

The J.P. Morgan View

Adding risk in the US

- **Asset allocation** — Cover long EMFX funded in euros and instead go outright long US equities as US has least event risk in September, upside risk on the economy and a more supportive central bank.
- **Economics** — Upside risks on US, due to better consumption, are offset by downside risks on China and Japan to keep our global growth forecasts and risk balance unchanged.
- **Fixed Income** — Portugal 2-yr yields include some 3% in EMU exit premium, making a clear case for new ECB SMP buying.
- **Equities** — Overweight US industries that benefit from sustained housing recovery.
- **Credit** — US HY and CMBS should benefit from any move to QE3, and are less exposed to event risk in Europe.
- **Currencies** — Shorts on EUR/USD are about 75% covered.
- **Commodities** — Stay OW energy vs. base metals.

- **Markets have been largely in a holding pattern over the past fortnight**, though giving back a touch of the risk rally of the previous fortnight. Equities are a percent or so lower, credit spreads a few bp wider and government bond yields some 10bp lower. With little news, investors are waiting for the potential policy fireworks over the next few weeks to decide which way to tilt their holdings.
- **Two weeks ago, we upgraded our global growth outlook from a negative risk bias to a more balanced one.** There has not been a lot of news since then, but the releases we did receive appear to be confirming that a bottoming process has taken place in world growth. We currently have the world economy expanding at a 2% pace in Q3, slightly up from Q2. We have seen no reason to change our 2012 and 2013 global projections for the past month now. Across regions, better consumer spending is creating some upside for Q3, but only modestly so given the recent rise in gas prices. European data are largely tracking our forecast for continued contraction of the economy. In Asia, weaker data are creating downside risks to both Japan and China.
- Economic data not getting worse is no source of comfort, as the current growth pace is some 1% below potential and risks driving the world into global deflation, if not depression. **Hence, our eyes remains on what policy makers can do to prevent this.** The US Federal Reserve is probably closest to having exhausted its armory, but is also seen as the policy maker most willing to do whatever it takes to reverse conditions. Hence, the preference of many investors to hold US equities relative to the rest of the world. Mr Bernanke today confirmed his commitments again at Jackson Hole, but is making us wait to the next FOMC meeting for details. **He will then likely extend rate guidance for another year**, with close to even odds of another bout of balance sheet extension.

See page 7 for analyst certification and important disclosures.

Global Asset Allocation

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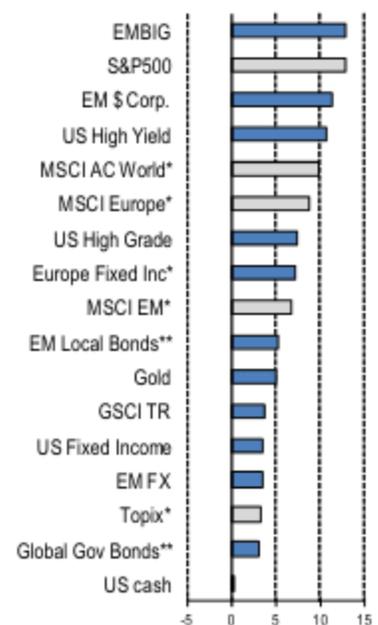
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YTD returns through Aug 30

%, equities are in lighter color.



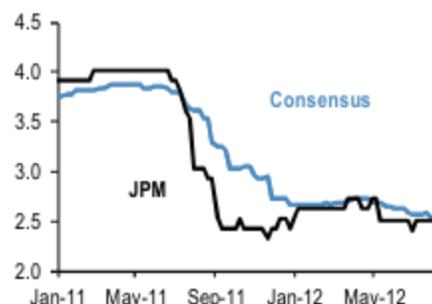
Source: J.P. Morgan, Bloomberg. See blue box on page 2 for description.

- Overall, we do not count on any of his actions to directly lift growth, and see it more as a boost to asset prices. **Hence, our overall positive stance in US asset prices.**
- EM policy makers clearly have more ammunition than DM ones, both on fiscal and monetary policy, and their current growth paces are underperforming potential as much as those in DM. We have seen some 60bp in EM rate cuts over the past year, but the average EM policy rate remains above 5.5% (GDW, p. 6), as the EM output gap remains small and inflation is close to their targets. Only modest rate cuts, little fiscal easing and disappointing data have combined to make EM stocks underperform DM and prevented EM currencies from benefiting much from the global search for yields so prevalent in fixed income. We retain an OW of EM sovereigns (vs USTs), but not in EM equities, given still weak data and unconvincing policy action. Our long EM FX funded in euros has given back some of its gains most recently from the combination of weak EM data and hopes of ECB policy action. We thus cover this position now.
- The real policy focus over the next fortnight will likely be on the Euro area (see this week and last *GDW* and *GFIMS*). Most important will be Thursday's ECB meeting when the world expects Mr Draghi to provide more information on his new SMP program to bring funding costs of EMU members in trouble to more economically sensible levels. There is ample scope for surprises on both sides, but the market is expecting some details and then some action. This analyst's views, at least, are biased to the upside for the near term given increased acceptance within Germany that some action must be taken and Mr Draghi's track record when he upgraded the ECB's liquidity provision to the shock and awe of LTRO last December.
- Specifically, we expect the ECB to confirm it will intervene in (buy) the shorter end of euro sovereign bond markets of countries in an EFSF program and compliant with EFSF conditionality, in an effort to bring down EMU exit (convertibility) risk premia (see below under Fixed Income). It should similarly confirm it will respect contract law (ie, no seniority), although the market will likely want to test this in practice over time. Our best guess is that the ECB will show off its new SMP program by buying 2-3 year debt of Portugal, given that is both in an EFSF program, is compliant, and its 2-year funding costs appear to include some 3% in EMU exit risk premium.

Fixed income

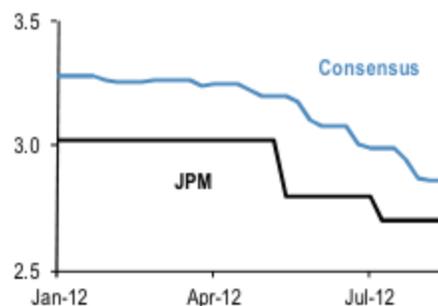
- Bonds edged up on the week. As so often over the past few years, all eyes are on central banks. Fed Chairman Bernanke delivered no major surprises today. But then Jackson Hole speeches last year and the year before did not provide clear signals or material rallies on the day (see chart), even as they were followed within a few months by policy action. We continue to expect the Fed's September meeting to bring **more asset purchases**, including in **MBS**, where we remain overweight on carry and negative net issuance.
- The Fed is likely to be overshadowed by next week's ECB meeting, however. The underlying rationale of the ECB's new bond purchase program is to reduce government yields it judges to be inflated by **convertibility premia**: the risk that a country could leave the euro, and re-denominate its bonds into a weaker currency. We estimate that convertibility risk has pushed up two-year yields by some 3% for Portugal and 2% for Spain (see *Convertibility Risk in Euro area peripheral bonds*, Seamus Mac Gorain, for details). And importantly, the uncertainty about the precise impact of convertibility risk

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 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 ELMF+ in \$.

gives the ECB significant leeway, in deciding the yield levels at which to conduct bond purchases. Though the ECB may not be ready to lay out the full detail of the new program at next week's meeting, we would **expect purchases of short-dated Portuguese bonds** to follow soon after. With yields on 2-year Portugal still close to 5%, there appears considerable room for them to fall further.

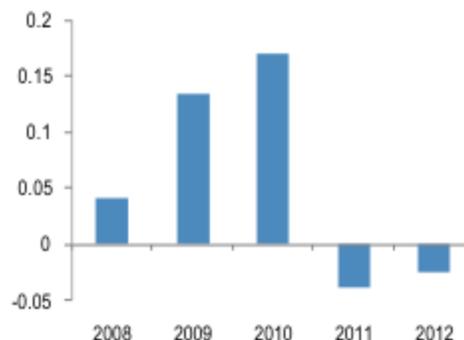
Equities

- The equity rally lost steam over the past two weeks in the absence of any significant news. The MSCI AC World index is slightly down, but still up 10% from its June low. The fading of the equity rally over the past two weeks can be considered normal after five straight weeks of gains. The equity market uptrend since June has never been a straight line, but it has rather followed an oscillating pattern with occasional pullbacks (see chart).
- Central bank policy response in Europe and the US is essential for this rally to continue, in our view. **We remain of the view that forthcoming policy response by the ECB and the Fed will be adequate to sustain the equity rally into September** Admittedly, September is seasonally a weak month from a technical point of view and our technical strategists are warning us that the S&P 500 index support zone at 1390-1400 (closed at 1399 yesterday) is absolutely critical. Two closes below this zone risk a downside acceleration to 1350, if not 1325.
- Two weeks ago, we closed our global Cyclical sector underweight. Our colleagues in Europe, Mislav Matejka and team, did the same this week for European equities (see *European Equity Strategy*, Aug 28). The stabilization in economic data induced us to make this change. Indeed, our US Economic Activity Surprise Index (EASI) has risen to positive territory this week, for the first time in 6 months.
- The recovery in US housing indicators has been partly behind the rise in the EASI. We believe this recovery is on a solid footing and recommend an OW in 5 US industry groups for this US sectoral play: Home Furnishing & Retail, Housing Infrastructure plays, Homebuilders, Timber stocks and Banks/Financials.

Credit

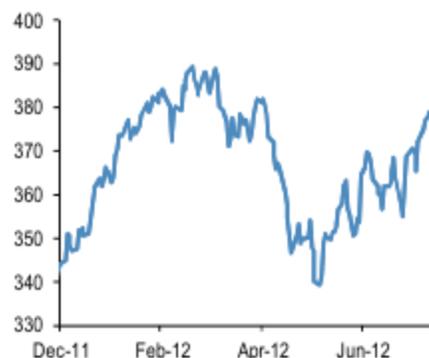
- **Headline bond indices were a mixed picture this week.** Major spread moves in either direction were absent but fresh yield lows were recorded in several markets. Most notably among the higher echelons of our YTD performance parade (p.1), EMBIG yields fell to 4.7%, CEMBI to 5.1% and US HY now offers a yield of just 6.7% vs a decade long average of closer to 10%. Such a yield environment is continuing to support primary markets, with \$238bn of corporate gross issuance globally this month. This is average for a normal month, but a record for August, which is normally a very quiet month.
- Additional monetary stimulus from the Fed remains the focus of markets, but September is littered with potential pitfalls in Europe, including German legal review of the ESM, clarity on the size of bond purchases by the ECB, and a Spanish downgrade among others. Our main call is that the FOMC will extend its rates guidance into 2015 and initiate a smaller scale round of purchases of Treasuries and mortgages, perhaps to the tune of \$150bn over two months and more if required. Such an outcome would likely prove beneficial to spread product, but carry strategies should steer clear of European event risks as far as possible. US HY, the stalwart of our credit strategy at present, is an obvious

Change in 10-year Treasury yields on day of Bernanke Jackson Hole speech
Per cent



Source: J.P. Morgan

MSCI AC World
Total return index



Source: J.P. Morgan

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.

candidate, but our colleagues in the US also **make a case for CMBS** based on the relative sensitivity of the asset class to past Fed duration purchases and its relative immunity to past European blow-ups (see *US FIMS*, Aug 24).

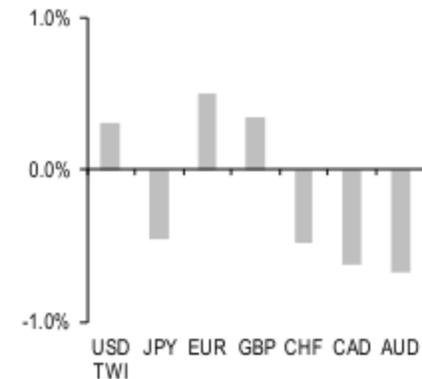
Foreign Exchange

- As August segues into September, the complacency which characterised late summer has started to recede ahead of potential pivot points for the Big 3 economies. FX vols and vol premia have started to rise, the dollar has gained versus most commodity currencies and euro-funded carry has been mostly unwound. September is important for every region but it may not be decisive. The ECB bond buying program will need to be judged by secondary market actions rather than an explicit press conference, in our view; China's putative upturn may need yet another month to materialise; and Fed easing is of questionable value ahead of the fiscal cliff. We therefore keep a portfolio of defensive and RV trades.
- Regarding the ECB meeting next week, buying bonds of 1-yr duration or less would be pointless for economic and financial stability. If this tenor is the extent of the bank's comfort zone, the euro would likely be sold. If the bank purchases debt longer than 3 years, the euro will likely rally on a view that the bank is willing to provide decent term financing to sovereigns. If the bank proves unwilling to push 2-yr yields below 2%-3%, the euro will also probably be sold on realisation that the ECB isn't doing much to reverse the periphery's recession. This meeting also comes against a much more balanced technical position in the euro market: managers appear to have shifted from very short of EUR/USD and euro crosses to slightly underweight, and short-term fair-value models indicate that the crosses have shifted from about 5% too cheap in July to fair value now. Together these two indicators suggest that short covering in the euro crosses is about 75% complete, and hence we expect EUR/USD to slip into the low 1.20s in September barring a Fed announcement on Sep. 13 of sizable asset purchases (more than \$250bn).

Commodities

- **Commodities are broadly flat this week** with a further rise in agriculture offsetting a fall in base metals, while energy is flat. **Oil markets endured two further supply setbacks** over the last two weeks. A fire at the world's second largest refinery in Venezuela has reduced production by c.330-390kbd and Hurricane Isaac has reduced crude production in the Gulf of Mexico by around 1mbd or 1% of world supply. Both outages should prove temporary but they do create further impetus for a release from strategic reserves, which has been much in focus as we get closer to the US presidential election.
- Our commodity strategist Colin Fenton has also raised the issue that a release from strategic reserves could make it easier for Israel to launch a surgical strike on Iran as the impact on oil prices would likely be less extreme (See *Commodity Mementos Video: Do Isaac and refinery cuts lift odds Israel attacks in September?*, Aug 30). We are by no means military experts and we are not forecasting such an event. However, negotiations with Iran have broken down and the IAEA's latest report out yesterday showed further development of uranium enrichment capabilities. As such, it does appear prudent to have some hedges against such a scenario in one's portfolio. We are OW energy vs. base metals which should provide some protection but more direct exposure to oil and oil volatility via options also makes sense.

FX weekly change in USD



Source: J.P. Morgan

More details in ...

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

Interest rates		Current	Sep-12	Dec-12	Mar-13	Jun-13	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	1.58	1.75	2.00	2.00	2.25	2.3%
Euro area	Refi rate	0.75	0.75	0.50	0.50	0.50	
	10-year yields	1.33	1.00	0.90	1.00	1.20	4.0%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	1.46	1.35	1.50	1.70	1.80	4.0%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.80	0.85	0.95	0.95	0.95	1.6%
GBI-EM hedged in \$	Yield - Global Diversified	5.89		6.00			5.4%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	188	JPMorgan JULI Portfolio Spread to Treasury	7.6%
Euro high grade (bp over Euro gov)	221	iBoxx Euro Corporate Index	7.2%
USD high yield (bp vs. UST)	602	JPMorgan Global High Yield Index STW	10.6%
Euro high yield (bp over Euro gov)	878	iBoxx Euro HY Index	15.3%
EMBIG (bp vs. UST)	0	EMBI Global	13.0%
EM Corporates (bp vs. UST)	381	JPM EM Corporates (CEMBI)	11.4%

Quarterly Averages

Commodities	Current	12Q3	12Q4	13Q1	13Q2	GSCI Index	YTD Return*
Brent (\$/bbl)	114	95	100	105	95	Energy	1.2%
Gold (\$/oz)	1681	1655	1725	1750	1775	Precious Metals	5.0%
Copper (\$/metric ton)	7557	8000	8300	8500	8700	Industrial Metals	-5.6%
Corn (\$/Bu)	7.97	8.25	8.25	8.00	7.75	Agriculture	23.5%

Foreign Exchange	Current	Sep-12	Dec-12	Mar-13	Jun-13	3m cash index	YTD Return* in USD
EUR/USD	1.26	1.22	1.24	1.25	1.25	EUR	-2.7%
USD/JPY	78.4	78	78	80	80	JPY	1.8%
GBP/USD	1.59	1.56	1.58	1.58	1.58	GBP	2.9%
USD/BRL	2.05	2.00	1.98	1.95	1.95	BRL	-3.9%
USD/CNY	6.35	6.33	6.30	6.30	6.25	CNY	0.3%
USD/KRW	1135	1150	1150	1090	1090	KRW	3.4%
USD/TRY	1.82	1.82	1.80	1.75	1.75	TRY	10.0%

Equities	Current	YTD Return (local ccy)
S&P	1410	12.9%
Nasdaq	3049	17.2%
Topix	732	3.4%
FTSE 100	5711	5.6%
MSCI Eurozone*	139	9.8%
MSCI Europe*	1078	8.8%
MSCI EM \$*	944	5.6%
Brazil Bovespa	57256	0.7%
Hang Seng	19483	7.5%
Shanghai SE	2048	-6.9%

*Levels/returns as of Aug 30, 2012

Local currency except MSCI EM \$

Source: J.P. Morgan

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD (\$)
Energy	3.2%	0.3%	-8.3%	-1.4%
Materials	6.7%	2.8%	-11.6%	-5.4%
Industrials	8.8%	9.6%	0.2%	5.4%
Discretionary	17.2%	19.3%	8.6%	6.8%
Staples	10.9%	13.8%	16.4%	10.9%
Healthcare	13.0%	13.3%	10.5%	20.9%
Financials	16.9%	10.1%	16.2%	8.2%
Information Tech.	19.4%	10.4%	-5.9%	12.1%
Telecommunications	20.9%	0.4%	9.0%	9.1%
Utilities	3.2%	4.1%	-19.9%	5.1%
Overall	12.9%	8.8%	3.4%	5.6%

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	2.0	2.0	1.7 ↑	1.5	2.0	1.5	2.3	2.5	3.3	1.9	2.1	2.3
Canada	2.4	2.0 ↓	2.2	1.8 ↓	1.8 ↓	2.1	2.0	2.2	2.2	2.4	2.7	1.6	2.4	2.0
Latin America	4.2	2.9	3.7	2.9 ↓	1.9 ↓	4.0	3.8	3.5	3.8	3.9	7.2	6.0	6.1	7.0
Argentina	8.9	3.3	2.2	3.6	-4.5	8.0	6.0	0.0	1.5	0.5	9.6	10.0	10.0	11.0
Brazil	2.7	1.7	4.1	0.5 ↓	1.6 ↓	4.5	4.6	3.8	4.0	4.3	6.7	5.0	5.2	5.2
Chile	6.0	5.0	4.5	5.1	7.1	2.0	4.0	4.6	4.7	4.4	4.0	3.1	2.5	3.1
Colombia	5.9	3.5	4.5	1.1	2.2	3.0	3.5	5.0	6.0	6.0	3.9	3.4	2.9	3.3
Ecuador	7.8	4.0	4.0	2.8	3.5	4.0	4.0	4.0	4.0	5.0	5.5	5.1	4.2	4.4
Mexico	3.9	3.6	3.5	4.9	3.5	2.2	3.0	4.4	3.7	3.3	3.5	3.9	4.2	3.6
Peru	6.9	6.0	7.0	8.2	5.5	5.5	6.0	8.0	8.0	7.0	4.5	4.1	2.9	2.8
Uruguay	5.7	3.5	4.0	11.65	-8.5	28.0	-10.3	13.5	-11.0	25.0	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	2.5	0.9	5.5	1.4	-0.3	0.5	1.0	1.2	1.3	-0.3	0.2	0.1	-0.1
Australia	2.1	3.7	2.5	5.3	3.8	2.1	1.2	3.9	2.4	1.8	3.1	1.0	1.5	2.7
New Zealand	1.3	2.5	2.8	4.7	0.4	3.3	3.0	2.3	3.4	3.2	1.8	1.1	2.5	2.8
Asia ex Japan	7.4	6.2	6.6 ↓	7.3 ↑	5.8 ↓	5.9 ↓	6.4 ↓	6.8	6.9 ↓	7.1	4.9	3.9	3.4	3.9
China	9.2	7.7	8.5	6.8	6.9	8.0	8.5	8.7	8.7	8.7	4.6	2.9	2.4	3.5
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	5.0	3.7	4.6	6.2	3.0	3.0	3.5	4.5	5.0	4.1	4.5	3.9	2.2
Korea	3.6	2.5	3.3	3.5	1.5	2.0	3.5	3.5	3.5	4.0	4.0	2.4	1.9	3.1
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	9.5	-0.7	0.8	4.1	4.1	4.1	4.1	5.5	5.3	3.4	2.4
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	2.9	4.4	2.8	3.2	2.0	2.8	4.9	6.1	6.1	2.5	1.6	1.3	1.5
South Africa	3.1	2.5	3.6	2.7	3.2 ↓	3.5	4.5	3.7	3.2	3.4	6.1	5.7	5.5	5.6
Europe														
Euro area	1.5	-0.4	0.2	0.1	-0.7	-1.0	-0.5	0.5	0.5	1.0	2.9	2.5	2.5	1.9
Germany	3.1	1.0	1.2	2.0	1.1	0.3	0.5	1.5	1.5	1.8	2.6	2.1	1.9	1.6
France	1.7	0.1	0.6	0.1	-0.2	-0.3	0.0	0.8	1.0	1.3	2.6	2.3	2.3	1.7
Italy	0.5	-2.3	-1.0	-3.3	-2.9	-2.5	-1.5	-0.8	-0.5	0.0	3.7	3.6	3.4	2.5
Spain	0.4 ↓	-1.5 ↓	-0.9	-1.3	-1.7 ↓	-2.8	-2.0	-0.5	0.5	0.5	2.7	1.9	3.2	2.6
United Kingdom	0.8	-0.4	1.5	-1.3	-1.8	2.0	0.5	1.5	2.0	2.5	4.6	2.8	2.7	2.6
Emerging Europe	4.8	2.7 ↓	3.1 ↓	2.3 ↓	1.3	1.4 ↓	2.4 ↑	3.1 ↓	3.1 ↓	3.3	6.4	5.0	5.8 ↑	5.8 ↑
Bulgaria	1.7	1.0	2.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	1.7	-1.1	0.9	-3.1	-0.8	-0.9	0.1	0.6	2.0	2.5	2.4	3.4	2.9	2.4
Hungary	1.6	-1.2	0.8	-4.1	-0.8	-0.5	0.5	1.0	1.5	1.8	4.1	5.5	5.5	3.3
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	0.8	1.0	-0.5	2.0	-0.4	2.8	1.6	-1.2	1.2	3.4	1.9	4.4	4.2
Russia	4.3	3.6 ↓	3.4	3.7	1.5	2.0 ↓	3.0 ↑	4.0	4.0	3.7	6.8	3.9	6.7 ↑	7.4 ↑
Turkey	8.5	2.8	4.5	...	...	...	...	...	...	...	9.2	9.4	6.5	5.9
Global	3.0	2.5	2.7	3.1	1.9 ↓	2.0	2.4	2.7	2.9 ↓	3.2	3.8	2.8	2.9	2.9
Developed markets	1.3	1.3	1.2	1.8	0.7	0.5	0.8	1.2	1.5	1.8	2.7	1.8	2.0	1.8
Emerging markets	6.1	4.7 ↓	5.3	5.4	4.2 ↓	4.7 ↓	5.2	5.4	5.6	5.7	5.7	4.6	4.5 ↑	4.9

Source: J.P. Morgan

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