

Quarterly Perspectives

UK | 4Q 2015

J.P. Morgan Asset Management is pleased to present the latest edition of *Quarterly Perspectives*. This piece explores key themes from our *Guide to the Markets*, providing timely economic and investment insights.

THIS QUARTER'S THEMES

- 1 Fed up with low rates? Relief may be at hand...
- 2 China: Not all doom and gloom
- 3 European recovery: Headwinds become tailwinds
- 4 UK equities - worth a closer look?



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1 Fed up with low rates? Relief may be at hand...

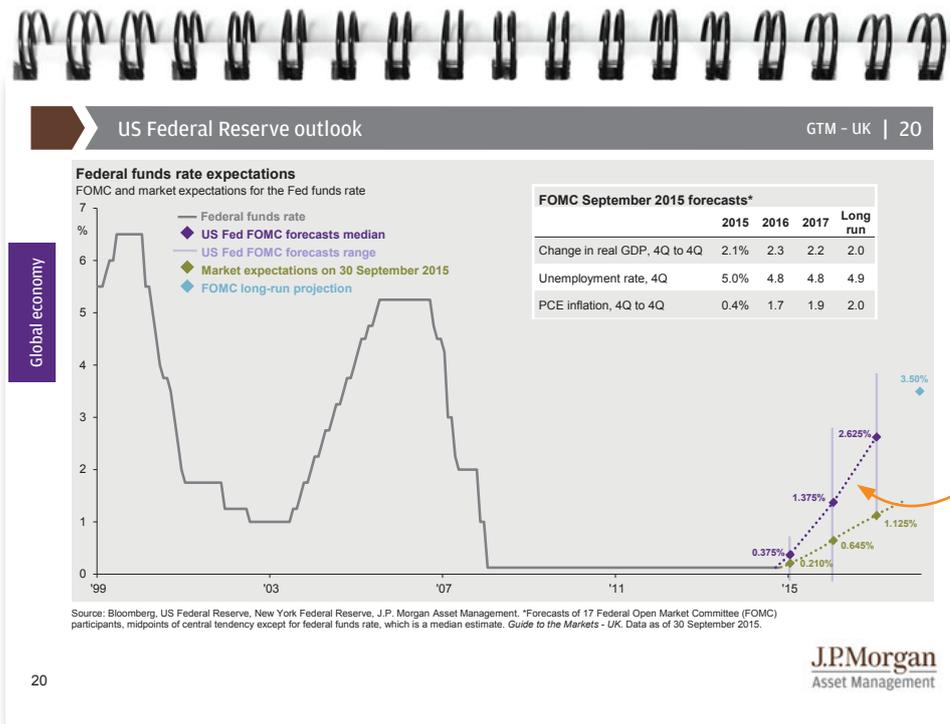
Domestic conditions are not quite there

Why has the Fed held off so far, and what needs to change for it to finally pull the trigger? Like most central banks, the Fed aims to keep inflation low and stable. It set a target in 2012 of a 2% increase per year in the cost of personal consumption expenditure. At present, the level of inflation is well below the 2% target. Although much of that weakness is due to the price falls in energy, so-called “core” inflation (which excludes volatile food and energy prices) is also the lowest it has been in years. Stronger evidence that underlying domestic price pressures are building is needed for the Fed to act.

Unlike most other central banks, the Fed also has a target of full employment, which represents the other half of its “dual mandate.” Unemployment has fallen significantly and other measures of the labour market have also improved as this expansion has continued, but obtaining full employment—the definition of which is often subjective and differs between analysts—has so far eluded the Fed. Wages are relevant to both sides of the mandate. They are a key driver of inflation and also the main indicator of the proximity of full employment. All eyes will continue to be trained on those indicators in the months ahead.

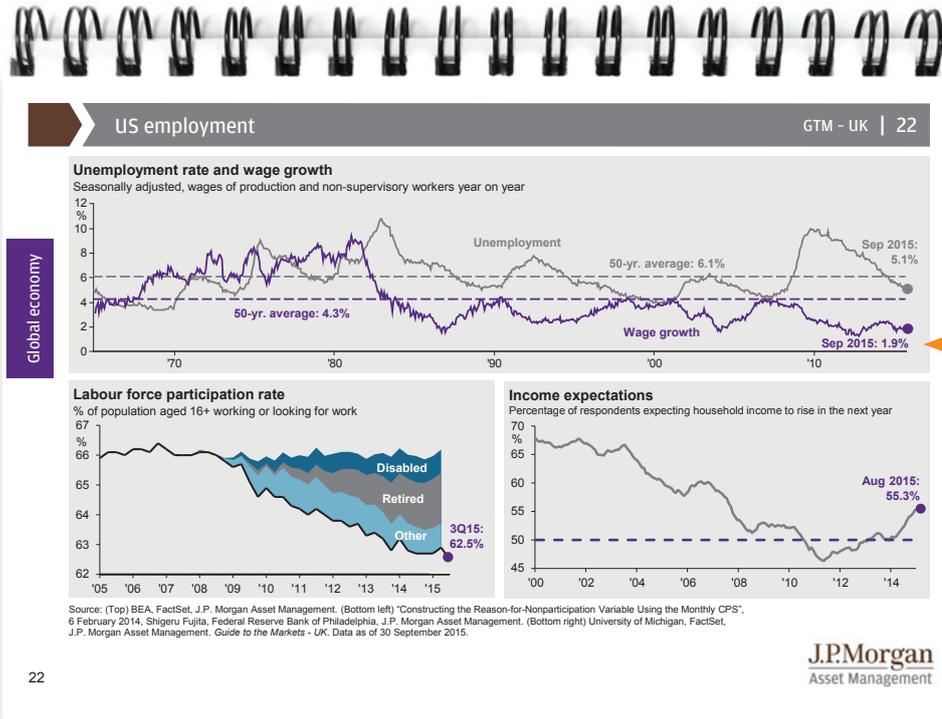
OVERVIEW

Investors moved into the summer expecting the US central bank to finally raise interest rates in the autumn, for the first time in nearly a decade. But come September, the Federal Reserve (Fed) once again decided to hold back, despite still healthy growth in the US economy, with chair Janet Yellen making clear that concerns over emerging markets were a key reason for the delay. This increased the level of uncertainty around the timing of rate rises but, for long-term investors, the pace of tightening matters more than the exact date. With a recovery continuing in the developed world and wage growth finally picking up, investors should expect policy rates to rise in the US and UK in the near future. But we would expect both long and short-term rates to remain at historically low levels for a long time to come.



Both markets and policy makers expect rates to rise, but when, how fast and where they end up are all subject for debate.

Source: Guide to the Markets - UK, page 20



Falling unemployment is a sign of how far the economy has come, but further declines are necessary to see wages accelerate.

Source: *Guide to the Markets - UK*, page 22

International concerns unlikely to fade on schedule

2015 has seen significant turbulence in the economies and markets of the emerging world, most notably China. That the Fed is concerned about market conditions is no surprise: the central bank manipulates markets as a course of its policy. But in our view, the focus on the emerging world does not reflect a general concern for global stability, but rather concern about the direct and indirect implications for US inflation and growth of a severe slowdown in emerging markets. The question marks over China will not lift any time soon. But stabilisation in emerging market growth and commodity prices would provide an easier environment for the Fed to raise interest rates than the environment that was presented at the last meeting.

INVESTMENT IMPLICATIONS

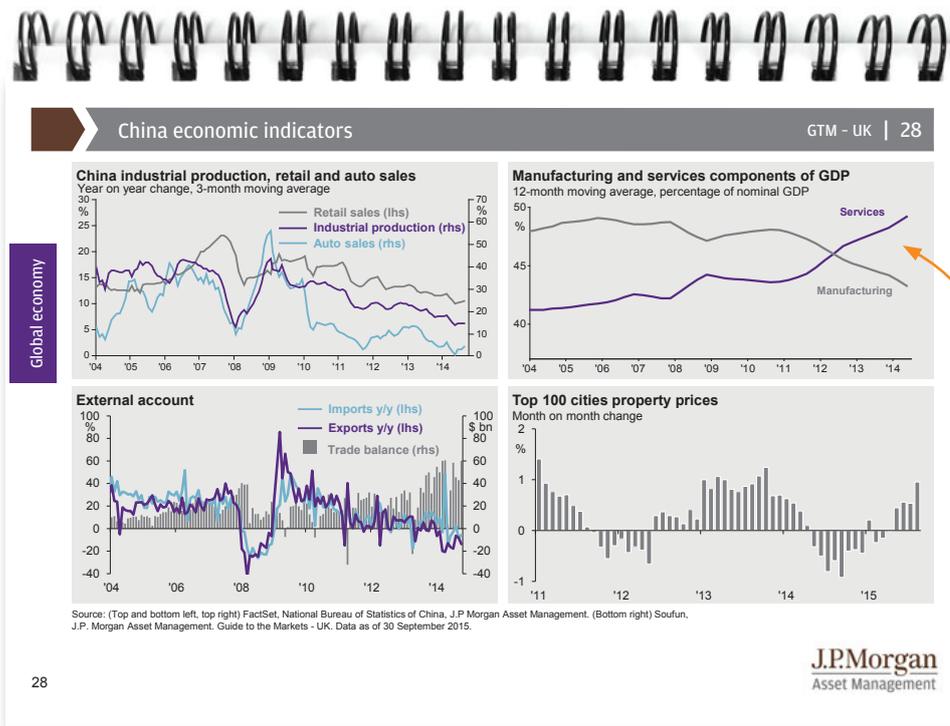
Investors need to prepare for the eventual lift off for US policy rates, whether it occurs this quarter or next year:

- Core bonds may well be challenged in a rising policy rate environment and diversification will be essential within fixed income portfolios.
- That diversification can come by including credit alongside core bonds. The recent sell off has created opportunities, but selectivity is key given the pockets of stress that exist in the asset class.
- Ultimately, rising short-term interest rates is a sign of economic strength and should provide a positive environment for equities, which have historically done well over the course of a tightening cycle by the Fed.

2 China: Not all doom and gloom

Industrial slowdown is not the whole story

There has been plenty of bad news coming out of the Chinese economy lately. Industrial production grew by only 6.1% year on year in August. In dollar terms, exports have shrunk by 1.4% year on year in the first 8 months of 2015, while imports have contracted by nearly 15%. Efforts to stimulate growth by reducing reserve requirements and lending rates for banks have also seemed less effective than in the past, perhaps because companies and local governments are already sitting on too much debt.



Source: *Guide to the Markets - UK*, page 28

But this is only one half of the picture. Though retail sales have recently decelerated, the more consumer-oriented service sector is doing much better and its importance is often understated. Services accounted for 48% of China's GDP in 2014, up from less than 40% in 2000, as shown in the chart above. In recent months there has been a clear divergence in the trend of the Chinese purchasing managers' index for manufacturing and for services. The Chinese property market also appears to be stabilising, with inventory levels continuing to decline for major cities and transaction volume and prices starting to pick up.

OVERVIEW

China's economy is slowing down due to both structural and cyclical factors, its equity market has been on a roller-coaster ride and its foreign exchange reserves have been falling. These problems have been on all investors' minds this year and have recently spilt over into the global financial markets. But we believe there is more to the China story than a potential "hard landing." Of course, the world's most populous country does face major economic and financial challenges. But the stabilisation of the real estate market, growing middle-class consumption and the rise of the services sector should all provide some stability to the economy going forward. The recent fall in the equity market also offers an opportunity for active investors to take advantage of long-term growth opportunities in key sectors, which remain in place.

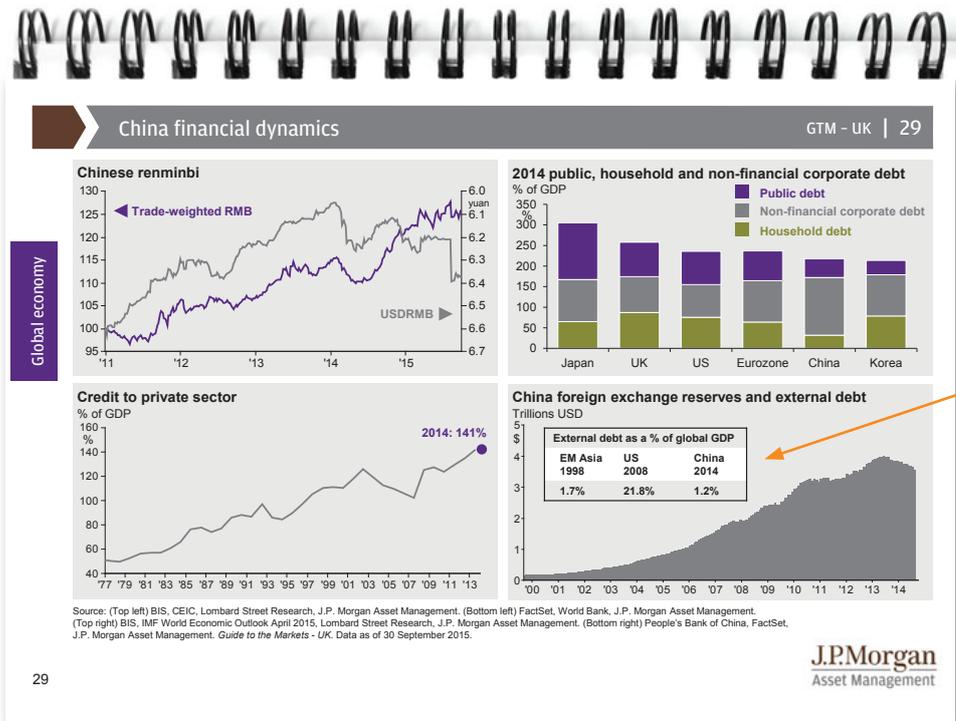
China's services sector is becoming increasingly important and looks more resilient than manufacturing.

Currency and credit risks need to be kept in proportion

When China devalued the yuan this summer, it was one of the last global currencies that had not adjusted to the strength of the US dollar. Some further downward move in the currency against the dollar is likely in the medium term, because the authorities would like to avoid the wide swings in the trade-weighted value of the currency that come from being closely pegged to the dollar. Allowing the currency to move with market forces would also make the case for the yuan's inclusion in the International Monetary Fund's special drawing rights currency basket.

However, China's policy makers have a great interest in keeping any adjustment in the currency gradual and relatively controlled. If the yuan massively depreciates in the short term, local spending power would be affected first, which would be a grave concern given the government's emphasis on domestic consumption. The authorities are also mindful of the difficulties that a rapid depreciation would cause for Chinese companies that have borrowed in dollars.

China has seen a sharp increase in private sector debt since the global financial crisis. This is likely to cause problems for China and its financial sector in the future. But China's very low level of public debt and substantial foreign exchange reserves put it in a much stronger financial position to resolve these issues than that of the developed economies in 2008, even after recent capital outflows. With China's capital market still fairly closed, it's also worth remembering that the direct exposure of the rest of the world to China's corporate debt problems is relatively small.



China has a corporate debt problem, but the rest of the world has very little direct exposure to it.

Source: Guide to the Markets - UK, page 29

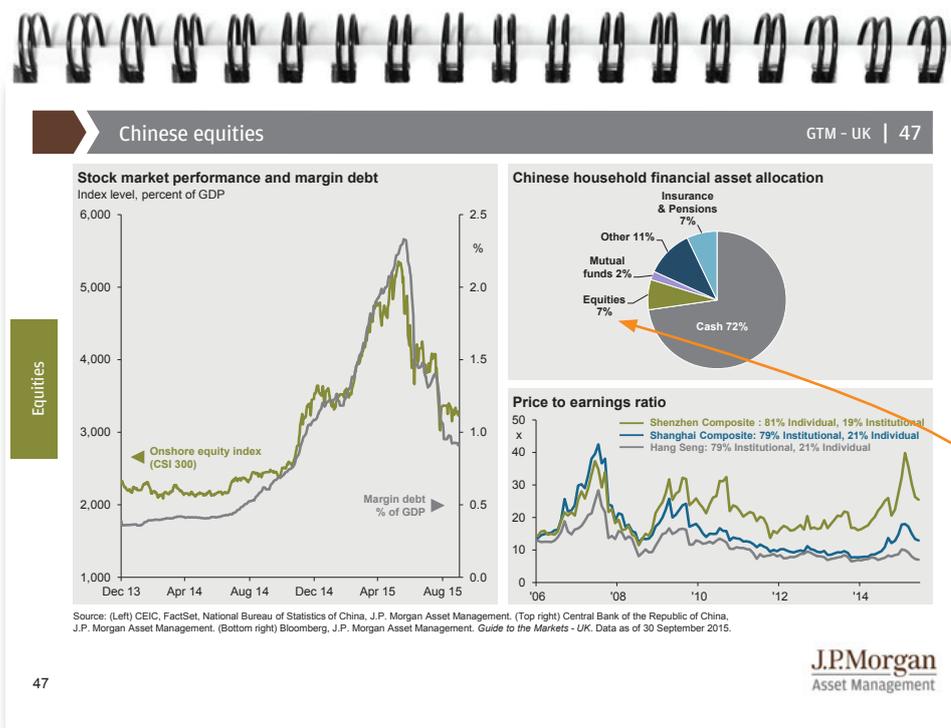
Chinese equity market swings are not all bad

The massive rally and subsequent decline in the Chinese equity market has illustrated the volatility and capriciousness of a stock exchange driven by margin lending for retail investors. While the losses of this summer were staggering, they are unlikely to have a major impact on the economy when only a small proportion of Chinese household assets are held in equities.

Short-term market volatility is likely to continue, especially in the onshore A-share market. But in the internationally-accessible parts of the market, the price declines in the past three months provide long-term active investors with a good opportunity to capitalise on positive structural growth opportunities in key parts of the economy.

INVESTMENT IMPLICATIONS

- China's shift from an investment-led to consumption-led economy is bound to cause some weakness in data releases, but investors should look beyond the headline figures to get a clearer picture.
- Volatility is likely to remain high for Chinese equities due to policy uncertainties and investor base, but the deflating of the equity market bubble makes this a good time to find opportunities through active management.
- More attractive valuations strengthen the case for selecting companies with solid balance sheets and strong earnings potential, particularly those in consumer services that are poised to benefit from reforms.



The stock market's gain and loss of the past 12 months has been massive, but the average Chinese household only invests 7% of its assets in equities.

Source: Guide to the Markets - UK, page 47

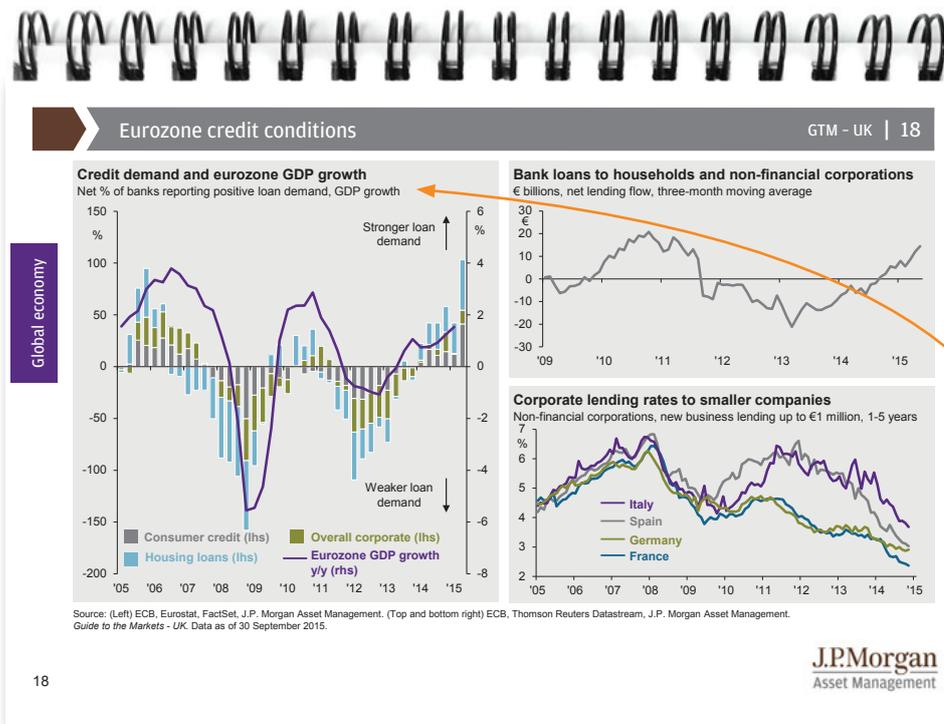
3 European recovery: Headwinds become tailwinds

Credit growth has been the biggest positive surprise

As borrowing costs have come down, demand for lending has picked up. This is important because, historically, credit demand has been a strong leading indicator for growth in GDP, as seen in the chart below. This makes sense as the majority of money that is borrowed is spent. Rising demand for credit suggests that borrowers have more confidence in the recovery. But the upturn in loan demand has so far been driven largely by households. Going forward we would hope to see more borrowing by companies to fund investment, which continues to lag. But with most companies still operating with spare capacity, it is no surprise to see them biding their time.

OVERVIEW

The good news from the eurozone has continued in 2015, with the economic recovery gaining ground in the summer—despite worries over Greece and China—and peripheral economies such as Spain making particular progress. But global volatility has hit European equities, leaving them looking reasonably valued on traditional metrics, although still not cheap. We believe that continued growth in corporate earnings, coupled with still highly supportive monetary policy, provides plenty of upside potential for asset prices, particularly in domestically oriented sectors that can now finally benefit from the recovery. The headwinds of a strong euro and higher borrowing costs that have hindered Europe over the last few years have reversed, becoming supportive tailwinds with the falls in the euro and in borrowing costs.



Improving loan demand is key for European growth and avoiding deflation.

Source: *Guide to the Markets - UK*, page 18

It's not just the cheaper euro - and it's not just the core economies

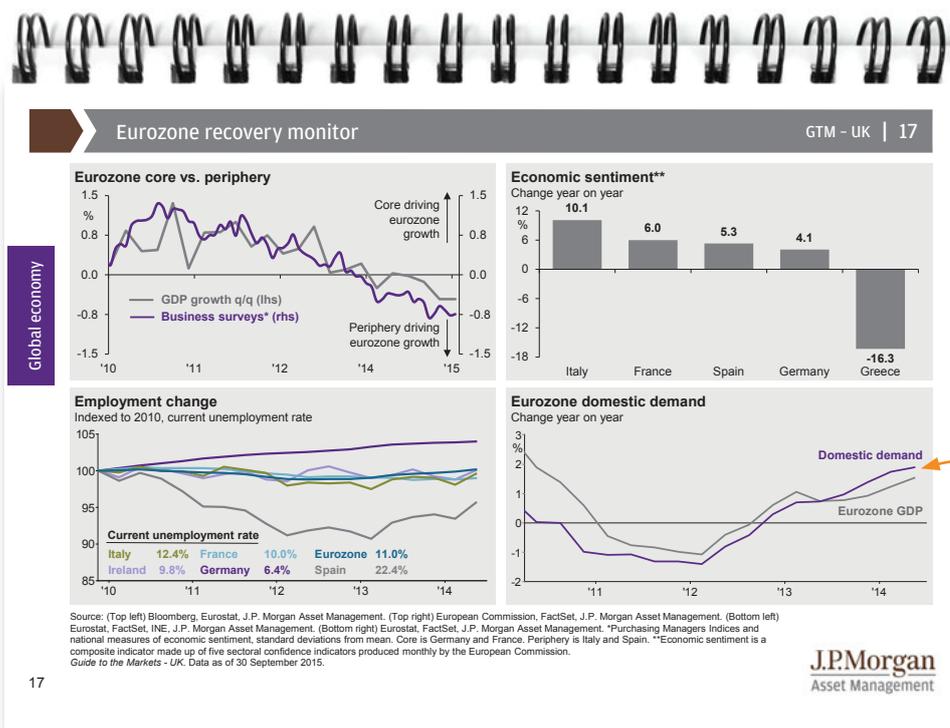
In recent years, eurozone growth was driven mainly by the core economies—notably Germany—and by net exports. Domestic demand was weak and peripheral economies such as Italy and Spain continued to struggle. But domestic demand has grown faster than exports so far in 2015, and business surveys show that the peripheral economies are now performing better than those in the core. The commitment of some countries in the periphery to reforms, together with the improvement in economic sentiment, which is helping to unlock significant pent-up demand, has helped to draw investor attention to peripheral asset markets. One example is Italy's stock market, which has outperformed other eurozone markets since the start of the year.

Emerging market and Greece concerns overdone

Recently, investors have begun to worry that emerging market (EM) weakness would hurt European exports. However, domestic demand is far more significant for eurozone GDP. For example, German domestic demand is more than 35 times larger than German exports to China.

A more significant EM slowdown would have some negative impact on Europe. But we would expect the European Central Bank (ECB) to offset any genuine tightening in global conditions by expanding or strengthening its quantitative easing programme, further weakening the euro and supporting eurozone equities. Conversely, if the EM growth outlook improves then equities should perform well too, as it was EM concerns, along with worries about Greece leaving the euro, that led to the summer sell-off.

Greece could still eventually leave the euro. The stand-off between Greece and its creditors has generated a fair amount of ill will on both sides. But with the anti-euro element of Syriza no longer in government and Alexis Tsipras having now committed to doing what it takes to keep Greece in the single currency, we do not believe that Greece's problems will pose a risk to European stability in the near term.



Eurozone GDP is no longer reliant on exports as domestic demand recovers.

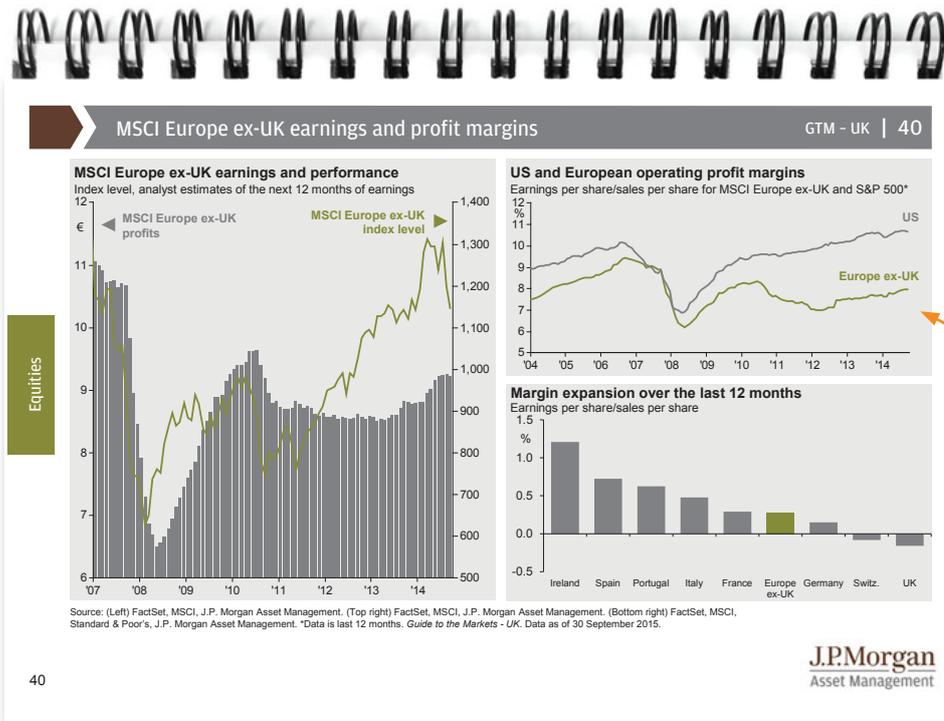
Source: Guide to the Markets - UK, page 17

Margins and earnings to improve

With the improving economy, corporate earnings in the eurozone are now also improving, after years of disappointments. European earnings excluding the energy sector grew by close to 20% year on year in the second quarter. We think earnings can continue to grow, because growth in the broader economy suggests not only higher sales but also higher margins, which have lagged behind the US in recent years. The weak euro, cheaper commodity costs and lower interest rates should all gradually feed through into higher profits as currency and commodity hedges roll off and companies refinance. The lags involved in this process suggest to us that the benefits of lower commodity prices, cheaper borrowing costs and the weaker euro are yet to be fully reflected in reported earnings. Further declines from here would provide an additional boost to earnings, but are not required for continued earnings growth.

INVESTMENT IMPLICATIONS

- The summer sell-off has left European equities looking relatively attractive, as earnings have increased and can grow further, while stock prices have declined.
- The ECB is willing to print even more money, if necessary, providing some downside protection in the event that emerging market turbulence hits European markets further. For UK- and US-based investors, a hedged strategy is worth considering, given the likely currency implications of further ECB easing.
- Domestically oriented sectors and companies have outperformed during the summer sell-offs and still look undervalued relative to export-oriented sectors, despite showing generally stronger earnings growth in recent months. This underscores the importance of an active approach, investing in assets that are poised to benefit from a long-awaited domestic recovery.



European margins have room to recover relative to the US and history.

Source: Guide to the Markets - UK, page 40

4 UK equities: Worth a closer look?

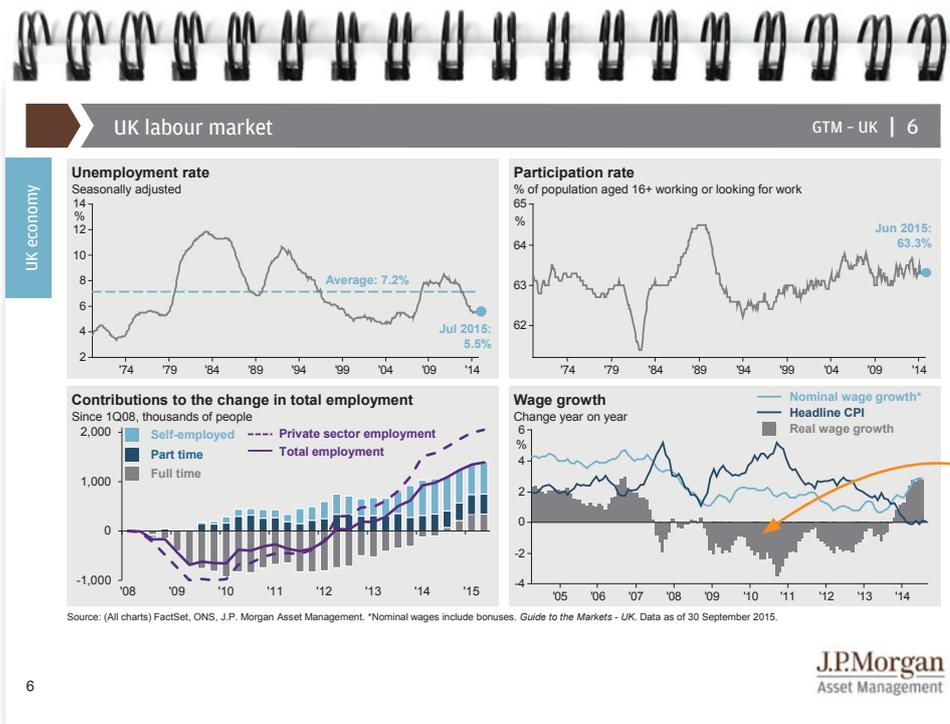
The UK economy continues to pick up pace

The UK has recently been one of the best-performing developed market economies, with an average growth rate of 1.9% year on year (y/y) over the last 12 months—well above the G7 average of 1.1% y/y. It was the fastest-growing economy in that group in 2014, when national output expanded by 2.6%.

Such strong growth is beginning to pay off for UK workers, with wages now starting to rise after years of falling living standards. As shown in the bottom right-hand chart, UK wages have grown in real terms for the last nine months, the longest period of sustained real wage growth since the global financial crisis began in 2007.

OVERVIEW

The UK equity market got off to a strong start in 2015, growing by over 8% by mid-April, driven by an improving outlook for global and European growth. However, a renewed fall in commodity prices has hurt the share prices of the basic materials and energy companies that make up 16% of the FTSE All Share. Thanks to the summer sell-off, both the FTSE 100 and the FTSE All Share are now in the red year to date, providing an attractive entry point for investors who missed the earlier market rally.



The UK is experiencing the longest period of sustained real wage growth since the financial crisis.

Source: Guide to the Markets - UK, page 6

Focus on domestically oriented companies

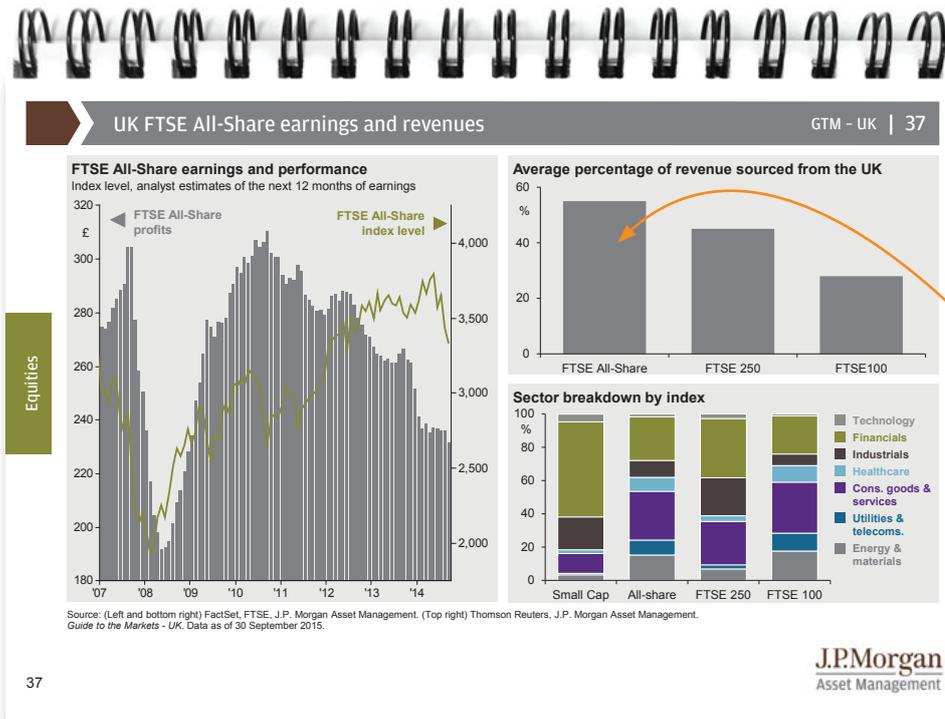
In order to gain exposure to the economic recovery taking place in the UK, investors should consider moving down the market capitalisation spectrum towards small and mid cap companies. As shown by the bottom right-hand chart, a large proportion of the mega cap FTSE 100 is made up of sectors such as basic materials, energy and financials. All of these sectors have global exposure and source very little of their revenue in the UK economy.

In contrast, as the top right-hand chart shows on slide 37 of *Guide to the Markets – UK*, smaller UK companies have more exposure to the UK than the global economy.

The valuations argument for UK equities is also compelling. The overall composite valuation of UK equities is below that of the global index. For investors seeking income, the UK is also an attractive opportunity. UK equities currently have a high dividend yield vs. their own history as well as relative to their peers.

INVESTMENT IMPLICATIONS

- The UK economy is among the fastest-growing economies in the developed world. This faster growth is beginning to have an impact on wages for UK-based workers, who are experiencing the longest period of sustained real wage growth since the financial crisis.
- Stronger wage growth and a healthier UK economy should be good for some UK equities, particularly small cap companies, which are more sensitive to changes in domestic growth.



Small cap companies source more of their revenue from the UK.

Source: *Guide to the Markets – UK*, page 37

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