

## The Morgan View

### Turning positive

- **Economics** — Hard activity data are coming in more solid than depressed surveys and confidence suggest. We raise US Q3 to 2.5% and lower our US recession probability to 1/3.
- **Portfolio strategy** — Better data, the start of growth upgrades and signals of coming actions to salvage the euro make us switch to a tactical long position in risk assets.
- **Fixed Income** — A more determined tone of EA policymakers and some encouraging activity data make us turn neutral on duration in DM.
- **Equities** — The turn in economic and market momentum is inducing us to close bearish positions. We close our UW in Cyclical sectors. We open an OW in Euro area vs. US equities and an overweight in US banks.
- **Credit** — Economic and policy momentum lead us to take a more positive view into YE. We turn neutral on US HG and close our OW EMBIG vs. CEMBI.
- **Foreign exchange** — Sell FX vol to position for reduced financial stress.
- **Commodities** — Brent crude prices should remain around current levels through to the end of the year, supported by cuts in OPEC production.

Risk markets rallied this week, even as EMU spreads widened, and safer government bonds sold off on a softening of some of the acute macro risks that have been battering markets this year. None of this is enough to convert one into a raging bull, but there is enough to expect risk markets to break out of their recent depressed ranges over coming weeks. We thus **reverse some of our defensive exposures into a modest, net long risk position.**

World markets continue to focus on an unchanged **trio of macro risks — US recession, euro meltdown, and a Chinese housing bust.** Stacked against these three are massive risk premia on equities and credit over cash and safer government bonds that make underweighting riskier assets very expensive. Over the two years through Q1 of this year, the high risk premium dominated, but over the past four months, each three of these threats escalated and forced the world into a more defensive position. Most investors we talk to remain bearish, if not scarred about the risks facing us, in particular given how little central bankers can do about and how little fiscal policy makers seem to be willing to do.

We have been mouthing the same concerns here in recent months, but an objective look at recent developments does suggest a **softening of risk on both the US economy and EMU blowup.** None of these puts us into the clear but they move us in the right direction and should induce continued short covering of risk positions. We thus reverse the tactical UW we have in global equities, energy, base metals and EM FX versus cash and bonds that we have in our *GMOS* portfolio.

We find that **hard activity data are coming in more solid than suggested by more bearish confidence and survey data.** Global IP actually rose at a 0.5%

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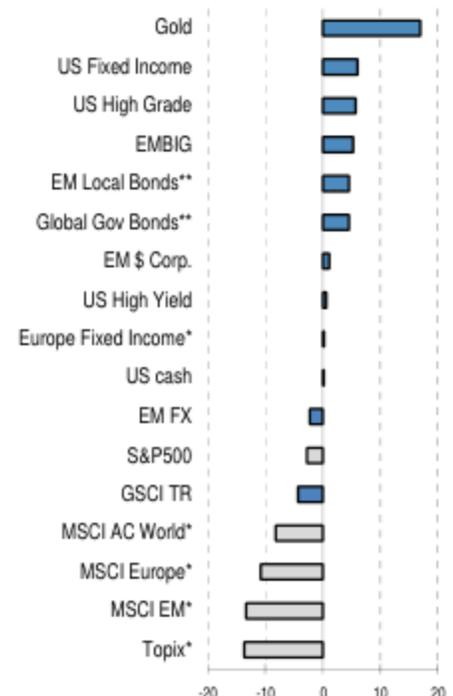
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#### YTD returns through Oct 13

%, 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 \$.

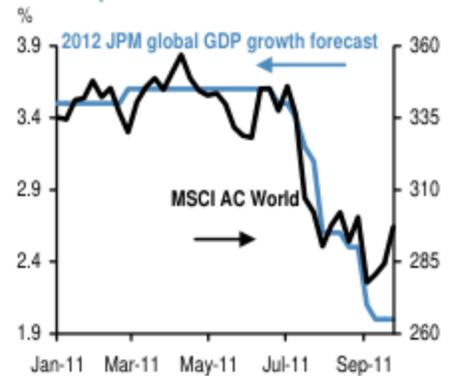
pace in August, a month when global equities took a dive. Global retail sales, auto sales and capital spending all rose in Q3. The surveys are supposed to be forward looking, and weak data may thus be just around the corner, as we are seeing in the Asian tech sector. However, the data are facts and surveys are just that.

- Our US Economic Activity Surprise Index has been in positive territory for several weeks now and has just induced our economists to raise their Q3 estimate to 2.5% — above the consensus of 1.9%. As a result, the 2-quarter growth pace rises to almost 2%, above the stall speed of 1% that the Fed itself is using as a signal of recession risk. We lower our risk of a US recession to 1/3, from 40%. But the risk remains as the real threat to the US economy comes from the ending of fiscal stimulus measures at year end, and there is still little hint of impending compromise in Washington. We keep Q4 at a below-consensus pace of 1% as inventories seem too high.
- A growing recognition among policy makers around the world that an EMU breakdown would be a super Lehman shock is accelerating efforts to contain the crisis. Investors have been looking for actions to isolate the Greek crisis, ring fence the banks through higher capital levels, and more broadly fund sovereigns through the EFSF and IMF. There is now so much smoke and rumours around these that it is becoming more likely that words will be turned into actions. One should not expect that these will produce a TARP-like shock-and-awe that will overwhelm a sceptical financial community. At the same time, expectations for what Europe can deliver are now so low that commitments and actions coming out of G20 and the EU Summit in coming weeks will likely force investors to upgrade the chance that Europe will salvage the euro. These actions, however, will not include less fiscal austerity and are thus unlikely to prevent recession in the Euro area.
- In EM, we are seeing a slow movement from monetary tightening to easing, and thus reduced downside risks on growth. Overall, we expect EM growth to move in tandem with DM, with a beta close to 1 (see Lupton, Hensley, and Ogan, *Nowhere to hide: EM decelerating alongside US and Euro Area*, Oct 11). Event risk on EM is largely focused on real estate leverage in China. We recognise this, but believe that low interest rates, improved regulation and a strong fiscal position will prevent a Chinese banking crisis over the next 2-3 years (see Zhu, Ng, and Jiang, *Chinese banks: rising risk, but still manageable*, Oct 14).

## Fixed income

- **Bonds fell again this week, with yields reaching late August levels.** US recession risks are receding, and hopes are rising of decisive policy action on the EMU crisis. In keeping with the position reversals across markets, our client surveys point to bond managers switching from slightly net long to short in both the US and Euro area.
- The emerging consensus among EU leaders appears to involve a greater Greek writedown, aggressive bank recapitalisation, and leveraging the EFSF by turning it into a bond insurer. That policy prescription comes with significant implementation risks, especially around investor demand for EFSF-insured bonds (see this week's *GFIMS* for an extensive discussion). But **we recognise the more determined tone of Euro area policymakers, and the more encourag-**

### 2012 JPMorgan global GDP growth forecast vs. Global equities



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.

### 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.

#### 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 Srinivasan 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.

ing activity data, and turn neutral on duration in DM (closing longs in the UK and Germany).

- **Intra-EMU spreads bucked the trend of risky asset outperformance, widening across the board.** With many potholes on the horizon, including Spanish supply next week, we remain cautious on this front. Most striking this week was the sharp rise in the France-Germany spread to a post-EMU high, on concerns about French banks. We estimate that French banks would need some €50bn of additional capital in the event of significant sovereign haircuts and a 9% Core Tier 1 capital target (see Steve Dulake, *The Counter Sovereign Buffer*, Oct 13). That is not a small number, but at around 2.5% of GDP would not decisively change French debt dynamics.

## Equities

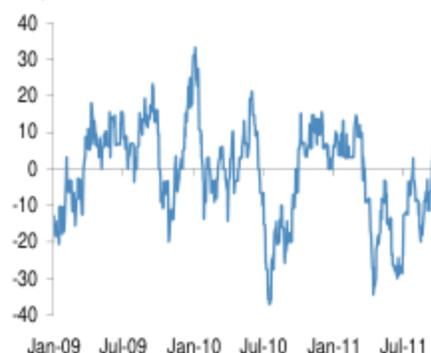
- **Equities rebounded further this week and are now up by almost 10% from their lows** at the beginning of October. Optimism regarding the Oct 24 EU leaders' summit continues to boost investor sentiment. This, coupled with better than expected economic data, is inducing investors to cover their underweight positions.
- **The turn in economic and market momentum is also inducing us to close bearish positions.** We close our underweight in Cyclical sectors as recent economic surprises make it likely that the global PMI will post an increase, the first in eight months, with the next release on November 1st. We also open an OW in Euro area (MSCI EMU) vs US equities (S&P500) as investor underweights are more extreme in the Euro area.
- **The reporting season is adding to positive momentum.** Our equity strategists are looking for a positive surprise in the Q3 reporting season. Tom Lee raised his Q3 S&P 500 EPS forecast to \$24.75 (from \$24.45) which is \$0.30 above the bottom-up consensus. Overall, S&P 500 revenues are forecast to be up 10% Y/Y and EPS up 12% Y/Y. The incremental driver for this improvement in EPS is actually from Financials, as their EPS is forecast to rise 44% Q/Q vs. Q2 driven by lower credit costs and higher refinancings and loan growth. As a result, we open an overweight in US banks (long BKX vs SPX Index).
- **We are more positive about the Q3 reporting season in Europe.** Mislav Matejka argues that the hurdle for European companies is lower due to excessive pessimism. Europe faced a higher hurdle rate in the Q2 reporting season vs the US, of the order of 8%, but that is not the case now. The Q3 EPS growth forecast in Europe is now 6% below that of the US. Currency should be less of a drag this time around as well, with the Euro 7% weaker in Q3, in contrast to 2% appreciation in Q2. All this is consistent with an OW in Euro area vs US equities mentioned above.

## Credit

- **Credit markets extended the rally that began mid-last week** as policy momentum picked up and hard economic data has been more favourable. The extension of the EFSF is now ratified and investors are gaining confidence in European policy makers' willingness to stem an EU Lehman-type event. Our US strategists have turned **Neutral from Underweight**, revised their **YE US HG target to 225bp from 250bp** and their **CDX.HY target to 125bp**. They believe that valuations are attractive, that HG investors want to add risk, and that

### 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.

credit fundamentals will remain strong even as earnings weaken (see today's *CMOS*, Eric Beinstein et al.). In fact, **US High Grade bond funds saw \$2.4bn of inflows last week**, more than 2.5 times higher than the average weekly inflow this year.

- **Similarly in the EU**, our strategists are realigning their portfolio towards a **more positive view going into year end**. They believe that a bank recapitalisation plan is likely to be the main market-moving event on the horizon and recommend **iTraxx Senior Financials vs. iTraxx Main** (see Tina Zhang., *The state of Play*, Oct. 13) to position for it. **In emerging markets**, external corporate debt significantly outperformed external sovereign debt, tightening 50bp relative to 33bp. For tactical reasons, we close the OW EMBIG vs. CEMBI in our GMOS portfolio. Whilst down on the week, it has returned a profit since inception.

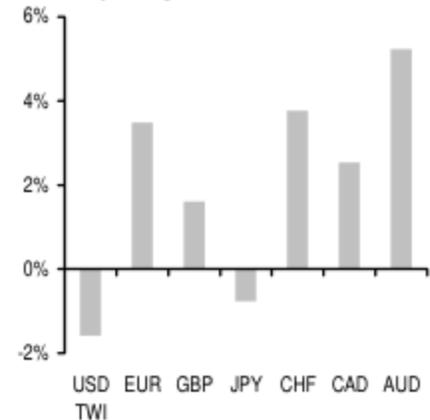
## Foreign Exchange

- The dollar is dropping in October as quickly and broadly as it rose in September. This relapse isn't surprising in view of the record USD longs with which investors entered the month, the potential for a policy breakthrough in Europe, and a decent start to the Q3 US earnings season. Event risks in the US and Europe remain substantial, which is why the base case has been a modest decline in the dollar indices in Q4 to roughly 76 on DXY and 77 on Morgan's trade-weighted index JPMQUSD, equivalent to EUR/USD 1.38, AUD/USD 1.05 and USD/JPY 75.
- **We continue to position for diminishing financial stress this month** by selling vol in pairs where too much recession risk has been priced. Last week, we sold USD/SGD cash and a 1.09 USD/CAD call. We add to this by selling a 9.29 EUR/SEK call and a 0.7550 NZD/USD put. We are still long a basket of 3-month yen options to hedge the numerous event risks which may follow the G-20 summit on Nov 3-4.

## Commodities

- **Commodities rallied strongly this week, up around 5% driven largely by energy and agriculture.** As we pointed out last week, the sell-off in corn was overdone given how tight global supply and inventories are. This week, corn prices are up over 6% and are now trading inline with our expectation of an average price of \$6.40/bu over Q4. The key upside risk to this is **Chinese demand**. Press reports indicate the Chinese government would like to release a significant amount of corn in November as part of their efforts to help dampen food price inflation. We believe that a considerable portion of Chinese corn demand will come via the US which will add further pressure to the US corn market, offsetting the slightly higher inventories we now expect.
- Last week, **our oil strategists reviewed their outlook and price forecasts** and kept their year end 2011 and 2012 forecasts unchanged at \$115/bbl and \$120/bbl respectively for Brent. They also initiated forecasts for **2013**, putting **Brent prices at \$130/bbl** by the end of 2013 (see *Oil Market Monthly*, Eagles et al. 7 Oct). Inventories are being drawn down and the backwardation in the Brent curve (downward sloping) remains close to historic highs. **OPEC has already cut production** over the summer and we would expect them to continue should prices fall past \$100/bbl. **We also do not view the return of Libyan supply as bearish** as it will likely result in an adjustment to other OPEC countries' production levels and as such would not push prices lower.

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	Dec-11	Mar-12	Jun-12	Sep-12	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	2.22	2.25	2.60	2.80	2.80	7.9%
Euro area	Refi rate	1.50	1.00	1.00	1.00	1.00	
	10-year yields	2.20	1.55	1.60	1.80	2.00	6.4%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.61	2.10	2.10	2.10	2.10	10.9%
Japan	Overnight call rate	0.10	0.05	0.05	0.05	0.05	
	10-year yields	1.02	0.85	1.00	1.10	1.10	1.8%
GBI-EM hedged in \$	Yield - Global Diversified	6.43		6.90			4.5%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	239	JPMorgan JULI Portfolio Spread to Treasury	5.5%
Euro high grade (bp over Euro gov)	297	iBoxx Euro Corporate Index	2.3%
USD high yield (bp vs. UST)	785	JPMorgan Global High Yield Index STW	1.4%
Euro high yield (bp over Euro gov)	910	iBoxx Euro HY Index	-5.5%
EMBIG (bp vs. UST)	406	EMBI Global	5.2%
EM Corporates (bp vs. UST)	457	JPM EM Corporates (CEMBI)	1.1%

Commodities	Current	Quarterly Averages				GSCI Index	YTD Return*
		11Q4	12Q1	12Q2	12Q3		
Brent (\$/bbl)	114.7	115.0	120.0	120.0	125.0	Energy	-1.6%
Gold (\$/oz)	1682	2150	1925	1875	1850	Precious Metals	16.9%
Copper (\$/metric ton)	7293	7250	8250	8500	9250	Industrial Metals	-21.1%
Corn (\$/Bu)	6.40	6.40	6.70	7.00	6.80	Agriculture	-12.2%

Foreign Exchange	Current	Dec-11	Mar-12	Jun-12	Sep-12	3m cash	YTD Return*
						index	in USD
EUR/USD	1.39	1.38	1.38	1.40	1.42	EUR	3.4%
USD/JPY	77.3	75	74	73	72	JPY	5.8%
GBP/USD	1.58	1.59	1.58	1.58	1.60	GBP	1.4%
USD/BRL	1.73	1.80	1.80	1.80	1.80	BRL	-0.2%
USD/CNY	6.38	6.30	6.20	6.10	6.00	CNY	1.7%
USD/KRW	1156	1070	1050	1020	1010	KRW	-0.1%
USD/TRY	1.84	1.65	1.65	1.65	1.65	TRY	-12.4%

Equities	Current	YTD Return (local ccy)
S&P	1216	-1.7%
Nasdaq	2646	0.3%
Topix	749	-14.8%
FTSE 100	5466	-4.6%
MSCI Eurozone*	132	-13.8%
MSCI Europe*	1009	-10.8%
MSCI EM \$*	930	-17.1%
Brazil Bovespa	54767	-21.0%
Hang Seng	18502	-15.4%
Shanghai SE	2431	-9.9%

\*Levels/returns as of Oct 13, 2011  
Local currency except MSCI EM \$

Sector Allocation *	US	Europe	Japan	EM
	YTD	YTD	YTD	YTD (\$)
Energy	-3.7%	-4.7%	-5.7%	-19.1%
Materials	-12.8%	-22.4%	-15.3%	-22.6%
Industrials	-7.9%	-17.8%	-13.2%	-25.8%
Discretionary	2.8%	-11.1%	-19.7%	-5.8%
Staples	6.6%	0.0%	4.3%	-3.5%
Healthcare	5.3%	3.5%	-3.5%	-16.6%
Financials	-21.1%	-20.9%	-22.0%	-20.7%
Information Tech.	2.9%	-7.8%	-23.7%	-16.4%
Telecommunications	1.0%	-0.9%	0.9%	-5.4%
Utilities	10.9%	-7.6%	-46.9%	-16.5%
<b>Overall</b>	<b>-1.7%</b>	<b>-10.8%</b>	<b>-14.8%</b>	<b>-17.1%</b>

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	1.7 ↑	1.5 ↑	0.4	1.3	2.5 ↑	1.0	0.5	1.5	2.5	1.2	3.3	3.2	1.4
Canada	3.2	2.2	2.2	3.6	-0.4	1.8	2.4	2.6	2.6	2.4	2.3	3.4	2.6	1.6
Latin America	6.0	4.2	3.2	5.6	4.1	3.1	2.5	1.6	4.4	4.7	6.7	6.7	7.2	6.9
Argentina	9.2	7.5	3.0	13.1	10.2	4.0	2.0	0.0	6.0	4.0	11.0	9.7	11.0	10.0
Brazil	7.5	3.3	3.4	5.0	3.1	1.9	2.7	3.3	4.2	4.2	5.6	6.6	6.7	5.3
Chile	5.2	6.5	4.0	6.4	5.7	3.5	2.5	3.5	4.5	5.0	2.5	3.3	3.6	3.6
Colombia	4.3	5.3	3.7	2.9	8.5	3.5	1.5	3.0	4.0	5.0	2.7	3.0	3.9 ↑	3.0 ↓
Ecuador	3.6	6.0	3.0	7.3	3.0	2.0	1.0	2.0	3.5	4.0	3.4	4.1	3.9	3.6
Mexico	5.4	4.0	2.5	2.4	4.5	5.7	2.6	-1.7	4.1	4.8	4.2	3.3	3.2 ↓	3.5
Peru	8.8	6.3	4.5	6.9	4.5	2.5	3.0	4.5	5.0	6.2	2.1	3.1	4.0 ↑	3.6 ↑
Venezuela	-1.5	3.5	3.0	14.7	-3.2	-1.5	3.0	3.0	5.0	6.5	27.3	24.6	29.0	33.6
<b>Asia/Pacific</b>														
Japan	4.0	-0.6	1.9	-3.7	-2.1	5.5	2.0	1.8	1.5	1.3	-0.3	-0.4	-0.1	-0.7
Australia	2.7	1.4	3.5	-3.4	4.8	2.1	2.2	4.1	3.4	4.8	2.7	3.6	3.8	3.2
New Zealand	1.7	2.0	3.8	3.5	0.4	2.8	4.1	3.9	3.9	5.6	4.0	5.3	3.2	2.4
Asia ex Japan	9.1	7.2 ↑	6.7	8.9	5.3	5.9	6.3	6.8	7.2	7.3	4.9	5.7	4.9	4.5
China	10.3	8.9	8.5	8.9	7.0	7.5	8.5	8.7	8.9	9.0	4.7	5.7	4.6	4.3
Hong Kong	7.0	5.2	4.0	13.0	-2.0	1.5	3.5	5.5	5.6	4.5	2.7	5.2	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	5.2	6.8	5.4	6.2	5.5	5.0	4.5	5.0	6.3	5.9	4.5	5.6
Korea	6.2	3.9	4.0	5.4	3.6	3.6	4.2	4.0	4.0	4.0	3.6	4.2	3.7	3.1
Malaysia	7.2	4.0	1.5	5.5	3.2	1.0	1.0	1.5	1.5	1.5	2.0	3.3	2.8	2.4
Philippines	7.6	4.1	4.0	7.8	2.4	4.1	2.4	2.4	7.4	5.3	3.5	5.0	4.6	3.3
Singapore	14.5	4.9 ↑	1.5	27.2	-6.5	1.6 ↑	-3.9 ↑	2.0	6.1 ↓	6.1	4.0	4.7	5.6	4.0
Taiwan	10.9	5.0	3.0	14.6	0.9	1.0	2.0	3.5	3.8	4.6	1.1	1.6	2.2	2.0
Thailand	7.8	3.0	1.5	8.1	-0.8	1.8	1.5	1.5	1.5	1.3	2.9	4.1	3.7	3.6
<b>Africa/Middle East</b>														
Israel	4.8	4.3	2.9	4.8 ↑	3.7 ↑	2.4	1.2	0.8	3.2	6.1	2.5	4.1	2.8	2.3
South Africa	2.8	3.1	2.5	4.5	1.3	1.0	3.9	2.3	2.6	2.8	3.5	4.6	6.2	6.4
<b>Europe</b>														
Euro area	1.7	1.6	-0.5	3.1	0.6	0.5	-0.5	-1.0	-1.5	0.0	2.0	2.8	2.8	1.6 ↓
Germany	3.6	2.8	0.2	5.5	0.5	1.5	-0.5	0.0	-0.5	0.5	1.6	2.5	2.6 ↑	1.6 ↑
France	1.4	1.6	-0.1	3.7	0.0	1.0	0.0	-0.5	-1.0	0.5	1.9	2.2	2.3 ↓	1.3 ↓
Italy	1.2	0.5	-1.2	0.5	1.2	-1.0	-1.5	-1.5	-2.5	-0.5	2.0	2.9	3.7 ↑	2.6 ↑
Norway	2.1	2.2	0.7	1.9	4.1	1.5	0.5	0.0	0.0	1.0	2.2	1.4	1.3	1.2
Sweden	5.4	4.1	0.4	3.1	3.6	2.0	0.0	-0.5	-0.5	0.5	1.9	2.9	2.6	1.3
United Kingdom	1.8	0.9	0.7	1.6	0.4	1.5	1.0	0.5	-1.0	2.5	3.4	4.4	4.9	2.8
Emerging Europe	4.5	3.8	2.5	3.6	1.2	2.0	1.3	3.1	3.0	3.8	6.6	7.1	6.2 ↑	5.5 ↑
Bulgaria	0.2	2.8	2.4	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	2.3	2.0	1.0	3.5	0.3	0.5	-0.3	0.3	1.3	2.5	2.1	1.8	1.8	2.5
Hungary	1.2	1.4	0.5	1.2	-0.2	0.3	0.0	0.0	1.0	1.5	4.4	4.0	3.8	4.2
Poland	3.8	3.8	2.7	4.5	4.5	2.5	2.0	2.0	2.5	3.0	2.9	4.6	3.9	2.5
Romania	-1.3	1.2	0.8	...	...	...	...	...	...	...	7.9	8.2	4.0	3.5
Russia	4.0	3.4	3.0	3.7	0.4	2.0	1.0	4.0	3.5	4.5	8.2	9.6	7.4	6.5
Turkey	9.0	6.3	2.7	...	...	...	...	...	...	...	7.4	5.9	7.6 ↑	7.2 ↑
<b>Global</b>	3.9	2.6 ↑	2.0	2.6	1.6	2.7 ↑	1.7	1.5	1.8	2.7	2.7	3.7	3.6	2.4
Developed markets	2.6	1.3	0.9 ↑	0.9	0.7	2.1 ↑	0.7	0.3	0.4	1.5	1.5	2.7	2.7	1.3 ↓
Emerging markets	7.3	5.7	4.9	7.1	4.3	4.4	4.5 ↑	4.8	5.7	6.0	5.6	6.2	5.7	5.3 ↑

Source: Morgan

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