MARKET INSIGHTS

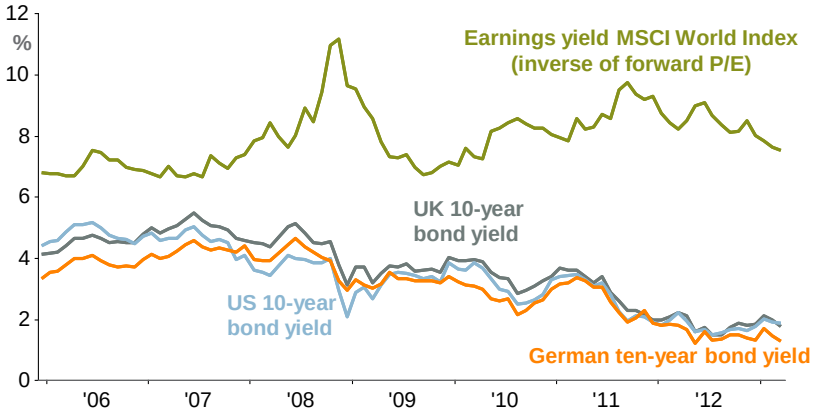
The Weekly Brief | 6 May 2013

Thought of the week

Despite the MSCI World Index reaching a new five year high last week, the case for equities remains strong. Bloomberg consensus earnings growth estimate is 7.9% over the next twelve months for the MSCI World Index, with a 5.2% increase in dividends. This is against a background of world GDP growth improving from 2.0% y/y in the first quarter 2013 to 3.1% in the first quarter of next year (Bloomberg consensus): hardly a global boom, but solid growth nonetheless. Furthermore, valuations look attractive with the trailing earnings yield on global equities at 5.9%. Recent falls in core government bond yields have accentuated the relative attractiveness of equities.

– Tom Elliott

Earnings yield and ten-year bond yields



Source: MSCI, Tullet Prebon, FactSet, J.P. Morgan Asset Management.

Week ahead

Day	Country	Event	Period	Survey	Prior
Mon	Eurozone	Retail sales (m/m)	Mar	-0.1%	-0.3%
Tue	France	Industrial production (m/m)	Mar	-0.3%	0.7%
	Germany	Factory orders (m/m)	Mar	-0.5%	2.3%
Wed	Germany	Industrial production (m/m)	Mar	-0.1%	0.5%
	China	Exports (y/y)	Apr	10.0%	10.0%
	China	Imports (y/y)	Apr	13.0%	14.1%
Thu	China	CPI (y/y)	Abr	2.3%	2.1%
	UK	Industrial production (m/m)	Mar	0.2%	1.0%
	UK	BoE rate announcement	May	0.50%	0.50%
Fri	Italy	Industrial production (m/m)	Mar	-0.3%	-0.8%

Market statistics

	Change (%)		
Equities	**Week ago**	**YTD**	**Year ago**
MSCI Europe	2.0	10.8	22.5
DAX	3.9	6.7	21.3
CAC 40	3.2	8.5	27.2
IBEX	3.1	6.7	33.8
FTSE MIB	2.2	4.3	24.9
FTSE 100	1.5	12.1	17.5
S&P 500	2.1	14.0	18.7
TOPIX	-0.7	35.4	48.7
MSCI EM	1.6	-0.2	6.2
MSCI China	0.7	-3.5	4.0
MSCI Brazil	3.2	-1.7	0.1
MSCI AC World	**1.7**	**12.0**	**19.4**
Energy	2.5	5.9	6.9
Materials	1.3	-4.0	0.4
Industrials	1.2	11.7	19.5
Cons Discr	1.6	16.4	24.5
Cons Staples	1.1	17.0	25.0
Healthcare	0.2	20.6	32.6
Financials	1.8	14.2	30.5
Technology	3.6	8.4	7.4
Telecom Svc	0.7	12.8	19.9
Utilities	1.2	14.1	17.2
Value	1.5	12.5	21.8
Growth	1.8	11.6	17.1

Fund flows ($bn)	**w/e 24Apr**	**w/e 17Apr**	**4 wk ma**
Equity	1.3	2.6	1.7
Fixed income	5.8	1.5	3.9
Money market	-1.8	-27.6	-8.9

	Level	Change (bps)		
Bond spreads	**3 May**	**Week ago**	**YTD/YE**	**Year ago**
Global IG	136	-3	-12	-67
EMBI+ (USD)	264	-20	16	-54
Global High Yld	431	-25	-71	-158
Bond yields (10 yr)				
UK	1.72	5	-9	-31
Germany	1.24	4	-7	-37
USA	1.74	8	-2	-19
Japan	0.56	-3	-24	-33
EMD* (local fx)	5.22	-5	-23	-103
Commodities		Change (%)		
Brent $/bbl	104	1.0	-6.2	-10.2
Gold $/oz	1,469	-0.2	-11.4	-10.3
Copper $/lb	3.31	4.1	-9.5	-11.8
Currency		Level		
$ per €	1.31	1.30	1.32	1.32
£ per €	0.84	0.84	0.81	0.81
$ per £	1.56	1.55	1.63	1.62
¥ per €	130	127	114	106
¥ per $	99	98	86	80
CHF per €	1.23	1.23	1.21	1.20
Volatility (%)				
VIX	13	14	18	18

Macro	**GDP (%)†**	**CPI (%)**
Eurozone	-2.3	1.2
UK	1.2	2.8
US	2.5	1.5
Japan	0.2	-0.9
China	6.6	2.1

Valuation	**Fwd P/E**
MSCI Europe	12.3
FTSE 100	11.7
S&P 500	14.0
MSCI EM	10.5
MSCI World	13.7

Note: All index returns are total returns in local currency. Fund flows are for US-domiciled funds only, excluding ETFs. *Term = index duration. †GDP q/q seasonally adjusted annual rate. Data sources listed on page 4.

J.P.Morgan Asset Management

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- **Sustainable and/or high dividend stocks continue to lead US equity markets higher, as the S&P 500 tops 1,600**
- **Better performance from growth sectors, however, will be required to sustain the rally**
- **The premium for dividend income is lower in Europe; alongside a rotation towards peripheral markets, this highlights a good opportunity**

The land of opportunity

The oxymoronic "defensive rally" that has pushed the S&P 500 to all time highs continues. Investors' desire for not just high but sustainable dividend yields has boosted sectors which traditionally lag when equity markets are rising. The focus on sustainability explains why the correlation between dividend yield and return is not stronger. Figure 1 shows that dividend yielding sectors have generally produced larger gains, but with exceptions. In the first quarter, health care, with a below average dividend yield of 2.2%, was the top performer.

The market has picked up a slightly more cyclical tone recently despite lingering worries about an economic summer slump. Financials and consumer discretionary have done comparatively well, but IT, for example, was just the seventh best performing sector in April. While it is perhaps encouraging to investors to see the S&P 500 above 1,600, the sustainability of the rally will ultimately depend on better performance from growth sectors.

The defensive phenomenon has driven valuations of high dividend yielding sectors to comparatively high levels, as we have discussed previously. But this valuation stretch is more notable in the US than elsewhere. In emerging markets, the forward PE for the MSCI High Dividend Yield index is actually trading at a greater than average discount to the broader emerging markets index. Europe, on the other hand, is trading at a premium like this US is, but the premium is not as large. Figure 2 shows the valuation of high dividend yielding stocks versus the rest of the market relative to long run averages.

(*continued on next page)*

Figure 1: S&P 500 sector monthly total returns and dividend yields

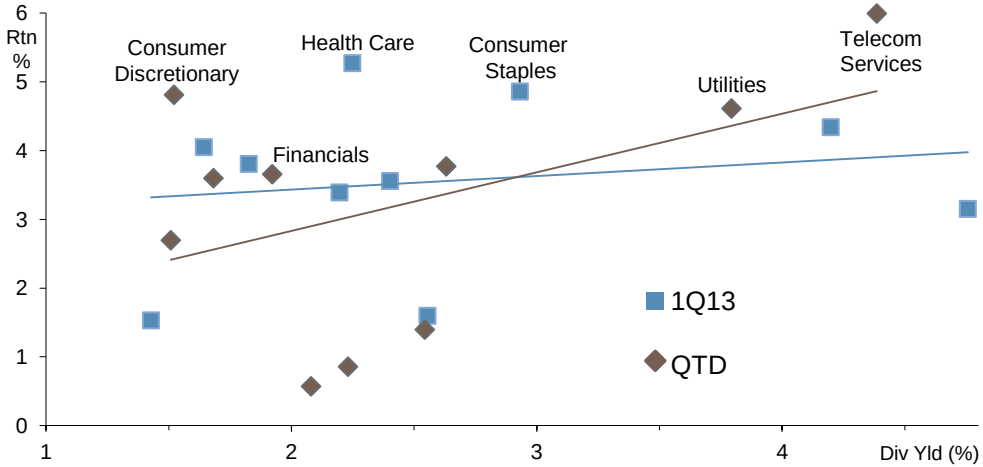
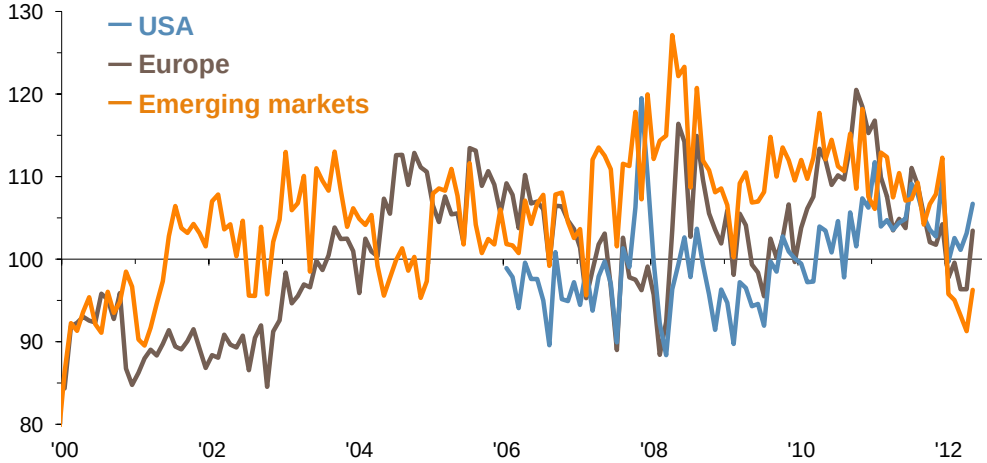


Figure 2: Relative valuation of high dividend yield indices vs standard*



Last data 3 May 2013 (figure 1), April 2013 (figure 2). *Forward PE ratio of MSCI high dividend yield index vs standard MSCI index, relative to long-run average. Source: MSCI, J.P. Morgan Asset Management.

J.P.Morgan Asset Management

One factor influencing the performance of stocks in Europe is the perceived country risk. A high dividend yielding stock in Spain is likely to perform differently than a stock with an equivalent yield in Germany. To understand the behaviour of the European indices, it helps to view returns through both a yield prism as well as a country risk prism.

In the first quarter of this year, when the US market gained 10%, Europe advanced just over six percent, even though the higher dividend yield on the European index (3.7% vs 2.2%), should have made it more attractive. Separating country risk (measured by 10-year government bond yields) from dividend yield and plotting the returns helps explain why (see Figure 3). You can see that generally the highest returns were associated with countries with comparatively low country risk — the largest green bubbles are clustered towards the left of the chart. The relationship between return and dividend yield is much weaker, otherwise the green bubbles would be clustered towards the top.

The nature of the returns in European markets has changed, however, over the last month, and this represents part of the opportunity in European equities relative to those in the US. The same bubble chart for the current quarter-to-date (Figure 4) shows that the better returns were more strongly associated with higher country risk, and also to higher yields. If this is evidence of a rotation from core towards periphery equity markets, mirroring the falls we have seen in peripheral government bond yields, there is room for significant outperformance. Valuations for several of the peripheral markets are better than average (Italy and Spain in particular). Dividend yields generally higher. Combined with the smaller dividend income premium versus the US, a peripheral yield strategy could “pay dividends” in the months ahead.

Dan Morris
Global Market Strategist

Figure 3: Europe country returns, 1q 2013
Bubble indicates size of return (green if positive, red if negative)

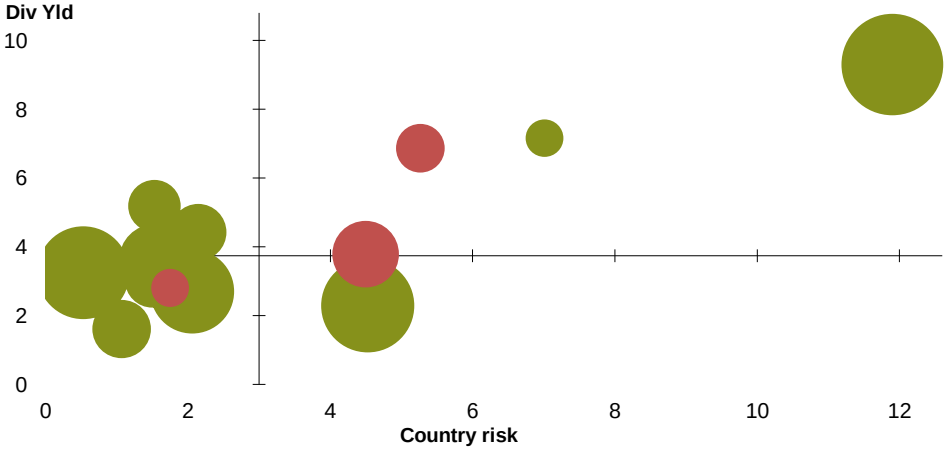
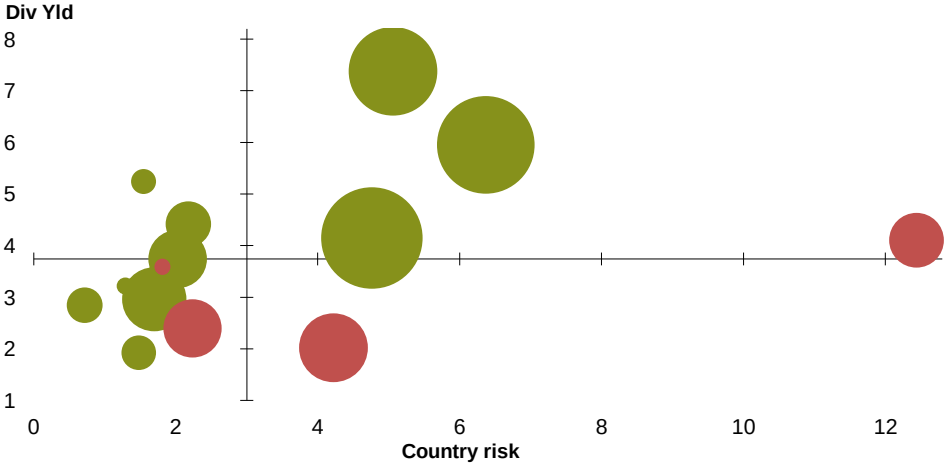


Figure 4: Europe country returns, quarter-to-date



Last data 3 May 2013. Note: Country risk based on 10-year government bond yields. Source: MSCI, Bloomberg, J.P. Morgan Asset Management.

.**The Market Insights programme provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the programme explores the implications of current economic data and changing market conditions.**

Unless otherwise stated, all data is as of 3/05/2013.

Economic releases: Bloomberg.

Equities: All data represents total returns for the stated period.

Fund flows: ICI.

Bond Yields: JPMorgan EMBI+ OAS over Treasuries ; Barclays Global Aggregate Corporate OAS; Barclays Global High Yield OAS; Government bond yields: Source: Tullett Prebon Inflormation, UK Government Bonds 10 Year Note Generic Bid Yield; German Government Bonds 10 Year Debencher; Japan 10 Year Bond Benchmark; US Generic Government 10 Year Yield.

Commodities: WTI and Brent are the crude oil price in $ per barrel, gold is $ per troy ounce, copper is $ per pound.

Rates: Bank of England Official Bank Rate; ECB Minimum Bid Refinancing Rate 1 Week; Federal Funds Target Rate; Bank of Japan Target Rate of Unsecured Overnight Call Rate; Bank of China 1 Year Best Lending Rate.

Macro: Headline CPI year on year percentage change; GDP growth quarter on quarter seasonally adjusted annualised rate.