

# Prudential International Investments Advisers, LLC.

## Global Investment Strategy – July 2009

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### ***Financial Market Outlook & Strategy: Stocks Rebounding from July Correction, Further Gains Likely. Bond Yields Range Bound***

[John Praveen's Global Investment Strategy – July 2009](#) remains positive on the outlook for stocks in H2 2009. Stocks are rebounding from the July sell-off which we view as a healthy, overdue correction. We expect stocks to recover fully and post further gains in the near-term with smaller GDP decline in Q2 and GDP growth turning positive in H2, Q2 earnings surprising on the upside and recovering further in H2, continued stabilization in credit conditions, and risk appetite improving. The stabilization in bond yields and interest rate expectations, and pullback in oil prices are also positive for the equity markets. In the near-term, stock volatility is likely to remain high with uncertainty about the timing and strength of the economic and earnings recovery, and exaggerated concerns about inflation and premature policy tightening.

After modest declines in June and early July, global government bond yields are likely to be in a trading range. However, since yields have already fallen near the low-end of that range, there is a possibility that yields bounce upward in the near-term. Yields are in the shadow of Q2 data, and should Q2 GDP grow faster than anticipated, then yields will edge up as well. There is still a risk that the recovery is weaker-than-expected and yields remain at lower levels. Nevertheless, most forecasts anticipate GDP growth turning positive in H2 and beyond, suggesting yields should edge higher.

Among stock markets, we remain overweight Emerging Markets, and modest overweight in the U.K. and Japan. We remain underweight on the U.S. and Eurozone. Among sovereign bond markets, we have upgraded Eurozone and U.K. to a modest overweight, remain neutral on U.S. and downgraded Japan to a modest underweight. We remain overweight Emerging Market bonds.

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### ***Financial Market Outlook: Stocks Rebounding from July Correction, Further Gains Likely. Bond Yields Range Bound***

#### ***Stocks: Stocks Rebounding from July Correction - Further Gains Likely with Macro & Earnings Recovery on Track***

- The long overdue correction in global equity markets materialized in late June/early July as stocks pulled-back after an uninterrupted run since the March 9th lows. Renewed concerns about the timing and strength of the economic and earnings recovery, rising bond yields and mortgage rates threatening the housing recovery, inflation concerns, and exaggerated fears about ending of monetary easing sparked the equity sell-off.
- While the stock market pullback reflects skepticism about the economic recovery, the global growth outlook continues to improve. The steady rise in business confidence points to a rebound in global industrial production. In fact, IP rebounded in Eurozone, Japan, and China in June. The rise in LEI, business and consumer confidence indicators points to a smaller GDP decline in Q2 and growth turning positive in H2.
- Investors enter the Q2 earnings season with cautious optimism about stabilization in U.S. earnings and signs of improvement for the coming quarters. Q2 earnings are likely to surprise on the upside with a smaller GDP decline in Q2. Favorable base effects, improved financial market conditions, and profitability due to the steep yield curve should boost Financials earnings. The rebound in global industrial production augurs well for earnings of Industrials while the rise in oil and commodity prices should support Materials and Energy earnings. Earnings growth is expected to recover further in the coming quarters as GDP growth is expected to move into positive territory in H2 resulting in better sales growth.
- Equity valuations remain attractive despite multiples rising. Equity market valuation multiples rose further in June to reflect downward revision to trailing earnings. However, P/E multiples are still below long-term averages. Stocks remain cheap relative to bonds, though their relative valuation advantage has decreased from the levels seen in early March, following the equity markets rally.
- ***We remain positive on the outlook for stocks in H2 2009. Stocks are rebounding from the July sell-off which we view as a healthy, overdue correction.***
- ***We expect stocks to recover fully and post further gains in the near-term with: 1) the global recession ending and GDP growth turning positive in H2; 2) earnings recovering with positive GDP growth, industrial rebound, higher oil and commodity prices and a more favorable backdrop for Financials earnings (loss write-downs abating, improving interest margins with steep yield curve); 3) further improvement in credit markets conditions; 4) risk appetite improving. The stabilization in bond yields and interest rate expectations, and pullback in oil prices are also positive for the equity markets.***
- ***In the near-term, stock volatility is likely to remain high as the Q2 earnings season unfolds, and with uncertainty about the timing and strength of the economic and earnings recovery, and exaggerated concerns about inflation and premature policy tightening.***

## ***Bonds: Bonds Gain in June on Recovery Doubts. Yields Likely to Remain Range Bound***

- Government bonds posted modest gains in June and yields fell further in early July on renewed concerns about the timing and strength of the global recovery pushing bond yields lower. Emerging Markets bonds continued to rise strongly, up nearly 10% LC in Q2.
- ***Looking ahead, bond yields are likely to be in a trading range. However, since yields have already fallen near the low-end of the range, there is a possibility that yields could bounce upward in the near-term. Yields are in the shadow of Q2 data, and should Q2 GDP data be better than anticipated, then yields will edge up as well. In the longer-term, there is still a risk that the recovery is weaker-than-expected and yields remain at lower levels. Nevertheless, most forecasts anticipate GDP growth turning positive in H2 and beyond, suggesting yields should edge higher.***
- ***In the U.S., the relatively stronger growth in H2 and rising supply are negative for Treasuries. However, questions about the strength of the recovery, data disappointment and further declines in inflation could provide support to Treasuries. Stronger economic growth in Japan, after the sharp declines the past two quarters, is a negative for JGB yields. The relatively weaker growth outlook for Eurozone (compared to the U.S. and Japan) and the smaller fiscal stimulus hence less concerns about supply suggest Eurozone should outperform. Weaker recovery and support from Quantitative Easing should support U.K. Gilts.***

## ***Investment Strategy: Remain Overweight Stocks as Macro & Earnings Recovery Remains on Track***

### **ASSET ALLOCATION: Stocks vs. Bonds**

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***Remain Overweight Stocks:*** The outlook for stocks in H2 2009 remains positive and we expect stocks to rebound from the July sell-off which we view as a healthy, overdue correction. We expect further stock gains over the remainder of 2009 with GDP growth turning positive in H2, Q2 earnings surprising on the upside and recovering further in H2, continued stabilization in credit conditions, and risk appetite improving.

***Remain Underweight Bonds:*** Government bond yields are likely to be in a trading range. However, since yields have already fallen near the low-end of the range, there is a possibility that yields could bounce higher in the near-term. Yields are in the shadow of Q2 GDP data, and should Q2 GDP data be better than expected, then yields will edge up as well.

### **GLOBAL BONDS**

***Overweight: Emerging Markets*** EM bonds have been supported by strengthening risk appetite as the global economy recovers. If the macro outlook for these countries remains solid, EM spreads are likely to narrow further. The decline in inflation in many emerging countries gives these central banks room to cut interest rates further, which is another positive.

***Modest Overweight: U.K., Eurozone*** 1) Eurozone: The relatively weaker growth outlook for Eurozone and the smaller fiscal stimulus hence less concerns about supply suggest Eurozone bonds should outperform. 2) UK: Weaker GDP recovery and support from Quantitative Easing should support U.K. Gilts. Increasing supply and low level of yields could put some upward pressure on yields.

***Neutral: U.S.*** Treasury yields are likely to be range bound with stronger macro data and supply concerns pushing yields higher. However, questions about the strength of the economic recovery, decline in inflation, and further volatility in equity could provide support to bonds.

***Modest Underweight: Japan*** The low levels of yields, valuations, and falling risk aversion are offsetting the benefits from the easy BoJ monetary policy. Further, the rebound in Q2 growth should put upward pressure on JGB yields relative to other markets.

### **GLOBAL EQUITIES**

***Overweight: Emerging Markets*** Macro outlook remains positive with fiscal and monetary stimulus boosting domestic demand and exports stabilizing. The recovery in oil and commodity prices is a positive for earnings, especially for EMEA and Latin America. Increased risk appetite is likely to lead to further gains for EM stocks. However, EM now trades at a premium to DM on some valuation measures.

***Modest Overweight: U.K. & Japan*** 1) UK: Improving macro outlook with rising business and consumer confidence points to smaller decline in Q2 GDP. Valuations and sector composition remain positives for U.K. stocks. Earnings likely to surprise on the upside; 2) Japan: GDP growth on track to a Q2 rebound. Earnings on recovery track. Yen depreciation (trade weighted) is a positive.

***Underweight: U.S. & Eurozone*** 1) U.S.: GDP is on track to a smaller decline in Q2 and GDP growth turning positive in H2. Q2 earnings recovering, but valuations are expensive relative to other markets. U.S. underperforms international markets during equity market rallies 2) Eurozone: GDP declines will moderate in Q2, but the macro outlook remains weak relative to other markets. Eurozone earnings likely to remain negative in Q2 before improving in H2 2009.

### **GLOBAL SECTORS**

***Overweight: Financials, Info. Technology; Modest Overweight: Energy, Materials, Industrials.***

***Modest Underweight: Consumer Staples, Healthcare; Underweight: Consumer Discretionary, Telecomms, Utilities.***

## CURRENCIES

**Overweight: Euro, Sterling; Neutral: Yen; Underweight: U.S. Dollar.**

The dollar is likely to weaken against most currencies given the increase in risk appetite, economic recovery and the ballooning fiscal and current account deficit. However, there could be some near-term volatility due to questions about the strength of the economic recovery.

## Regional Equity Strategy

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**Emerging Markets (EM):** Macro outlook remains positive with emerging economies continuing to show signs of recovery with improved domestic demand and exports stabilizing. Emerging economies are on track to recover further in H2 2009 and 2010 with recession ending in developed economies. Fiscal and monetary stimulus boosting domestic demand in Emerging Asia. The recovery in oil and commodity prices is a positive for earnings, especially for EMEA and Latin America. Increased risk appetite is likely to lead to further gains for EM stocks. However, EM now trades at a premium to DM on some valuation measures. **Remain Overweight.**

**U.K.:** Improving macro outlook with recovery in U.K. business confidence and stabilization in industrial activity suggesting that the economic contraction is ending and a smaller decline in Q2 GDP. Valuations and sector composition remain positives for U.K. stocks. The BoE held the bank rate at 0.5% in July and decided to hold the size of their QE program at £125bn after increasing it by £50bn in May. While current expectations are for earnings decline of -33% in 2009, earnings are likely to surprise on the upside with improved backdrop for Financials and rising oil prices boosting Energy earnings. **Remain Modest Overweight.**

**Japan:** Japan's GDP appears on track to a rebound in Q2 after plunging -3.8% QoQ, -14.2% annualized in Q1, the sharpest decline since 1955. The BoJ kept its policy rate on hold in July, extended Quantitative Easing measures and upgraded its economic assessment. Earnings are likely to recover gradually in coming quarters with the GDP rebound. The depreciation of the yen on trade weighted basis in recent months is a positive for Japanese stocks. **Remain Modest Overweight.**

**U.S.:** Rising Leading Economic Indicators and business confidence point to a much smaller -1% QoQ annualized GDP decline in Q2. Upside surprise in Q2 earnings and further earnings recovery in H2. However, U.S. remains expensive relative to other markets. The Fed kept rates unchanged in the 0 and 25bps range, and made no change to its asset purchase programs at its June meeting. Given its defensive characteristics, the U.S. has underperformed international markets during equity market rallies. Given, our expectations of further stock gains, international markets are likely to outperform the U.S. Hence, **Remain Underweight.**

**Eurozone:** Strengthening business and consumer confidence, and improving trade and retail sales data suggest that the GDP declines will moderate in Q2 after the -9.7% annualized plunge in Q1. However, the macro outlook remains weak relative to other markets. The ECB left rates unchanged at 1% at its July meeting and held their target of €60bn in purchases of euro-denominated covered bonds. Recent appreciation of the euro is a modest negative for Eurozone stocks. Eurozone earnings are expected to remain negative in Q2 2009 after posting a sharp -44% decline in Q1. However, earnings are expected to improve in H2 2009 after declining in H1. Expectations for full year 2009 are for a -17% decline after a -25% fall in 2008. **Remain Underweight.**

## Regional Bond Strategy

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**Emerging Markets:** EM bonds are supported by strengthening risk appetites as the global economy recovers. The macro outlook for these countries remains solid and EM spreads are likely to narrow further. Economic data out of the emerging markets, such as exports and production, have been more solid than those in developed economies. The decline in inflation in many emerging countries gives these central banks room to cut interest rates further, another positive for these bonds. **Remain Overweight.**

**Eurozone:** Strengthening Eurozone, business and consumer confidence, and improving trade and retail sales data suggest that Eurozone GDP decline is expected to moderate to around -2% annualized in Q2 and rise around 1% in Q3. However, growth outlook for Eurozone is weaker compared to the U.S. and Japan. Eurozone headline inflation held at 0% YoY in June from 0.6% in March, while core inflation eased to 1.4% in June. Favorable base effects and a large output gap are likely to keep inflation depressed in the coming months. Further, since the fiscal stimulus was relatively small in Eurozone, growing bond supply is not a negative for Eurozone. The ECB left rates unchanged at 1% at its July meeting and held their target of €60bn in purchases of euro-denominated covered bonds. The relatively weaker growth outlook for Eurozone (compared to the U.S. and Japan) and the smaller fiscal stimulus hence less concerns about supply suggest Eurozone bonds should outperform. **Upgrade to Modest Overweight.**

**U.K.:** BoE's QE programs should continue to provide support to U.K. Gilts, although stabilizing U.K. GDP growth, increased gilt supply, and already low levels of yields are likely to put pressure on U.K. yields. U.K. Q1 GDP was revised lower to -9.3% annualized in Q1 2009. However, the continued improvement in U.K. business and consumer confidence suggests a smaller Q2 decline, around -1%. The BoE again held the bank rate at 0.5%. Headline inflation rose for the fifth straight month, up 0.3% MoM in June, but eased to 1.8% YoY on a favorable base effect. Weaker GDP recovery and support from Quantitative Easing should support U.K. Gilts. **Upgrade to Modest Overweight.**

**U.S.:** Treasury yields are likely to be range bound, between 3.3% to 4%, with stronger macro data and supply concerns pushing yields higher. However, questions about the strength of the economic recovery, potential data disappointment or further declines in inflation, further volatility in equity markets, and a renewed increase in risk aversion could provide support to bonds. In the near-term, since yields are around the lower end of the range, the risk is for Treasury yields to rise. U.S. Leading Economic Indicators (LEI), ISM manufacturing and service indexes, and consumer confidence indicators continued to improve in June/early July indicating a smaller GDP decline in Q2, around -1%. Rising fiscal deficit and increased Treasury supply are also negative for Treasuries. Headline inflation jumped 0.7% MoM, but the YoY rate eased to -1.2% YoY. **Remain Neutral.**

**Japan:** Given the modest recovery in net exports and fiscal stimulus boosting production and consumption, the Japanese economy appears to have troughed in Q1 and on track to a rebound in Q2, with GDP rising around 1% QoQ annualized, the first positive GDP reading in five quarters. Core inflation fell at its sharpest pace on record, falling -1.1% YoY in May due to lower energy prices and downward pressure from economic slack. The BoJ kept its policy rate on hold in July, extended Quantitative Easing measures and upgraded its economic assessment. The low levels of yields, valuations, and falling risk aversion are offsetting the benefits from the easy BoJ monetary policy. Further, the rebound in Q2 growth should put upward pressure on JGB yields relative to other markets. **Downgrade to Modest Underweight.**

## Global Sector Strategy

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**Our global sector model ranks sectors on a comparative basis using macro factors, valuation, earnings and risk measures.**

- **Financials** - Earnings results likely to beat expectations in Q2 with loss write downs largely completed, improved financial market conditions and steep yield curves. Earnings growth expected to improve over H2. Financial market stabilization and improvement in capital market activities likely to benefit Diversified Financials. Consumer Finance remains relatively weaker. **Overweight.**
- **Information Technology** - Ongoing recovery in tech orders is a positive. Earnings revisions have recovered sharply in past two months. Valuations are expensive relative to other global sectors. New product launches and high cash levels are positives for the sector. European Tech firms likely to benefit from net cash position and lesser exposure to consumers and Financials. **Overweight.**
- **Energy** - Oil prices pull back to around \$60 in July with the sell-off in equity markets. However, oil prices are likely to recover and trade between \$70-\$75 in H2 with GDP expected to turn positive in H2. Energy valuations attractive and the sector trades at a discount to the Global Index. Oil Services valuations attractive and supported by continued demand for maintenance. Earnings revisions have recovered sharply in the past two months and likely to trend higher in coming months. **Modest Overweight.**
- **Materials** - Copper, Tin and Zinc prices are all off in June/July from their earlier peaks. However, the CRB index remains solid driven by still strong demand for materials such as iron ore. Construction Materials remains weak with housing markets still in a decline. M&A activity and improvement in demand due to increased fiscal spending are positives. **Modest Overweight.**
- **Industrials** - Industrial activity is improving in major economies after the sharp plunge in Q1. Business confidence indices in all regions continue to rise rebound in industrial production. In fact, IP rose in June in Eurozone, Japan, China and posted smaller decline in the U.S. The fiscal stimulus in the U.S. and China are positive for infrastructure spending. Valuations are relatively attractive. Earnings on recovery track. **Upgrade to Modest Overweight.**
- **Consumer Staples** - Sector rotation towards cyclicals from defensives due to declining risk aversion is a negative for the sector. Earnings growth is modestly better compared with other sectors. However, increase in oil and commodity prices are negative for the sector due to increase in input costs. Prefer International tobacco relative to U.S. on increasing U.S. regulations. **Modest Underweight.**
- **Healthcare** - Current valuations are expensive relative to the market. Easing of risk aversion is a negative for the sector. Further, Pharma faces headwinds such as regulatory risk, political pressures, pricing weakness and downgrades to long-term earnings outlook. Sector's earnings and dividend growth remain relatively solid. **Downgrade to Modest Underweight.**
- **Consumer Discretionary** - Macro outlook remains negative with unemployment continuing to rise and negative wealth effects in the U.S. Outlook for Eurozone, U.K., and Japan Discretionary are also weak with poor consumer fundamentals. Sector earnings outlook remains negative relative to other global sectors. Valuations are modestly expensive. **Underweight.**
- **Telecomm Services** - Consumer fundamentals remain negative. Valuations are at par with other global sectors. Negative earnings revisions continue for the sector. Sector earnings outlook is relatively negative, and likely to be revised down further with weak consumer fundamentals. Big Telecomms favored due to their strong and stable cash flows and cost saving opportunities. **Underweight.**
- **Utilities** - Sector likely to underperform with the decline in risk aversion and rotation into cyclical sectors. European Utilities face headwinds of expensive valuations, regulatory headwinds and weak pricing power. Sector valuations are attractive. Earnings revisions have held up well due to the ability of Utility operators to pass on higher input costs to customers. **Underweight.**

## ***Strategy Summary:***

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**Asset Allocation** – Overweight: Stocks. Underweight: Bonds.

**Global Equities** – Overweight: Emerging Markets; Modest Overweight: U.K. & Japan; Underweight: U.S. & Eurozone

**Global Bonds** – Overweight: Emerging Markets; Modest Overweight: Eurozone, U.K.; Neutral: U.S.; Underweight: Japan

**Global Sectors** – Overweight: Financials, Info. Technology; Modest Overweight: Energy, Materials, Industrials; Modest Underweight: Consumer Staples, Healthcare; Underweight: Consumer Discretionary, Telecomms, Utilities.

**Currencies** – Overweight: Euro, Sterling; Neutral: Yen; Underweight: U.S. Dollar.

**Disclosure:**

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