

The J.P. Morgan View

Seven puzzles

- **Asset Allocation** — No changes. Long equities and credit vs bonds and cash over next 3 months. Signals for next few weeks seem quite neutral.
- **Economics** — No forecast changes, but weaker data bias our 2.5% Q2 US forecast to the lower 2's.
- **Fixed Income** — We recommend bearish money market positions.
- **Equities** — Earnings expectations momentum favours US vs other regions.
- **Credit** — We stay overweight senior financials and LTH bonds.
- **Foreign exchange** — Low FX vol to stay. Focus trades on mean reversion.
- **Commodities** — We expect the spread to continue to narrow and stay long Dec-12 WTI vs. Dec-12 Brent with a \$5/bbl target.

• In a week where a lot of price screens are reading UNCH (unchanged) and economic forecasts have not moved, we would like to focus on some longer-term issues — not views, nor concerns, but things that puzzle many of us. For each, we provide our best explanation, while admitting they remain puzzles. Each requires a much longer and deeper study.

- **Why has neither Greece nor Germany left EMU, yet?** Or even, why did they ever get in? The crisis has revealed the cost of giving up one's currency. Resolution requires massive deflation in the periphery and massive funding from the core. The reason countries joined into EMU and have not (yet) left is that monetary union was planned as the first step towards a political union — a US of E. The cost of abandoning EMU is not merely related to capital flight and creation of a new currency, but is paramount to ditching European integration, and moving back to the bad old days of a divided and quarrelsome Europe. EMU members will likely do everything they can to keep the union together, even as they will need more crises to push them that way.
- **Why has the euro not collapsed, yet, given a recession and EMU break-up risk?** The EMU periphery cannot devalue against the core, but would greatly benefit from a drop in the euro. The answer is likely that currencies are relative prices, and the fiscal situation in the US, UK, and Japan is as bad as in the Euro area, even as the latter has problems with internal funding. Each of these four currencies has fallen dramatically against the smaller G10 countries that are in better shape (CAD, CHF, AUD, NOK). The Euro area also has no external deficit, and funding problems may have led to capital repatriation, supporting the euro.
- **Why are US HG credit spreads still near recession levels?** US HG remains about 200bp above USTs, a spread level that before Lehman was only seen

The certifying analyst is indicated by an ^{AC}. See page 7 for analyst certification and important legal and regulatory disclosures.

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YTD returns through Apr 19

%, 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 EUMI+ in \$.

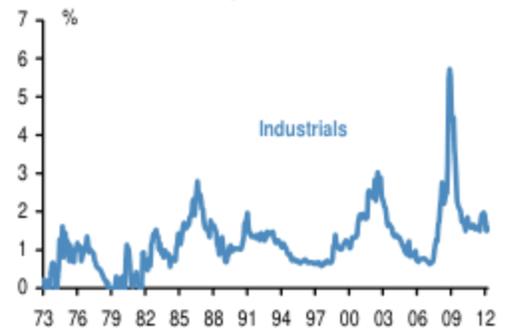
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around recessions. We are almost 3 year out of the last recession. Much of this puzzle goes away when we take out financials, with nonfinancials HG spreads trading near historic averages, even as they are somewhat wide for this point in the cycle (charts opposite). But this explanation moves the puzzle to why Financials are so wide against history, especially given stronger capital and other regulations that are making banks much safer than before. The only likely explanation is that the Lehman crisis changed investors perceptions away from the old view that banks are too big to fail. The EMU crisis is keeping bank risk elevated.

- Who do some many investors pile into safe assets that offer no real return after taxes and inflation?** The average yield on all global bonds now stands at 2.4%. Managers tell us that the end investors care most about capital preservation. If so, they are forgetting about taxes and inflation — global headline CPI was +3.8% oya in 2011. Two explanations come to mind. Institutional investors are steered away from equities, as regulators are forcing them to judge the risk on equities, which are long-term investments, on the basis of short-term volatility (1-year), despite equities being long term assets. G4 insurers and pension funds have been buying \$6 of bonds for every \$1 of equity over the past 6 years. The puzzle is greater for unregulated end investors, in particular retail. YTD, funds and ETFs have seen the same 6-for-1 bonds to equity inflows. Widespread fear and persistent uncertainty are likely behind this puzzle.
- Why no deflation, given global slack, nor rise in inflation expectations given debt demonetization?** Simple output gap models would indeed have suggested a dramatic drop in global inflation, if not outright deflation. We did not get this, showing there is clear downward rigidity to nominal wages, and also less useable slack than we thought. These give this puzzle a name but are not an explanation. A better explanation could be ultra easy monetary policy that killed deflation fears. But why have these not turned into inflation fears? Part of the explanation is that central bankers have done a tremendously good job in convincing us they are only combating deflation and will react decisively when inflation emerges. And the world wants them to be right.
- Why are commodities up 65% since the recession, while the world economy is growing below capacity?** The answer is likely an application of the hog cycle. During the recession, commodity prices cratered and project financing evaporated. Commodity producers cancelled investment projects, greatly restraining future supply growth. Demand growth since the recession has outstripped weak supply growth, pushing up commodity prices. But with much higher commodity prices and easier funding, producers are investing and capacity is increasing. The hog cycle is not dead.
- Why do Japanese investors keep buying their own public sector debt, which is racing to 250% of GDP by 2015, twice the level that got Greece in trouble?** Part of the explanation is what we call financial repression, where the government puts pressure on domestic institutional investors, frequently through regulations. But much of the explanation is likely deflation, which creates acceptable real return to bonds, that are not taxed. The eventual JGB crisis must await 2015 or later, when demographics drive the country into an external balance that requires foreign borrowing, something that will not be possible at current yields.

Long-term US industrials spread to treasuries

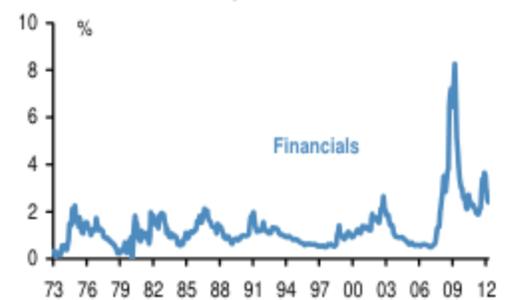
Barclays Industrial Intermediate yield - Barclays Government Intermediate yield



Source: Datastream

Long-term US financials spread to treasuries

Barclays Financial Intermediate yield - Barclays Government Intermediate yield



Source: Datastream

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 Srin 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.

Fixed income

- **Bonds are flattish on the week**, but with Canada and the UK notable underperformers, as their central banks signalled a more hawkish outlook. Canada has weathered the crisis better than most in DM, and the Bank of Canada now envisages full employment by mid-2013. There is a limit to how far monetary policy in Canada can diverge from the US, but even so we agree with the market's move to price a 4Q12 hike, and expect more to come in 2013.
- The **UK** is in a far more difficult position. Growth is still anaemic, but inflation remains stubbornly above target, having surprised to the upside again this week, dampening the prospects of more QE. Persistently high inflation means we continue to favour **short-dated UK linkers**. And though we think hikes are a long way off in the UK, we recommend **money market steepeners**, expecting a greater risk premium to be priced into the curve (see *GFIMS UK*).
- With short rates so low, similar arguments for greater money market risk premia apply to varying degrees in many developed markets. For example, we think **Fed Funds implied rates do not fully reflect the risk that unemployment will fall faster than the FOMC expects**, and advise shorts in late 2014 Fed Funds.
- In the Euro area, French bonds were weak ahead of the first round of the Presidential election. Spain outperformed Italy, and relative supply means we expect that move to continue: Spain has aggressively frontloaded its bond issuance this year, while Italy has not.

Equities

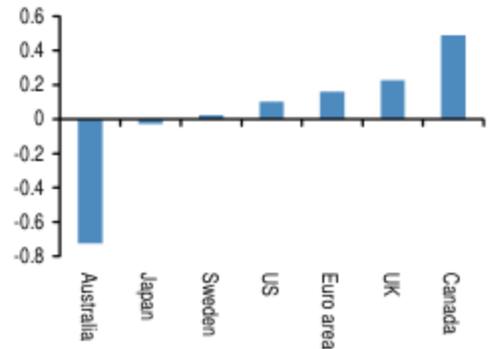
- The **US reporting season** is on track to post another positive surprise with the S&P500 Q1 EPS up 5% vs. the bottom analysts' expectation at the beginning of the month. In absolute terms there is little reason to celebrate, though, as both Revenues-Per-Share and Earnings-Per-Share are down Q4 and up only modestly from a year ago. But this weakness, the result of weak global growth and higher commodity prices, is well telegraphed.
- This decent positive earnings surprise has failed to boost equity markets, though. We believe unconvincing macro data and continued uncertainty around the Euro debt crisis and China are making **investors reluctant to buy equities** despite the 5% correction. Indeed the equity fund flow picture remains weak with US equity funds and ETFs seeing large outflows of -\$7.9bn this week, making this the fifth consecutive week of outflows.
- Last week, we reiterated our **OW in US equities**. We mention the headwinds from the Euro debt crisis and the Chinese hard landing fears as reasons to be more cautious in Europe and EM. But there is another reason that makes the US look better: earnings momentum. This factor has been largely behind the outperformance of US equities last year and the top chart suggests that it is still in place. Analysts have cut their 2012 US EPS projections by 3% over the past six months, but much more in the rest of the world.

Credit

- **Credit spreads were a bit of a mixed picture this week**. CDS mostly widened, equities gained, and bonds went both ways. Thus far, earnings season is providing some upside surprises, which, in light of the weaker tone in US economic data of late, helps reaffirm that corporate credit fundamentals are

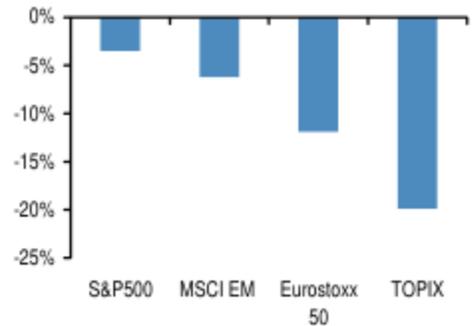
Expected change in DM policy rates

%, 1y1y OIS rates less policy rate (less 1m OIS rate for euro)



Source: Bloomberg, J.P. Morgan

2012 EPS forecast change since Sept 30th



Source: Datastream, IBES

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.

solid, if not improving. In particular, **large financials have generally surpassed expectations in terms of revenues and credit losses.** On the flip-side, rating reviews hang over banks and last week Moody's pushed the process out by roughly a month (to begin mid May). **We suspect that the impact of the downgrades will be less severe than the market anticipates for three main reasons.** 1) Haircuts applied by the ECB are not particularly sensitive to any one agencies' ratings. 2) In the aggregate, downgrades will already be priced in spreads and 3) the delay in publishing new ratings gives more time to shore up collateral to meet derivative requirements if necessary. **The positive impact of term liquidity provided by the LTRO is a much more important driver of spreads and we stay overweight senior financials and Lower Tier II bonds** (See Alan Bowe, *The Great Bank Downgrade Part III*).

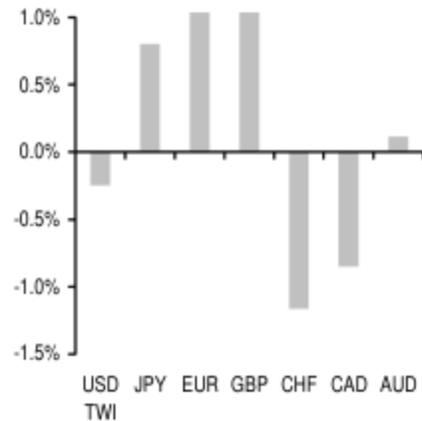
Foreign Exchange

- **The dollar continues to traverse three-month ranges on below-average volumes,** flattening volatility to its lowest level in four years (VXY Global at 9.8%) and creating one of the stingiest return environments for FX managers since the Lehman crisis. We have discussed previously the reasons for this pattern: a collection of low-intensity, local dramas which are largely offsetting, including funding stress and political risk in Europe (USD positive); a sidelined Fed (USD negative); China's Q1 deceleration (USD positive) but its Q2 promise of further stimulus (USD negative). Even though currencies are the asset class most sensitive to regional divergences, as FX is simply a relative price, this abundance of crosscurrents has become too much of a good thing for anyone but the best of range-traders.
- The alternative strategy is usually to earn **carry**, which would be as profitable in FX as in credit were it not for the fact that most high-yield currencies belong to commodity exporters (so exposed to China) or central banks inclined to intervene aggressively (Brazil). Given these offsets it is unsurprising that the trade-weighted USD continues to weave between 80 and 82 on our index (JPMQUSD) and 78 and 81 on the DXY. The case for a range break remains weak since the chain of events which would convert a local event to a global one requires too many things to all go right (Fed tightening) or all go wrong (China, Europe). French elections could confuse an always-complicated European situation in Q2. If the euro will break the 1.30 - 1.34 range which has held for most of the year, it should do so this quarter. By comparison China, Japan and the US provide fewer triggers for large currency moves over the next few weeks.

Commodities

- **Commodities were down again this week, led, lower by energy** as Brent fell around 3%, offsetting a 1% gain for WTI. The spread between the two oil benchmarks has narrowed significantly over the past few weeks from \$20/bbl at the beginning of April to around \$15/bbl currently. The Seaway pipeline between Cushing, where WTI is priced, and the US Gulf Coast is due to be reversed in early May which **should help alleviate the bottleneck at Cushing.** This should help WTI to reconnect to world oil markets. This week, the company operating Seaway announced a tariff proposal for its use. This provided much needed clarity around the economics of moving oil out of Cushing now via other means versus storing the oil and moving it later once the pipeline is available. **We expect the spread to continue to narrow and stay long Dec-12 WTI vs. Dec-12 Brent with a \$5/bbl target.**

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	Jun-12	Sep-12	Dec-12	Mar-13	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	1.98	2.40	2.50	2.50	2.50	0.0%
Euro area	Refi rate	1.00	1.00	1.00	1.00	1.00	
	10-year yields	1.71	1.80	2.00	2.00	2.00	1.2%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.18	2.55	2.55	2.40	2.40	-1.8%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.93	1.15	1.05	1.05	1.15	0.6%
GBI-EM hedged in \$	Yield - Global Diversified	6.34			6.30		2.3%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	201	JPMorgan JULI Portfolio Spread to Treasury	3.1%
Euro high grade (bp over Euro gov)	268	iBoxx Euro Corporate Index	3.5%
USD high yield (bp vs. UST)	649	JPMorgan Global High Yield Index STW	5.5%
Euro high yield (bp over Euro gov)	876	iBoxx Euro HY Index	10.6%
EMBIG (bp vs. UST)	351	EMBI Global	5.8%
EM Corporates (bp vs. UST)	400	JPM EM Corporates (CEMBI)	6.2%

Commodities	Current	Quarterly Averages				GSCI Index	YTD Return*
		12Q2	12Q3	12Q4	13Q1		
Brent (\$/bbl)	119	112	120	125	125	Energy	6.6%
Gold (\$/oz)	1643	1825	1900	1925	1850	Precious Metals	2.7%
Copper (\$/metric ton)	8094	8500	8875	9000	8750	Industrial Metals	5.0%
Corn (\$/Bu)	6.02	6.70	6.50	6.60		Agriculture	1.3%

Foreign Exchange	Current	Jun-12	Sep-12	Dec-12	Mar-13	3m cash YTD Return*	
						Index	in USD
EUR/USD	1.32	1.34	1.36	1.36	1.36	EUR	1.9%
USD/JPY	81.6	86	84	83	82	JPY	5.6%
GBP/USD	1.61	1.61	1.62	1.62	1.62	GBP	3.9%
USD/BRL	1.86	1.84	1.82	1.80	1.80	BRL	1.9%
USD/CNY	6.31	6.20	6.20	6.10	6.10	CNY	0.5%
USD/KRW	1140	1120	1100	1090	1090	KRW	2.1%
USD/TRY	1.79	1.80	1.77	1.75	1.70	TRY	8.2%

Equities	Current	YTD Return (local ccy)
S&P	1386	12.6%
Nasdaq	3024	18.0%
Topix	812	15.6%
FTSE 100	5772	4.0%
MSCI Eurozone*	134	6.4%
MSCI Europe*	1061	5.6%
MSCI EM \$*	1023	13.7%
Brazil Bovespa	63011	12.6%
Hang Seng	21011	14.4%
Shanghai SE	2407	2.9%

*Levels/returns as of Apr 19, 2012

Local currency except MSCI EM \$

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD (\$)
Energy	2.5%	-1.1%	10.5%	11.7%
Materials	10.2%	8.3%	15.0%	10.0%
Industrials	10.5%	8.6%	13.9%	18.0%
Discretionary	15.0%	15.3%	26.3%	14.5%
Staples	5.5%	4.5%	13.9%	12.6%
Healthcare	8.7%	2.7%	5.3%	13.6%
Financials	20.3%	10.5%	28.9%	14.3%
Information Tech.	21.0%	12.4%	17.5%	21.7%
Telecommunications	2.7%	-4.8%	-1.3%	6.4%
Utilities	-1.3%	-0.2%	8.5%	12.3%
Overall	12.6%	5.6%	15.6%	13.7%

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			
	2011	2012	2013	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	4Q11	2Q12	4Q12	2Q13
The Americas														
United States	1.7	2.5	2.2	3.0	<u>2.5</u>	2.5	3.0	2.0	1.5	2.3	3.3	2.2	1.9	1.7
Canada	2.5	2.3	2.5	1.8	<u>2.1</u>	2.6	2.3	2.4	2.7	2.4	2.7	1.7	1.7	2.0
Latin America	4.3	3.8	4.0	2.4	<u>3.7</u>	5.1	4.3	4.1	4.4	3.8	7.2	6.4	6.3	6.9
Argentina	8.9	4.5	4.0	3.2	<u>0.0</u>	5.5	6.5	5.0	3.0	4.0	9.6	10.0	10.0 ↓	11.0
Brazil	2.9	3.1	4.5	1.3	<u>2.6</u>	5.7	5.5	5.7	4.5	4.5	6.7	5.1	5.1	5.3
Chile	6.0	5.0	4.5	8.2	<u>5.1</u>	4.9	4.6	4.7	4.5	4.4	4.0	4.2	3.9	3.4
Colombia	5.9	5.0	5.0	5.4	<u>4.5</u>	4.9	4.1	3.0	5.7	6.0	3.9	3.6	3.3	3.0
Ecuador	7.8	4.0	4.0	4.1	<u>2.0</u>	3.5	4.0	4.0	4.0	4.0	5.5	5.3	4.7	4.7
Mexico	3.9	3.8	3.5	1.7	<u>5.1</u>	3.9	2.0	3.2	4.9	2.8	3.5	4.2	4.0	3.8
Peru	6.9	5.5	7.0	2.8	<u>5.2</u>	5.8	6.2	7.3	8.0	8.0	4.5	3.9	3.1 ↓	3.0
Venezuela	4.2	4.0	1.0	3.5	<u>6.0</u>	6.0	4.0	-3.0	0.0	0.0	28.5	23.9	23.4	31.7
Asia/Pacific														
Japan	-0.7	2.0	1.3	-0.7	<u>2.8</u>	2.0	1.4	1.2	1.0	1.2	-0.3	0.1 ↑	0.1 ↑	-0.1 ↑
Australia	2.0	3.0	3.3	1.7	<u>3.1</u>	1.9	3.7	4.1	4.5	2.0	3.1	2.5	3.3	3.0
New Zealand	1.4	2.9	2.7	1.4	<u>5.1</u>	2.1	3.7	3.0	0.9	3.4	1.8	1.2	2.5	2.7
Asia ex Japan	7.0	6.5	7.1	4.6	<u>8.0</u>	6.7	7.2	7.5	7.0	7.0	4.9	3.9	4.4 ↑	4.9 ↑
China	9.2	8.2	9.1	8.8	<u>6.8</u>	<u>7.8</u>	9.5	10.0	9.1	8.7	4.6	3.3	3.6	4.6
Hong Kong	5.0	2.8	4.2	1.6	<u>3.0</u>	4.0	5.5	6.0	3.0	3.5	5.7	4.5	3.6	3.2
India	7.0	7.1	7.3	3.8	<u>13.0</u>	5.5	6.3	6.5	6.7	7.5	8.4	7.8	8.2	8.5
Indonesia	6.5	5.3	5.5	9.9	<u>5.0</u>	5.0	4.5	5.0	5.5	5.5	4.1	3.9	7.4	7.3
Korea	3.6	3.3	4.0	1.3	<u>3.0</u>	4.0	4.5	5.0	4.0	4.0	4.0	3.0	3.5	3.8
Malaysia	5.1	3.9	3.2	4.8	<u>5.0</u>	2.0	2.0	2.5	4.0	4.5	3.2	2.6	2.2	1.8
Philippines	3.7	4.3	4.8	3.5	<u>4.3</u>	4.9	5.7	4.9	4.5	4.5	4.7	3.9	4.0	4.0
Singapore	4.9	3.7	4.0	-2.5	<u>9.9</u>	6.6	3.2	2.0	4.5	4.5	5.5	4.6	3.4	2.8
Taiwan	4.0	2.8	5.1	-0.6	<u>3.3</u>	4.8	5.8	6.5	4.5	4.6	1.4	1.3	1.7	1.2
Thailand	0.1	5.1	3.5	-36.4	<u>45.0</u>	20.0	2.0	0.5	5.0	6.5	4.0	3.7 ↑	3.5 ↑	3.2 ↑
Africa/Middle East														
Israel	4.8	2.9	4.4	3.2	<u>0.8</u>	3.2	6.1	7.4	4.5	2.8	2.5	2.3	2.5	2.1
South Africa	3.1	2.7	3.6	3.2	<u>2.3</u>	2.6	2.8	3.2	3.8	3.5	6.1	6.0	6.2	5.9
Europe														
Euro area	1.5	-0.4	0.4	-1.2	<u>-0.5</u>	-0.8	-0.5	0.3	0.5	0.5	2.9	2.4	2.2 ↑	1.7 ↑
Germany	3.1	0.6	1.4	-0.7	<u>0.3</u>	1.0	0.8	1.3	1.5	1.5	2.6	2.3	2.1	1.7 ↓
France	1.7	0.3	0.7	0.6	<u>0.0</u>	0.0	0.3	0.5	0.8	1.0	2.6	2.6 ↑	2.3 ↑	1.9 ↑
Italy	0.5	-1.9 ↓	-0.7	-2.6	-2.5 ↓	-2.5	-1.5	-1.0	-0.5	-0.5	3.7	3.6 ↑	4.0 ↑	3.6 ↑
Norway	2.7	1.4	1.8	2.5	<u>0.0</u>	0.0	1.0	1.0	2.0	2.5	0.9	0.9	1.4	1.7
Sweden	4.0	-0.3	1.7	-4.4	<u>-0.5</u>	-0.5	0.5	1.0	2.0	2.3	2.3	1.1	1.1	1.5
United Kingdom	0.7	0.4	1.9	-1.2	<u>0.5</u>	-1.0	2.5	1.5	2.0	2.0	4.6	3.0	3.0	2.7
Emerging Europe	4.8	2.8	3.5	4.6	<u>1.2</u> ↓	1.4	3.0 ↑	3.1 ↓	3.5	3.2	6.4	5.0 ↓	5.5 ↓	6.1
Bulgaria	1.7	1.5	2.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	1.7	-0.2	1.7	-0.5	<u>-0.8</u>	-1.0	1.1	2.3	3.3	-1.3	2.4	2.7	2.9	2.5
Hungary	1.7	0.5	1.5	1.2	<u>-0.3</u>	0.3	1.0	1.5	1.5	2.0	4.1	5.8	5.9	3.8
Poland	4.3	3.2	3.0	4.5	<u>2.8</u>	2.0	2.5	3.0	3.0	3.0	4.6	3.9	3.5	2.8
Romania	2.5	0.8	2.7	-0.8	<u>-1.2</u>	-1.5	0.8	2.4	2.5	3.0	3.4	3.3	4.4	4.0
Russia	4.3	3.7	3.7	6.4	<u>1.5</u> ↓	2.0	4.0 ↑	3.5 ↓	4.0	4.0	6.8	3.9 ↓	6.1 ↓	6.8
Turkey	8.5	2.5	4.5	...	...	...	...	...	...	...	9.2	9.0	6.8	8.8
Global	2.6	2.3	2.6	1.5	2.5 ↓	2.2	2.7 ↑	2.5 ↓	2.5	2.6	3.6	2.8	2.8 ↑	2.7 ↑
Developed markets	1.3	1.3	1.5	0.6	<u>1.4</u>	1.0	1.5	1.3	1.3	1.5	2.8	2.0	1.9 ↑	1.6 ↑
Emerging markets	5.8	5.0	5.6	4.0	5.7 ↓	5.3	5.7 ↑	5.9	5.7	5.5	5.7	4.8	5.1	5.6 ↑

Source: J.P. Morgan

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