

The J.P. Morgan View

Can the risk rally last?

- **Asset allocation** — Following our re-entry into long US equities vs cash last week, we have further upgraded our risk exposure by being long both equities and credit versus cash and government debt. Given the overnight announcement of Chinese infrastructure spending, even if not all new, we cover our underweight in Chinese equities and in industrial metals and reverse the short in commodity FX.
 - **Economics** — World growth is in a bottoming process, but at well below potential with a return to trend only projected by the middle of next year. Policy easing is restarting in the US, UK, Euro area with monetary policy, and in China with both monetary and fiscal policy.
 - **Fixed Income** — Position on ECB policy though Spanish curve flatteners, and Fed QE3 through long end Treasury steepeners.
 - **Equities** — We take profit on our BRIC underweight within EM.
 - **Credit** — We go further up in yield and down in quality in our credit portfolio.
 - **Currencies** — Close defensive trades and go long commodity FX vs Europe.
 - **Commodities** — The newly announced Chinese stimulus makes us take profits on our OW energy vs. base metals trade. We stay long energy on Middle East risk.
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- **ECB President Mario Draghi's** promise yesterday to provide a backstop to EMU members with funding problems, by using Outright Monetary Transactions (OMTs) to keep risk premia low, induced a massive rally in periphery bonds and global equities. Even a weak US jobs report could not rain on this parade. And all this without him actually spending any money as no country yet meets his conditions cleanly. Both US and German equity indices reached new cycle highs. While consistent with our long-risk strategy, these new highs do force us to ask **whether the good times for risk assets can last.**

- We think **the positive environment for risk assets can and will last over the next 3-6 months.** And this is not because of a strong economy, as we foresee below potential global growth over the next year and are below consensus expectations. Overall, we continue to see data that signal that **world growth is in a bottoming process.** With most countries having now reported, global GDP looks to have expanded at a tepid 1.9% pace in 2Q12, 1.3%-point below what would simply be trend. On the back of weak gains in consumer and business spending at mid-year, global IP growth has come to a stand-still. And while things appear to have bottomed with some signals of improvement in consumer spending in July, the soft trajectory of both spending and production through June is expected to hold global GDP growth to another tepid quarter of just 2%.

See page 7 for analyst certification and important disclosures.

Global Asset Allocation

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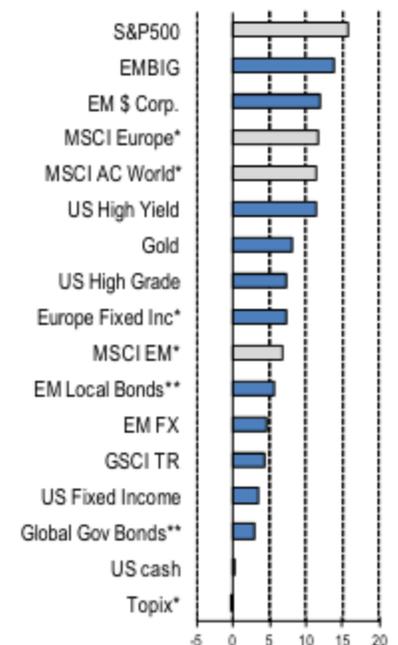
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YTD returns through Sep 6

%, equities are in lighter color.



Source: J.P. Morgan, Bloomberg. See blue box on page 2 for description.

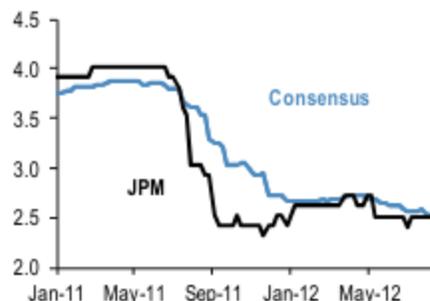
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- More important to us as **positive drivers of risk markets are coming policy stimulus measures, price momentum, and the continuing but more medium-term forces of asset reflation and high risk premia.**
- **On policy**, we expect further QE announcements by the Fed next week, and the UK MPC later this year. The ECB confirmation and clarification yesterday that it will use its balance sheet to depress risk premia for EMU members in an EFSF support program likewise increases confidence that policy makers stand ready to support growth. The overnight Chinese announcement of infrastructure spending worth 2% of GDP may not all be new money, but likely signals a renewed commitment to provide support. We similarly expect a supplementary budget from Korea next week.
- The impact of further policy easing does not make us immediately upgrade economic growth projections, but it does not make us more bullish on risk markets. That is because we see the main impact of policy on asset prices via risk premia and liquidity. The ECB's new OMT policy will not spend any money next week. It is merely a promise to buy short-dated debt, if a country applies for help and meets conditions. As with other policy measures, it largely works by providing insurance, and thus reduces tail risk. With still high sky-high risk premia on equities and periphery debt and less so on credit, it supports risk assets without making us more bullish on growth.
- The second, and in our view, equally important aspect of actual liquidity injections from QE is that they increase the supply of cash in the market, which will likely be redeployed into better yielding financial assets. This is the force we keep referring to, ad nauseam, as **asset reflation**. "Don't fight the Fed" is an old adage in the market, and applies doubly when other central banks pursue the same kind of monetary expansion. It keeps us short cash and long financial assets, overweighting the riskier ones (equities and credit) as they should gain most from asset reflation.

Fixed income

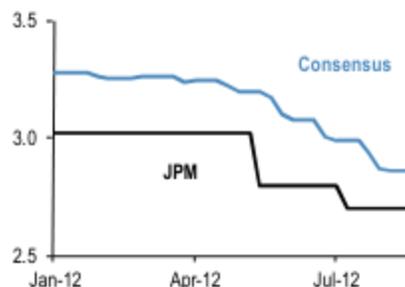
- Core yields are much higher on the week, with the **ECB trumping today's soft US Employment Report**. ECB President Draghi signaled again that the new "OMT" program, with no set limit on bond purchases of up to three years' maturity, should have a much more persistent impact on yields than its predecessor, the SMP. There remains considerable uncertainty as to when bond buying will begin, not least because the ECB's request for the IMF to be involved in setting the related conditionality will likely make Spain all the more reluctant to sign up.
- Peripheral bonds have already enjoyed a dizzying rally since July. From here, we favor **2- to-5-year curve flatteners in Spain**. If the ECB succeeds in anchoring front end bonds, 5-year yields should compress towards the short end. On the other hand, any disappointment on ECB purchases would be most keenly felt at the front end.
- Today's payroll print makes QE3 all the more likely at next week's FOMC meeting. We think that should **steepen the long end of the Treasury curve**, in line with past QE announcements. We are neutral overall on duration, but have a medium-term bearish stance on Treasuries, and think short yields are too low in the UK, compared to Germany.
- Just how much all these unconventional central bank measures will affect inflation remains a keen topic of discussion, and our *10th J.P.Morgan Inflation Expectations Survey* includes a question on the impact of the ECB's

2012 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.

2013 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 Srinivas 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.

Description of YTD Chart on front page:

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 \$.

new program. Please help us gauge prospects for inflation by completing the survey on <https://www.surveymonkey.com/s/September2012InflationSurvey>.

Equities

- Equity markets responded strongly to this week's ECB's press conference with the S&P500 and other DM indices reaching new post-Lehman highs. We argued last week that policy response is essential for the equity rally to continue into September and this **policy response appears to be coming through nicely**.
- Positive announcements were not only confined to Europe this week. China announced large projects, totaling close to 2% of GDP, triggering the biggest rally in Chinese stocks in almost eight months. These policy announcements prompt us to **take profit on our BRIC underweight within EM**, i.e. our long in MSCI EM against MSCI BRIC.
- Next week's FOMC meeting appears set to announce a new round of QE adding to the policy chorus.
- **Our preferred region is the US**. The outperformance of US economic indicators is the main reason. The JPM US Economic Activity Surprise Index (EASI) has risen to positive territory last week, for the first time in six months. In contrast, EM economies continue to print weak economic data. Macro data are also weak in Europe, but European equities are still benefiting from underweights that are not yet fully covered by investors.

Credit

- **Spreads tightened across the board this week**, as markets received the ECB's bond buying plan -- one that combines **capacity** with **conditionality** -- as a positive step forward. Higher beta sectors outperformed, but the degree of spread tightening was surprising, given that apart from the role of the IMF, Mr Draghi revealed relatively little new information about the contours of the OMT.
- With global growth likely in the process of bottoming out, in *GMOS* yesterday we outlined our **down-in-quality** strategy. We do not have a strong regional bias, given that central banks are easing monetary policy globally, but today's weak US payroll numbers will have **raised expectation of QE3** at next week's FOMC meeting, and **should provide a boost to US CMBS**, one of the core longs of our portfolio this month.
- **There was an uptick in defaults in August**, with \$3bn of high-yield bonds and institutional loans defaulting, the second highest month YTD. However, the continued focus on refinancing amid buoyant primary markets should keep longer-term defaults well anchored. In the US, we forecast a **2% or lower default rate for the next two years** (see Peter Acciavatti and team, *Default Monitor*).

Foreign Exchange

- With yesterday's pledge to "remove the tail risk of Europe", the ECB has triggered a series of hedge unwinds across global markets. FX vols have fallen to a 5-year low (basis VXY), EUR/CHF has posted a 2-sigma rally, EUR/USD skews are flattening aggressively, European sovereign CDS are approaching 2012 highs and the dollar is collapsing. It might be a stretch to call the ECB's strategy a game changer when remaking EMU remains a multi-year game and when Spain and Italy are likely too proud to get on the pitch.

More details in ...

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.

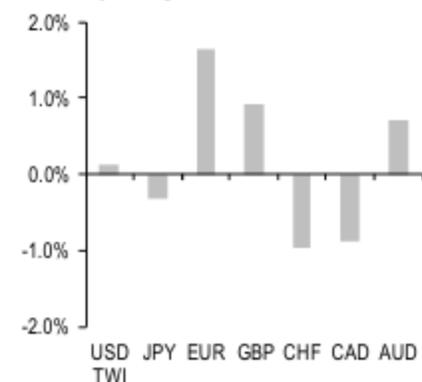
Still, we view the bank's tail-risk emphasis is a short-term boon for carry trades which rely on vol suppression to deliver returns.

- Whether to fund in euros or dollars depends on how much further EUR/USD can rally. We suspect not much more given Spanish and Italian aversion to the EFSF plus ECB rate cuts next month. The EUR/USD year-end target is therefore unchanged at 1.24. The corresponding EUR/GBP target is 0.79 and EUR/JPY 97.) Some will probably counter that politics plus future ECB rate cuts justify a much weaker euro, but we believe that view ignores the likelihood of Fed QE this fall. Also unconvincing is the normative argument that the euro will trend lower because currency depreciation will restore competitiveness. This is true -- in the same way that yen depreciation will generate Japanese inflation -- but irrelevant, in our view. Unless the ECB cuts rates as it buys bonds, it will likely be difficult to offset the region's decent balance of payments profile (small current surplus) in the same way that the Bank of Japan struggles to weaken the yen while Japan still runs an external surplus.
- The more material change in view is that the majority of euro crosses (EUR vs commodity FX, Scandies, Latam, and Asia) are topping out after a summer rally, even if their decline may be limited to a few percent due to the mediocrity of global growth. Close defensive trades (short commodity FX) and open trades that benefit from less event risk in Europe. Take profits on short AUD/USD, short AUD/NZD, long NOK/SEK and long USD/SEK, and buy commodity FX vs Europe, expressed through NZD/SEK given the overvaluation of the Swedish currency.

Commodities

- **Commodities are more or less unchanged on the week with base metals rallying some 4%, offsetting a fall in energy.** We went **OW energy vs. base metals** at the beginning of June on the argument that global manufacturing, especially in China, was slowing and that supply issues would support oil (*GMOS*, Jun 7). Since then, the GSCI energy index has made 15% compared to only 0.5% for the GSCI industrial metals index (excess return). Last night, the Chinese authorities announced significant stimulus via further infrastructure investment to the tune of around 1.7% of Chinese GDP. It is not yet clear how much of this is simply existing stimulus repackaged but it is enough for us to **take profit on this trade. We keep the long leg** as the steeply inverted Brent forward curve suggests oil markets remain tight and geopolitical risk in the Middle East appears unlikely to decline anytime soon.
- **Gold is up 10% over the last two months** and is perhaps an indication that the market anticipates further QE. The ECB's new OMTs should significantly expand their balance sheet once they start buying peripheral debt and we also expect both the Fed and the BoE to do the same over the coming months. This should create **bullish conditions for gold and we stay long.**

FX weekly change in 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, Fenton et al.
Daily Metals Note, Fenton et al.
Agriculture Weekly, Dietz et al.

Interest rates		Current	Sep-12	Dec-12	Mar-13	Jun-13	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	1.62	1.75	2.00	2.00	2.00	2.1%
Euro area	Refi rate	0.75	0.75	0.50	0.50	0.50	
	10-year yields	1.52	1.00	0.90	1.00	1.20	2.5%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	1.68	1.40	1.45	1.55	1.65	2.9%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.82	0.85	0.95	0.95	0.95	1.7%
GBI-EM hedged in \$	Yield - Global Diversified	5.85		6.00			5.7%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	186	JPMorgan JULI Portfolio Spread to Treasury	7.4%
Euro high grade (bp over Euro gov)	212	iBoxx Euro Corporate Index	7.2%
USD high yield (bp vs. UST)	590	JPMorgan Global High Yield Index STW	11.1%
Euro high yield (bp over Euro gov)	822	iBoxx Euro HY Index	16.4%
EMBIG (bp vs. UST)	304	EMBI Global	13.8%
EM Corporates (bp vs. UST)	371	JPM EM Corporates (CEMBI)	11.9%

Quarterly Averages

Commodities	Current	12Q3	12Q4	13Q1	13Q2	GSCI Index	YTD Return*
Brent (\$/bbl)	114	95	100	105	95	Energy	1.2%
Gold (\$/oz)	1739	1655	1725	1750	1775	Precious Metals	5.0%
Copper (\$/metric ton)	7693	8000	8300	8500	8700	Industrial Metals	-5.6%
Corn (\$/Bu)	8.04	8.25	8.25	8.00	7.75	Agriculture	23.5%

Foreign Exchange	Current	Sep-12	Dec-12	Mar-13	Jun-13	3m cash index	YTD Return* in USD
EUR/USD	1.26	1.24	1.24	1.25	1.25	EUR	-1.6%
USD/JPY	79.0	78	78	80	80	JPY	2.4%
GBP/USD	1.59	1.59	1.58	1.58	1.58	GBP	3.7%
USD/BRL	2.03	2.00	1.98	1.95	1.95	BRL	-3.0%
USD/CNY	6.34	6.33	6.30	6.30	6.25	CNY	0.5%
USD/KRW	1134	1150	1150	1090	1090	KRW	3.5%
USD/TRY	1.81	1.82	1.80	1.75	1.75	TRY	10.7%

Equities	Current	YTD Return (local ccy)
S&P	1436	15.6%
Nasdaq	3130	20.2%
Topix	735	0.0%
FTSE 100	5795	7.3%
MSCI Eurozone*	145	14.7%
MSCI Europe*	1107	11.8%
MSCI EM \$*	950	6.4%
Brazil Bovespa	57774	4.4%
Hang Seng	19209	8.0%
Shanghai SE	2052	-6.7%

*Levels/returns as of Sep 06, 2012

Local currency except MSCI EM \$

Source: J.P. Morgan

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD (\$)
Energy	5.1%	1.1%	-15.3%	-0.5%
Materials	9.6%	6.8%	-16.3%	-3.4%
Industrials	10.5%	12.7%	-4.2%	5.5%
Discretionary	20.3%	22.1%	5.2%	5.6%
Staples	12.7%	15.4%	12.9%	12.1%
Healthcare	15.5%	16.0%	9.4%	22.0%
Financials	20.6%	16.0%	14.5%	8.9%
Information Tech.	23.0%	11.4%	-10.9%	12.2%
Telecommunications	23.9%	2.2%	6.6%	11.3%
Utilities	4.2%	7.4%	-23.6%	5.9%
Overall	15.6%	11.8%	0.0%	6.4%

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	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q11	2Q12	4Q12	2Q13
The Americas														
United States	1.8	2.2	2.0	2.0	1.7	1.5	2.0	1.5	2.3	2.5	3.3	1.9	2.1	2.3
Canada	2.4	2.0	2.1 ↓	1.8	1.8	1.9 ↓	2.0	2.1 ↓	2.1 ↓	2.2 ↓	2.7	1.6	2.4	2.0
Latin America	4.2	2.8	3.7	2.9	1.9	4.2	3.8	3.5	3.8	3.9	7.2	6.0	6.2 ↑	7.0
Argentina	8.9	3.3	2.2	3.6	-4.5	8.0	6.0	0.0	1.5	0.5	9.6	10.0	10.0	11.0
Brazil	2.7	1.4	4.1 ↓	0.5	1.6	4.8	4.6	3.8	4.0	4.3	6.7	5.0	5.2	5.2
Chile	6.0	5.0	4.5	5.1	7.1	2.0	4.0	4.6	4.7	4.4	4.0	3.1	2.5	3.1
Colombia	5.9	3.5	4.5	1.2 ↑	2.0 ↓	2.8 ↓	3.4 ↓	5.0	6.0	6.0	3.9	3.6 ↑	3.3 ↑	3.2
Ecuador	7.8	4.0	4.0	2.8	3.5	4.0	4.0	4.0	4.0	5.0	5.5	5.1	4.2	4.4
Mexico	3.9	3.6	3.5	4.9	3.5	2.2	3.0	4.4	3.7	3.3	3.5	3.9	4.2	3.6
Peru	6.9	6.0	7.0	8.3 ↑	6.0 ↑	5.5	6.0	8.0	8.0	7.0	4.5	4.1	3.1 ↑	2.8
Uruguay	5.7	3.5	4.0	11.65	-8.5	28.0	-10.3	13.5	-11.0	25.0	8.3	8.0	7.6	7.2
Venezuela	4.2	5.0	0.0	10.1	0.6	3.5	-3.0	-3.0	0.0	3.0	28.5	22.3	23.4	37.3
Asia/Pacific														
Japan	-0.7	2.5	0.9	5.5	1.4	-0.3	0.5	1.0	1.2	1.3	-0.3	0.2	0.1	-0.1
Australia	2.1	3.5 ↓	2.5	5.6 ↑	2.6 ↓	1.5 ↓	1.8 ↑	3.8 ↓	2.5 ↑	1.8	3.1	1.2 ↑	1.7 ↑	2.7
New Zealand	1.3	2.5	2.8	4.7	0.4	3.3	3.0	2.3	3.4	3.2	1.8	1.1	2.5	2.8
Asia ex Japan	7.4	6.2	6.6	7.3	5.7 ↓	5.9	6.4	6.8	6.9	7.1	4.9	3.9	3.5 ↑	4.0 ↑
China	9.2	7.7	8.5	6.8	6.9	8.0	8.5	8.7	8.7	8.7	4.6	2.9	2.6 ↑	3.7 ↑
Hong Kong	5.0	1.2	3.2	2.4	-0.4	2.0	2.5	3.5	3.5	5.0	5.7	4.2	2.5	2.7
India	6.5	5.6	6.0	6.1	5.3	5.2	5.0	5.8	6.0	6.8	8.4	10.1	9.8	9.0
Indonesia	6.5	5.0	3.7	4.6	6.2	3.0	3.0	3.5	4.5	5.0	4.1	4.5	3.9	2.2
Korea	3.6	2.4 ↓	3.3	3.5	1.1 ↓	2.0	3.5	3.5	3.5	4.0	4.0	2.4	1.9	3.1
Malaysia	5.1	4.7	2.9	5.8	5.9	2.5	1.5	2.0	3.0	3.5	3.2	1.7	1.1	1.2
Philippines	3.8	5.3	3.5	12.6	0.9	1.2	1.2	4.5	4.5	4.5	4.7	2.9	2.3	2.3
Singapore	4.9	2.1	3.4	9.5	-0.7	0.8	4.1	4.1	4.1	4.1	5.5	5.3	3.4	2.4
Taiwan	4.0	1.1	3.9	1.5	3.5	1.8	3.8	4.5	4.6	4.8	1.4	1.7	2.1	1.8
Thailand	0.1	5.8	2.7	50.8	13.9	2.0	2.0	1.5	2.0	2.0	4.0	2.5	1.3	1.1
Africa/Middle East														
Israel	4.8 ↑	3.0 ↑	4.4	3.0 ↑	2.0 ↓	2.0	2.8	4.9	6.1	6.1	2.5	1.6	1.3	1.5
South Africa	3.1	2.6 ↑	3.2 ↓	2.7	3.2	2.3 ↓	2.4 ↓	3.8 ↑	3.2	3.6 ↑	6.1	5.7	5.5	5.6
Europe														
Euro area	1.5	-0.5 ↓	0.2	-0.1 ↓	-0.7	-1.0	-0.5	0.5	0.5	1.0	2.9	2.5	2.5	1.9
Germany	3.1	1.0	1.2	2.0	1.1	0.3	0.5	1.5	1.5	1.8	2.6	2.1	1.9	1.6
France	1.7	0.1	0.6	0.1	-0.2	-0.3	0.0	0.8	1.0	1.3	2.6	2.3	2.3	1.7
Italy	0.5	-2.3	-1.0	-3.3	-2.9	-2.5	-1.5	-0.8	-0.5	0.0	3.7	3.6	3.4	2.5
Spain	0.4	-1.5	-0.9	-1.3	-1.7	-2.8	-2.0	-0.5	0.5	0.5	2.7	1.9	3.2	2.6
United Kingdom	0.8	-0.4	1.5	-1.3	-1.8	2.0	0.5	1.5	2.0	2.5	4.6	2.8	2.7	2.6
Emerging Europe	4.8	2.7	3.0 ↓	2.4 ↑	1.3	1.3 ↓	2.2 ↓	3.1	3.1	3.6 ↑	6.4	5.0	5.8	5.8
Bulgaria	1.7	1.0	2.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	1.7	-1.1	0.9	-3.1	-0.8	-1.2 ↓	-1.3 ↓	2.1 ↑	1.0 ↓	4.3 ↑	2.4	3.4	2.9	2.4
Hungary	1.6	-1.2	0.8	-3.5 ↑	-0.9 ↓	-0.5	0.5	1.0	1.5	1.8	4.1	5.5	5.5	3.3
Poland	4.3	2.4	2.1	2.4	1.6	1.2	1.6	1.8	2.4	3.5	4.6	4.0	3.7	2.6
Romania	2.5	0.6 ↓	0.9 ↓	0.6 ↑	2.1 ↑	-1.0 ↓	0.8 ↓	1.2 ↓	-0.4 ↑	3.2 ↑	3.4	1.9	4.4	4.2
Russia	4.3	3.6	3.4	3.7	1.5	2.0	3.0	4.0	4.0	3.7	6.8	3.9	6.7	7.4
Turkey	8.5	2.8	4.1 ↓	...	...	...	...	...	...	...	9.2	9.4	6.5	5.9
Global	3.0	2.5	2.7	3.1	1.9	2.0	2.4	2.7	2.9	3.2	3.8	2.8	2.9	3.0 ↑
Developed markets	1.3	1.2 ↓	1.2	1.8	0.7	0.5	0.9 ↑	1.2	1.5	1.8	2.7	1.8	2.0	1.8
Emerging markets	6.1	4.7	5.3	5.4	4.1 ↓	4.7 ↓	5.1 ↓	5.4	5.5 ↓	5.8 ↑	5.7	4.6	4.5	5.0 ↑

Source: J.P. Morgan

Disclosures

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