

## The Morgan View

### Where can you hide?

- **Economics** — A very weak US H1 GDP, combined with forecast cuts for India and Taiwan, brings our 2011 global growth forecast to 2.8%, which is below the historic average of 3%.
- **Portfolio strategy** — The falling credit quality of public sectors in Europe and the US is inducing capital to move away as far as possible, to the credit and currencies of smaller DMs, EM, and to commodities. Even Japan is gaining, as its fiscal problems are longer term, its economy is rebounding, and it is so far from Europe and the US.
- **Fixed Income** — Be long duration in EM and in euros (Bunds), underweighting the EMU broad periphery.
- **Equities** — Reporting season is less encouraging in Europe. So far 40% of DJStoxx 600 companies are beating estimates, compared to 78% in S&P500.
- **Credit** — EM and HY remain preferred as they are furthest removed from the crisis in public sector debt.
- **Foreign exchange** — EUR and USD are competing on which is worse. EUR/USD thus in a range. We stay positive on the G6 and EM, as well as JPY.
- **Commodities** — Gold is the best performing commodity this year. Stay long on flows, momentum and lacklustre economies.

Equities lurched down again, undoing last week's gains, on the deadlock in Washington. A very weak US GDP report, renewed spread widening in the EMU periphery, and some lukewarm earnings reports did not help, but the **uninspiring picture in Washington** surely trumped it all. Safer, still AAA-rated government debt rallied strongly, while credit is largely unchanged this week, and commodities are down 1%.

**What is likely to happen now and how do you deal with it?** Both these questions have a near-term and more medium term angle. **Over the next week**, our base case remains that Congress will agree to some lifting of the debt ceiling, but the probability is growing rapidly that we will either get a small hike in the ceiling that buys Treasury just a few months worth of spending, or that Aug 2 passes without any hike in the ceiling at all. The Administration has refused so far to state what bills get paid first. Our assumption is that coupons and bond maturities will get top priority, to avoid a default, and that the government will initially use extra cash and sell liquid assets to pay salaries, social security and medicare. Even excluding its gold reserves — which it would be loath to sell — the Federal Government has some \$670bn in student loans, TARP assets, MBS and foreign cash that it could try to monetize, carrying it to year end, even without a higher debt ceiling. Such a fire-sale would be disruptive and is unlikely to yield good prices, but the ability to avoid a default and government shut-down is there.

Even with a hike in the debt ceiling, we believe it quite likely that the US government will **lose its AAA rating** in coming months. That is because on

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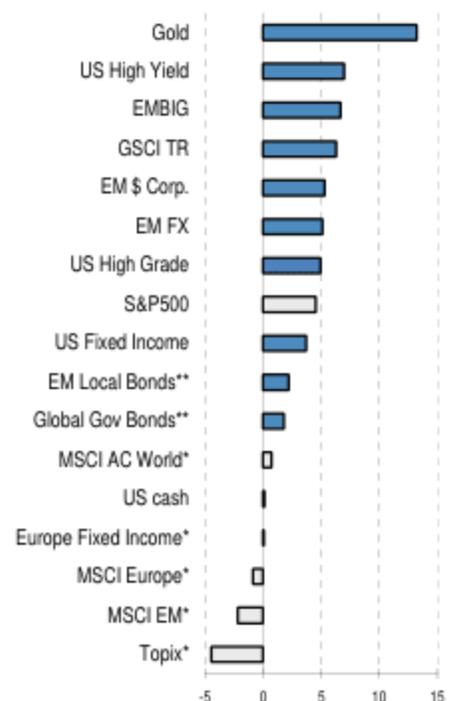
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### YTD returns through Jul 28

%, equities are in lighter colour.



Source: Morgan, Bloomberg. Returns in USD. \*Local currency. \*\*Hedged into USD. Euro Fixed Income is Iboxx Overall Index. US HG, HY, EMBIG and EM \$ Corp are JPM indices. EM FX is ELM+ in \$.

any compromise between the two sides in Congress, US government debt will continue to grow faster than GDP for years to come, and growth is set to remain anaemic. Fiscal policy in 2012-13 will be at its tightest levels in decades, even without extra spending cuts coming from any agreement to lift the debt ceiling.

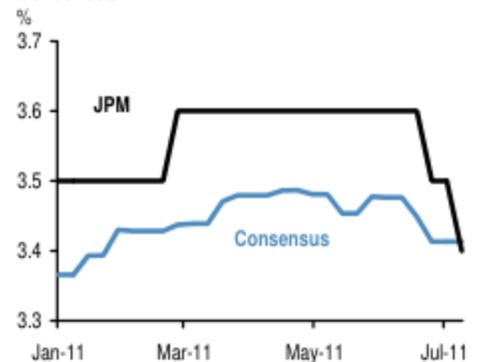
- Even as we see no chance of an outright US default next month, the failure to lift the debt ceiling would be **highly disruptive**, and will have hard-to-foresee market implications. This is because most investors are very uncertain on how to react. The old ‘flight-to-quality’ trade into US Treasuries clearly makes much less sense now. We are already seeing large outflows from UST-only money market funds into bank deposits, exactly the reverse of what we saw post Lehman. Given how much world bond and money markets have relied on the absolute safety and liquidity of US Treasuries, the shenanigans in Washington are throwing buckets full of sand in the plumbing of the fixed income markets. This means reduced liquidity, and as yet undetected disruptions.
- **How does one invest in a world where the global benchmark — US Treasuries — is not perfectly safe anymore?** Many market participants feel lost as their models require the existence a risk-free asset. Given the lack of something safer than USTs, the US market will either just stick with USTs as the risk-free assets, or switch to the European practice that uses swaps instead. Our sister publication — *Flows & Liquidity* — this week brings together our thinking on the direct impact of a US downgrade. In a nutshell, we do not see much pressure among bond managers to sell USTs as few have AAA mandates, and those with average rating targets would sell other assets. There is likely to be more pressure on money market funds, not from their managers, but from their end investors.
- More broadly, the weakening credit quality of major government debt markets will accelerate an asset allocation away from these weaker credits. The asset classes and regions furthest removed from where the sovereign debt storm is raging — Europe and the US — will benefit the most. This means that **USD, GBP and EUR will weaken further against EM and other DM currencies (the smaller developed)**. Even **Japan** is gaining, as its fiscal problems are longer term, its economy is rebounding, and it is so far from Europe and the US. One might think that such credit concerns should similarly hurt US and EU bonds and equities versus the rest of the world, but this logic does not work well. High public sector debt leads to fiscal tightening, low growth and thus easier monetary policy, which boosts bond prices. The weaker currencies and low wage growth of these countries by themselves support earnings growth of their companies who frequently operate on a multinational basis. It is worth overweighting the exporters in the US and Europe.
- The circus in Washington and Brussels has taken some attention away from **economic** data. Until today’s US GDP report, activity data were largely in line with expectations (lowered over past months). But the overall lowering of the US GDP profile over recent years — a 5.1% contraction during the recession, and only 5% growth since then — reinforce the malaise around the medium-term US growth outlook. We retain a 2.5% projection for Q3 in the US, but accept a downside risk bias around it.

2011 global GDP growth forecasts: JPMorgan and Consensus



Source: Morgan, Consensus Economics. Consensus Economics forecasts are for regions and countries that we averaged using the same 5-year rolling USD GDP weights that we use for our own global growth forecast.

2012 global GDP growth forecasts: JPMorgan and Consensus



Source: Morgan, Consensus Economics. Consensus Economics forecasts are for regions and countries that we averaged using the same 5-year rolling USD GDP weights that we use for our own global growth forecast.

More details in ...

*Global Data Watch*, Bruce Kasman and David Hensley  
*Global Markets Outlook and Strategy*, Jan Loeys, Bruce Kasman, et al.

*US Fixed Income Markets*, Terry Belton and Srinivas Ramaswamy

*Global Fixed Income Markets*, Pavan Wadhwa and Fabio Bassi

*Emerging Markets Outlook and Strategy*, Joyce Chang

*Key trades and risk: Emerging Market Equity Strategy*, Adrian Mowat et al.

*Flows and Liquidity*, Nikos Panigirtzoglou et al.

## Fixed income and credit

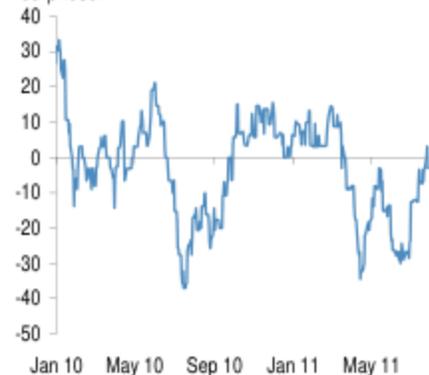
- Bonds rallied strongly around the world on the US debt crisis and weaker US growth data. Over the longer-term, a US public sector debt and deficits are bearish for USTs. But nearer term, these depress growth and equities, and make any monetary tightening unlikely in coming years. Most investors have no safer alternative to US Treasuries, and will push yields down on an equity sell off, and vice versa. We are bullish volatility in USTs, but have no duration positions on.
- In Europe, we move to long duration and underweight the periphery. Most of Europe is going on vacation this weekend, but that will not prevent further funding pressures for the periphery. EU authorities feel they went massively out of their way to satisfy bond investors, and are very disappointed they got only 24 hours of peace. Investors (most in Europe itself) remain unconvinced as the EMU member states remain very far from taking joint responsibility for their fiscal affairs. **A united EMU stands tall, but divided it will fall.**
- Credit markets roll up and down with equity markets, but are showing much less volatility and beta to stocks than normal. This suggests that both positions and supply are light. As with other markets, credits most removed from the government debt crisis in the US and Europe will do best. We keep a preference for HY and EM.

## Equities

- The rise in government risk spooked equity markets this week. The impasse in debt ceiling negotiations, a high chance of a US rating downgrade and a sharp rise in Italian and Spanish spreads have all created a negative mix for risky markets. But **not everything was negative this week**. The rise in our US Economic Activity Surprise Activity to positive territory for the first time in almost five months highlights that a capitulation in expectations has already taken place and that it is becoming easier for activity indicators to beat consensus expectations. In our view, this positive message is not cancelled by the disappointment today in the rather backward looking Q2 US GDP report.
- We thus keep a positive overall stance favouring Cyclical and Commodity sectors. A recovery in global manufacturing is the part of the economic picture we are more confident about. Industrials, Technology and Materials are the sectors most sensitive to manufacturing. Materials remain the US sector with the highest short interest.
- The US reporting season is coming in better than expected but the magnitude of positive surprises shrank this week. With 302 companies of the S&P500 index having reported so far, the average EPS beat (vs. expectation at the beginning of the reporting month) is 3.7, slightly below the average of previous reporting seasons. Top-line revenues are also beating by an average 1.9% so far, suggesting that US companies are able to generate decent top line growth even in a low GDP growth environment.
- But the reporting season is less encouraging in Europe. So far 40% companies are beating estimates in Europe within the DJStoxx 600 index, as compared to 78% in the US. This supports our model driven recommendation to OW US vs. Euro area equities — see Panigirtzoglou et al., *Trading the US vs Europe* June 24.

### US EASI Index

Balance of positive minus negative US economic surprises.



Source: Morgan

### More details in ...

*EM Corporate Outlook and Strategy*, Warren Mar et al.

*US Credit Markets Outlook and Strategy*, Eric Beinstein et al.

*High Yield Credit Markets Weekly*, Peter Acciavatti et al.

*European Credit Outlook & Strategy*, Steven Dulake et al.

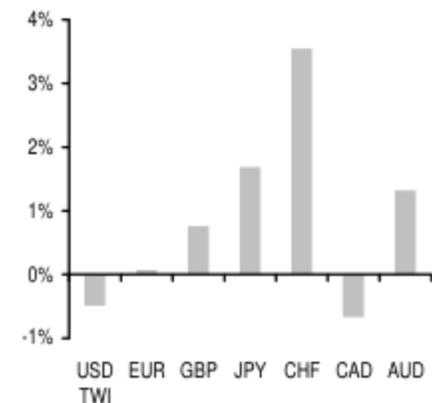
## Foreign Exchange

- Despite enormous uncertainties around European and US fiscal policy, the **dollar is unchanged trade-weighted this week**. The surprise is that many cyclical currencies (commodity FX and EM), which have most to lose from an unimpressive Washington effort, are stronger on the week, and vol premia remain within this year's range. Only short-dated vols evidence stress through their inverted term structure between 1 and 2 week maturities, but then only for a handful of markets such as EUR/USD and EUR/CHF. These patterns suggest **some complacency** that Aug 2 will pass as a non-event.
- This pricing seems at odds with the importance of next week's decision. Even excluding the extreme scenario of a technical default, Aug 2 will leave four questions unanswered: (1) will an unambitious package trigger an immediate downgrade; (2) is a downgrade a vol event for currencies; (3) will fiscal tightening depress US growth as much as it has peripheral Europe's/UK's; and (4) has Washington's budget process permanently damaged the dollar? "Probably" seems the most reasonable answer to most of these questions, which is why ranges on most currencies but JPY and CHF should persist for another month. Despite events in Spain today (credit watch, early elections), EUR/USD still looks set to remain in the 1.40s. Fiscal issues are enough to inspire reserve manager bids for the currency, even if the majority of private investors see the currency as a clear sell.
- We've held no directional risk for three weeks, on a view that cyclical and policy offsets would keep markets in a range. Cyclically, Japan's resurgence and impressive US earnings coincide with mixed activity data from Emerging Asia and sluggishness from the US and Europe. Policywise, Europe's great intentions announced at last week's summit face an implementation lag, as well as several unanswered questions from the Washington debate. We will stick with a no-touches for another week to monetise the ranges on USD/CAD, AUD/USD, EUR/GBP and EUR/GBP.

## Commodities

- **Commodities** fell in tandem with other risky assets this week, with losses largely driven by energy. **Gold managed to maintain its winning streak** with another 1.5% gain and industrial metals outperformed, up around 1%. **Copper is supported by the ongoing strike at the world's largest copper mine in Chile**, which shows no signs of abating. **Gold continues to see strong demand via ETFs** with a further \$1.2bn inflow this week. The lack of a hike in the US debt ceiling is no doubt supporting gold as investors look for an alternative to the usual safe haven of US Treasuries. The deleterious fiscal situation in both the US and Europe coupled with weaker economic data keep us bullish gold.
- **Yesterday, our natural gas analyst lowered his forecast for US gas considerably from \$5.13 to \$4.43 for 2011 and from \$5.40 to \$4.95 for 2012** (see *Natural Gas Monthly*, Scott Speaker, July 28, 2011). In order to comply with emissions guidelines, utilities in the US will start to shift to gas-fired power generators over the coming years but the current level of domestic production growth should easily be able to cope with this increase in demand. Further development of the infrastructure needed to deliver the gas and increasing supply means prices will stay below \$5/MMBTu over the next year.

FX weekly change vs USD



Source: Morgan

### More details in ...

*FX Markets Weekly*, John Normand et al.

*Commodity Markets Outlook & Strategy*, Colin Fenton et al.

*Oil Markets Monthly*, Lawrence Eagles et al.

*Metals Review and Outlook*, Michael Jansen

*Global Metals Quarterly*, Michael Jansen

Interest rates		Current	Sep-11	Dec-11	Mar-12	Jun-12	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	2.83	3.25	3.50	3.70	3.80	3.5%
Euro area	Refi rate	1.50	1.50	1.50	1.75	2.00	
	10-year yields	2.54	2.90	3.10	3.30	3.50	2.3%
United Kingdom	Repo rate	0.50	0.50	0.50	0.75	1.00	
	10-year yields	2.86	3.25	3.40	3.60	3.90	4.4%
Japan	Overnight call rate	0.10	0.05	0.05	0.05	0.05	
	10-year yields	1.08	1.10	1.30	1.35	1.40	1.0%
GBI-EM hedged in \$	Yield - Global Diversified	6.79			7.10		2.2%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	149	JPMorgan US Index (JULI) i-spread	5.0%
Euro high grade (bp over Euro gov)	183	iBoxx Euro Corporate Index	0.8%
USD high yield (bp vs. UST)	567	JPMorgan Global High Yield Index	7.0%
Euro high yield (bp over Euro gov)	596	iBoxx Euro HY Index	3.1%
EMBIG (bp vs. UST)	299	EMBI Global	6.7%
EM Corporates (bp vs. UST)	313	JPM EM Corporates (CEMBI)	5.3%

Commodities	Current	Quarterly Averages				GSCI Index	YTD Return*
		11Q3	11Q4	12Q1	12Q2		
Brent (\$/bbl)	116.7	110.0	115.0	120.0	120.0	Energy	9.5%
Gold (\$/oz)	1624	1650	1800	1800	1750	Precious Metals	13.2%
Copper (\$/metric ton)	9794	9750	10000	10250	9500	Industrial Metals	2.2%
Corn (\$/Bu)	6.68	7.20	6.90	7.10	7.40	Agriculture	-4.0%

Foreign Exchange	Current	Sep-11	Dec-11	Mar-12	3m cash		YTD Return*
					index	in USD	
EUR/USD	1.44	1.45	1.48	1.48	EUR		7.4%
USD/JPY	77.1	79	78	78	JPY		4.4%
GBP/USD	1.64	1.59	1.64	1.66	GBP		5.0%
USD/BRL	1.55	1.58	1.6	1.62	BRL		10.8%
USD/CNY	6.44	6.35	6.3	6.2	CNY		1.3%
USD/KRW	1054	1040	1070	1050	KRW		9.2%
USD/TRY	1.69	1.57	1.6	1.57	TRY		-5.0%

Equities	Current	YTD Return (local ccy)	2011 Forecast	Sector Allocation *				
				US YTD	Europe YTD	Japan YTD	EM YTD (\$)	
	1297	4.2%	1475	Energy	13.5%	2.8%	11.8%	5.0%
Nasdaq	2766	4.8%		Materials	1.4%	-5.3%	-4.1%	1.1%
Topix	841	-5.2%		Industrials	1.0%	-5.0%	1.1%	-3.5%
FTSE 100	5815	0.5%	6600	Discretionary	7.3%	2.3%	-4.5%	11.9%
MSCI Eurozone*	153	-1.0%	181	Staples	7.0%	1.8%	3.9%	6.7%
MSCI Europe*	1117	-1.7%	1310	Healthcare	10.0%	8.3%	-2.2%	-3.0%
MSCI EM \$*	1145	1.3%	1300	Financials	-6.3%	-5.1%	-10.1%	-1.7%
Brazil Bovespa	58683	-15.3%		Information Tech.	4.6%	-2.8%	-13.5%	-4.6%
Hang Seng	22440	-0.6%		Telecommunications	1.4%	1.3%	6.4%	5.5%
Shanghai SE	2702	-3.8%		Utilities	9.1%	-1.6%	-41.2%	2.1%
				<b>Overall</b>	<b>4.2%</b>	<b>-1.7%</b>	<b>-5.2%</b>	<b>1.3%</b>

\*Levels/returns as of Jul 28, 2011

Local currency except MSCI EM \$

Source: Bloomberg, Datastream, IBES, Standard & Poor's Services, Morgan estimates

## Global Economic Outlook Summary

	Real GDP			Real GDP							Consumer prices			
	% over a year ago			% over previous period, saar							% over a year ago			
	2010	2011	2012	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q10	2Q11	4Q11	2Q12
<b>The Americas</b>														
United States	3.0 ↑	1.8 ↓	2.7	0.4 ↓	1.3 ↓	2.5	3.0	2.0	3.0	3.5	1.2	3.3	3.0	1.4
Canada	3.2	2.8	2.6	3.9	1.5	2.4	2.7	2.9	2.7	2.6	2.3	3.2	2.6	1.6
Latin America	6.0	4.6	3.9	5.8	3.6	4.7	3.8	3.6	4.0	3.4	6.7	6.8	7.2	7.3
Argentina	9.2	7.0	4.8	11.7	5.0	6.0	3.0	4.0	6.0	4.0	11.0	11.0	11.0	13.0
Brazil	7.5	4.0	3.8	5.4	4.7	3.8	3.7	4.0	3.5	3.5	5.6	6.8	6.5	5.7
Chile	5.2	6.5	4.5	5.4	6.0	5.5	3.5	4.5	4.5	4.3	2.5	3.4	4.5	4.0
Colombia	4.3	4.9	4.0	7.7	3.8	3.7	4.2	4.5	3.5	4.0	2.7	3.1	3.4	3.0
Ecuador	3.6	4.5	3.5	7.3	2.5	1.5	1.0	3.5	3.5	3.5	3.4	4.1	3.9	3.6
Mexico	5.4	4.5	3.8	2.1	2.1	7.5	4.0	2.5	4.0	2.0	4.2	3.3	3.4	3.6
Peru	8.8	6.6	5.5	6.6	4.0	3.0	8.0	6.0	5.0	5.0	2.1	2.9	2.8	3.0
Venezuela	-1.7	3.5	3.0	14.1	0.0	-1.5	3.0	3.0	5.0	6.5	27.3	24.4	29.0	33.6
<b>Asia/Pacific</b>														
Japan	4.0	-0.4	3.5	-3.5	-3.0	6.0	6.5	3.5	3.0	2.0	0.1	0.2	0.2	0.1
Australia	2.7	1.6	4.6	-4.7	5.2	4.4 ↑	5.5	4.6	3.1 ↓	4.8	2.7	3.6 ↑	3.8	3.2
New Zealand	1.7	2.2	3.7	3.4	2.1	3.5	3.7	3.5	4.6	3.5	4.0	5.2	3.3	2.5
Asia ex Japan	9.1	7.3	7.4 ↓	9.0	4.8 ↑	6.8 ↓	7.7 ↓	7.6 ↓	7.6 ↓	7.5 ↑	4.9	5.7	4.6	4.2
China	10.3	9.1	9.0	8.9	7.0	8.3	9.5	9.3	9.1	8.9	4.7	5.7	4.1	3.8
Hong Kong	7.0	5.2	4.6	11.7	-1.5 ↓	2.5	5.0 ↑	5.8 ↓	5.8 ↓	4.5	2.8	5.1	5.1 ↓	4.3 ↓
India	8.5	7.6 ↓	8.5 ↓	8.3	7.6 ↓	7.5 ↓	7.1 ↓	8.6 ↓	9.0 ↓	9.5 ↑	9.2	9.1 ↑	8.7	7.8
Indonesia	6.1	6.3	6.0	6.9	4.5	6.5	6.0	6.0	5.5	6.5	6.3	5.9	4.5	5.6
Korea	6.2	4.2	4.7	5.4	3.4 ↑	5.8 ↓	6.0	4.0	4.5	4.5	3.6	4.2 ↓	3.5	2.7
Malaysia	7.2	3.6	4.3	5.7	-2.5	2.5	5.0	5.5	4.5	4.3	2.0	3.3	2.8	2.4
Philippines	7.6	4.7	5.5	7.8	2.0	7.4	6.1	5.3	5.3	5.3	3.0	4.8	4.9	3.1
Singapore	14.5	5.2 ↑	4.3 ↓	22.5	-4.7 ↑	5.3	4.1 ↓	4.9	5.3	4.9	4.0	4.7	3.8 ↑	2.7 ↑
Taiwan	10.9	5.0 ↓	4.1 ↓	19.0	-3.6 ↑	2.0 ↓	5.3 ↓	5.2	5.0	4.5	1.1	1.6	2.2	2.0
Thailand	7.8	3.1	4.1	8.4	-2.0	2.0	4.5	5.0	5.2	4.5	2.9	4.1	3.7	3.6
<b>Africa/Middle East</b>														
Israel	4.7	4.5	4.0	4.6	4.0	4.2	4.5	4.5	4.0	4.0	2.5	4.1	4.0	3.4
South Africa	2.8	3.6 ↓	3.7 ↓	4.8	2.1	3.6 ↓	3.5 ↓	3.6 ↑	4.1 ↓	4.4 ↑	3.5	4.6	5.8	5.1
<b>Europe</b>														
Euro area	1.7	1.9	1.8	3.4	1.5	0.5	1.8	2.3	2.0	2.0	2.0	2.8	2.5 ↓	1.6
Germany	3.5	3.4 ↑	2.1 ↑	6.1	2.0	1.0	2.5 ↑	2.5	2.0	2.0	1.6	2.5	2.4 ↑	1.5 ↑
France	1.4	1.9 ↓	1.9 ↑	3.8	0.5 ↓	1.0	2.5 ↑	2.0	2.0	2.0	1.9	2.2	2.2	1.4
Italy	1.2	0.9 ↑	1.3 ↑	0.5	1.8 ↑	0.0	1.3 ↑	1.8 ↑	1.5	1.5	2.0	2.9	2.4 ↓	1.4 ↓
Norway	2.1	2.6	2.8	2.4	4.0	2.5	2.5	3.0	2.8	2.8	2.2	1.4	1.6	1.6
Sweden	5.4	4.5 ↑	2.7 ↑	3.2 ↓	3.9 ↑	1.5	2.5	3.0	2.8	2.8	1.9	2.9	2.9	2.6
United Kingdom	1.4	1.2 ↑	2.4	1.9	0.7 ↑	2.0	2.5	2.5	2.5	3.0	3.4	4.4 ↓	4.8 ↓	3.0
Emerging Europe	4.5	4.3	4.3 ↓	4.5	1.8	3.9	5.5	4.8	4.3	4.1	6.6	7.2	6.4 ↓	5.5 ↓
Bulgaria	0.2	3.5	4.0	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	2.3	2.7	3.0	3.6	2.5	3.0	3.0	3.5	3.5	3.5	2.1	1.9	2.5	3.3
Hungary	1.2	2.6	2.7	2.8	2.0	2.0	3.0	3.0	2.5	2.5	4.4	4.0	3.9	3.3
Poland	3.8	4.2	3.8	4.1	4.0	4.0	4.5	3.5	3.5	3.5	2.9	4.6	4.1	2.7
Romania	-1.3	2.0	4.0	...	...	...	...	...	...	...	7.9	8.6	5.7	5.3
Russia	4.0	4.5	5.0	5.1	0.8	4.2	6.5	5.7	5.0	4.5	8.2	9.5 ↓	7.7 ↓	6.9 ↓
Turkey	8.9	5.6	4.3	...	...	...	...	...	...	...	7.4	6.0	7.1	5.9
<b>Global</b>	3.9	2.8 ↓	3.4 ↓	2.7 ↓	1.7 ↓	3.2	3.9	3.4 ↓	3.5 ↓	3.6 ↑	2.7	3.7	3.4 ↓	2.5
Developed markets	2.6 ↑	1.6 ↓	2.5	1.0 ↓	0.9 ↓	2.3	3.0	2.4	2.6	2.8	1.6	2.8	2.6	1.5
Emerging markets	7.3	6.0	5.9	7.4	4.0 ↑	5.7 ↓	6.2 ↓	6.1 ↓	6.1 ↓	5.9 ↑	5.6	6.2	5.6	5.2

Source: Morgan

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