**Topics: a self- assessment of our 2012 market, economic and investment views; the "ifs" in Europe, and an aerial view of the June summit**

This week, a mid-year self-assessment of the views published in our 2012 Outlook. In volatile markets, assessments can swing from red to green and back to red rapidly. With that caveat, **here's a review of the major market, economic and investment views that we shared with you in January.** This exercise is a healthy part of any investment process, particularly when looking at what views didn't work out. The first column refers to the page number in the 2012 Outlook; the second to the view; the third is a discussion of the results; and the fourth is a simplified color gradient on how we did. Supporting charts appear on page 5; market returns are all YTD through Friday's close unless noted otherwise.

| Page | The view | What happened | Grade |
|---|---|---|---|
| 1, 2 | OECD private sector economies will mostly have to make it on their own, with fiscal stimulus coming to an end and monetary easing modest outside Europe. The ECB's balance sheet might have to grow by another trillion | So far, yes. OECD fiscal stimulus appears to be ending, and monetary stimulus has been modest in the US and Japan. The ECB's balance sheet has grown by €620 billion Euros since we wrote our report (ch.1), and may have to grow further. Despite massive borrowing already, Spanish banks only finance 12% of their assets at the ECB, and may need a LOT more money. | |
| 1 | US economy more resilient than Europe and Asia, with the latter two showing more signs of a slowdown | US manufacturing surveys hovered above European and Asian counterparts until the disappointing June report; now all of them look weak (ch.2). US new orders and export orders collapsed in June, to the weakest reading since Spring 2009. | |
| 1 | US is our largest regional equity position, next largest Asia, with a large underweight to Europe and Japan | The right call so far: US equities are up 9%, Asia ex-Japan is up 7.9% and Europe is up 1.1% (ch.4). Japan is up 2.5%, Emerging Market equities are up 5.1%, and China is up 2%. | |
| 1 | Optimistic on US corporate profits, but rising earnings pre-announcements are a sign that earnings *growth* is slowing | S&P earnings growth is coming down from 20%-30% y/y gains in 2010 and 2011 to 10% growth this year (ch.5). Weakening foreign demand remains the biggest risk to profits. | |
| 3 | German government debt ratio of 80% would prevent it from acceptance of commingled risks such as Eurobonds or pan-European deposit guarantees | So far, Germany has resisted these measures, insisting on strict fiscal controls first. However, *if* the EU sovereign bailout facility (ESM) directly recapitalizes EU banks, that's a level of burden sharing we haven't seen before (see p.3 for more details) | ESM bank recap |
| 3 | Markets are not convinced that Italy is solvent, and that its debt is declining. We remain very concerned about Italy's low growth and high debt burden | Italy runs a tight ship in terms of its primary deficit, but its credit spreads remain high (ch.6). YTD, Italian banks have bought all net issuance of the Italian government, and a lot of Italian gov't bonds sold by foreign holders. GDP contracting at a ~2% pace. | |
| 3, 11 | Spain is a mess and would be the focal point of the EU crisis this year | Completely. Spain is in recession, capital flight out of Spain is substantial, many of its banks need to be rescued, credit spreads have risen sharply and its equity market is down 19.5%, the most in Europe. | |
| 4 | We expect US payroll growth of 200k per month, US GDP growth of ~2.25%, and continued good news on US capital spending | We were close, but a bit too optimistic. Q1 GDP growth was 1.9%, and Q2 looks to be 1.5% (ch.3). Why so low? Rising services consumption has not been high enough to offset declining durable goods purchases, and the recovery in residential investment hasn't been enough to offset declines in construction and defense. Nonfarm and private payroll gains have averaged 150k/159k per month through June; the weather flattered earlier results. Core capital goods orders are no longer growing, and the strong contribution from equipment and software spending since 2009 is fading (ch.7). | |
| 5 | We remain concerned about the long-term US fiscal situation, and are nervous about long-duration US government bonds | Bond markets are not nervous at all. We did not offer a prediction on US rates, but if we did, we would have been too high. Between Fed purchases (66% of all Treasury issuance in 2011) and demand from foreign central banks, US banks and households, there is plenty of demand for US Treasury bonds, despite the untenable long-term fiscal outlook and an 8% deficit. | |

**Topics: a self- assessment of our 2012 market, economic and investment views; the "ifs" in Europe, and an aerial view of the June summit**

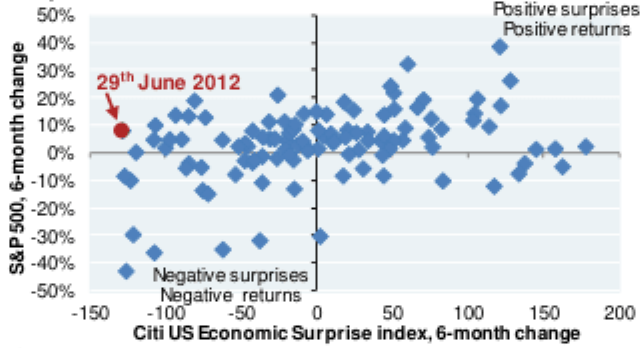
| | | | |
|---|---|---|---|
| 6 | Chinese inflation would slow, as would the rate of RMB appreciation, allowing for more monetary stimulus. We are optimistic on Chinese consumption, and do not see a hard landing in China | Mixed bag. Headline and core inflation are falling, allowing the government to ease bank reserve requirements and take other modest easing steps (ch.8). We were also on target that the Chinese RMB would stop appreciating (it's down 1.1% vs. up 5% in 2011), and Chinese consumption as a % of GDP growth is the highest it's been since the late 1990s. However, we did not anticipate the degree of the slowdown in the Chinese economy, which looks to have settled in at 6%-7% growth. | |
| 7 | Putting some capital to work in equity markets seems reasonable, given the largest sidelined corporate and household cash balances in 25 years, and low valuations | Markets have been volatile, and this is a view that will have to be examined again later in the year. So far, despite the generally poor macroeconomic global backdrop, the MSCI World Equity Index is up 5.8% and our preferred investment strategy of MSCI World ex-Europe is up 7.6%. | |
| 7 | Technology stocks look attractive, given P/E multiples that are flat to the broad market | The S&P 500 Info Tech sector is up 12.8%, outperforming the S&P 500 (which is up 9%) | |
| 7 | Large cap multinational stocks are worth looking at, at current valuations | The Morgan Stanley Multinational Nifty Fifty Index is up 10.7% compared to the MSCI World up 5.8% | |
| 7 | Continue to focus on high dividend/equity income stocks | Individual portfolios vary, but the general outperformance of dividend stocks in 2010 and 2011 stopped in 2012. As one indication, the S&P Dividend Aristocrats Index is up 8.4% YTD, behind the S&P 500 which is up 9% | |
| 8 | Equity valuations: low and likely to stay that way | We remain in a low P/E multiple environment, a reflection of macro imbalances, and the fact that high profit margins are more dependent on low labor compensation than in past cycles. The MSCI World Index trailing P/E ratio started the year at 13x, rose above 15x in March, and has fallen back to 14x (ch.9). | |
| 8, 9 | Good value in loan portfolios sold by over-leveraged European banks, oil & gas rescue projects, distressed real estate and private market lending ("mezzanine debt") | These are long-term investments that will take years to evaluate. | N.A. |
| 9 | We see value in both high yield and leveraged loans. Two reasons: (i) we estimate that the demand for credit now outstrips supply, and (ii) on US high yield, implied default rates are above the losses actually experienced during the last 2 recessions | YTD, the Barclays High Yield Index is up 7.9% and the S&P/LSTA Leveraged Loan Index is up 4.8%. Fed policy (zero interest rates) has created a lust for yield, the consequences of which will not be known for many years. | |
| 10 | We see value in macro hedge funds | YTD through May, the HFRI Macro Hedge Fund index is up only 1%, compared to 1.6% for both the HFRI Fund of Funds Diversified Index and the HFRI Fund Weighted Composite. In other words, low returns and no outperformance vs. a broader measure of hedge fund returns. Many macro managers exited the long duration trade earlier in the year before the rally in the long bond; others were whipsawed on the Yen which rallied after selling off to 84; and most have not made money on oil or gold. | |
| 10 | Gold will remain volatile, but until monetary tightening is on the horizon, we would not sell and believe gold will end the year higher than where it began | So far, a wild ride that's back where it started. Gold started the year at $1,563, rose close to $1,800 in February, and has since fallen back to $1,584. | |

**Topics: a self- assessment of our 2012 market, economic and investment views; the "ifs" in Europe, and an aerial view of the June summit**

Here's a summary: Europe looks as bad as we thought it would, but our US economic outlook was too optimistic. However, as things stand now, resilient corporate profits and a ton of liquidity (see below) has helped stabilize US equities. The disconnect between profits and economics does not happen very often. As shown in the chart, **for a period when US economic data has been generally subpar (i.e., a large YTD negative reading on Citigroup's economic surprise index), US equities have done better than they have in the past.**

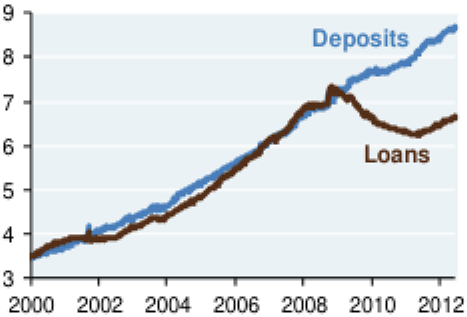
We have been considerably more bearish than consensus since March 2010 on all things European, and are looking closely at the summit outcome to see if things are changing enough for us to revise our views. Our take on the summit appears below.

**US equity performance relative to change in Economic Surprise index**



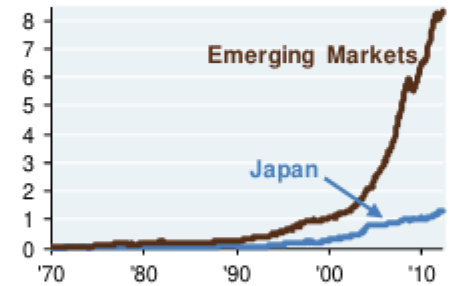

Source: Bloomberg, J.P. Morgan Asset Management. Data since 2003.

**US commercial bank excess deposits**
Trillions, USD



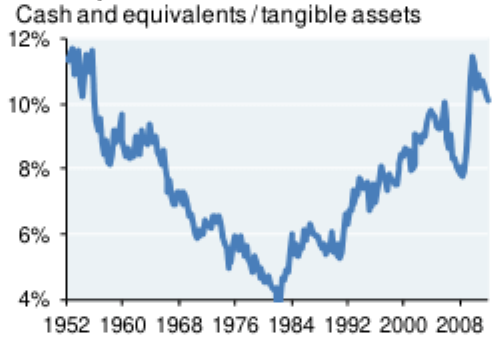

Source: Federal Reserve Board.

**Foreign exchange reserves**
Trillions, USD




Source: Ministry of Finance Japan, IFS, J.P. Morgan Securities LLC.

**US corporate cash balances**
Cash and equivalents / tangible assets




Source: Federal Reserve Board.

## European Subjunctivitis

The markets liked the EU summit, presumably since a green light was given to the EU bailout facility (European Stability Mechanism) to directly recapitalize banks, and buy Periphery bonds in the secondary market to stabilize yields. This was the only major news from the summit, and was notable since Germany had objected to this beforehand. Germany had insisted that as per its original mission, the ESM lend to governments who then recapitalize banks on their own. Merkel reportedly changed her view after pressure from Italy and Spain, and the "French Resistance" (see next page). Recapitalization of banks is generally good news: in most debt crises, recapitalization of banks has been more successful in boosting GDP and equity markets than governments buying bad loans or lending to banks (see June 11 EoTM). That may explain the rally after the summit.

However, there's a lot of **subjunctive tense** that bears watching. The summit result on the ESM bank recap is good news…

- IF the ESM were established and ratified by all governments, which is expected to happen but hasn't yet. The EU only needs approval from 90% of all capital commitments to activate, making it harder for smaller countries to derail it
- IF the ESM were to recapitalize banks and not just lend to them, the latter being its primary mission
- IF recapitalizations were not rejected by any member of the Eurozone, as the required protocols state
- IF subsequent losses on any recapitalizations do not end up discouraging future lending or investment decisions (Ireland's National Reserve Pension Fund lost 80% on its bank recaps, so the risk of loss for the ESM in Spain is material)
- IF the German Constitutional Court does not concur with objections raised already, or with objections raised in the future

Given the pattern of prior summits disappointing markets once results were digested[1], caution is warranted here. The EU crisis is primarily one of **external imbalances between private sector economies in the core and the periphery**. The sovereign and banking issues are *by-products* of these private sector problems. The summit didn't do much to address this, so I'm waiting for the next round of growth, employment and private sector credit data before drawing conclusions. As things stand now, **loan creation in Italy has gone negative** for the first time in 20 years. This may prove problematic for a country with the lowest growth rate in the OECD over the same period, other than Japan.

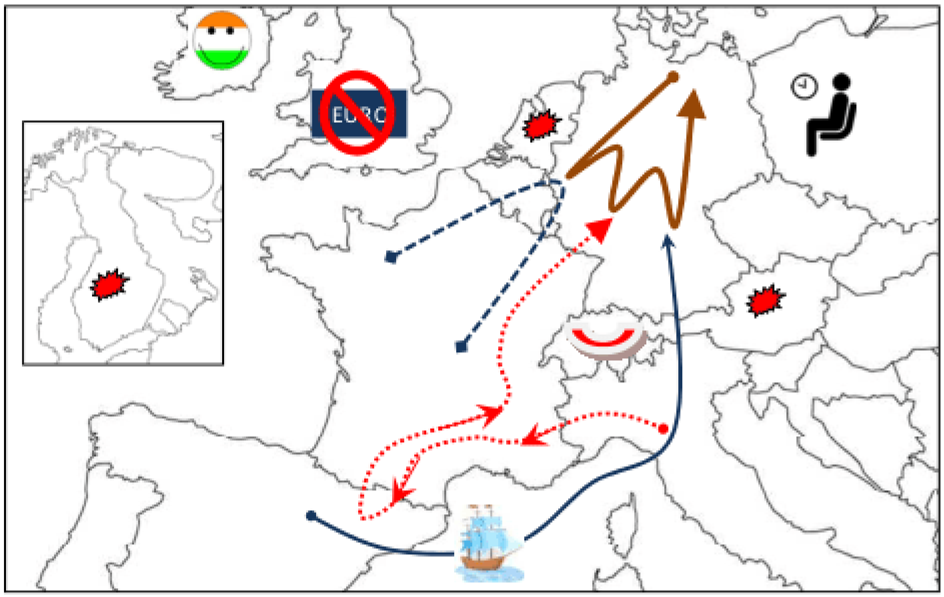
[1] Pavan Wadhwa at JP Morgan Securities LLC wrote a good, short piece on this last week with a chart showing post-summit disappointment in credit and equity markets after the last 4 summits.

**Topics: a self- assessment of our 2012 market, economic and investment views; the "ifs" in Europe, and an aerial view of the June summit**

I suppose the bottom line is that while Germany is inclined to do what it can to prevent any further sovereign or banking systems failures in the Periphery, it is unclear what form this assistance will take. The markets would like a road map, but I am not sure we will get a clear one. At least Europe is trying to get off the front pages long enough for markets to focus on the private sector recoveries in the US and China, and whether more monetary stimulus and lower oil prices will help in the second half of the year.

**One last thing: the politics of the EU summit appear quite tense, and you have to wonder if this is how monetary unions are made or broken: by strong-arming the Chancellor of the country primarily expected to fund the Euro's survival.** To close this week's note, an aerial view of the summit and how these maneuvers played out. The next move is Germany's.

Michael Cembalest
J.P. Morgan Asset Management



June 2012 EU Summit Maneuvers

***Key [This is my own read of who did what and why. Obviously, opinions will vary]***

The **French Resistance** to German austerity demands started with a threat by Hollande to surrender immediately, to not even support his own growth compact and to let the summit fail, unless Germany changed course. The growth compact was then agreed to. While it sounds good, no new monies were committed (the 120 bn Euros mentioned are from existing sources).

**Italy switches sides**: Prime Minister Monti, whose technocratic government was approved by Germany and who was expected to follow Germany's austerity line, defected to Hollande's camp and also threatened to allow talks to fail and blame the entire mess on Merkel. Sidenote: watch for a possible Napoleonic return from Berlusconi should conditions in Italy deteriorate.

**Spain allied itself with Italy**, and allowed Italy to attack Germany directly, since Spain's banks and its entire economy are in much worse shape. Along with Italy, Spain is pushing for EU purchases of sovereign bonds with limited/no strings attached.

An **isolated Germany** retreated on its ESM lending stance and got little in return other than vague language about region-wide banking oversight by the ECB. Germany now has to sort out the internal politics of post-summit magazine covers showing an Italian kicking a soccer ball with Merkel's head on it; a letter from 160 German economists criticizing Merkel's approach at the summit; a comment by the German President that Merkel has the duty to describe in great detail what summit agreements mean for Germany's budget; and France still reluctant to cede banking system or fiscal authority to an EU regulator, one of Germany's demands.

**Austria, Finland (inset) and the Netherlands**, fiscally conservative allies of Germany, are dealt a blow by German concessions. Certain ESM provisions requiring 85% and 90% thresholds appear designed to thwart their potential objections.

**Ireland sees itself as a big winner from the Hollande-Monti revolt**, having argued since 2009 that the rich members should recapitalize EU banks directly, rather than each country being responsible for its own banks. Without any concessions from Germany, Ireland's debt-GNP ratio would rise above 140%. Not clear if reality matches Irish expectations; perhaps Ireland will convince the EU to recap Allied Irish Bank and the Bank of Ireland with 15 billion (around 10% of Irish GNP).

**After Great Britain vetoed the fiscal compact last year (which probably would not have applied to them anyway)**, it has been left on the sidelines politically, in "Splendid Isolation". Given what is going on in Europe, not a bad place to be. The UK is not in great shape, but would be in disastrous shape had it joined the European Monetary Union.

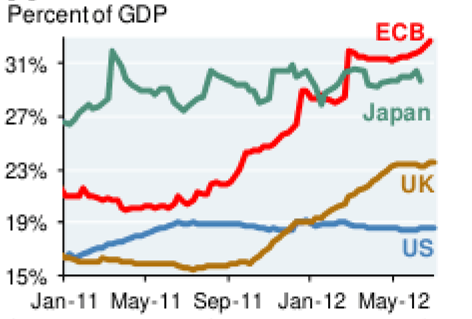
**Swiss** wall of monetary neutrality under siege by capital inflows from the Periphery. Swiss National Bank FX reserves have grown by 40% of GDP since 2009, an enormous amount that China took over a *decade* to accumulate.

In a speech last November, **Poland's foreign minister stated that he may be the first to say he feared German *inaction* more than German *action***. On the other hand, he stressed the value of money, responsibility and the honest intention to repay as being the foundations of a moral order. Bottom line: Poland still wants to join the EMU, but is **waiting** for Germany to clean up the mess, and for the Periphery to adhere to new fiscal rules which would be "almost impossible to block".

**Topics: a self- assessment of our 2012 market, economic and investment views; the "ifs" in Europe, and an aerial view of the June summit**

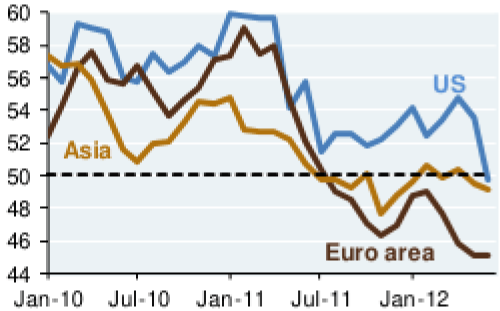
**Report card charts**

**[1] Central bank balance sheets**
Percent of GDP



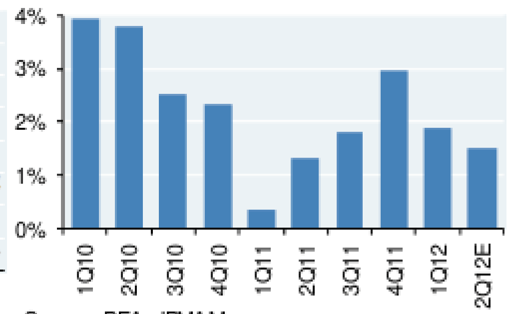

Source: FRB, BEA, ECB, Eurostat, BoE, UK Office for National Statistics, BoJ, Japan Cabinet Office.

**[2] Global manufacturing surveys**
Purchasing Managers Index, sa




Source: ISM, Markit, J.P. Morgan Securities.

**[3] US real GDP growth**
Percent change, annualized

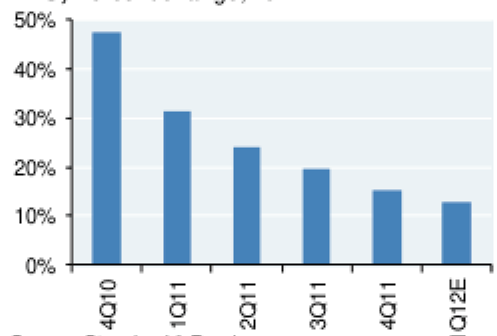



Source: BEA, JPMAM.

**[4] Regional equity returns**
Total return, USD, percent


Source: Bloomberg.

**[5] Trailing 4-qtr S&P 500 operating EPS,** Percent change, YoY




Source:Standard & Poor's.

**[6] Italian 10-year government bond yield,** Percent


Source: Bloomberg.

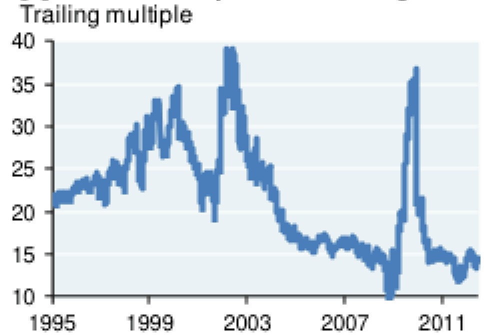
**[7] Equipment + software spending**
Contribution to real GDP growth, percent


Source: BEA.

**[8] Chinese reserve requirement ratio and YoY headline inflation**


Source: PBOC, NBS.

**[9] MSCI World price to earnings**
Trailing multiple




Source: Bloomberg.

| | |
|---|---|
| OECD | Organization for Economic Cooperation and Development |
| ECB | European Central Bank |
| RMB | Ren Min Bi |
| MSCI | Morgan Stanley Capital International |
| HFRI | Hedge Fund Research Inc |
| EU | European Union |
| ESM | European Stability Mechanism |

**Topics: a self- assessment of our 2012 market, economic and investment views; the "ifs" in Europe, and an aerial view of the June summit**

*IRS Circular 230 Disclosure: JPMorgan Chase & Co. and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with JPMorgan Chase & Co. of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties. Note that J.P. Morgan is not a licensed insurance provider.*

*The material contained herein is intended as a general market commentary. Opinions expressed herein are those of Michael Cembalest and may differ from those of other J.P. Morgan employees and affiliates. This information in no way constitutes J.P. Morgan research and should not be treated as such. Further, the views expressed herein may differ from that contained in J.P. Morgan research reports. The above summary/prices/quotes/statistics have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness, any yield referenced is indicative and subject to change. Past performance is not a guarantee of future results. References to the performance or character of our portfolios generally refer to our Balanced Model Portfolios constructed by J.P. Morgan. It is a proxy for client performance and may not represent actual transactions or investments in client accounts. The model portfolio can be implemented across brokerage or managed accounts depending on the unique objectives of each client and is serviced through distinct legal entities licensed for specific activities. Bank, trust and investment management services are provided by JP Morgan Chase Bank, N.A, and its affiliates. Securities are offered through J.P. Morgan Securities LLC (JPMS), Member NYSE, FINRA and SIPC, and its affiliates globally as local legislation permits. Securities products purchased or sold through JPMS are not insured by the Federal Deposit Insurance Corporation ("FDIC"); are not deposits or other obligations of its bank or thrift affiliates and are not guaranteed by its bank or thrift affiliates; and are subject to investment risks, including possible loss of the principal invested. Not all investment ideas referenced are suitable for all investors. Speak with your J.P. Morgan Representative concerning your personal situation. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Private Investments may engage in leveraging and other speculative practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuations to investors and may involve complex tax structures and delays in distributing important tax information. Typically such investment ideas can only be offered to suitable investors through a confidential offering memorandum which fully describes all terms, conditions, and risks. This material is distributed with the understanding that J.P. Morgan is not rendering accounting, legal or tax advice. You should consult with your independent advisors concerning such matters.*

*In the United Kingdom, this material is approved by J.P. Morgan International Bank Limited (JPMIB) with the registered office located at 25 Bank Street, Canary Wharf, London E14 5JP, registered in England No. 03838766 and is authorised and regulated by the Financial Services Authority. In addition, this material may be distributed by: JPMorgan Chase Bank, N.A. (JPMCB) Paris branch, which is regulated by the French banking authorities Autorité de Contrôle Prudentiel and Autorité des Marchés Financiers; J.P. Morgan (Suisse) SA, regulated by the Swiss Financial Market Supervisory Authority; JPMCB Bahrain branch, licensed as a conventional wholesale bank by the Central Bank of Bahrain (for professional clients only); JPMCB Dubai branch, regulated by the Dubai Financial Services Authority.*

*In Hong Kong, this material is distributed by JPMorgan Chase Bank, N.A. (JPMCB) Hong Kong branch except to recipients having an account at JPMCB Singapore branch and where this material relates to a Collective Investment Scheme (other than private funds such as private equity and hedge funds) in which case it is distributed by J.P. Morgan Securities (Asia Pacific) Limited (JPMSAPL). Both JPMCB Hong Kong branch and JPMSAPL are regulated by the Hong Kong Monetary Authority.*

*In Singapore, this material is distributed by JPMCB Singapore branch except to recipients having an account at JPMCB Singapore branch and where this material relates to a Collective Investment Scheme (other than private funds such as a private equity and hedge funds) in which case it is distributed by J.P. Morgan (S.E.A.) Limited (JPMSEAL). Both JPMCB Singapore branch and JPMSEAL are regulated by the Monetary Authority of Singapore.*

*Each recipient of this presentation, and each agent thereof, may disclose to any person, without limitation, the US income and franchise tax treatment and tax structure of the transactions described herein and may disclose all materials of any kind (including opinions or other tax analyses) provided to each recipient insofar as the materials relate to a US income or franchise tax strategy provided to such recipient by JPMorgan Chase & Co. and its subsidiaries. Should you have any questions regarding the information contained in this material or about J.P. Morgan products and services, please contact your J.P. Morgan private banking representative. Additional information is available upon request. "J.P. Morgan" is the marketing name for JPMorgan Chase & Co. and its subsidiaries and affiliates worldwide. This material may not be reproduced or circulated without J.P. Morgan's authority.* 