J.P.Morgan

Global Asset Allocation
J.P.Morgan Chase Bank NA, J.P. Morgan Securities Ltd.
Oct 28, 2011

The J.P. Morgan View

Did markets overreact?

- **Economics** — We raise US Q4 GDP from 1.0% to 2.5%, after having done the same to Q3 over the past month.
- **Portfolio strategy** — Equities and credit may have overreacted to an EU Summit that was short on details, but we stay long risk assets as the EU is heading in the right direction, and we should get support from reduced US recession risks.
- **Fixed Income** — We remain defensive on Euro area peripherals, despite EU leaders' statement of intent.
- **Equities** — We close our underweight in China and move BRICs to an overweight within EM, i.e long MSCI BRICs vs MSCI EM.
- **Credit** — All-time record US HY inflows signal further spread narrowing.
- **Foreign exchange** — European bank recapitalization could lead to repatriation on foreign holdings, but the impact on EUR will likely be small.
- **Commodities** — We expect the Brent-WTI spread to narrow further to $10/bbl by the end of next year.

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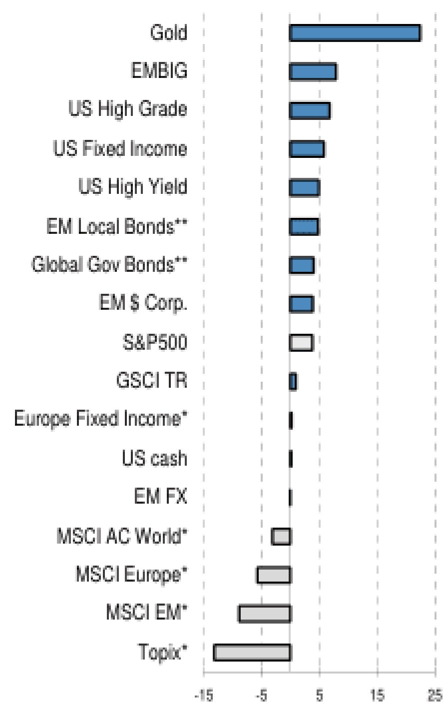
- Risk markets all rallied hard this week following the Euro Summit statement on Thursday morning that suggested a more determined commitment by EU heads of state to address the root causes of their debt crisis. **We retain a long risk position** — overweight riskier asset classes against defensive ones — on a judgement that Europe is finally recognizing what it must do to contain the crisis; that it is showing an increased willingness to implement such measures; that global investors remain broadly defensively positioned; and that you get badly penalised — through record low yields — if you choose to stay in safe assets.

- **This week's violent lurch up in equity prices took many market participants by surprise,** as they did not consider the EU Summit that impressive. In addition, the largest eurobond markets at the core of the crisis — Italy — ended down on the week as it saw weak demand at bond auctions today. If the Summit did not move us towards an eventual resolution of the EMU debt crisis, then surely equity and credit market overreacted and are due to fall back as fundamental disagreements emerge on the implementation of the Summit measures.

- **We do not think so and remain long risk.** Much has been written about how the **EU Summit Statement** is full of vague promises and short of concrete details, while glossing over still large disagreements between major stakeholders. We do not disagree (see Barr and Mai, *EU summit leaves plenty of gaps in €1tn of "firepower"* in today's GDW). The next few weeks and months will likely see a seesaw in perceptions of whether this new plan will do the job. At the same time, we are sufficiently impressed that the heads of states are committing to the main elements of resolution — Greek debt reduc-

YTD returns through Oct 27
%, 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.

tion, bank recapitalization, wider liquidity and funding support for Euro members, and stronger coordination and constraints on future deficits and debt.

- We thus see reason to repeat what we said last week: This summits defines the **start of the end of the sovereign debt crisis,** but that this process will be drawn out (likely in years), 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.

- If the EU Summit were the only reason to be long risk assets, then we accept that we may be on thin ice. **But there is more.** US economic activity data continue to come in stronger — or, better, not as weak — as we had foreseen. Over the past month, we raised our Q3 US GDP forecast from 1% to 2.5%. Today we did the same for Q4. Forward-looking PMIs and confidence data had made us anticipate weaker spending growth, but consumption is coming in much stronger than these signals suggested. In Europe, the fall in PMIs is consistent with our call that a recession has just started. But in emerging economies, the fall in inflation and growth are inducing a switch from monetary tightening to easing. This includes China, and is bringing about a strong rebound in EM equities, motivating us to move to OW EM equities and BRICs within EM (see below).

Fixed income

- **Bonds sold off as the summit of European leaders delivered more than many investors feared.** Government yields have reversed around two fifths of their summer decline, significantly less than the retracement in equity markets (see Chart). In part that reflects flattish positioning in bonds, whereas equity investors have had significant shorts to cover. But it is also down to the reopening of the monetary policy spigot, with the Federal Reserve, Bank of England, and Bank of Japan all having eased to varying degrees, and the ECB to follow by year end on our forecast. The path of least resistance for yields is slightly higher, and **we are underweight duration in the US**, where activity data have been strongest.

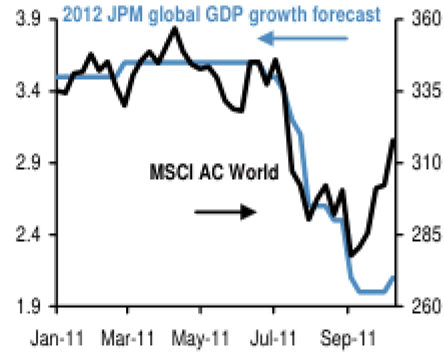
- **Peripheral spreads tightened in the face of EU leaders' statement of intent**, with only Italy lagging. The question is how long-lasting this improvement will be, in the face of several months of filling in the blanks from the statement, not all of which will run smoothly. Our view is that private demand for peripheral bonds will remain weak. The reduced liquidity and increased volatility of Spanish and Italian bonds since the summer is a clear negative, while the Euro area's slide towards probable recession makes fiscal targets all the harder to hit. That underlines the importance of official support, from the ECB in the first instance, to keep yields in check. **We remain defensive on peripherals, and add back the Spain underweight we closed last week.**

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

Equities

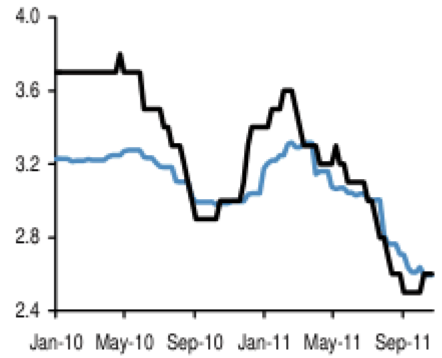
- **US equities continued to rally for a fourth straight week** fuelled by this week's EU summit, better than expected earnings news, and still positive US economic surprises.

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.

- 296 companies of the S&P500 have reported so far and 65% have beaten expectations. The S&P500 EPS is tracking a $25.2 level for Q3, 3% 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 17% YoY in Q3, vs 11% for Sales-per-Share.

- **We stay with a positive stance as we believe that there are still plenty of shorts to be covered.** As we highlighted in this week's *Flows & Liquidity*, around a quarter of the position retrenchment of the previous months has been reversed in October. Macro HFs have moved to neutral, after spending most of September/October being modestly short equities. Their inclination is to go long equities, as this is their best hope to boost performance into year-end.

- Last week we opened an overweight in EM vs. DM equities as EM policy makers have started focusing on stimulating their economies. Just as in November 2008, EM policy priorities are shifting from inflation to growth. This shift is more pronounced in BRICs, including China. As a result, we close our underweight in China (i.e. short MSCI China vs MSCI South East Asia) and move BRICs to an overweight within EM (**long MSCI BRICs vs MSCI EM**). BRICs have been underperforming steadily since the end of 2009, mostly due to overheating and tightening fears. These fears are gradually fading. See Adrian Mowat, *EM Equity Strategy* for more details.

- Across regions we remain OW in Euro area (MSCI EMU) vs US equities (S&P500) as investor underweights are still more prevalent in the Euro area.

Credit

- With announcements from Europe having beaten expectations, **seventeen straight days of gains** have been registered in both the US HG and HY indices. **The move into high-yield accelerated** as HY mutual funds/ETFs saw an all-time-record $4.2bn of inflows, surpassing last week's two-year record of $2.3bn. HY spreads have tightened after each of the four past times that HY saw weekly inflows over $2bn (See last week's *Flows & Liquidity*).

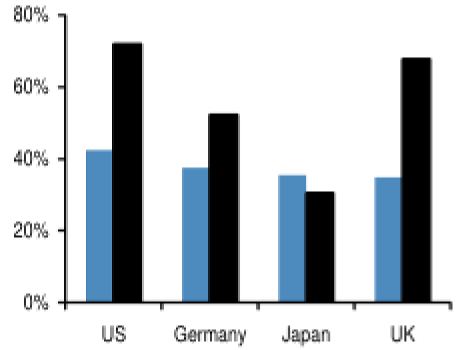
- Yesterday, **European CDS indices saw the biggest one-day tightening since May 2010** when the original Greek rescue package was announced. Our credit sales and trading force estimates that some 80% of recent flows constituted short covering, while the rest was real buying (see Stephen Dulake, *This Time it Could Be Different*). Today, our **EM strategists trimmed some of their defensive positions** as tail risks retrace in Europe, and they lowered their year-end EMBIG forecast from 425bp to 400bp, compared with 371bp today.

Foreign Exchange

- Now that Europe's latest summit agreement moves into implementation mode, the most opaque issue for currencies will be the **impact of bank recapitalization**. There is no question that **a leveraged EFSF or IMF credit lines would prove euro-positive** by diffusing credit risk without resorting to debt monetisation. Bank recapitalization's FX impact is much murkier given the variables involved, such as the reliance on government capital injections versus asset sales; the split between domestic and foreign asset sales; the currency mismatch between overseas assets and liabilities; and the country's position as a net international creditor or debtor.

Retracement in government bond and equity markets

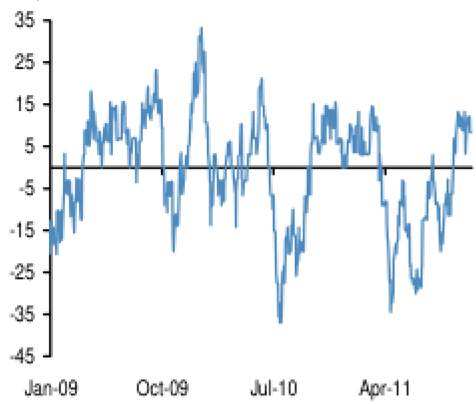
Change from recent lows, as a proportion of fall from highest level in July.



Source: J.P. Morgan, Bloomberg

US EASI Index

Balance of positive minus negative US economic surprises.



Source: 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.

- Japanese bank deleveraging in the late 1990s coincided with massive yen strength, but investor deleveraging post LTCM drove most of this move in 1998, while foreign buying of the Nikkei drove the last leg in 1999. At first blush European bank recapitalization looks quite euro-positive, since the region's banks are three times more extended overseas than Japanese banks, but the currency mismatch isn't huge. This issue has significant impacts for certain regions like CEEMEA, but in aggregate, shouldn't drive the euro broadly over the next year. We are sticking with **1.38 as the baseline for the next two quarters.**

- Adjustments to our portfolio are minor: take part profits on JPY longs, rotate USD shorts and continue earnings options premia where recession risks are overpriced. Add a short in USD/MYR, rotating out of USD/SGD. In options, we have been long the yen versus some combination of USD, EUR and GBP since August, and then yen is finally edging higher now that this week's trade data confirm the return of Japan's trade surplus. Take profits on short USD/JPY to minimize concentration risk if the Bank of Japan intervenes, but stay long vs EUR and GBP. Also stay short USD calls vs CAD and NZD and EUR calls vs EUR. Option markets continue to price more recession risks than cash markets do, judging from how little skews in commodity currencies and EM FX have retraced relative to spot.

Commodities

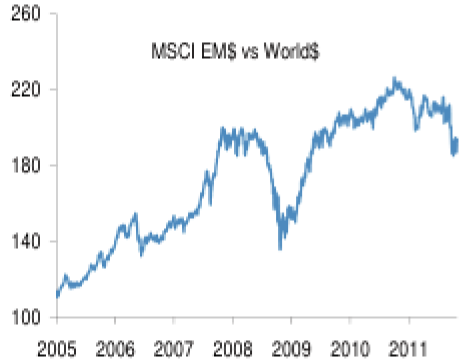
- **Commodities rallied nearly 4% this week, once again led by base metals with copper up almost 14%.** Indicators of physical demand for copper are strong, especially in China where inventories are at multi-year lows. Recent better-than-expected US economic data show that the probability of a recession is much lower than had been priced into base metals until recently. The better Chinese PMI also points to continued strong commodity demand. We remain positive on base metals.

- **Oil is up 4% this week, but this masks a considerable divergence between the two main oil benchmarks**: **Brent was flat and WTI rallied nearly 7%** — a complete reversal of the trend we have seen all year. As a result, the gap between the two has narrowed from almost $28/bbl two weeks ago to only $17/bbl now. The WTI futures curve also moved into backwardation (downward sloping), as inventories at Cushing, where WTI is priced, fell sharply.

- **Until mid 2010, WTI had traded at a slight premium to Brent,** but the increase in Canadian production last year caused a build up of inventories at the landlocked WTI pricing point in Oklahoma. The flow of oil into Cushing far exceeded the amount that could physically flow out, depressing WTI prices relative to Brent. **Our oil analysts estimate that a spread of around $25/bbl is sufficient to make it profitable to move oil out of Cushing** by unconventional means. We started to see this over the summer. **This spread should continue to narrow and reach $10/bbl by the end of next year,** as more oil is moved out of Cushing. This may happen sooner should a planned pipeline between the mid west and the gulf coast be approved shortly.

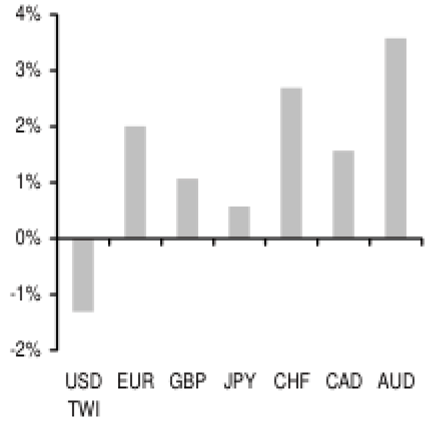
MSCI EM vs. World

Relative total return index based on MSCI World$ sector indices



Source: Datastream, J. P. Morgan

FX weekly change vs 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, 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	2.32	2.25	2.60	2.80	2.80	6.8%
Euro area	Refi rate	1.50	1.00	1.00	1.00	1.00	
	10-year yields	2.18	1.55	1.60	1.80	2.00	6.0%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.61	2.10	2.10	2.10	2.10	10.7%
Japan	Overnight call rate	0.10	0.05	0.05	0.05	0.05	
	10-year yields	1.04	0.85	1.00	1.10	1.10	1.8%
GBI-EM hedged in $	Yield - Global Diversified	6.39		6.90			4.9%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	206	JPMorgan JULI Porfolio Spread to Treasury	6.6%
Euro high grade (bp over Euro gov)	269	iBoxx Euro Corporate Index	2.3%
USD high yield (bp vs. UST)	684	JPMorgan Global High Yield Index STW	5.7%
Euro high yield (bp over Euro gov)	783	iBoxx Euro HY Index	-1.1%
EMBIG (bp vs. UST)	370	EMBI Global	7.9%
EM Corporates (bp vs. UST)	404	JPM EM Corporates (CEMBI)	3.9%

Commodities	Current	Quarterly Averages 11Q4	12Q1	12Q2	12Q3	GSCI Index	YTD Return*
Brent ($/bbl)	110.1	115.0	120.0	120.0	125.0	Energy	5.1%
Gold ($/oz)	1745	2150	1925	1875	1850	Precious Metals	22.5%
Copper ($/metric ton)	8143	7250	8250	8500	9250	Industrial Metals	-15.7%
Corn ($/Bu)	6.56	6.40	6.70	7.00	6.80	Agriculture	-10.9%

Foreign Exchange	Current	Dec-11	Mar-12	Jun-12	Sep-12	3m cash index	YTD Return* in USD
EUR/USD	1.42	1.38	1.38	1.40	1.42	EUR	6.8%
USD/JPY	75.7	75	74	73	72	JPY	7.2%
GBP/USD	1.61	1.59	1.58	1.58	1.60	GBP	3.6%
USD/BRL	1.68	1.80	1.80	1.80	1.80	BRL	3.3%
USD/CNY	6.36	6.30	6.20	6.10	6.00	CNY	2.3%
USD/KRW	1105	1070	1050	1020	1010	KRW	3.6%
USD/TRY	1.74	1.65	1.65	1.65	1.65	TRY	-8.0%

Equities	Current	YTD Return (local ccy)
S&P	1284	3.8%
Nasdaq	2733	3.8%
Topix	771	-12.2%
FTSE 100	5702	-0.5%
MSCI Eurozone*	140	-8.6%
MSCI Europe*	1066	-5.7%
MSCI EM $*	994	-11.4%
Brazil Bovespa	59361	-14.3%
Hang Seng	20019	-7.6%
Shanghai SE	2473	-7.4%

*Levels/returns as of Oct 27, 2011
Local currency except MSCI EM $

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD ($)
Energy	**8.0%**	**4.5%**	**-0.6%**	**-9.5%**
Materials	-4.6%	-16.0%	-16.8%	-16.2%
Industrials	-0.2%	-12.3%	**-11.3%**	-20.5%
Discretionary	**7.8%**	**-4.4%**	-18.5%	**1.5%**
Staples	**9.7%**	**2.3%**	**2.1%**	**2.1%**
Healthcare	**10.2%**	**5.2%**	**-5.7%**	-16.0%
Financials	-10.8%	-14.8%	-19.6%	-16.3%
Information Tech.	**6.7%**	**-1.7%**	-21.5%	-12.9%
Telecommunications	2.7%	**1.9%**	**-0.7%**	**-0.4%**
Utilities	**16.2%**	-6.6%	-45.9%	**-10.4%**
Overall	**3.8%**	**-5.7%**	**-12.2%**	**-11.4%**

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

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	**1.8** ↑	**1.7** ↑	0.4	1.3	**2.5** ↓	**2.5** ↑	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	**7.1** ↓	6.6	9.0	5.7	**5.9** ↓	5.8	7.0	6.8	**7.3** ↑	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	**5.0** ↓	**3.6** ↓	13.0	-2.0	**1.0** ↓	**2.5** ↓	**4.0** ↓	**5.5** ↓	**5.5** ↑	2.7	5.2	**5.2** ↑	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	**3.8** ↓	4.0	5.4	3.6	**3.0** ↓	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	**4.6** ↓	3.0	14.6	0.9	**-0.5** ↓	**2.5** ↑	3.5	**4.0** ↑	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	**3.9** ↑	2.5	3.6	1.2	**2.7** ↑	1.3	3.1	3.0	3.8	6.6	7.1	**6.0** ↓	**5.4** ↓
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	**3.6** ↑	3.0	3.7	0.4	**2.8** ↑	1.0	4.0	3.5	4.5	8.2	9.6	**7.0** ↓	**6.2** ↓
Turkey	9.0	6.3	2.7	...	...	...	...	...	...	...	7.4	5.9	7.6	7.2
Global	3.9	2.6	**2.1** ↑	2.6	1.7	**3.0** ↓	**2.1** ↑	1.5	1.7	2.7	2.7	3.7	3.6	2.4
Developed markets	2.7	1.4	**1.0** ↑	0.9	0.7	**2.4** ↓	**1.3** ↑	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	**4.8** ↓	5.4	6.0	5.6	6.2	5.8	**5.1** ↓

Source: J.P. Morgan

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