

This document is produced by The Global Multi-Asset Group

■ Economic activity is firming in the US and stabilising in Europe, while there are signs of a slowdown in Asia. Monetary policy is expected to remain accommodative in 2012.

■ Equities look attractively valued relative to bonds and credit, and we look for stocks to outperform over the year. Bond valuations remain poor, based on real yields.

■ It remains to be seen whether monetary policy will prove more effective in the OECD, but there is now greater scope for emerging market central banks to ease policy as the year progresses, which increases the chance of successful growth rebalancing.

■ We remain overweight stocks versus bonds and favour the US, Canada, Japan and the emerging markets in our balanced portfolios. We are neutral in Europe and are underweight in the UK and Australia.

### Returns – Changes over December 2011, %

	Equity Markets*	Bonds*	Exchange Rates+
Global	0.6	0.8	n/a
US	0.9	0.9	1.5
Eurozone	0.8	1.0	-2.6
Japan	-0.1	0.5	1.8
UK	1.3	5.5	0.7
Emg. Mkts	-0.0	1.3	n/a
Hong Kong	1.8	n/a	-0.1

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

### Policy Outlook

The outlook for policy remains clouded in one of the most downbeat market environments for several years. Hedge fund net equity positions at the end of 2011 were as low as in March 2009, suggesting that risk appetite remains at depressed levels. Remarks by the president of the New York Federal Reserve, Bill Dudley, in early January, emphasised the need for policymakers to support the housing market and asset prices. The importance of wealth to household (and corporate) sentiment remains paramount. However, in the current straitened environment, and against the backdrop of increasingly politicised debate about income and wealth distribution in society, further support from policymakers for asset prices is potentially difficult as the beneficiaries of central bank stimulus tend to be the better off.

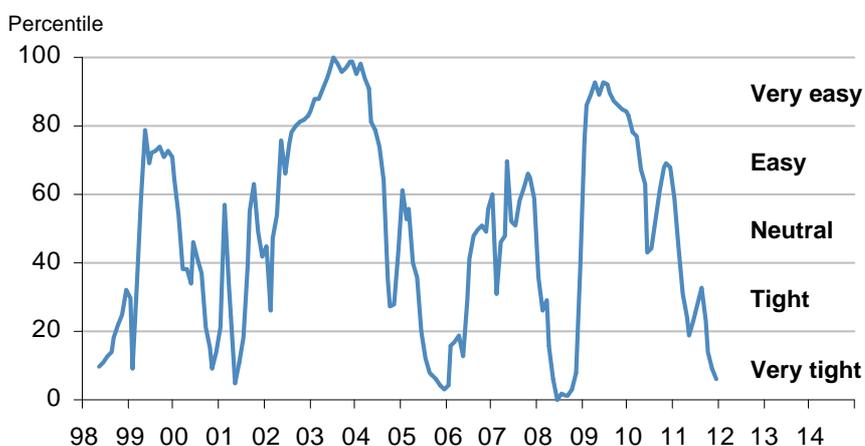
The environment for monetary policy is affected by the trend towards fiscal tightening across much of the OECD. According to the International Monetary Fund, only two of the member nations of the OECD (Finland and Belgium) are

### Chart of the Month

Our COTM shows our proprietary monetary conditions indicator (MCI) for China. It is comprised of four standardised variables, which help gauge the stance of monetary policy. The MCI shows that monetary conditions have become very restrictive, with slower money and credit growth offsetting negative real interest rates. This suggests that a harder landing remains a possibility in China and this could prompt an aggressive easing.

Sources: MacData, J.P.Morgan Asset Management Global Multi Asset Group. Data up to December 2011

### Chinese monetary conditions – worryingly tight



**Consensus economic forecasts**

Real GDP	2012	2013
US	2.1	2.5
Europe	-0.2	1.1
Japan	1.7	1.7
UK	0.6	1.8
China	8.5	8.4

Source: Bloomberg

**Consensus headline consumer price inflation forecasts**

CPI	2012	2013
US	2.1	2.2
Europe	1.9	1.8
Japan	-0.3	-0.1
UK	2.6	2.2
China	3.4	3.9

Source: Bloomberg

**Bond Yields (as at 30 December 2011)**

	2 Yrs %	10 yrs %	10-2 yrs bp
US	0.24	1.88	164
Europe	0.14	1.83	169
Japan	0.14	0.99	85
UK	0.33	1.98	165
China	2.86	3.44	58

Sources: Bloomberg, J.P. Morgan Asset Management

**Policy Outlook cont/...**

not projected to see a cumulative underlying tightening of fiscal policy over the next five years. This creates a deflationary backdrop for the world economy, which will need to be alleviated by central banks.

US monetary conditions are extremely easy, according to our proprietary indicator. Based on a range of variables that gauge the different transmission channels of monetary policy – including real interest rates borne by the household and corporate sectors, the yield curve and real exchange rate, as well as the amount of monetary growth – our measure suggests conditions are very easy, which helped to drive a reacceleration in the US economy towards the end of 2011. The question remains whether the Federal Reserve will need to provide further accommodation during the year. Our view is that the recovery that is unfolding could run out of steam by midyear, and this could easily bring further quantitative easing.

The most important central bank in 2012 is likely to be the European Central Bank (ECB). So far, the ECB has been behind the curve in terms of the policy stimulus it has provided across the eurozone. The central bank has shown that it is prepared to provide almost unlimited levels of liquidity to the banking system via its long-term refinancing operations, but has made it clear that it will not prop up the solvency of the system. Our currency team's fundamental proprietary policy indicator suggests that there is fundamental scope for the ECB to cut interest rates rapidly and aggressively to 0.5%. We suspect that this will be the most important monetary policy development in 2012.

There are increased hopes that the Chinese authorities will shortly ease policy to support the slowing economy. The People's Bank of China reduced bank reserve requirements towards the end of 2011, which was seen as an easing policy, though in practice it was probably an offset to the contraction in the monetary base arising from the fall in foreign exchange reserves. While recent forward indicators, including the purchasing managers' indices, have shown some signs of recovery, the underlying state of the economy remains soft. With the current rate of inflation falling from the mid-2011 peak of 6.5% year on year to about 4% at present, the case for further policy easing is growing. From an investment perspective, the biggest single event risk for a cautious investor would be if the Chinese authorities announced a massive fiscal easing

**Economic outlook**

There are signs of an upturn in the forward indicators. The proprietary indicators produced by our currency team reveal an upturn for the US economy, while they have stabilised for the eurozone. This trend was signalled by our monetary conditions indicators which had showed that US monetary conditions were very easy, although policy appeared to be more neutral in the eurozone.

There is a clear consensus that the eurozone went into recession towards the end of 2011 and will stay in a period of slow growth during at least the first half of 2012. Forward indicators for several of the peripheral countries point to contractions in activity. There is evidence of fiscal slippage in Spain, which could require further austerity.

However, recent data show the German economy generally to be in fine fettle. The December IFO survey came in significantly stronger than consensus, with an acceleration in both the business climate and expectations components of the survey. Employment data were better than expected, indicating a decline in joblessness, with the unemployment rate falling to 6.8% in December. It was therefore a surprise to see factory orders collapse in November, falling 4.8%

**Currency markets (as at 30 December 2011)**

	\$ rate	REER*	5yr avg
US		80.9	82.6
Euro zone	1.30	117.7	124.1
Japan	76.91	88.5	79.0
UK	1.55	82.7	85.8
China	6.29	121.3	111.7

\*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	11.0	12.7	-13.2
US	11.8	13.4	-12.1
Eurozone	9.7	11.1	-12.6
Japan	11.7	16.5	-29.0
UK	9.4	10.6	-11.4
Hong Kong	13.2	15.7	-15.7
Brazil	8.7	10.1	-14.1
China	8.5	13.1	-35.0
India	11.8	15.7	-24.6
Russia	4.7	7.5	-37.0

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

**Dividend Yields**

	Current	5-yr avg	Cash Rate*
US	2.2	2.1	0.58
Eurozone	4.5	3.6	1.35
Japan	2.7	1.9	0.34
UK	3.7	3.8	1.08
Hong Kong	3.1	2.9	0.38
Brazil	4.1	3.1	10.91
China	3.2	2.2	5.47
India	1.4	1.1	9.84
Russia	2.4	1.8	7.13

\*3-month interbank rates, except for Brazil where overnight Selic rate used. Data as at 30 December 2011  
Sources: Thomson Datastream, MSCI, Bloomberg, J.P. Morgan Asset Management

**Economic outlook cont/...**

month on month, well adrift of expectations. There are signs that the other core members of the eurozone, such as the Netherlands, have seen strong activity.

The good news is that inflation is beating a retreat. Headline rates of inflation have peaked and are trending down in several economies, including the US, the UK and China. Part of this reflects commodity price base effects, where the surge in prices has passed through into the general price level. However, underlying inflation remains manageable, with little evidence that organised labour in the OECD has regained any form of pricing power, and with high levels of spare capacity remaining in economies.

With tentative evidence of an upturn in economic activity (though it remains to be seen how long-lasting this will be) and signs of a downward trend in inflation, it looks as if the global economy could be exiting from the stagflation regime it occupied for much of 2011. From an investment perspective, a shift to a regime in which inflation is trending down tends to be more favourable for risk assets. Nevertheless, it is too early to make a confident assessment of the likely next regime, because any upturn in output could prove short-lived. The next two-to-three months could therefore be volatile.

**Earnings and valuations**

By market, upgrade/downgrade ratios remain very weak, with just two markets out of the twenty-four we cover recording positive earnings momentum (where the ratio is above one), the same as in November. Seventeen countries saw earnings momentum improve from November, with sixteen of these seventeen having earnings momentum of less than 1. There are wide divergences between markets: Indonesia has the highest earnings momentum, at 1.5, while Poland has the lowest, at 0.04, which means that for every one upgrade there are 25 downgrades.

There are still inbuilt valuation supports for equities for longer-term value investors, despite the current challenging macroeconomic environment. The US market is trading on a price-to-book value (P/B) of 2.0x, which is 30% below its long-term average, and on a forward price-to-earnings ratio (P/E) of 11.8x, 24% lower than its long-term average of 15.5x. Europe ex UK also looks cheap: its P/B ratio is 1.3x, 39% below the long-term average of 2.1x, while the forward P/E ratio is 9.7x, 32% below the historical average of 14.4x. These multiples contrast with 2012 consensus earnings growth of 9.5% and 9.2% for the US and Europe ex UK respectively.

By contrast, government bond markets are discounting an era of no growth, judging by real yields. Ten-year yields on TIPS (Treasury inflation-protected securities) fell to -0.12% in December, from -0.02% in November. 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 -1.8%, with the US at +0.5%. Both of these real yields are well below potential rates of economic growth, which suggests that these bond markets are unattractive. The only two markets where real yields are close to underlying potential growth rates are Japan, at 1.8%, and the eurozone, at 1.6%.

### About GMAG

The Global Multi-Asset Group is a 68-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\$59bn, 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.

Neill Nuttall is Chief Investment Officer of the Global Multi-Asset Group.

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### Earnings and valuations cont/...

It is therefore not surprising that equities look attractive when valued against bonds and also against credit. Using our proprietary valuation process, the S&P 500 offered an equity risk premium (ERP) of 7.3% in excess of US Treasury yields at the end of December, 2.2 standard deviations above the 28-year average. Nevertheless, we are more conservative on the valuation front because we believe that markets will require a higher ERP over the next five-to-ten years. This perhaps makes the past three decades a less relevant base of comparison, and suggests that more recent data may offer a better base. If so, then valuations are not so supportive.

### Markets

2011 proved to be a treacherous year for markets, with several short-term turning points. It was also a year in which volatility levels made risk taking painful, and in which a small number of investment decisions determined performance. A portfolio that was short stocks versus bonds, short emerging versus developed equity markets, and short financials, but long corporate credit and AAA-rated government bond markets, and long US versus European equities, would have performed handsomely. If only it were so simple.

The first days of 2012 have brought a stealth rally, in which under-risked investors are being tested by accommodative central banks and better macro news. Nevertheless, we believe that the current year could be equally as choppy as 2011, with multiple twists and turns. To some extent, the most important macro assessment concerns whether the fiscal tightening in the developed world will be offset by easier monetary policy, with household or corporate activity replacing the drag on activity from the public sectors. To this rebalancing question is added another question – whether increased demand from emerging markets will offset any loss from the developed world. In retrospect, inflation concerns in emerging markets last year meant that their central banks had to tighten monetary policy, which contributed to a drag on global demand. This lack of rebalancing proved deflationary, thereby leading to the asset class performances mentioned above.

It remains to be seen whether monetary policy will prove more effective in the OECD this year, but there is now greater scope for emerging market central banks to ease policy as the year progresses, which increases the chance of successful growth rebalancing. Overall, we expect equities to outperform bonds in 2012, although once again it could be a bumpy ride.

Within our balanced portfolios we remain overweight stocks versus bonds, and overweight in credit. We are also overweight US, Canadian, Japanese and emerging market equities, while we are neutral in Europe ex UK and underweight the UK and Australia.

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