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The J.P. Morgan View

Patience during political season

- **Asset allocation** — No changes in our medium-term, value-focused strategy to be long assets with high risk premia, equities, credit, and carry trades, even as upcoming political events will likely create shorter-term volatility.
- **Economics** — No major forecast changes, although increasing uncertainty around US fiscal cliff posturing creates downside risk on US Q4 and Q1.
- **Fixed Income** — We prefer German Bunds to US Treasuries.
- **Equities** —US earnings season favors domestically-oriented stocks and US Financials.
- **Credit** — We expect further spread tightening in US HG as the lack of credit supply brought about by QE3 is not fully priced in.
- **Currencies** — We launch a Chinese *Economic Surprise Index*.
- **Commodities** — Stay long Brent time spreads on Middle East uncertainty.

- **Equity markets are trading heavy,** and are giving back most of their gains of the past 1-2 weeks, despite no clear change in fundamentals. Other risk markets, such as credit, commodities, and the euro periphery, are not following equities this time, indicating we are largely seeing profit taking after the hefty rally in stocks over the last four months.
- **There are no meaningful changes in growth forecasts this week,** except for moving 1% in growth from Q4 to Q3 in the Euro area, due to better IP data in Q3 which we do not think will last. But as a result, global growth in Q4 at 2% is now barely different from the previous two quarters. In GDP terms, there is not as much sign of a rebound as we had hoped, even as the underlying PMI orders and inventory data do hint at this coming rebound.
- We are only at the beginning of the Q3 **earnings** season, but what we have is in line with subdued expectations for small oya drops. Profit margins then hit new highs and world growth has since fallen below potential. But global equities are up 10%. Why? We have argued that equities and other risk markets can rally despite lackluster growth as they offer high risk premia against events that will not all come through. Hence, if the world turns out less ugly and volatile than what most feared, as is our view, then investors will over time gradually switch some of their defensive holdings into better-return, but riskier asset classes.
- This risk-premium-focused strategy into equities, credit and carry assumes volatility will remain subdued and markets will be buffeted by only modest adverse shocks. We don't see huge volatility from data or earnings surprises, with macro volatility having collapsed over the past 2 years, and aggregate earnings now also showing almost no movement anymore. This leaves us with the **political surprise factor**. Here we have to tread more carefully as the next few weeks will see another EU Summit, US elections, and Chinese leadership change, each of which with potentially momentous impact.

See page 7 for analyst certification and important disclosures.

Global Asset Allocation

Jan Loeys AC
(1-212) 834-5874
jan.loeys@jpmorgan.com
JPMorgan Chase Bank NA

John Normand
(44-20) 7134-1816
john.normand@jpmorgan.com
J.P. Morgan Securities plc

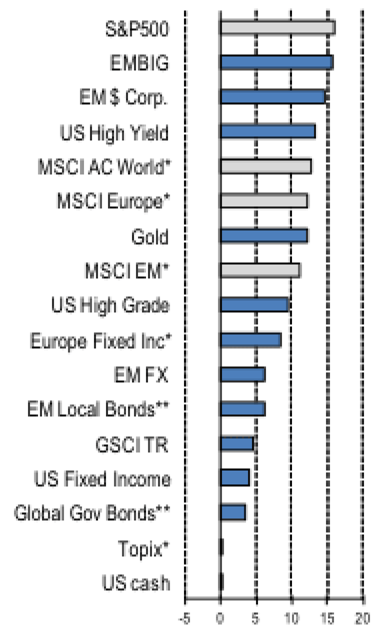
Nikolaos Panigirtzoglou
(44-20) 7134-7815
nikolaos.panigirtzoglou@jpmorgan.com
J.P. Morgan Securities plc

Seamus Mac Gorain
(44-20) 7134-7761
seamus.macgorain@jpmorgan.com
J.P. Morgan Securities plc

Matthew Lehmann
(44-20) 7134-7813
matthew.m.lehmann@jpmorgan.com
J.P. Morgan Securities plc

Leo Evans
(44-20) 7742-2537
leonard.a.evans@jpmorgan.com
J.P. Morgan Securities plc

YTD returns through Oct 11
%, equities are in lighter color.



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

www.morganmarkets.com

Jan Loeys
(1-212) 834-5874
jan.loeys@jpmorgan.com

- On the last, the top priority of Chinese leaders will likely be stability and continuity. We do not foresee a major change in direction nor worsening of the territorial conflict with Japan. The recent rebound in Chinese equities shows the market is hoping for positive news coming out of the Communist Party Congress on Nov 8. The **EU Summit** on Oct 18-19 has an ambitious agenda on both long- and short-term issues. But the lack of an imminent crisis, thanks to the ECB's OMT promise, means to us we are unlikely to see much progress. Unfortunately, given the need to merge sovereignty, EMU members seem to be unable to make major decisions without being subject to undue pressure (detailed analysis by Alex White in *GDW*).
- That leaves the **US elections** and nearing fiscal cliff. Irrespective of who wins the elections, both parties will soon have to seek compromise on avoiding a recession caused by fiscal tightening, as it appears extremely unlikely one party will have a blocking majority. But into the elections, and the yearend decisions on taxes, inevitable political posturing, as neither side wants to show their cards yet, can easily have a depressing effect on economic activity, if not on risk prices. In our view, it supports taking some chips off the table, without going as far as neutral, let alone short risk assets. We stay medium-term positive on risk assets.

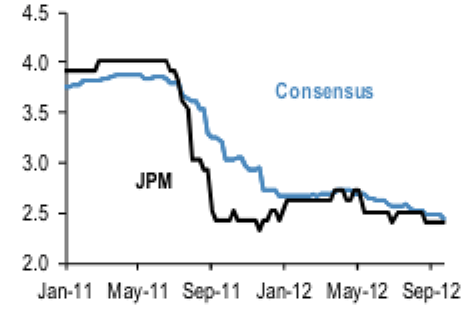
Fixed income

- **Bonds edged higher on the week,** but essentially remain in the very narrow range they have held since the summer**.** That overall stability masks some striking crosscurrents, however. One is the Fed-fuelled compression of **US MBS** spreads, which we expect to hold given an extremely tight supply-demand balance. Another is the **marked outperformance of Australian bonds**, triggered by a more dovish central bank, but also reflecting a long-standing yield compression towards core markets. We are reluctant to oppose this outperformance, given the uncertainty about the RBA's reaction function engendered by last week's rate cut.
- The most important shift has been the better tone in Euro area sovereign debt markets. We share the broad view that the promise of the OMT backstop marks a major step forward in the Euro area's crisis management, and are encouraged by some **tentative signs of capital returning to the periphery**. These include a fall in Spain's Target 2 balance and bond managers' shift to overweight peripheral bonds, for the first time since 2010, as reported in our *European Duration Survey*. But for the near term, we are wary of a Spanish downgrade from Moody's, to below investment-grade, and thus move to a more defensive stance, including by **cutting overweights in the EMU core vs Germany**, and adding **outright longs in German Bunds**.

Equities

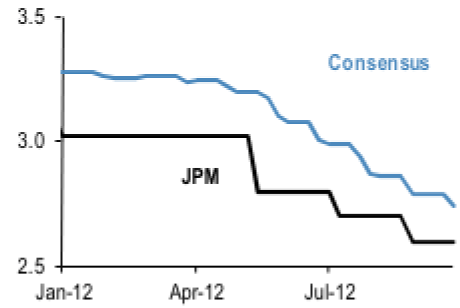
- **Global equities have paused** over the past 5 weeks, following 3 months of strong gains. MSCI AC World at 330 is practically unchanged since the beginning of September and is at the same level as at the end of April, before the May crash. It is still 8% below its post-Lehman peak seen in May 2011.
- **With short covering largely behind us, the equity market appears to be lacking strong drivers**. **The US reporting season is generating a small positive surprise, but this is not enough of an impetus**. As we argued last week a subpar 2% pace in global GDP growth for Q3 is not enough to change the pattern of stagnation seen in S&P500 EPS since Q3 2011. We thus look

2012 global GDP growth forecasts: JPMorgan and Consensus



Source: J.P. 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: J.P. 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 Srini 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 $.

for a Q3 EPS of around $26, similar to Q2's $25.8 and little changed from Q3 2011. The bottom-up analyst forecast is $25.2, so such an outturn would represent a small positive surprise of around 3%, similar to the previous reporting season. At the time, a 3% surprise in the Q2 reporting season failed to lift equity markets during the first half of July.

- There is **not enough impetus in the macro picture** either. This week's macro news was rather mixed, raising doubts about the anticipated rebound in global manufacturing. The rebound in the September global manufacturing PMI induced us last week to re-enter our Cyclical vs. Defensive equity sector overweight, but the trade has yet to perform.

- However, **the US reporting season provides two interesting sectoral themes** . First, domestically oriented US companies are the ones whose earnings are outperforming, suggesting a focus on US-centric stocks. Second, Financials will likely be one of the bright spots in Q3 driven by improving credit and loan demand and a solid recovery in US housing. Our US Equity Strategist Tom Lee points out that a tailwind is also building for US Financials into 2013, which is the resetting of the credit scores for millions of Americans. The peak year of personal bankruptcies was 2005 and those records are removed from credit reports after 2012. Thus, we should see rapid improvements in the credit quality of millions of Americans in 2013.

Credit

- **Spreads gave a mixed picture this week** as US high-grade tightened, treasuries rallied, and lower-quality credit and equity markets sold-off. **At 160bp, US high-grade is now back to pre-August 2011 levels,** and the Fed's activity in mortgage markets seems to be bolstering demand for high-quality corporates as MBS portfolio holdings are replaced. Yet even as issuers take advantage of low all-in yields to push net supply across all USD spread product towards our forecast of $25bn/month, $40bn of Agency MBS purchases and $60bn of coupon payments per month will drive a $75bn/month shortfall of spread product going forward. **We believe such strong technicals are not fully priced in and expect further spread tightening to occur**. Eric Beinstein and his team elaborate in this week's *CMOS*.

- Our colleagues in credit derivatives strategy continue to cite liquidity as the over arching theme in European credit markets. Given that OMT can be seen as the ECB taking the role of lender of last resort, just as the Bank of England has done over the last three years, they feel that financial conditions between the UK and Europe will normalize and so examined relative value ideas between the two this week. They **argue for a long in Euro vs. UK in investment grade corporates**, which comes with an attractive entry point given the UK's recent outperformance. See Saul Doctor and team, *CD Player*.

Foreign Exchange

- A few trend reversals this week excepted, currency markets still look listless. The trade-weighted dollar and aggregate FX volatility are unchanged this week, FX volumes are below average and manager returns are flat-lining for some composites. We have argued that easy money from the world's central banks wouldn't deliver easy returns immediately since the global economy looked flaccid, commodity currencies were rich and central bank intervention likely. This remains the outlook and – unfortunately – an exercise in patience, particularly ahead of two massive weeks for US earnings and Chinese data.

More details in ...

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

High Yield Credit Markets Weekly, Peter Acciavatti et al.

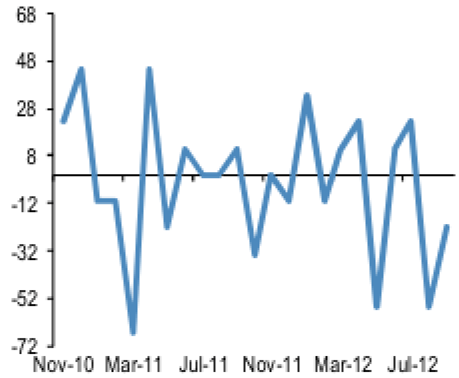
European Credit Outlook & Strategy, Steven Dulake et al.

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

Earnings look well on track to be unimpressive but in line with expectations. Trades are mostly unchanged this week and geared around three themes: carry (long NZD/USD), less sovereign stress in Europe (long EUR/GBP and short EUR/Scandi puts) and commodity FX relative value (AUD/CAD).

- China releases its usual array of activity data next week, the last before the November leadership transition. Any data improvement should lift currencies in China's orbit (AUD, NZD, EM Asia), but how much? The China Economic Surprise Index described in this week's *FXMW* provides some guidance. Identical to the US Economic Activity Surprise Index (US EASI) we developed over 10 years ago, this one tracks the balance of positive versus negative surprises on monthly Chinese data releases since 2009. Months where the balance of surprises is positive are associated with 2% rises that month in commodity currencies, whereas months with negative surprises are associated with small declines (about 0.3%).
- Should China disappoint again as the index shows it has been doing for the past two months (see chart on right), it isn't clear that the commodity currencies would decline that much or for that long, given the proximity of the leadership transition. If China observes its usual political-business cycle by engineering stronger growth in the year after the transition, expectation for imminent stimulus would probably prevent much weakness in China-linked currencies. Regardless, we have few strong priors on this month's releases so combine limited commodity FX longs (long NZD/USD) with a relative value trade (sell downside in an oversold cross like AUD/CAD).

Chinese Economic Surprise Index



Source: J.P. Morgan

Commodities

- **Commodities are up around 2% this week**, led by oil as tensions between Turkey and Syria escalated further. Syrian crude output is very small and world oil markets are already insulated from a supply disruption caused by the sanctions and logistical constraints affecting Syrian production. Of more concern is the possible threat to the 1mbd of crude exports that pass through Turkey from Azerbaijan and Iraq to the Mediterranean around 50 miles from the Syrian border (see *Daily Oil Note*, Fenton et al., Oct 10). The threat to these pipelines seems low, while the conflict is limited to sporadic border skirmishes, but this does further raise uncertainty in an already tense situation and is likely at least partially responsible for the rally in oil this week. In our *GMOS* portfolio, **we remain long Brent time spreads,** to hedge our long risk exposures against an oil shock. This hedge has worked very well over the past weeks and we maintain it.
- USDA data out yesterday showed lower than expected corn stocks but soybeans were in line with expectations and wheat stocks were higher, although both were lower than previous USDA estimates. This caused a sharp rally in grains, which recovered all of the week's earlier decline to finish broadly flat. In *GMOS*, **we remain short agriculture** on the argument that the US harvest is essentially over and that planting conditions for the new crops are much improved and high prices mean much higher future supply. Agriculture prices have historically exhibited an element of mean reversion precisely due to this dynamic and we believe they have peaked over the summer and will gradually move lower over the coming months.

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	1.65	2.00	2.00	2.00	2.25	2.1%
Euro area	Refi rate	0.75	0.50	0.50	0.50	0.50	
	10-year yields	1.45	1.50	1.50	1.60	1.70	2.9%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	1.72	1.65	1.65	1.80	1.95	2.4%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.77	0.90	0.90	0.95	1.00	1.9%
GBI-EM hedged in $	Yield - Global Diversified	5.79	6.00				6.3%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	159	JPMorgan JULI Porfolio Spread to Treasury	9.6%
Euro high grade (bp over Euro gov)	190	iBoxx Euro Corporate Index	8.6%
USD high yield (bp vs. UST)	573	JPMorgan Global High Yield Index STW	12.8%
Euro high yield (bp over Euro gov)	753	iBoxx Euro HY Index	19.0%
EMBIG (bp vs. UST)	292	EMBI Global	15.7%
EM Corporates (bp vs. UST)	340	JPM EM Corporates (CEMBI)	14.7%

		Quarterly Averages					
Commodities	Current	12Q4	13Q1	13Q2	13Q3	GSCI Index	YTD Return*
Brent ($/bbl)	114	105	112	105	120	Energy	-1.0%
Gold ($/oz)	1754	1725	1750	1775		Precious Metals	12.2%
Copper ($/metric ton)	8242	8300	8500	8700		Industrial Metals	5.1%
Corn ($/Bu)	7.52	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	0.8%
USD/JPY	78.4	78	79	79	79	JPY	1.8%
GBP/USD	1.61	1.62	1.62	1.63	1.65	GBP	4.5%
USD/BRL	2.04	2.02	2.02	2.00	1.98	BRL	-3.0%
USD/CNY	6.27	6.32	6.32	6.30	6.25	CNY	2.0%
USD/KRW	1111	1125	1125	1110	1100	KRW	5.5%
USD/TRY	1.81	1.80	1.75	1.75	1.70	TRY	11.2%

Equities	Current	YTD Return (local ccy)
S&P	1427	15.9%
Nasdaq	3044	17.3%
Topix	718	0.2%
FTSE 100	5793	7.4%
MSCI Eurozone*	144	14.2%
MSCI Europe*	1111	12.3%
MSCI EM $*	996	11.6%
Brazil Bovespa	59162	5.5%
Hang Seng	21136	19.0%
Shanghai SE	2105	-3.0%

*Levels/returns as of Oct 11, 2012

Local currency except MSCI EM $

Source: J.P. Morgan

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD ($)
Energy	6.8%	0.5%	-4.0%	5.5%
Materials	11.1%	8.9%	-13.1%	3.0%
Industrials	10.9%	**13.9%**	-3.6%	9.9%
Discretionary	**19.9%**	**21.8%**	0.0%	10.9%
Staples	12.6%	**13.7%**	**11.3%**	**18.5%**
Healthcare	**18.5%**	**16.5%**	**8.6%**	**28.3%**
Financials	**25.0%**	**19.8%**	**18.2%**	**14.9%**
Information Tech.	**17.9%**	10.1%	-10.4%	**17.8%**
Telecommunications	**24.2%**	-0.2%	**5.5%**	**13.0%**
Utilities	5.1%	7.5%	-18.2%	4.9%
Overall	**15.9%**	**12.3%**	**0.2%**	**11.6%**

Jan Loeys
(1-212) 834-5874
jan.loeys@jpmorgan.com

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	2.1	1.9	2.0	1.3	**1.4** ↓	2.0	1.5	2.3	2.5	3.3	1.9	**1.9** ↓	**1.6** ↓
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	3.7	**2.8** ↑	**2.4** ↑	4.5	4.0	3.3	3.6	3.9	7.2	6.0	6.3	7.3
Argentina	8.9	3.3	2.2	2.4	-3.2	8.0	6.0	0.0	1.5	0.5	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** ↑	4.0	4.0	**4.2** ↑	**4.8** ↑	4.0	4.0	4.0	4.0	5.0	5.5	5.1	4.2	4.4
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	-3.0	-3.0	0.0	3.0	28.5	22.3	23.4	37.3
Asia/Pacific														
Japan	-0.7	2.0	0.6	5.3	0.7	-2.0	-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	1.7	1.8
Asia ex Japan	7.4	6.1	6.4	7.2	5.7	**5.6** ↑	6.3	6.4	6.5	6.8	4.9	3.9	3.3	3.8
China	9.3	7.6	8.0	6.5	6.7	7.4	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	2.4	3.3	3.5	1.1	2.0	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	2.0	1.5	2.0	2.0	4.0	2.5	1.3	1.1
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	2.1	3.0	2.7	3.2	0.3	-1.2	5.9	3.8	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	-0.3	1.5	-1.2	-1.5	2.0	0.5	1.5	2.0	2.5	4.6	2.8	2.7	2.6
Emerging Europe	4.8	2.7	2.7	2.4	1.3	1.2	2.1	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	0.6	0.9	0.5	1.9	-1.0	0.8	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	6.8	3.9	6.7	7.4
Turkey	8.5	2.8	3.7	---	---	---	---	---	---	---	9.2	9.4	7.7	6.9
Global	3.0	2.4	2.6	3.0	1.8	**1.9** ↑	**2.0** ↓	2.7	2.9	3.2	3.8	2.8	2.8	2.8
Developed markets	1.3	1.2	1.2	1.7	0.4	**0.5** ↑	**0.3** ↓	1.4	1.7	1.9	2.7	1.8	1.9	1.6
Emerging markets	6.1	4.7	5.1	5.3	4.2	**4.6** ↑	5.0	5.1	5.2	5.6	5.7	4.6	4.5	5.0
Memo:														
Global — PPP weighted	3.8	3.0	3.2	3.6	2.4	**2.6** ↑	**2.7** ↓	3.2	**3.4** ↓	3.8	4.2	3.3	**3.2** ↓	3.3

Source: J.P. Morgan

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