

The J.P. Morgan View

It is all up to fiscal policy. Monetary is done.

- **Economics** — Growth forecasts reduced for UK, EM Asia, and Latin America, bringing 2012 EM growth down by 0.2%. US data are tracking a soft growth picture, but one that is not falling into recession at the moment.
- **Portfolio strategy** — Monetary policy has provided great help to the world economy but is now nearly done. Fiscal and regulatory policy makers have done more damage than good, by creating huge uncertainty. We do not see imminent changes here and thus remain defensive on risk assets.
- **Fixed Income** — EM bonds are at risk of further foreign outflows.
- **Equities** — The market rebound over the past week was largely driven by short covering, induced by rumours and speculation. We stay with a defensive stance, underweighting Cyclical sectors.
- **Credit** — Keep a preference for EM sovereign vs. EM corporate credit and US vs. Euro credit as flight to quality prevails.
- **Foreign exchange** — Take profits on the last USD short (vs NOK), but keep sovereign hedges in USD/JPY, EUR/JPY and GBP/JPY.
- **Commodities** — Copper prices below \$7,000/mt are likely to encourage restocking in China.

- With the exception of credit, most riskier asset classes — equities, commodities, and EM FX — are on net up this week, and bond yields rose amidst still sky-high volatility. US economic data came out better than expected across the board, punctuated by an upward surprise on US Payrolls today, while investors keep speculating about imminent action on a TARP-like recapitalization of Europe's banks.
 - We would love to be proven too pessimistic, but feel instead merely **realistic** about the uncertainties that investors face. **We retain a defensive stance**, underweighting riskier asset classes versus cash and safe government debt. Of the quartet that we monitor to signal a need to change our defensiveness — positions, data, value, and policy — the first two are at least partially in place for a rebound. It is our sense that tactical investors are now indeed underweight riskier asset classes, though not by as much as during the 2007-08 crisis. US **data** are now beating expectations, with modest upside risk on Q3 GDP, even as the rest of the world is still showing quite a mixed picture. China is stabilizing with its PMI above 50, but the rest of EM Asia is much weaker, as industrial and trade data there have clearly disappointed.
 - **Value** is harder to assess as markets are priced as a probability-weighted average of two binary risks — developed economy recession, and Euro breakdown. Risk markets are dirt cheap if neither of these risks materialises, but remain expensive if one or more of these become reality. We project a recession in Europe but not in the US, at the moment, even as the US economy is hostage to the amount of fiscal tightening next year. We consider a euro breakdown very unlikely, but do believe that conditions in the Euro area will, and need, to become much worse before EMU member countries are forced to
- The certifying analyst is indicated by an ^{AC}. See page 7 for analyst certification and important legal and regulatory disclosures.

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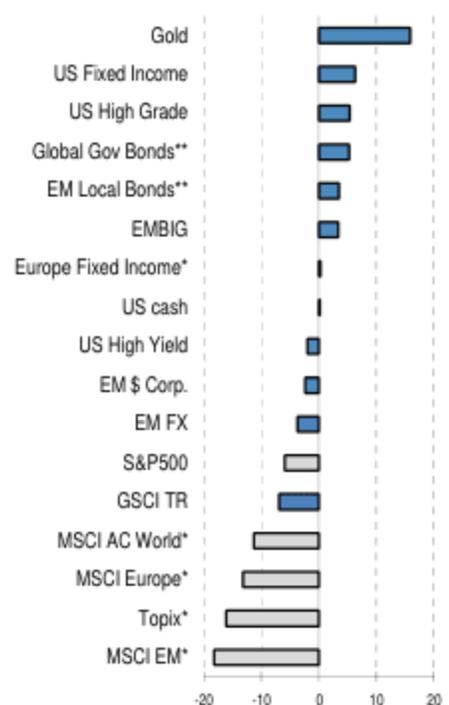
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Seamus Mac Gorain

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YTD returns through Oct 6

%, 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 ELM+ in \$.

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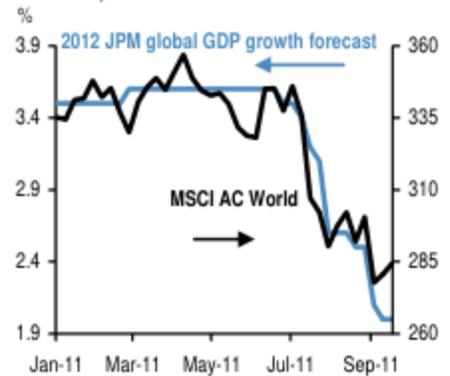
take the difficult decisions required to keep the union together.

- It is on the fourth corner of our quartet — **policy actions** — that we have seen the least progress and where the biggest risks remain. **We are very happy with monetary policy makers** as they have given it their all to provide stimulus to developed economies without sacrificing their reputation, so far. Central banks have gone way beyond their traditional tool kit, massively expanding their balance sheets, but have combined this with clean communication of intent such that inflation expectations have remained stable. By now, though, it is not clear what they can do more without endangering their reputation and credibility, or that they have much more impact.
- The Bank of England's MPC promised extra QE buying of gilts this week, while the ECB indicated it would again buy covered bonds issued by banks and would create two 1-year repos to provide bank with longer-term funding than their normal repos. All this is great, but does not do much to solve the main uncertainty gripping economic agents, which is on fiscal policy.
- Much of the fall in global equities this year took place in a 5-day crash in early August, around the time of the chaos around the US debt ceiling, its downgrade from AAA, and the collapse in consumer and company confidence. This timing coincidence provides good evidence that **uncertainty around fiscal and regulatory policies**, in both the US and the Euro area, is the root cause of weaker economies and asset markets. This uncertainty, if not chaos, was not preordained, but is a self-inflicted wound.
- Our US political observers report here that there is little movement towards compromise in Washington to combine near-term fiscal stimulus with longer-term fiscal control. In Europe, we need sufficient non-ECB funding for illiquid sovereigns, a restructuring of insolvent sovereigns (i.e. Greece), and a ringfencing of the banks through large scale recapitalization. We think some €200bn in new bank capital will be needed (see Kian Abouhossein, *European Banks, Euro TARP macro sensitivity analysis*, Oct 1). There remain strong differences of opinion among European policy makers on this and we thus do not expect much progress soon. As has been too regular a pattern, European policy makers are more likely to stay one step behind what the markets need.

Fixed income

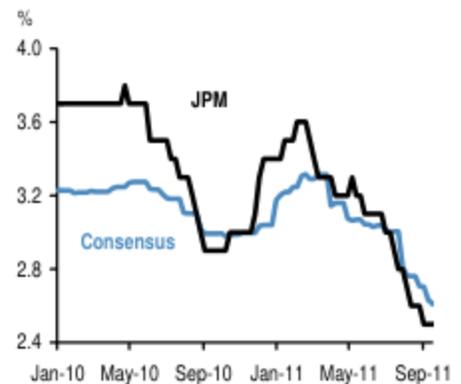
- **Yields backed up to the top of their one-month range, on some better activity data and hopes of a European bank recap.** The ECB's new steps to support bank funding were trumped by a surprisingly aggressive £75bn of QE from the BoE. Our forecast of another £75-£125bn of purchases beyond this announcement would leave the BoE owning over a third of the UK gilt market.
- Yet monetary policy takes second place right now to the keenly awaited decisions of EU politicians, first on bank capital and then on Greek funding. **The increased likelihood of bank recaps** has helped Spanish and Italian bonds to rally in the past two weeks, even as ECB buying has slowed. More concrete proposals on this score at the EU summit the week after next would bolster peripheral bonds some more. But further ahead, we remain **defensive on the periphery**, as the Euro area remains a house divided, making it difficult for policy makers to get decisively ahead of markets' exalted expectations.

2012 JPMorgan global GDP growth forecast vs. Global equities



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.

2011 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.

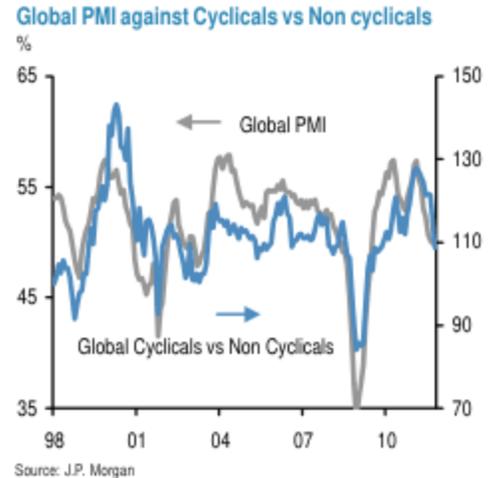
- **EM local bonds** have stabilised in the past two weeks, in spite of heavy outflows from EM bond funds. Nonetheless, the risk of a self-reinforcing spell of falling prices and foreign outflows remains, with markets with the greatest foreign participation — e.g. Hungary, Indonesia — the most vulnerable. We thus **turn underweight duration in EM local markets**. See this week's *Emerging Markets Outlook and Strategy* (Joyce Chang) for details.

Equities

- **The market rebound over the past week was largely driven by short covering, induced by rumours and speculation.** We still see a high risk of disappointment in terms of policy makers' actions over the coming weeks. As a result, we retain a defensive stance.
- The prospective rebound in global manufacturing has yet to materialize. **Our Global PMI downshifted for a seventh straight month in September** (released on Oct 1). Our Cyclical vs. Defensive trading rule, which goes short Cyclicals when the monthly change in the global PMI is negative and vice versa, points to an underweight in Cyclical sectors.
- The high beta of EM equities makes us believe that it is too early to overweight EM versus DM equities, despite better fundamentals in EM economies. Similarly, we find it less attractive to overweight Small caps. Within EM, we continue to underweight BRICs and focus our exposure on ASEAN countries. Investors remain sceptical about BRICs and are concerned about overheating and corporate governance. We recommend a long in **MSCI South East Asia\$ vs MSCI China\$**. Other country trades include: long **DAX vs. Eurostoxx50**, and long **MSCI Japan\$ vs. MSCI World\$**.
- For value investors, who are not constrained by near-term marking to market, we recommend buying dividend futures — **2012 Eurostoxx50 dividends**. The prospect of a recession in the Euro area does not meaningfully change the attractiveness of 2012 dividends, since they are paid out of 2011 earnings which are nearly 3/4 accrued. See Peng Cheng, *European Equity Derivatives Strategy*, Sep 28.

Credit

- **Major credit indices moved wider into Tuesday and then tightened into week end.** Expectations about EU bank recapitalizations as well as the ECB's announcement on resuming covered bonds purchases helped push European spreads lower in particular.
- Still, we witnessed two similar credit rallies in September which were followed by subsequent, larger corrections. Whilst true of US, European, and EM credit markets, the speed of the sell-off of late has been particularly surprising in EM where, with the exception of the EM sovereigns, all EM debt classes as now posting YTD losses. We remain defensive and stay **overweight EM sovereigns vs. EM corporates** as a preferred way to trade up in quality.
- US payrolls surprised to the upside today and should provide some relief for risk assets as concerns about the US economy abate for now. We see Europe edging closer towards recession and so maintain **overweights in US vs. Euro credit** (see this week's *GMOS*).



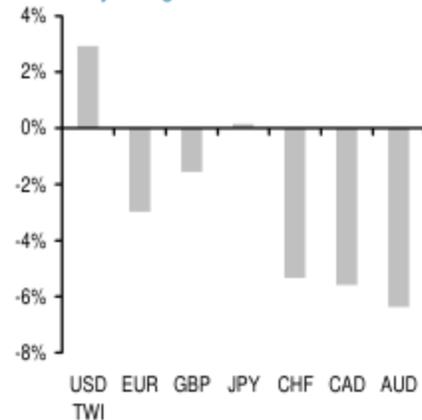
More details in ...

EM Corporate Outlook and Strategy, Warren Mar et al.
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.

Foreign Exchange

- After breaking a five-month range in September, **the dollar peaked this week**, falling 1.5% in trade-weighted terms and declining versus all currencies but CHF, GBP, INR and COP. Rebounds in commodity currencies and the emerging markets have been particularly sharp, and the euro has benefited per usual during a dollar sell-off, confirming that a sovereign crisis hasn't altered the typical behavior of currency markets. EM central bank intervention and recycling into euros will probably resume before year end.
- Macro developments haven't been particularly conclusive in that Europe has only hinted at comprehensive bank recapitalization by the Nov 3 G-20 summit; holdout voter Slovakia has inched closer towards approving the EFSF; and US data have stabilized at sub-trend levels. Still, in a market where investors are longer of dollars than they have been entering any previous recession or global easing cycle, the dollar's vulnerability to collapse on even marginally positive events should be clear.
- There are still too many event risks in the US and Europe over the next several months to suggest that the dollar downtrend will be forceful, which is why the baseline forecasts only show a 1% decline in Q4. But for the next few weeks, earnings seasons could reinforce this week's cap. EPS expectations are tame given Q3 GDP growth; equity hedge funds hold little exposure to stocks; and valuation extremes like the current one in stocks tend to align with the dollar's inflection points. Take profits on the last USD short (vs NOK); sell options where recession premia are too high (USD/CAD); but keep sovereign hedges in USD/JPY, EUR/JPY and GBP/JPY.

FX weekly change vs USD



Source: J.P. Morgan

Commodities

- **Commodities are up around 3% on the week.** Better than expected economic data in the US and rumours of bank recapitalizations in Europe saw some position squaring and a relief rally across risky assets. **Copper was the top performing commodity** with prices rallying 6% since the low at the beginning of the week. We believe that prices between \$6,500/mt and \$6,800/mt are likely to encourage **restocking in China** and so support prices. Brent also regained its early losses and is now up 3% since last week. We maintain the view that OPEC will act to keep a floor on global oil prices of around \$100/bbl should demand begin to fade.
- **Corn prices are down 22%** since the recent peak at the end of August. This is due both to the increase in fears of a DM recession and the large increase in estimated US corn inventories reported by the USDA last week. Just as one can derive a fair price through fundamental supply and demand factors, it is also possible to reverse engineer this process to arrive at an implied inventory number from current prices.
- Our commodity strategist, Colin Fenton, has done just this and makes the point that the current level of prices implies an inventory number double that what is currently estimated by the USDA. This seems somewhat unlikely, and **for investors who have a strong view that we will not see a DM recession, this is a good entry point.** We remain neutral for now given our view that the odds of going into recession are about even.

More details in ...

FX Markets Weekly, John Normand et al.

Commodity Markets Outlook & Strategy, Colin Fenton et al.

Oil Markets Monthly, Lawrence Eagles et al.

Metals Review and Outlook, Michael Jansen

Global Metals Quarterly, Michael Jansen

Interest rates		Current	Dec-11	Mar-12	Jun-12	Sep-12	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	2.04	2.25	2.60	2.80	2.80	8.7%
Euro area	Refi rate	1.50	1.00	1.00	1.00	1.00	
	10-year yields	2.00	1.55	1.60	1.80	2.00	7.2%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.47	2.10	2.10	2.10	2.10	12.0%
Japan	Overnight call rate	0.10	0.05	0.05	0.05	0.05	
	10-year yields	0.99	0.85	1.00	1.10	1.10	2.0%
GBI-EM hedged in \$	Yield - Global Diversified	6.62		6.90			3.5%

Credit Markets		Current	Index	YTD Return*
US high grade (bp over UST)		257	JPMorgan JULI Porfolio Spread to Treasury	5.2%
Euro high grade (bp over Euro gov)		322	iBoxx Euro Corporate Index	2.8%
USD high yield (bp vs. UST)		837	JPMorgan Global High Yield Index STW	-0.8%
Euro high yield (bp over Euro gov)		993	iBoxx Euro HY Index	-8.1%
EMBIG (bp vs. UST)		450	EMBI Global	3.4%
EM Corporates (bp vs. UST)		527	JPM EM Corporates (CEMBI)	-2.4%

Commodities	Current	Quarterly Averages				GSCI Index	YTD Return*
		11Q4	12Q1	12Q2	12Q3		
Brent (\$/bbl)	105.7	115.0	120.0	120.0	125.0	Energy	-4.5%
Gold (\$/oz)	1633	2150	1925	1875	1850	Precious Metals	15.8%
Copper (\$/metric ton)	7208	7250	8250	8500	9250	Industrial Metals	-21.5%
Corn (\$/Bu)	6.02	6.90	7.10	7.40	7.00	Agriculture	-15.7%

Foreign Exchange	Current	Dec-11	Mar-12	Jun-12	Sep-12	3m cash	YTD Return*
						index	in USD
EUR/USD	1.34	1.38	1.38	1.40	1.42	EUR	1.1%
USD/JPY	76.8	75	74	73	72	JPY	6.0%
GBP/USD	1.56	1.59	1.58	1.58	1.60	GBP	-0.9%
USD/BRL	1.78	1.80	1.80	1.80	1.80	BRL	-1.8%
USD/CNY	6.36	6.30	6.20	6.10	6.00	CNY	1.8%
USD/KRW	1178	1070	1050	1020	1010	KRW	-3.1%
USD/TRY	1.85	1.65	1.72	1.65	1.65	TRY	-12.8%

Equities	Current	YTD Return (local ccy)
S&P	1156	-6.6%
Nasdaq	2483	-5.8%
Topix	742	-15.6%
FTSE 100	5303	-7.5%
MSCI Eurozone*	128	-16.9%
MSCI Europe*	983	-13.1%
MSCI EM \$*	864	-23.1%
Brazil Bovespa	51299	-26.0%
Hang Seng	17707	-20.9%
Shanghai SE	2359	-16.0%

*Levels/returns as of Oct 06, 2011

Local currency except MSCI EM \$

Sector Allocation *	US	Europe	Japan	EM
	YTD	YTD	YTD	YTD (\$)
Energy	-7.2%	-8.5%	-10.1%	-24.7%
Materials	-15.6%	-25.1%	-20.2%	-28.7%
Industrials	-11.4%	-21.2%	-17.9%	-33.1%
Discretionary	-1.7%	-16.4%	-21.4%	-14.3%
Staples	3.9%	-1.0%	5.6%	-7.7%
Healthcare	3.0%	2.8%	-2.5%	-20.3%
Financials	-22.2%	-22.6%	-25.1%	-27.9%
Information Tech.	-2.1%	-11.3%	-27.1%	-21.6%
Telecommunications	-1.4%	-2.5%	-3.8%	-7.4%
Utilities	9.5%	-8.7%	-45.7%	-21.2%
Overall	-6.6%	-13.1%	-15.6%	-23.1%

Source: Bloomberg, Datastream, IBES, Standard & Poor's Services, J.P. Morgan estimates

Global Economic Outlook Summary

The global economic outlook in summary

	Real GDP			Real GDP							Consumer prices			
	% over a year ago			% over previous period, saar							% over a year ago			
	2010	2011	2012	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q10	2Q11	4Q11	2Q12
The Americas														
United States	3.0	1.6	1.3	0.4	1.3	1.5	1.0	0.5	1.5	2.5	1.2	3.3	3.2	1.4
Canada	3.2	2.2	2.2	3.6	-0.4	1.8	2.4	2.6	2.6	2.4	2.3	3.4	2.6	1.6
Latin America	6.0	4.2 ↓	3.2 ↓	5.6	4.1	3.1 ↓	2.5 ↓	1.6 ↓	4.4 ↑	4.7 ↑	6.7	6.7	7.2	6.9 ↓
Argentina	9.2	7.5 ↑	3.0 ↓	13.1	10.2	4.0 ↓	2.0 ↓	0.0 ↓	6.0	4.0	11.0	9.7	11.0	10.0 ↓
Brazil	7.5	3.3 ↓	3.4 ↓	5.0	3.1	1.9 ↓	2.7 ↓	3.3 ↓	4.2 ↑	4.2 ↑	5.6	6.6	6.7	5.3
Chile	5.2	6.5	4.0 ↓	6.4	5.7	3.5	2.5	3.5 ↓	4.5	5.0 ↑	2.5	3.3	3.6 ↓	3.6
Colombia	4.3	5.3	3.7	2.9	8.5	3.5	1.5	3.0	4.0	5.0	2.7	3.0	3.5	3.1
Ecuador	3.6	6.0	3.0	7.3	3.0	2.0	1.0	2.0	3.5	4.0	3.4	4.1	3.9	3.6
Mexico	5.4	4.0	2.5	2.4	4.5	5.7	2.6	-1.7 ↓	4.1 ↑	4.8 ↓	4.2	3.3	3.3 ↓	3.5 ↓
Peru	8.8	6.3	4.5	6.9	4.5	2.5	3.0	4.5 ↓	5.0 ↓	6.2 ↑	2.1	3.1	3.6	3.0
Venezuela	-1.5	3.5	3.0	14.7	-3.2	-1.5	3.0	3.0	5.0	6.5	27.3	24.6	29.0	33.6
Asia/Pacific														
Japan	4.0	-0.6	1.9	-3.7	-2.1	5.5	2.0	1.8	1.5	1.3	-0.3	-0.4	-0.1 ↑	-0.7
Australia	2.7	1.4	3.5	-3.4	4.8	2.1	2.2	4.1	3.4	4.8	2.7	3.6	3.8	3.2
New Zealand	1.7	2.0	3.8	3.5	0.4	2.8	4.1	3.9	3.9	5.6	4.0	5.3	3.2	2.4
Asia ex Japan	9.1	7.1 ↓	6.7 ↓	8.9	5.3	5.9	6.3 ↓	6.8 ↓	7.2 ↓	7.3 ↓	4.9	5.7	4.9	4.5
China	10.3	8.9	8.5	8.9	7.0	7.5	8.5	8.7	8.9	9.0	4.7	5.7	4.6	4.3
Hong Kong	7.0	5.2	4.0	13.0	-2.0	1.5	3.5	5.5	5.6	4.5	2.7	5.2	5.1	4.3
India	8.5	7.6	8.5	8.3	7.6	7.5	7.1	8.6	9.0	9.5	9.2	9.1	8.7	7.8
Indonesia	6.1	6.3 ↓	5.2 ↓	6.8	5.4	6.2 ↓	5.5 ↓	5.0 ↓	4.5 ↓	5.0 ↓	6.3	5.9	4.5	5.6
Korea	6.2	3.9	4.0	5.4	3.6	3.6	4.2	4.0	4.0	4.0	3.6	4.2	3.7	3.1
Malaysia	7.2	4.0 ↓	1.5 ↓	5.5	3.2	1.0	1.0 ↓	1.5 ↓	1.5 ↓	1.5 ↓	2.0	3.3	2.8	2.4
Philippines	7.6	4.1 ↓	4.0 ↓	7.8	2.4	4.1	2.4 ↓	2.4 ↓	7.4 ↑	5.3	3.5	5.0	4.6	3.3
Singapore	14.5	4.6 ↓	1.5 ↓	27.2	-6.5	0.0	-5.1 ↓	2.0 ↓	8.2 ↑	6.1 ↓	4.0	4.7	5.6	4.0
Taiwan	10.9	5.0	3.0 ↓	14.6	0.9	1.0 ↓	2.0 ↓	3.5 ↓	3.8 ↓	4.6 ↓	1.1	1.6	2.2	2.0
Thailand	7.8	3.0 ↓	1.5 ↓	8.1	-0.8	1.8 ↓	1.5 ↓	1.5 ↓	1.5 ↓	1.3 ↓	2.9	4.1	3.7	3.6
Africa/Middle East														
Israel	4.8	4.3	2.9	4.7	3.5	2.4	1.2	0.8	3.2	6.1	2.5	4.1	2.8	2.3
South Africa	2.8	3.1	2.5	4.5	1.3	1.0	3.9	2.3	2.6	2.8	3.5	4.6	6.2 ↑	6.4 ↑
Europe														
Euro area	1.7	1.6	-0.5	3.1	0.6	0.5	-0.5	-1.0	-1.5	0.0	2.0	2.8	2.8	1.7
Germany	3.6	2.8	0.2	5.5	0.5	1.5	-0.5	0.0	-0.5	0.5	1.6	2.5	2.5	1.5
France	1.4	1.6	-0.1	3.7	0.0	1.0	0.0	-0.5	-1.0	0.5	1.9	2.2	2.4	1.4
Italy	1.2	0.5	-1.2	0.5	1.2	-1.0	-1.5	-1.5	-2.5	-0.5	2.0	2.9	3.5	2.5
Norway	2.1	2.2	0.7	1.9	4.1	1.5	0.5	0.0	0.0	1.0	2.2	1.4	1.3	1.2
Sweden	5.4	4.1	0.4	3.1	3.6	2.0	0.0	-0.5	-0.5	0.5	1.9	2.9	2.6	1.3
United Kingdom	1.8 ↑	0.9 ↓	0.7 ↓	1.6 ↓	0.4 ↓	1.5	1.0	0.5	-1.0	2.5	3.4	4.4	4.9	2.8
Emerging Europe	4.5	3.8	2.5	3.6	1.2	2.0	1.3	3.1	3.0	3.8	6.6	7.1	6.0	5.2
Bulgaria	0.2	2.8	2.4	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	2.3	2.0	1.0	3.5	0.3	0.5	-0.3	0.3	1.3	2.5	2.1	1.8	1.8	2.5
Hungary	1.2	1.4	0.5	1.2	-0.2	0.3	0.0	0.0	1.0	1.5	4.4	4.0	3.8	4.2
Poland	3.8	3.8	2.7	4.5	4.5	2.5	2.0	2.0	2.5	3.0	2.9	4.6	3.9	2.5
Romania	-1.3	1.2	0.8	...	...	...	...	...	...	...	7.9	8.2	4.0	3.5
Russia	4.0	3.4	3.0	3.7	0.4	2.0	1.0	4.0	3.5	4.5	8.2	9.6	7.4	6.5
Turkey	9.0	6.3	2.7	...	...	...	...	...	...	...	7.4	5.9	6.7	6.0
Global	3.9	2.5	2.0	2.6	1.6	2.4 ↓	1.7 ↓	1.5 ↓	1.8	2.7	2.7	3.7	3.6 ↑	2.4
Developed markets	2.6	1.3	0.8	0.9	0.7	1.7	0.7	0.3	0.4	1.5	1.5	2.7	2.7	1.4
Emerging markets	7.3	5.7	4.9 ↓	7.1	4.3	4.4 ↓	4.4 ↓	4.8 ↓	5.7 ↓	6.0	5.6	6.2	5.7	5.2 ↓

Source: J.P. Morgan

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