J.P.Morgan

Global Asset Allocation
J.P.Morgan Chase Bank NA, J.P. Morgan Securities Ltd.
Nov 4, 2011

The J.P. Morgan View

Everyone is short risk

- **Economics** — H2 data are coming in less weak than expected.
- **Portfolio strategy** — We cannot be called bullish, but high risk premia and growth upgrades make us net long risk.
- **Fixed Income** — We hold Treasury shorts, and add a short in 2yr Germany.
- **Equities** — Focus risk on country trades: long EM vs. DM, long BRICs vs EM, long Japan vs. DM, long MSCI EMU vs. S&P500 and long DAX vs. Eurostoxx50.
- **Credit** — We move to UW US HG and prefer EM Sovereigns vs corporates.
- **Foreign exchange** — We still prefer USD/JPY and EUR/JPY to EUR/USD given the risk of further QE in the US.
- **Commodities** — The Thai floods may reduce global rice exports considerably, leading to a potential rise in EM food price inflation.

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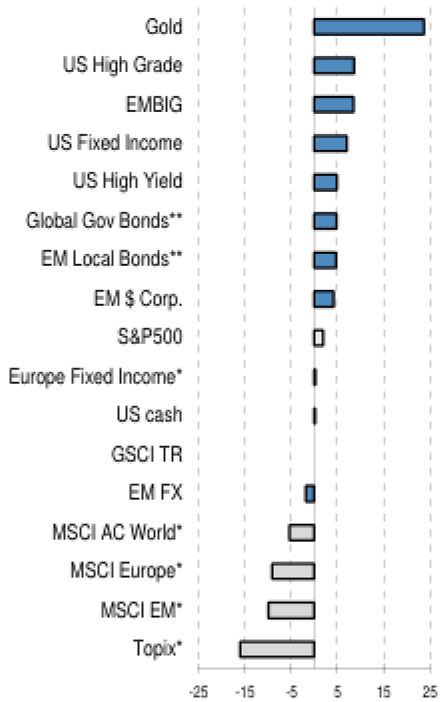
- Risk markets reversed part of their post EU Summit short-covering rally this week as the lack of details in the agreement settled in, and Greek politics played havoc again. But overall, equities remain up on two weeks ago, and are still above the 10-week range that had held between the crash early August and the middle of October, when we turned long risk.
- **Our long risk position does not mean we are bullish on the world.** It is merely the result of the observation that risk premia are sky high and higher even than early this year, and that everyone we see is bearish and underweight risk, combined with a judgement that uncertainty about the world seems set to come down from greatly elevated levels. Risk never goes away, but we feel that a modest improvement in economic activity data, and a rising-to-the-challenge by policy makers are set to reduce downside risk perceptions.
- **The main risk threatening markets remains the euro sovereign debt crisis though.** The crisis started two years ago, after the Greek elections, when the new incoming government massively revised up the deficit estimates from 6% to what is now known to have been 15.7%. In the two years since, the crisis has steadily escalated and broadened, and policy makers have not yet waved a magic wand to stop it. This raises the issue of **whether they can, whether they want to, and whether they can execute.**
- We would argue that the Euro Area (EA) has the resources, and the motivation to fix the crisis, but is less than competent in executing this fix, as it is not yet operating is a single decision making unit. The EA has the resources as it has enough domestic savings to handle a modest government deficit of under 5% of GDP, half that of the US, UK and Japan. The EA has enough motivation to fix its crisis as not doing so must lead to EMU disintegration and likely the EU, implying many times higher costs than is needed to fix the crisis. The main problem, and the reason why the crisis continues to linger, is that the EA is not operating as a single country with centralised decision making. The worsening

YTD returns through Oct 3
%, 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.

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debt crisis is now forcing the EA to move towards more efficient decision making, with the Merkel-Sarkozy team emerging as the day-to-day managing directorate of the EA. Other euro member may not like it, but recognise the need for concerted and faster action.

- **Action and reaction.** There are a ton of things that can go wrong in Europe, and will go wrong, from political resistance to austerity, slow decision taking (always behind the market), resistance to a loss of sovereignty, miscalculations, and so on. Putting odds on each of these surely lead to a aggregate probability over 100% that the euro breaks apart. But each negative action on the debt crisis will elicit a positive reaction by policy makers. Over the two years of crisis, the positive reactions have been overwhelmed later by negative shocks. If the EU has indeed the resources and motivation to stem the crisis — as this analyst believes — then these correcting reaction must ultimately conquer the crisis.

- **This week shows much of this brinkmanship action and reaction at work,** as the sudden threat of a Greek referendum was reversed by a move now to a national unity government. The decision by the G20 and IMF (as of writing) not to provide large funding to Italy is setting the risk markets back today, but it is largely a statement that the EA has no external funding crisis and that the EMU debt crisis is thus really an internal problem. That will now puts the responsibility back on the EU decision makers (the "Merkozy" team).

- Near term, much of the responsibility will fall on the ECB. Incoming ECB President Mario Draghi was very dismissive in his first interview on expanding his bond buying program, but given the alternative of a euro collapse, we feel he will be forced to step further onto the plate. The fact that ECB periphery bonds buying this year has not depressed the value of the currency — stable external value and stable inflation expectations — means that the ECB still has a lot of credibility.

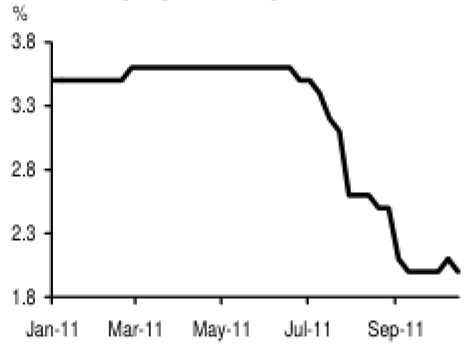
- The shenanigans around Europe are obscuring more positive developments in the rest of the world. US economic data, including today's Payrolls, make us increasing confident in a 2.5% growth pace in Q4. Congressional discussions on the budget remains chaotic, but both sides have some incentive to move towards compromise as neither wants to take the blame for inaction on the economy. In EM, inflation is turning and will move central banks increasingly towards easing. All eyes are here on China where we believe the 12-month inflation rate will be coming down fast and is inducing a move towards monetary easing.

Fixed income

- **Greek politics repriced the yield curve lower,** but the aborted referendum was just the most striking of a gamut of European surprises, including an unexpected ECB rate cut. The renewed Greek drama, an inconclusive G-20, and a poor Spanish auction all conspired to send intra-EMU spreads soaring once more, and Italian yields to perilous new highs. We **close our intra-EMU wideners** in the light of the large move.

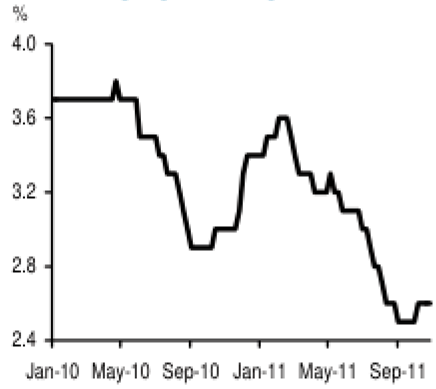
- The other big Euro area surprise was France and Germany's suggestion that **EMU break-up** was a possibility. We think it is most unlikely that Greece will leave the euro: the legal and technical barriers to break-up are formidable, while it is not at all clear that exit and depreciation would bring a sustained

2012 JPMorgan global GDP growth forecast



Source: J.P. Morgan

2011 JPMorgan global GDP growth forecast



Source: J.P. Morgan

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.

improvement in competitiveness. Any material likelihood that currency risk could emerge between EMU countries would be a clear negative for peripheral bonds, risk an acceleration of deposit outflows from Greek banks, and challenge Euro area firms with cross-border asset-liability mismatches.

- We keep a **tactical short in 30yr Treasuries**, ahead of long end supply next week, and add a short in 2yr Germany, with yields at the bottom of their recent range.

Equities

- The negative news flow from Europe offsets better earnings and economic news. **We stay with a positive stance due to excessive pessimism and bearish positions among investors**. Having said that we recognize the risk of a very negative outcome in Europe, especially with the Italian 10y yield moving to well above 6%. This highlights the importance of having peripheral hedges in an equity portfolio.

- Overweighting **DAX vs. Eurostoxx50 is such a hedge.** This trade posted a gain in both September and October. Although this trade can operate as a hedge, it is also motivated by the growth outperformance of Germany vs. the rest of the Euro area. This theme is still in place as healthier balance sheets (both private and public) in Germany allow the country to escape the painful adjustments that other Euro area countries have to make.

- On Oct 14th, when we decided to turn positive on equity markets, we closed a previous underweight in Cyclical sectors on the hope that the downshifting in global manufacturing is coming to an end. Our Global manufacturing PMI rose in October (released on Nov 2), for the first time since February. Our Cyclical vs. Defensive trading rule, which goes UW Cyclicals when the monthly change in the global PMI is negative and vice versa, points to an **OW in Cyclical sectors** currently (see top chart).

Credit

- With the EMU crisis deteriorating before the firewalls set out to protect the other peripherals are in place, our **US HG strategists have moved from a neutral to an underweight recommendation** and revised their **YE targets back to 250bp for bonds** and 135bp for CDS.

- Our European credit strategists believe the **likelihood of Greek CDS triggering in the future remains high** as the number of holdouts regarding private sector involvement may be large (see Saul Doctor, *Greece exchange offer – not a CDS credit event: But the risks are rising,* Nov 3).

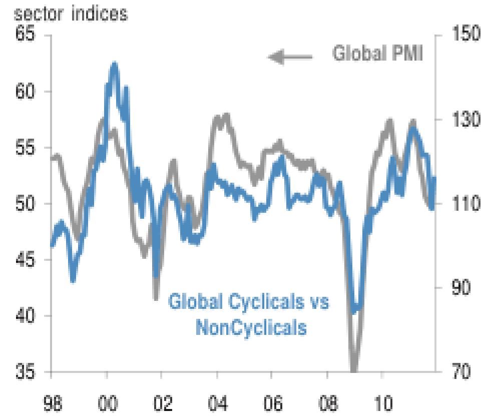
- Whilst spreads are net wider on the week, the **move into US high-yield continues**. A further $1.9bn of inflows into mutual funds/ETFs were recorded last week, taking the three week total to $9bn, or approximately 7.1% of AUM. In Europe, high-yield funds saw an inflow of €272mm last week which brings the 4 week total to €506mm, or 5.4% of AUM (see Daniel Lamy, *European High Yield Funds Flows*).

Foreign Exchange

- In a crisis now infamous for delivering the unexpected, EU leaders broke new

MSCI World cyclicals vs. noncyclicals

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.

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ground this week by instructing Greece to vote on its EMU membership. Exiting EMU is easier said than done, considering the immense costs of breaking a currency union and the lack of legal mechanism to expel a current member. The sub-text, however, is clear: Europe will finance countries willing to converge to core fiscal standards but will not fund the uncooperative indefinitely.

- This isn't the first time a European leader has referenced EMU exit, but it is the first expression of the EU's collective stance on rightsizing EMU. Unfortunately the path to a smaller, more stable euro must pass through a high-volatility depression, whether the weak country withdraws voluntarily or is expelled by its neighbours. That is why the decision cannot be taken lightly and cannot be forced without a pre-commitment from the ECB to provide all necessary liquidity to manage contagion. Polls suggest Greece has no interest in withdrawing. The risk is more of political pressure for expulsion if Greece defaults on its official debt, an act which seems inconsistent with the union's principle of solidarity. It is premature to focus on how stable the euro might be without some part of the periphery when the interim stage would be much more volatile and euro-negative than the Lehman crisis.

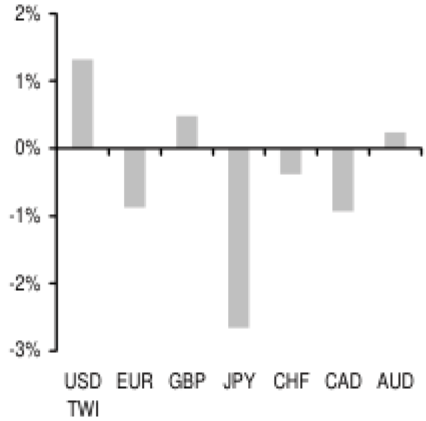
- If EMU exit sounds like the economic equivalent to mutually assured destruction, it is. EMU exit still seems like the least likely of Europe's paths, but if Greece does not honor its repayment obligations to the official sector, political pressure to pursue expulsion will intensify. The arguments for owning some hedge protection – we still prefer USD/JPY and EUR/JPY to EUR/USD given the risk of further QE in the US – are only stronger after this week's drama.

Commodities

- **Commodities are slightly up this week driven entirely by oil.** The premium that spot Brent trades over the first futures contract increased further this week in a sign of continued tightness in the global oil market. This backwardation is generally considered a sign of market tightness as it reflects the premium consumers are willing to pay to procure the oil they need today rather than waiting for lower prices in the future. Currently, this reflects the low level of inventories and supply due to the lack of Libyan crude and continued growth in EM oil demand. However, this bullish fundamental picture is balanced by the tail risks inherent in the Euro area crisis. Even with supply tight, a serious credit event and subsequent deleveraging in Europe has the potential to severely impact the world economy and thus oil demand.

- Rising inflation in emerging markets and especially China has been a threat over the past year due to rising food and energy prices. Recently this has begun to decline in line with our Economists' forecasts however, the flood in Thailand raises a risk to this. **Our Agriculture analyst Jonah Waxman expects the flood in Thailand to reduce global exports of rice by between 8% and 12% for this year's crop** (see *Agriculture Weekly*, 28, Oct). Unfavourable weather in the US has also led the USDA to project a 21%yoy decline in US rice production and on top of this, export restrictions in India remain in place as the country attempts to guard against a rise in food price inflation there. All this means the global rice market is likely to get very tight and given the importance of rice as a food staple in many emerging countries, **food price inflation in EM may tick up into the end of the year.**

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	2.05	2.50	2.60	2.80	2.80	8.6%
Euro area	Refi rate	1.50	1.00	1.00	1.00	1.00	
	10-year yields	1.82	2.00	2.10	2.15	2.15	7.8%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.31	2.80	2.85	2.90	2.90	12.6%
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	1.9%
GBI-EM hedged in $	Yield - Global Diversified	6.43		6.90			4.8%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	210	JPMorgan JULI Porfolio Spread to Treasury	8.4%
Euro high grade (bp over Euro gov)	248	iBoxx Euro Corporate Index	2.6%
USD high yield (bp vs. UST)	709	JPMorgan Global High Yield Index STW	5.7%
Euro high yield (bp over Euro gov)	834	iBoxx Euro HY Index	-1.8%
EMBIG (bp vs. UST)	389	EMBI Global	8.5%
EM Corporates (bp vs. UST)	430	JPM EM Corporates (CEMBI)	4.2%

		Quarterly Averages					
Commodities	Current	11Q4	12Q1	12Q2	12Q3	GSCI Index	YTD Return*
Brent ($/bbl)	111.1	115.0	120.0	120.0	125.0	Energy	5.1%
Gold ($/oz)	1754	2150	1925	1875	1850	Precious Metals	22.5%
Copper ($/metric ton)	7902	7250	8250	8500	9250	Industrial Metals	-15.7%
Corn ($/Bu)	6.51	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	1.38	1.38	1.38	1.40	1.42	EUR	3.8%
USD/JPY	78.2	75	74	73	72	JPY	4.3%
GBP/USD	1.60	1.59	1.58	1.58	1.60	GBP	2.9%
USD/BRL	1.75	1.80	1.80	1.80	1.80	BRL	1.8%
USD/CNY	6.34	6.30	6.20	6.10	6.00	CNY	2.5%
USD/KRW	1111	1090	1090	1060	1030	KRW	2.3%
USD/TRY	1.77	1.65	1.65	1.65	1.65	TRY	-8.6%

Equities	Current	YTD Return (local ccy)
S&P	1246	2.6%
Nasdaq	2674	3.1%
Topix	752	-11.6%
FTSE 100	5521	-0.7%
MSCI Eurozone*	134	-8.6%
MSCI Europe*	1027	-5.7%
MSCI EM $*	974	-11.4%
Brazil Bovespa	58367	-14.2%
Hang Seng	19843	-11.5%
Shanghai SE	2528	-11.3%

*Levels/returns as of Nov 03, 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	**2.6%**	**-5.7%**	**-11.6%**	**-11.4%**

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	2Q11	4Q11	2Q12	4Q12
The Americas														
United States	3.0	1.8	1.7	0.4	1.3	2.5	2.5	0.5	1.5	2.5	3.3	3.2	1.3	1.1
Canada	3.2	2.2	2.2	3.6	-0.4	1.8	2.4	2.6	2.6	2.4	3.4	2.6	1.6	1.7
Latin America	6.0	4.2	3.2	5.6	4.1	3.1	2.5	1.6	4.4	4.7	6.7	7.2	6.9	6.6
Argentina	9.2	7.5	3.0	13.1	10.2	4.0	2.0	0.0	6.0	4.0	9.7	11.0	10.0	10.0
Brazil	7.5	3.3	3.4	5.0	3.1	1.9	2.7	3.3	4.2	4.2	6.6	6.7	5.3	5.2
Chile	5.2	6.5	4.0	6.4	5.7	3.5	2.5	3.5	4.5	5.0	3.3	3.6	3.6	3.4
Colombia	4.3	5.3	3.7	2.9	8.5	3.5	1.5	3.0	4.0	5.0	3.0	3.9	3.0	2.9
Ecuador	3.6	6.0	3.0	7.3	3.0	2.0	1.0	2.0	3.5	4.0	4.1	3.9	3.6	3.5
Mexico	5.4	4.0	2.5	2.4	4.5	5.7	2.6	-1.7	4.1	4.8	3.3	3.2	3.5	3.6
Peru	8.8	6.3	4.5	6.9	4.5	2.5	3.0	4.5	5.0	6.2	3.1	4.0	3.6	2.7
Venezuela	-1.5	3.5	3.0	14.7	-3.2	-1.5	3.0	3.0	5.0	6.5	24.6	29.0	33.6	30.3
Asia/Pacific														
Japan	4.0	-0.6	1.9	-3.7	-2.1	5.5	2.0	1.8	1.5	1.3	-0.4	-0.1	-0.7	-0.5
Australia	2.7	1.4	3.5	-3.4	4.8	2.1	2.2	4.1	3.4	4.8	3.6	3.8	3.2	3.3
New Zealand	1.7	2.0	3.8	3.5	0.4	2.8	4.1	3.9	3.9	5.6	5.3	3.2	2.4	2.1
Asia ex Japan	9.1	7.1	**6.5** ↓	9.0	5.7	5.9	5.8	**6.7** ↓	**6.5** ↓	**7.1** ↓	5.7	5.1	4.3	4.2
China	10.4	9.0	8.3	9.0	7.9	7.9	8.0	8.2	8.2	8.9	5.7	4.9	3.8	3.5
Hong Kong	7.0	5.0	3.6	13.0	-2.0	1.0	2.5	4.0	5.5	5.5	5.2	5.2	4.3	4.5
India	8.5	**7.4** ↓	**7.7** ↓	8.3	**7.7** ↑	**7.3** ↓	**7.0** ↓	**6.9** ↓	**7.3** ↓	**8.5** ↓	**8.9** ↓	**8.6** ↓	**7.6** ↓	7.8
Indonesia	6.1	6.3	5.2	6.8	5.4	6.2	5.5	5.0	4.5	5.0	5.9	4.5	5.6	5.4
Korea	6.2	3.8	4.0	5.4	3.6	3.0	4.2	4.0	4.0	4.0	4.2	3.7	3.1	3.5
Malaysia	7.2	4.0	1.5	5.5	3.2	1.0	1.0	1.5	1.5	1.5	3.3	2.8	2.4	2.5
Philippines	7.6	4.1	4.0	7.8	2.4	4.1	2.4	2.4	7.4	5.3	5.0	4.6	3.3	3.8
Singapore	14.5	4.9	1.5	27.2	-6.5	1.6	-3.9	2.0	6.1	6.1	4.7	5.6	4.0	2.8
Taiwan	10.9	**4.4** ↓	3.0	**14.5** ↓	**0.6** ↓	**-1.1** ↓	2.5	3.5	**4.3** ↑	4.6	1.6	2.2	2.0	2.4
Thailand	7.8	2.5	2.6	8.1	-0.8	1.8	-6.0	15.0	-1.0	1.3	4.1	3.7	3.6	3.7
Africa/Middle East														
Israel	4.8	4.3	2.9	4.8	3.7	2.4	1.2	0.8	3.2	6.1	4.1	2.8	2.3	2.5
South Africa	2.8	3.1	**2.7** ↑	4.5	1.3	1.0	3.9	2.3	**2.8** ↑	**3.0** ↑	4.6	6.2	6.4	6.1
Europe														
Euro area	1.8	1.7	**-0.6** ↓	3.1	0.7	1.5	**-1.0** ↓	**-1.5** ↓	-1.5	**-0.3** ↓	2.8	**2.9** ↑	**1.7** ↑	1.4
Germany	3.6	3.0	0.3	5.5	0.5	3.0	-0.5	**-0.3** ↓	**-0.3** ↑	0.5	2.5	2.6	**1.5** ↓	1.3
France	1.4	1.7	**-0.1** ↓	3.7	0.0	2.0	**-1.0** ↓	**-0.8** ↓	**-0.8** ↑	0.5	2.2	2.3	1.3	1.1
Italy	1.2	0.6	**-1.5** ↓	0.5	1.2	0.0	**-2.0** ↓	**-2.5** ↓	-2.5	**-1.0** ↓	2.9	**3.8** ↑	**2.7** ↑	1.7
Norway	2.1	2.2	0.7	1.9	4.1	1.5	0.5	0.0	0.0	1.0	1.4	1.1	1.2	1.3
Sweden	5.4	4.1	0.4	3.1	3.6	2.0	0.0	-0.5	-0.5	0.5	2.9	2.5	1.1	1.1
United Kingdom	1.8	**1.0** ↑	**0.8** ↑	1.6	0.4	**2.0** ↑	1.0	0.5	-1.0	2.5	4.4	4.9	2.8	1.8
Emerging Europe	4.5	3.9	2.5	3.6	1.2	**2.6** ↓	1.3	3.1	**2.9** ↓	3.8	7.1	**6.2** ↑	**5.5** ↑	5.7
Bulgaria	0.2	2.8	2.4	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	2.3	2.0	**0.6** ↓	3.5	0.3	**0.3** ↓	-0.3	**0.0** ↓	**0.8** ↓	**2.0** ↓	1.8	1.8	2.5	2.8
Hungary	1.2	**1.2** ↓	0.5	1.2	-0.2	**0.0** ↓	**-0.3** ↓	0.0	**0.8** ↓	1.5	4.0	3.7	4.4	5.1
Poland	3.8	4.0	2.7	4.5	4.5	3.5	2.0	2.0	2.5	3.0	4.6	3.9	2.5	2.7
Romania	-1.3	**1.5** ↑	0.8	...	...	...	...	...	...	...	8.2	4.0	3.5	3.5
Russia	4.0	3.6	3.0	3.7	0.4	2.8	1.0	4.0	3.5	4.5	9.6	7.0	6.2	7.2
Turkey	9.0	6.3	2.7	...	...	...	...	...	...	...	5.9	**8.3** ↑	**7.8** ↑	6.0
Global	**4.0** ↑	2.6	**2.0** ↓	2.6	1.7	3.0	**1.9** ↓	**1.4** ↓	1.7	**2.6** ↓	3.7	3.6	2.4	2.2
Developed markets	2.7	1.4	1.0	0.9	0.7	**2.5** ↑	**1.1** ↓	**0.2** ↓	0.4	1.5	2.7	2.7	**1.4** ↑	1.1
Emerging markets	7.3	5.7	**4.8** ↓	7.2	4.5	**4.5** ↓	4.2	**4.7** ↓	**5.3** ↓	**5.9** ↓	**6.1** ↓	5.8	**5.2** ↑	5.1

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