From: US GIO <[redacted]>
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Global Asset Allocation
05 October 2012

The [redacted]. Morgan View

What do you buy your children?

- **Asset allocation** — A long-term portfolio, for you or your children, should concentrate on value. This means large holdings of equities, especially value stocks, small caps and EM, combined with BB/BBB rated debt of corporates and sovereigns, plus smaller holdings of gold, crude, and undervalued currencies.
- **Economics** — Rise in Global PMIs, and in particular order-to-inventory ratios, are the first signal that growth rebound is coming, even as Q4 will likely remain well below potential.
- **Fixed Income** — Hold spread compression trades, and longs in UK breakevens.
- **Equities** — Re-enter overweight in Cyclical sectors.
- **Credit** — Short-dated corporates around the investment-grade boundary offer the most attractive carry-to-risk, particularly European BBs.
- **Currencies** — Keep limited short USD positions.
- **Commodities** — We are long gold and base metals and short agriculture.

- **Credit and equity markets continue to rally, with only minimal damage to bond markets.** The rise in Global PMIs, both manufacturing and services, combined with better US jobs data, are giving greater confidence that world growth has bottomed and is set to rebound into Q4. Even with a rebound this quarter, the world economy is set to expand at a well below-par growth pace through the middle of next year. This should keep corporate earnings with little or no growth this quarter. As such, we do not expect much support for risk markets from economic or earnings releases over coming months, aside from reducing downside risk perceptions.
- Our investment strategy remains instead based on **medium-term value**, which means to us still high risk premia on equities and credit, in the presence of falling market volatility and steadily improving familiarity with, if not fading concerns about, the world's main event risks. Worries about the US fiscal cliff have not gone away and the Middle East remains on edge. But the coming leadership change in China is raising hopes of new stimulus measures, while the ECB planned OMTs have bought euro sovereigns some breathing space.
- We thus **remain comfortably long equities and credit** versus government debt and cash, focusing on the higher-yielding credit sectors. Globally, we continue to like carry strategies in FX and fixed income. This week's *GMOS* has our full set of recommendations. The criticism is raised frequently that massive liquidity injections are creating new asset prices. Bubbles are historically characterized by easy money, leverage and hugely overvalued markets. Money is surely super easy, but equity and risk premia are above historic means and surely above where they were at this point in past business cycles. In addition, there is little evidence of financial leverage, except for central banks, but these have no problems with liquidity.

See page 7 for analyst certification and important disclosures.

Global Asset Allocation

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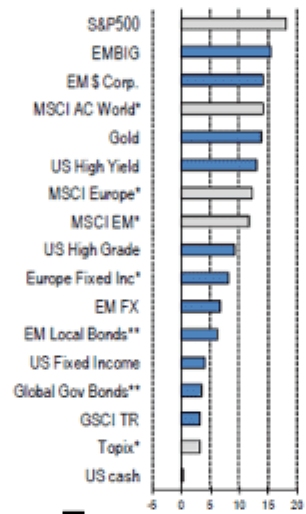
YTD returns through Oct 4
%, equities are in lighter color.



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