From: US GIO <[redacted]
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The J.P. Morgan View

EM policy cavalry is saddling up

- **Asset Allocation** — Position now for EM monetary easing through EM local bonds, and wait with EM FX and equity longs until EM data and growth expectations have bottomed.
- **Economics** — Q2, at 1.7%, is ending up as the weakest quarter in the recovery, so far. We project a rebound for H2, on falling inflation, but only to a still below potential pace of 2.5%. EM policymakers have by far the greatest room to counteract economic weakness.
- **Fixed Income** — We still prefer German Bunds to US Treasuries.
- **Equities** — The US reporting season is delivering a positive surprise, supporting equities near term.
- **Credit** — Outright longs in US HG corporate and EU bank bonds combine a safe and a risky asset and thus offer good diversification against changes in the growth outlook.
- **Foreign exchange** — Still long dollar vs. euro.
- **Commodities** — We lower our 2012 copper price forecast but raise next year's.

- **Fixed income continues to beat equities** as investors are trimming growth expectations and wonder whether policy makers have what it takes to reverse deflationary conditions. We similarly trimmed our Q2 estimate to 1.7%, the weakest quarterly pace, so far, in this recovery. Our economists maintain that the second half should be better, as falling inflation should boost real income. But at a projected pace of 2.5%, H2 growth would still be a good half a point below what we consider the level needed to keep global inflation and unemployment rates unchanged.
- The cause of the Q2 soft patch is not entirely clear, but it is quite plausibly related to the same force that has been keeping both investors and companies cautious over the past year — **fundamental uncertainty** about what the future will bring. To some degree, this uncertainty is self fulfilling: "I will not invest if I do not see others investing also." In past decades, the market has then looked for policy leadership to break this logjam through decisive stimulus measures. But here we believe that **G4 policy makers are either unwilling or unable to provide much stimulus** or in such internal disarray that they are actually adding to economic and market uncertainty. EM policymakers, in contrast, still have the ability and willingness to counteract an economic slump, and are thus creating greater opportunities for active investors.
- More concretely, policy makers can boost spending through **monetary stimulus, fiscal stimulus, or simply by providing more clarity** about their future actions. In the advanced economies, nominal monetary policy rates have been cut to a GDP-weighted average of 0.5%, or more than 1% below inflation. As a result, the G4 have added various QE programs to push bond yields down to new historic lows. We expect another round of G4 QE this fall, through

See page 7 for analyst certification and important disclosures.

Global Asset Allocation
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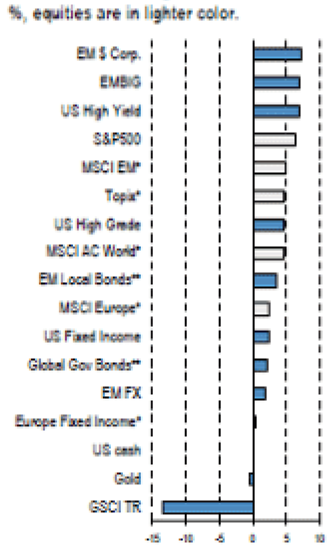
YTD returns through Jun 21
%, equities are in lighter color.



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 $.