

The J.P. Morgan View

Lower fiscal uncertainty needed to unleash capital

- **Asset allocation** — Value dictates that long-term investors start switching from credit to equities, but low growth, fiscal uncertainties, still attractive credit spreads, and little sign of worsening credit fundamentals keep us overweight both equity and credit vs government debt, especially in higher-yield.
- **Economics** — Bottom in global growth is now 3-quarters wide. Rebound in Q1 requires lifting of fiscal risks in the US, in our view.
- **Fixed Income** — Favor EM local bonds over DM.
- **Equities** — UW US equities against Europe and EM Asia.
- **Credit** — EMBIG year-end spread target is lowered to 250bp, from 275bp, and CEMBI to 300bp, from 325bp.
- **Currencies** — We are long the yen, as the sell off appears overdone.
- **Commodities** — Low oil inventories and high uncertainty in the Middle East keep us long Brent time spreads.

- **Risk markets continue to yo-yo, with this week being down, while last week was up.** Bond markets are sitting out the last wiggle, with government yields barely changed on the week, and corporate bonds only a few bips wider. Most assets remain in their 2-month trading range.

- Range trading is hiding a lot of anxiety in markets and economies, recently focused on the US. We have argued that world growth is in a bottom formation, but the low part of this pattern keeps getting longer and is up to 3 quarters now (Q2-to Q4). The expected rebound has been pushed out now to Q1, and is softer than we originally thought. There are a whole host of forces holding back growth, but one negative that we believe explains both weaker corporate spending and still massive capital flows into fixed income must be **fundamental uncertainty about gov't policies**. The consumer has not been affected much, but our reading of institutional and company managers is that many have simply postponed major investments in real and financial capital until the fog lifts around the US and European fiscal crises, and the direction of China's economy.

- The recent rebound in **European and Chinese** equities suggests investors have become less worried about these two regions. It is probably too early to see the impact on capex, but we do expect this to show up in coming months and to support a growth rebound in Q1. The US fiscal crisis is now right upon us, with the Nov 6 elections letting voters express their views on tax hikes versus cuts in spending. Congress then needs to act urgently to avoid a fiscal tightening caused recession in January, and needs to continue next year on a 10-year fiscal plan, or Simpson Bowles Take 2, in our view. Our best estimate is that the elections do not provide a clear mandate for either side, that Congress does act to bring 2013 fiscal drag down to 2% of GDP, instead of 3.7% without action, but that a longer-term plan remains elusive, keeping a tab on investing by both investors and companies. If we were to get a US long-term fiscal plan next year, then it would surely create upside on stock markets, and be supportive to growth, both US and global, in our view.

See page 7 for analyst certification and important disclosures.

Global Asset Allocation

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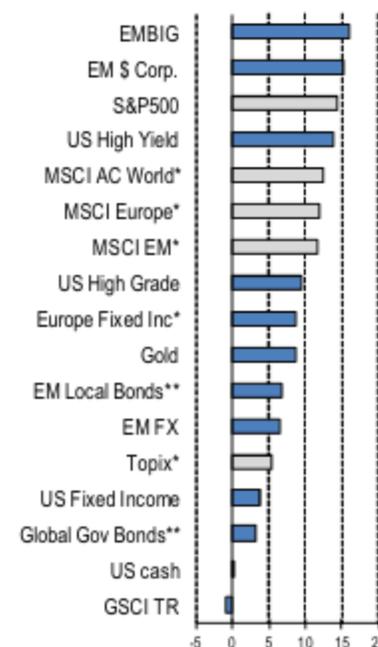
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YTD returns through Oct 25

%, equities are in lighter color.



Source: Morgan, Bloomberg. See blue box on page 2 for description.

- The big decision that most long-term investors now face is **how long they will keep piling into bonds**, even better-yielding HY and EM, pushing yields every month to new all-time lows, instead of moving on to where we believe the real long-term returns are, in stocks. We remain overweight both higher-yielding credit and equities versus cash and safer government debt. But equity returns are lagging. Given their higher beta, stocks should have shown double the return of HY and EMBI YTD and they are not (p. 1). Mutual fund flows are showing \$0.5tr bond inflows, and nothing in equities, YTD.
- Our discussions with many investors are telling us that **they will only switch from credit to equities if they see strong growth in economies and earnings, and/or, forces that make bonds less attractive, but do not hurt stocks**. The latter include soft monetary tightening, higher inflation, corporate leverage, and/or spreads near all-time lows. None of these conditions are in place, yet, and we do not see them emerging in coming months. But we are monitoring the steady tightening of spreads to cycle lows, and early signs of corporate leverage. No flashing red here, but surely not all green anymore either, with amber signs starting to pop up. Our hope is that over the coming year, we can increasingly switch risk from credit to equities.

Fixed Income

- **The bond selloff stalled, without managing to break the summer range**, amid a modest downdraft in risky assets. Euro area peripherals gave back some of their recent gains. **We remain positive on peripheral bonds**, and are encouraged by a range of signs of capital flowing back to the periphery, including increased Spanish bank borrowing from private repo markets, and a continued drift down in aggregate bank borrowing from the ECB. Our *European Client Survey* (Chordia, 26 October) indicates a rise in bond managers' over-benchmark in peripheral bonds. These positions may look high right now, but they are relative to benchmarks that are now a lot lower than they used to be
- In a week of mixed economic signals, the strong Q3 gain in UK GDP caught the eye, and prompted us to scale back our call for more BoE QE next month, to £25bn from £50bn. Diminished prospects of further QE represent a modest headwind for gilts. More broadly, **we remain bearish on duration in DM**, reflecting reduced tail risks in the Euro area, and the view that elevated long positions in US Treasuries will be unwound as year end approaches.
- **EM local bonds have largely sidestepped the October rate selloff**, and their 4% gain relative to DM govies (currency hedged) so far this year is in keeping with a steady pattern of outperformance since 2009. One supporting factor has been a step up in inflows to EM local currency bond funds in recent weeks, triggered by QE3. The rate outlook is more idiosyncratic across countries in EM than DM, and we counterbalance long positions supported by yield-seeking inflows, with shorts elsewhere (e.g. Mexico, with its closer link to US Treasuries). Full details in our *EM Cross Product Weekly* (Beinstein et al.).

Equities

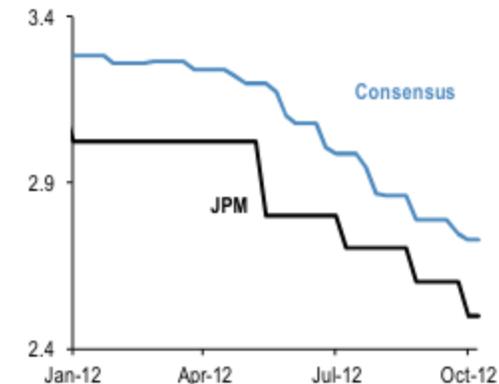
- Last week, we opened a **US UW** within a global equity portfolio. The reporting season appears to be lending support to this view. With around half of S&P500 and a quarter of DJStoxx600 companies having reported so far, the reporting season is showing a significant divergence between the US and Europe. In the case of the S&P500, the Q3 EPS is coming in line with the

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.

2013 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.

Description of YTD Chart on front page:

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 ELMI+ in \$.

expectation at the beginning of the month, but revenues have disappointed by around -1%. In the case of the DJStoxx600, both EPS and revenues are so far posting positive surprises of 2% and 1%, respectively. These results are consistent with UW US vs. European equities.

- Similarly, we see more upside in **EM Asian EM equities**. This week's disappointing US durables report is adding to concerns regarding corporate retrenchment in the US, which contrasts with an improvement in orders and shipments in Asia x Japan. To play this EM Asia outperformance against US equities, we prefer option structures rather than delta one exposures. Our colleague Tony Lee in derivatives research recommends taking advantage of current volatility levels to buy a Call Spread on MSCI Asia Pacific x Japan (MXAPJ index) and sell a Call Spread on the S&P500 index. This structure allows the investor to receive a premium upfront.
- The OW in Cyclical vs. Defensive equity sectors we initiated a month ago has barely performed. Given rising US growth risks, it would appear to make more sense to have this trade in Europe or in EM.

Credit

- **A softer tone this week fed into single-digit widening in bond spreads.** Since QE3 was announced on Sep 13, US HG spreads have rallied 27bp, stocks have lost over 3% and CDX.IG has widened 10bp. Clearly, cash bond technicals remain overwhelming positive, especially for higher-rated, shorter-dated bonds, which are the closer proxy for mortgages and Treasuries.
- Such strong demand is likely a key factor in the CDS-bond basis pushing towards zero in the investment-grade space this week as well, an otherwise infrequent event. However, the broad fixed-income market wide reversing of leveraged carry positions, on the anticipation of falling liquidity into year end, may also be playing a role. **We believe the equilibrium level of the basis going forward is around -10bp**, based on current funding and repo costs. Eric Bernstein's team elaborates in this week's *CMOS*.
- The equity sell-off has seen EM external and corporate debt climb back to the top of our YTD performance. Despite uncertainties about the US, we anticipate further spread tightening as the macro backdrop remains broadly credit supportive. Also, yesterday's EM client survey points to solid hard currency fund inflow momentum continuing to support these asset classes. **We move our YE targets for EMBIG to 250bp**, down from 275bp, **and to 300bp for CEMBI**, down from 325bp.

Foreign Exchange

- For the first time in several quarters, stocks are falling and the dollar is rising during US earnings season. This pattern partly reflects comeuppance, since EPS have stagnated for a year but this season is the first since late 2011 during which hedge funds and currency managers have entered longs stocks & short dollars. Thankfully other parts of the world (China, Brazil) are accelerating modestly while corporate America idles, which is likely why currencies such as AUD, NZD, EM Asia & BRL are outperforming USD, CAD & MXN.
- **The next two weeks are crowded in every region** — more US earnings, global PMIs, US payrolls, Bank of Japan and Reserve Bank of India decisions, US elections on Nov 6 and China's leadership transition on Nov 8. The last two events deserve considerable attention, and not just because

More details in ...

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.

Emerging Markets Cross Product Strategy Weekly, Eric Beinstein et al.

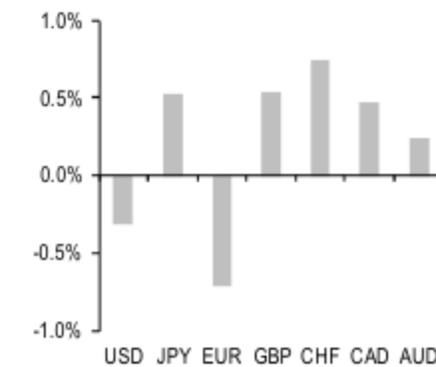
political cycles in the world's two largest economies have never coincided as they do next month. In the US, the election outcome determines management of likely the most serious (and imminent) fiscal challenge in a generation. In China, the leadership transition is assumed to unblock additional stimulus, so could reinforce the outperformance of China-linked currencies. Unfortunately history provides little evidence that Republicans or Democrats better manage the US economy or strengthen the dollar. There is also little confirmation of China's political business cycle. Keep directional risk limited to an options hedge against the fiscal cliff (USD/JPY), take part profits on a trade predicated on China's upturn (AUD/CAD), but keep positions which profit from less sovereign stress (EUR/GBP, EUR/NOK).

- The **Bank of Japan's** Oct 30 decision is highly anticipated judging from USD/JPY's behavior this month. Although the Bank of Japan will probably deliver another round of its 2012 QE strategy of upping its asset purchase program by ¥10trillion each quarter, USD/JPY appears to be pricing in a risk premium for something more dramatic, such as an increase in the BoJ's inflation goal from 1% to 2% or purchases of foreign bonds (i.e. FX intervention). Indeed, USD/JPY trades about 1% too strong controlling for US-Japanese rates spreads, similar in trajectory to the 4% USD/JPY overshoot of fair value which occurred when the Bank first announced its inflation goal on Feb 14. We suspect changing the inflation goal is an issue for the next BoJ Governor in spring 2013 and that purchasing foreign bonds (FX intervention) is off limits under the Obama Administration, much less a Romney one. We remain short USD/JPY through options to hedge the US fiscal cliff.

Commodities

- **Commodities corrected sharply this week, down 3% with energy and base metals leading.** We continue to prefer picking and choosing among commodity sectors rather than taking an outright position across the asset class. **We are neutral energy**, as we think the weak economic picture is balanced by still low inventories and high uncertainty in the Middle East. **We maintain our long Brent time spread position**, which has performed well in spite of the drop in oil prices. This trade benefits from the very low state of inventories and high uncertainty as the front of the Brent curve outperforms relative to longer dated contracts. The trade also carries positively and should, we believe, perform well should a supply shock materialize.
- **We are long base metals** but this trade has not performed recently and is down around 6% month-to-date. We went long on the argument that global growth is bottoming and should start to pick-up modestly over the coming months. In addition, we think that the Chinese leadership change should bring more positive news out of the world's biggest metal consumer. We have not changed this view and **recommend investors use the recent underperformance as an opportunity to go long.**
- Recent announcements of capex deferrals and cancellations by miners coupled with slower Chinese growth have raised the question of whether the commodity supercycle is intact. We think it is. Our commodity strategist, Colin Fenton, estimates that capex has still not expanded production capacity enough for supply to catch up with demand for metals and that demand from other countries outside China over the next 10 years will keep the supercycle going (see *Commodity Mementos*, Oct 25).

FX weekly change in USD



Source: Morgan

More details in ...

FX Markets Weekly, John Normand et al.
Commodity Markets Outlook & Strategy,
Colin Fenton et al.
Oil Markets Monthly, Colin Fenton et al.
Daily Metals Note, Colin Fenton et al.
Agriculture Weekly, Dietz et al.

Interest rates		Current	Dec-12	Mar-13	Jun-13	Sep-13	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	1.76	2.00	2.00	2.00	2.25	1.4%
Euro area	Refi rate	0.75	0.75	0.75	0.75	0.75	
	10-year yields	1.54	2.00	2.15	2.25	2.25	2.4%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	1.87	2.20	2.30	2.35	2.35	1.6%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.77	0.85	0.90	0.95	1.00	1.7%
GBI-EM hedged in \$	Yield - Global Diversified	5.70	6.00				6.8%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	151	JPMorgan JULI Portfolio Spread to Treasury	9.4%
Euro high grade (bp over Euro gov)	179	iBoxx Euro Corporate Index	8.7%
USD high yield (bp vs. UST)	563	JPMorgan Global High Yield Index STW	13.2%
Euro high yield (bp over Euro gov)	726	iBoxx Euro HY Index	20.3%
EMBIG (bp vs. UST)	286	EMBI Global	16.1%
EM Corporates (bp vs. UST)	321	JPM EM Corporates (CEMBI)	15.2%

Quarterly Averages

Commodities	Current	12Q4	13Q1	13Q2	13Q3	GSCI Index	YTD Return*
Brent (\$/bbl)	109	105	112	105	120	Energy	-1.0%
Gold (\$/oz)	1713	1725	1750	1775		Precious Metals	12.2%
Copper (\$/metric ton)	7814	8300	8500	8700		Industrial Metals	5.1%
Corn (\$/Bu)	7.40	8.75	8.50	8.25		Agriculture	17.3%

Foreign Exchange	Current	Dec-12	Mar-13	Jun-13	Sep-13	3m cash index	YTD Return* in USD
EUR/USD	1.30	1.30	1.30	1.32	1.34	EUR	1.0%
USD/JPY	79.3	78	79	79	79	JPY	3.8%
GBP/USD	1.60	1.61	1.60	1.62	1.63	GBP	5.2%
USD/BRL	2.03	2.02	2.02	2.00	1.98	BRL	-2.0%
USD/CNY	6.25	6.32	6.32	6.30	6.25	CNY	2.6%
USD/KRW	1103	1125	1125	1110	1100	KRW	7.2%
USD/TRY	1.80	1.80	1.75	1.75	1.70	TRY	11.8%

Equities	Current	YTD Return (local ccy)
S&P	1406	17.9%
Nasdaq	3021	19.8%
Topix	741	5.6%
FTSE 100	5807	9.7%
MSCI Eurozone*	143	17.5%
MSCI Europe*	1106	14.7%
MSCI EM \$*	999	13.7%
Brazil Bovespa	59166	8.9%
Hang Seng	21552	19.6%
Shanghai SE	2128	-3.1%

*Levels/returns as of Oct 25, 2012

Local currency except MSCI EM \$

Source: Morgan

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD (\$)
Energy	9.8%	2.0%	0.0%	7.5%
Materials	15.2%	11.9%	-5.3%	5.0%
Industrials	13.8%	16.5%	2.5%	13.1%
Discretionary	23.0%	22.8%	7.2%	12.9%
Staples	13.7%	14.1%	15.1%	21.3%
Healthcare	21.3%	18.8%	12.8%	29.7%
Financials	27.3%	25.2%	25.3%	17.1%
Information Tech.	18.0%	12.3%	-3.8%	19.8%
Telecommunications	24.6%	0.2%	3.6%	13.5%
Utilities	7.2%	10.3%	-15.0%	5.8%
Overall	17.9%	14.7%	5.6%	13.7%

Global Economic Outlook Summary

	Real GDP			Real GDP							Consumer prices			
	% over a year ago			% over previous period, saar							% over a year ago			
	2011	2012	2013	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q11	2Q12	4Q12	2Q13
The Americas														
United States	1.8	2.2	1.7	2.0	1.3	2.0 ↑	2.0	1.0	1.5	2.5	3.3	1.9	1.9	1.7
Canada	2.6	2.2	2.1	1.8	1.9	1.9	2.0	2.1	2.1	2.2	2.7	1.6	2.4	2.0
Latin America	4.2	2.9	3.9 ↑	2.8	2.4	4.2 ↓	4.5 ↑	3.4 ↑	3.7 ↑	4.0 ↑	7.2	6.0	6.0	6.8
Argentina	8.9	2.7 ↓	3.6 ↑	2.4	-3.2	5.0 ↓	10.0 ↑	2.0 ↑	2.5 ↑	2.0 ↑	9.6	9.9	10.0	11.0
Brazil	2.7	1.4	4.1	0.5	1.6	4.8	4.6	3.8	4.0	4.3	6.7	5.0	5.5	5.6
Chile	6.0	5.4	4.5	5.1	7.1	3.0	4.0	4.0	5.0	5.0	4.0	3.1	2.5	3.1
Colombia	5.9	4.3	4.5	0.9	6.7	2.8	3.8	4.2	5.5	5.5	3.9	3.4	3.1	3.2
Ecuador	8.0	5.0	4.0	4.2	4.8	3.0	5.5	5.0	3.0	3.0	5.5	5.1	5.1	5.4
Mexico	3.9	3.9	3.6	4.9	3.5	3.5	3.5	4.0	3.2	3.3	3.5	3.9	4.4	4.1
Peru	6.9	6.0	7.0	8.3	6.0	5.5	6.0	8.0	8.0	7.0	4.5	4.1	3.4	2.8
Uruguay	5.7	3.5	4.0	11.8	2.1	9.0	-9.0	12.0	7.0	9.0	8.3	8.0	7.6	7.2
Venezuela	4.2	5.0	0.0	10.1	0.6	3.5	0.0	-4.0	0.0	3.0	28.5	22.3	18.5	30.2
Asia/Pacific														
Japan	-0.7	1.8 ↓	0.5 ↓	5.3	0.7	-3.0 ↓	-0.8	1.4	1.6	1.3	-0.3	0.2	0.0	-0.2
Australia	2.1	3.5	2.5	5.6	2.6	1.5	1.8	3.8	2.5	1.8	3.1	1.2	1.7	2.7
New Zealand	1.3	2.6	2.9	4.1	2.3	1.5	3.5	3.7	3.3	2.0	1.8	1.0	1.4	1.5
Asia ex Japan	7.4	6.1	6.4	7.2	5.9	5.6 ↓	6.3	6.4	6.5	6.8	4.9	3.9	3.4	3.8
China	9.3	7.6	8.0	6.6	7.1	7.7	8.2	8.0	8.2	8.2	4.6	2.9	2.2	3.3
Hong Kong	5.0	1.2	3.2	2.4	-0.4	2.0	2.5	3.5	3.5	5.0	5.7	4.2	2.5	2.7
India	6.5	5.6	6.0	6.1	5.3	5.2	5.0	5.8	6.0	6.8	8.4	10.1	9.8	9.0
Indonesia	6.5	5.7	3.5	4.6	6.2	4.0	3.0	3.0	4.0	4.0	4.1	4.5	3.9	2.2
Korea	3.6	2.3 ↓	3.2 ↓	3.5	1.1	0.6 ↓	3.5	3.5	3.5	4.0	4.0	2.4	1.9	3.0
Malaysia	5.1	4.7	2.9	5.8	5.9	2.5	1.5	2.0	3.0	3.5	3.2	1.7	1.1	1.2
Philippines	3.8	5.3	3.5	12.6	0.9	1.2	1.2	4.5	4.5	4.5	4.7	2.9	2.3	2.3
Singapore	4.9	2.1	3.4	10.0	-0.7	-1.6	8.2	6.1	-1.2	4.5	5.5	5.3	4.1	3.3
Taiwan	4.0	1.1	3.9	1.5	3.5	1.8	3.8	4.5	4.6	4.8	1.4	1.7	2.1	1.8
Thailand	0.1	5.8	2.7	50.8	13.9	2.0	1.5	1.5	2.0	2.0	4.0	2.5	3.3	3.0
Africa/Middle East														
Israel	4.6	3.0	3.1	3.1	3.4	2.0	2.8	4.9	6.1	6.1	2.5	1.6	1.3	1.5
South Africa	3.1	2.2	2.7	2.7	3.2	1.6	-1.3	5.4	3.3	3.6	6.1	5.7	5.3	5.4
Europe														
Euro area	1.5	-0.4	0.2	0.0	-0.7	0.0	-1.5	0.8	0.8	1.3	2.9	2.5	2.5	2.0
Germany	3.1	1.0	1.4	2.0	1.1	1.0	0.0	1.5	2.0	2.5	2.6	2.1	2.1	1.8
France	1.7	0.1	0.0	0.1	-0.1	0.5	-1.5	0.0	0.5	1.0	2.6	2.3	1.9	1.3
Italy	0.5	-2.3	-0.6	-3.3	-3.3	-1.0	-2.5	0.0	0.3	0.8	3.7	3.6	3.2	2.3
Spain	0.4	-1.5	-1.3	-1.3	-1.7	-1.5	-4.5	-1.0	0.5	0.5	2.7	1.9	3.4	2.9
United Kingdom	0.9	0.0 ↑	1.8 ↑	-1.2	-1.5	4.1 ↑	0.5	1.5	2.0	2.5	4.6	2.8	2.6 ↓	2.5 ↓
Emerging Europe	4.8	2.6 ↓	2.7	2.4	1.3	1.1 ↓	2.0 ↓	2.8	2.5	3.8	6.4	5.0	6.1	6.2
Bulgaria	1.7	1.0	1.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	1.7	-1.1	0.9	-3.1	-0.8	-1.2	-1.3	2.1	1.0	4.3	2.4	3.4	2.9	2.4
Hungary	1.6	-1.2	0.7	-3.5	-0.9	-1.0	-0.5	1.0	1.5	1.8	4.1	5.5	5.9	5.0
Poland	4.3	2.4	2.1	2.4	1.6	1.2	1.6	1.8	2.4	3.5	4.6	4.0	3.7	2.6
Romania	2.5	0.0 ↓	0.8 ↓	0.5	1.9	-2.4 ↓	-1.2 ↓	1.2	-0.4	3.2	3.4	1.9	4.7	6.4
Russia	4.3	3.6	3.0	3.7	1.5	1.8	3.0	3.5	3.0	4.0	6.7 ↓	3.8 ↓	6.7	7.4
Turkey	8.5	2.8	3.7	...	...	...	...	...	...	...	9.2	9.4	7.7	6.9
Global	3.0	2.5	2.5	3.0	1.8	2.1	2.0	2.6	2.7	3.2	3.8	2.8	2.8	2.8
Developed markets	1.3	1.2	1.1	1.7	0.4	0.7	0.3	1.2	1.4	1.9	2.7	1.8	1.9	1.6
Emerging markets	6.1	4.7	5.1	5.4	4.3	4.6 ↓	5.1 ↑	5.1	5.2	5.6	5.7	4.6	4.4	4.9

Source: J.P. Morgan

Disclosures

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