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Market Comments

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After many months of strong performance, global equity markets exhibited broad-based weakness in January with the MSCI World and Emerging Markets indices falling by 4.1% and 5.6% respectively. Three developments in particular appeared to trigger the pullback: (1) the beginning of monetary tightening by China accompanied by official expressions of concern about potential economic overheating and speculative excess, (2) growing concerns about fiscal sustainability in some European nations triggered by the revelation that the 2009 fiscal deficit in Greece likely reached 12.7% of GDP compared to an earlier estimate of 6% of GDP, and (3) growing concerns about populist drift in the Obama administration's economic policies as banks have become political targets at the same time that health care reform efforts have met increased political resistance.

None of these developments seems sufficient to derail the global economic recovery that is clearly underway. J.P. Morgan's economic research team estimates that global GDP rose at a 3.7% annual rate in the fourth quarter of 2009, with a broad-based recovery in manufacturing output leading the way. That said, the pace and breadth of the recovery remains uneven, with emerging Asia and the U.S. posting strong numbers while economic activity in Europe and Japan remains more muted. China continues to lead the way in Asia, with year-on-year growth in the fourth quarter approaching 9% in response to massive fiscal and monetary stimulus put in place in early 2009. In the U.S., while unemployment remains stubbornly high at around 10%, growth in the fourth quarter accelerated to an annual rate of 5.7%. The combination of rapidly recovering output growth with minimal growth in labor input reflects booming productivity growth and a rapid recovery in corporate profit margins. Those trends augur well for an eventual recovery in U.S. employment growth in 2010.

The uneven pace of the global recovery suggests that economic policies may begin to diverge substantially in 2010 as various nations pursue different exit strategies from the hyper-active stimulus measures that were put in place in 2009 in response to the global financial crisis. China, for example, is now clearly beginning to worry more about inflation than growth, with consumer prices in China rising at an annual rate of nearly 5% in the fourth quarter at a time when export volumes appear to have risen at a 40% annual rate. In response, authorities have raised reserve requirements for banks and have started to rein in excess liquidity while

placing greater restrictions and oversight on speculative lending activity. It is now widely anticipated that Chinese authorities will let the yuan begin to appreciate again by the middle of the year as they continue moving toward more traditional monetary tightening activity. In addition, other emerging market nations that have experienced strong recoveries, like Brazil, are widely expected to begin monetary tightening measures in coming weeks as well.

In contrast, somewhat disappointing economic data from Europe and Japan in recent months make it clear that monetary policy in those areas will need to remain easy for many quarters to come. And while the Fed has made it clear that it is in no hurry to raise interest rates, the U.S. dollar appears to have gained some support in recent weeks from the developing perception that the U.S. will be in a position to begin normalizing monetary policy well ahead of central banks in Europe and Japan. Mounting expectations that China will let the yuan appreciate may also be providing support to the U.S. dollar by pointing toward another channel for curbing the U.S. current account deficit other than further dollar weakness against developed nations' currencies.

In short, the policy environment has changed significantly from a year ago, when it was clear that virtually every major government in the world would embrace aggressive policy measures to restore growth in response to the global financial crisis. In our view, it remains clear that policymakers in the developed nations remain focused on supporting growth, while it has become time for authorities in some key emerging market nations to begin tapping gently on the monetary brakes. Overall, we continue to believe that the world economy has entered a phase of self-sustaining economic expansion that should remain positive for equity markets despite recent jitters.

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