market thoughts

J.P.Morgan

Richard Madigan, Chief Investment Officer, J.P. Morgan Private Bank

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A brief introduction (and a promise)

For those of you who don't know me from my former position as Chief Investment Officer of the Global Access Portfolios, where I oversaw $16 billion in private and institutional client assets, **I want to briefly introduce myself in my new role as Chief Investment Officer of the J.P. Morgan Private Bank.**

I've been part of the investment and strategy team at the Private Bank since 2004, when I returned to the firm to work with Michael Cembalest as he assembled a global strategy team to work on behalf of private clients. I was responsible for global multi-asset investment strategy and asset allocation for our international clients before taking on the role as CIO for Global Access.

During my time with Global Access, I wrote a regular investment strategy note, *Market Thoughts*, which we sent to clients globally. In my new role, I want to re-establish the discipline of putting pen to paper around our market views: what we are thinking, what we are seeing as core investment themes, and how we are investing across global markets.

There is nothing more humbling than writing down and clearly explaining what you think, and why, about the world and markets. I have a well-established practice with our family physician: I promise not to confuse him with investment nonsense if he promises not to do the same with medical gibberish. I promise the same clarity with this note.

Same as it ever was

"Once in a Lifetime" is a song by the band Talking Heads. It has come to mind repeatedly as I've listened to the media talk about the recent U.S. elections. There is a line in the song that keeps repeating the phrase "same as it ever was," which seems to be, post-election, where we've landed.

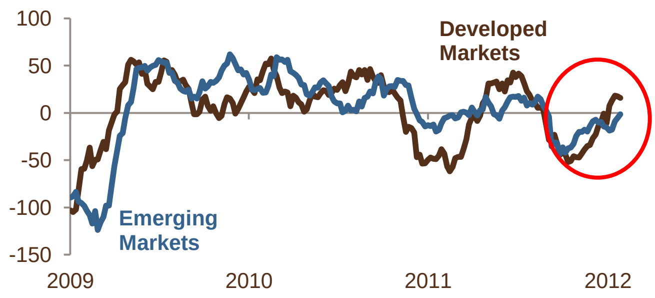
The United States just ran a national election where an estimated $6 billion was spent campaigning. The result across Congress, state governorships and the presidential popular vote was effectively a 50/50 split. **Ironically, an election this important is supposed to help bring direction and clarity, and instead we have continued short-term uncertainty. We believe that will translate into a market that trends higher over the next 12 months, but with air pockets.**

Right now, the most important policy debate and air pocket is around the fiscal cliff. The good and bad news is we have to see movement in the next few months. There isn't a choice. The one thing that did ring clearly from the U.S. election is the degree of frustration around partisan bickering and policy inaction. This was Obama's last campaign, so he is playing for posterity. Congress recognizes it is already playing to mid-term elections in 2014, and while I never count on pragmatism from politicians, **it's actually in everyone's interest for the first time in three years to work together.** Everyone wins, and if not, has the other side to blame come 2014.

Looking ahead

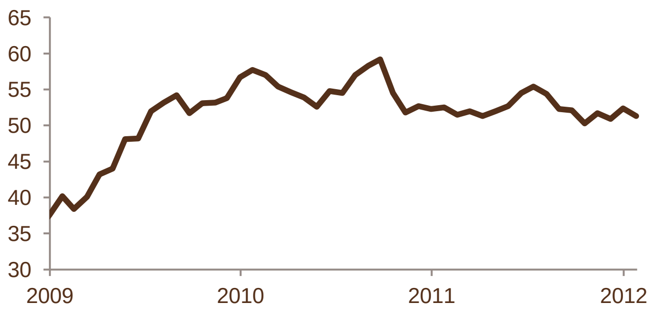
From a macro perspective, we believe the global economy is bottoming, though we are likely to sit along the bottom of a U-shaped recovery into early next year: growing, but not yet inspiring. The immediate effects on growth from Hurricane Sandy are going to need to be better understood, along with how protracted a recession Europe is facing. Markets reflect expectations, and already, data that is less bad shows improved leading indicators, consumer confidence and surprise indices. So less bad will eventually be good; we simply need to see a trough in activity to lessen market uncertainty.

Economic data has been surprising to the upside
Economic surprises; Index level



Source: Citigroup, Bloomberg. Data as of November 2012.

Global manufacturing and services survey
J.P. Morgan Global Composite PMI



Source: J.P. Morgan Securities LLC, Bloomberg. Data as of October 2012.

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Our core macro view remains that the global economy continues to muddle through. We see U.S. growth between +1.5% and 2.0%, Europe continuing to work its way out of recession, and emerging economies growing +4%-5%, led by China as growth moves to a more sustainable trend-like +7%-8%. **Global growth next year should be somewhere between +2.5% and 3%.**

China has just gone through a major political transition. We expect the new Government to focus on reform initiatives and inward investment. **As my team in Hong Kong continues to remind me, 7% growth feels pretty good. There simply isn't the sense of concern or urgency in China as there has been outside the country around a Chinese hard landing.** It's a domestic economy that is maturing, which is exactly what we expect to see ahead.

With the U.S. election behind us, we believe there should be little doubt across markets that until inflation becomes a meaningful concern, central banks will continue to make holding cash and core bonds frustrating for investors—slowly pushing investors to take on incremental risk across markets. **But like deleveraging, increased risk taking needs to be a process, not an event.**

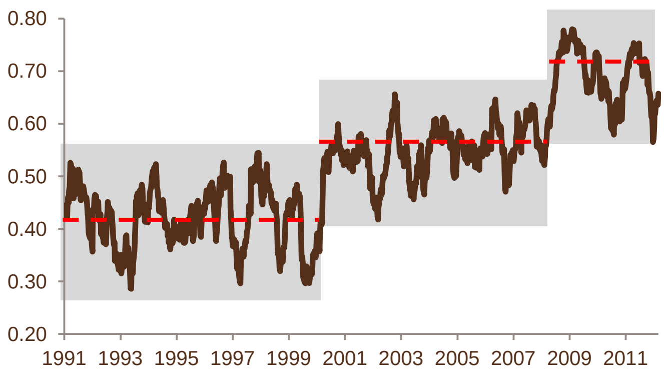
Fundamentals matter

I'm a pragmatist in life and as an investor, especially when measuring and trying to understand risk. My team is very much macro driven, and I believe in fundamentals (as a parent, I have to). I like to have a view on both the upside and downside of an investment. **My favorite investment ratio is 2:1, when thinking about the potential upside-relative-to-downside, and those investments are hard to find.** Credit has been one of them.

I recently challenged our quantitative research and analytics team to help me think about the benefits and the risk in portfolio diversification. We continue to have significant investment tilts across our portfolios, and I wanted to make sure we weren't taking on additional risk because of a lack of diversification. My intuition is that there is far less benefit today than there has been traditionally in a set-it and forget-it approach to asset allocation (something we don't practice). Let me also add that there is a tremendous difference between an investor who is less diversified and one who is out of the market, which continues to be painful for many investors still on the sidelines.

The team looked back to 1991 at the correlation between assets across world equity, bond, commodity and foreign exchange markets. What we found is that correlation across risk assets has been particularly high since the 2008 financial crisis. **You get less benefit owning a little bit of everything and a great deal more reward for being disciplined and investing only where you see the most value.** What was even more interesting is that while some of this is obviously cyclical, there appears to be a structural pattern here as well.

Correlation across risk assets has risen



Source: J.P. Morgan Private Bank, Bloomberg. Data as of November 2012.

Why is this relevant? Because it helps explain why we've been comfortable barbelling the risk we've taken across portfolios this year with a significant overweight to credit markets; it's allowed us to own less equities for similar returns. **Effectively, we've been able to take normal levels of risk in portfolios but focus on the higher certainty of those returns coming from yield rather than more volatile equity price appreciation.**

We still see fundamental value in our credit allocations, but the return ahead is going to be driven by yield or the coupon, not by bond price appreciation. I'm going to argue that it places us right where we should be in the deleveraging and global recovery cycle. It's time to revisit the balance of how we are taking risk in portfolios. **If we want to achieve similar portfolio returns next year, we'll need to take more directional risk where we see value across global markets.**

The end of "easy money"

Index	2012 YTD Return	Annualized Return	Realized Volatility*
Global Equities (MSCI World)	8.6%	10.8%	19.1%
J.P. Morgan Developed High Yield Bonds	12.7%	22.4%	9.4%
Investment Grade (JULIexEM)	9.9%	11.9%	4.9%
Emerging Market Debt (J.P. Morgan EMBI)	16.1%	16.5%	6.9%

Source: Bloomberg. Data from January 2009 through November 14, 2012.

* Data from January 2009 through October 2012.
It is not possible to invest directly in an index.

The great rotation

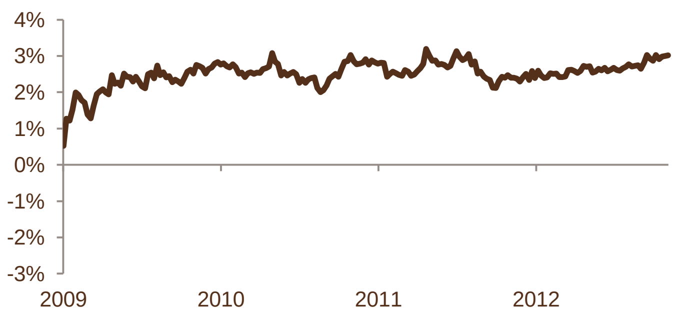
There is an awful lot being written about the next bursting bubble, which, according to pundits, is fixed income. The fear is either that inflation very quickly begins to reaccelerate because of monetary policy and central banks will need to aggressively slam on the policy brakes, or that investors are going to begin a Great Rotation out of fixed income.

The Great Rotation *scare* being talked about argues that individual investors will apparently all wake up one day and collectively sell their bonds to buy stocks. For individual investors, it's very unlikely that we will see selling of core bonds until investors actually lose money—and we don't expect that to happen soon. **In our portfolios next year, we envision owning more world equity markets, and owning less cash and short-duration fixed income.** So I agree with the risk rotation, but a mad dash by individual investors out of fixed income seems unnecessary and unlikely.

The balancing act for central banks is to try to stimulate growth without provoking inflation. There is enough excess capacity in labor markets that the greater policy concern remains disinflationary pressure. **While we are keeping a close eye on inflation expectations, which have been rising, our economics team continues to believe inflation comes after growth and therefore isn't a threat to this cycle of easy monetary policy.** We expect the Fed, European Central Bank and Bank of Japan will continue to promote "easy money."

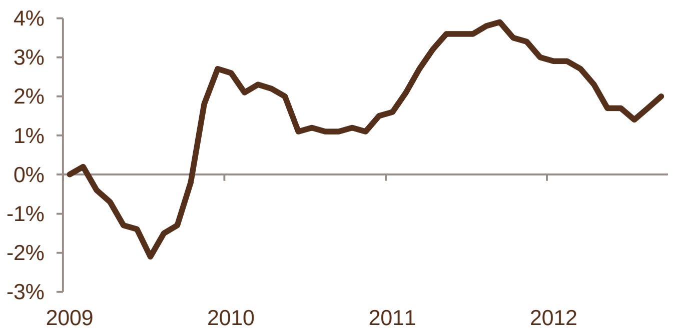
There is going to be an inflation shock that will come with accelerating growth—we just don't see it next year. But in preparation for that scenario, our team has already begun to do work on the theme of inflation protection.

Inflation expectations remain stable
5Y5Y forward breakeven inflation



Source: Bloomberg. Data as of November 2012.

U.S. inflation is not yet troubling
U.S. CPI YoY NSA



Source: Bloomberg, Bureau of Labor Statistics.
Data as of November 2012.

Now what?

We invest with a 12-month outlook, but also take advantage of short-term trading opportunities. But to borrow a phrase from my daughter, **patience is the key to joy.** Into year-end, markets face higher uncertainty and weaker activity. We are going to see more headlines, unfortunately with less real news. In the short term, both issues will extract a higher risk premia from risk assets, which should create some interesting opportunities.

For where we believe the macro cycle is right now, we want to be increasing our allocation to equities as we look into 2013. We continue to barbell those equity allocations between the United States, which continues to lead the global recovery, and emerging markets, where we see significant growth potential. While we have added to our exposure in Europe and continue to see scope for investment opportunity ahead, we don't feel it's a market that is gapping away from us.

We are also doing tactical work in our hedge fund allocations. **We are looking to be more directional in our risk taking next year, particularly looking at long/short and event-driven strategies. In fixed income, we continue to like credit, but need to be more selective.** We are looking at total and absolute return fixed income strategies that can be more nimble in how they invest duration. We expect to hold less short-duration and cash next year across portfolios.

As a last mention, for anyone looking for a timely read, I just finished William Silber's book about Paul Volcker. It is great context for how we got to where we are today and a reminder that while the past doesn't ever exactly repeat itself, it does rhyme. It's also a subtle reminder of why strong leadership and bipartisan counsel are essential for effectively navigating the road ahead.

I very much look forward to our ongoing investment dialogue with you.

Richard Madigan
November 2012

Richard Madigan is Chief Investment Officer and Head of Investment Strategy for J.P. Morgan Private Bank. In his role, he is responsible for the development of investment strategy, tactical and strategic asset allocation for over $800 billion in high-net-worth and institutional client assets. Richard is Chair of the Private Bank's Global Investment Committee.

The Private Bank CIO Team is composed of market strategy, portfolio construction and a dedicated quantitative research and analytics team that also oversees investment risk. The team is global, with senior CIO Team members based in New York, London, Geneva, Hong Kong and Singapore. Strategy and Portfolio Construction for Latin America are based in New York.

Previously, Richard held the title of Chief Investment Officer for the Global Access Portfolios, where he and his team managed in excess of $16 billion in client assets across 35 countries.

Richard brings over 20 years of experience in portfolio management and international capital markets to the firm. Prior to his current role at J.P. Morgan, he held the title of Managing Director, Head of Emerging Markets Investments and Senior Portfolio Manager at Offitbank, a New York-based wealth management boutique, where he managed peak assets in excess of $1 billion in both domestic and offshore portfolios, including the firm's flagship emerging markets mutual fund. He was also a senior member of the firm's investment committee. Before joining Offitbank, Richard worked for J.P. Morgan's Investment Banking division in New York in the emerging markets securities business. He previously spent six years with Citicorp, first as a banker in Mexico and then in the firm's international corporate finance division in New York.

Richard's commentaries have appeared in the *Financial Times, The New York Times*, *The Wall Street Journal*, Bloomberg and Reuters. He is a frequent guest speaker on CNBC, and has also appeared on CNN and *Bloomberg News*, as well as various industry conferences. Richard holds a master's degree from New York University, where he majored in Finance and International Business. He has lived both in Europe and Latin America, and currently resides with his wife and children in New York City.

MSCI World Index—The MSCI World Index is a capitalization weighted index that monitors the performance of stocks from around the world
J.P. Morgan Developed Market High Yield Index (JPM Global High Yield)—An index of developed market high yield bonds
J.P. Morgan Investment Grade Index (ex Emerging Markets)—An index of investment grade corporate bonds, excluding emerging markets
J.P. Morgan Emerging Markets Bond Index—An index of emerging market bonds