The J.P. Morgan View

Stay in mid-risk assets

- **Asset Allocation** — Investors flows and the environment of low growth, super easy money and no fiscal blowups yet continue to support the strategy of mid-risk assets, EM and corporate bonds and defensive stocks.
- **Economics** — Weak PMIs and demand indicators are pointing to a risk scenario of an extended bottom in growth and a delay in our expected lift in growth, but not to an acceleration in the downshift in growth.
- **Fixed Income** — Weakening growth and scramble for yield support duration overweights**.**
- **Equities** — An underweight in Cyclical vs. Defensives is not necessarily inconsistent with a long equity directional stance.
- **Credit** — Carry is king in a weak growth, cheap money, low-volatility world. OW EM credit and US high-yield.
- **Foreign exchange** — We add two mean reversion trades, short GBP/NOK and AUD/NZD.
- **Commodities** — We maintain our OW in energy vs. base metals and our long in gold. We also open a small OW in agriculture.

- **Equities are again net up on the week, and fixed income overall is slightly up,** both beating zero-yielding cash and commodities, and continuing to play by the asset reflation tune we have been harking on for some time. Cash and commodities remain at the bottom of the YTD return parade (chart on right).
- Investor flows, and our strategy continue to focus on what we call **mid-risk assets -- better-yielding corporate and EM bonds as well as defensive equities --** which sit in between aggressive asset classes, such as higher-beta cyclical and EM stocks on one side, and safer cash and government bonds. The combination of low, below-trend economic growth, super-easy monetary policy, and a postponing of fiscal blowups in the US and Europe remains positive for the mid-risk strategy, in our view.
- **On the growth side,** this week's Global Manufacturing PMI was even weaker than feared, and is near recession levels. To offset the dangerous signal of this production indicator, we need to get better news from services, demand, and jobs. Much of what we have received recently is quite mixed. June retail sales were poor and G3 shipments likely fell. But July car sales and US jobs data were OK, but not great. The July Global All-Industry PMI, which includes services, did move up 1.4%, but still only to a level consistent with no change in growth from Q2. As a result, we believe the risk is that global growth will not rise much from the estimated 1.7% pace in Q2, which is so far the lowest in the expansion. But there is little in the data that suggests a further lurching down in growth. We view a more extended bottoming in growth and later modest rebound as the more likely scenario (more details in GDW).

See page 7 for analyst certification and important disclosures.

Global Asset Allocation

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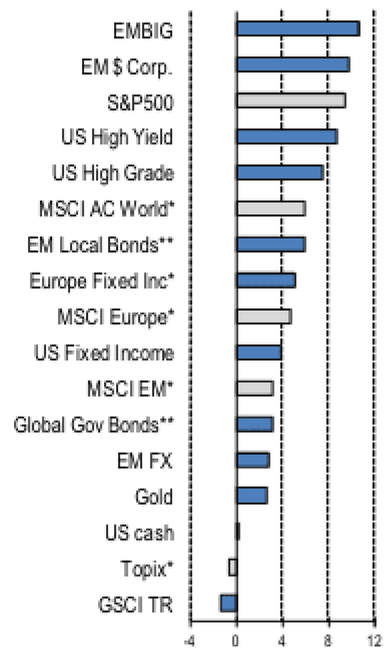
YTD returns through Jul 26
%, equities are in lighter color.



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

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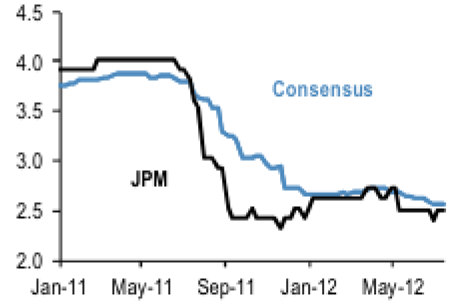
- On the **policy** side, there is no real news on the Western front. The **US FOMC** is in wait-and-see mode and announced no new policy measures. Congress could only agree to extend government funding for 6 months in the new fiscal year (from October) but remains in gridlock on everything else. The tone of the Presidential campaign does not suggest any move to compromise either.
- But it was surely the **ECB** that created all the fireworks this week. ECB President Draghi had raised hopes of novel actions. His announcement of plans to provide guidance to ECB committees on possible support, conditional on applications to the EFSF and more fiscal conditionality, however, sounded so feeble as to force risk markets badly down yesterday. But 24 hours of more careful consideration of the ECB's new approach have since led to a realization it could strengthen the ECB's hand in addressing the debt crisis.
- Importantly, Mr Draghi stated that higher sovereign yields affect the transmission of monetary policy and are thus within the mandate of the central bank. But unlike the somewhat random and ineffective SMP bond buying program under his predecessor, Mr. Draghi's plan is to link ECB buying to EFSF lending and conditionality. This should buy him much needed political legitimacy and backing. Mr Draghi statement to reconsider ECB seniority relative to private sector bond holders also could be a potential game changer.
- If ECB committees in coming weeks were to decide that they are accepting being on par with the market (pari-passu) and that they are willing to buy enough of the debt (1-3 year) of a country that asks funding support from the EFSF to bring yields that are affordable and sustainable, then it will have likely taken a large step towards the eventual resolution of the EMU crisis.
- But these are big if's, and these steps will need to be complemented over time with many other measures, such as not forcing countries in recession to pursue greater austerity, enlarging the EFSF/ESM, creating democratic legitimacy to central fiscal control and funding, to start with the most obvious. **Most importantly, if the ECB and governments cannot pull the euro economy out of recession, then voters could ultimately demand regime change.**

Fixed income

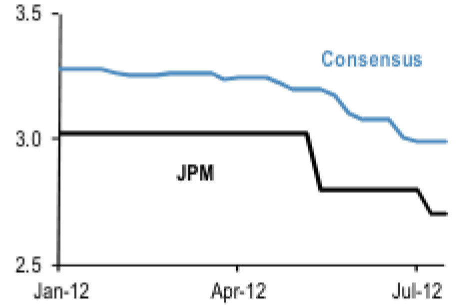
- Bonds are little changed after an up and down week. Just as further disappointing activity data were tempered by better US Payrolls , so interpretations of ECB policy have waxed and waned in the day since President Draghi's press conference. Our view is that **substantial measures are in train from the ECB**, likely including a revised collateral framework, further LTROs, and significant support for short-dated peripheral bonds.
- The first catch is the timing of Spain's anticipated request for EFSF assistance, which would open the door to ECB bond buying. The second is that in announcing that any purchases will be focused on the short end, **the ECB has somewhat orphaned the long end of the Spanish curve**, which is left without an obvious buyer.
- We remain **positive on duration**, on the weakening economy and ever-easier monetary policy. We favour German Bunds, with DM economic risks most pronounced in the Euro area, and EM local bonds, whose real yield pickup is more attractive in a world of meager returns on the safest government bonds. Within EM, we are most bullish on Asian local markets, which are less susceptible to Euro area flare-ups, and where domestic investors are underweight.

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 $.

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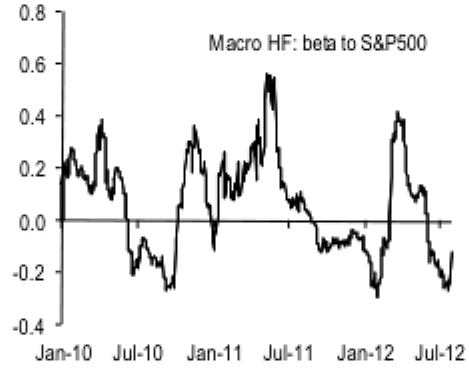
Equities

- Global equities (MSCI AC World) are up on the week. They gained 2% in July, following a 5% rise in June. Despite still elevated uncertainty and weekly oscillations, the trend in equity markets since June is positive.
- This uptrend is likely driven by short covering, despite weak macro data. Widespread skepticism and fear suggest this has further to go. Our Macro HF beta, shown in the chart at the top, suggests that **Macro HFs**, which were caught up with short positions in both June and July, **have started covering their shorts**.
- Europe has most upside across regions due to heavier shorts there, and signals from policy makers in Europe that a loss of market access for Spain is both preventable and undesirable. **Indeed the Eurostoxx50 index has outperformed the S&P500 index in both June and July**.
- The **global manufacturing PMI** fell by 0.7 points in July. This represents an improvement from last month's sharp decline, but is not enough for us to change the UW in Cyclical vs. Defensive equity sectors. The two-month change, our preferred lookback period based on historical back testing, remains heavily negative. The PMI rarely falls below the breakeven 50 mark outside of recessions, underscoring the **weakness of this expansion**. Equally concerning is the absence of any sign of stabilization in the PMI, based on the further deterioration in the forward-looking indexes of new orders and finished goods inventory.
- **An underweight in Cyclical vs. Defensive sectors is not necessarily inconsistent with a long equity stance**. Around 70% of the time (based on monthly data), being long equities and OW Cyclical sectors coincide in terms of sign. But 30% of the time they differ, as it happened over the past month: Indeed, equities are up but cyclical sectors underperformed in July.

Hedge fund equity exposure

Rolling 21-day beta.



Source: J.P. Morgan

Credit

- New yield lows in high-quality issues in global credit markets this week, but the highest yielding sectors also came in nicely. A straight credit rally was noticeable as treasuries finished roughly flat. Carry strategies are king in a weak growth, cheap money, low-volatility world.
- In *GMOS* this week, we expanded the rationale behind our down in quality, up in yield mentality. Mid -risk assets, EM credit and US HY, are our preferred sectors, which we see as the most likely beneficiaries from asset reflation given their solid credit fundamentals and distance from the problems in Europe. We also introduced a new long-only portfolio that incorporates these tactical views. It is designed to be easily replicable for the long-only investor. OW dollar credit vs. Europe, and trade down in quality are the key takeaways.

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.

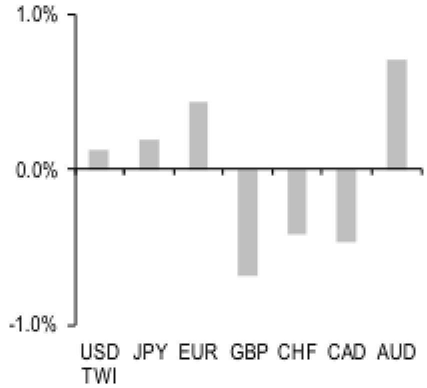
Emerging Markets Cross Product Strategy Weekly, Eric Beinstein et al.

Foreign Exchange

- Numerous **non-dollar currencies** are entering August through a **stealth rally**, such that the trade-weighted greenback has broken through a two-month floor (82.50 on JPMQUSD), FX volatility is approaching its year-to-date low of 8.6% (basis VXY) and even EUR/USD is rebounding after a disastrous July. Some of this move lower in the dollar and higher in most other currencies could be catch-up since the FX carry trade has lagged the credit carry trade all year. Related, manager returns for global macro, emerging markets and some currency overlay composites are well behind their usual pace for this time of the year. The thinness of Mr Draghi's plan and the absence of decent data anywhere but US payrolls make this USD sell-off unattractive to sell into. We confine trades instead to the sovereign stress hedges and a clutch of relative value positions.

- **The portfolio was poorly positioned for July**. Our thinking entering last month was that the Chinese economy was stabilising, so commodity currencies should enter a range; that European sovereign stress would persist because Europe could not approve banking union until later this fall; and that the decline in the euro crosses would begin to reverse either due to Fed QE3 (supporting EUR/USD, EUR/GBP and EUR/JPY) or global deleveraging around sovereign stress and the US fiscal cliff.
- Certainly a grab-bag of themes, and one which motivated several adjustments when we last rebalanced on July 20. We took profits then on short EUR/JPY and USD/JPY, but kept a core short in EUR/USD, a long in USD/SEK (as a leveraged trade on euro weakness before Fed QE began) and a range binary in a commodity currency such as EUR/NOK. Exiting EUR/JPY and USD/JPY was well-timed, but we grossly underestimated the demand for AAA currencies like SEK and NOK as risky markets rallied in July: short USD/SEK was stopped out and the EUR/NOK barriers triggered.
- The highest-conviction directional view for August is that EUR/USD should retrace lower by a few cents as the ECB moves to negative deposit rates and that EUR/JPY resume its decline, particularly since the Bank of Japan is unlikely to announce further assert purchases next week nor intervene at this level. Complement these with two relative value trades such as **short GBP/NOK and AUD/NZD** to position for mean reversion in currencies which have diverged from shifts in rate spreads over the past several weeks.

FX weekly change in USD



Source: J.P. Morgan.

Commodities

- **Commodities are down slightly this week**, led lower by base metals. Economic data came in worse than expected and our global PMI fell further with no sign of improvement even in the more forward looking components. We do expect stimulus from policy makers to combat the worsening economic picture, but this is likely to be limited and not enough to bring economic growth back to trend. This is clearly **not a supportive environment for commodities,** which are very closely linked to economic growth. However, **some commodity markets are still likely to outperform due to supply problems** which can push up prices in spite of the weaker demand.
- In our monthly *GMOS* published yesterday, we maintained our **OW in energy vs. base metals** as well as our **long gold** position. **We also opened a small OW in agriculture**. In energy, North Sea maintenance coupled with reduced Iranian exports due to sanctions as well as a reduction in production by the gulf trio has left oil markets tight. In stark contrast, base metals face no such supply concerns and are suffering from weakening demand as the economy slows. Although we don't think further monetary stimulus will be enough to bring the economy back to trend growth, it will likely help **gold** and **we expect demand to pick up as the economy weakens further and the likelihood of QE3 rises**. Agriculture prices are supported by the worst US drought in 50 years with little respite forecast currently. **Our agriculture analysts see further upside in corn and soybean prices** from here, as the extent of the crop damage is revealed.

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.

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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	2.00	2.5%
Euro area	Refi rate	1.00	0.75	0.50	0.50	0.50	
	10-year yields	1.42	1.00	0.90	1.00	1.20	3.5%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	1.56	1.35	1.50	1.70	1.80	3.6%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.73	0.85	0.95	0.95	0.95	1.9%
GBI-EM hedged in $	Yield - Global Diversified	5.77		6.00			5.9%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	192	JPMorgan JULI Porfolio Spread to Treasury	7.4%
Euro high grade (bp over Euro gov)	243	iBoxx Euro Corporate Index	6.2%
USD high yield (bp vs. UST)	627	JPMorgan Global High Yield Index STW	9.5%
Euro high yield (bp over Euro gov)	910	iBoxx Euro HY Index	13.2%
EMBIG (bp vs. UST)	323	EMBI Global	12.1%
EM Corporates (bp vs. UST)	392	JPM EM Corporates (CEMBI)	10.5%

Commodities	Current	Quarterly Averages 12Q3	12Q4	13Q1	13Q2	GSCI Index	YTD Return*
Brent ($/bbl)	109	95	100	105	95	Energy	-2.5%
Gold ($/oz)	1604	1655	1725	1750	1775	Precious Metals	0.4%
Copper ($/metric ton)	7322	8000	8300	8500	8700	Industrial Metals	-2.7%
Corn ($/Bu)	8.11	8.25	8.25	8.00	7.75	Agriculture	26.3%

Foreign Exchange	Current	Sep-12	Dec-12	Mar-13	Jun-13	3m cash index	YTD Return* in USD
EUR/USD	1.24	1.22	1.24	1.25	1.25	EUR	-4.3%
USD/JPY	78.6	78	78	80	80	JPY	1.5%
GBP/USD	1.57	1.56	1.58	1.58	1.58	GBP	1.3%
USD/BRL	2.01	2.00	1.98	1.95	1.95	BRL	-4.4%
USD/CNY	6.38	6.33	6.30	6.30	6.25	CNY	-0.2%
USD/KRW	1138	1150	1150	1090	1090	KRW	3.9%
USD/TRY	1.81	1.82	1.80	1.75	1.75	TRY	10.6%

Equities	Current	YTD Return (local ccy)
S&P	1393	10.7%
Nasdaq	2945	13.4%
Topix	724	1.4%
FTSE 100	5787	6.3%
MSCI Eurozone*	132	4.3%
MSCI Europe*	1053	5.9%
MSCI EM $*	945	5.4%
Brazil Bovespa	55072	-2.6%
Hang Seng	19275	7.5%
Shanghai SE	2129	-3.2%

*Levels/returns as of Aug 02, 2012
Local currency except MSCI EM $

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD ($)
Energy	2.2%	-2.1%	-15.8%	-2.5%
Materials	5.2%	3.6%	-13.7%	-1.5%
Industrials	7.2%	**8.9%**	-1.2%	**7.6%**
Discretionary	**12.0%**	**17.5%**	**4.3%**	5.1%
Staples	**11.0%**	**13.7%**	**12.6%**	**10.9%**
Healthcare	**12.2%**	**14.8%**	**9.3%**	**18.8%**
Financials	**13.4%**	5.7%	**17.1%**	**9.8%**
Information Tech.	**14.1%**	**10.8%**	-8.2%	**11.3%**
Telecommunications	**23.9%**	0.2%	**7.0%**	**11.3%**
Utilities	6.8%	-0.1%	-24.2%	**6.0%**
Overall	**10.7%**	**5.9%**	**1.4%**	**5.4%**

Source: J.P. Morgan

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Global Economic Outlook Summary

	Real GDP % over a year ago			Real GDP % over previous period, saar							Consumer prices % 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	1.5	1.5	2.0	1.5	2.3	2.5	3.3	1.9	1.5	1.3
Canada	2.4	2.1	2.2	1.9	2.0	2.1	2.0	2.2	2.2	2.4	2.7	1.9	2.1	2.2
Latin America	4.2	2.9	3.7	3.2	2.1	4.0	3.8	3.8	3.9	3.9	7.2	6.1	6.0	6.6
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	0.8	2.4	4.5	4.6	4.3	4.3	4.3	6.7	5.0	4.9	5.0
Chile	6.0	5.0	4.5	5.7	3.5	3.8	5.0	4.6	4.7	4.4	4.0	3.2	3.1	3.0
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	2.9
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	4.0
Mexico	3.9	3.6	3.5	5.3	2.1	1.7	3.4	4.4	3.7	3.3	3.5	3.8	4.0	3.9
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	3.0
Venezuela	4.2	5.5	0.0	10.9	6.0	3.0	-6.0	-1.0	0.0	3.0	28.5	23.9	23.4	31.7
Asia/Pacific														
Japan	-0.7	2.6	1.2	4.7	2.0	1.0	0.8	1.0	1.2	1.3	-0.3	**0.1** ↓	0.1	-0.3
Australia	2.1	3.2	2.8	5.3	1.3	1.6	2.4	4.4	3.3	1.8	3.1	1.0	1.5	2.2
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	2.7
Asia ex Japan	7.4	**6.1** ↓	6.7	**7.2** ↓	5.5	**5.9** ↓	**6.4** ↓	6.8	7.0	7.2	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	3.3
Hong Kong	5.0	1.9	3.6	1.6	3.0	3.5	3.5	3.0	3.5	5.0	5.7	4.2	2.5	2.4
India	6.5	6.0	6.5	5.8	6.3	5.8	5.6	6.2	6.5	6.8	8.4	10.2	9.8	9.3
Indonesia	6.5	5.0	3.7	4.8	4.0	3.0	3.0	3.5	4.5	5.0	4.1	4.5	3.9	3.4
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	**2.2** ↓	**2.8** ↓
Malaysia	5.1	3.0	2.5	5.1	1.0	0.0	1.0	2.0	4.0	4.5	3.2	1.7	1.1	1.1
Philippines	3.8	5.3	3.5	10.2	3.6	1.2	1.2	4.5	4.5	4.5	4.7	2.9	2.3	2.4
Singapore	4.9	2.2	3.5	10.0	**-0.8** ↑	**0.8** ↓	4.1	4.1	4.1	4.1	5.5	5.2	3.1	2.4
Taiwan	4.0	**1.1** ↓	**3.9** ↓	**1.3** ↓	**3.2** ↑	**1.8** ↓	**3.8** ↓	4.5	4.6	4.8	1.4	1.7	2.1	1.9
Thailand	0.1	3.5	2.3	52.1	4.0	1.0	0.0	2.0	3.0	4.0	4.0	2.5	1.3	1.9
Africa/Middle East														
Israel	4.8	2.9	4.4	3.0	3.2	6.1	7.4	4.5	2.8	2.4	2.5	2.3	2.5	2.1
South Africa	3.1	2.5	3.6	2.7	2.4	3.5	4.5	3.7	3.2	3.4	6.1	5.8	5.6	5.7
Europe														
Euro area	1.5	-0.5	0.1	0.1	-1.0	-1.0	-0.5	0.5	0.5	1.0	2.9	2.5	2.1	1.6
Germany	3.1	0.9	1.1	2.1	0.5	0.3	0.5	1.5	1.5	1.8	2.6	2.1	1.7	1.4
France	1.7	0.1	0.6	0.1	-0.5	-0.3	0.0	0.8	1.0	1.3	2.6	2.3	2.2	1.8
Italy	0.5	-2.2	-1.0	-3.2	-2.5	-2.5	-1.5	-0.8	-0.5	0.0	3.7	3.6	**3.4** ↑	**2.9** ↑
Spain	0.7	-1.3	-0.9	-1.3	-1.6	-2.8	-2.0	-0.5	0.5	0.5	2.7	1.9	**2.9** ↑	**2.4** ↑
United Kingdom	0.8	-0.6	1.4	-1.3	-2.8	2.0	0.5	1.5	2.0	2.5	4.6	2.8	2.1	1.8
Emerging Europe	4.8	2.7	3.2	3.0	-0.8	2.1	2.9	3.3	3.0	3.2	6.4	4.9	5.5	5.4
Bulgaria	1.7	1.0	2.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	1.7	-1.1	0.9	-3.1	-1.3	0.2	0.9	1.5	-0.6	2.5	2.4	2.7	2.9	2.5
Hungary	1.6	-1.2	1.0	-4.1	-1.3	-0.5	0.5	1.0	1.5	2.0	4.1	5.4	5.3	3.3
Poland	4.3	2.8	2.6	3.2	1.5	1.5	2.0	3.0	3.0	3.5	4.6	3.9	3.4	2.8
Romania	2.5	0.8	1.0	-0.5	1.3	-0.4	2.8	1.6	-1.2	1.2	3.4	2.2	4.4	4.0
Russia	4.3	3.6	3.4	4.6	-1.5	3.0	3.5	4.0	4.0	3.5	6.8	3.7	6.1	6.7
Turkey	8.5	2.8	4.5	...	...	...	...	...	...	...	9.2	9.4	6.5	5.8
Global	3.0	2.5	2.7	**3.0** ↓	**1.7** ↑	2.2	2.5	2.8	3.0	3.2	3.8	2.8	2.6	2.5
Developed markets	1.3	1.2	1.3	1.7	0.5	0.7	0.9	1.2	1.5	1.8	2.7	**1.8** ↓	1.6	1.3
Emerging markets	6.1	4.7	5.3	5.6	**3.8** ↑	**4.9** ↓	5.3	5.5	5.6	5.7	5.7	4.6	4.4	4.8

Source: J.P. Morgan

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