MARKET
INSIGHTS

The path to a stronger Europe

Where politics meets economics

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The path to a stronger Europe

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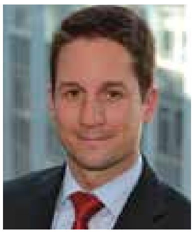

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IN BRIEF

News that the European economy had failed to grow in the second quarter of 2014 was a timely reminder that any recovery remains fragile and the risk of a Japanese-style scenario still looms large. There are ways to put the eurozone back on the path of growth but political courage is required at both the European and national level to push through badly needed structural reforms. The distinction between a promise of reform and being able to deliver it is likely to be highly relevant in the months ahead and it will be important for investors to discriminate between governments that can deliver and those that cannot. In this paper we analyse the challenges the four major European economies are facing. We will also highlight the fundamentals that, in our opinion, mean European equities and bonds deserve a place in any diversified portfolio, especially in the context of decisive European reforms.

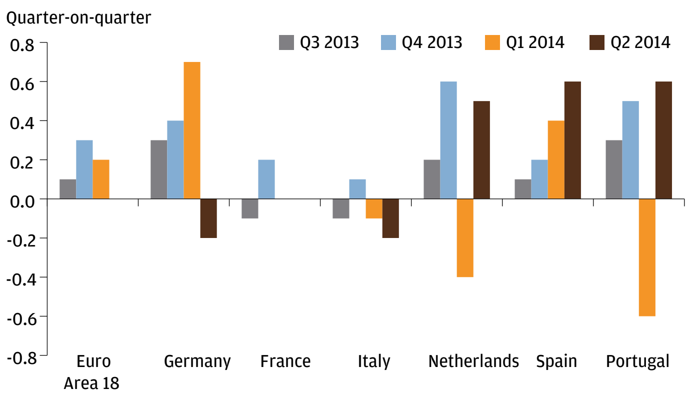
Assessing the economic backdrop

Despite generally encouraging first-quarter growth and a promising pickup in leading indicators, large parts of the eurozone economy lost momentum coming into the middle of the year, fueling fears of a new slowdown in Europe.

The eurozone economy failed to expand in the second quarter compared to the first three months of the year, while most observers were expecting a small increase. Surprisingly, Germany—the engine room of the regional economy—contracted and underperformed the eurozone for the first time since 2009. It would be easy to put Germany's weakness down to external factors, such as the Ukrainian crisis, but the issue is internal to the Eurozone as Germany's main trading partners within the eurozone, France and Italy, continue to struggle to get their economies back on track. Italy slipped back into a technical recession, while France suffered its second quarter of stagnation. However, it was not all bad news as Spain and Portugal posted growth of 0.6% in the second quarter. Admittedly, this growth was from a very low base, but it does show that the painful reforms undertaken by these countries are starting to pay off.

Eurozone growth by country

EXHIBIT 1: EUROZONE GROWTH BY COUNTRY



Sources: J.P. Morgan Asset Management. Data as at 31 August 2014.

From a macroeconomic perspective, the outlook for growth in the second half of the year is beginning to darken, with eurozone manufacturing purchasing managers' indices (PMIs) falling in the last couple of months. However, much of this weakness might be a re-adjustment as leading indicators looked like they were getting ahead of themselves prior to the second-quarter GDP release. Industrial production also remains weak and geopolitical tensions with Russia continue to have a negative impact on exports.

This decline in economic momentum, coupled with the continued undershoot in eurozone inflation have once again put the focus on the European Central Bank (ECB). At the recent gathering of central bankers at Jackson Hole, Wyoming, the ECB's president, Mario Draghi, repeated that the ECB stood ready to do more to support the eurozone economy. This was followed up in September by a surprise decision to cut interest rates and begin the purchase of asset backed securities (ABS) and covered bonds.

These measures and the steps announced in June have helped put downward pressure on the Euro against the USD. This is helpful for Europe as the strength of the currency has been a source of disinflation and has been eroding the competitiveness of European companies. Additionally, the cut in deposit rates to negative levels seems to have encouraged banks to increase lending to the real economy, as the pace of the contraction in bank lending has slowed down. The ECB's Bank Lending Survey, published in June, showed that most financial institutions had started to loosen their lending conditions for the first time since 2007. Other measures still need to be implemented, like the targeted long term repurchasing operations, while in October the ECB will release the results of its Asset Quality Review (AQR) and stress tests carried out on 127 European financial institutions since the beginning of the year.

Will this be enough? The ECB certainly hopes so, but the slowdown in the economy and the continued low levels of inflation mean that further action—including a more ambitious US-style of quantitative easing (QE) – remains firmly on the table. We will see a form of QE starting in October with the purchasing of private asset backed securities but initially at least, such credit easing is likely to make less of an impact due to the lack of private debt within the marketplace. That is why we think large-scale purchases public debt are still a strong possibility, despite the ECB's reservations about taking this step and doubts about its effectiveness. Even the critics of QE recognise that politicians are going to find it harderto push forward with difficult domestic reforms if the ECB is not felt to be playing its part.

Even if the ECB is forced to act, it will be important for politicians to take up the baton in the race to put Europe back on the path of growth. Mario Draghi suggested at Jackson Hole that fiscal policy should be allowed to play a role, stating that it "would be helpful for the overall stance of policy if fiscal policy could play a greater role alongside monetary policy, and I believe there is scope for this, while taking into account our specific initial conditions and legal constraints." The ECB president also suggested that stronger fiscal co-ordination across the eurozone would achieve a more growth-friendly fiscal stance for the region.

This is a topic of ongoing and vigorous debate in Brussels and national capitals. However, as Draghi also pointed out, any monetary or fiscal stimulus to the economy is likely to run out of steam if it isn't accompanied by more lasting structural reforms.

There are many ways to implement structural reforms to increase Europe's growth potential and the European Commission already has a roadmap. In March of this year, the European Parliament published a paper[1] that attempted to quantify the impact of the completion of the internal market, and more generally, calculate what closer European integration could mean for the growth potential of the eurozone. It is estimated that further European integration could add another EUR 800 billion to the size of the eurozone economy annually, or 6% of current GDP. The good news is that some of the measures for further integration are already being implemented, such as the banking union that could, according to the calculations of the European Parliament, allow efficiency gains of EUR 35 billion a year. In addition the European Commission could also plant the seeds of future growth by complying with the recommendations of the Lisbon Treaty which says that 3% of the eurozone's GDP should be invested in research and development (R&D). At the moment, R&D spending for the eurozone as a whole only accounts for 2% of GDP, while the US and Germany structurally spend close to 3% of their GDP on R&D.

European leaders, as well as the European Commission, should consider the second-quarter growth figures as a warning that the eurozone economy is far from safe and further structural reforms are needed in order to secure the economic stability of the region over the longer term. However, there is no standard solution for every country in the eurozone, as each one is in a different position and faces its own unique set of challenges. Therefore, in this paper we have thoroughly examined the fundamental situation of each of the major four eurozone nations and outlined the challenges that each country faces.

The immediate outlook in the four major European economies

We have chosen to focus on the four largest European economies (Germany, France, Italy and Spain). These four countries, which account for 75% of eurozone GDP, can help investors to better understand and compare economic dynamics and structural reform agendas across Europe.

1.1. Germany: The strain of being the star

As the Brazilian football team discovered at this summer's World Cup, it is fine to build your team around one all-star player, just as long as that one player stays fit and healthy. Should the eurozone's star economy limp off injured it is likely to lead many investors to fear for the long-term stability of the region's recovery.

EXHIBIT 2: EUROPEAN ECONOMIC SCORECARD

	GDP in EUR bn	% of Euro area GDP	GDP growth yoy	Inflation yoy	Budget balance (% of GDP)	Primary balance (% of GDP)	Gross debt (% of GDP)	CA balance (% of GDP)	Unemploy-ment rate	Tax burden
Year	2014	2014	2014	2014	2014	2014	2014	2014	2014	
Euro Area 18	10,204	100%	1.2%	0.8%	-2.5%	0.4%	97.0%	2.9%	10.5%	
Germany	2,742	27%	1.8%	1.1%	0.0%	2.0%	76.0%	7.3%	5.1%	49.3%
France	2,098	21%	1.0%	1.0%	-3.9%	-1.5%	96.0%	-1.8%	10.2%	48.9%
Italy	1,542	15%	0.6%	0.7%	-2.6%	2.6%	135.0%	1.5%	12.3%	47.8%
Spain	1,009	10%	1.1%	0.1%	-5.6%	-2.1%	100.0%	1.6%	24.5%	40.7%

Source: FactSet, J.P. Morgan Asset Management. Data as at 30 August 2014.

[1] *Mapping the Cost of Non-Europe, 2014-19*, European Parliamentary Research Service, March 2014.

Germany accounts for 25% of the total population of the eurozone as well as 27% of the region's overall GDP, therefore any signs that the domestic economy is beginning to stall is not just a concern for German policymakers but also for the eurozone as a whole.

The monthly ZEW economic sentiment survey, based on polls of investors, reached its lowest level in 12 months in July, suggesting that the German economy is struggling. Such a low figure is likely the result of investor uncertainty surrounding Ukraine and the escalating level of sanctions being placed on Russia. Surveys that relate more closely to real economic activity paint a more encouraging picture: for example, the German manufacturing PMI reached a three-month high in July.

German policymakers have been quick to highlight the geopolitical tensions in eastern Europe as the reason for the modest contraction in German GDP in the second quarter, but Russia accounts for only 6% of German exports. Weakness in key export markets such as France and Italy is likely to have been a more important factor pulling down exports in the past few months.

All of these factors may cause further weakness in the third quarter and delay the acceleration in German growth that many were expecting to occur in the second half of 2014. But, barring a further downward lurch in European demand over the next few months we would expect Germany to fairly quickly return to the 1%-1.5% growth rate it has achieved since the eurozone moved out of recession in the spring of 2013.

If it is going to grow faster than this on a sustainable basis, Germany—like most eurozone economies—needs to press ahead with pro-growth investments and structural reforms. The extra challenge for the coalition is to find policies that increase the country's long-term potential but can also help to raise Europe's growth and inflation right now. The traditional German response to declining demand for German exports from the emerging world and increased global competition would be to squeeze labour costs to increase competitiveness—as was achieved in the late 1990s and early 2000s. However, in the aftermath of the eurozone crisis, the external pressure on Germany is pushing the other way.

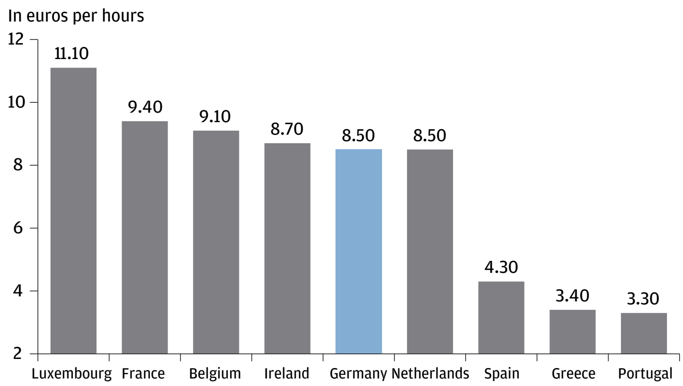
The International Monetary Fund (IMF) and other international bodies have pointed to Germany's persistent and large current account surpluses as a potential source of international financial instability. There have also been calls across Europe for faster nominal wage growth in Germany to help see off the threat of deflation in the eurozone and make it easier for the crisis economies to rebuild their competitiveness in relation to Germany. Many, including Mario Draghi at the ECB, have also pressed for looser fiscal policy in Germany to boost domestic consumption and make policy more "growth-friendly".

In response to these pressures, it is possible that Chancellor Merkel will sanction a modest loosening of fiscal policy over the next year. There is room for Germany to do this without undermining its long-term position. However, other reforms being introduced by the new German coalition that came into power in October 2013 seem to us much less constructive and possibly damaging to Germany's long-term position. These include pension changes that could reduce labour force participation among older workers and the introduction of a new EUR 8.5 per hour federal minimum wage, which will come into effect at the beginning of 2015.

The new minimum wage will be the fifth highest in the eurozone, making peripheral economies, such as Spain, Portugal and Greece, look more competitive as well as increasing wage pressure and inflation in the domestic economy. But the new minimum risks increasing unemployment in low-wage parts of the economy, including some regions where joblessness is already quite high.

Although the German government has pledged to increase public investment over the medium term, we believe further spending in this area could more effectively support demand in the medium term while also raising Germany's long-term growth rate. Greater liberalisation of the services side of the economy could also help boost domestic demand in a way that Germany's partners might welcome. However, the coalition appears to have only limited appetite for such reforms. This will not prevent the German recovery moving forward, but it does reduce the chance that the country will be able to make a much greater contribution to European growth going forward than it has in the recent past.

EXHIBIT 3: MINIMUM WAGE IN A SELECTION OF EUROZONE ECONOMIES



Sources: National Statistics Agencies, J.P. Morgan Asset Management. Data as at 30 August 2014.

1.2. France: Another existential crisis

If the German economic engine does begin to stall then unfortunately France does not have the horsepower to take over, as the country is once again suffering one of its existential crises. During the latest European elections, the far right and anti-Europe

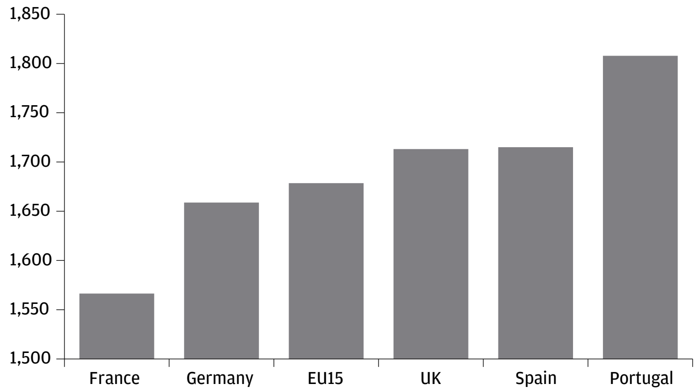
National Front party became the first political party in France with 25% of the votes at the European elections, while the popularity of the president is at the lowest level ever seen in the Fifth Republic. In addition, the disagreements between François Hollande and the left wing of his own party have already led to two government reshuffles in six months.

In this context, the popularity of President François Hollande remains low and the French remain sceptical about government action. Worse, there is strong resistance to any attempt to introduce reforms, as evidenced by the rail and air traffic control strikes in June. The ability of the government to revive the economy is limited, especially since France remains under supervision of the European Commission because of its excessive budget deficit. In March the government signed a "responsibility pact" with unions and employers' organisations. The agreement offers EUR 30 billion in tax breaks and cuts in contributions to family benefits for companies in exchange for job creation, and will be financed by spending cuts of EUR 50 billion spread over the period 2015-2017. This plan has yet to convince the rating agencies as they maintain their negative outlook, given that France will probably not be able to meet the 2015 budget deficit targets set by Brussels.

The French government is seeking support from its European partners, such as Italian prime minister Matteo Renzi, in its attempt to alter the position of the European Commission, while it is also trying to convince Germany to boost domestic demand, increase imports from its European neighbours, and reduce its trade surplus with the rest of the eurozone. Sustainable solutions to France's problems, however, must be found within the country itself. Any relaxation of the Stability Pact, for example, would only provide a temporary respite for the French economy while making it more likely that the government would postpone unpopular but much-needed reforms.

There are several reasons why France is becoming less competitive, but discussing these remains taboo in France. The MEDEF, which represents French companies, points to the low number of hours worked by French employees and the complex legal framework that binds the labour market. The Aubry law, introduced in 2000 to establish the transition to the 35-hour working week, seemed like a good idea to stimulate employment and consumption, but it had a negative impact on the competitiveness of French companies. According to the European Industrial Relations Observatory, the French work on average 1566.4 hours per year, or two weeks less than the Germans and almost four weeks less than the British. Even adjusted for any inaccuracies and roundings these figures speak volumes.

EXHIBIT 4: HOURS WORKED PER YEAR PER EMPLOYEE IN 2013



Source: National Statistics Agencies, J.P. Morgan Asset Management. Data as at 30 August 2014.

The competitiveness of French companies is also hampered by a restrictive and complex legal framework. For example, the official labour market rules run to 3,500 pages (Dalloz edition). French labour market law is focused primarily on job retention, not on the employability of workers. In comparison to France, Anglo-Saxon employment laws may appear less friendly but they are more conducive to job creation and so can potentially better help the working poor, young and old to gain access to the labour market. The difference in approach is evident in the much lower unemployment rates of 6.2% in the US and 6.5% in the UK compared to 10.2% in France.

Without reform, France will continue to lag its European counterparts. Nevertheless, the French market retains much strength. France is the second largest Eurozone economy, one of the world's leading tourist destinations and a leader in areas such as aerospace, energy, engineering and agriculture. Demographics also remain relatively strong, with the French fertility rate standing at 1.99 births per woman on average, compared to just 1.36 in Germany. This suggests that the growth differential between the two countries will diminish over time and that, on current population growth rates, France will become the eurozone's most populous country in the long run. However, to become the largest eurozone economy France will need to tackle a number of issues that are currently taboo, such as the 35 hour week, its bureaucratic administrative complexity and the over protection of its workers.

1.3. Italy: Reforms may lead to growth

Investors rightly focus on Italy because they know that the eurozone will not move on to a more stable footing without lasting progress in this part of the continent: Italy accounts for 18% of the eurozone economy and a quarter of its sovereign debt. Italy's growth and productivity performance were poor even before the financial crisis. The country's latest GDP release revealed the tenth quarterly contraction in economic output in the past 11 quarters. Since 2010, successive governments have promised reform but largely failed to deliver.

It is therefore understandable if investors were sceptical about the prospects for the new prime minister, Matteo Renzi, when he was appointed in February 2014. However, Renzi's tenure as prime minister has got off to a strong start. First of all, the results of the European Parliament elections strongly reinforced the position of Renzi and his party (the centre-left Partito Democratico) after receiving 40.8% of the vote. Such an endorsement has given Renzi a strong mandate to deal with the persistent issues that are affecting the social, political and economic life of the country. Moreover, Renzi (who is the youngest prime minister in Italy's history) has embarked on a new political era with the appointment of fresh, new leaders and a radical renovation of the political forces inside Italy.

Renzi opened the Italian EU Council Presidency with the message that "without growth there is no future." With that statement in mind he has recently launched an ambitious programme of reforms focused on five key areas:

1) Simplifying and reducing the cost of government bureaucracy.

2) Increasing labour market flexibility.

3) Improving public education.

4) Restructuring the health system.

5) Reforming the justice system and reducing the period needed to announce final verdicts.

Other important parts of this programme are the reduction of local municipalities, the approval of a new electoral law and continuing the fight against tax evasion. Effective results in these areas could boost growth, encourage hiring and enhance competitiveness. There is inevitably going to be resistance to these reforms from some quarters. Therefore, Renzi's decision to tackle Senate reform first is likely to be a wise one. A more stable political situation is likely to create a more conducive environment to completing the other reforms on the list, which are currently still in their infancy.

As well as an ambitious reform programme, investors have also been heartened by the strength of the Italian banking system, which has undergone a series of reforms in order to comply with the ECB's AQR. Traditionally the banking system has been very cautious in terms of investments, cash and provisions management. Italy did not experience any bubbles in its credit or real estate sectors, and this helped the country to avoid the most dangerous implications of the last crisis. However, the level of non-performing loans remains elevated at close to 10%, reflecting the high exposure of the Italian banks to a domestic corporate framework that is still suffering from fragile domestic demand. On the other hand, the ratio of bad debts to outstanding loans is falling (2.6% in the first quarter of 2014 vs. 3% at the end of 2013). The main banks have successfully pursued a process of recapitalisation, which since the beginning of the year has amounted to roughly EUR 10 billion. This process will improve capital ratios.

The ECB's targeted longer-term refinancing operations (TLTROs), which will start in September, are expected to provide additional liquidity. The strong rebound of Italian government bonds has helped to increase and stabilise the net asset values of Italian banks that are most exposed to sovereign debt. These factors could encourage smaller and medium-sized banks in all regions of Italy to boost the credit supply, which is still declining. An improving credit backdrop would help to kick-start investment and growth. The government's decision in 2013 to restart a programme to pay its arrears, estimated at roughly 60 billion Euro, could give a respite to the corporate private sector that is still suffering a liquidity shortage. These arrears payments were delayed in the second quarter, which may explain some of the economic weakness. However, payments are due to restart over the next few months, potentially giving a boost to third-quarter GDP.

For investors, Italy may be behind the curve when it comes to reforms, especially when compared to other peripheral economies such as Spain and Portugal. However, a new coalition government with a strong mandate from the people and led by a young and committed leader could see Italy finally embark on a path way of meaningful reform. Investors are already optimistic on Italy's outlook, as shown by the partial discount in government bond yields. Should Renzi continue to implement meaningful reforms the economy and Italian equity markets should begin to pickup in the near future.

1.4. Spain: One ray of sunlight on an otherwise cloudy horizon

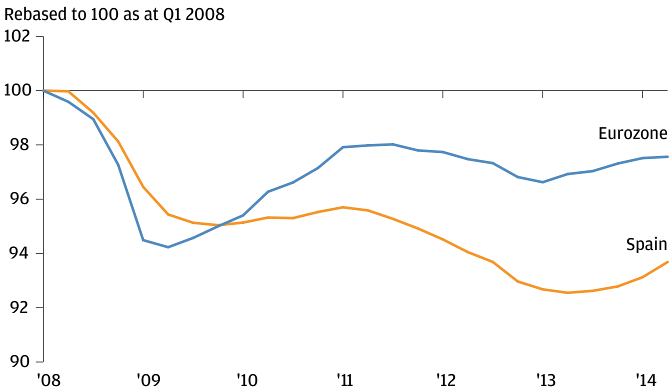
The growth of the Spanish economy provided a glimmer of hope in Eurostat's second-quarter 2014 GDP report. Indeed, the economy is rapidly regaining external competitiveness, as shown by the 8.1% year-on-year (y/y) rise in exports recorded in the first quarter of this year. Much of this strong export growth has come from the readjustment in unit labour costs, which have declined by 5% since the start of 2012. The return to growth in Spain has also been helped by rising private non-residential investment, which is a reflection of rising business confidence in the country.

After coming dangerously close to collapse in 2008 the Spanish bank system is now in a healthier position following a programme of restructuring and recapitalisation, to provide credit to the wider economy. Confidence has also jumped to multi-year highs as the uptick in growth is beginning to be felt among businesses and consumers.

This re-acceleration of the Spanish economy has caught a number of analysts off guard. Spain's economy has now grown for 12 consecutive months and on a quarter-on-quarter basis is the second fastest growing economy in the eurozone in the three months to June, behind only Latvia. Growth is also well ahead of analyst forecasts. At the beginning of 2013, analysts only expected the Spanish economy to grow by 0.4% in 2014. Expectations are now for growth of 1.2% this year.

However, investors should be cautious of the Spanish resurgence. As shown in **Exhibit 5** the Spanish economy is growing from a very low base and is still well below its 2008 peak, as well as the rest of the eurozone. Therefore it is possible that growth will slow over the medium to long term, as the economic rebound runs out of momentum.

EXHIBIT 5: EUROZONE REAL GDP



Source: Eurostat, FactSet, J.P. Morgan Asset Management. Data as at 30 August 2014.

Challenges remain for Spain's economy. Over 315,000 jobs have been added to the economy in the last year, but unemployment remains high at 24.5%. Such large levels of unemployment are likely to lead to a lack of skills and labour market inflexibility in the long term. In light of this, the European Commission has recommended that the Spanish authorities continue to implement reforms to increase labour market flexibility. One particular reform is to look at the severance costs borne by companies for permanent employees, which remain among the highest in the European Union even after reforms were bought in last year. The European Commission has also recommended that the authorities continue to ramp up vocational training courses, after highlighting that 35.2% of those who are long-term unemployed lack any formal qualification.

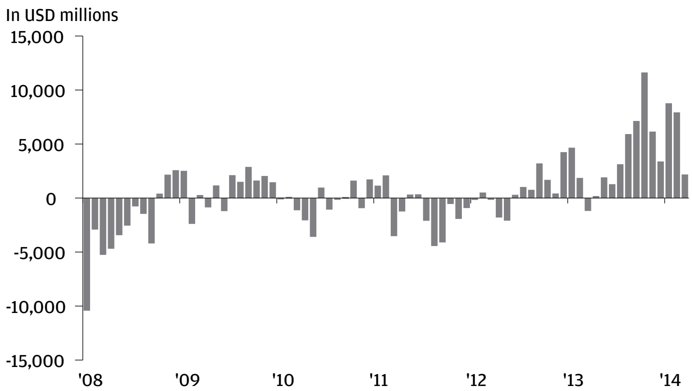
Investors may also be concerned that the reformist zeal of prime minster Rajoy may dampen somewhat now that the economy has picked up speed, leading to delays or cancellations of important economic reforms.

European Equities – an improving outlook?

After a strong start to the year, European equities have had a torrid few months as heightened geopolitical risks in the Ukraine, Iraq and Gaza, combined with a slowdown in economic fundamentals, took a toll on investor sentiment. At the end of August, the Stoxx 600 was at 4.2% on a year-to-date basis; talk of ECB actions in September helped push up European stocks during that month.

However, despite this mixed performance, flows into European equities continue to gain momentum. As shown in **Exhibit 6**, flows into European mutual funds have continued to accelerate, suggesting that despite the headwinds that continue to face the region, investors remain positive on the long-term potential of the eurozone economy and markets.

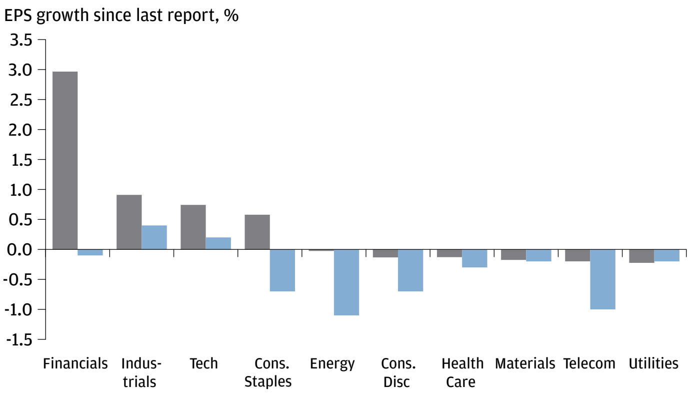
EXHIBIT 6: EUROPEAN EQUITIES FUND FLOWS



Source: Lipper, J.P. Morgan Asset Management. Data as at 30 August 2014.

This positive outlook towards European equities may be rewarded in the near future. As the second-quarter earnings season comes to a close, investors should be pleasantly surprised by the results, and a little more optimistic about the future for European equities. Earnings growth for the overall Stoxx 600 reached 4.3% (y/y) in the second quarter, its strongest growth rate since the first quarter of 2011. As shown in **Exhibit 7**, we have observed robust improvement across a significant number of sectors, with eight out of the 10 GICS sectors fairing better in the current earnings season than was the case three months earlier.

EXHIBIT 7: EARNINGS PER SHARE GROWTH BY SECTOR



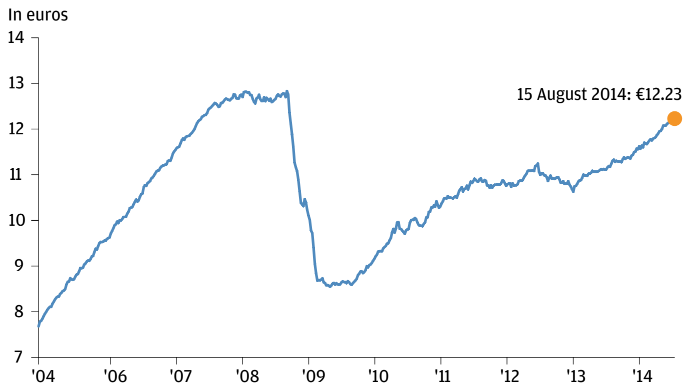
Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Data as at 30 August 2014.

Another positive point for investors to consider is that as long as companies can keep costs under control and hold margins at the current level then even a moderate amount of revenue growth should lead to higher profits through operational leverage.

However, the concentration of earnings growth may be a point of concern for investors. Over 30% of the 4.3% (y/y) increase in Stoxx 600 earnings was derived from UK-based companies, with most of the top performing companies in the UK financial sector, reflecting the stronger economic environment in the UK. Such a one-sided recovery does have its risks, but investors should note that earnings growth has been positive in almost every major eurozone economy, with the exception of small economies such as Belgium and Greece. As earnings begin to pick up momentum, we can expect the burden of earnings growth to be spread across a wider set of economies.

The boost in corporate profitability in Europe has seen the Stoxx 600 dividend-per-share value reaching EUR 12.22 per share as of the end of July—a five-year high. European companies, excluding UK-based ones, paid out USD 153.4 billion in the second quarter of 2014, up 18.2% (y/y). Further increases in profits, coupled with low interest rates, should keep payouts flowing to investors for the foreseeable future despite the geopolitical risks and fears over a loss of economic momentum. As the ECB stress tests come to an end, financial companies will be better capitalised and investors will have more transparency about the inner workings of the financial system. Furthermore, investors may benefit from increasing payout ratios as the financial sector begins to increase distributions to shareholders, having in many cases been prohibited by governments and regulators from paying dividends.

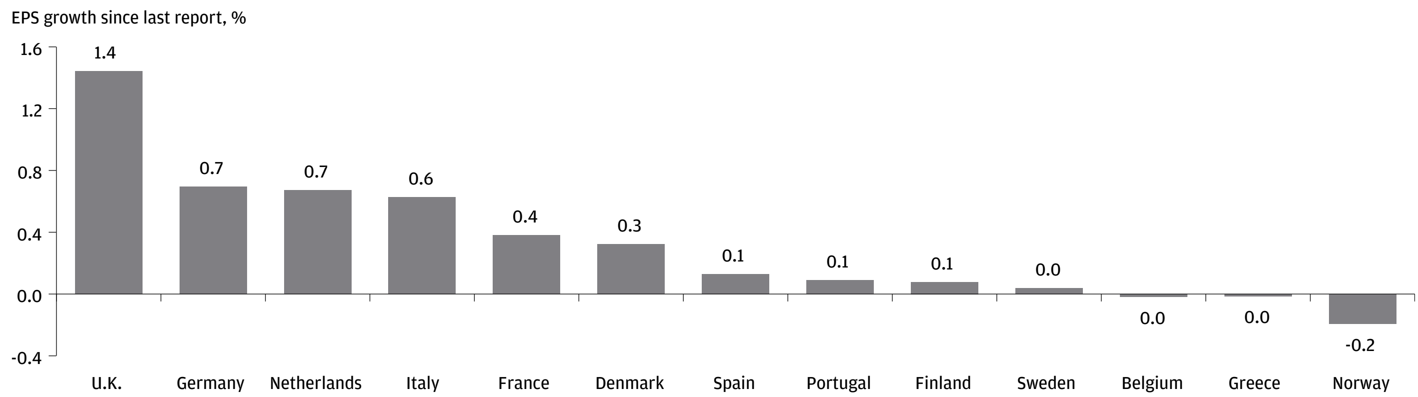
EXHIBIT 9: STOXX 600 DIVIDENDS PER SHARE



Source: Stoxx, FactSet, J.P. Morgan Asset Management. Data as at 30 August 2014.

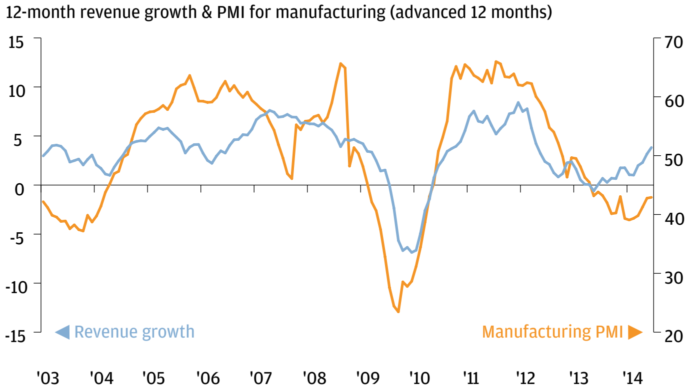
Furthermore, the outlook for earnings looks brighter than it has for a while. **Exhibit 10** highlights that revenues tend to lag the eurozone manufacturing PMI by about nine months. Assuming that this relationship continues to hold, coupled with the fact that eurozone PMIs began to pick up in mid-to-late 2013, we can expect revenues to continue to grow over the coming quarters, providing a tailwind to European equities. In addition to this, ECB action could help drive down the Euro further, providing a tailwind for both exports and earnings.

EXHIBIT 8: EARNINGS PER SHARE GROWTH BY COUNTRY



Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Data as at 30 August 2014.

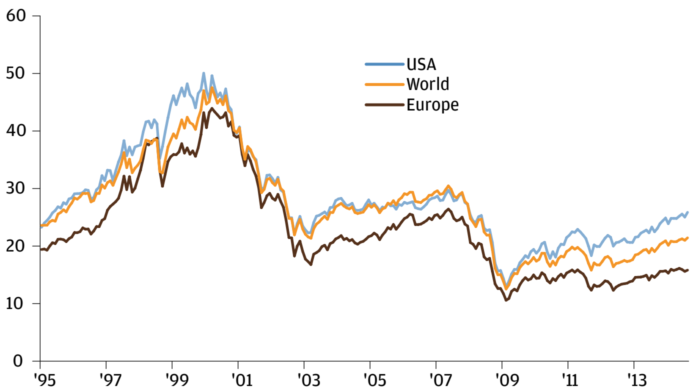
EXHIBIT 10: ECONOMIC GROWTH AND REVENUE GROWTH ESTIMATES



Source: MSCI, Markit, FactSet, J.P. Morgan Asset Management. Data as at 30 August 2014.

As the global bull market enters into its sixth year, global equity markets are trading right around average. It is therefore, understandable if investors are struggling to identify less expensive areas in which to invest their hard earned cash. When considering the cyclically adjusted price-to-earnings ratio for global, European and US equities, investors may be able to identify areas of value. **Exhibit 11** suggests that European equities are cheap on a global basis and considerably more attractive than the US, despite the lack of earnings growth in recent quarters. Relatively attractive valuations combined with an improving earnings outlook and a pickup in dividends suggests that, despite the macroeconomic risks, there is still value to be found in European equities.

EXHIBIT 11: CYCLICALLY-ADJUSTED P/E FOR SELECTED REGIONS*



Source: Datastream, J.P. Morgan Asset Management. *Cyclically adjusted measure does not take into account the impact of inflation during the selected period. Data as at 30 August 2014.

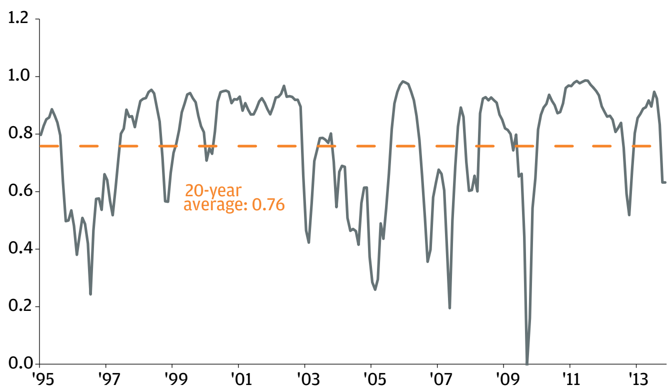
Fixed Income markets – still opportunities for value

With the prospect of rising rates in the US, investors could look to diversify their portfolios by increasing their exposure to Europe. In this context, and despite the economic difficulties the eurozone is facing, we believe that the European bond markets could be preferred by investors for several reasons.

The spread between 10-year German and US yields recently reached 140 basis points, its highest level in 15 years. Some of this widening was driven by Draghi's dovish tone at Jackson Hole in August, and subsequent action in September, which reinforced the view that there is a growing divergence in monetary policy between Europe and the United States—a situation that investors expect to persist or even increase over the coming months. Since the beginning of the year, the US Federal Reserve (the Fed) has decided to decrease its asset purchases at the end of each of its policy meetings. Though some of these announced by the ECB in June and September have already been put in place, including the cut in the refinancing and deposit rates, others have yet to be implemented. The TLTROs, for example, will take effect on 18 September, and the purchase of ABS and covered bonds will not begin until October.

Additionally, the ECB should have completed its AQR at the end of August and will publish the results in mid October this year. This should, in theory, restore the confidence of investors with regard to the European banking system and allow the banks to take risks to fund the real economy. Against this backdrop, and given the fact that the correlation between European and US rates is significantly lower than its historical average, we expect that the European bond markets will suffer less from rising US rates.

EXHIBIT 12: CORRELATIONS BETWEEN EUROPE AND AMERICA



Source: FactSet, J.P. Morgan Asset Management. Data as at 30 August 2014.

The debt crisis in the eurozone has shattered the convergence of European bond markets, which had been made possible thanks to the introduction of the euro in 1999. Despite the various measures taken by the ECB in the last few years, the yield curves of each member country are now more influenced by the economic fundamentals of these countries. The structural reforms previously discussed in this document are therefore particularly important and this is a factor investors should look to focus upon.

European bond markets, and especially those in the core of Europe, are not cheap from a historical point of view, yet they could still become more expensive as countries continue to improve their economic fundamentals and benefit from an increase in their credit ratings. Countries like Spain, Portugal and Ireland, who agreed to painful reforms, now have a positive outlook for their credit ratings. In contrast, countries where the implementation of such reforms has not yet taken place, like France and Italy, suffer from a negative outlook. There is thus no single European bond market, but there are 18 different economic realities that investors can utilise to diversify their portfolios.

EXHIBIT 13: SOVEREIGN RATINGS

	S&P	Moody's	Fitch
Austria	AA+	Aaa	AAA
Belgium	AA	Aa3	AA
Finland	AAA NEG	Aaa	AAA
France	AA	Aa1 NEG	AA+
Germany	AAA	Aaa	AAA
Greece	B-	Caa1	B
Ireland	A- POS	Baa1	A-
Italy	BBB NEG	Baa2	BBB+
Netherlands	AA+	Aaa	AAA
Portugal	BB	Ba1	BB+ POS
Slovenia	A- NEG	Ba1	BBB+
Spain	BBB	Baa2 POS	BBB+

Source: Moody's, S&P, Fitch, J.P Morgan Asset Management.
Data as at 30 August 2014.

Despite the fact that investors are beginning to focus more upon the economic fundamentals rather than the words and actions of Draghi, the ECB continues to hold great sway in the direction of eurozone yields. Investors are now expecting further action from the ECB. Draghi's comments at Jackson Hole suggests that he is looking to individual governments to implement fiscal reforms rather than continuing to rely solely on monetary intervention to drive the European recovery forward. This suggests a downside risk to European markets if expectations of continued ECB actions are disappointed.

According to the latest estimates from our investment bank, net issuance of government debt in the eurozone is expected to be EUR 290 billion in 2014, slightly more than in 2013. However, over 70% of this issuance was already completed in August, which at this point of the year is better than what we have seen in the past five years. This is especially true for countries in the European periphery, which have already covered 75% of their financing needs—6% better than the average of the past five years. Italy has already covered 100% of its target of net issuance for 2014.

In this context, the net supply of government debt in the eurozone is expected to be more limited in the last four months of the year. This should support the European bond markets, given the stable or even higher demand for European fixed income securities.

In this context we expect European fixed income markets to outperform other developed fixed income markets over the coming months. Upward pressure on interest in the US and UK is likely to make for a challenge environment in other regions of fixed income. However, we believe that an exposure to European fixed income can help investors to mitigate their interest rate risk as the correlation between US and European rates has decreased due to the divergence in monetary policy. This divergence could further widen if the ECB decide to embark on a more ambitious form of QE. European fixed income markets are certainly not cheap, but they will be supported by improving economic fundamentals which on a relative basis make them an attractive opportunity.

Conclusion: Putting Europe on the right path

European member states are confronted with different economic realities. It is becoming increasingly evident that the path back to sustainable growth will require monetary policy action and structural reforms, but perhaps also fiscal leniency in this weak growth environment. While member states should continue to focus on balancing their budgets, the European Commission should take care of the stimulus measures. The ECB has managed to restore a more favourable ecosystem for the eurozone economy, but now politicians have to take over the baton and make sure that the whole is greater than the sum of the parts by urgently implementing policies to boost growth, jobs and competitiveness.

Europe's fragmentation remains an issue from an economic perspective, but this fragmentation also offers opportunities for active investors as it makes financial markets less efficient. European equity markets remain in most cases well below their 2007 peaks, but European companies are now showing positive earnings growth, which should allow stock markets to move higher. In addition, although it remains a hypothesis, new budget stimulus measures should support activity in the eurozone.

On the fixed income side, European markets have reached new heights, helped by the ECB, but they should continue to perform relatively well in the coming months. A combination of factors, including the divergence of monetary policy, the fundamental improvements in some countries and a more limited supply of government bonds, should support European bond markets going forward.

Europe is in a difficult situation at the moment but the ingredients for a faster recovery are there. All that is required is for governments to do their part to finally bring Europe back onto the sustainable growth path. Europe can benefit from huge efficiency gains in the future and this should further support its financial markets.

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