J.P.Morgan

Global Asset Allocation
Oct 9, 2009

The J.P. Morgan View

New investment themes

- **Portfolio strategy** — The recovery trade is becoming consensus and should lose its power to drive markets at some point. We thus diversify through 8 new investment themes for the coming year. In aggregate, they are also long equities and credit, and short the USD.
- **Economics** — The foundations of the recovery are in place, even as risks are clearly there
- **Fixed Income** — Range trading. Focus on carry and spreads.
- **Equities** — Financials should benefit most from Q3 reporting season. Be long outright and versus other sectors.
- **Credit** — We stay overweight US HG given the exceptionally strong demand
- **FX** — No urgency to exit the dollar short.
- **Alternatives** — Stay short WTI. Be long agricultural products, particularly sugar and cocoa.

- Equities, credit and commodities are up this week, while the dollar and government bonds are down. Straight from **central casting for the recovery trade**. We stay with the recovery trade, but know we should not make it the sole idea on which to build an investment strategy for the coming 6 months. It is not that the data cast great doubt on the recovery, but more that it is **in the process of becoming consensus** and thus losing its power to drive asset prices. This week's economic data were supportive to our global growth forecasts, but the sum total of the past few weeks was not far from consensus. Our 6-week rolling US Economic Activity Surprise Index actually slipped below zero this week. And we were forced to lower our UK Q3 growth forecast. Hence the need to **diversify beyond the recovery trade.**

- We discussed **eight broad investment themes** for the next 6-12 months yesterday in our monthly *Global Markets Outlook and Strategy* (pp. 6-10). Here follows a brief summary of these forces and their respective impacts on markets.

- **Asset reflation**: Cash is the most expensive asset in the world, and the main reason to hold it, which is uncertainty, is fading. The flow out of cash is lifting all other asset prices in the world. This will end only when G3 central banks start hiking or investors have become underweight cash. We are far from these.

- **G3 disinflation.** A massive output gap will push core inflation rates down in the US, Japan and Europe. This keeps G3 central banks on hold through next year. Long-term inflation expectations should fall, supporting bonds, flattening curves, but depressing commodities. This is not a negative to equities as we expect profit margins to be maintained.

The certifying analyst is indicated by an AC. See page 7 for analyst certification and important legal and regulatory disclosures.

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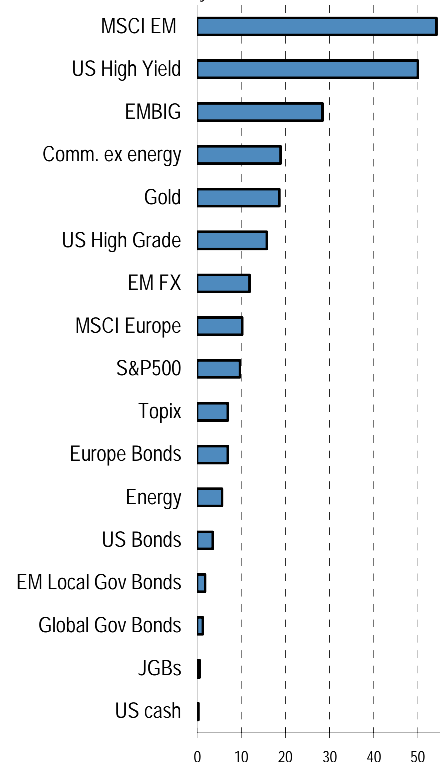
YTD returns through Oct 8
% in local currency



Source: J.P. Morgan, Bloomberg. Global Bonds is JPM GBI hedged into $, EM Local Bonds is GBI-EM unhedged in $, US Bonds is the Barclays aggregate, Europe Bonds is JPM Maggie, JGBs is JPM GBI - Japan local currency, EM FX is JPM ELMI+ in $, US HG is JPM JULI index. Energy is JPMCCI Energy TR index, Comm. ex Energy is JPMCCI ex Energy TR index, Gold is JPMCCI Gold TR index.

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- **Policy normalization outside the G3.** Economies on the global periphery are closer to full capacity, and are thus likely to normalize monetary policy rates earlier. Think of **Australia, Korea, Czech, Norway, and Brazil**. This will benefit their currencies, but hurt their bond markets. It should be neutral for their stock markets.

- **The new EM trade**. Emerging economies are exiting the crisis relatively unscathed and with an improved economic, financial and fiscal position versus developed economies. This means medium-term ourperformance of their equities, currencies and credit. Near term, it makes their local debt likely to underperform, except for the highest-yielding markets that should benefit from the search for yield. With much of the EM growth impetus emanating from commodity-hungry China, this should be bullish commodities.

- **Banking revival**. Markets are returning rapidly to normal and so are bank profits. Bank losses are not over, but we feel that we are about 3/4rs through total cycle losses, with the remainder spread over the next five years. The main threat to bank earnings will eventually come from higher capital requirements. These will dilute bank earnings, but make bank debt even safer. They suggest overweighting banks debt, but underweighting bank stocks. The latter is probably somewhat premature as governments will take at least a year to decide how much these ratios should go up and will not impose them before 2011.

- **Carry and the search for yield.** The steady fall in volatility, inflation risks and yield levels are forcing institutional investors — in particular insurers and banks — to move out along the risk return trade off line in search of higher yields. Many insurers are in dire need of fixed income products with higher yields as they have a lot of liabilities that promise minimum payouts. This search for yield and carry is bullish for bonds and credit, and flattens yield curves in our view. It would be a negative for the USD against better-yielding currencies, which are largely in EM.

- **Death of the equity culture?** Disappointing long-term equity returns, aging, and falling wealth are inducing US and European investors to depend less on equities as the mainstay of their retirement savings. Are they becoming like Japanese savers? Possibly, but there is one major force standing in the way of increased reliance on bonds to fund retirements: Yields on global bonds have fallen below 3%, requiring a massive increase in savings rates in order to meet pension needs solely with bonds (see chart on right). We believe that ultimately the low value of bonds will trump the fear of equities and entice end investors back into stocks to fund their pensions.

- **Fortress balance sheets and delevering.** Repairing balance sheets by improving liquidity, and making greater use of equity and long-dated debt funding will be with us for years. It implies continued high issuance of equity and long-dated debt. At this moment, this neatly matches the desire by investors to move out of low-return cash holdings, thus preventing a significant steepening of yield curves, or losses on equities. Longer out, it implies that the risk premium of bonds and equities over cash will stay higher than it has been over the past decades.

Source: J.P. Morgan. US EASI is defined as the net balance of positive activity surprises over the past 6 weeks divided by the total number of releases over the period.

Source: J.P. Morgan, BarCap, Datastream. The reported yield is the yield of the BarCap Global Aggregate index.

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 and Grace Koo

The economy

- **A sustained upward trajectory in global growth momentum appears to have been broken in September.** Our global manufacturing PMI survey stalled last month and the new orders index moved lower, following solid increases in both in each previous month this year. Global car sales also look to have begun a correction last month after having rocketed up 33% this year to a new record high. And the move towards stability in US labor markets was rudely interrupted by the September employment reports.

- While disappointing, **these developments do not point to a near-term weakening in growth.** Our PMI survey along with a wide range of releases indicates that global IP and GDP gains will likely remain strong into year end. What's more, there is every reason to expect a bumpy pattern of data releases to emerge in an environment in which rates of growth accelerated sharply around midyear and are now expected to level off. We thus maintain our view that **a foundation for a sustained global recovery is intact.** Nonetheless, not all the pillars are in place and the latest news provides reason to recognize the downside risk.

Fixed income

- **Government bonds backed up this week, getting back towards the middle of its 5-month trading range.** Slightly better data this week, and a nervous reaction to the latest Bernanke speech contributed to today's sell-off. Both supply and demand for bonds are at record highs, but are keeping each other in rough balance at the moment. We this continue to play the range, and focus exposures on earning carry and outperformance of higher-yielding bonds.

Equities

- Equities rebounded sharply this week, erasing the losses of the previous two weeks. The rebound was driven by a strong start in the **Q3 US reporting season**. 81% of the 31 S&P 500 companies having reported so far have beaten estimates. The average EPS beat was 18%.

- We project a Q3 EPS of $16.30 for the S&P500, 10% above the bottom-up consensus of $14.82. This will represent the third consecutive quarter of positive surprises. We are **most bullish on Financials** (beat by 25%) and Cyclicals (beat by 10%).

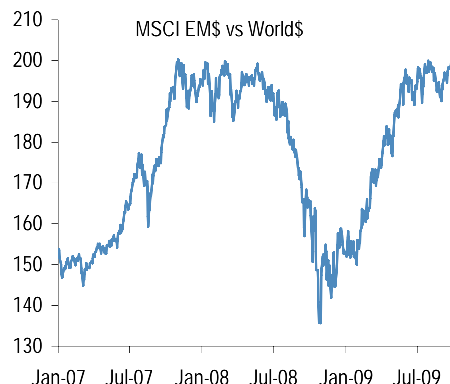
- All eyes will be on the **top line**. Q2 bottom-line earnings surprised on the upside, but top-line revenues came in slightly below consensus. The market is now looking for signs that not only cost-cutting but also revenues are driving the profit recovery. We project that top line will beat by 1% in Q3 for the S&P500, led by Financials (5%), Energy (5%-10%), and Technology (1%).

- **Pre-announcements** are also supportive of a positive surprise in Q3. Q3 saw the highest level of positive pre-announcements since 2006. Meanwhile, negative pre-announcements are at the lowest level in 10 years.

- Q3 results should validate a trajectory toward our 2010 $75 EPS. The $75 EPS forecast for 2010 would only match the 2002 expansion. Cost-cutting by corporates this cycle was 20% greater than in 2002, and we expect a stronger GDP recovery than that seen after the 1991 and 2001 recessions. For more details, see 3*Q09 Preview: The Bar Is Higher*, Tom Lee, Oct 8.

EM vs DM equities

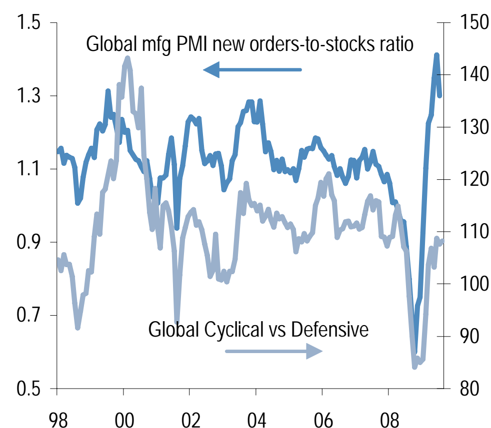
Relative total return index on y-axis using MSCI World$ and MSCI EM$ indices



Source: Datastream, J.P. Morgan

Global PMI new orders-to-stocks ratio

LHS is the new orders-to-stocks ratio and RHS is the excess return index of global cyclical vs defensive



Source: Datastream, J.P. Morgan

More details in ...

EM Corporate Outlook and Strategy, Victoria Miles et al.

US Credit Markets Outlook and Strategy, Eric Beinstein et al.

High Yield Credit Markets Weekly, Peter Acciavatti et al.

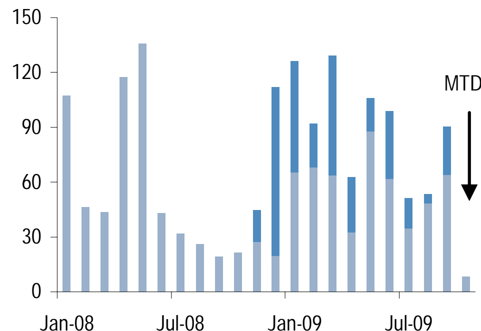
European Credit Outlook & Strategy, Steven Dulake et al.

Credit

- **Retail demand of HG bonds has accelerated further**. The current 4-week average inflow into US HG bond funds reached more than $5bn per week , the strongest since data are available in 1992. Stay overweight US HG.

- Higher rated CMBS should continue to gain over the next 6 months. We stay **overweight super senior CMBS**. Thus far, $3bn of PPIP investment funds has been raised from private investors, which creates $12bn of purchasing power. We expect PPIP funds to start investing this month, restarting the tightening trend.

US gross issuance
$bn, Gov't. guaranteed issues are in dark blue



Source: J.P. Morgan

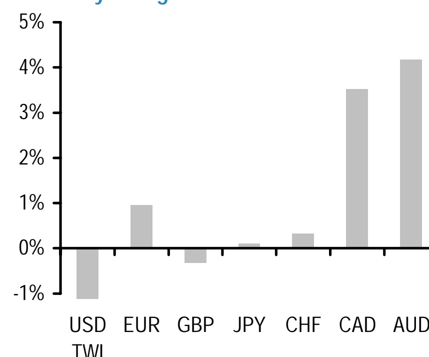
Foreign Exchange

- Despite the impressiveness of earnings, the sense that markets are over-shooting is as prevalent in FX as it is in equities and credit. But just as record returns since March do not make stocks or credit expensive, neither do record runs in most currency pairs. Based on regressions of currencies on cyclical drivers such as rates spreads and commodity prices, several currencies are at least 5% misaligned. Those trading at least 5% too strong are **NZD**/USD (12%), **AUD**/USD (6%) and **EUR/GBP** (5%). Those trading at least 5% too weak are **USD/JPY** (-6%) and **GBP/USD** (-5.4%). Given the standard error of the models, only NZD/USD and USD/JPY are meaningfully misaligned. And counter to the conventional view, EUR/USD is not very stretched even at current levels (only 3% rich on the two-year regression), and EUR/NOK sits at fair value even after a 9% collapse in Q3.

- Of course valuations only matter when fundamentals change, which is economists' perversion of Newton's Law – objects stay in motion until acted upon by another force. Reversals in commodity currencies were prompted by external shocks or policy shifts such as the 120bp sell-off in US Treasuries in spring 2004 in anticipation of Fed tightening; the subsequent lift in Fed funds from 1% to 5.25% from 2004 to 2006; the onset of the credit crisis in 2007; and the initiation of RBA/RBNZ easing cycles in 2008.

- Given that such event risks are unlikely this year, there is **little urgency to reduce dollar shorts.** Stay long cyclical currencies and short the dollar, but be discriminating. Add short USD/CAD and GBP/CAD to existing shorts in USD/JPY, NZD/NOK, EUR/NOK and GBP/NOK. Stay long EUR/GBP and NOK/SEK.

FX weekly change vs USD



Source: J.P. Morgan

Alternatives

- **Commodities** rallied this week, with industrial metals gaining almost 7%. We maintain an overall neutral allocation. Our tactical short in WTI is offset by long positions in base metals and now in agricultural products, particularly sugar and cocoa. Disinflation risk is a negative for the asset class; investor/hedger's interest in inflation protection is likely to go down. The global recovery will, however, limit near-term downside.

- **Hedge funds continue to perform well.** The major indices suggest they made 2.8% last month. Emerging Markets, Distressed, Convertible Arb and Equity Long-Short performed best. The latter three are our top picks for the remainder of the year. Last month, we upgraded Distressed Securities to overweight after almost two years of underweight or neutral recommendations. HY market fundamentals continue to improve, particularly in the US. We expect the US HY default rate to collapse to 4% in 2010.

More details in ...

Alternative Investments Outlook and Strategy

FX Markets Weekly, John Normand *et al.*

Energy Monthly, Lawrence Eagles et al.

Metals Review and Outlook, Michael Jansen

Global Metals Quarterly, Michael Jansen

Grains & Oilseeds Monthly, Lewis Hagedorn

Interest rates		Current	Dec-09	Mar-10	Jun-10	Sep-10	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	3.37	3.50	3.75	4.00	4.25	-2.2%
Euro area	Refi rate	1.00	1.00	1.00	1.00	1.00	
	10-year yields	3.21	3.20	3.30	3.35	3.40	2.4%
United Kingdom	Repo rate	0.50	0.50	0.50	0.75	1.00	
	10-year yields	3.45	3.70	3.95	4.10	4.30	2.6%
Japan	Overnight call rate	0.10	0.10	0.10	0.10	0.10	
	10-year yields	1.28	1.45	1.40	1.30	1.40	0.6%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	206	JPMorgan US Index (JULI)	15.8%
US high grade (bp over swaps)	186		
Euro high grade all (bp over swaps)	112	JPMorgan Euro Credit Index (MAGGIE)	13.5%
USD high yield (bp vs. UST)	780	JPMorgan Global High Yield Index	50.0%
Euro high yield (bp over Euro gov)	814	JPMorgan Euro Credit Index (MAGGIE)	64.9%
EMBIG (bp vs. UST)	305	EMBI Global	28.4%

		Quarterly Averages					
Commodities	**Current**	**09Q4**	**10Q1**	**10Q2**	**10Q3**	**JPMCCI Index**	**YTD Return***
WTI ($/bbl)	71.4	70.0	70.0	65.0	70.0	Energy	5.6%
Gold ($/oz)	1048	1000	-	-	-	Precious Metals	18.6%
Copper ($/metric ton)	6312	5950	-	-	-	Industrial Metals	57.1%
Corn ($/Bu)	3.66	3.65	4.00	4.15	4.05	Agriculture	0.4%

Foreign Exchange	Current	Dec-09	Mar-10	Jun-10	Sep-10	3m cash index	YTD Return* in USD
EUR/USD	1.47	1.50	1.50	1.47	1.45	EUR	8.4%
USD/JPY	89.7	89	91	97	100	JPY	3.3%
GBP/USD	1.59	1.63	1.60	1.58	1.58	GBP	14.3%
AUD/USD	0.90	0.90	0.92	0.93	0.94	AUD	34.0%
USD/CAD	1.04	1.06	1.04	1.03	1.02	CAD	18.5%
NZD/USD	0.73	0.71	0.72	0.72	0.73	NZD	30.3%

Equities	Current	YTD Return (local ccy)
S&P	1068	18.2%
Topix	898	4.5%
FTSE 100	5162	16.4%
MSCI Eurozone*	158	26.2%
MSCI Europe*	1092	24.3%
DAX	5712	18.7%
CAC	3800	18.1%
MSCI EM*	40967	54.2%
MSCI EM $*	940	69.6%

*Levels/returns as of Oct 8, 2009

Sector Allocation *	US	YTD ($)	Europe	YTD ($)	Japan	YTD (¥)	EM	YTD ($)
Energy	OW	11.8%	UW	38.7%		13.7%	UW	81.0%
Materials	OW	40.7%	N	72.8%	N	19.8%	N	92.8%
Industrials	OW	14.5%	OW	46.3%	N	11.5%	N	55.6%
Discretionary	OW	31.2%	OW	35.0%	N	29.2%	OW	94.8%
Staples	UW	11.2%	UW	30.2%	UW	-9.4%	UW	9.5%
Healthcare	UW	9.3%	UW	16.1%	UW	-9.9%	UW	28.1%
Financials	OW	22.6%	N	57.7%	OW	-8.6%	OW	76.3%
Information Tech.	OW	46.6%	N	43.3%	N	10.4%	OW	84.8%
Telecommunications	N	-1.0%	OW	19.0%	N	-10.5%	UW	29.3%
Utilities	UW	3.6%	OW	11.0%	UW	-20.5%	UW	51.1%

Source: Bloomberg, Datastream, IBES, Standard & Poor's Services, J.P. Morgan estimates

Global Economic Outlook Summary

	Real GDP % over a year ago			Real GDP % over previous period, saar							Consumer prices % over a year ago			
	2008	2009	2010	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	2Q09	4Q09	2Q10	4Q10
The Americas														
United States	0.4	-2.4	3.2	-6.4	-0.7	4.0	3.0	3.0	4.0	4.0	-0.9	1.2	2.0	0.9
Canada	0.4	-2.4	2.6	-6.1	-3.4	2.0	3.0	3.0	3.0	3.5	0.1	1.3	1.9	2.3
Latin America	3.8	-3.0	4.5	-10.0	0.8	7.7	4.1	5.2	4.9	3.8	6.7	5.4	6.2	6.5
Argentina	6.8	-4.5	2.5	0.2	1.1	-10.0	-4.0	12.0	10.0	6.0	5.5	6.0	10.0	10.2
Brazil	5.1	0.0	5.0	-3.8	7.8	6.5	5.0	4.3	5.0	4.0	5.2	4.2	4.5	4.7
Chile	3.2	-1.5	5.0	-3.0	-1.4	8.0	6.0	6.0	5.0	3.0	3.1	-1.5	2.0	3.0
Colombia	2.4	-0.5	3.0	1.1	2.7	1.9	3.2	3.5	4.3	5.5	4.8	3.3	3.9	4.3
Ecuador	6.5	-1.0	1.5	-5.1	-1.0	-2.0	0.0	2.0	2.5	4.0	5.5	3.5	2.4	4.0
Mexico	1.3	-6.5	5.0	-21.2	-4.4	15.5	5.0	5.0	4.0	3.0	6.0	4.0	3.3	3.5
Peru	9.8	1.0	5.4	-6.3	-1.6	8.0	13.0	3.0	3.5	3.5	4.0	1.1	1.5	2.0
Venezuela	4.8	-1.5	2.5	-7.3	-3.3	0.0	2.0	3.0	4.0	4.0	28.2	29.5	36.4	37.1
Asia/Pacific														
Japan	-0.7	-5.6	2.2	-12.4	2.3	3.0	2.5	2.5	1.5	1.5	-1.0	-2.0	-2.2	-1.5
Australia	2.4	1.0	2.9	1.6	2.5	1.2	3.8	2.1	2.4	4.4	1.5	1.5	1.9	2.6
New Zealand	0.1	-1.3	2.8	-3.0	0.3	2.5	2.1	2.6	4.3	3.4	1.9	1.8	1.6	1.7
Asia ex Japan	5.8	3.9	7.2	2.5	12.6	7.5	6.7	6.5	7.0	6.9	1.3	2.0	3.5	3.2
China	9.0	8.4	9.5	8.3	14.9	9.5	9.1	9.0	9.5	9.3	-1.5	0.9	3.2	2.7
Hong Kong	2.4	-2.6	5.3	-16.1	13.9	9.0	5.0	4.2	4.0	3.8	-0.1	-0.4	0.6	2.1
India	6.1	6.0	7.5	8.2	6.7	5.2	5.6	7.0	7.7	8.3	8.9	7.4	6.3	4.7
Indonesia	6.1	4.1	5.0	5.4	3.8	4.0	4.0	5.0	6.0	6.0	5.6	2.4	4.6	6.0
Korea	2.2	-0.8	4.0	0.5	11.0	4.0	3.5	3.5	3.5	3.5	2.8	2.5	3.0	3.3
Malaysia	4.6	-3.0	5.0	-17.7	12.8	6.1	4.5	1.6	4.9	4.9	1.3	-1.2	0.5	1.5
Philippines	3.8	1.5	5.0	-8.1	10.0	4.0	4.0	5.0	5.0	5.0	3.2	3.0	3.6	3.7
Singapore	1.1	-1.8	6.5	-12.2	20.7	14.8	2.0	4.0	5.3	6.1	-0.5	-0.8	1.9	1.8
Taiwan	0.1	-3.8	5.5	-10.2	20.7	9.5	8.0	3.0	3.0	2.0	-0.8	-1.0	1.8	2.1
Thailand	2.6	-3.1	6.1	-7.2	9.6	7.0	5.3	4.9	5.7	7.0	-2.8	1.4	4.6	4.0
Africa/Middle East														
Israel	4.0	0.0	3.0	-3.2	1.0	1.5	2.5	3.0	3.0	3.0	3.2	3.3	3.4	3.3
South Africa	3.1	-2.0	3.0	-6.4	-3.0	0.6	3.4	4.5	3.7	3.6	7.7	6.3	4.5	4.1
Europe														
Euro area	0.6	**-3.7** ↓	**2.6** ↓	**-9.6** ↓	**-0.7** ↓	3.0	2.5	3.0	3.0	3.0	0.2	0.3	0.9	1.2
Germany	1.0	-4.6	3.6	-13.4	1.3	5.0	4.0	3.5	3.5	3.5	0.2	0.3	0.5	0.3
France	0.3	-2.0	2.7	-5.4	1.1	2.8	2.5	3.0	3.0	3.0	-0.2	0.6	1.0	0.7
Italy	-1.0	-4.9	1.5	-10.4	-2.0	1.5	1.0	2.0	2.0	2.0	0.9	1.0	1.4	1.0
Norway	2.5	-1.1	2.8	-5.0	1.3	2.5	3.0	3.0	3.0	3.0	3.1	1.2	1.0	0.4
Sweden	-0.4	-4.5	3.2	-3.7	0.6	1.0	4.0	4.0	3.5	3.5	-0.4	-0.2	0.9	0.5
Switzerland	1.8	-1.3	2.2	-3.5	-1.0	1.8	2.3	2.5	2.5	3.0	-0.7	-0.3	0.7	0.7
United Kingdom	0.6	**-4.4** ↓	**2.0** ↓	-9.6	-2.3	**0.5** ↓	3.0	2.0	2.5	2.8	2.1	**2.2** ↑	**2.3** ↑	**1.4** ↓
Emerging Europe	4.1	-5.3	3.9	-19.3	1.9	5.4	4.7	3.5	3.3	3.3	7.7	6.8	6.3	6.0
Bulgaria	6.1	-5.0	-1.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	2.7	-4.0	2.5	-17.9	0.4	4.5	5.0	2.8	2.5	2.2	1.4	1.0	2.7	3.4
Hungary	0.6	-6.2	1.0	-10.0	-7.9	-2.0	2.0	2.0	2.0	2.5	3.6	5.5	3.9	2.4
Poland	4.9	1.2	3.0	1.2	2.0	2.2	2.5	3.2	3.5	3.5	3.7	3.7	2.7	2.5
Romania	7.1	-6.0	2.0	...	...	...	...	...	...	...	6.1	6.0	6.2	6.5
Russia	5.6	-8.5	5.0	-33.6	4.9	9.0	6.5	4.5	4.0	4.0	12.6	10.6	9.1	9.2
Turkey	0.9	-5.3	5.0	...	...	...	...	...	...	...	5.7	5.0	6.3	5.2
Global	1.3	-2.5	3.4	**-7.5** ↓	1.3	**3.9** ↓	3.4	3.4	3.7	3.7	0.6	1.1	1.7	1.5
Developed markets	0.4	-3.3	2.8	**-8.3** ↓	**-0.4** ↓	**3.1** ↓	2.8	2.8	3.1	3.2	-0.3	**0.5** ↑	1.0	0.7
Emerging markets	4.9	0.5	5.8	-3.9	7.5	7.0	5.6	5.6	5.7	5.5	3.8	3.7	4.5	4.4

Source: J.P. Morgan

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