Global Asset Allocation
J.P. Morgan Securities Ltd.
London, Sep 5, 2008

The JPMorgan View

Stay defensive

- **Economics** — Rising US unemployment and lower core inflation into next year are likely to leave the Fed on hold until late 2009
- **Asset Allocation** — The negative momentum in economic data and opinion keep us with a recession focus
- **Fixed Income** — Stay long duration, and long Agency debt and MBS
- **Equities** — EM equities to remain under pressure as weakness is more clearly migrating to EM
- **Credit** — Stay bearish. Investors appear to be comfortable with high cash balances and hope to get a better entry point before deploying their cash.
- **FX** — Stay short EM Asia but add longs in JPY and CHF within the G-10
- **Commodities** — Oil will likely fall further absent indications of a production cutback

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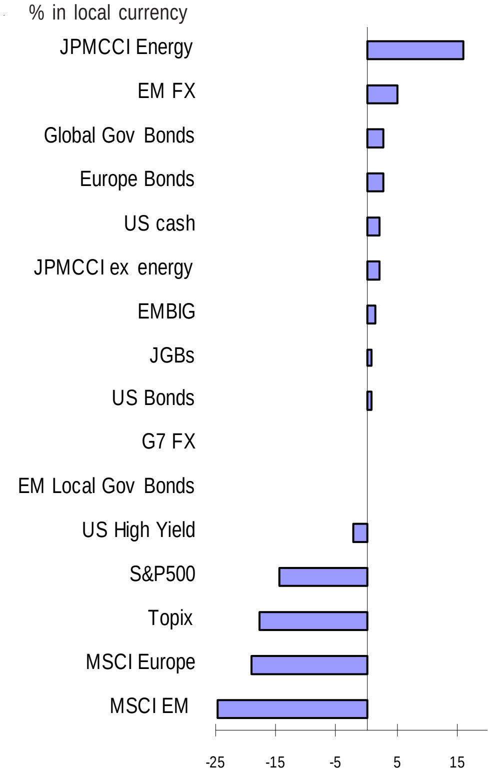
YTD Returns
% in local currency



Source: JPMorgan. * Global Bonds is JPM GBI hedged into $, EM Local Bonds is GBI-EM unhedged in $, US Bonds is the Lehman aggregate, Europe Bonds is JPM Maggie, JGBs is JPM GBI - Japan local currency, EM FX is JPM ELMI+ in $, G7 FX is GBI cash index in $

Economic Outlook

- **Today's US payroll report was rather weak** but the path of job losses and hours is still in line with our forecast of US growth averaging between 0-1% in H2. In our view, the pace of corporate cost-cutting has not yet intensified to a pace that we would typically associate with recessions, but we admit that the risk of this happening in the current quarter remains uncomfortably high at 40%.

- The unemployment rate did spike higher again as full-time employment is contracting sharply and labor supply continues to grow at an above-trend pace. As a result, we are **raising our estimated peak in the US unemployment** rate to 6.6% from 6.1%, and we are lowering our forecast of core PCE inflation rate for 2009 to 1.9% from 2.1%. These changes are likely to **leave the Fed on hold longer** than we had expected and we are moving the start of the Fed tightening cycle back from the end of Q1 to the beginning of Q4 of next year.

- It is harder to track EM growth, but the data so far indicate that **EM economies started slowing** in Q2 to a trend like pace, and that further slowing is likely in Q3. It is important to remember that the transmission from developed to emerging market growth operates through two channels: trade and financial markets. Growth weakness so far has been concentrated in the trade sector with domestic demand holding up relatively well. But with EM equities, currencies and credit under pressure at the moment, financial conditions are tightening in EM, raising the risk of a more broad slowdown.

More details in ...

Global Data Watch, Bruce Kasman and David Hensley

The certifying analyst is indicated by an [AC]. See page 6 for analyst certification and important legal and regulatory disclosures.

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Keeping a recession bias

- Markets remain in recession mode, with fixed income rallying and credit and equities down on the week. The negative momentum in economic data and opinion do keep us with a recession focus. In addition, we believe we are only **halfway in the process of bank write-downs and credit provisions**. Over the past year, global banks have written off, and have added to credit provisions, some $500bn. Our equity analysts estimate the running total will reach, if not breach, $1 trillion, by end 2009. Over the past year, banks have been able to replenish some 2/3rds with new capital and long-dated debt. The next half trillion of losses will be less easy to cover, raising the likelihood that banks will have to shrink their balance sheets.

- Tactically, we thus continue to **trade markets from an economy-bearish side**, even if we do not yet forecast a global recession at the moment. This implies curve steepeners as well as being long duration in fixed income — largely at the short end in developed markets, and across the curve in EM local bond markets. In credit, we have predominantly trades with a bearish bias, even as we accept that spreads have become attractive to buy-and-hold participants.

- The case for being outright short equities, a traditional position during recessions, is less clear. This is because we feel that many end-investors are already underweight equities and because there is little supply pressure in equities, outside the financial sector. A case can be made that equities have already paid a large recession penalty. Bad economic data are thus more likely to keep **US equities in a range**, with participants trying to time re-entry.

- We have positioned on the growth rotation trade this year, first from the US to Europe. This induced us to switch recession trades to Europe. We took profit on this two weeks ago. Now, **weakness is more clearly migrating to EM**. We thus keep to being long duration in EM local markets, but now also add underweight EM currencies and equities.

Index of riskier market and carry trade performance

Source: JPMorgan. Excess return index over cash constructed as a weighted average of daily excess returns of 7 asset classes: G7 equities in $, EM vs G7 equities in $, GBI EM vs GBI Global, HY vs USTs, EMBIG vs USTs and JPM's CarryMAX and IncomeFX indices as a proxy for carry trades in bonds and currencies. The weights in each asset class are adjusted daily based on the inverse of past 3-month volatility, so that 100bp risk is targeted for each asset class on an ex-ante basis. The annualised volatility of the index has been 4% since 1 April02.

Fixed income

- Bonds continue to rally strongly, as global recession fears intensify and falling oil prices depress inflation expectations. We **remain long duration,** largely in 2s and 5s, across global markets, as risk is biased to central banks having to ease more, or hike less, than is currently priced in.

- **Momentum** is a powerful force in bonds, but needs to be complemented with some sense of value. On this basis, we have taken profit on our long 2-year USTs and curve steepening as the 2-year breached our 2.25% yield target. In Europe, we take profit on our UK steepener and switch this position to euros.

- Spreads over government paper remain extremely wide and offer great value. We see **best value in Agency senior debt**, as we believe the US government has no option but to fully support the GSE's. Swap spreads remain near historic wides. Value and the likely surge in swapping from corporate issuance this month suggest spread tightening, but credit concerns on banks going into broker-dealer earnings season will likely prevent significant tightening.

More details in ...

Global Markets Outlook and Strategy, Jan Loeys, Bruce Kasman, et al.

US Fixed Income Markets Outlook, Terry Belton and Srini Ramswamy.

Global Fixed Income Markets, Pavan Wadhwa, Fabio Bassi.

Equities

- Negative momentum in growth expectations and flows to continue to weigh on equity markets. We stay with an overall **defensive stance** and in our model portfolio we underweight Cyclical sectors (Materials, Industrials, Consumer Discretionary and IT) vs non-Cyclical (Consumer Staples, Healthcare, Telecom and Utility).

- **Small caps continue to beat large caps** globally. We stay overweight for two reasons. First, we expect small caps to exhibit a higher than one beta vs large caps in market rallies, and to face less pressure in selloffs as equity investors first sell their more liquid large caps. Second, global small caps have only recaptured a small portion of their 2007 underperformance (see chart in the middle).

- **EM** equities are facing the headwind of weakening EM activity indicators, especially outside China, and negative momentum in growth expectations. Even in **China**, where we expect a soft landing due to policy makers support, we could easily see a couple of months of weak demand data before the policy stimulus actually kicks in. In addition, as explained in our Global Issues piece "*The odd decouple*" Dec 07, **EM growth resilience is conditional on the performance of EM financial markets.** With EM equities, currencies and credit under pressure at the moment, financial conditions are tightening in EM, raising the risk of a more serious slowdown there. The consensus, along with ourselves, have only recently started trimming growth forecasts in EM economies and these downward revisions are likely to continue in coming months. **EM Asia and EM EMEA are more vulnerable** to further negative growth revisions.

- With continued downbeat data in Europe and Japan and more evidence that weakness is spreading to EM, **investors are switching out of global and into US equities.** Mutual fund flows show that although US retail investors bought $2bn per week of domestic equities over the past month, they have sold $2bn per week of international equities. Indeed, EM, Japanese and Developed Europe equity funds continue to experience heavy outflows. Across sectors, **the rotation away from commodity sectors appears to still be underway**, with continued outflows from Energy and Natural Resources funds and oil exporters in EM.

Credit

- Credit spreads continue to widen with US HG exceeding, and HY approaching, the peaks of last March. We **stay bearish** overall and continue to focus our underweights in European HG, US ABS and US CMBS.

- **Supply is putting pressure in HG** and new issues are coming to market significantly wider to secondaries. As September is both a month with high redemptions and quarter-end for banks, it is likely that spread pressures will continue for a few more weeks at least.

- Our latest **Credit Client Surveys** suggest that, despite wider spreads, inves-

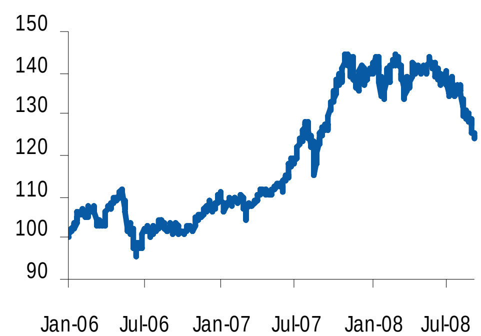
Cyclicals versus Non-Cyclicals
Relative price index, MSCI World $

Cyclical sectors include Materials, Industrials, Consumer Discretionary and IT. Non-cyclical sectors include Consumer Staples, Healthcare, Telecom and Utility. Source: Datastream, JPMorgan

Small cap versus Large cap
Relative price index, MSCI World $

Source: Datastream, JPMorgan

MSCI EM$ vs MSCI World$
Relative total return index



Source: Datastream, JPMorgan

More details in ...
Key trades and risk: Emerging Market Equity Strategy, Adrian Mowat et al.

Emerging Markets Outlook and Strategy, Joyce Chang

EM Corporate Outlook and Strategy, Warren Mar et al.

US Credit Markets Outlook and Strategy, Eric Beinstein

High Yield Credit Markets Weekly, Peter Acciavatti

European Credit Outlook & Strategy, Steve Dulake tors remain reluctant to engage the market. Cash balances have risen over the summer, partly a reflection of negative net issuance in summer months, but investors appear to be comfortable with these higher cash balances and hope to get a better entry point before deploying their cash.

Foreign Exchange

- What began as the broadest dollar rally in a decade has morphed into one of the most **violent deleveraging** in almost as long. Position flips as measured by various indicators have been swifter and sharper than during LTCM, the dot-com crisis and previous phases of the credit crisis for many currencies. The common thread throughout these convulsions has been the buyback of funding currencies, which explains the yen's outperformance globally and the dollar's strength vs commodity currencies and emerging markets.

- As it is becoming obvious that global stagnation is catching too many investors wrong-footed – they are still sizably long in commodity currencies and EM, and short in JPY and CHF – we expect liquidations to persist. But given how advanced this process already is on a range of metrics, we target only a handful of currencies: **stay short EM Asia but add longs in JPY and CHF within the G-10**. The rationale for avoiding EUR/USD shorts is that risk reversals and IMMs are already too extreme. We admit that there are still many unknowns and unknowables around EUR positioning (to paraphrase Rumsfeld), but we are more comfortable taking risk in yen where at least the quantifiable positions are still decent in size. We are flat EUR/USD but short USD/JPY and EUR/CHF.

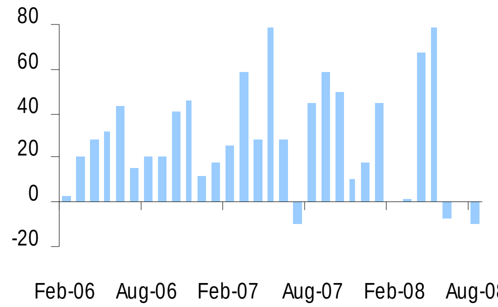
- We have avoided most of the carnage in emerging markets by squaring-up Latam longs in early August, taking CEEMEA exposure through the crossrates (long TRY/CZK) and being long USD vs the lowest-yielders (THB and CZK). The **outlook for most currencies in EM is negative short-term** given their status as leveraged commodity bets (BRL, RUB), their exposure to G-3 stagnation (EM Asia) or their vulnerability to yen short-covering. We recommend keeping existing trades. USD/Asia has posted its largest quarterly move in almost a decade yet is still rich to equity market levels, suggesting further risk for portfolio outflows. THB has been the preferred outright trade due to the balance of payments backdrop, political tensions and low risk of sustained intervention. We recommend increasing exposure.

Commodities

- Commodities were crushed in the first week of September, with few making it into positive territory and in the metals the losses were acute. Oil fell 10%, copper was down 8%, aluminium was down 2.5% while silver was able to break away from gold, crashing through range support at $12.45, while gold consolidated around $800/oz, supported by solid buying out of the Indian subcontinent. Broadly the stronger USD was the key price driver but macro economic sentiment collapsed with commodity equities under significant pressure as a result. We **still favour the downside in the precious metals** due to catch up to USD strength, while base metals are likely to consolidate at these lower levels in anticipation of a price driven supply response. **Oil will likely fall further absent indications of a production cutback.**

US HG net issuance

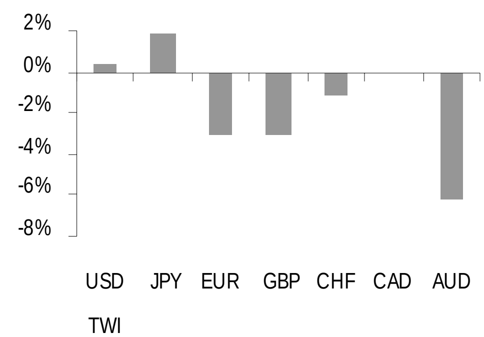
$bn, monthly data



Source: Bloomberg and JPMorgan

Foreign exchange

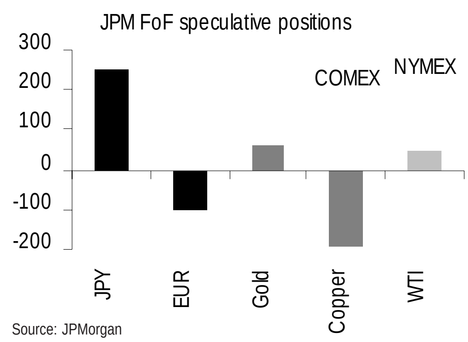
% change vs USD this week



Source: JPMorgan

FX and commodities speculative positions

Scaled index, 100 = annual average position



Source: JPMorgan

More details in ...

Measuring the extent of USD short covering, J Normand, Aug 29

FX Markets Weekly, J Normand

Global Metals Quarterly, M Jansen

Grains & Oilseeds Monthly, L Hagedorn

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Interest rates		Current	Sep-08	Dec-08	Mar-09	Jun-09	GBI YTD Return
United States	Fed funds rate	2.00	2.00	2.00	2.00	2.00	
	10-year yields	3.64	3.85	3.90	4.00	4.20	5.0%
Euro area	Refi rate	4.25	4.25	4.25	4.00	3.75	
	10-year yields	4.03	3.95	3.90	3.90	3.85	3.6%
United Kingdom	Repo rate	5.00	5.00	4.75	4.50	4.00	
	10-year yields	4.39	4.40	4.20	4.20	4.20	2.9%
Japan	Overnight call rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	1.44	1.50	1.60	1.60	1.80	1.0%

Credit Markets	Current	Dec-08	Index	YTD Return
US high grade (bp over UST)	293	230	JPMorgan US Index (JULI)	0.6%
US high grade (bp over swaps)	201	168		
Euro high grade corporates (bp over swaps)	102	65	JPMorgan Euro Credit Index (MAGGIE)	2.1%
USD high yield (bp vs. UST)	815	800	JPMorgan Global High Yield Index	-2.1%
Euro high yield (bp over Euro gov)	869	800	JPMorgan Euro Credit Index (MAGGIE)	-5.5%
EMBIG (bp vs. UST)	347	250	EMBI Global	1.5%

		Quarterly Averages			
Commodities	Current	08Q3	08Q4	Index	YTD Return
Gold ($/oz)	798	915	900	JPMCCI Precious Metals	-7.9%
Copper ($/metric ton)	7266	8800	8000	JPMCCI Industrial Metals	4.4%
Corn ($/Bu)	5.47	6.15	6.30	JPMCCI Agriculture	4.6%

Foreign Exchange	Current	Sep-08	Dec-08	Mar-09	Jun-09	3m cash index	YTD Return in USD
EUR/USD	1.43	1.47	1.47	1.45	1.42	EUR	1.9%
USD/JPY	107	108	110	112	115	JPY	4.2%
GBP/USD	1.77	1.84	1.84	1.81	1.80	GBP	-7.1%
AUD/USD	0.81	0.87	0.84	0.83	0.83	AUD	0.0%
USD/CAD	1.07	1.05	1.07	1.07	1.08	CAD	-4.6%

Equities	Current	Dec-08	YTD Return (local ccy)
S&P	1235	1450	-14.5%
Topix	1171		-17.7%
FTSE 100	5241	6400	-14.3%
MSCI Eurozone	182	216	-22.7%
MSCI Europe	1210	1410	-19.0%
DAX	6127		-22.2%
CAC	4197		-21.0%
MSCI EM	38116	46000	-24.5%
MSCI EM - USD	893	1110	-26.8%

S&P500 EPS	2007E	2008E
JPMorgan	83.1	89.0
IBES (bottom-up)	83.1	83.0

MSCI Europe EPS (€)	2007E	2008E
JPMorgan	108.2	103.9
IBES (bottom-up)	108.2	108.6

Medium Term Sector Allocation	US	YTD ($)	Europe	YTD ($)	Japan	YTD (¥)	EM	YTD ($)
Energy	Neutral	-13.3%	Underweight	-22.4%		-30.3%	Underweight	-26.6%
Materials	Underweight	-11.9%	Neutral	-19.8%	Neutral	-26.7%	Underweight	-24.7%
Industrials	Underweight	-14.0%	Neutral	-24.1%	Overweight	-19.0%	Neutral	-40.4%
Discretionary	Overweight	-7.4%	Underweight	-24.4%	Neutral	-19.3%	Neutral	-21.4%
Staples	Underweight	-1.8%	Overweight	-20.1%	Underweight	-6.9%	Neutral	-10.2%
Healthcare	Neutral	-8.5%	Neutral	-8.9%	Underweight	-5.8%	Neutral	-1.9%
Financials	Overweight	-26.6%	Overweight	-27.8%	Overweight	-18.8%	Overweight	-26.1%
Information Tech.	Overweight	-17.8%	Overweight	-22.7%	Overweight	-18.0%	Overweight	-23.3%
Telecommunications	Overweight	-21.1%	Neutral	-25.1%	Neutral	-8.2%	Underweight	-23.4%
Utilities	Underweight	-13.6%	Underweight	-22.6%	Neutral	0.7%	Underweight	-17.1%

Source: Bloomberg, Datastream, IBES, Standard & Poor's Services, JPMorgan estimates

Real GDP	%q/q saar						% over year ago		
	08Q1	08Q2	08Q3	08Q4	09Q1	09Q2	2007e	2008e	2009e
United States	0.9	3.3	0.5	1.0	2.0	3.0	2.0	1.8	2.1
Latin America	0.6	4.2	3.3	3.6	2.6	3.8	5.3	4.0	3.4
Japan	3.2	-2.4	-0.5	0.2	0.7	1.2	2.0	0.7	0.6
Asia ex-Japan	8.6	6.6	5.6	6.2	7.1	7.6	8.8	7.2	7.2
Euro area	2.7	-0.8	-0.5	0.0	0.5	0.7	2.6	1.1	0.4
United Kingdom	1.1	0.8	-1.0	-1.0	0.5	1.0	3.1	1.1	0.4
Emerging Europe	6.9	5.2	4.8	4.8	4.7	5.0	6.5	5.8	5.2
Global	2.7	1.8	1.0	1.5	2.1	2.7	3.4	2.4	2.2
Developed markets	1.7	0.8	0.0	0.5	1.3	1.8	2.4	1.4	1.3
Emerging markets	6.2	5.7	4.8	5.2	5.5	6.1	7.5	6.1	5.8

Consumer Prices	% over year ago						% over year ago		
	08Q1	08Q2	08Q3	08Q4	09Q1	09Q2	2007e	2008e	2009e
United States	4.2	4.3	5.6	4.4	3.7	2.9	2.9	4.6	2.5
Euro area	3.4	3.6	3.9	3.5	3.2	2.7	2.1	3.6	2.5
United Kingdom	2.4	3.4	4.6	4.9	4.6	3.4	2.3	3.8	3.2
Japan	1.0	1.4	2.3	2.0	1.9	1.6	0.1	1.7	1.3
Developed markets	3.2	3.5	4.4	3.7	3.3	2.6	2.1	3.7	2.4
Emerging markets	6.9	7.8	7.9	7.4	6.8	5.9	5.0	7.5	5.9

Source: JPMorgan

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