GMAG INSIGHT SERIES

Global Multi-Asset Group – Weekly Strategy Report

14 May 2012

- **European equities – a bullish thought experiment**
- **China – more evidence of a slowdown**
- **COTW: US equities look overbought against Europe**

Changes over the past week (4 – 11 May)

	Equity Market	10yr Bonds (bps)	Currency Trade Weighted
US	-1.1%	-4	0.5%
Eurozone	-0.4%	-7	-0.8%
UK	-1.4%	-3	0.9%
Japan	-4.2%	-4	0.5%
Hong Kong	-5.5%	n/a	0.3%

Source: Bloomberg

European equities – a bullish thought experiment. Is it time to go overweight Europe? Every investor's favourite regional equity bet seems to be underweight Europe against overweight the US. We agree, and are positioned in line with consensus. But when opinion is *so* unanimous it is usually a good thing to run through a thought experiment on what the arguments in the other direction might be.

The political backdrop in Europe is, of course, horrible, with speculation over a possible Greek eurozone exit reaching fever pitch and safe-haven flows seemingly driving German bond yields to new all-time highs on a daily basis. And the longer-term structural perspective for Europe still looks challenging to say the least. However, political surprise can cut both ways and better news out of Greece or the announcement some sort of new bailout agreement could be an obvious trigger for a spurt of European equity outperformance.

The good news from the crisis-front is that the interbank market seems to have been more or less unaffected by eurozone worries. The LTROs clearly had the desired effect, and this would seem to limit downside risk in European equities in the short term.

This is somewhat reflected in the relative performance numbers. European equities have fallen by about 8.3% from the mid-March high, but are still up 1.7% year to date. The stuff of panic this is not. However, even on this short term perspective US equities have been by far the better bet, with the S&P 500 up by 8% year to date and down by only 4.6% since the mid-March peak. The longer-term perspective is more interesting: Europe has essentially been underperforming the US since April 2007, interrupted by just a few noteworthy bounces; overall underperformance has been -28% in total return terms.

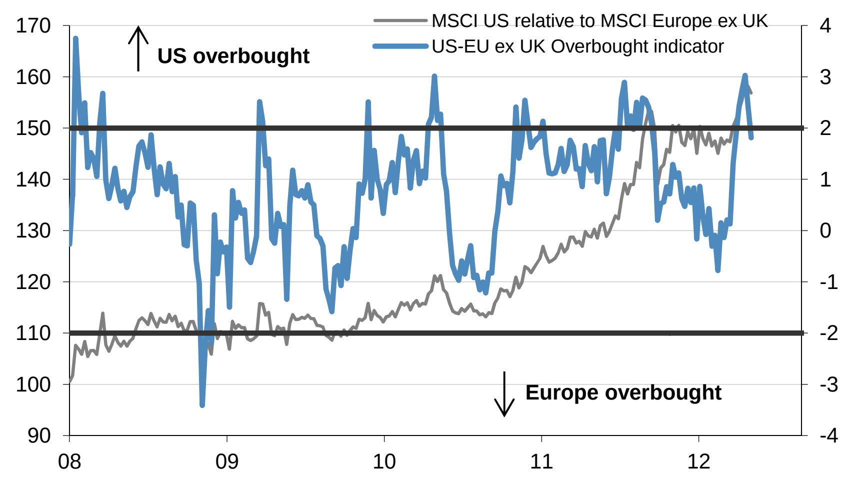
The valuation argument in favour of Europe is well-worn, but bears repeating. Europe ex UK trades on a forward P/E of 10.2x, while the US is on 12.7x. Relative to their own histories, Europe is valued 29% below average on this metric, and the US by just 18%. On price to book, Europe trades at 1.3x versus a long-run average of 2.1x (a 38% discount). The US price to book is at 2.3x versus a long-run average of 2.9x (a 21% discount).

Chart of the Week

Our COTW shows our technical overbought/oversold indicator for US equities against Europe ex UK. On this measure, US equities are 1.8 standard deviations overbought relative to Europe, although this has recently started to turn as the outperformance run has started to look exhausted.

Sources: Thomson Datastream, J.P. Morgan Asset Management Global Multi Asset Group

US equities look technically overbought against Europe



J.P.Morgan Asset Management

The Week Ahead

- **US.** On Tuesday, April headline consumer price inflation is expected to be 0.1% m/m, taking the annual rate from 2.7% y/y in March to 2.4% in April. The core inflation rate, also due Tuesday, is expected to remain at 2.3% y/y in April, with the monthly change at 0.2% m/m. On Tuesday, Retail sales are expected to moderate noticeably in April, registering a 0.2% gain after a 0.8% increase in March. On Wednesday, industrial production in April is expected to have grown by 0.5% m/m on the back of an increase in manufacturing production and a pickup in mining and utilities.
- **Europe.** Eurozone industrial production (due Monday) is expected to have increased by 0.4% m/m in March, taking the annual rate to -1.4% y/y from -1.5% in February. The ZEW economic sentiment survey (due Tuesday) is expected to drop to 19.0 in May from 23.4 in April. The scope for improvement from May is likely limited because of renewed uncertainty in the eurozone following the French election. Also on Tuesday, Q1 eurozone real GDP data is released and is expected to contract by 0.2% q/q, taking annual growth down to -0.2% y/y from 0.7%. On Wednesday, eurozone headline inflation in April is expected to be 2.6% y/y, while core inflation eases from 1.6% to 1.5% y/y.
- **Japan.** On Tuesday, machinery orders are expected to fall 3.5% m/m in March, taking the annual change from 8.9% y/y to 4.4%. .

This document is produced by The Global Multi-Asset Group

So what would be the case for a tactical overweight?

For one, US equities look very much overbought relative to Europe (about 1.8 standard deviations on our own measure), and there are some early signs the outperformance is becoming exhausted. Second, investor positioning on the pair is extreme: according to the latest Bank of America Merrill Lynch Fund Manager survey a net 32% of investors are underweight Europe, which is more than 1.6 standard deviations more negative than usual. At the same time, a net 26% are overweight the US (1.6 standard deviations more positive than average). A gap in preference this large signals a clear risk of a sharp and potentially sizable reversal in performance – *should there be sufficient catalysts*. Third, earnings momentum has turned up more sharply in Europe than in the US (albeit from a worse starting position),which has historically been a good lead indicator for European outperformance – but so far this has been ignored by markets. Fourth, on the economic side, longer leading indicators for Europe have started to turn upwards.

So while we are unlikely to change our cautious intermediate view on Europe, the odds for a short-term bout of European outperformance are increasing.

China – more evidence of a slowdown. China data last week painted the picture of a slowing economy, which disappointed the expectations of the (over)-optimistic consensus. While the releases are consistent with the tail risk of an unpleasant hard landing of the export sector, the data remains inconclusive. The bottom line is that policy needs to be eased – and fast – for the authorities to avoid a very unpleasant downturn.

The April trade figures showed further weakness in exports and imports, although the data was affected by the aftermath of the Lunar New Year holiday, which disrupted trade flows. The annual pace of export growth has slowed from 18% y/y in February to just 4.9% in April, although these comparisons are distorted by the timing of the Chinese New Year. Indeed, using a three-month moving average, the annual growth rate has ticked up in April, which would support the argument of those that believe that the Chinese economy may have bottomed in the first quarter. Moreover, with April having one working day fewer in 2012 than in 2011, the adjusted annual growth rate would be nearer to 10%.

The greater concern was the weakness of imports, which were flat compared to a year ago. This is worrying because imports of processing inputs and investment goods were weaker, which , in turn, suggests that exports of processed goods could weaken in the next few months. This raises further questions over growth in the second quarter.

Elsewhere, the activity data was disappointing, with industrial production, fixed asset investment and retail sales all below expectations. Industrial production slowed from 11.9% y/y to 9.3%, the lowest growth rate since May 2009 and well below expectations. This was accompanied by better-than-expected inflation data, with consumer prices rising 3.4% y/y, down from 3.6% in March, while producer price inflation came in at -0.7% y/y. While this may reflect lower energy costs, it may also reflect the underlying slowdown in activity. Monetary growth has continued to drop, with M2 reported at 12.8% y/y, close to 11-year lows. Meanwhile, new loan growth came in at a very soft CNY 682 billion, well adrift of the first-quarter average of CNY 820 billion. These releases together suggest that monetary conditions remain very tight, which suggests that a rebound in activity is not imminent, barring a meaningful easing in policy.