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To: US GIO <[redacted]>
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J.P.Morgan

Global Asset Allocation
J.P.Morgan Chase Bank NA, J.P. Morgan Securities Ltd.
Sep 23, 2011

The J.P. Morgan View

Who will win the race to recession?

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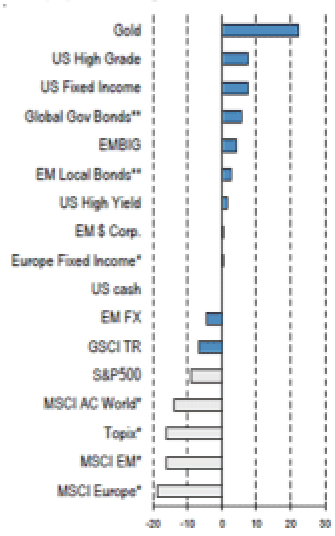
- **Economics** — Europe is falling into recession, by our new forecast. Weaker PMI's suggest serious downside to Asian forecasts. US is tracking our already weak growth forecasts.
- **Portfolio strategy** — The market reversal signals of Value, Positions, Timing, Data and Policy remain in defensive mode. Stay underweight risky assets.
- **Fixed Income** — We think a more severe Greek restructuring than agreed in July is inevitable, and stay cautious on the Euro area.
- **Equities** — Worsening technicals and fundamentals and the lack of clear triggers justify a defensive stance.
- **Credit** — We stay defensive.
- **Foreign exchange** — Yen and dollar are the world's strongest currencies in the face of surging volatility.
- **Commodities** — The sharp fall in base metal prices implies a close to 50% chance of a US recession.

- The global risk-off trade moved into the **phase of cross hedging and indiscriminate selling**. Witness the 20% drop in the Mexican peso, and falls in EM local bonds and gold. Unfortunately, by itself this does not signal that we are near the end. But it does help clear the deck and creates relative value opportunities that investors will move to once volatility becomes less threatening. A squaring of aggressive positions and building of defensive postures are both required conditions to define a market bottom and coming reversal. What we need in addition is that most of the worst news is priced in, data and events no longer surprise on the downside, and policy actions are taken to reverse the negative fundamentals. And here the news remains broadly negative and keeps us in defensive mode.

- **On value**, risk markets have cheapened significantly, but most remain well off worst-news levels, which we equate to a US recession here. By our reckoning, we would need to see that S&P500 to have fallen by its average move of past recessions — to about 1,000 — to give comfort that the almost-worst is priced in. Similarly, we would need to see HY widen another 2% and base metals fall another 20% to price in a US recession. Two markets are much closer to pricing in a recession: US HG, and USTs. USHG spreads, now near 240bp over USTs, are already wider than all US recessions, with the exceptions of the 2008-09 crisis, when they peaked over 500bp. And 10-year USTs already saw near historic lows.

- However relevant the Value signal will be to signal a bottom, it needs to get support from **Timing**. We know that risk markets typically do not rebound until the light at the end of the recession tunnel is in sight — on average 3 months before the end. But any US and European fiscal tightening induced recession may not even have started yet. In the Euro area, we think this recession will start any moment (Q4). In the US, fiscal policy will only begin tightening seriously in January, and only if the Administration's Jobs Act is

YTD returns through Sep 22
%, equities are in lighter colour.



Source: J.P. 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 ELMI+ in $.

The certifying analyst is indicated by an [AC]. See page 7 for analyst certification and important legal and regulatory disclosures.