J.P.Morgan

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

Oct 21, 2011

The J.P. Morgan View

A beginning to the end of the euro crisis

- **Economics** — We raise Q3 in the Euro area by 1%, but lower 2012 China by 0.2%. A Euro area recession remains our forecast.
- **Portfolio strategy** — Stay long risky assets as activity data remain better than feared, and odds favor fiscal compromises in Europe and the US.
- **Fixed Income** — We move to flat duration in EM, as in DM.
- **Equities** — Open an overweight in EM vs. DM equities.
- **Credit** — We stay optimistic as the economic and technical picture improves. Near-record HY bond fund inflows lead us to close our UW CCC vs US HY.
- **Foreign exchange** — Stay long the yen.
- **Commodities** — The physical copper market is showing signs that the global demand picture is improving.

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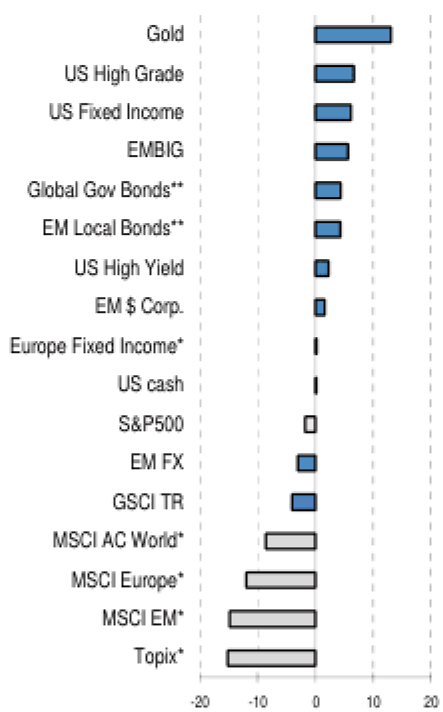
- Confusing rumors and counter-rumors on what the EU Summit would or would not deliver whipsawed markets all week, but leave credit and US equities net up. Most market participants refused to participate and are simply waiting for Europe to make up its mind. The normally high correlation between different risk markets in volatile periods was therefore not in evidence.

- **What can we expect from Europe next week?** This weekend will likely produce decisions on the Greek haircut (close to 50%) and quite possibly on higher capital ratios to be achieved by EU banks by the middle of next year. The decision on how to improve funding of illiquid sovereigns by leveraging the EFSF seems to have been pushed to a second summit on Wednesday. Some commitments on moving towards joint decision making on fiscal policy are also quite possible. Details on our views in Barr and Mackie, *The EU summit(s): where is the bazooka?,* in today's GDW

- The big question is **whether these summits can finally end the Euro-sovereign debt crisis** that began in the aftermath of the 2007-09 financial crisis. We think the odds are favorable that next week will define the **start of the end of the sovereign debt crisis,** but that this process will be drawn out, will have reversals, will not be obvious for some time, and will not prevent Europe from falling into recession again, as banks delever and austerity bites hard.

- It has been our view that **Europe needed to come right to the edge of disaster** before it would be forced to make the painful decisions necessary to reverse the crisis. Europe has the resources to achieve this. It just needs to have the political will to do so. This requires that the alternative is right in your face, and that procrastination is no longer possible. It is our perception that these conditions are in place today. The rest of the world is screaming for a solution as it sees the Euro debt crisis as a super Lehman that can bring all down. It is quite possible the rest of the world is willing to help though the IMF. We are willing to interpret the strong disagreements still evident between France and Germany and the postponing of the summit end to next Wednesday as signs

YTD returns through Oct 20
%, 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 $.

[redacted]

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

of the momentous decisions to be made rather than a breakdown in political will to come up with a solution.

- **How will markets react** if the EU summits provide the goods? Global investors have been hedging the EMU debt crisis by underweighting Europe, European banks, and global banks in both equity and credit markets. One should thus expect banks and European stocks broadly to react most to good news. Bonds will probably not move as much as duration positions are very light, with our US Treasury duration survey showing a 9-82-9 percentage exposure across shorts, neutrals and shorts. The euro should rally against the USD, but not that much as it never fell much. Expect stronger rallies in EM currencies.

- **We retain the bullish view and OW positions on risky assets** — equities, credit, commodities, and EM currencies — that we initiated last week. The favorable odds on the EU summits is are a clear plus. So are signs that Washington is edging towards compromise on the Obama tax plans. Economic data have been a plus, both on the global demand and supply side. Both are coming in stronger — or better, a lot less weak — than had been feared. Our forecast remains for a confidence and inventory-led fall in growth from 2.7% in Q3 to 1.7% in Q4. But there is now clear upside risk on Q4. This week, we raised last quarter growth in the Euro area from 0.5% to 1.5%, while keeping a forecast that the recession starts this quarter. We lowered China 2012 growth from 8.5% to 8.3%, still comfortably consistent with a soft landing.

Fixed income

- **Bonds rallied back a little, as hopes of a Euro area agreement by this weekend unravelled.** Together with the brighter tone in US activity data, this allowed German Bunds to outperform Treasuries slightly, and we think that move can continue.

- This week brought more clarity on bank recaps — likely sub-€100bn, below many market expectations. But the details on how Euro area leaders will leverage their resources, and the exact haircuts to be applied to Greek debt, still appear up in the air. Intra-EMU spreads rose across the board, with France again lurching wider, partly on rumblings from the ratings agencies. **Its high proportion of ratings-sensitive official sector investors underlines the importance for France of maintaining its AAA status**. We remain defensive on intra-EMU spreads, but in smaller size, closing Spain underweights on the risk of increased ECB buying.

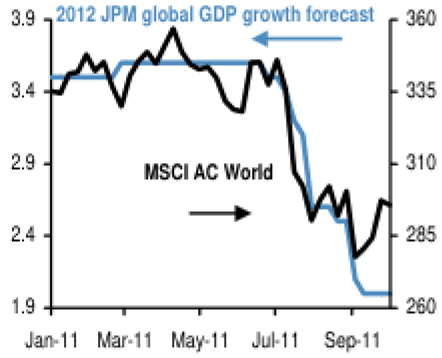
- EM local bonds have this month retraced half the September sell-off. After four weeks of significant outflows, EM bond mutual fund flows were about flat this week. We take profit on underweights in EMEA, **moving from overall short duration in EM local bonds to flat**. Our new *EM Cross Product Strategy Weekly* (Eric Beinstein, Oct. 19) details our top trade recommendations, including receivers in South Africa, and inflation linkers in Brazil.

- Please help us to gauge prospects for inflation by completing our Inflation Expectations Survey on: [redacted]

Equities

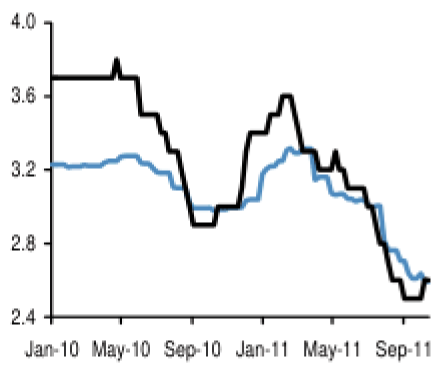
- US equities continued to rally for a third straight week. A **better than expected**

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 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.

US reporting season, coupled with **positive economic suprises**, fuel the market rally.

- 125 companies of the S&P500 have reported so far and 63% have beaten expectations. The S&P500 EPS tracks a $24.9 level for Q3, 30 cents above the bottom-up expectation at the beginning of month. More importantly, profit margins appear to have expanded over the past year. The S&P500 EPS is set to grow 16% YoY in Q3, vs 10% for Sales-per-Share.

- Last week, we closed our underweight in Cyclical sectors as recent economic surprises make it likely that the global PMI will post an increase, the first in eight months, with the next release on Nov 1. We also opened an OW in Euro area (MSCI EMU) vs US equities (S&P500) as investor underweights are more extreme in the Euro area.

- This week we add an overweight in EM equities. Our EM strategist Adrian Mowat believes that **Emerging Market equities are bottoming out vs their DM counterparts.** The MSCI EM $ Index has declined by 25% from its April peak vs. 16% for MSCI World $. The cumulative underperformance of MSCI EM vs. MSCI World since 6 Oct 2010, stands at 18%. This is the worst relative performance since the Lehman bankruptcy.

- We see similarities with the post-Lehman period. At the time, in October 2008, EM equities started outperforming their DM counterparts, as EM policy makers started focusing on stimulating their economies. Just as then, EM policy priorities are shifting from inflation to growth.

- The EM policy shift dictates a shift from defensive to domestic cyclical and interest rate sensitive stocks, especially those in Brazil, ASEAN and India. We upgrade Russia from UW to OW. Political risk is excessively discounted. At a 50% discount to EM, Russian equities are attractive.

Credit

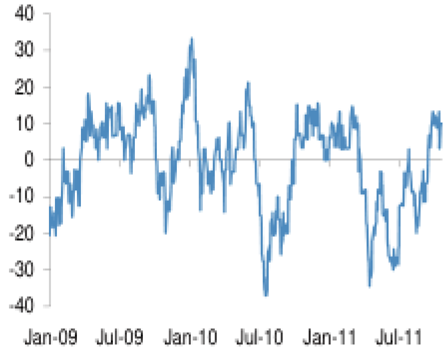
- While risk markets have been eagerly anticipating the EU summit, **better-than-expected economic data and earnings helped US credit extend the rally into a second week**. JULI has retraced 32bp, and US HY 115bp, since the Oct 4 peak without a single daily up-tick in spreads.

- The technical picture is looking more buoyant going forward as well, particularly in HY markets. **US HY bond funds saw a two-year record inflow of $2.3bn last week** and our European strategists reported that **EU HY bond funds saw a weekly inflow for the first time in three months** also. US HG funds saw a ninth consecutive inflow last week.

- **Emerging market external debt finished the week wider,** although EMBIG has tightened 78bp and CEMBI 99bp since the recent wides. The results of our sovereign survey suggest that investors identify EM corporates as having the most value following last month's sell-off (Jonny Goulden et al, *Sovereign External Debt Investor Survey*, Oct 20). Within the CEMBI, the strongest gains have come from companies in high-beta countries such as China, Indonesia and Russia.

US EASI Index

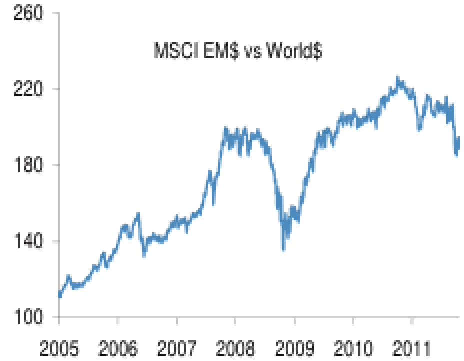
Balance of positive minus negative US economic surprises.



Source: J.P. Morgan

MSCI EM vs. World

Relative total return index based on MSCI World$ sector indices



Source: Datastream, J. P. Morgan

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.

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

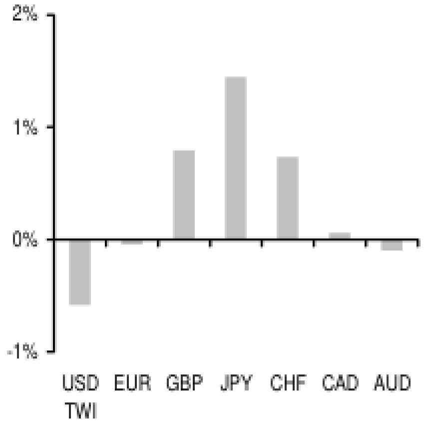
Foreign Exchange

- **The base case on the EU summits is that they deliver meaningful EFSF leverage without ECB funding; hint strongly at IMF credit lines; but require only moderate, private-sector funded bank recapitalization**. That outcome could disappoint and prompt deleveraging, but existing USD longs and pre-hedging would limit moves. **Keep yen hedges** in this environment. Given the importance of recapitalization, an unambitious bank strategy could trigger deleveraging and modest USD strength, though positions constrain how far the dollar can move. Investors are long of dollars on a variety of measures ranging from currency futures to fund manager betas, even if exposure has declined from the near-record level held at the end of September. Other indicators also suggest considerable pre-emptive hedging ahead of the summit. EUR/USD 7-day vol has spiked close to the year-to-date highs, and risk reversals across USD-based pairs are still heavily skewed for USD upside.

- **For the past two weeks, we have been barbelled between tactical longs in cyclical currencies which overpriced recession risks; and core yen longs to hedge event risks and position for lower rates in the US and Europe**. The cyclical trades consisted of owning cheap currencies (SGD vs USD), and selling USD or EUR upside where option skew priced in a Lehman-like event (sold 1.09 USD/CAD call, 0.7550 NZD/USD put and 9.29 EUR/SEK call). Keep these trades: we doubt the EU package will be underwhelming enough to deliver USD strength beyond these CAD and NZD strikes, or EUR upside beyond the SEK strike. Owning the yen always served two purposes: hedging short-term event risk and positioning for rate compression between US/Europe and Japan. Keep the basket of yen call spreads.

- Given the importance of recapitalization, **an unambitious bank strategy could trigger deleveraging and modest USD strength**, though positions constrain how far the dollar can move. Investors are long of dollars on a variety of measures ranging from currency futures to fund manager betas, even if exposure has declined from the near-record level held at the end of September.

FX weekly change vs USD



Source: J.P. Morgan

Commodities

- **Commodities are down around 1% this week led lower by base metals.** Copper was particularly volatile this week, down 6% yesterday but up 5% today. The physical market has now started to show signs that the demand picture is improving. Cancelled warrants, a demand indicator, are at their highest globally for two years and **physical premia in China** are currently at their highest this year, suggesting strong domestic demand. Given a tight scrap market and weak supply outlook, this reaffirms our view that **demand for copper will outpace supply this year** and that the recent correction was overdone.

- **Oil is broadly flat this week** in spite of the news that Colonel Gaddafi was killed along with the head of his armed forces by the Libyan rebels. This news does not have an immediate impact on prices as the rebels had already secured the country's oil facilities and progress towards returning supply to pre-crisis levels appears to be going well. However, **it does remove one notable risk**. Gaddafi had apparently been planning a campaign of insurgency that would have complicated the restoration of oil production. Iraq and Nigeria have shown how much of an impact sustained campaigns of insurgency can have on oil supply.

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

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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	2.20	2.25	2.60	2.80	2.80	7.9%
Euro area	Refi rate	1.50	1.00	1.00	1.00	1.00	
	10-year yields	2.11	1.55	1.60	1.80	2.00	7.0%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.53	2.10	2.10	2.10	2.10	11.7%
Japan	Overnight call rate	0.10	0.05	0.05	0.05	0.05	
	10-year yields	1.01	0.85	1.00	1.10	1.10	1.8%
GBI-EM hedged in $	Yield - Global Diversified	6.48		6.90			4.3%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	225	JPMorgan JULI Porfolio Spread to Treasury	6.4%
Euro high grade (bp over Euro gov)	277	iBoxx Euro Corporate Index	2.0%
USD high yield (bp vs. UST)	748	JPMorgan Global High Yield Index STW	3.1%
Euro high yield (bp over Euro gov)	845	iBoxx Euro HY Index	-3.7%
EMBIG (bp vs. UST)	406	EMBI Global	5.6%
EM Corporates (bp vs. UST)	456	JPM EM Corporates (CEMBI)	1.6%

		Quarterly Averages					
Commodities	Current	11Q4	12Q1	12Q2	12Q3	GSCI Index	YTD Return*
Brent ($/bbl)	110.8	115.0	120.0	120.0	125.0	Energy	-0.3%
Gold ($/oz)	1638	2150	1925	1875	1850	Precious Metals	13.0%
Copper ($/metric ton)	6722	7250	8250	8500	9250	Industrial Metals	-26.5%
Corn ($/Bu)	6.58	6.40	6.70	7.00	6.80	Agriculture	-12.3%

Foreign Exchange	Current	Dec-11	Mar-12	Jun-12	Sep-12	3m cash index	YTD Return* in USD
EUR/USD	1.39	1.38	1.38	1.40	1.42	EUR	3.4%
USD/JPY	76.1	75	74	73	72	JPY	5.8%
GBP/USD	1.59	1.59	1.58	1.58	1.60	GBP	1.1%
USD/BRL	1.77	1.80	1.80	1.80	1.80	BRL	-1.1%
USD/CNY	6.38	6.30	6.20	6.10	6.00	CNY	2.0%
USD/KRW	1148	1070	1050	1020	1010	KRW	0.8%
USD/TRY	1.84	1.65	1.65	1.65	1.65	TRY	-13.4%

Equities	Current	YTD Return (local ccy)
S&P	1234	-0.3%
Nasdaq	2632	-0.2%
Topix	744	-15.3%
FTSE 100	5489	-4.2%
MSCI Eurozone*	129	-15.8%
MSCI Europe*	996	-11.9%
MSCI EM $*	908	-19.1%
Brazil Bovespa	55282	-20.2%
Hang Seng	18026	-20.9%
Shanghai SE	2317	-20.9%

*Levels/returns as of Oct 20, 2011
Local currency except MSCI EM $

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD ($)
Energy	**0.8%**	**-1.2%**	**-5.0%**	-20.2%
Materials	-13.1%	-25.4%	-18.4%	-26.0%
Industrials	-6.6%	-19.8%	**-15.1%**	-28.8%
Discretionary	**3.4%**	-12.2%	-20.7%	**-7.1%**
Staples	**7.5%**	**0.4%**	**4.5%**	**-3.7%**
Healthcare	**5.0%**	**3.4%**	**-4.0%**	-20.1%
Financials	-18.7%	-23.9%	-22.4%	-23.7%
Information Tech.	**1.5%**	**-7.7%**	-25.1%	**-17.4%**
Telecommunications	**0.9%**	**-2.5%**	**-2.1%**	**-5.7%**
Utilities	**13.1%**	**-11.1%**	-44.8%	**-16.6%**
Overall	**-0.3%**	**-11.9%**	**-15.3%**	**-19.1%**

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

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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			
	2010	2011	2012	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q10	2Q11	4Q11	2Q12
The Americas														
United States	3.0	1.7	1.5	0.4	1.3	**2.8** ↑	1.0	0.5	1.5	2.5	1.2	3.3	3.2	**1.3** ↓
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	3.9	3.0
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	3.2	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	4.0	3.6
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	7.2	**6.6** ↓	**9.0** ↑	**5.7** ↑	**6.1** ↑	**5.8** ↓	**7.0** ↑	**6.8** ↓	**7.2** ↓	4.9	5.7	**5.1** ↑	**4.3** ↓
China	**10.4** ↑	**9.0** ↑	**8.3** ↓	**9.0** ↑	**7.9** ↑	**7.9** ↑	**8.0** ↓	**8.2** ↓	**8.2** ↓	**8.9** ↓	4.7	5.7	**4.9** ↑	**3.8** ↓
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	4.9	1.5	27.2	-6.5	1.6	-3.9	2.0	6.1	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	**2.5** ↓	**2.6** ↑	8.1	-0.8	1.8	**-6.0** ↓	**15.0** ↑	**-1.0** ↓	1.3	2.9	4.1	3.7	3.6
Africa/Middle East														
Israel	4.8	4.3	2.9	4.8	3.7	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	**1.8** ↑	**1.7** ↑	**-0.3** ↑	3.1	**0.7** ↑	**1.5** ↑	-0.5	-1.0	-1.5	0.0	2.0	2.8	2.8	1.6
Germany	3.6	**3.0** ↑	**0.3** ↑	5.5	0.5	**3.0** ↑	-0.5	0.0	-0.5	0.5	1.6	2.5	2.6	1.6
France	1.4	**1.7** ↑	**0.0** ↑	3.7	0.0	**2.0** ↑	**-0.5** ↓	-0.5	-1.0	0.5	1.9	2.2	2.3	1.3
Italy	1.2	**0.6** ↑	**-1.1** ↑	0.5	1.2	**0.0** ↑	-1.5	-1.5	-2.5	-0.5	2.0	2.9	3.7	2.6
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	**1.1** ↓	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	**2.5** ↓	**1.1** ↓
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	**2.2** ↑	1.3	3.1	3.0	3.8	6.6	7.1	6.2	5.5
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	**3.7** ↓	**4.4** ↑
Poland	3.8	**4.0** ↑	2.7	4.5	4.5	**3.5** ↑	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	7.6	7.2
Global	3.9	2.6	2.0	2.6	**1.7** ↑	**3.1** ↑	**1.6** ↓	1.5	**1.7** ↓	2.7	2.7	3.7	3.6	2.4
Developed markets	**2.7** ↑	**1.4** ↑	0.9	0.9	0.7	**2.6** ↑	0.7	0.3	0.4	1.5	1.5	2.7	2.7	1.3
Emerging markets	7.3	5.7	4.9	**7.2** ↑	**4.5** ↑	**4.6** ↑	**4.2** ↓	**4.9** ↑	**5.4** ↓	6.0	5.6	6.2	**5.8** ↑	**5.2** ↓

Source: J.P. Morgan

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