

Defensive reflex

Retreat toward defensives is a chance to buy into recovery

A relatively minor correction in equity markets has sent skittish European investors retreating into defensive sectors, much more so than investors in other regions and clashing with European investors' own, still improving, macro expectations. While markets will likely stay fairly nervous short-term until we see clearer data confirming the imminent economic recovery, these moves in our view provide another opportunity to re-load on pro-cyclical trades in the meantime.

Growth expectations rise and recession fears recede...

European investors' growth expectations improved modestly in spite of weak markets, but continue to lag behind those in other regions. A net 34% of respondents now expect a stronger economy over the next 12 months, up from 32% last month. On corporate profits, a net 23% expect improvement over that horizon, up from 17% in June. Somewhat at odds with this, a net 52% of panellists still see a recession in Europe over the next 12-months – although a big improvement from 70% in June, this is still much higher than in other regions.

... but investors hole-up in defensive sectors positions

Sector positions have become much more defensive in July and overweights have once again become very narrow. Investors have increased positions in the big 4 defensive sectors, and cut positions in the remaining 15. This has left them overweight just 4 sectors: Healthcare, Telecoms, Oil & Gas and Technology, which are also seen as the 4 most undervalued sectors. Investors' confusion seems to have left them unwilling to pay up for either growth or defensiveness. This positioning is reminiscent of the situation at the start of the year and may set us up for another bout of anti-defensive rotation on improving macro data.

Equities cheap again after recent falls; cash levels drop

A net 20% of European investors see equities as undervalued after the recent correction, up from just 2% in June. Running counter to their sector moves, fund managers have reduced their cash holdings, with a net 18% now overweight cash, down from 25% in June (and a recent peak of 53% in February). The average cash balance also fell, to 3.8% from 4.1% last month.

Global investors avoid Europe and intend this to continue

Europe remains unloved by asset allocators, with a net 23% now underweight the Eurozone, up from 20% last month. A net 17% are underweight the UK, an improvement from 20% in June. Significantly, a net 30% of respondents intend to be underweight the Eurozone over the coming year, the lowest reading in survey history. We still believe that this extreme and entrenched underweight on Europe could prove painful and untenable as and when the macro picture improves.

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Important change to the FMS

Survey period 2nd-9th July. A total of 191 investors with \$405bn AUM responded to the regional 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 Banc of America Securities - Merrill Lynch sales representative.

Notes to Readers

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

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Heading for the hills

After stalling last month, European investors' view of the macro picture improved gradually again in July – yet it still lags behind that of global investors or investors in other regions.

The European growth expectations composite (combines economic and profit growth expectations) rose to 64 from 62 last month. This compares to a reading of 82 both in the US and Japan.

Profit and economic growth expectations both rose – on profits, a net 23% of panellists see EPS higher over the next 12 months, up from 17% last month and the highest since the reading of +51% in May 2006. Despite the recent stagnation in expectations this is still a remarkable turnaround from -72% in March. For the wider economy, a net 34% of respondents expect improvement over the coming year, up from 32% in June and -78% as recently as March.

Chart 1: Growth Expectations Composite by region

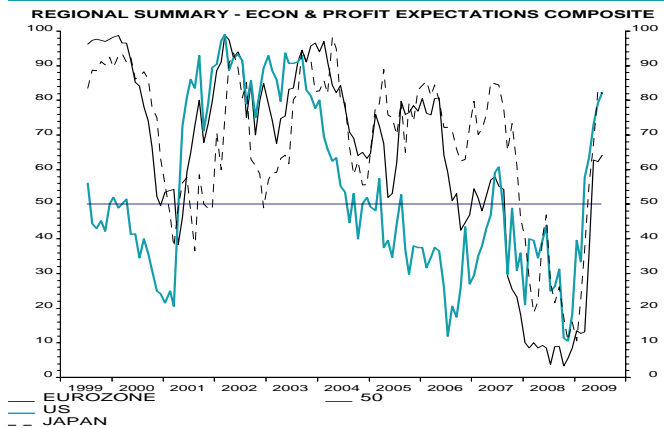
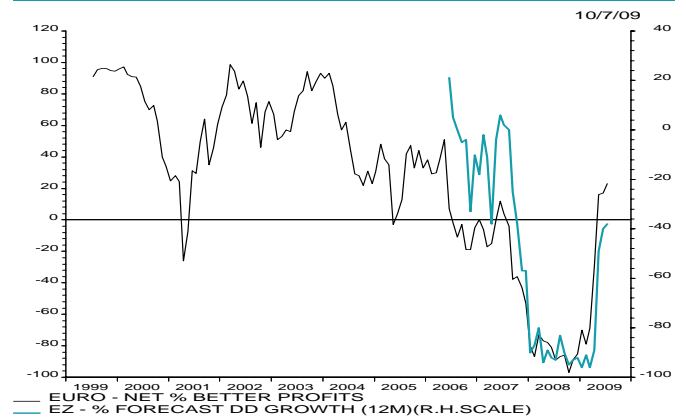


Chart 2: European profit outlook and double-digit growth forecasts

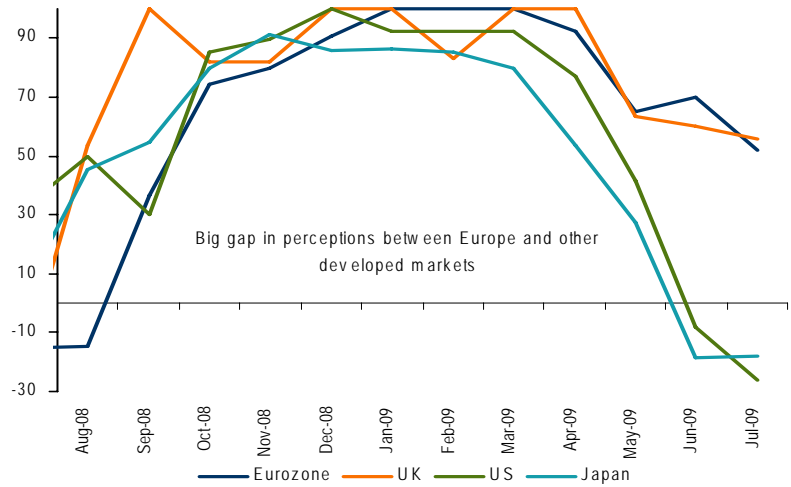


Confusion over timing of recovery continues

Where European investors' perspective on the macro picture differs most clearly from other regions is on the timing of recession. In July, a net 52% of respondents still see recession (defined as 2 quarters of negative growth) over the next 12 months, down from a net 70% in June (and 100% in March). While this is an improvement, it still jars with the expectations of an improving economy described above. It also contradicts the views of both the respondents in other regions (see chart below) - and those of our economists.

In all other regions this reading has gone *negative*, i.e. a majority of respondents don't see recession as likely over the coming year a recession – for instance, in the US a net -26% now expect recession, down from a net -8% in June. Our economists forecast that we will most likely see positive GDP growth in Q3 across most regions, *including* Europe. If they are correct, this should lead to an uncomfortable and potentially sudden adjustment of European fund managers' growth outlook, as and when hard economic data starts to improve, which would most likely be positive for equities, cyclicals and financials. However, this could take until the latter part of Q3 and in the meantime markets may well remain choppy and investors skittish.

Chart 3: How likely is a recession in your region over the next 12-months?



How to explain the divergence in European views from those held in other regions? An easy explanation would be that as the European economy has lagged, so have the perceptions of those physically located within it. Another explanation would be European diversity, with the experience and outlook of a respondent in, say, Spain potentially very different from that of a respondent located in Germany.

Monetary policy stimulative; inflation expectations up

A net 2% of panellists saw European monetary as stimulative this month, up from -13% in June and this is the first time this reading has turned positive since August 2007, the month which arguably marked the start of the financial crisis.

Consistent with this, inflation expectations continue to rise, although the pace of increase has slowed after the rapid rises of previous months. In July a net 38% of respondents said they see prices heading higher over the coming year, up from a net 32% last month and a low of -72% back in March. This month's increase is mostly driven by a drop in the number of respondents expecting falling prices.

Chart 4: Assessment of European monetary policy

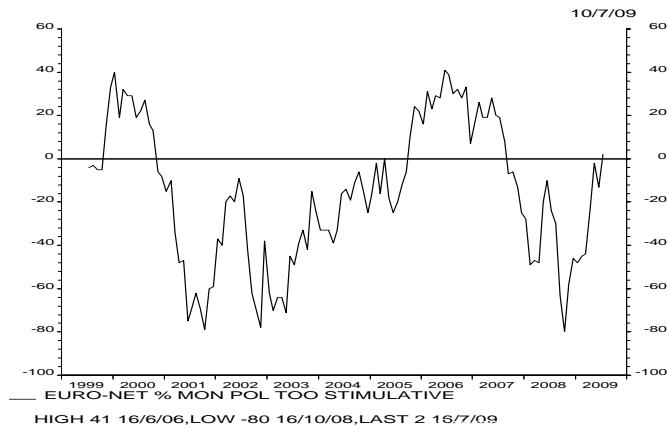
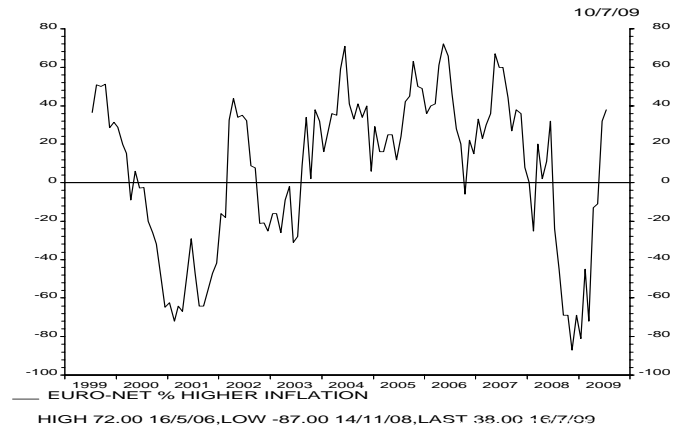


Chart 5: European inflation expectations



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Equities seen much cheaper after recent falls

After the recent pull-back in equity markets, investors' view of valuations have improved sharply, with a net 20% saying European equities are undervalued, after just 2% in June.

Somewhat at odds with the very defensive sector moves this month, European fund managers decreased their cash levels in July. A net 18% of respondents now say they are overweight cash, down from 25% last month (and 53% back in February). The average cash balance also fell, to 3.8%, from 4.1% last month.

Chart 6: Valuation of European equities

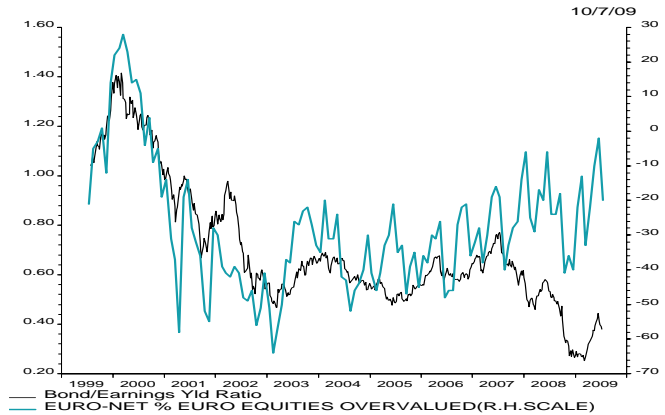
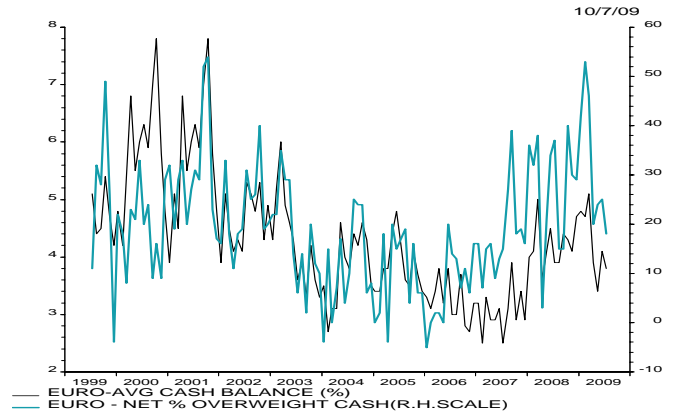


Chart 7: European cash positions



Global asset allocators don't want to be involved in Europe

The negative outside-view of Europe continues and asset allocators remain underweight the region. A net 23% of asset allocators are underweight the Eurozone in July, little changed on the net 20% reading seen in June. The size of the underweight position has been fairly stable over the past few months.

The size of the UK underweight shrank marginally with a net 17% of asset allocators underweight in July, down from 20% in June, but still a lot larger than the recent low of 11% in May, which now looks a little erratic.

Chart 8: Eurozone Equities – Asset Allocation

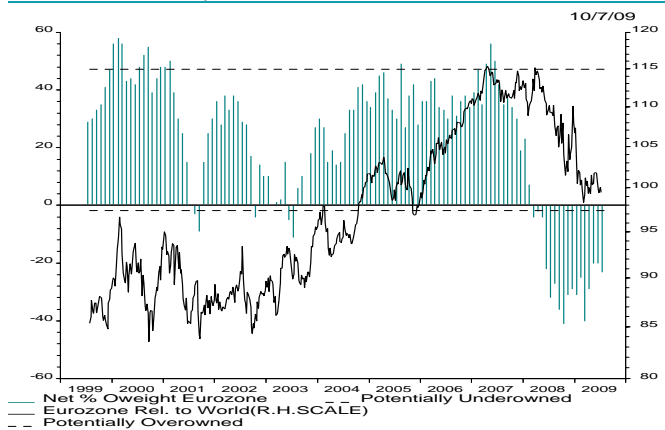
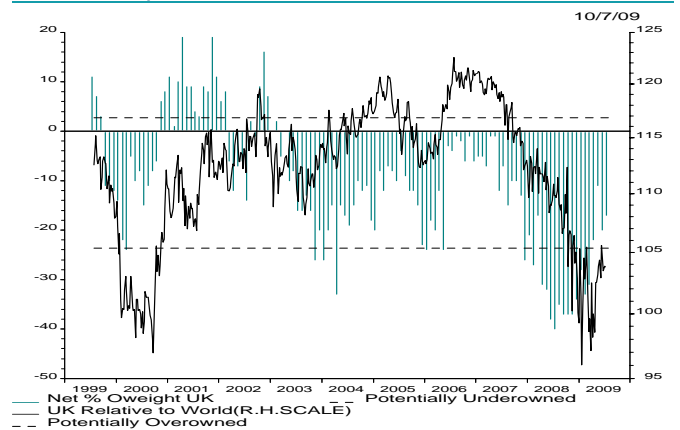


Chart 9: UK Equities – Asset Allocation

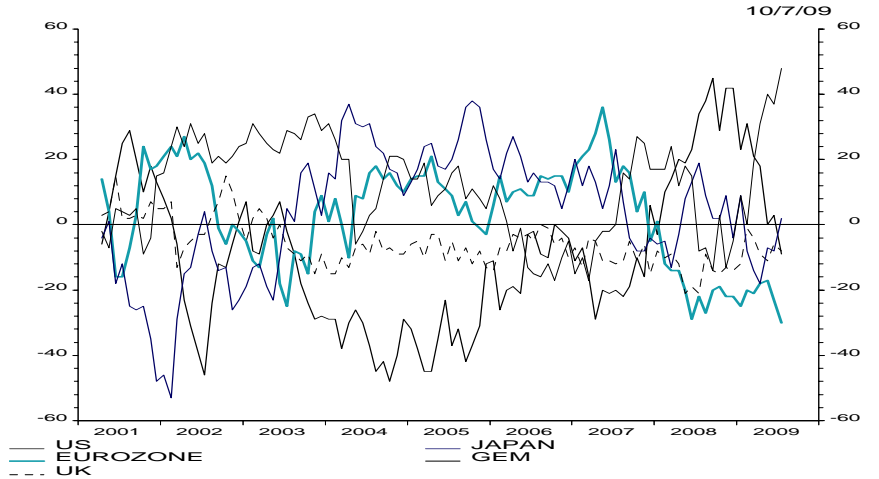


Not only have asset allocators been underweight the Eurozone since February 2008, they also have no intention of reversing that stance for the foreseeable future: a net 30% want to underweight the Eurozone on a 12-month view, up from 23% last month, and the lowest reading ever (history since April 2001).

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As we have said before, this entrenched negative stance on Europe looks dangerous to us and is likely to prove untenable if investors' generally positive global economic outlook eventually proves to be correct. Europe has a relatively cyclical and export-oriented equity market (and economy), and would normally be expected to outperform the developed universe in an upturn (driven mostly by the US market's defensive characteristics).

Chart 10: Net % would like to overweight the region on a 12-month view



Euro still seen overvalued, Sterling still neutral

There was little change in views on Europe's currencies this month. A net 42% of asset allocators now think the Euro is overvalued, down marginally from 46% last month. After its strong appreciation, Sterling is now seen as undervalued by only a net 3% of asset allocators in July, down from 6% in June and a peak reading of 24% just 2 months ago.

Chart 11: Perception of EUR valuation & Trade Weighted

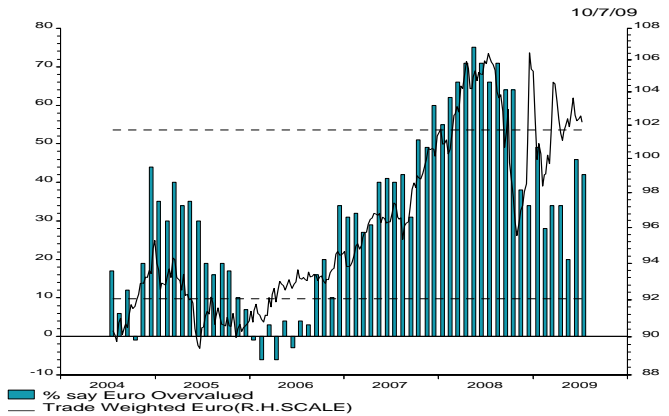
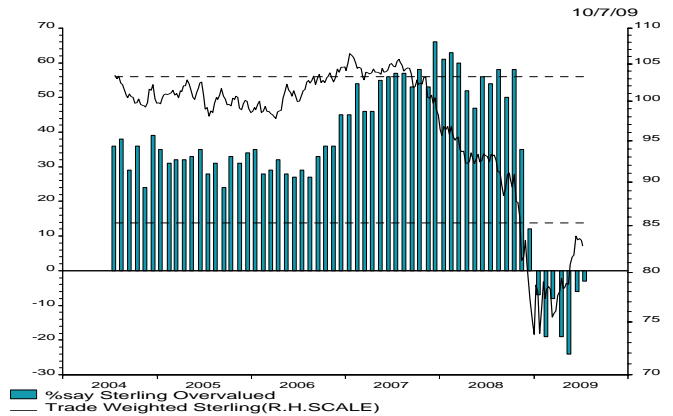


Chart 12: Perception of GBP valuation & Trade Weighted



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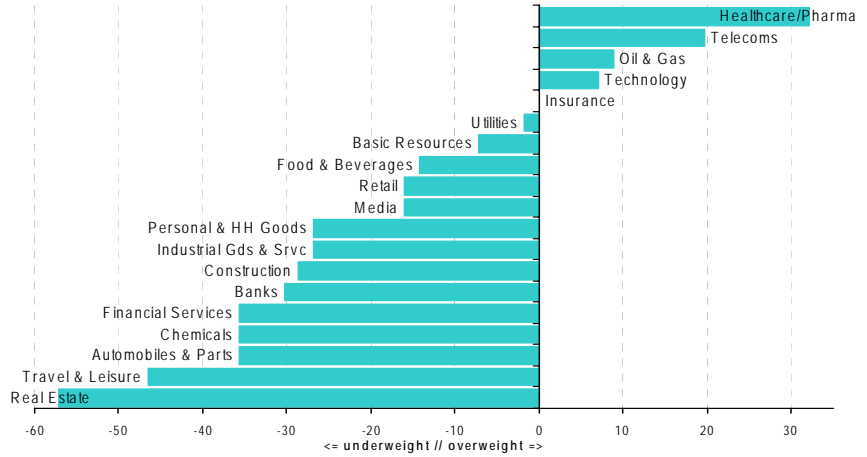
Table 1: Sector positions
(% saying overweight-% saying underweight)

	MoM Chg
Healthcare/Pharma	25
Telecoms	14
Utilities	6
Food & Beverages	5
Media	-1
Insurance	-8
Pers. & HH Goods	-10
Autos & Parts	-11
Construction	-12
Retail	-12
Banks	-13
Basic Resources	-13
Travel & Leisure	-13
Technology	-16
Oil & Gas	-18
Real Estate	-19
Chemicals	-28
Financial Services	-30
Ind. Goods & Srv	-33

Sectors: back to square one

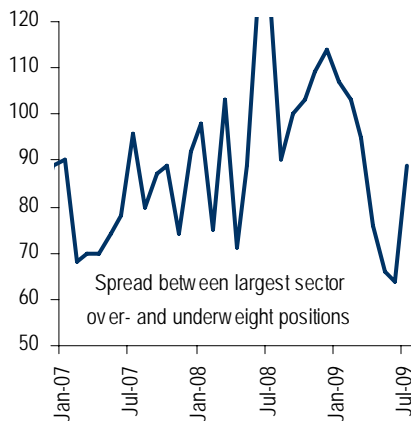
Sector positioning

Chart 13: Current European sector snapshot (% overweight-% underweight)



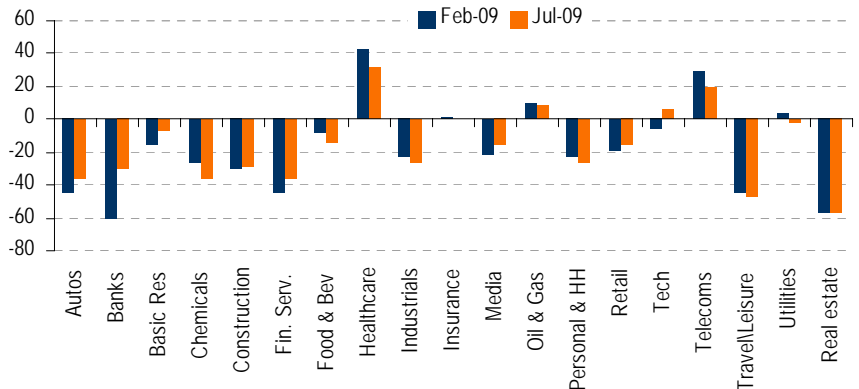
European sector moves this month were unequivocally pro-defensive and anti-cyclical, reversing much of the sector rotation seen over recent months - more so than in other regions or at the global level. This in our view represents an opportunity to buy further into sectors geared into the economic recovery, which we expect in Q3 (i.e. cyclicals) - although short-term markets may remain very nervous, and sector moves volatile, until we see more hard data confirmation.

Chart 14: Sector conviction has rebounded



Investors increased weightings in just 4 out of 19 sectors, all of them defensive: Healthcare/Pharma, Telecoms, Utilities and Food & Beverages. All other sectors saw position cuts, with the largest reductions seen in Industrials, Financial Services and Chemicals. Position changes this month were among the largest in survey history and the absolute size of sector positions has also increased again after last month's low in conviction (see chart) – mostly driven by the now pretty extreme-looking underweight position in Real Estate (-57%).

Chart 15: Sector weight comparison today vs. Feb 09 – very similar



This has left European fund managers once again with sector overweights narrowly positioned in just a few sectors, all of which are seen as undervalued (see below). Investors have sizeable overweight positions only in the two defensive stalwarts, Healthcare and Telecoms. Sector positioning is now very narrow and very similar to the positions in February (see chart above), which set the stage for the vicious sector rotation post the March-low.

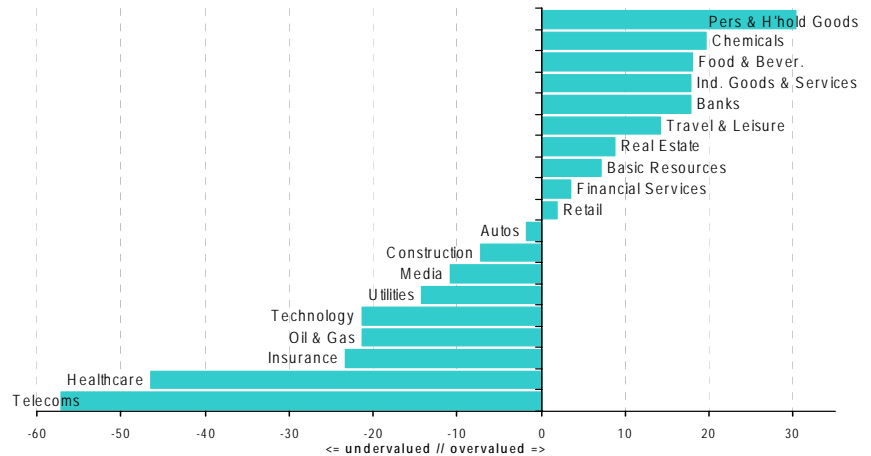
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Sector valuations

Chart 16: European sector valuation (% overvalued-% undervalued)

Table 2: Sector valuation
(% saying overvalued-% saying undervalued)

	MoM Chg
Oil & Gas	26
Banks	20
Basic Resources	15
Chemicals	8
Media	4
Real Estates	3
Financial Services	2
Pers & H'H Goods	2
Travel & Leisure	1
Ind. Goods & Serv.	-1
Insurance	-1
Utilities	-3
Construction	-5
Food & beverages	-10
Technology	-12
Autos	-13
Retail	-13
Healthcare	-22
Telecoms	-23



Perceptions of sector valuations also saw a lot of movement over the month, with a slight bias towards defensives moving towards 'cheaper' readings, but the pattern is not nearly as clear as in actual positioning: while the big 4 defensives sectors are all seen as more attractively valued than last month, this is also true of a few cyclicals such as Autos and Technology. The commodity-related sectors (Oil & gas, Basic Resources) were the clearest losers, presumably as a consequence of falling commodity prices. Financials are mostly seen as more expensive than last month – especially so the banks, where perceptions have been moving around a lot over recent months, underlining investors' difficulties in valuing the sectors.

These changes have left the ranking of sector valuations (see bar chart above), with a clear theme, with defensives occupying the extreme ends of the cheapness-scale and cyclicals and financials split between expensive and cheap.

Cross Reference

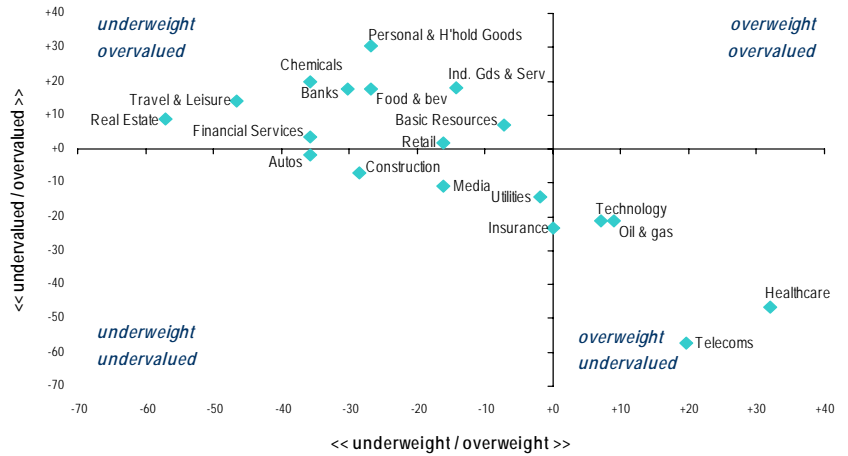
[Defensive red herrings, European Equity Strategy, 29 June 2009](#)

As we've outlined in recently, (see link to report on the left), we disagree with wide-spread perceptions (admittedly not totally reflected in the above chart), that defensive sectors as a whole have become cheap again following the post-March rally. We believe the apparent cheapness is mostly due to with the fall in cyclical sectors' earnings that is normal for this stage of the business cycle. On cyclically adjusted valuations (and to some degree, simply on PBRs), the alleged cheapness of many defensive sectors largely disappears.

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Sector positioning versus value

Chart 17: European sector valuation vs. sector positioning



The chart above combines fund managers' views on valuation with their positioning. Investors' general uncertainty and nervousness has left them unwilling to invest in anything other than sectors seen as undervalued - they are not prepared to pay up for either growth or defensiveness, with the top right-right quadrant of the chart completely empty.

Top sector positioning charts

Over/underowned = current sector position above/below 1 standard deviation of long-run average

Sharp move into Defensives makes near-term reversal likely
While neither of the top-two most popular sectors are formally in overowned territory, the Pharma & Healthcare sector comes very close, and the large increase in positions for both sectors makes a near-term pull-back likely.

Chart 18: Net % overweight Pharma/Healthcare

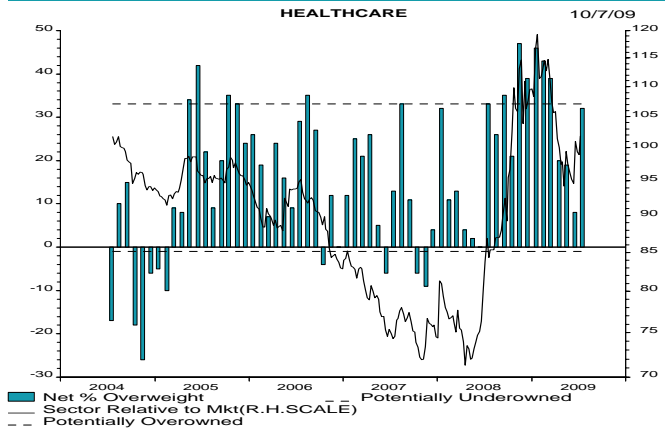
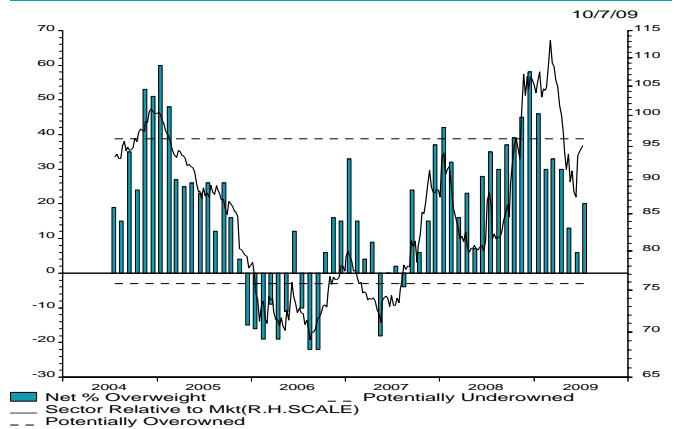


Chart 19: Net % overweight Telecoms



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Conversely, sharp move out of cyclicals may prompt bounce-back

The Industrial Goods & Services sector saw the largest outflow of any sector and is now in 'potentially underowned' territory – a bounce-back next month is likely.

Financial services saw the second-largest decrease in positioning, but has not yet entered 'potentially underowned' territory.

Chart 20: Net % overweight Financ. Services (ex. Banks & Insurance)

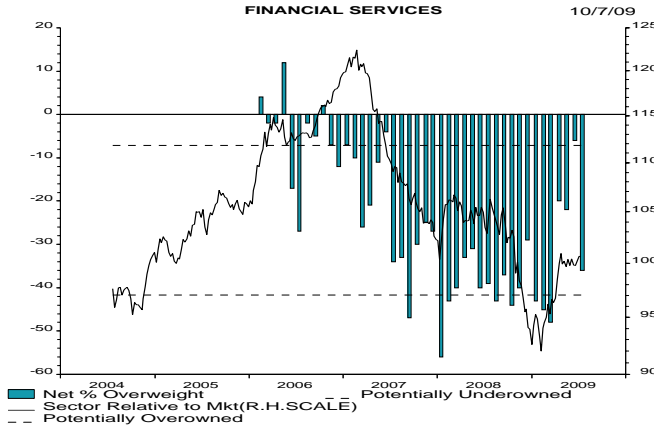
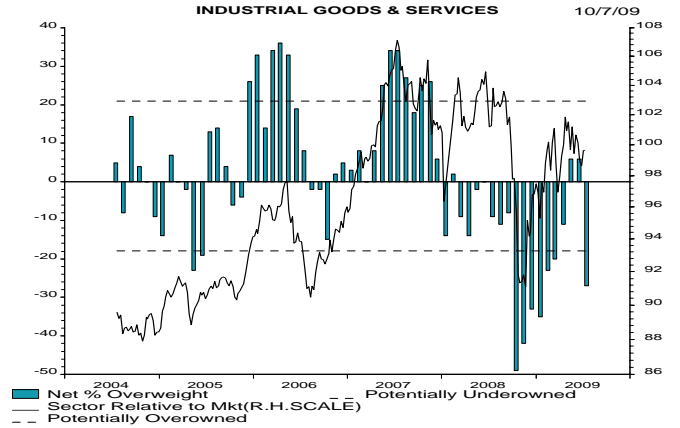


Chart 21: Net % overweight Industrial Goods & Services



Oil & Chemicals on cut-off to under-owned territory

Positioning in the Oil & Gas sector has been volatile over recent months, but the most recent drop (presumably driven by falling crude prices), has left the sector once again in the potentially underowned part of the chart – near-term bounce-back likely.

The Chemicals sector saw the third largest drop in popularity this month (and at -28 a very large one-month drop in absolute terms), taking the sector all the way from a potentially overowned position, to the brink of underowned – near-term bounce-back likely here too.

Chart 22: Net % overweight Oil & Gas

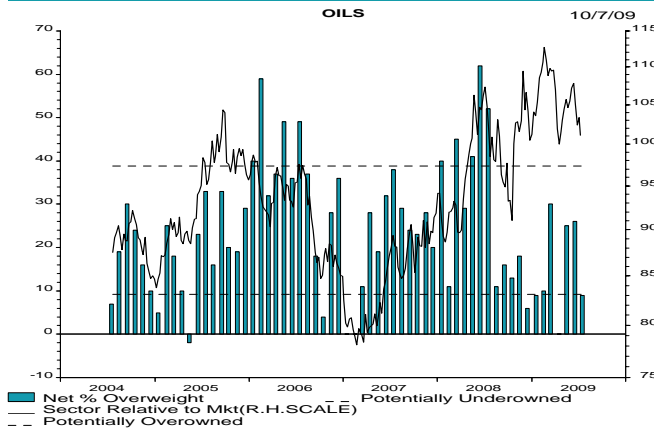
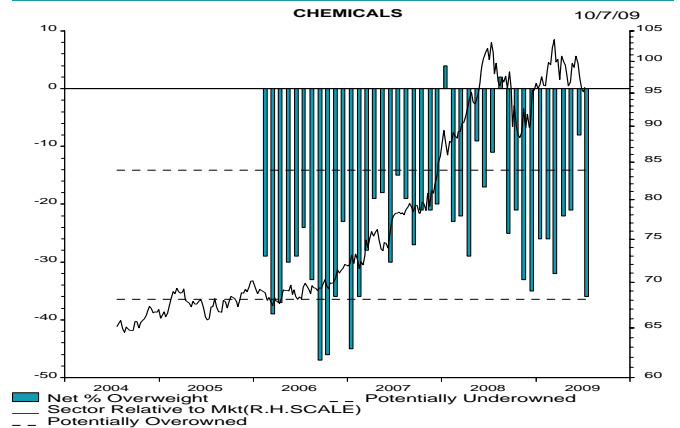


Chart 23: Net % overweight Chemicals



Regional survey demographic data

Table 3: Position / Institution / Approach to Regional Equity Strategy

	Jul	Jun	May	Apr
Structure of the panel by position				
Chief Investment Officer	26	23	21	23
Asset Allocator / Strategist / Economist	20	26	25	24
Portfolio Manager	125	121	121	120
Other	20	14	15	15
Structure of the panel by expertise				
Regional specialists + EM Specialists	102	95	99	89
Regional specialists with a global view	89	89	83	93
Total # of respondents to regional questions	191	184	182	182
Which of the Following Best Describes the Type of Money You are Running?				
Institutional Fund	81	79	78	71
Hedge Fund	28	28	24	28
Retail Fund	69	63	64	69
Other	13	14	16	14
What Do You Estimate to be the Total Current Value of Assets Under Your Direct Control?				
Up to \$250mn	39	43	42	51
Around \$500mn	30	33	31	29
Around \$1bn	33	25	31	26
Around \$2.5bn	30	24	22	22
Around \$5bn	22	18	21	16
Around \$7.5bn	7	8	5	5
Around \$10bn or more	11	10	10	13
No Funds Under Direct Control	16	18	14	16
Total (USDbn)	405	362	355	356
What best describes your investment time horizon at this moment? (Regional + GEM Respondents)				
3 months or less	54	51	58	58
6 months	65	64	46	46
9 months	14	17	18	15
12 months or more	54	45	54	55
Weighted average	7.1	6.9	7.2	7.2
Don't know	4	7	6	8
Which region do you specialise in?				
US / North America	27	24	24	26
Europe / Continental Europe / Eurozone	56	53	63	54
UK	9	10	11	9
Japan	40	43	33	41
Asia Pacific ex. Japan (i.e. including Australia)	17	18	17	18
Emerging Markets	27	25	24	23
South Africa*	15	11	10	11

*For more information on South Africa, please see "South African Fund Manager Survey", John Morris at al, Merrill Lynch Johannesburg.

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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