MARKET INSIGHTS

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A new fiscal world order: Implications for investors

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Introduction

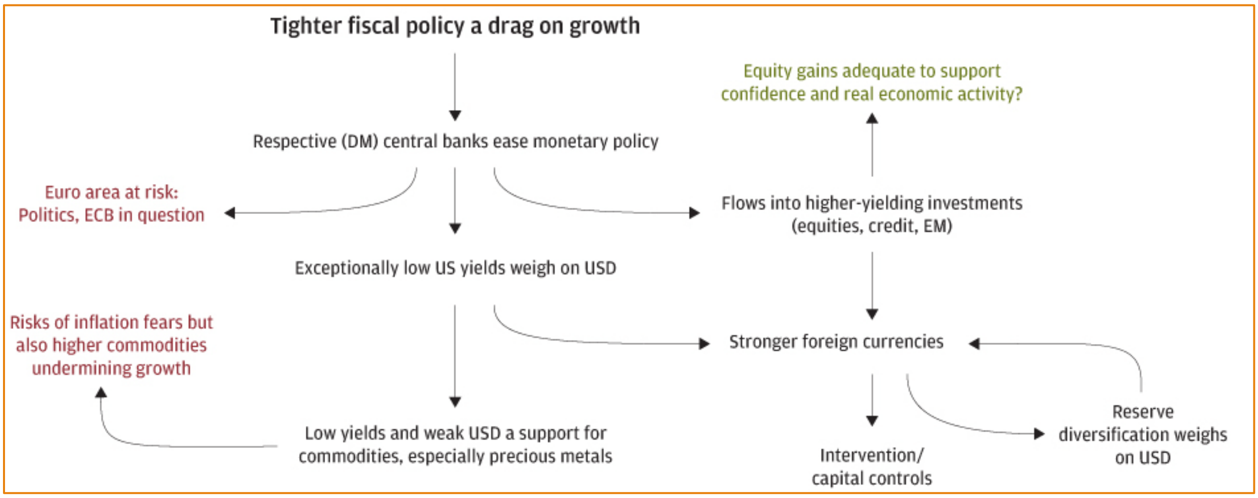
Recent macro events– the US downgrade, the debt-ceiling resolution and Europe's fiscal challenges – mark a turning point for the global economy and markets and, in our view, signal a new fiscal world order.

Ultimately, the events of recent weeks are likely to result in tighter fiscal policy, which could prove to be a drag on economic growth throughout much of the developed world in the coming years. But that does not guarantee that all cyclical markets are going to perform badly. Fiscal policy can be offset by a number of factors, including monetary policy and structural supports from emerging markets.

Ultimately, we believe the new fiscal world order has several key implications for investors:

- Fiscal tightening across most of the developed world in the coming years is exceptional and warrants thinking differently about investing.
- Europe's fiscal challenges are extraordinary, given the lack of offsets (so far) from currency or monetary policy.
- We see opportunities in particular in high-dividend equities, emerging markets and selective commodities tied to this new fiscal world order.

The new fiscal world order starts with tighter fiscal policy which spurs respective central banks to ease monetary policy



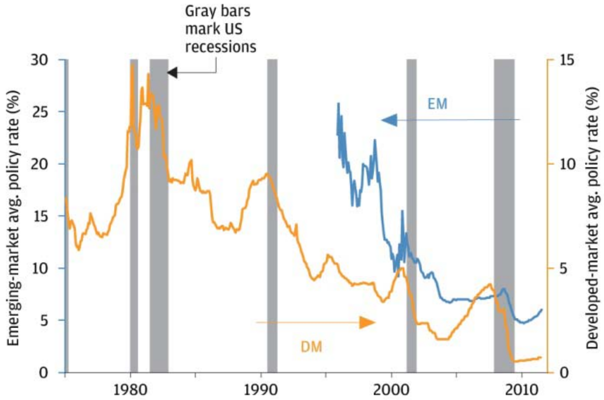
Source: J.P. Morgan Asset Management. For illustrative purposes only.

Let's start with what we know about the new fiscal world order.

- We know that the US, while losing its AAA rating in the process, is embarking on what looks likely to be a multi-year, fiscal-tightening cycle. At the margin, this will likely weigh on growth.
- We know that the US is not alone. With the euro area, UK, and Japan also tightening, developed-market growth seems "capped" to a degree in the coming years. Cyclically adjusted fiscal balances for the Organisation for Economic Cooperation and Development (OECD) countries are set to tighten at least three percentage points just between the end of 2009 and 2012, with more to follow in subsequent years.
- Finally, we know that with fiscal trajectories hemmed in by the need to address multi-decade high budget deficits and debt/GDP ratios, the onus has fallen on central banks to provide an offsetting support for growth. Central banks are responding to this new fiscal world order. As of late July, developed-market average policy interest rates stood at just 71 bps, up less than 20 bps from the 2009 recession lows (**Exhibit 1**). Looking more broadly, monetary conditions across developed markets remain very near 2008-2009 recession lows; US monetary conditions (at -6.5 in July) were the easiest they have been since February 1975, according to JPMS LLC data.

Monetary policy is still an important growth support

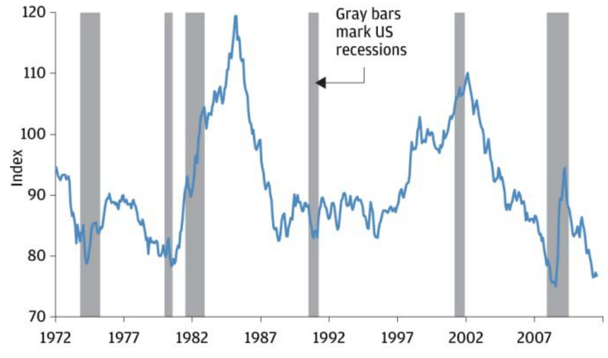
Exhibit 1: Global Monetary policy remains E-A-S-Y



Source: JPMS LLC; data as of July 2011. For illustrative purposes only. Past performance is not indicative of future results. It is not possible to invest directly in the index.

Trade-weighted USD as of mid-August was only 3.7% above its all-time low reached in mid-2008

Exhibit 2: Trade-weighted USD, Index



Source: JPMS LLC; data as of July 2011.

Early August saw even more easing steps, with the Federal Reserve suggesting it would hold the federal-funds rate at current levels (0-25 bps) at least until mid-2013, and the Swiss National Bank adding liquidity to reduce short-term local yields. The Fed's move quickly pulled US two-year yields (reflecting the Fed stance two years out through mid-2013) to just 16 bps, a record low, and just 4 bps above Japanese two-year yields (Bloomberg data).

Capital-flow consequences from the new fiscal world order

As the flow diagram on the first page illustrates, the new fiscal world order starts with tighter fiscal policy which, because of the subsequent drag on economic growth, spurs respective central banks to ease monetary policy.

From here, the new fiscal world starts to get messy. Exceptionally low US yields have weighed on the dollar. Indeed, as shown in **Exhibit 2**, the trade-weighted USD as of mid-August was only 3.7% above its all-time low reached in mid-2008, according to JPMS LLC data.

The US low-yield/weak dollar combination has led to a number of different, large capital-flow trends. First, US investors have sought currency diversification and higher yields overseas, especially in emerging markets with strong fundamentals. It is extraordinary today that on average, emerging-market countries have budget deficit/GDP ratios and debt/GDP ratios that are half those of developed markets. Further, emerging-markets, as they have matured and become more liquid, are less volatile than in the past (especially in emerging Asia). So not only are yields more attractive, but fundamentals are stronger and volatility is less of a headwind. Not surprisingly, in the year through the end of July, emerging-market fixed-income inflows reached USD 33.8 billion, according to JPMS LLC.

The growing differences between developed and emerging markets are especially pronounced in China. Even with the market jitters so far this year, China has stayed on course with its five-year economic plan. With a longer-term view towards creating more balance between exports and domestic demand, China has allowed USD/CNY to slowly fall (a stronger yuan creating more purchasing power for the Chinese and slowly raising barriers to entry for would-be exporters). Indeed, by 11 August, USD/CNY was trading below 6.4, about 22% below levels in mid-2005 before the yuan revaluation, according to Bloomberg data.

China is welcoming a gradually stronger currency, but most other emerging markets are fighting back, as the largely Fed-driven capital flows into their countries boost local FX and undermine respective exporters. An increasing number of countries have intervened to slow currency trends and some, like Brazil, have even tried forms of capital controls. The intervention "war" is a hard one to win, however. When these central banks intervene and sell local currency, most of the dollars they acquire go back into US bonds, in turn keeping US yields low. That simply encourages US investors to look overseas for yield even more.

There is a caveat to the "global currency war." Central banks increasingly diversify reserves. It is not a surprise in today's environment that these important investors want to own assets beyond G-3 bonds, given the issuing countries' various fundamental challenges. So where to diversify? Some capital has been heading into smaller G-10 markets with sound economies, such as countries like Australia, Canada and Norway.

Some capital has been going into commodities, and gold in particular. The countries and markets receiving these flows have to consider how they react to appreciation of local assets as well. In the cases of Canada, Australia and Norway, a commodity-exporting status has helped offset stronger currencies, as terms of trade have improved (in Australia's case, to the strongest level seen in nearly 100 years)!

Another twist from fiscally led low yields is capital flows into commodities. While part of this story stems from central banks and sovereign wealth funds looking for diversification, there is more to it. Over the last several years, the interest by non-traditional commodity players to invest in this asset class – as a source of return as well as diversification – has mushroomed. The number of exchange-traded products (ETPs), mutual and hedge funds focused on commodities has multiplied, as have assets under management. Consider just long-only ETPs. Just in the year through early August, these investment vehicles saw USD 7.8 billion in inflows, taking total ETP assets to USD 182.4 billion (JPMS LLC data as of 5 August, 2011).

As was evident in the first half of 2011, commodity price swings, whether driven by financial or other flows, can create their own problems. In the first four months of the year, Brent crude oil prices rose nearly 33%, following (inverted) trends in the trade-weighted dollar, according to Bloomberg and JPMS LLC data. The weaker dollar and higher oil prices moved hand in hand. Unfortunately, higher oil prices also led retail US gasoline prices higher, fuelling fears about a consumer slowdown and weighing on markets into the summer. This, in turn, triggered an exceptional supply increase from the International Energy Agency (IEA), although too late to prevent a softening in US consumption.

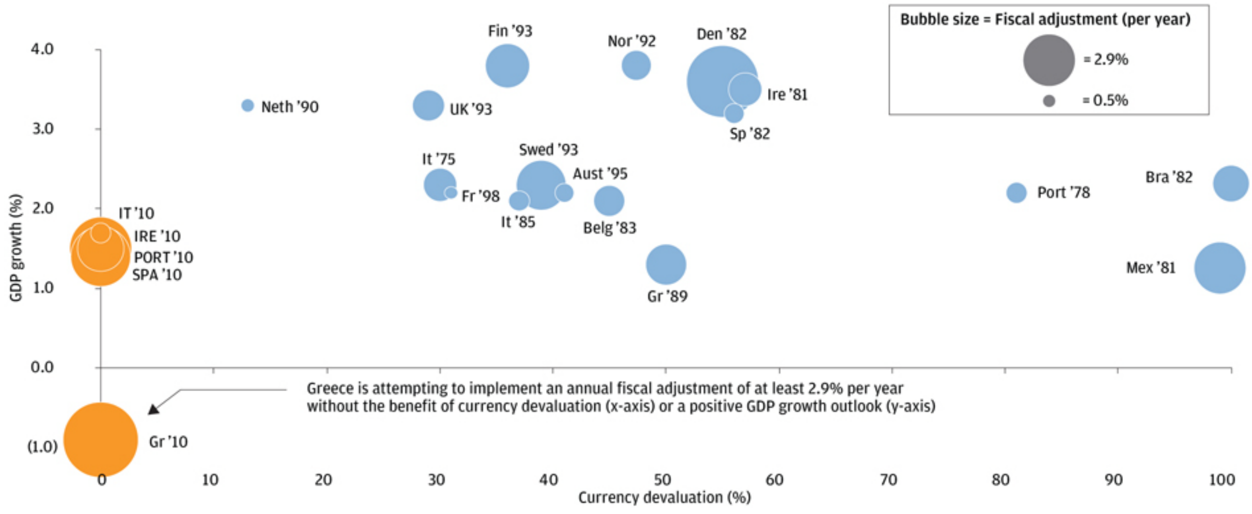
One reason we believe the Federal Reserve might be reluctant to embrace another quick round of significant quantitative easing as an offset to tighter fiscal policy and growth fears is exactly this: it does not want to encourage a "bubble" in commodities such as oil, given that rapidly rising oil prices could undermine the recovery the Fed was trying to support in the first place.

Europe in its own world in the new fiscal world order

One thing history has shown is that fiscally tightening countries tend to have offsets to cushion growth and help support local markets. Specifically, easy monetary policy and weaker currencies have boosted exports and broader growth in almost every instance of major fiscal austerity (**Exhibit 3**). The US today certainly reflects this historical pattern.

History helps explain why markets (so far) are skeptical: No fiscal tightening without growth or currency devaluations

Exhibit 3: Greece fiscal adjustment in 2010: "No man's land"



Source: IMF, OECD, Barclays Capital, Bloomberg.

The euro area appears the exception to the rule, with tighter monetary policy and a stronger currency hurting growth and sentiment, adding to the fiscal drag rather than offsetting it. In the year through the end of July, the euro gained 7.5% against the dollar (and 4% in trade-weighted terms), while the European Central Bank (ECB) raised policy rates by 50 bps.

With this headwind, alongside the cacophony of messages that often result from a 27-member European Union, the euro area has had a tough time convincing markets that peripheral countries can successfully manage austerity. Indeed, as **Exhibit 4** shows, peripheral government bond spreads over German Bunds (the latter seen as the "anchor" for the euro area) have continued to widen throughout 2011, reaching levels not seen since the start of EMU in 1999.

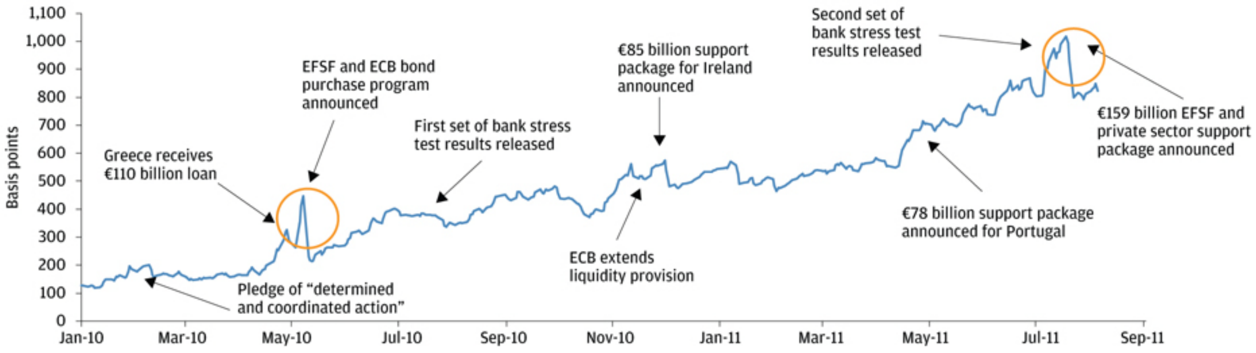
Creating more certainty around Europe will be a big challenge in the fiscal new world order, and will be important for markets not just in the region but globally. What can European policymakers do? Steps so far – providing aid and loans to countries showing fiscal progress – have been incremental and too frequently perceived by markets as "too little, too late."

It is encouraging that policymakers have been willing to change direction as Europe's situation has evolved; for instance, the ECB agreed to buy Spanish and Italian debt in August to stabilise those markets after having limited efforts previously to smaller peripheral states. Going forward, we believe a positive resolution in the euro area will likely require even bigger steps than what has been taken so far, and specifically steps towards so-called fiscal federalism. That is, economically stronger core countries, especially Germany, will likely be required to provide more financial aid to the periphery in return for those countries' efforts to get more Germanic budget balances (possibly via an expanded European Financial Stability Fund, or EFSF, or Eurobond issuance). With a federal election in Germany in 2013, gaining consent to provide such funding should be difficult, possibly costing Chancellor Merkel her office.

Even with a more comprehensive approach, we do not rule out the possibility that Greece (and maybe other smaller states) may still have to restructure or re-profile debt (extending maturities) in order to reduce fiscal burdens. Fortunately, a substantial amount of this risk is already discounted in market prices.

Pain from euro area fiscal tightening supposedly offset with peripheral aid: so far, markets aren't "buying it"

Exhibit 4: Eurozone periphery* spread to German 10-year government bond yield



Source: Bloomberg, J.P. Morgan. Data as of 3 August 2011
*Equal-weighted average of Portugal, Ireland, Greece, Spain.

How will markets perform in the new fiscal world order?

Thinking through investing in this new fiscal world order, a few things seem reasonably straightforward. Looking at bonds, we can expect short-term yields to remain firmly anchored, at least for the next year or so, as central banks are forced to stay expansionary by modest growth prospects. That should help keep a lid, at least to a degree, on longer-term yields as well. Looking at the US specifically, if we go back to the 1950s, the ten-year US yield has rarely started to rise on a sustained basis until the federal-funds rate first started to head higher. The Fed, for now, is telling us that will not happen at least until mid-2013. Beyond well-anchored policy rates, continuing demand from banks, insurance firms and pensions in particular should also help cap G-5 yields along the curve (even in the US, and even with the early August rating downgrade, given the lack of liquid alternatives).

The new fiscal world order, by reducing the "income" part of fixed income, should provide a measure of support to equities. The average S&P 500 dividend yield as of late July was around 2%, nearly 50 bps higher than the five-year Treasury yield at the time (**Exhibit 5**). With this difference unlikely to change anytime soon, investors looking for sources of income may be willing to consider using equities more for this reason.

Equities: Another source of yield in a new fiscal world order

Exhibit 5A: S&P 500, last 12 months' dividend yield

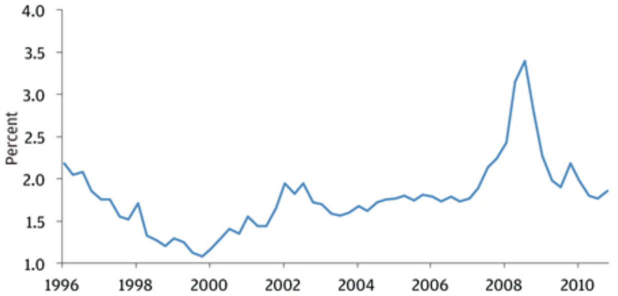
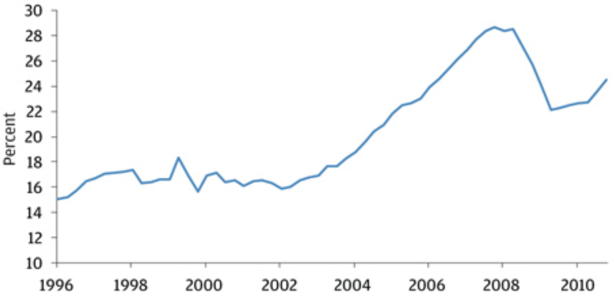


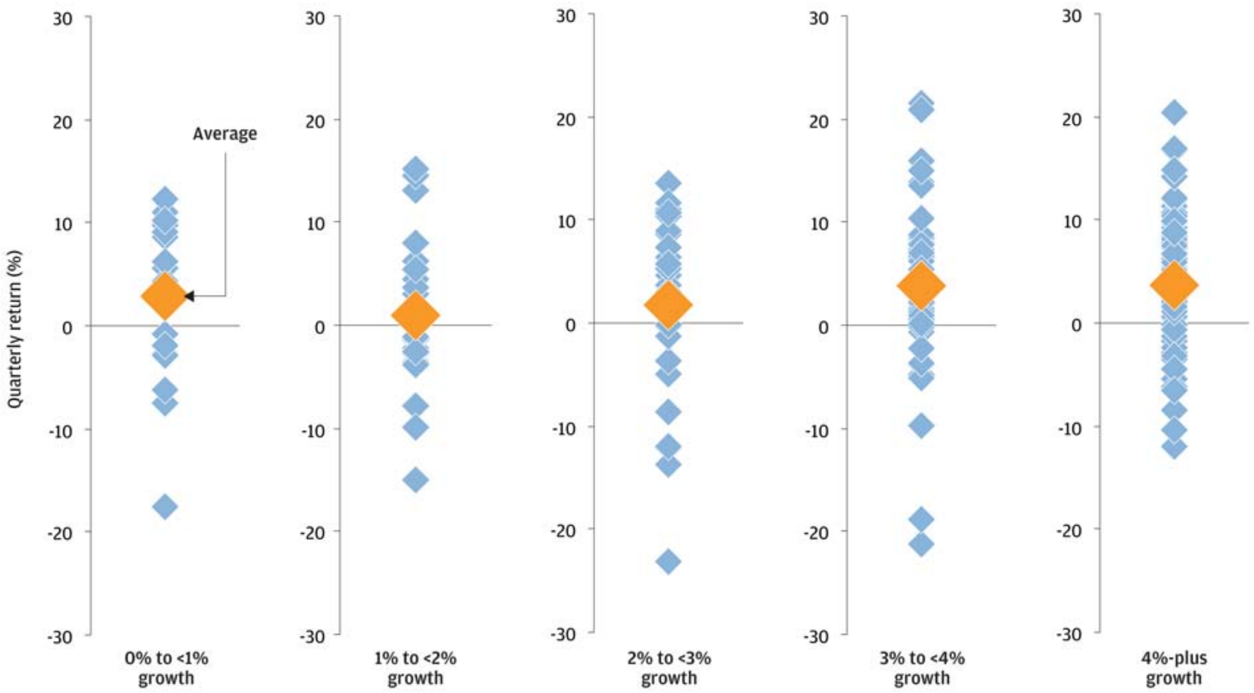
Exhibit 5B: S&P 500, last 12 months' dividend per share



Source: J.P. Morgan Asset Management; data as of July 2011.

US GDP quarterly changes (annualised) and S&P 500 returns (1 quarter lagged)

Exhibit 6: S&P 500 price return*



Source: Bureau of Economic Analysis, Bloomberg, J.P. Morgan. Data as of 2Q, 2011.
*Based on quarterly data between 1Q, 1947 and 2Q, 2011.

The broader equity market may also take some of its cues, however, from growth sentiment. Here, with fiscal tightening, the risks are more balanced. While history is obviously an imperfect guide, the dispersion in annual S&P equity returns, as shown in **Exhibit 6**, has been much greater when US GDP growth ranged between 1-2%, versus when it ranged between 2-3% (in both cases, average returns have been modestly positive). Simply put, recession fears in a very low-growth world have tended to create less predictable equity-return trends.

One factor that makes the new fiscal world order different from the past, and hence makes us want to view this historical analysis cautiously, is emerging markets. As noted earlier, emerging markets today – on average – have much stronger fundamentals than developed markets. They also play a greater role in the broader global economy today than they have in past economic cycles. Specifically, the percentage of global consumption represented by emerging markets is now larger than the percentage from developed markets. These structural

Where does growth come from in the new world order? Overseas...

Exhibit 7A: % of total global nominal consumption

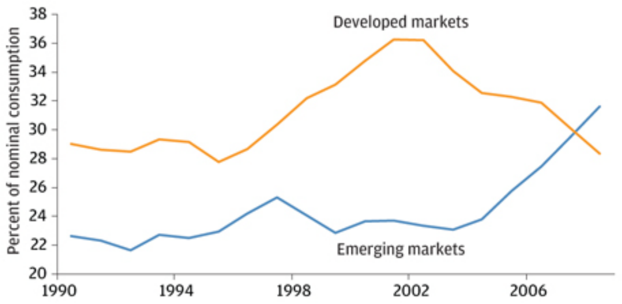
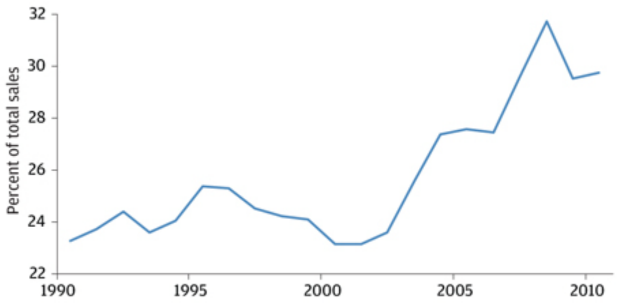


Exhibit 7B: Foreign sales, % of total sales, S&P 500 firms



Source for both charts: J.P. Morgan; consumption data as of end-2008; sales data as of end-2010.

consumption shifts suggest that developed-market companies that rely on emerging market demand can see strong revenue growth even if domestic demand is constrained by the fallout of tightening fiscal policy (**Exhibits 7 and 8**).

What about emerging markets themselves? A struggling developed world, with softer consumers, risks a hit to emerging market exports. Further, even to the degree local emerging markets growth can hold on, strong growth in these economies historically has not guaranteed equally strong local equity performance. China has been a great example of that, not just recently, but also over the last several years.

Still, the structural shifts in many emerging markets, with the growth of middle class consumers, suggest some selective equity opportunities, both in public and private markets. There is clearly also value in many emerging-market bonds, given relatively higher yields and underlying fundamentals. It's interesting that even this summer, with all the market turmoil and global-growth uncertainties, that emerging-market fixed income funds continued to see steady, large capital inflows.

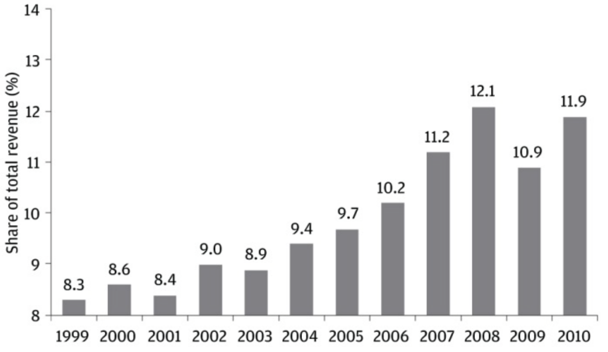
One reason investors have been more comfortable considering emerging markets ties back to the dollar in a new fiscal world order – investors want currency diversification. As noted earlier, in a US economy with "low-for-forever" monetary policy, USD-based investors will likely look more overseas. So beyond the yield one can receive in an emerging-market bond, there is also a hedge against further dollar weakness. (Looking at the next one-to-two years, we see relatively greater value in emerging Asian currencies versus the dollar, not only based on respective valuations but also because of the likely structural appreciation of the Chinese currency and spillover to the other regional FX.)

A final thought on this new fiscal world order: commodities. We mentioned earlier that flows seem more likely to support commodities broadly, via central bank diversification and also through financial investors looking for other return sources than traditional stocks and bonds.

But which commodities? In a world where central banks are biased towards "printing more money," keeping longer-term inflation fears alive, precious metals stand out. In addition, we would focus on more supply-constrained commodities (such as crude oil and copper, but also gold, platinum and palladium). Even in the event that demand from developed markets falls more than expected, the combination of structural emerging-market demand alongside limited supplies should help cushion any fall in prices.

...and especially emerging markets

Exhibit 8: S&P 500 revenue sourced from emerging markets



Source: Empirical Research Partners, UBS, J.P. Morgan. United States and China as of 2009, other countries as of 2007 or 2008.

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