

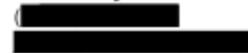
The J.P. Morgan View

EMU now more clearly in a liquidity crisis, affecting all

- Economics** — Q4 GDP growth in US raised to 3%, even as Q3 was probably only 2%. We reduce UK 2012 growth from 0.8% to 0.5%, with a mini-recession in H1.
 - Portfolio strategy** — Near -term volatility as EMU plays poker.
 - Fixed Income** — Economic momentum favours UK gilts over JGBs.
 - Equities** — Continue to focus on country trades favouring Germany and BRICs.
 - Credit** — Senior French bank bonds vs. OATS look attractive in very good, and very bad, states of the world.
 - Foreign exchange** — We remain short EUR/JPY through options to hedge adverse outcomes in Europe.
 - Commodities** — We raise our WTI forecast to reflect our view that the Brent-WTI spread should narrow to only \$4/bbl by the end of next year.
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- Markets remain extremely volatile and continue to react to the latest political statements out of Europe on who will or will not, or should or should not, do what to resolve the Euro sovereign debt crisis. Economic data in the rest of the world, and especially the US, were supportive for risk markets, but were outshouted by the political chaos in Europe, leaving riskier assets significantly down over the week.
 - US activity data continue to impress, relative to subdued expectations, and are bringing our forecast for Q4 up to 3%, even as we downsize Q3 to only 2%. The average for H2 stays at 2.5%, much better than the 1% pace we projected only two months ago. This good news improves the glide path of the economy into 2012, but itself does not eliminate the downside risk due to the expiring of a number of fiscal stimulus measures at the end of this year. There remains no sign of compromise in Washington on the 2012 budget nor on the Supercommittee's effort to reduce the 10-year out deficit by \$1.5 trillion. One could hope that both sides know the nation needs clarity and will compromise at the last minute, but time is running out. Monday should bring news from the Supercommittee.
 - Elsewhere, we see further evidence that slower growth this year is now starting to bring **headline inflation down**. By our forecast, global headline inflation should fall from 3.6% oya this quarter to 2.4% oya in 6 months' time. Our latest Inflation Expectations Survey (*Garayo and Chordia*, Nov 11) revealed that investors have raised their probability of deflation over 2 of the next 5 years by 5% to 10% in the US and 15% in the Euro Area (EA). For the EA, this equals their probability of high inflation (>4%).
 - Falling inflation and inflation expectations** should provide both support to consumers and comfort to central bankers that they should be thinking about providing greater stimulus, through rate cuts in EM and quantitative easing in the major developed markets. The **Bank of England** is in the midst of raising its

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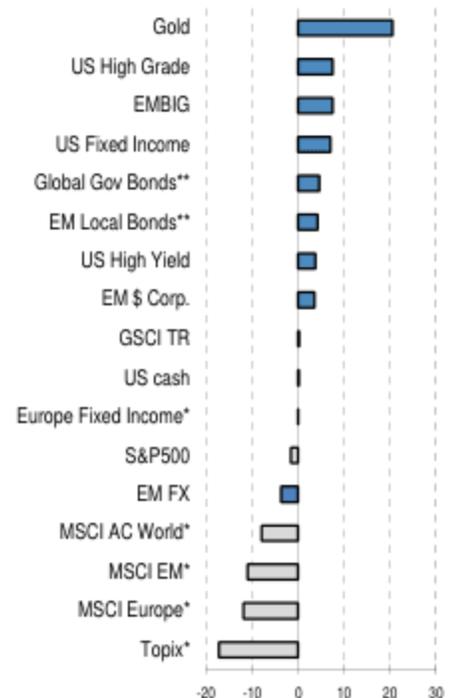


Leo Evans



YTD returns through Nov 17

%, 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 \$.



Asset Purchase Facility from £200bn to £275bn by February, but we expect it to decide at some point to raise it to £425bn in 2012. In the US, we see close to even odds that the Fed will move to QE3 next year. And in the Euro area, rising deflation fears should reduce some of the area's reluctance to use the ECB balance sheet to purchase debt of sovereigns with liquidity problems.

- The **Euro area** remains at the core of investor concerns. **Auctions by Belgium and Spain** were not well received and caused their bond markets to back up and underperform the rest of the EA. Periphery bonds as a whole backed up, but in a novel development this week, not only did we see Dutch and Finnish bond spreads rise dramatically, but the German government bond market itself sold off, despite rallies in the US, UK and Japan. Anybody still arguing that spread widening in the EA is due to rising solvency risk and not a liquidity crisis needs to think again. A self-fulfilling run on governments can affect each and every euro bond market, even Germany.
- **This run on government debt requires a lender of last resort**, not just for banks, but also for sovereigns. The creditor EMU member countries have been reluctant to approve an enlargement of the EFSF, or to support the ECB providing this function for sovereigns as they do not want to lend to debtor EMU member countries that they believe are not making sufficient efforts to redress their fiscal excesses. One can consider the chaos of statements and opinions around this issue as a poker game where neither side wants to show its cards. Germany clearly has the best hand at the moment, but wants to make sure that borrowing member countries provide enough commitment to fiscal austerity and growth stimulus before unleashing further liquidity support. That at least is the benign view, with the more pessimistic one being that positions are well entrenched, inflexible, and thus unable to come to the compromises that are needed to salvage the monetary union.
- This author is taking the benign view, that credit member countries have the power and willingness to exchange further support for borrowing member countries in exchange for greater fiscal austerity. But the game is not over and it will take some time for this to become obvious. The market will remain in the dark for some time and thus under pressure.

Fixed income

- **The gathering EMU storm has begun to engulf the very core**, with even fiscally upstanding Finland and the Netherlands seeing their spreads lurch wider by midweek, before retracing. Credible fiscal consolidation and supply-side reforms in the periphery are necessary for a long-term solution, but cannot stem the liquidity crisis. Thus, the path of least resistance is to wider spreads, and a further flattening of intra-EMU credit curves, absent more concerted official action (e.g. EFSF leverage via ECB liquidity support).
- Economic newsflow has sometimes taken a back seat to the EMU drama in recent months, with Treasuries rallying this week despite further encouraging activity data. Yet **economic momentum, as measured by changes in unemployment rates, has historically been a strong signal both for duration timing within bond markets, and for cross-market allocation** (see our Investment Strategy No. 67, *Using unemployment to trade bonds*, 16 November). Currently this signal favours UK gilts over JGBs. Indeed, gilts are supported by a dovish Bank of England, with this week's *Inflation Report* prompting us to

raise our QE forecast to a cumulative £425bn (£150bn more than the BoE's current target), or a little over a quarter of GDP.

Equities

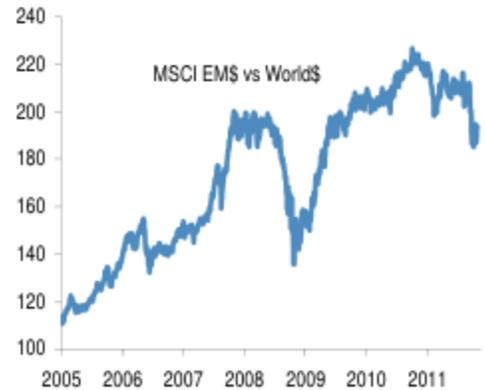
- **Equity markets retrenched in November but they remain well above the beginning of October lows.** The MSCI AC World index is still 8% above the October low and has retraced a third of the Aug-Oct downmove. While we recognize the risks stemming from the Euro debt crisis, we are reluctant to abandon our positive stance. Excessive pessimism and bearish positions among investors, continue to create an asymmetric outlook for equity markets, with bearish news creating limited downside and positive news more pronounced rebounds. As we highlight in *Flows&Liquidity*, positions remain low, supporting further equity rallies in the absence of big negative news.
- We continue to believe in the importance of having peripheral hedges in an equity portfolio. Overweighting **DAX vs. Eurostoxx50** is such a hedge. This trade posted a gain in September, October and November. 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.
- The shift in EM policy priorities from inflation to growth is favouring an **overweight in EM vs DM equities**. The shift is more pronounced in BRICs, including China. As a result, we **overweight BRICs within EM** 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.

Credit

- With policies, politicians and increasingly EU membership subject to change, **spreads are bleeding wider as the European storm rumbles on.** A slew of German bank downgrades earlier in the week set the tone and the iTraxx Senior Financials stands at 300bp, up from 206bp before the EU summit and 35bp on the week.
- In this environment where extreme scenarios should be considered, we look for tactical opportunities which pay off if tail events in either direction materialize. Ten year Senior French bank bonds are trading at a spread of 100-200bp to France. A significant deterioration of the crisis, putting nationalisation on the cards, would see a convergence of sovereign and bank risks, making a **long in 10y French banks bonds vs. OATS profitable**. Conversely, if funding conditions improve significantly, spreads will also compress making this an attractive, positive carry play.
- Our European strategists published their 2012 outlook this week. They favour **long risk in iTraxx senior financials vs. bank equity** on looming capital injections to the banking system and **short cyclical vs. non-cyclical euro credit** on the likelihood of an EU recession. **US data continued to improve** on the whole but US credit is far from immune to a more bearish EU sentiment. Our US HG strategists however reiterated the impressive strength of US HG credit metrics this week (see Eric Beinstein and team, *High Grade Credit Fundamentals*, today). Revenue growth, EBITDA and free cash flow were all

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.

strong in 3Q11, profit margins remain at a near decade high and leverage continues to decline.

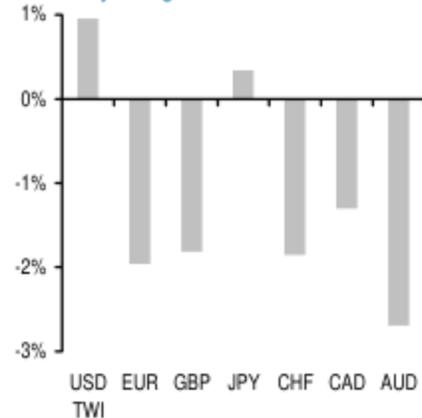
Foreign Exchange

- The dollar is up versus every currency but the yen this week in classic deleveraging fashion. Anxieties about peripheral Europe remain the driver, but we take some comfort from an emerging pattern: ECB bond buying which pushes peripheral yields lower has tended to be dollar-negative versus all currencies including the euro. This trend will run counter to some investors' expectations that ECB bond purchases are necessarily currency-negative, so should sink the euro. We disagree. Debt monetisation is currency-negative when it raises inflation expectations and lowers real yields. This impact can be particularly severe for countries which are capital importers like the US, which is why QE1 in 2009 was so USD-negative.
- In Europe's case, even a trillion euros of debt monetisation is unlikely to lift inflation expectations during a recession. More importantly, QE will diffuse default risk, which is the main bearish force for the euro now. Of course no amount of QE will matter if governments fail to implement structural reform, which is why the actions of the new Monti government in Italy and the new Spanish government likely to emerge through Sunday elections will be key for EUR/USD too over the next few months. We remain short EUR/JPY through options to hedge an adverse outcome.
- USD/JPY has now given back 75% of its gains from the October 31 Bank of Japan intervention, a move which confirms our view that the BoJ cannot peg the yen as the SNB did the Swiss franc. No doubt intervention is a recurring feature of currency markets where no one welcomes a strong currency, but some central banks are clearly more constrained than others. Any BoJ intervention is a buying opportunity for the yen.

Commodities

- **Commodity markets are down around 1% this week** as all commodities fell in tandem with other risky markets. Gold was one of the worst performers this week down around 3%. We remain bullish gold as there are strong fundamental drivers of higher prices from here. Gold demand in Q3 grew strongly, driven by Chinese consumers and EM central banks. We expect this trend of increasing EM demand to continue and to underpin higher gold prices going forward.
- One notable change in oil market dynamics that occurred this week was the announcement that **a pipeline between the US Midwest, where WTI is priced, and the Gulf Coast will be reversed**. This is significant because it will help to alleviate the bottleneck that had built up at the WTI pricing point, which had depressed WTI relative to world oil prices (i.e. Brent). The announcement itself resulted in the **spread between Brent and WTI prices** narrowing by over \$3/bbl. Assuming the pipeline owners gain regulatory approval, the reversal should take place in Q2 2012. We highlighted in August that the very wide spread between Brent and WTI was enough of an incentive for market participants to find ways to move oil out of the US Midwest that would have been too expensive under normal conditions (see *Oil Market Weekly: Brent and WTI Forecasts and Risks*, Eagles et al., Aug 25). **We now raise our WTI forecasts** to reflect this new development which means **we now expect the Brent-WTI spread to narrow to only \$4/bbl by the end of next year**, from \$10/bbl currently.

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

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	2.02	2.25	2.50	2.50	2.50	9.3%
Euro area	Refi rate	1.25	1.00	1.00	1.00	1.00	
	10-year yields	1.97	1.75	2.00	2.10	2.15	8.4%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.25	2.45	2.45	2.55	2.65	14.5%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.95	0.85	1.00	1.10	1.10	2.1%
GBI-EM hedged in \$	Yield - Global Diversified	6.53	6.70				4.3%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	240	JPMorgan JULI Portfolio Spread to Treasury	7.4%
Euro high grade (bp over Euro gov)	229	iBoxx Euro Corporate Index	0.6%
USD high yield (bp vs. UST)	741	JPMorgan Global High Yield Index STW	4.7%
Euro high yield (bp over Euro gov)	805	iBoxx Euro HY Index	-3.0%
EMBIG (bp vs. UST)	411	EMBI Global	7.6%
EM Corporates (bp vs. UST)	454	JPM EM Corporates (CEMBI)	3.6%

Commodities	Current	Quarterly Averages				GSCI Index	YTD Return*
		11Q4	12Q1	12Q2	12Q3		
Brent (\$/bbl)	107.9	115.0	120.0	120.0	125.0	Energy	6.5%
Gold (\$/oz)	1724	2150	1925	1875	1850	Precious Metals	20.6%
Copper (\$/metric ton)	7518	7250	8250	8500	9250	Industrial Metals	-21.5%
Corn (\$/Bu)	6.13	6.40	6.70	7.00	6.80	Agriculture	-17.3%

Foreign Exchange	Current	Dec-11	Mar-12	Jun-12	Sep-12	3m cash	YTD Return*
						Index	in USD
EUR/USD	1.35	1.38	1.38	1.40	1.42	EUR	2.2%
USD/JPY	76.9	75	74	73	72	JPY	5.6%
GBP/USD	1.58	1.59	1.58	1.58	1.60	GBP	1.9%
USD/BRL	1.78	1.80	1.80	1.80	1.80	BRL	-0.3%
USD/CNY	6.36	6.30	6.20	6.10	6.00	CNY	2.6%
USD/KRW	1139	1090	1090	1060	1030	KRW	2.3%
USD/TRY	1.83	1.78	1.82	1.80	1.75	TRY	-10.4%

Equities	Current	YTD Return (local ccy)
S&P	1220	-1.2%
Nasdaq	2583	-2.0%
Topix	720	-18.1%
FTSE 100	5363	-6.0%
MSCI Eurozone*	127	-16.9%
MSCI Europe*	994	-11.8%
MSCI EM \$*	952	-15.1%
Brazil Bovespa	56944	-17.8%
Hang Seng	18491	-18.0%
Shanghai SE	2417	-14.6%

Sector Allocation *	US	Europe	Japan	EM
	YTD	YTD	YTD	YTD (\$)
Energy	2.2%	1.0%	-2.5%	-11.3%
Materials	-11.7%	-23.0%	-24.7%	-19.9%
Industrials	-4.7%	-19.6%	-13.9%	-25.7%
Discretionary	2.5%	-12.4%	-23.1%	-4.9%
Staples	7.6%	1.8%	2.5%	-1.2%
Healthcare	6.3%	4.8%	-9.7%	-21.5%
Financials	-21.2%	-27.3%	-25.7%	-22.0%
Information Tech.	2.4%	-5.4%	-26.2%	-13.5%
Telecommunications	0.2%	-1.7%	2.2%	-2.1%
Utilities	13.3%	-13.3%	-47.0%	-13.2%
Overall	-1.2%	-11.8%	-18.1%	-15.1%

*Levels/returns as of Nov 17, 2011

Local currency except MSCI EM \$

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

Global Economic Outlook 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	2Q11	4Q11	2Q12	4Q12
The Americas														
United States	3.0	1.8	1.8 ↑	0.4	1.3	2.5	3.0 ↑	0.5	1.5	2.5	3.3	3.3	1.5	1.2
Canada	3.2	2.3 ↑	2.1 ↓	3.6	-0.4	3.0 ↑	1.7 ↓	2.1 ↓	2.6	2.3 ↓	3.4	2.6	1.6	1.7
Latin America	6.0	4.1	3.0 ↓	5.7 ↑	4.1 ↓	3.1 ↑	2.0	1.6	4.8	4.9	6.7	7.2	6.4	6.2 ↑
Argentina	9.2	7.0	1.0 ↓	13.1	10.2	4.0	2.0	0.0	6.0	4.0	9.7	11.0	10.0	9.0
Brazil	7.5	3.0	3.1	5.0	3.1	0.4	1.3	2.9	5.0	5.3	6.6	6.7	5.2	5.2
Chile	5.2	6.5	4.0	5.8 ↓	5.3 ↓	2.6 ↓	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	6.5 ↑	3.0	7.1	9.1	3.0 ↑	1.0	2.0	3.0 ↓	3.0 ↓	4.1	5.5 ↑	5.3 ↑	4.6 ↑
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	3.5
Peru	8.8	6.7	4.5	7.3 ↑	4.6 ↑	3.7	2.7	4.5	5.0	6.2	3.1	4.0	3.6	2.7
Venezuela	-1.5	3.8 ↑	4.0	16.0 ↑	-4.1 ↓	6.8 ↑	3.0 ↓	6.0	6.0	4.0	24.6	28.6	26.7	25.3
Asia/Pacific														
Japan	4.1 ↑	-0.2 ↑	2.1 ↑	-2.7 ↑	-1.3 ↑	6.0 ↑	1.7 ↓	2.0 ↑	1.5	1.3	-0.4	-0.1	-0.5 ↑	-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	2.3	2.8	3.5	0.4	5.7	2.4	-0.2	6.5	3.7	5.3	2.9	2.2	2.5
Asia ex Japan	9.1	7.0 ↓	6.4	9.0	5.7	6.0 ↑	5.1 ↓	6.7	6.9 ↑	7.1	5.7	4.9 ↓	4.0 ↓	4.0 ↓
China	10.4	9.0	8.3	9.0	7.9	7.9	8.0	8.2	8.2	8.9	5.7	4.8 ↓	3.6 ↓	3.4 ↓
Hong Kong	7.0	5.0	3.0	13.0	-1.6	0.4	1.5	3.5	4.0	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	3.2	3.6	4.0
Korea	6.2	3.8	3.8	5.4	3.6	3.0	4.2	3.0	4.0	4.0	4.2	3.7	3.1	3.5
Malaysia	7.2	4.0	1.5	6.7 ↑	2.1 ↓	5.8 ↑	0.0	1.0	1.0	2.0	3.3	2.4	1.5	1.3
Philippines	7.6	4.1	4.0	7.8	2.4	4.1	2.4	2.4	7.4	5.3	5.0	4.9	3.9	4.0
Singapore	14.5	4.8	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	0.9 ↓	0.7 ↓	2.4
Thailand	7.8	1.0 ↓	1.5 ↓	8.1	-0.8	1.8	-25.0 ↓	20.0	11.0 ↑	0.5 ↓	4.1	3.5	3.9	3.5
Africa/Middle East														
Israel	4.8	4.3	2.9	4.7 ↓	3.5 ↓	3.4 ↑	1.3	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	2.6	2.8	4.6	6.2	6.4	6.1
Europe														
Euro area	1.8	1.6	-0.7 ↓	3.1	0.7	0.8 ↓	-1.0	-1.5	-1.5	-0.3	2.8	2.9	1.9 ↑	1.5 ↑
Germany	3.6	3.2 ↑	0.4 ↑	5.5	1.1 ↑	3.0	-0.5	-0.3	-0.3	0.5	2.5	2.7	1.7	1.3
France	1.4	1.6	-0.2	3.8 ↑	-0.2 ↓	1.5	-1.0	-0.8	-0.8	0.5	2.2	2.5 ↑	1.7 ↑	1.3 ↑
Italy	1.2	0.5	-1.6	0.5	1.2	-0.5	-2.0	-2.5	-2.5	-1.0	2.9	3.8	2.8 ↑	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	0.9 ↓	0.5 ↓	1.6	0.4	2.0	0.5 ↓	0.0 ↓	-1.5 ↓	2.5	4.4	4.6 ↓	2.6 ↓	1.9 ↑
Emerging Europe	4.5	4.1 ↑	2.4	3.6	1.4 ↑	3.5 ↑	1.0	2.7	2.7	3.2 ↓	7.1	6.2	5.6	5.7
Bulgaria	0.2	2.2 ↓	2.5 ↑	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	2.3	2.0	0.6	3.5	0.3	0.0 ↓	-0.3	0.0	0.8	2.0	1.8	1.8	2.5	2.8
Hungary	1.2	1.5 ↑	0.5	2.0 ↑	0.8 ↑	2.0 ↑	-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	3.5 ↓	0.7 ↑	3.5 ↑	1.0	4.0	3.5	4.0 ↓	9.6	7.1	6.3	7.3
Turkey	9.0	7.0	2.2	...	...	...	...	...	...	...	5.9	8.3	7.8	6.0
Global														
Developed markets	2.7	1.5 ↑	1.0 ↑	1.1 ↑	0.8 ↑	2.3 ↓	1.2 ↑	0.1	0.4	1.4 ↓	2.7	2.8	1.5 ↑	1.2
Emerging markets	7.3	5.7	4.7	7.2	4.5	4.7 ↑	3.6 ↓	4.7	5.5 ↑	5.9	6.1	5.7	4.9 ↓	4.9

Source: J.P. Morgan

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