

# Fright prompts flight

## Growth up+ risk down+ defensives in = another opportunity

The July FMS shows how a modest correction in equity markets together with a larger one in commodity prices punctured investor confidence and prompted a hasty retreat back toward defensive sectors. This nervous response came despite growing conviction that we are through the worst of the economic problems and still rock-solid faith in the GEM story. It does suggest that any surprise in Q2 results could see markets being squeezed upward into H2.

## Past-the-worst conviction rises; inflation scare eases

Investors are convinced that global growth will improve (+79% vs. 78% in June) and that this will lift corporate margins & profits (a net 51% see improvement over the next 12 months). However, a downtick in risk appetite saw a very skittish retreat back into defensive areas. That is, apart from GEM assets, which remain famously popular; and this despite China optimism coming off the boil, only to be replaced by Indonesia - now the most O/W GEM. Meanwhile, inflation fears eased as commodity & oil prices tumbled (a net 14% now see higher inflation, down from 19%) and this stabilised views on how quickly interest rate are likely to rise.

## Asset allocators skittish as risk appetite falters

Asset allocators are in wait-and-see mode as overweights in cash (+9%) and equity (+7%) were trimmed, with bond U/W easing to -13% from -15%. Risk appetite fell, with our composite indicator standing at 36 from 38. Average cash balances saw a very sharp jump to 4.7% (vs. 4.2%), with only 12% of investors now reporting higher-than-normal risk-taking in portfolios. Hedge funds are more active, with leverage rising to 1.2, but net long exposure fell to 23% (from 35%).

## Equities good value, but it's GEM vs. the Rest of the World

Equities are viewed as undervalued by a net 8% of investors, while a net 30% say bonds are expensive (up from 22% in June). But it's not about value: a net 8% of respondents view GEM as overvalued and yet it is still seen as the only game in town, with nearly **half** of all investors saying it is the region they want to O/W on a 12-month view (vs. -30% for Eurozone, the lowest reading ever).

## Retreat to defensives provides chance to re-load

Having fleetingly been U/W all big 4 defensive sectors last month, investors turned on a sixpence in July with telecom, pharma and staples all recovering strongly, at the expense of materials, energy and industrials. The degree of optimism on EM vs. Eurozone looks dangerously extreme and, more broadly, the retreat to the defensive positioning of February, in our view, provides another opportunity to reload on cyclical over defensives trades on the expectation of confirmation of real economic growth emerging across all regions from Q3.

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Refer to important disclosures on page 18 to 20.

Investment Strategy | Global  
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## Notes on the Survey

Survey period 2<sup>nd</sup>-9<sup>th</sup> July. A total of 221 investors with \$635bn AUM responded to the global FMS questions.

Only participants in the survey can receive the full data, but only for the relevant month in which they participate.

Investors/clients are encouraged to sign up to participate in the Survey. This can be done by contacting Gary Baker, Michael Hartnett or your Merrill Lynch sales representative.

## Notes to Readers

Source for all tables and charts:  
Merrill Lynch Fund Manager Survey,  
Datastream.

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## Survey sound bites

The fieldwork for the July survey took place between Thursday 2<sup>nd</sup> and Thursday 9<sup>th</sup> July 2009.

Table 1: Markets between fieldwork periods

	2 <sup>nd</sup> – 9 <sup>th</sup>	5 <sup>th</sup> – 11 <sup>th</sup>	8 <sup>th</sup> – 14 <sup>th</sup>
% change in	Jul	Jun	May
World Equities	-4.9	5.7	11.4
Dow Jones	-6.0	4.1	6.3
US 10y Bond (bps)	-11.3	22.5	10.3
Commodities (CRB)	-6.8	4.8	7.3
Crude Oil-WTI	-9.8	20.2	14.4
Trade Weighted Dollar	0.2	-2.5	-3.4
CBOE VIX (level)	29	29	32

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### Growth expectations

Fund manager optimism on global economic prospects continues to move higher, with our growth composite indicator reaching 79, up marginally on June and the highest level since February 2004. This was achieved despite the first reversal in China economic optimism since last October, as the % of regional PMs expecting stronger China growth fell to 56% from 62% last month, but failed to diminish enthusiasm for GEM generally.

Economic optimism is raising expectations of corporate profitability in both margins and earnings. More than half of all investors now expect corporate profits to rise in the coming 12 months, with only net 3% now expecting margins to fall (compared to >50% only 4 months ago). And yet a net 38% still see consensus forecasts as too high, which somewhat flies in the face of recent trends in earnings revision ratios.

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As commodity and oil prices fell, so too did inflation worries. A net 14% now see higher inflation in the coming 12 months, down from +19% in June. Alongside this move down, views on monetary policy and interest rate rises also moderated, with less than half of respondents now expecting higher short-term rates.

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### Risk appetite

The stubborn refusal of investors to loosen the bounds on risk appetite in line with rising economic confidence was once again illustrated, as our Risk & Liquidity indicator actually fell to 36 from 38 last month. Investor time horizons remained subdued and average cash holdings rose sharply to 4.7% from 4.2% last month, although the proportion overweight cash against benchmark remained at +21%.

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Hedge funds continued to raise participation levels, with the ratio of gross assets to capital rising to 1.2x, the highest in 11 months. However, with net long exposure falling to net 23%, it perhaps suggests short opportunities were proving popular, helped by liquidity conditions in markets still being viewed favourably (net 3% positive).

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### Valuation & Asset Allocation

Having moved overweight equities in June, asset allocators chose not to get too carried away and trimmed the O/W to +7% from +9%, while raising bonds to 13% underweight (from -15%) and cutting cash to 9% OW. The biggest loser on the month was commodities, where the net O/W fell to +8% from +19% in June.

Pages 13 & 14

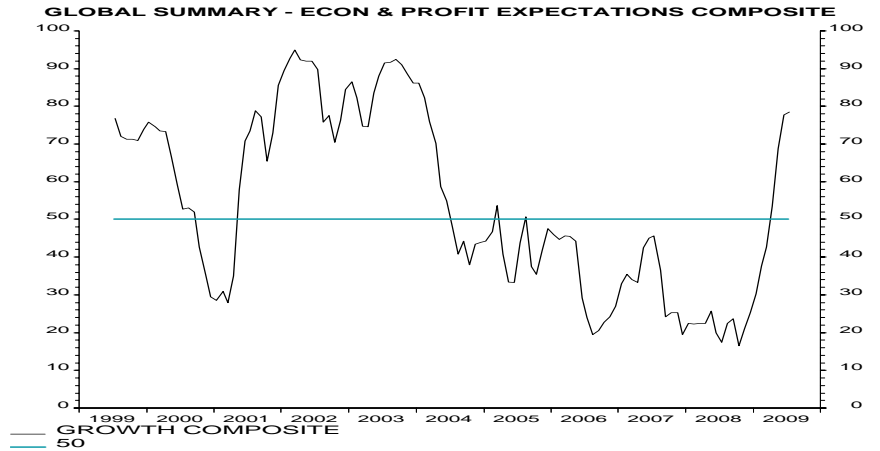
Regional preferences saw no change in the popularity of Emerging Markets, where a net 54% of investors are overweight (2<sup>nd</sup> highest reading ever). However, investors seemingly lost patience with the US, as a net 10% are now underweight (the first U/W in the US since May 2008). The Eurozone is the least popular region with asset allocators (-23%), followed by the UK (-17%) and Japan, which did see some closing of its U/W to -9% from 23% in June.

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The pull-back in oil price has only marginally shifted views, with a net +9% still seeing it as overvalued, compared to +11% in June.

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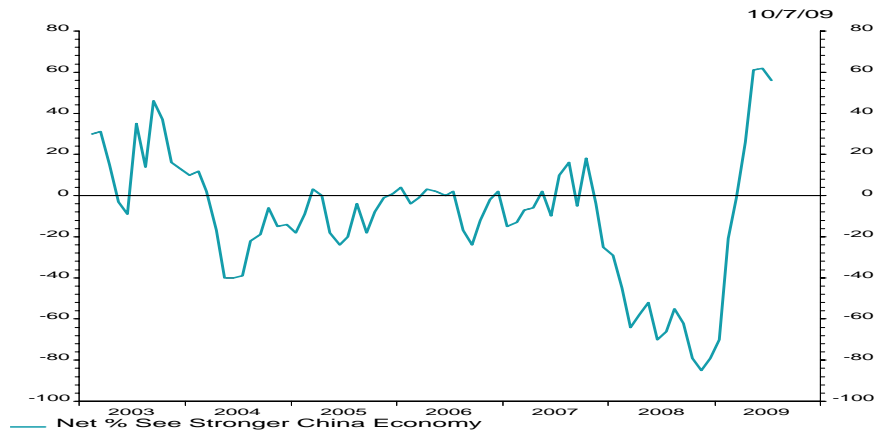
Chart 1: Growth Expectations Composite – Global FMS



No change in the degree of optimism on global growth outlook, which at 79 represents another 6-year high.

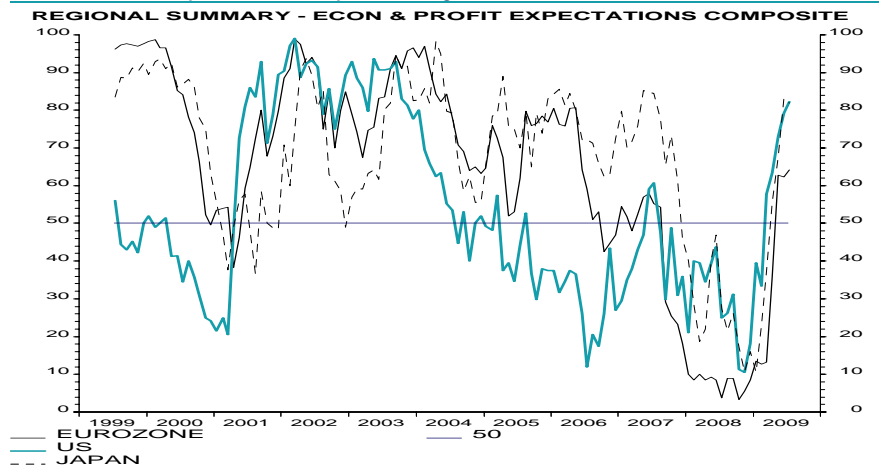
The composite growth indicator combines the outlook for economic activity with the expectations for corporate profit growth.

Chart 2: Net % of regional FMs expecting stronger Chinese economy



Interestingly, global growth optimism survived a small tick down in confidence on China, with a net 56% of regional PMs now expecting better economic prospects 12 months out, down from 62% last month.

Chart 3: Growth Expectations Composite – Regional FMS



Fund managers in all regions are optimistic on the economic growth outlook, but the level of conviction in Europe still lags behind the other regions.  
Japan (82 from 83)  
Eurozone (64 from 62)  
US (82 from 79)

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Chart 4: Fund Managers' Growth Expectations & OECD Leading Indicator

The upward pull on G7 indicators continues, as the FMS expectations lead indicator shows no signs of retreat

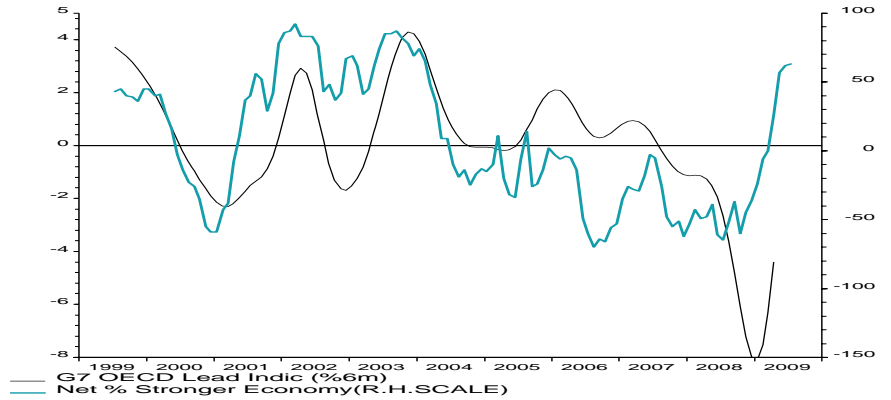


Chart 5: Profit expectations

Corporate profit expectations continue to edge higher, having staged a remarkable recovery over the past 6 months. July's reading moved up to 51% (from 49% last month).

40% of fund managers now believe global corporate earnings can rise by >10% over the coming 12 months.

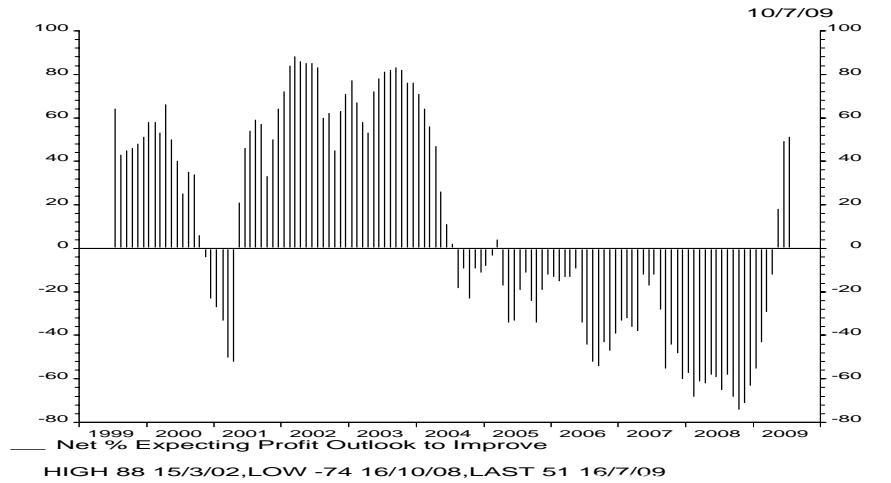
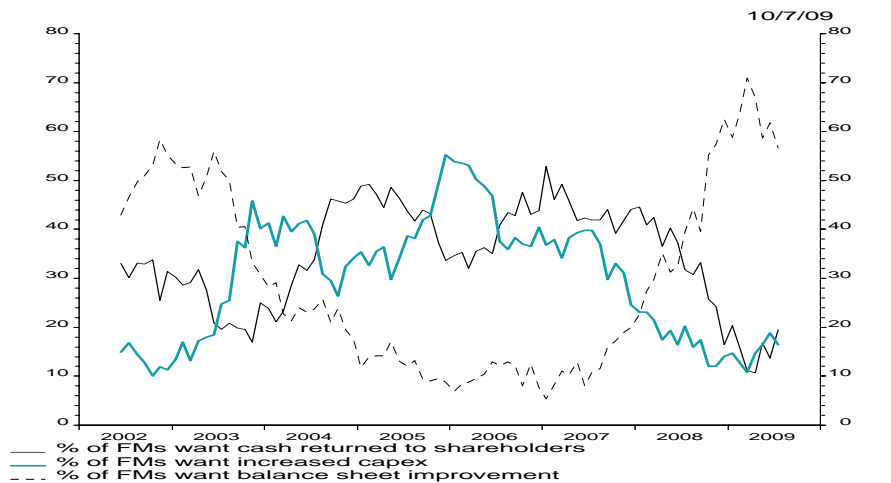


Chart 6: What would you most like to see companies doing with cash flow?

A tick up in views that cash should be returned to shareholders (20% vs. 14%) did not change the overall message of continuing balance sheet repair.



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Chart 7: Phases of the Global Economic Cycle, In Degrees\*

To track how managers view progress through the economic cycle, we've expressed their responses as if positioned on a circle. We have positioned "recession" at 360°, "early cycle" at 450°, "mid-cycle" at 180° and "late cycle" at 270° and calculated an overall position from those four locations.

A marginal move back on the *clock face* was perversely due to some investors now seeing the global economy in mid-cycle?

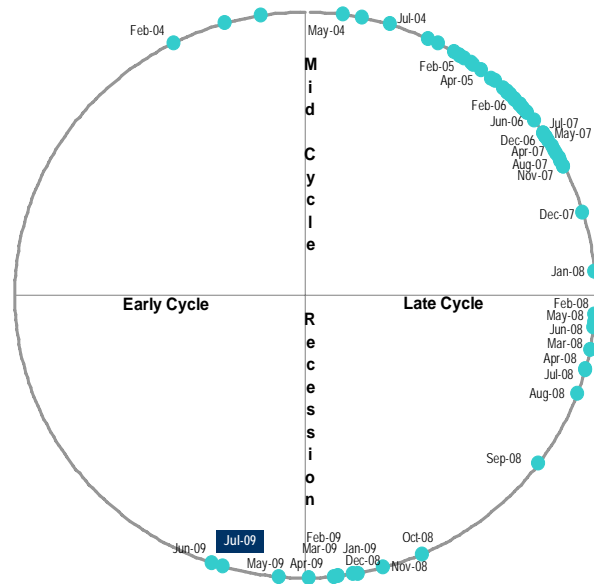
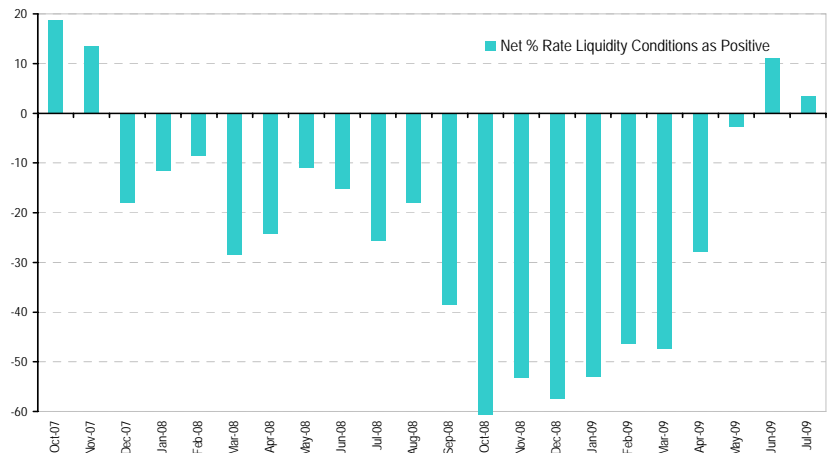


Chart 8: How would you rate liquidity conditions (e.g., depth of markets, narrowness of bid-offer spreads, ease of execution etc) at this time?

Chart 8 continues to show that markets are back to normal functioning in terms of liquidity conditions as measured by depth of markets, narrowness of bid/offer spreads etc. This could have encouraged the greater activity rates reported amongst hedge funds in their employment of gross leverage.



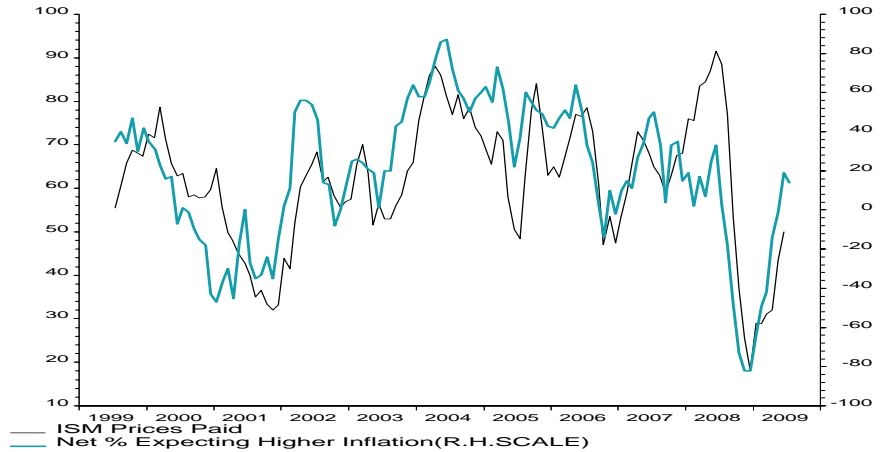
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## Inflation and interest rates

The rate of increase in inflation fears looks to have topped out this month, taking rate expectations down with it.

The inflation outlook for the next 12 months eased back (+15% versus +19%) as commodity and oil prices staged a retreat. This indicator continues to be a pretty good pointer for ISM prices paid component.

Chart 9: Inflation expectations and ISM 'Prices Paid'



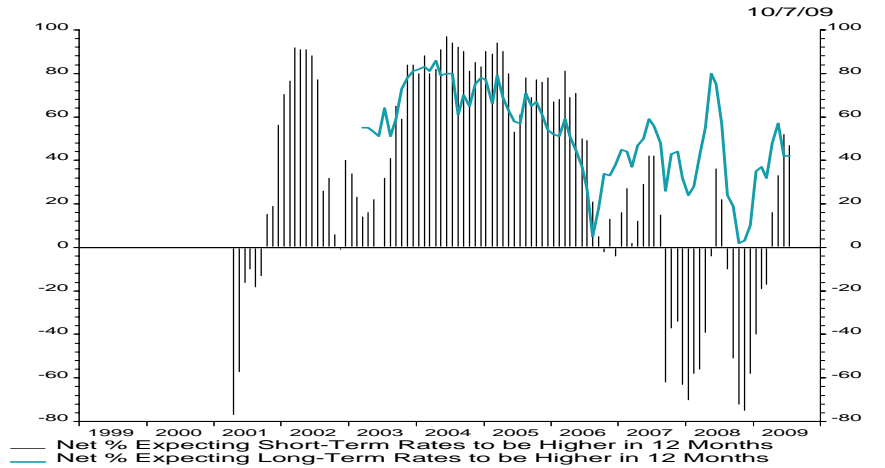
The spike in rates seen in May seems a somewhat distant concern, as views on likely short-term rate hikes over the coming 12 months abated.

+47% see short-term rates going higher over the next 12 months time, down from +52% in June.

Expectations on long-term rates were steady at +42%.

This tallies well with views on the steepness of the yield curve (chart not shown), where respondents essentially expect no change, with only a net 7% expecting a flatter curve 12 months out.

Chart 10: Expectations for long- and short-term interest rates



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# Risk Appetite

Chart 11: The ML Risk & Liquidity Composite Indicator

Chart 11 presents an overall view of Risk & Liquidity, combining readings on risk appetite, investor time horizon and cash weightings.

However much investors believe we are through the worst economically, risk appetite remains firmly controlled; indeed, it has fallen back to 36 from 38 over the last 2 months. It still stands below the average of 40 seen since the indicator was introduced in 2002.

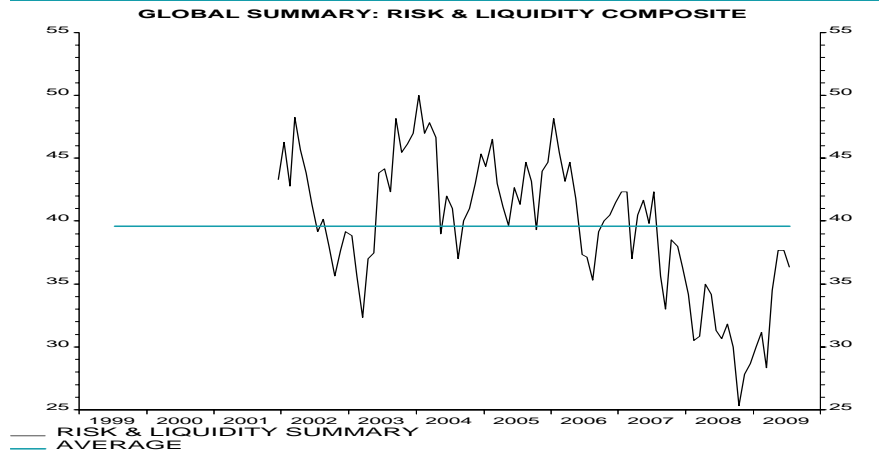


Chart 12: Hedge Fund positioning

Chart 12 poses two questions to hedge fund panellists: what is the current ratio of your gross assets relative to your capital, and what is your current net exposure to the equity market (long minus short as % of capital).

As indicated above, hedge funds were much more active this month, as gross exposure rose to 1.2x, the highest level in 11 months. However, interestingly, net exposure fell sharply to 23% from 35%, perhaps indicating greater short activity.

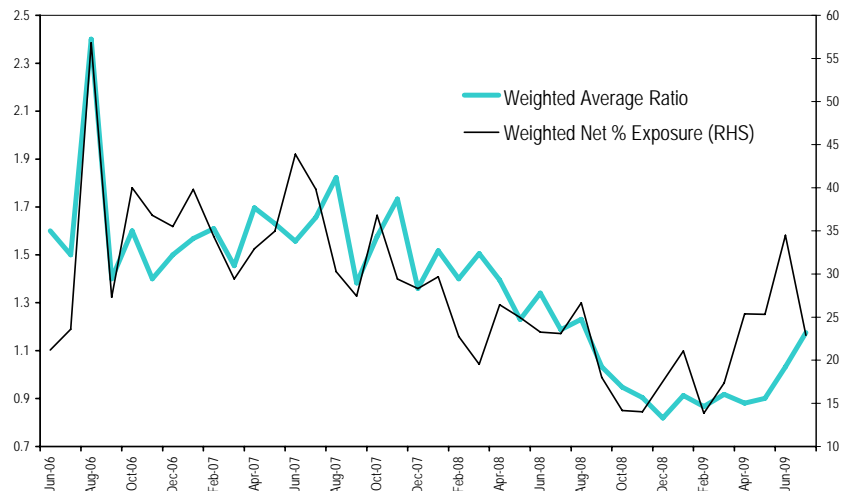
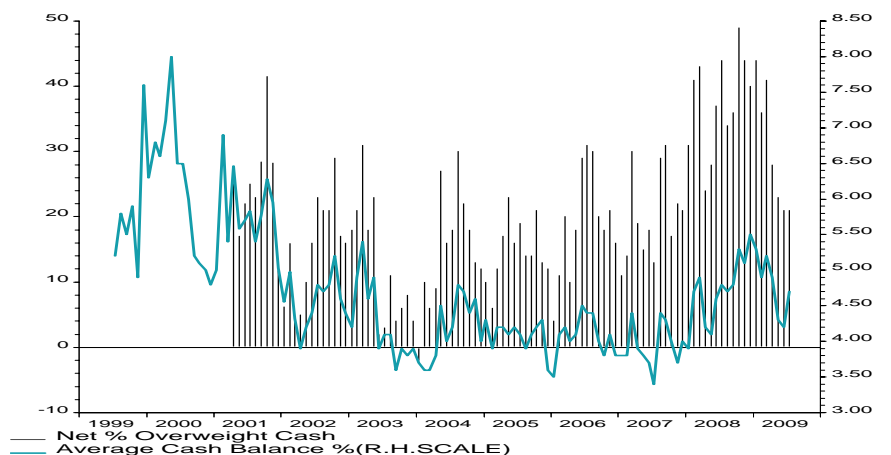


Chart 13: Net Overweight Cash and Mean Cash Balance

FMS questions on cash positions address both global investors and asset allocators.

At the global level, there was a very sharp increase in average cash positions to 4.7% (from 4.2%) and cash O/W remained relatively high at +21% (unchanged on June).

Asset allocators, however, continue to put cash to work, with net O/W falling to +9% from 12% in June and 21% in May



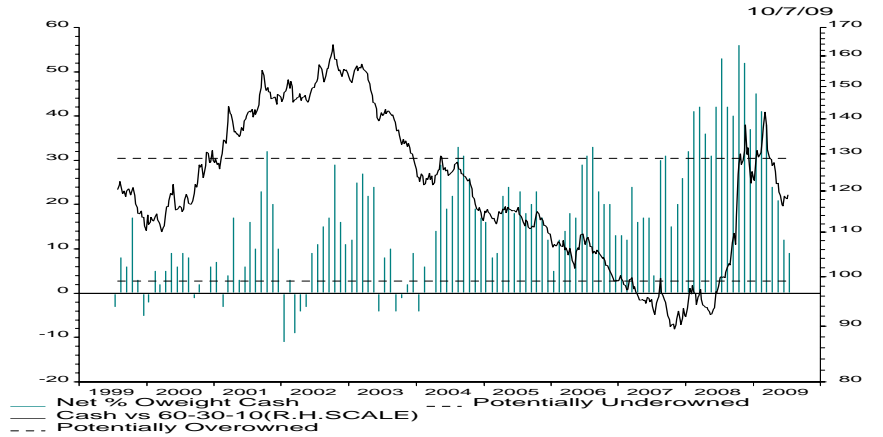
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## Asset allocation: current positions

Asset allocators finally moved overweight equities in June, but promptly trimmed positions in July, slightly raising bond weightings to -13 from -15% and also cutting cash (+9%). Commodities were the major casualty as the O/W was cut back to +8% (from +19%).

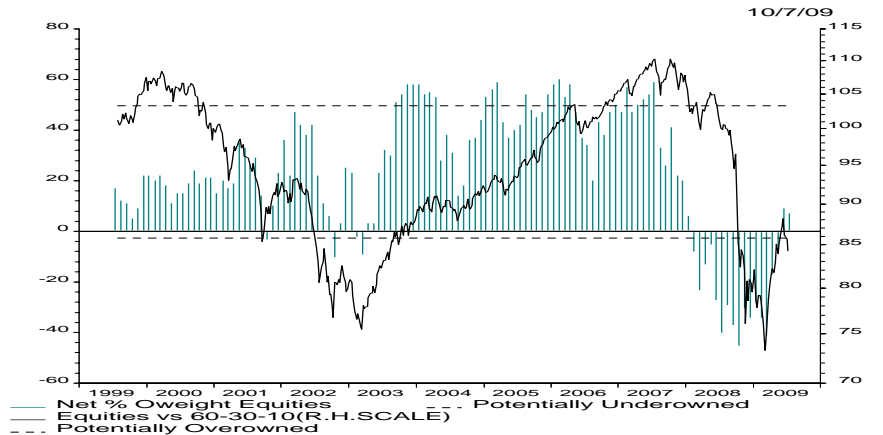
In charts 14-16, we plot the performance of each asset class relative to a synthetic asset allocation benchmark comprising: 60% global equities, 30% global bonds and 10% US cash. The base currency is USD.

Chart 14: Cash\*



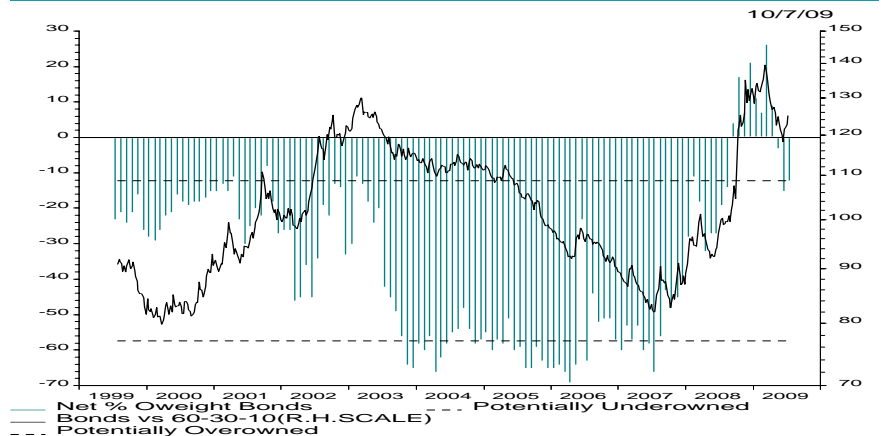
While still overweight equities at +9% (vs. +12%), conviction is hardly rousing...

Chart 15: Equities\*



... nor is it in bonds, where underweights were marginally trimmed to -13%.

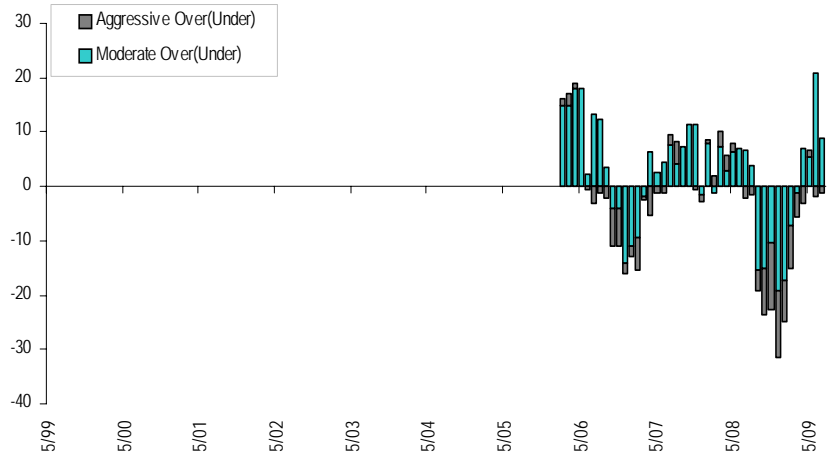
Chart 16: Bonds\*



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The thirst for commodities was quenched rather quickly as commodity prices tumbled, cutting the O/W to +8%.

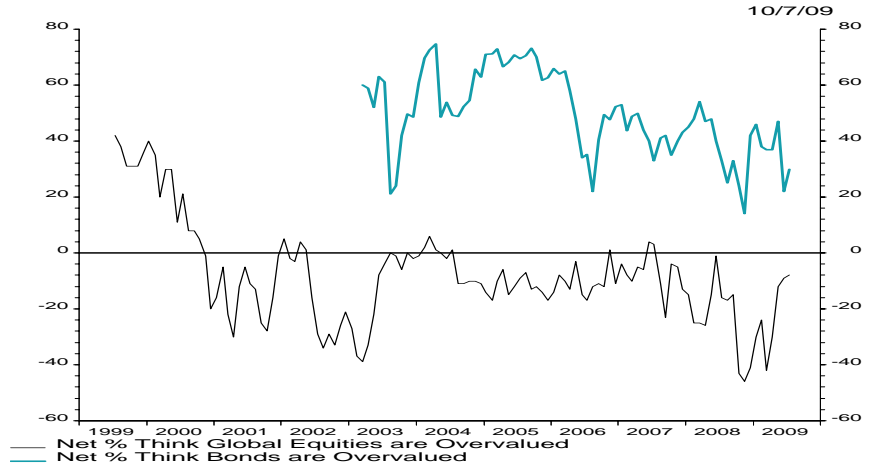
Chart 17: Commodities



## Relative Valuation

With confidence skittish in many areas, as ever equities are viewed as undervalued (8% vs. 9%) against expensive bonds (+30%).

Chart 18: Equity market valuation vs. bond market valuation



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## Global sectors

The brief experiment of investors being underweight all big 4 defensive sectors was quickly reversed, as telecoms, pharma and staples all saw major moves upward in sector positioning, so that utilities is now the only underweight defensive. This came at the expense of the commodity cyclicals of materials, energy and industrials, all of which fell back sharply.

Technology remains the stand-out sector in popularity, darling of all. Energy ranks #1 or #2 most-favoured sector in every regional survey.

Table 2: Changes in global sector positioning

	MoM Chg
Telecoms	17
Pharma	13
Staples	11
Tech	1
Utilities	0
Discretionary	-2
Insurance	-2
Banks	-7
Energy	-8
Industrials	-9
Materials	-14

Chart 19: Current Sector Positioning

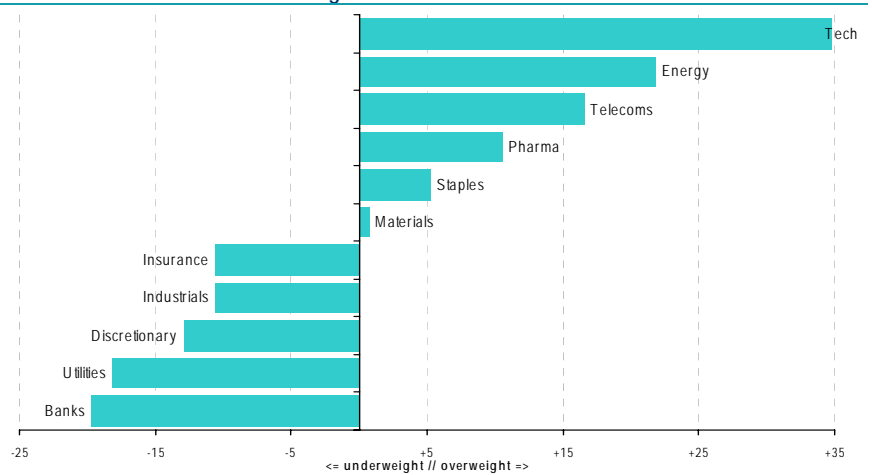
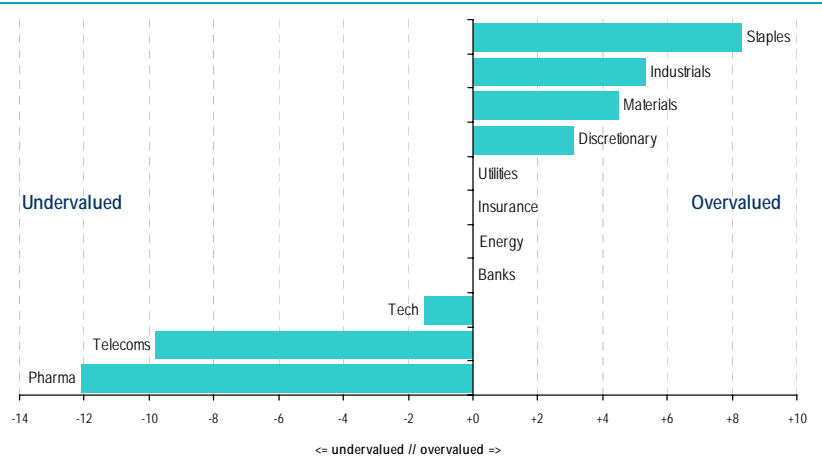


Table 3: Changes in global sector valuation

	MoM Chg
Insurance	8
Energy	5
Banks	2
Industrials	2
Materials	2
Discretionary	-1
Pharma	-3
Staples	-3
Tech	-4
Utilities	-4
Telecoms	-5

Chart 20: Sector Valuation Assessment



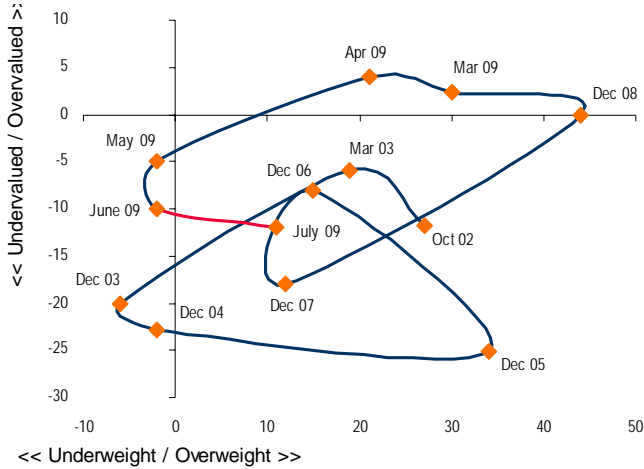
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## Sector changes through time

Charts 21-24 show a longer-term perspective on FMS sector positioning linked to our report [European Equity Strategy, 24 March 2009](#). They provide a map (or Rorschach picture for those so inclined) looking at movement in sector positioning/valuation over the course of the last market cycle.

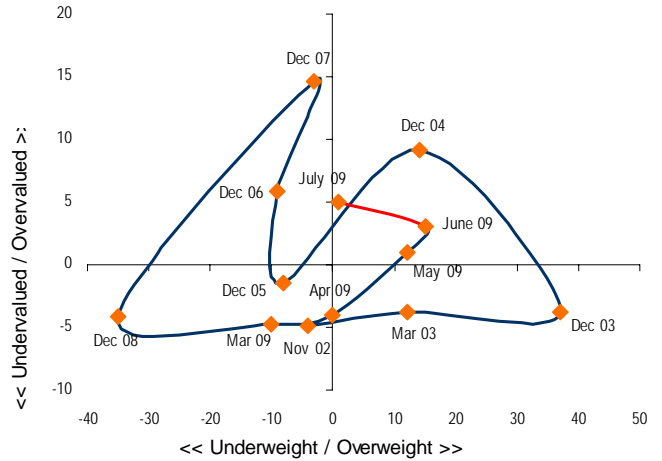
The charts highlight the sharp relative reversals seen between the defensive sectors of Telecom and Pharma vs. Industrials & Materials.

Chart 21: Sector Valuation vs. Positioning Trail – Global Pharma



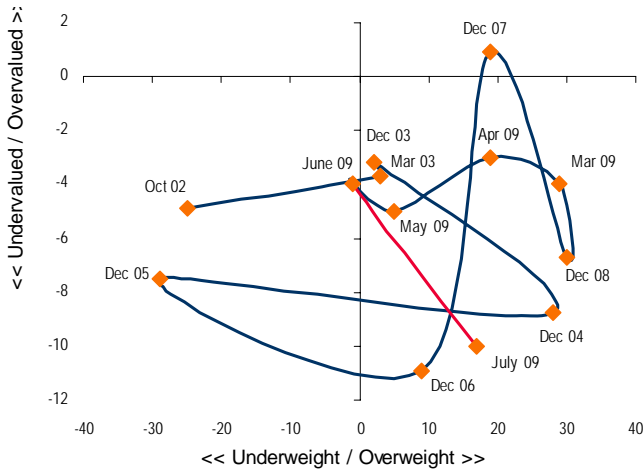
Source: Merrill Lynch Fund Manager Survey

Chart 22: Sector Valuation vs. Positioning Trail – Global Materials



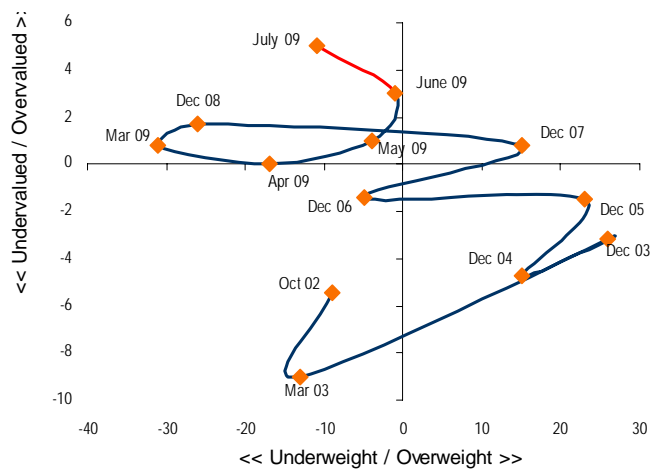
Source: Merrill Lynch Fund Manager Survey

Chart 23: Sector Valuation vs. Positioning Trail – Global Telecoms



Source: Merrill Lynch Fund Manager Survey

Chart 24: Sector Valuation vs. Positioning Trail – Global Industrials

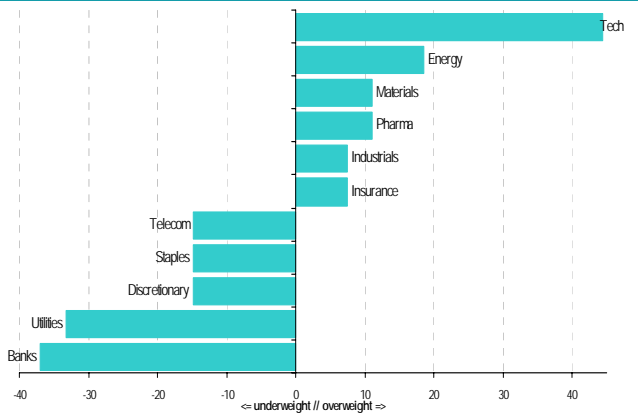


Source: Merrill Lynch Fund Manager Survey

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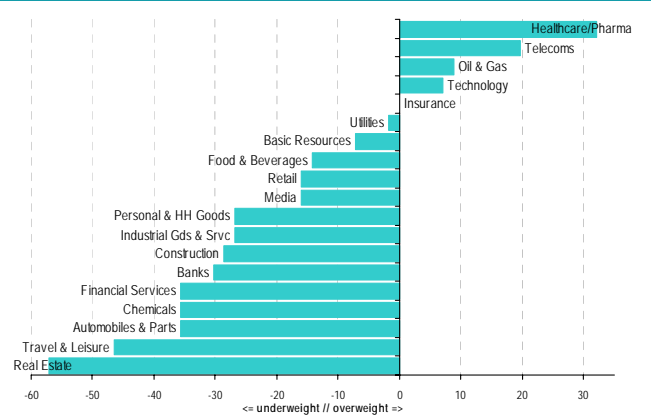
## Sector Positions - by Region

Chart 25: U.S.



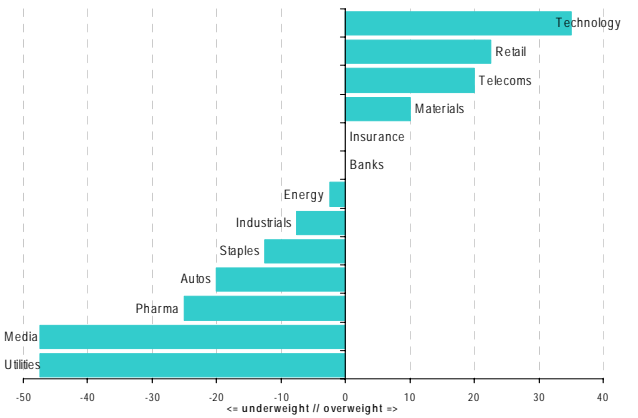
Source: Merrill Lynch Regional Fund Manager Survey

Chart 26: Europe



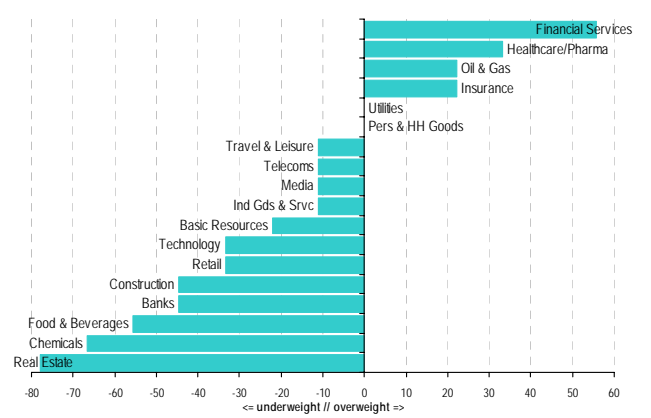
Source: Merrill Lynch Regional Fund Manager Survey

Chart 27: Japan



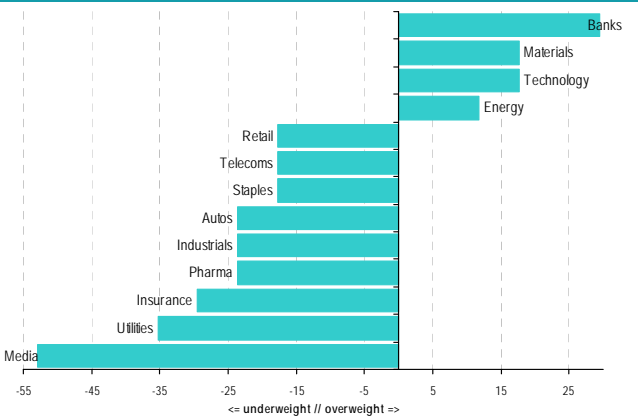
Source: Merrill Lynch Regional Fund Manager Survey

Chart 28: UK



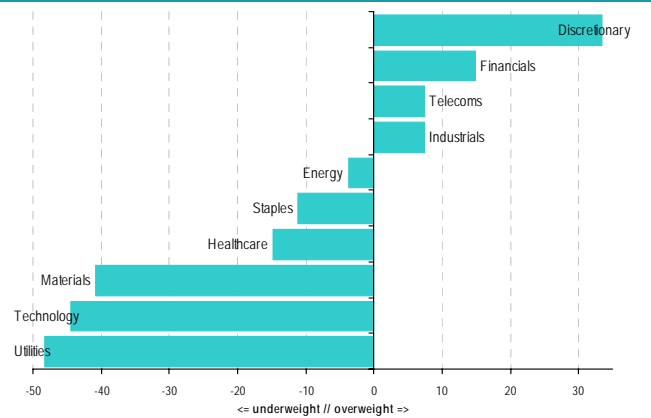
Source: Merrill Lynch Regional Fund Manager Survey

Chart 29: Pacific - ex Japan



Source: Merrill Lynch Regional Fund Manager Survey

Chart 30: GEM



Source: Merrill Lynch Regional Fund Manager Survey

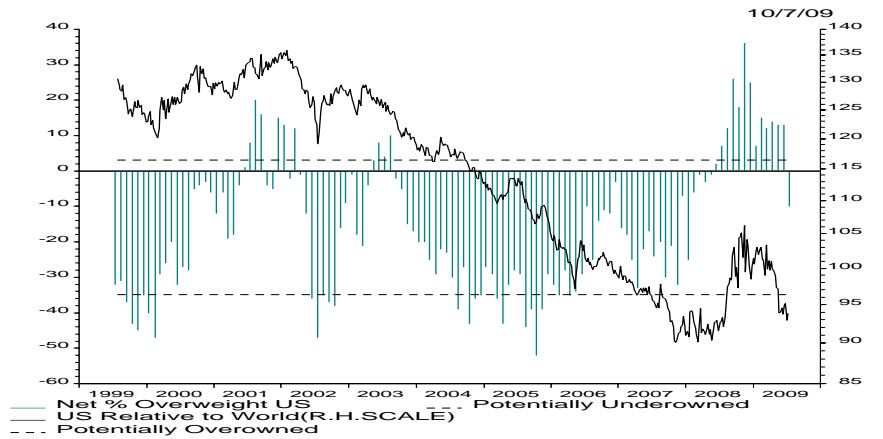
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## Equities: regional allocation

There was a shift in sector preferences this month, as investor patience with the US finally cracked and moved U/W for the first time in 14 months. This merely served to increase the spotlight on the GEM overweight, which continued to inch higher. The stark contrast is with the Eurozone, which asset allocators cut to -23%. More dramatically, a net 30% of regional fund managers see Europe as the region to underweight over the next 12 months- this is the lowest ever reading.

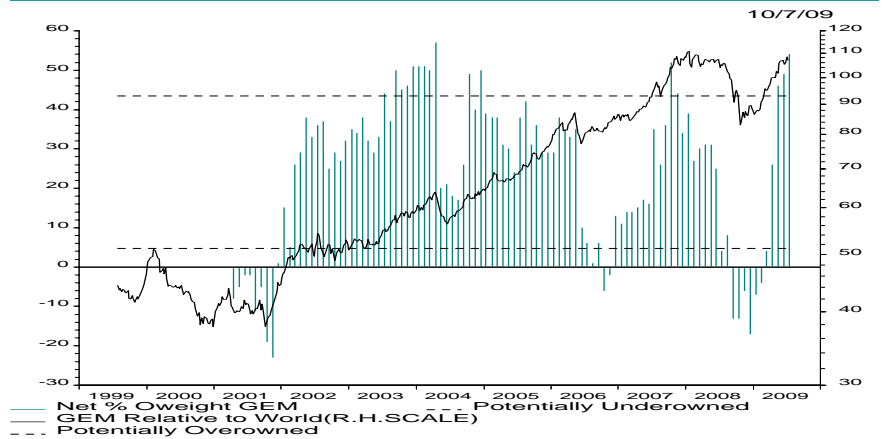
After stubborn resistance, PMs finally cut weights on the US to -10%, the first U/W in 14 months.

Chart 31: U.S. Equities



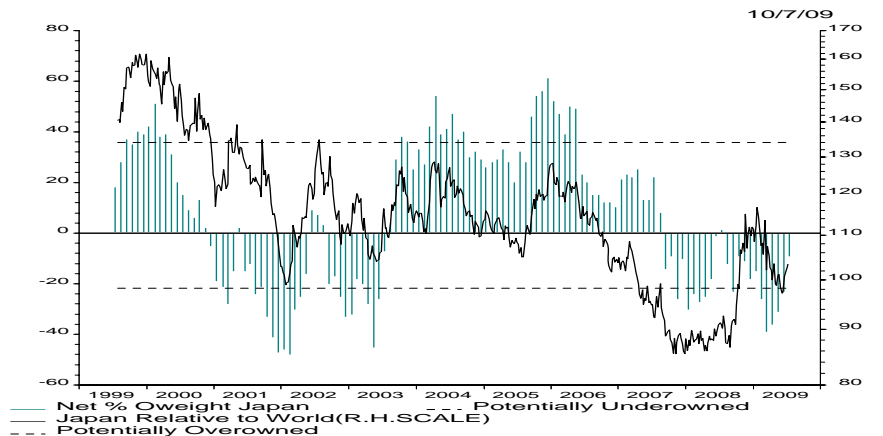
Strong performance from GEM continues to attract moths to the flame, with a net 54% of asset allocators now overweight.

Chart 32: Global Emerging Markets Equities



Japan's rehabilitation continues, with a net 9% underweight, the lowest reading for 9 months.

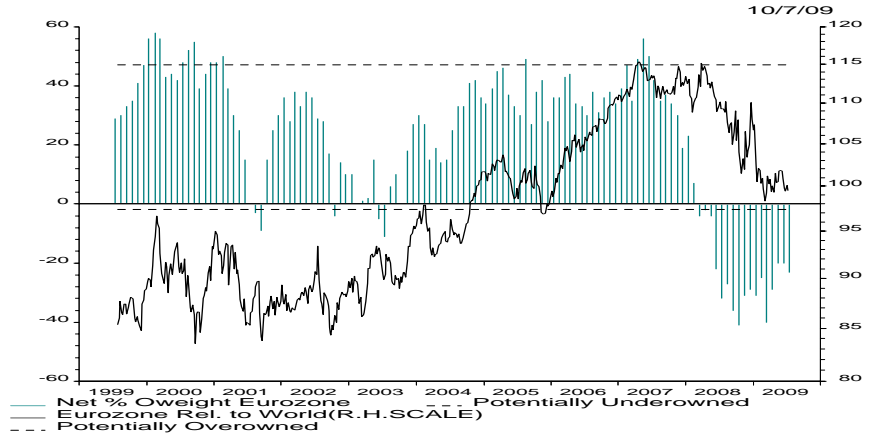
Chart 33: Japanese Equities



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Pessimism on Europe remains profound, with a net 23% underweight (down from 20% last month). This seems a vulnerable position: once confirmation of the economic recovery comes through in Q3, Europe is likely to follow Japan's lead.

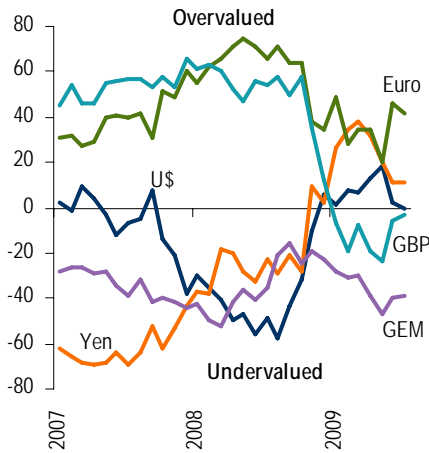
Chart 34: Eurozone Equities



## Currency valuation

The lack of conviction in direction for USD continues, with investors evenly split on the likely next move. GEM remains the currency region of choice, but the strongest conviction remains on the overvaluation of the Euro (42%, albeit down from 46% last month).

Chart 35: Net % saying currency overvalued



Investors are evenly split on prospects for the USD, giving a net score of 0%.

The Yen is still seen as overvalued (11%), the same level as in June.

As in many things European, investors view prospects dimly, with 42% seeing the Euro as overvalued (vs. 46% last month).

Chart 36: Perception of USD valuation & Trade Weighted

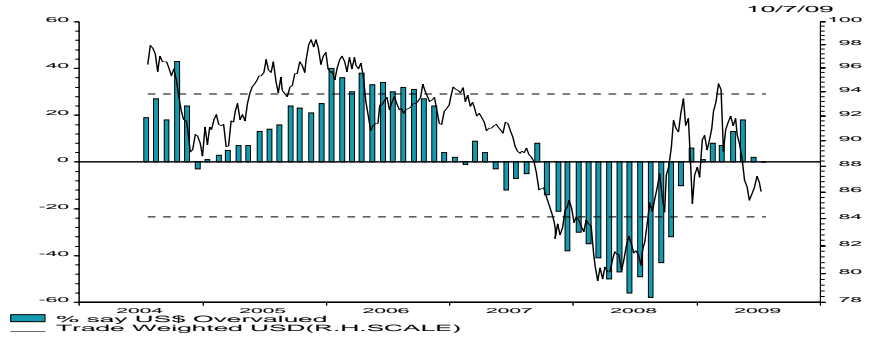


Chart 37: Perception of JPY valuation & Trade Weighted

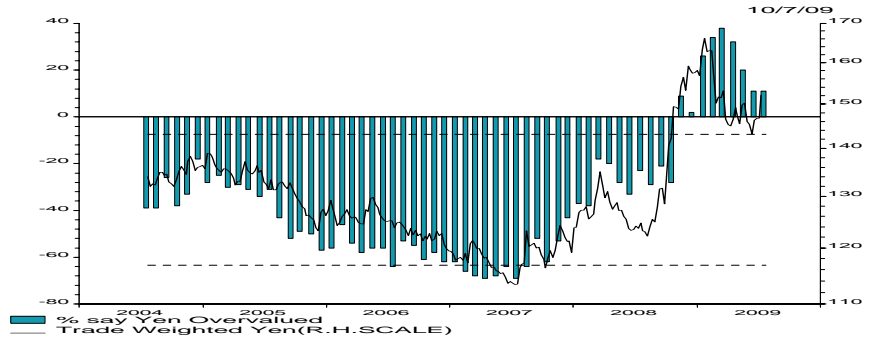
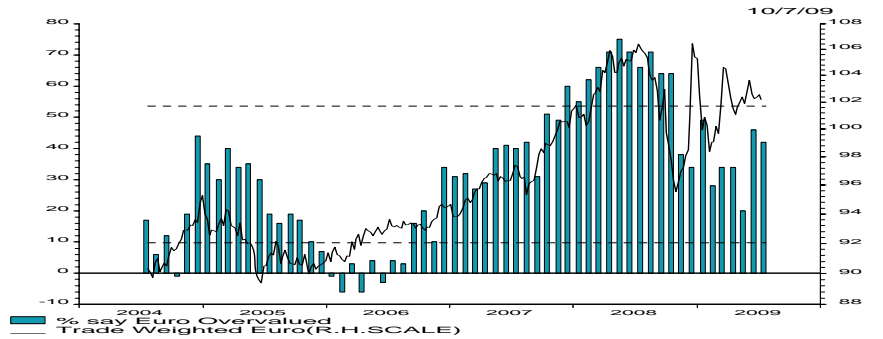
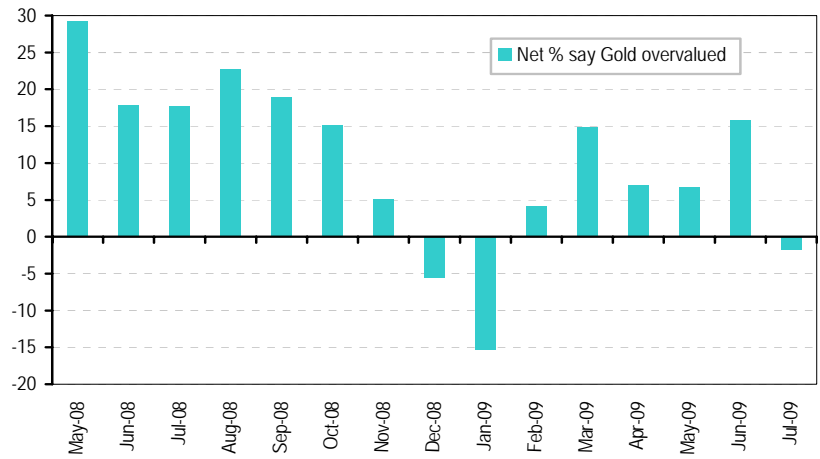


Chart 38: Perception of EUR valuation & Trade Weighted



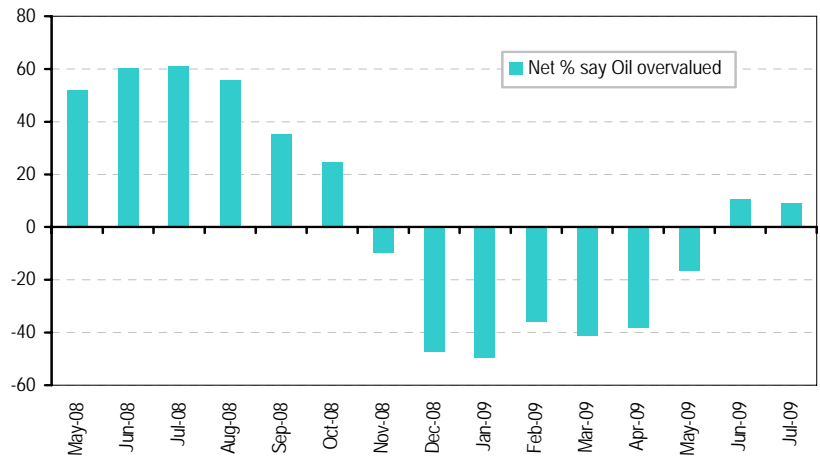
The investor base we sample in the FMS still appears to struggle to find real conviction on gold, in either direction.

Chart 39: Gold Valuation



Meanwhile, the sharp reversal in the oil price seen in recent days is tempering views on oil overvaluation.

Chart 40: Oil Valuation



## Global survey demographic data

Table 4: Position / Institution / Approach to Global Equity Strategy

	Jul	Jun	May	Apr
<b>Structure of the panel by position</b>				
Chief Investment Officer	24	23	22	26
Asset Allocator / Strategist / Economist	85	82	86	77
Portfolio Manager	94	105	95	94
Other	18	16	17	17
<b>Structure of the panel by expertise</b>				
Global Specialists	132	137	137	121
Regional Specialists With A Global View	89	89	83	93
<b>Total # of Respondents to Global Question</b>	<b>221</b>	<b>226</b>	<b>220</b>	<b>214</b>
<b>Which of the Following Best Describes the Type of Money You are Running?</b>				
Institutional Fund	103	108	103	96
Hedge Fund	26	29	28	27
Retail Fund	65	59	58	61
Other	27	30	31	30
<b>What Do You Estimate to be the Total Current Value of Assets Under Your Direct Control?</b>				
Up to \$250mn	42	47	46	48
Around \$500mn	28	32	27	23
Around \$1bn	28	27	27	32
Around \$2.5bn	25	25	22	26
Around \$5bn	23	18	18	20
Around \$7.5bn	6	11	12	4
Around \$10bn or more	36	33	33	31
No Funds Under Direct Control	32	32	32	28
<b>Total (USDbn)</b>	<b>635</b>	<b>620</b>	<b>617</b>	<b>561</b>
<b>What best describes your investment time horizon at this moment? (Global Respondents)</b>				
3 months or less	72	69	79	75
6 months	69	79	46	62
9 months	12	13	21	11
12 months or more	60	60	64	60
<b>Weighted average</b>	<b>6.8</b>	<b>6.9</b>	<b>7.0</b>	<b>6.8</b>
Don't know	8	5	10	6

### Additional information on how the survey works

TNS begins fieldwork on the day the U.S. payroll data is released. Fieldwork continues through the following week and is closed on the following Thursday. TNS sends a link containing the unprocessed results to its survey panellists on Friday. All bona fide institutional fund managers are welcome to participate in the panel.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where BAS-ML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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