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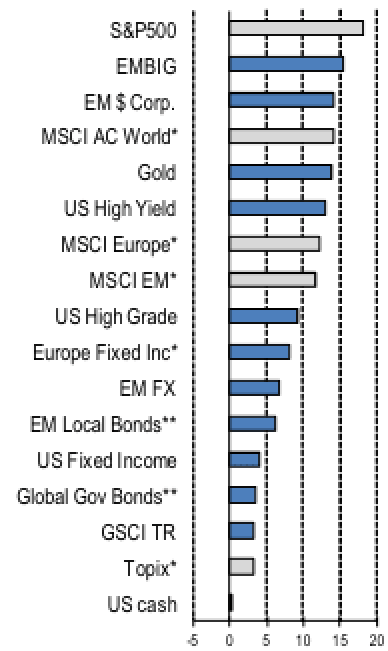
YTD returns through Oct 4
%, equities are in lighter color.



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

[redacted]

- Our regular readers will have noticed that we have become a lot **more appreciative of value** in asset allocation and less reliant on price and economic momentum, which have been the mainstay of our strategy in the past. This is both because momentum is not performing as well any more as a market signal and because valuation reached new extremes in the cycle, which gives it greater potency. The chart to the right shows the clean mean reversion in our measure of the US risk return trade off slope, and how this signals that risk premia will continue to come down in coming years.

- The impact of value on investment decisions grows with the horizon over which one intends to hold a portfolio. In this context, many of you have asked **what we would hold in a retirement fund, for ourselves, or our children**. Even over the next 20 years, your entry points matter, so you should start with undervalued assets. You should focus on assets that produce good time diversification. That is, real assets, such as equities and real estate, that may have high short-term volatility, but that mean-revert well over time. Nominal assets, such as bonds, do not time-diversify as well. Over this horizon, we see more risk of inflation rising than deflation taking hold. Hence, we like inflation hedges in a portfolio, such as gold and oil, on top of equities.

- Using round numbers, your long-term portfolio should hold some 75% in equities. Stock holdings should be concentrated on global Value, small caps, high-dividends, and EM, as each has shown superior long-term performance. Our normal preference is to allocate to passive funds, but in each of these categories, there is evidence that active managers can outperform. Outside of stocks, we like gold (inflation hedge), oil (commodity super cycle, if not peak oil), BB/BBB rated corporate debt, as well as EM local and external sovereign debt. Put some money in the world's most undervalued currencies, largely Asian EM.

Fixed income

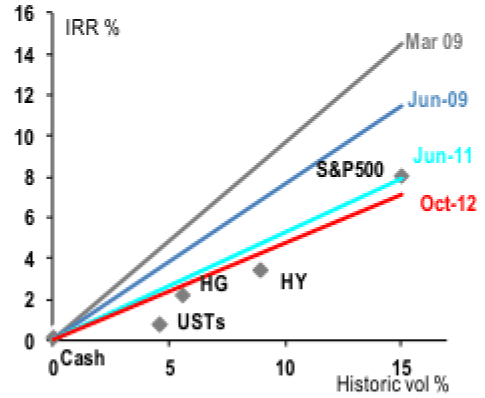
- **Today's encouraging payroll print jolted government yields higher**, after a week of remarkable stability. We remain broadly neutral on duration, while expecting higher US Treasury yields over the balance of the year. We focus instead on spread compression trades, including continued overweights in US MBS, and underweighting Germany within the EMU core.

- In a paper this week, we described a set of **simple systematic rules for trading duration**, as a complement to more qualitative and discretionary approaches (see *Investment Strategies No. 74: Simple rules to trade duration*). These rules seek to capture a range of influences of yields, including economic news, investor perceptions of risk, and carry. Combining a range of diverse signals in this way yields a substantial diversification benefit, and this approach would have garnered a return to risk of 1.1 in G-4 10-year bond futures since 1990. For this month, the strategy suggests a small duration short.

- We continue to think that **UK inflation breakevens are too low**. They have fallen because of expectations of significant changes in the coming months to the way the RPI measure of UK inflation is calculated. We think the reaction to these prospective changes is overdone, and recommend longs in 10-year UK breakevens. An attractive feature of this position is that its key near term risk factor (the decision on the methodology for RPI) is essentially uncorrelated with the broader market. See this week's *Monthly Inflation Outlook* (Diamond et al) for details.

US risk-return trade-off lines

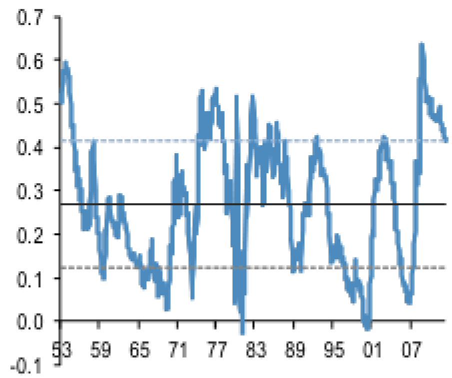
2009-2012, 30-year return volatility on horizontal axis. IRR on vertical axis. IRR is yields for cash and USTs; yield minus long-term default losses for credit; earnings yield plus inflation for equities.



Source: [redacted]. Morgan

Slope of US risk-return trade-off line

The line shows the slope of the US risk-return trade-off line lines shown in the chart above. It excludes US HY as it only exists since 1987.



Source: [redacted]. 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 Srini 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:

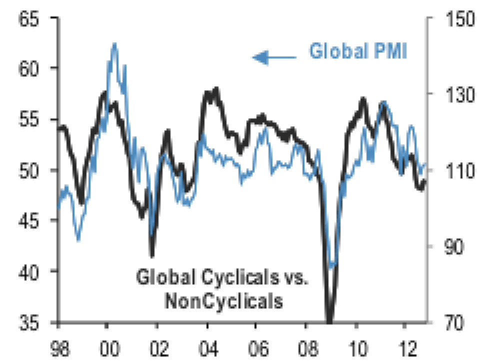
Returns in USD. *Local currency. **Hedged into USD. Euro Fixed Income is iBoxx Overall Index. US HG, HY, EMBIG and EM $ Corp are JPM indices. EM FX is ELMI+ in $.

Equities

- Equities are up on the week and back to last month's highs. September represented the fourth straight month of equity gains, pushing the MSCI AC World index up by15% from its June low.
- Macro data, PMIs and US payrolls were the main drivers of this week's gains. The rebound in the global manufacturing PMI is inducing us to re-enter our Cyclical vs. Defensive equity sector overweight. At the same time, our economists are seeing a constructive constellation of forward-looking indicators, with an encouraging move up in new orders and a sharp move down in the inventory component. Such constructive moves have typically pointed to the beginning of a rebound in industrial output. The chart to the right shows that Cyclical sectors have recaptured only a quarter of the underperformance seen between March and August. So we see a lot of room for Cyclicals to outperform Defensives.
- We exit our EM equity underweight vs. DM equities. Although macro indicators still favor DM over EM equities, market participants appear to be increasingly focusing on the hope that the Chinese leadership in November will be accompanied by stimulus. We are skeptical, but admit that momentum has turned in favor of EM equities and thus prefer to close this trade.
- The US earnings reporting season that kicks off next week should be mildly positive. A 2% pace in global GDP growth for Q3 is not enough to change the pattern of stagnation seen in S&P500 EPS since Q3 2011. We thus look for a Q3 EPS of around $25.6, similar to the first half of this year and unchanged from Q3 2011. The bottom up analyst forecast is $25.1, so such an outturn would represent a small positive surprise.

Cyclical vs. Defensive equity sectors

Relative return index



Source: [redacted]. Morgan

Credit

- **Spreads tightened this week,** as the PMIs set a positive tone for subsequent data releases, including today's US payroll numbers which were well received by risk markets. But the extent to which improvements in the labor market are credit positive depends on the unemployment thresholds that the Fed ultimately uses to justify more or less QE down the line. Whilst yesterday's FOMC meeting didn't give much clarity in that direction, there was an extended discussion on the merits and challenges of doing so at least. See Michael Feroli, *Next stop: Evans rule* for more details.
- **We outlined our tactical calls in *GMOS* this week**. Our top-down thinking remains broadly the same, with central bank liquidity the overarching theme in credit markets. We continue the focus on carry, looking to earn the highest risk-premia per unit of vol and find the most value in shorter dated corporates around the investment-grade boundary on this metric. **Particularly in European BB rated corporates** now that OMT has significantly diminished tail-risk in the periphery.

Foreign Exchange

- Following a September when systemic issues such as ECB and Fed policy dominated global markets, October is delivering currency moves much more aligned with country specifics. The two worst-performing currencies so far have been ZAR (-4%) and AUD (-1.2%) on a mining strike and a surprise rate cut, respectively. Amongst the best have been PLN (+3%), INR (+2%) and EUR (+1.5%) on less-dovish central banks or reform initiatives. Correlations amongst USD pairs have remained at slightly below-average levels,

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.

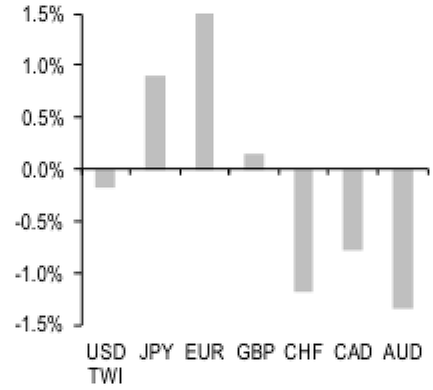
Emerging Markets Cross Product Strategy Weekly, Eric Beinstein et al.

confirming the more idiosyncratic nature of markets in the ECB/Fed's wake.

- With any luck, the country emphasis will persist, since currency managers seem to deliver higher returns in this sort of environment than one ruled by systemic issues for the obvious reason that decorrelated markets provide more opportunities for diversification. Unfortunately the next two to three weeks will probably deliver a return to global issues. Stocks face a key hurdle with the Q3 earnings season, and commodity currencies another test with China's monthly data deluge. Keep limited short USD positions.

- [redacted]. Morgan's China team has downgraded their growth forecasts for 2012 and 2013 to 7.6% and 8%, respectively. For commodity currencies, every point counts: every 1% change in Chinese real GDP growth drives a 4%-5% change in commodity currencies, so recent range in AUD/USD (1.02-1.06) and NZD/USD (0.79-0.83) would break to the downside if China's slowdown persists. The key release will be China's Q3 GDP due October 18. Next week delivers only money supply and trade, which are too narrow to sway opinions dramatically on the commodity currencies. The window for commodity currency strength may be closing ahead of the GDP release and in the run-up to the US fiscal ramp, but for the next week, we remain short USD/CAD in options and long NZD/USD in cash. Also sell EUR/NOK puts on a view that commodity currency strength will be limited this year.

FX weekly change in USD



Source: [redacted]. Morgan

Commodities

- **Commodities are flat this week,** with gains for precious metals offsetting a fall in agriculture, while energy and base metals were flat. In our *GMOS* model portfolio, published on Wednesday, we closed our long in energy on the basis that production by the Saudis is more than offsetting lost Iranian exports, and as far as we can tell, the probability of a military conflict between Iran and Israel this year has declined materially. **We maintain our long Brent time spread** as a hedge to this risk. We remain **short agriculture** on the argument that the harvest in the US for key grains is essentially over so falling uncertainty around the harvest combined with higher plantings due to the current very high prices should steadily push prices lower.

- Further central bank balance sheet expansion coupled with increased tolerance of higher inflation should support gold. Additionally, in this analyst's view, **a longer term very important driver of gold is uncertainty around inflation, rather than any specific level of inflation.** Two measures of this, the standard deviation of realized inflation and the dispersion of economist forecasts of inflation are at historically high levels (see *GMOS: Commodity Strategy*, 3 Oct). **We stay long gold. We also open a long in base metals** on the view that the global economy is starting to rebound and that the China leadership change early next month will likely bring stimulus.

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.

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J.P.Morgan

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	1.71	2.00	2.00	2.00	2.25	2.1%
Euro area	Refi rate	0.75	0.50	0.50	0.50	0.50	
	10-year yields	1.52	1.50	1.50	1.60	1.70	3.2%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	1.77	1.65	1.65	1.80	1.95	3.0%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.78	0.90	0.90	0.95	1.00	1.9%
GBI-EM hedged in $	Yield - Global Diversified	5.82	6.00				6.1%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	165	JPMorgan JULI Porfolio Spread to Treasury	9.2%
Euro high grade (bp over Euro gov)	193	iBoxx Euro Corporate Index	8.3%
USD high yield (bp vs. UST)	576	JPMorgan Global High Yield Index STW	12.6%
Euro high yield (bp over Euro gov)	764	iBoxx Euro HY Index	18.9%
EMBIG (bp vs. UST)	287	EMBI Global	15.5%
EM Corporates (bp vs. UST)	348	JPM EM Corporates (CEMBI)	14.1%

		Quarterly Averages					
Commodities	Current	12Q4	13Q1	13Q2	13Q3	GSCI Index	YTD Return*
Brent ($/bbl)	111	105	112	105	120	Energy	-1.0%
Gold ($/oz)	1782	1725	1750	1775		Precious Metals	12.2%
Copper ($/metric ton)	8296	8300	8500	8700		Industrial Metals	5.1%
Corn ($/Bu)	7.51	8.75	8.50	8.25		Agriculture	17.3%

Foreign Exchange	Current	Dec-12	Mar-13	Jun-13	Sep-13	3m cash index	YTD Return* in USD
EUR/USD	1.30	1.30	1.30	1.32	1.34	EUR	1.3%
USD/JPY	78.7	78	79	79	79	JPY	1.7%
GBP/USD	1.62	1.62	1.62	1.63	1.65	GBP	5.3%
USD/BRL	2.03	1.98	1.95	1.95	1.95	BRL	-1.9%
USD/CNY	6.32	6.32	6.32	6.30	6.25	CNY	1.7%
USD/KRW	1111	1125	1125	1110	1100	KRW	5.5%
USD/TRY	1.80	1.80	1.75	1.75	1.70	TRY	11.8%

Equities[redacted]	Current	YTD Return (local ccy)
S&P	1466	18.2%
Nasdaq	3152	21.4%
Topix	737	3.3%
FTSE 100	5871	8.8%
MSCI Eurozone*	144	14.3%
MSCI Europe*	1112	12.3%
MSCI EM $*	1006	12.7%
Brazil Bovespa	59181	4.0%
Hang Seng	21012	18.0%
Shanghai SE	2086	#DIV/0!

*Levels/returns as of Oct 04, 2012

Local currency except MSCI EM $

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD ($)
Energy	8.1%	-0.5%	-4.3%	5.1%
Materials	12.6%	8.2%	-11.8%	3.5%
Industrials	12.7%	**14.7%**	-1.3%	11.4%
Discretionary	**23.1%**	**21.0%**	**4.9%**	12.4%
Staples	14.4%	**14.2%**	**14.1%**	**18.3%**
Healthcare	**20.7%**	**17.4%**	**10.4%**	**28.1%**
Financials	**25.4%**	**19.3%**	**22.1%**	**15.2%**
Information Tech.	**22.4%**	11.9%	-5.8%	**23.1%**
Telecommunications	**28.1%**	0.4%	**9.9%**	**13.4%**
Utilities	5.5%	8.1%	-15.9%	5.9%
Overall	**18.2%**	**12.3%**	**3.3%**	**12.7%**

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Global Economic Outlook Summary

	Real GDP % over a year ago			Real GDP % over previous period, saar							Consumer prices % over a year ago			
	2011	2012	2013	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q11	2Q12	4Q12	2Q13
The Americas														
United States	1.8	2.1	1.9	2.0	1.3	1.5	2.0	1.5	2.3	2.5	3.3	1.9	2.0	1.7
Canada	**2.6** ↑	**2.2** ↑	2.1	1.8	**1.9** ↑	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	2.7	2.3	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	2.4	-3.2	8.0	6.0	0.0	1.5	0.5	9.6	9.9	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	**6.4** ↓	7.2	5.7	5.5	**6.3** ↓	**6.4** ↓	**6.5** ↓	**6.8** ↓	4.9	3.9	**3.3** ↓	**3.8** ↓
China	9.3	7.6	**8.0** ↓	6.5	6.7	7.4	**8.2** ↓	**8.0** ↓	**8.2** ↓	**8.2** ↓	4.6	2.9	**2.2** ↓	**3.3** ↓
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	3.0
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	10.0	-0.7	-1.6	8.2	6.1	-1.2	4.5	5.5	5.3	4.1	3.3
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	**2.1** ↓	3.0	2.7	3.2	**0.3** ↓	**-1.2** ↓	**5.9** ↑	**3.8** ↑	3.6	6.1	5.7	**5.3** ↓	**5.4** ↓
Europe														
Euro area	1.5	-0.5	0.3	**0.0** ↑	-0.7	-1.0	-0.5	0.8	0.8	1.3	2.9	2.5	2.5	2.0
Germany	3.1	1.0	**1.5** ↑	2.0	1.1	0.3	**1.0** ↑	1.5	**2.0** ↑	**2.5** ↑	2.6	2.1	2.1	1.8
France	1.7	0.1	**0.1** ↓	0.1	-0.1	**-0.5** ↓	**-0.5** ↓	**0.0** ↓	**0.5** ↓	**1.0** ↓	2.6	2.3	2.1	1.5
Italy	0.5	-2.5	**-0.6** ↑	-3.3	-3.3	-2.5	-1.5	**0.0** ↑	**0.3** ↑	**0.8** ↑	3.7	3.6	3.1	2.2
Spain	0.4	**-1.5** ↓	**-1.2** ↓	-1.3	-1.7	**-2.0** ↑	**-4.0** ↓	**-1.0** ↓	**0.5** ↓	**0.5** ↓	2.7	1.9	3.3	2.7
United Kingdom	0.9	-0.3	1.5	-1.2	-1.5	2.0	0.5	1.5	2.0	2.5	4.6	2.8	2.7	2.6
Emerging Europe	4.8	2.7	2.7	2.4	1.3	1.2	2.1	2.8	2.5	3.8	6.4	5.0	6.1	**6.2** ↑
Bulgaria	1.7	1.0	**1.5** ↓	...	...	...	...	...	...	...	...	...	...	...
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	0.7	-3.5	-0.9	-1.0	-0.5	1.0	1.5	1.8	4.1	5.5	5.9	5.0
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	**0.5** ↓	**1.9** ↓	-1.0	0.8	1.2	-0.4	3.2	3.4	1.9	4.7	6.4
Russia	4.3	3.6	3.0	3.7	1.5	1.8	3.0	3.5	3.0	4.0	6.8	3.9	6.7	7.4
Turkey	8.5	2.8	3.7	...	...	...	...	...	...	...	9.2	9.4	**7.7** ↑	**6.9** ↑
Global	3.0	2.4	2.6	3.0	1.8	1.7	2.3	2.7	2.9	**3.2** ↓	3.8	2.8	**2.8** ↓	**2.8** ↓
Developed markets	1.3	1.2	1.2	1.7	0.4	0.2	0.8	1.3	1.6	1.9	2.7	1.8	1.9	1.6
Emerging markets	6.1	4.7	5.1	5.3	4.2	4.5	**5.0** ↓	**5.1** ↓	**5.2** ↓	**5.6** ↓	5.7	4.6	**4.5** ↓	5.0

Source: [redacted]. Morgan

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