indicator of stress in money markets and thus stress in the banking system. This indicator has stayed conspicuously flat despite renewed eurozone jitters and equity market weakness, suggesting that at least in this regard, the ECB's LTROs have been successful in insulating the banking system from market stresses and thus removing systemic risk.

Source: Bank of America Merrill Lynch. Data up to 7 May 2012

### European equities nervous, but no money market stress evident as of yet



**Consensus economic forecasts**

**Real GDP**                      **2012**                      **2013**

US	2.3	2.5
Europe	-0.4	1.0
Japan	1.7	1.5
UK	0.6	1.6
China	8.4	8.5

Source: Bloomberg

**Consensus headline consumer price inflation forecasts**

**CPI**                                      **2012**                                      **2013**

US	2.4	2.1
Europe	2.4	1.8
Japan	-0.2	0.0
UK	3.0	2.0
China	3.3	3.6

Source: Bloomberg

**Bond Yields (as at 30 April 2012)**

	<b>2 Yrs</b> <b>%</b>	<b>10 yrs</b> <b>%</b>	<b>10-2 yrs</b> <b>bp</b>
US	0.26	1.91	166
Europe	0.08	1.66	158
Japan	0.11	0.90	79
UK	0.45	2.11	166
China	2.90	3.55	65

Sources: Bloomberg, J.P. Morgan Asset Management

**Policy Outlook cont/...**

We have long viewed the eurozone crisis through a framework with three underlying driving forces: fiscal solvency pressures; banking system illiquidity and solvency fears; and a lack of growth impetus, owing in large part to a lack of competitiveness across much of the periphery. So far, most efforts by governments have focused on fiscal austerity in trying to address the first driver, while the ECB has addressed the second driver, most notably through the LTROs. Insofar as the third driver has been addressed at all, it has been through the lens of supply-side reforms aimed at improving competitiveness. While this is surely the right thing to do in the long run, such policies help little in the near term and may have even contributed to the economic slowdown throughout the eurozone.

If the pendulum now swings towards more direct fiscal stimulus, this could be a positive if it is properly framed – talk is of an infrastructure programme of perhaps around EUR 200bn. The danger is that any direct stimulus will be too small to matter and any real fiscal effects come in the form of 'austerity slippage' vs. previously agreed plans, which could risk upsetting bond markets.

This prospect may actually lead to looser ECB policy before long. The ECB has, at its recent policy meeting, appeared reluctant to engage in further stimulus, but the truth may well be that a serious upset in financial markets due to a loss of political commitment will leave it no choice but to intervene again, perhaps in the shape of another LTRO. This is something that many politicians may indeed be counting on. A Greek exit from the eurozone would be guaranteed to spark an even bigger reaction. Apart from these risk scenarios, the ongoing slowdown in economic activity should force further interest rate cuts before long.

The Fed's policy statement following its 25 April meeting was substantively unchanged, though the coincident release of the FOMC members' forecasts (and the confusion created therewith) received most of the press attention.

The FOMC's decision-making structure is a hybrid. Its chairman, predominant but not dominating, enjoys power sufficient to cloak an ongoing process of negotiation among current voting members. A potential downside to Bernanke's effort to make the institution more transparent is that it reveals the dynamics of this process before they have been resolved into a collective decision. The much-cited dispersion in the latest member forecasts suggests they may not result from a single model of the US economy, or perhaps even from a single agreed-upon Fed reaction function.

In their speeches over the month, FOMC members continued to throw cold water on the idea that any sort of QE3 might be forthcoming. The answer is no, the FOMC seemed to say to a market prone to tantrums at being refused its liquidity treat. This writer believes the deterioration required in macro indicators to produce a QE3-like response by the June meeting is highly unlikely — though European politics could come into play here as well.

**Economic outlook**

Our regime work shows still shows a significant degree of divergence across the global economy. While all the major EM economies remain in the disinflationary regime, the eurozone still inhabits its stagflationary regime of the past 19 months, consistent with weak April PMI data (slowing to 45.9 from 47.7), which suggest a continuation of recession in Q2. In contrast Japan, which has been skipping back and forth between regimes over recent months, has now moved firmly into a reflationary regime as the bounce-back effects from last year's earthquake make their mark in its industrial output data.

Our regime map shows the US economy remains in the inflationary regime it has

**Currency markets (as at 30 April 2012)**

	\$ rate	REER*	5yr avg
US	-	80.5	82.3
Euro zone	1.32	117.0	123.6
Japan	79.82	82.7	80.1
UK	1.62	85.0	84.7
China	6.28	122.1	112.8

\*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	11.8	12.5	-5.9
US	12.7	13.2	-4.1
Euro zone	10.2	10.9	-6.2
Japan	12.2	16.2	-24.3
UK	9.9	10.4	-4.9
Hong Kong	14.3	15.5	-7.9
Brazil	9.6	10.2	-5.4
China	9.1	12.6	-27.6
India	13.0	15.4	-15.8
Russia	5.1	7.1	-28.6

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

**Dividend Yields**

	Current	5-yr avg	Cash Rate*
US	2.1	2.1	0.47
Euro zone	4.3	3.8	0.71
Japan	2.4	1.9	0.34
UK	3.7	3.9	1.01
Hong Kong	2.9	2.9	0.40
Brazil	4.5	3.1	8.90
China	2.9	2.3	4.70
India	1.3	1.1	9.64
Russia	2.5	1.9	7.14

\*3-month interbank rates, except for Brazil where overnight Selic rate used. Data as at 30 April 2012  
Sources: Thomson Datastream, MSCI, Bloomberg, J.P. Morgan Asset Management

**Economic outlook cont/...**

inhabited for the past four months (i.e. where both the trend of output growth and inflation is upward). Data releases over the course of the month were disappointing, expectedly so, following our prediction of some apparent retrenchment from seasonal adjustment distortions owing to the behavior of macro aggregates over the 2008-2009 winter and the unseasonably warm winter. Indeed, weekly unemployment claims data started the month somewhat below trend, though had considerably strengthened by the month's end, by which time seasonal adjustment distortions were significantly diminished. Most of the distortions from the seasonal adjustment process should be gone by the June reporting dates, at which point we should be able to discern more clearly the underlying trend in growth.

The credit mechanism appears to be alive and well in the US judging by the latest Senior Loan Officer survey, which shows growing demand by firms for commercial and industrial loans, along with somewhat loosened credit standards over Q1, compared to the end of last year.

Going into the late spring, we remain focused on the following data points: 1. Any acceleration in the rate of household formation, which would suggest an uptick in the housing market, and so in residential investment going into the summer buying season; 2. Any uptick in capex spending by firms indicating they are (at last!) prepared to draw down their hefty balance sheets; and 3. Any signs that the recent weakness in real disposable income will lead to a deceleration in real personal consumption expenditure, particularly on durables, which has been unusually strong relative to other parts of domestic demand in this recovery. The last could be ameliorated by a loosening of consumer credit availability, though most of the expansion in consumer credit thus far in the recovery has been either student or auto loans according to data from issuers, which is not altogether surprising given household balance-sheet data showing a dramatic reduction since 2008 in credit card debt outstanding. In a reversal of this trend, Federal Reserve data on consumer credit exhibited an expansion in credit card debt outstanding in March which, although only one data point, is consistent with the turn in the household deleveraging cycle we have been pointing out.

**Earnings and valuations.**

Results in the US earnings season have come in well ahead of expectations and it seems to have marked the low point for earnings expectations. With 81% of numbers now reported, year-on-year EPS growth for the S&P 500 companies has come in at 7.8% in Q1, above expectations for 3.2% growth at the start of the reporting season – a large positive surprise by historical standards. Consequently consensus growth forecasts for 2012 have ticked-up to 9.5%, after falling continuously from a peak of 15% in July 2011 to a low of 8.5% last month. In Europe, too, the earnings season has been an improvement with a much higher surprise factor than in recent quarters.

Global upgrade/downgrade ratios also improved again in April, with 18 of the 24 markets we cover stronger than in March. The breadth of markets that are actually seeing rising estimates is also improving, with 11 markets now showing a ratio above 1, up from seven in March (with the US, UK, France, Japan and Singapore swinging into positive territory, while Taiwan has swung negative).

After the so-far mild correction, valuation support for equities for longer-term value investors has grown a little stronger again. The US market is trading on a price-to-book value (P/B) of 2.3x, 21% below its long-term average, and on a forward P/E ratio of 12.7x – 18% lower than its long-term average of 15.5x. Europe ex UK also looks cheap: its P/B ratio is 1.3x, 38% below the long-term average of 2.1x, while the forward P/E ratio is 10.2x, 28% below the historical average of 14.4x.

### About GMAG

The Global Multi-Asset Group is a 74-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 and supervising assets totalling over US\$74bn, 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 24 years.

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### Earnings and valuations cont/...

Government bond markets still look expensive, offering low real yields. Ten-year TIPs yields were at -0.3% in April, while on a comparable basis, and using trailing three-year headline inflation as a proxy for inflation expectations, real yields look unattractive in nearly all cases. The UK has a real yield of -1.3%, with the US at 0.2%. Both of these real yields are well below potential rates of economic growth, which suggests that these bond markets remain unattractive. The only two markets where real yields are close to, or above, underlying potential growth rates are Japan, at 1.6%, and the eurozone, which yields 1.4% in real terms. Given this, it is not surprising that equities look attractive when valued against bonds and also against credit. Using our proprietary DDR process, the S&P 500 offered an equity risk premium of 7.1% in excess of US Treasury yields at the end of January, 2.0 standard deviations above the 30-year average of 3.0%.

### Markets

The market jitters that began in mid-March are continuing, but have yet to conclusively turn into something more serious. Risk appetite has fallen back from elevated levels, but only to neutral territory. This is true for the Credit Suisse Risk Appetite index as well as the American Association of Individual Investors' Bull/Bear series. The State Street fund flow data points to a distinct lack of investor participation, with risk appetite still in 'riot point' territory – but it has now been stuck there for 11 months in a row.

Weakness in equity markets was once again sparked by eurozone worries, and European equities have suffered more than other regions, but wider global growth worries now look poised to take hold in the wake of the weaker US data and this has taken the shine off the US market, which had remained more sanguine until then. While we think the weakness will be temporary, this won't be proven either way for some time and uncertainty could weigh on markets over the next few months.

On the bright side, money markets barely reacted to this most recent bout of eurozone panic (see COTM). In this regard at least, the LTROs clearly have had the desired effect of insulating the financial sector from the crisis, and the risk that a systemic crisis will be ignited seems remote. Equities also no longer look overbought on our own indicators, although they are now merely in neutral territory and from this point a correction can often continue to run further.

We continue to have a constructive view towards equities and credit over the medium term (the next six to 18 months), but are still cautious over the shorter term (the next three to six months), retaining a neutral stock/bond position, while continuing to emphasise credit (US high yield and emerging markets debt) and broadly avoiding active positions in government bond markets (except for a tactical underweight position in Japanese government bonds). Our preferred equity regions are the US (with a large versus small cap relative-value play), Japan, Hong Kong and Canada. We are underweight in Europe, the UK and Australia, and are neutral in emerging markets.

The aim of the Monthly Investment Outlook is to give general information regarding financial markets and economic trends in an educational context only. This document is published for illustrative purposes only and is issued by the strategists of the Global Multi-Asset Group at J.P. Morgan Asset Management. The opinions expressed in this report are those held by the authors at date of this document and may be subject to change. The views expressed herein are not to be taken as advice or recommendation for investors to sell or buy shares. For information adapted to their personal situation, investors should check with their financial advisor.

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