

Equity Strategy Alert

Risk Reward improved - adding to stocks

- We have reached a point over the past few days where financial markets started to create their own economic outcomes, rather than serve as a discounting mechanism. The feedback loop seems to have taken on a life of its own.
- It seems to us that equity desks were probably selling bank names because the "CDS spreads were blowing out", while on the credit side they were probably selling because "stocks were plunging". We see parallels with 1987 when it was the portfolio insurance that was causing a vicious spiral.
- What could be the circuit breakers? Obviously the measure regarding the suspension of short selling will have a knee-jerk positive effect. But, by far the strongest support, in our view, is the pending creation of a "Resolution trust corporation" type entity. This would go a long way towards restoring liquidity and allowing the markets to function in a more orderly way. Following the creation of Resolution Trust Corporation in '89, despite 90-91 US recession, S&P500 was up 35% over the 2 year period.



European Equity Strategy

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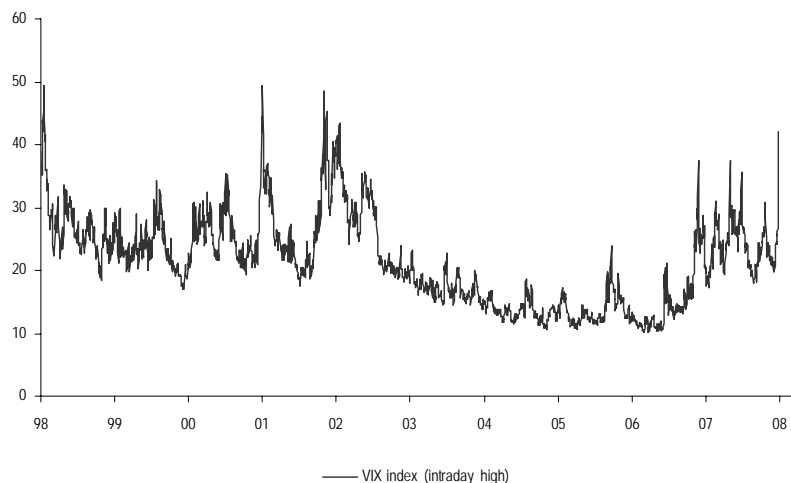
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Figure 1: "Fear gauge" VIX the highest in 6 years



Source: Datastream

- Vix has yesterday spiked to 42 intraday, the highest in 6 years, just shy of level in 2002 which marked the last bear trough. This is just

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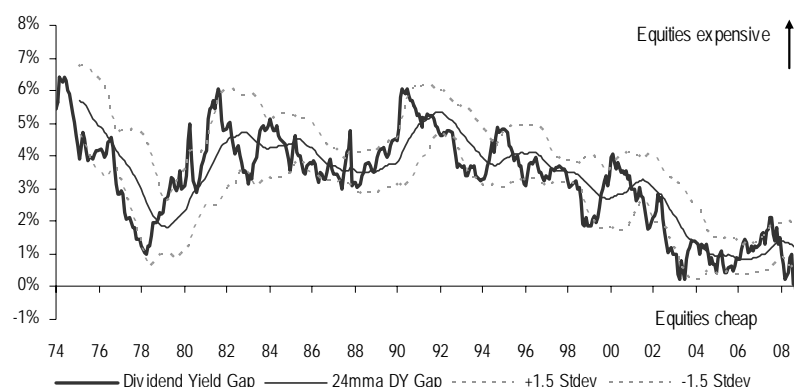
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one of the indicators pointing to market being oversold.

- On fundamentals, for what it is worth, we still expect Q3 reporting season to be very poor (see our report “[Earnings weakness to broaden](#)” dated 29th August), but we recognize that the market is not priced for perfection as well.

Figure 2: The dividend yield on equities above bond yield for the first time in at least 35 years



Source: Datastream

- Indeed, as we highlighted on Monday (see “[Short term pain for a long term Gain](#)”), the Eurostoxx 50 trailing dividend yield (5.2%) has spiked above 10 year bund yield (4.0%), for the first time in at least 35 years. Removing Financials from the basket, the dividend yield is still above govt bond yield. For FTSE100, DY is at 4.7%, vs Gilts at 4.4%.

Table 1: %age change needed to move back to market levels from last month

MSCI Europe sectors	Top sectors
Hardware	22.8%
Diversified Financials	21.7%
Materials	20.9%
Capital Goods	16.6%
Banks	16.3%
Energy	14.2%
Insurance	13.7%
Utilities	13.2%
Semiconductors	12.8%
Consumer Durables	11.9%
MSCI Europe	11.9%

Source: Datastream

- We think Risk Reward for equities is improving and are adding 5% to equities in asset allocation, funding this by removing 5% from government bonds. **We are now OW stocks and UW both cash and bonds.** Naturally, the parts of the market which suffered the most over the past weeks are likely to receive the most near term support.

Table 2: JPM Recommended asset allocation

	Benchmark weighting	Allocation	Deviation	Recommendation
Equities	60%	70%	10%	Overweight
Bonds	30%	25%	-5%	Underweight
Cash	10%	5%	-5%	Underweight
	100%	100%	0%	Balanced

Source: Datastream

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