

The J.P. Morgan View

Weak economy vs. strong liquidity. Who wins?

- **Asset allocation** — Strong liquidity, heavy supply of safe assets, high risk premia, defensive positioning by end investors, and a QE focus on reducing downside risk are not technicals but are true fundamental drivers of the risk rally that trump weak economic growth, in our view.
 - **Economics** — Q3 global growth remains as soft as Q2, confirming bottoming process, but not yet a rebound. Only rising order/inventory ratios and rallying markets hint at rebound into Q4, we believe. We nudge up 2013 Euro area growth from 0.2% to 0.3% on improved financial conditions.
 - **Fixed Income** — Position on wider swap spreads in Treasuries, Bunds and UK.
 - **Equities** — Stay long value stocks in Europe, commodity sectors globally, US-housing-sensitive sectors within the US, and US against EM.
 - **Credit** — Stay long credit spreads across the US HY and EM sovereigns and corporates and we expect further spread compression.
 - **Currencies** — New FX forecasts, with weaker dollar into year-end.
 - **Commodities** — We think agriculture prices have peaked and will move lower from here. Open a short in the GSCI agriculture index.
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- **Markets took a breather this week, after last week's fireworks**, with equities and credit largely flat, and bonds yields and commodities down. It was a quiet week for data, but what we got was on the softer side. We continue to think global growth is bottoming, but the evidence so far confirms only that growth has come down and that Q3 seems equally soft as Q2. There seems no real evidence yet of a rebound in growth. All we have is a rise in orders relative to inventories in flash PMIs, a rise in confidence, & surging financial asset prices.
 - The weak economic data of the past two years and rising asset prices have created a conundrum to investors on what they should really follow -- **the weak fundamentals or the good "technicals"**? We have argued here frequently that liquidity driven asset reflation in a market with high risk premia and defensive positions trumps weak economic growth, as long as the latter does not deteriorate into recession. Hence, we have chosen to remain long risk assets despite repeated downgrades to economic growth projections. We like to make clear though, that these so-called technicals are to us very fundamental and are not as short term in nature as many would suspect. And this for three reasons.
 - For one, the **relative supply and demand** for financial assets is not a mere short-term technical but is based on the first fundamental law of economics, which is that of supply and demand. Government supply of government debt and cash is many times the supply (net issuance) of corporate debt and equities. Hence the latter, scarcer corporate securities should rise in price against the much more abundant supply of government liabilities (high-powered money and government debt). This force is not a short-term technical impact, but in fact works more slowly and profoundly.

See page 7 for analyst certification and important disclosures.

Global Asset Allocation

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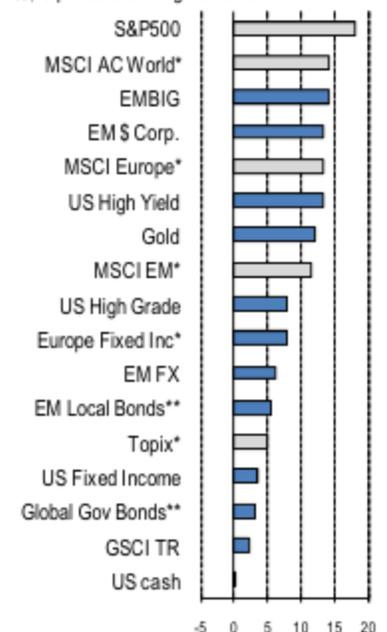
Leo Evans



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YTD returns through Sep 20

%, equities are in lighter color.



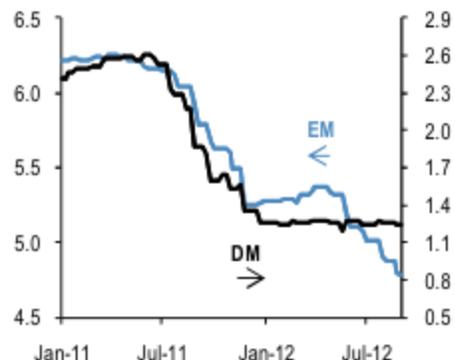
Source: Morgan, Bloomberg. See blue box on page 2 for description.

- Second, credit and equities are characterized by much higher **risk premia** versus government debt than we typically see in this point of the cycle. Central banks are now acting not merely to increase the supply of cash, but are also casting their policy in term of providing downside risk protection (insurance). We would classify the ECB's OMTs as exactly that. They will be implemented only if needed and with an explicit objective to eliminate risk premia on sovereign EMU debt. The Fed's new QE3 similarly is conditional on the state of the economy and labor market and will be accelerated if the economy weakens. If only US and Euro fiscal authorities could similarly reduce downside risk, risk premia would surely come crashing down. Risk premia are thus fundamental and not merely technical.
- Third, it is frequently argued that markets are running ahead of still weak fundamentals (growth) and are thus wrong. We would argue that the **transmission process** of monetary policy in a world of zero interest rates runs exactly from markets to growth. It is through asset reflation that central banks try to stimulate growth. Hence market will lead economies. Don't fight a determined Fed, ECB, BOJ and BoE, especially not when they work together.
- To be clear, **we are not telling you to ignore economic growth**. Stronger growth would have given us higher equity prices. But at this point in the cycle (we assume we are mid-cycle), volatility of economic data is trumped by relative supply & demand & changing risk perceptions, as long as we do not have another recession. Growth, however, does have an impact on relative country and sector performance. The top chart shows how growth forecasts for 2012 have been stable in DM, but have trended down in EM over the past 6 mths, which likely explains why EM equities have underperformed. The 2nd chart shows how cyclical stocks have not kept up with their high-beta nature over the past 2 years, underperforming defensives, despite an overall rally in stocks, likely as cyclicals are more vulnerable to downgrades in growth.

Fixed income

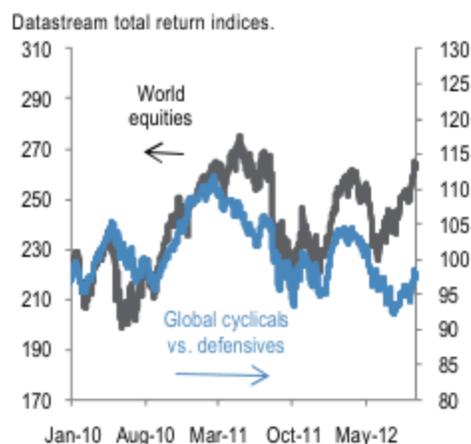
- Yields edged lower on weaker data. Spain's largest bond auction since January provides more evidence of the impact of the ECB's backstop, although it remains unclear when the backstop will be activated. The Bank of Japan joined its counterparts in announcing further bond purchases, but with the focus remaining on bills and short-dated bonds, the impact is likely to be limited, and we are in fact modestly bearish on duration in Japan.
- G-4 central banks are slated to buy nearly \$1trillion net of bonds over the next year, half of that due to the Fed's MBS purchases. Together, FX reverse managers and G-4 central banks already own an estimated \$1trillion of bonds, equivalent to over one third of global bonds rated AA and above, or more than half of those rated AAA, following a steady upward trend in recent years (see Chart, and today's *Flows and Liquidity*). By hoovering up most of the net issuance of safer bonds, the official sector appears to be continuing to push investors into riskier or less liquid alternatives.
- We are not strongly positioned on duration, even as we expect higher US Treasury yields over the balance of the year. We remain positioned for narrower intra-EMU spreads, consistent with a broader view that credit and liquidity spreads are a more attractive source of carry than extending duration. We do, however, look for the sharp narrowing in swap spreads across markets, driven in part by heavy swapped issuance, to reverse course, and hold spread wideners (long govies vs swaps) in USTs, Bunds, and UK gilts.

2012 EM vs. DM consensus GDP growth forecasts



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.

Global cyclical vs. defensive equities vs. global equities



Source: Datastream, 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 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.

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 \$.

Equities

- Equity markets paused this week following two weeks of strong gains of almost 5% for MSCI AC World in the first two weeks September. We find no reason to change our stance. We stay tactically long equities and we favor **value stocks in Europe, commodity sectors globally, US-housing-sensitive sectors within the US, and US against EM equities regionally.**
- Market gyrations have been a permanent feature of the market environment over the past few years. But despite this year's crisis or "soft patch", equities have delivered double digit returns outperforming other asset classes. In our opinion, this justifies a focus on the long term. Our quarterly publication "*Trade opportunities for long term investors, Sep 19*" does exactly this. It looks beyond short-term gyrations and focuses on long-term trading themes.
- Our recommendation for the long term is to focus on monetizing extremities in yield gaps and risk premia, e.g., the multi-decade-high yield gap between equities and bonds and risk premia such as correlation and skew risk premia. Our equity specific trades are shown below:
- Buy high dividend yield US equities vs. 10y USTs
- Buy 2013 FTSE 100 dividend futures for defensive growth
- Stay short S&P 500 long-dated skew
- Stay short S&P500 correlation
- Stay short Nikkei convexity
- Stay OW European SMid vs US SMid
- Buy MSCI EM\$ vs. MSCI World\$
- Long Dax vs. EuroStoxx50

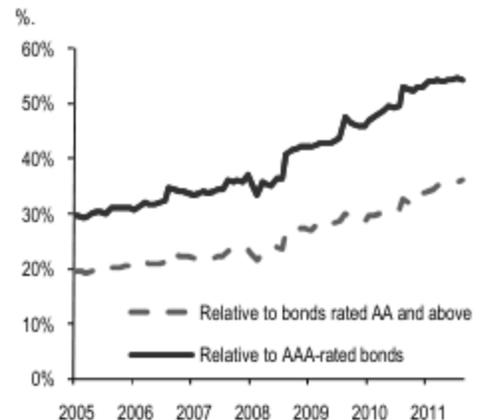
Credit

- **This week was mixed for credit.** US HG spreads continued to come in and are now at their lowest level for over a year and US CMBS also rallied further. However, HG spreads in Europe and US HY spreads both widened a little along with EM sovereign and corporate spreads. Some profit taking is not surprising given the almost straight line rally we have seen across spread products over the last few months but we think a big correction is unlikely. In our view, credit remains the most attractive asset from a carry-to-risk perspective and QE is pushing fixed income investors out of low yielding government debt, leaving little choice but to move out further and further along the risk spectrum.
- **This week saw a record weekly inflow into European HY funds** (*European High Yield Fund Flows: Weekly Update*, Daniel Lamy et al., 21 Sep) Our European credit strategists believe investor positioning in European HY is still light and supports further spread compression. They also see value in Spanish covered bonds, where there could be significant positive event risk from Spanish bank recapitalization announcements in the next few weeks.

Foreign Exchange

- We published our monthly Key Currency Views today. We **revised forecasts globally to reflect greater inflation risks in the US and less sovereign stress in Europe** following the Fed's proclamation of open-ended asset

Official sector bond holdings relative to global bond market



Source: J.P. Morgan, Bloomberg

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.

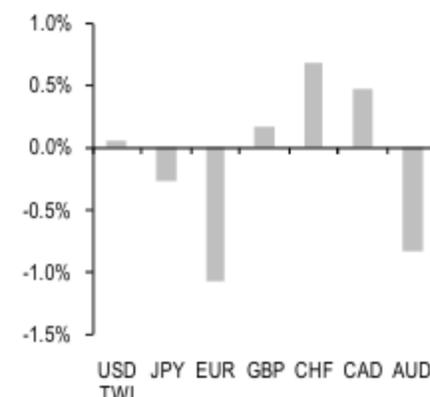
purchases on September 13 and the ECB's commitment to fund the periphery (within conditions) on September 6. End-2012 targets with previous forecast in parentheses are now EUR/USD 1.30 (1.24), GBP/USD 1.62 (1.58), USD/JPY 78 (78), AUD/USD 1.04 (1.02), USD/BRL 1.98 (1.98), USD/MXN 12.50 (12.50), USD/CNY 6.32 (6.30), USD/KRW 1125 (1150), USD/TRY 1.8 (1.8) and USD/ZAR 8.50 (8.30).

- Although the world's biggest central banks (Fed, ECB, BoE, BoJ and SNB) have been engaging in various forms of QE all year, the dollar has been the biggest casualty so far. It is down 3% trade-weighted, outdone only by the declines in IDR, BRL, ARS and GHS. This momentum surprises some who think of all balance sheet expansions as equal and therefore offsetting as far as their currency influence. Not true, in our view: As we have argued before, balance sheet expansion entails positive and negative effects on currencies, so the central bank's decision on how and when to deploy liquidity is critical. The currency-positive effect is lower default risk if the central bank targets distressed assets (ECB). The negative effect is lower real yields if asset purchases push nominal rates down and inflation expectations up. If default rates decline, this impact is positive where investors are underweight the currency as a credit hedge (EUR), since QE drives short-covering. If real rates fall, QE is more negative if the country is a capital importer (US) or if investors had been long the currency (USD in 2009) or close to neutral (September 2012), since investors will fund carry trades in the lowest-yielder.
- From this perspective it should be clear why the Fed should have more luck weakening the dollar with its balance sheet than will the ECB or the Bank of Japan. Fed QE is driving up inflation expectations more quickly and from a higher level than are the ECB or BoJ; the US is the current account debtor amongst the G-3; and investors are roughly neutral between funding in dollars and euros after six weeks of short-covering in the euro crosses. To offset the Fed's move, the ECB would need to cut rates again, in our view.

Commodities

- **Commodities sold off sharply this week, led lower by oil. Oil is down 6%** as Saudi Arabia stated it will be offering extra oil in an attempt to lower prices. Since then, prices have stabilized somewhat and are moving higher again. It seems unlikely we will see materially lower oil prices for the time being given ongoing tensions in the Middle East and a QE induced weaker USD. We remain long energy and long Brent time spreads in our *GMOS* portfolio as a hedge against the risk of a supply shock in the Middle East.
- Agriculture prices have been in a choppy range for the last two months and appear to have peaked. Historically, agriculture prices have experienced some element of mean reversion. This should make sense from a fundamental perspective as price spikes typically occur because of some supply shock, often because of unfavorable weather. However, higher prices induce higher planting and so greater supply from subsequent harvests, which pushes prices back down. Our Agriculture strategists see prices falling through next year precisely because of this dynamic. **We thus take profit on our longs in corn and soybeans and open a short GSCI agriculture position.** This trade also has positive slide given the current upward slope of most agriculture curves. In our *GMOS* long-only commodity portfolio, we balance this trade by removing our UW in base metals so that we are **OW energy and gold but UW agriculture.**

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, Colin Fenton et al.
Daily Metals Note, Colin Fenton et al.
Agriculture Weekly, Dietz et al.

Interest rates		Current	Dec-12	Mar-13	Jun-13	Sep-13	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	1.77	2.00	2.00	2.00	2.25	1.6%
Euro area	Refi rate	0.75	0.50	0.50	0.50	0.50	
	10-year yields	1.60	1.50	1.50	1.60	1.70	2.5%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	1.83	1.65	1.65	1.80	1.95	2.5%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.80	0.90	0.90	0.95	1.00	1.6%
GBI-EM hedged in \$	Yield - Global Diversified	5.87	6.00				5.7%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	170	JPMorgan JULI Portfolio Spread to Treasury	8.0%
Euro high grade (bp over Euro gov)	196	iBoxx Euro Corporate Index	7.9%
USD high yield (bp vs. UST)	555	JPMorgan Global High Yield Index STW	12.8%
Euro high yield (bp over Euro gov)	771	iBoxx Euro HY Index	18.7%
EMBIG (bp vs. UST)	293	EMBI Global	14.1%
EM Corporates (bp vs. UST)	346	JPM EM Corporates (CEMBI)	13.4%

Commodities	Current	Quarterly Averages				GSCI Index	YTD Return*
		12Q4	13Q1	13Q2	13Q3		
Brent (\$/bbl)	111	105	112	105	120	Energy	-1.0%
Gold (\$/oz)	1776	1725	1750	1775		Precious Metals	12.2%
Copper (\$/metric ton)	8263	8300	8500	8700		Industrial Metals	5.1%
Com (\$/Bu)	7.50	8.75	8.50	8.25		Agriculture	17.3%

Foreign Exchange	Current	Dec-12	Mar-13	Jun-13	Sep-13	3m cash		YTD Return*
						index	in USD	
EUR/USD	1.30	1.30	1.30	1.32	1.34	EUR		0.9%
USD/JPY	78.2	78	79	79	79	JPY		1.4%
GBP/USD	1.62	1.62	1.62	1.63	1.65	GBP		5.5%
USD/BRL	2.02	1.98	1.95	1.95	1.95	BRL		-2.3%
USD/CNY	6.31	6.32	6.32	6.30	6.25	CNY		1.2%
USD/KRW	1119	1125	1125	1110	1100	KRW		4.6%
USD/TRY	1.79	1.80	1.75	1.75	1.70	TRY		11.7%

Equities	Current	YTD Return (local ccy)
S&P	1464	18.0%
Nasdaq	3190	22.6%
Topix	756	4.8%
FTSE 100	5853	8.4%
MSCI Eurozone*	147	16.2%
MSCI Europe*	1122	13.3%
MSCI EM \$*	998	11.8%
Brazil Bovespa	61971	9.3%
Hang Seng	20735	14.9%
Shanghai SE	2027	-7.9%

*Levels/returns as of Sep 20, 2012

Local currency except MSCI EM \$

Source: J.P. Morgan

Sector Allocation *	US	Europe	Japan	EM
	YTD	YTD	YTD	YTD (\$)
Energy	9.0%	1.6%	-4.6%	6.1%
Materials	14.4%	11.8%	-6.3%	5.4%
Industrials	12.7%	15.5%	1.1%	10.8%
Discretionary	23.4%	22.3%	9.1%	10.5%
Staples	13.6%	14.0%	12.5%	14.7%
Healthcare	17.5%	15.3%	10.8%	24.4%
Financials	23.9%	20.1%	22.9%	14.5%
Information Tech.	24.6%	14.9%	-3.6%	19.9%
Telecommunications	26.6%	1.8%	9.2%	12.5%
Utilities	3.1%	9.7%	-20.0%	4.1%
Overall	18.0%	13.3%	4.8%	11.8%

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	2.0 ↓	1.7 ↓
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	2.9 ↑	3.7	2.9	2.2 ↑	4.5	4.0	3.3 ↓	3.6 ↓	3.9	7.2	6.0	6.3	7.2
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	5.4	5.5
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	4.3 ↑	4.5	0.9 ↓	6.7 ↑	2.8 ↓	3.8 ↑	4.2 ↓	5.5 ↓	5.5 ↓	3.9	3.4	3.1	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	3.9	3.6	4.9	3.5	3.5	3.5	4.0	3.2	3.3	3.5	3.9	4.4	4.1
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	11.8 ↑	2.1 ↑	9.0 ↓	-9.0 ↑	12.0 ↓	7.0 ↑	9.0 ↓	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	2.0	0.6	5.3	0.7	-2.0	0.0	1.0	1.2	1.3	-0.3	0.2	0.0	-0.2
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	2.6 ↑	2.9 ↑	4.1 ↓	2.3 ↑	1.5 ↓	3.5 ↑	3.7 ↑	3.3 ↓	2.0 ↓	1.8	1.0 ↓	1.7 ↓	1.8 ↓
Asia ex Japan	7.4	6.1	6.5	7.2	5.7	5.5	6.4	6.6	6.9	7.1	4.9	3.9	3.5	3.9
China	9.3	7.6	8.3	6.5	6.7	7.4	8.5	8.5	8.7	8.7	4.6	2.9	2.5	3.5
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	4.6 ↓	3.0	3.1 ↓	3.1 ↑	3.4 ↑	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	0.3 ↑	-0.1	-0.7	-1.0	-0.5	0.8 ↑	0.8 ↑	1.3 ↑	2.9	2.5	2.5	1.9
Germany	3.1	1.0	1.3 ↑	2.0	1.1	0.3	0.5	1.5	1.8 ↑	2.0 ↑	2.6	2.1	2.1 ↑	1.8 ↑
France	1.7	0.1	0.7 ↑	0.1	-0.2	-0.3	0.0	0.8	1.3 ↑	1.5 ↑	2.6	2.3	2.1 ↓	1.5 ↓
Italy	0.5	-2.5 ↓	-0.7 ↑	-3.3	-3.3 ↓	-2.5	-1.5	-0.3 ↑	0.0 ↑	0.5 ↑	3.7	3.6	3.1 ↓	2.2 ↓
Spain	0.4	-1.4 ↑	-0.5 ↑	-1.3	-1.7	-2.5 ↑	-2.0	0.0 ↑	1.0 ↑	1.0 ↑	2.7	1.9	3.3 ↑	2.7 ↑
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	5.9	5.9
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	4.7	6.4
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	2.4	2.6	3.0	1.9 ↑	1.8	2.3	2.7	3.0 ↑	3.2	3.8	2.8	2.8 ↓	2.8 ↓
Developed markets	1.3	1.2	1.2	1.7	0.6	0.2	0.8	1.3 ↑	1.6 ↑	1.9 ↑	2.7	1.8	1.9 ↓	1.6 ↓
Emerging markets	6.1	4.7	5.2	5.3	4.2 ↑	4.6	5.1	5.3	5.5	5.8	5.7	4.6	4.5	5.0

Source: J.P. Morgan

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