MARKET INSIGHTS

Quarterly Perspectives

2Q | 2012

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J.P. Morgan Funds Management is pleased to present the latest edition of *Quarterly Perspectives*. This piece highlights key themes from our *Guide to the Markets* book and offers critical insights for engaging in portfolio discussions.

Both *Quarterly Perspectives* and *Guide to the Markets* are elements of our **Market Insights** program, which was developed to provide investors with a way to address the markets and the economy based on logic rather than emotion, ultimately helping investors to make rational investment decisions.

This quarter's themes

1. The road back to normal
2. Will oil be kryptonite for the economy?
3. Earnings growth, margins and the opportunity in equities
4. The recent up-trend in consumer confidence

To learn more about the **Market Insights** program, please visit us at www.jpmorganfunds.com/mi.

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1 The road back to normal

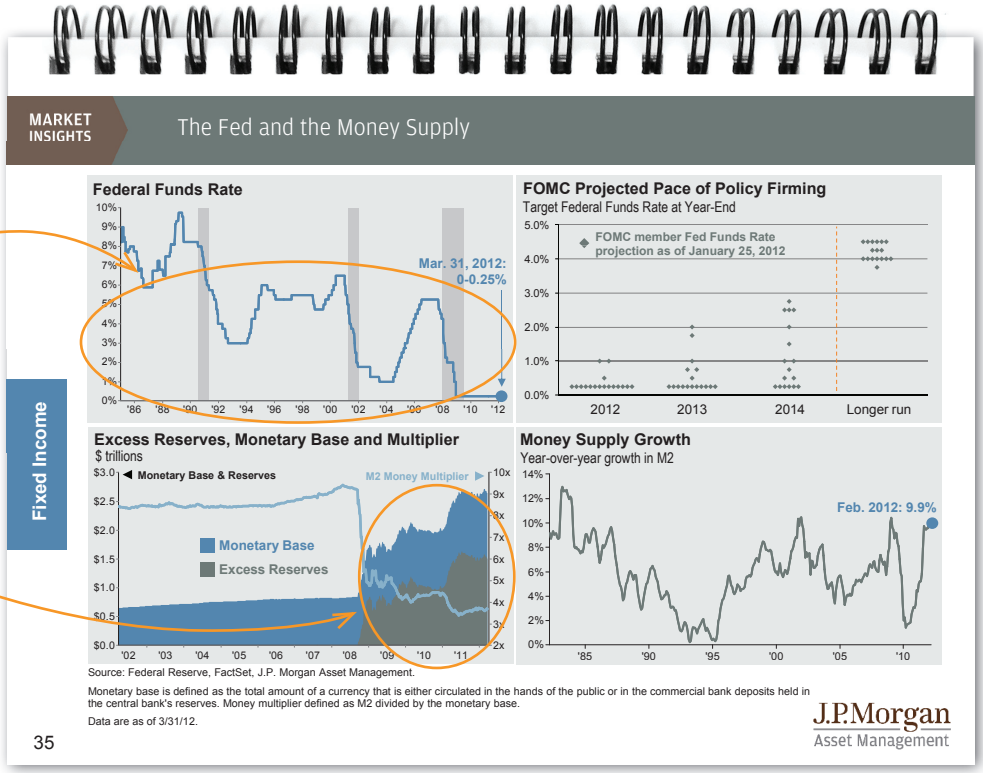
Overview

Central banks around the world worked to support their economies during the financial crisis by lowering policy rates and taking unconventional action. As a result, both emerging and developed market central banks have found themselves in unprecedented territory. Although their behavior helped prevent a deeper recession, global monetary policy remains extremely easy, which begs the question of how these actions will be unwound.

The Federal Reserve

The Federal Reserve has historically utilized a counter-cyclical interest rate policy to smooth the pace of U.S. economic growth. However, interest rates can only go to zero, and 30 years of declining interest rates have put the Fed face-to-face with the zero-bound. This has forced them to employ other tactics to support the economy, such as balance sheet expansion and more explicit policy communication.

- Historically low interest rates have forced the Fed to employ other policy tools, such as balance sheet expansion, better known as quantitative easing.
- However, instead of lending, banks have stashed this cash at the Federal Reserve.



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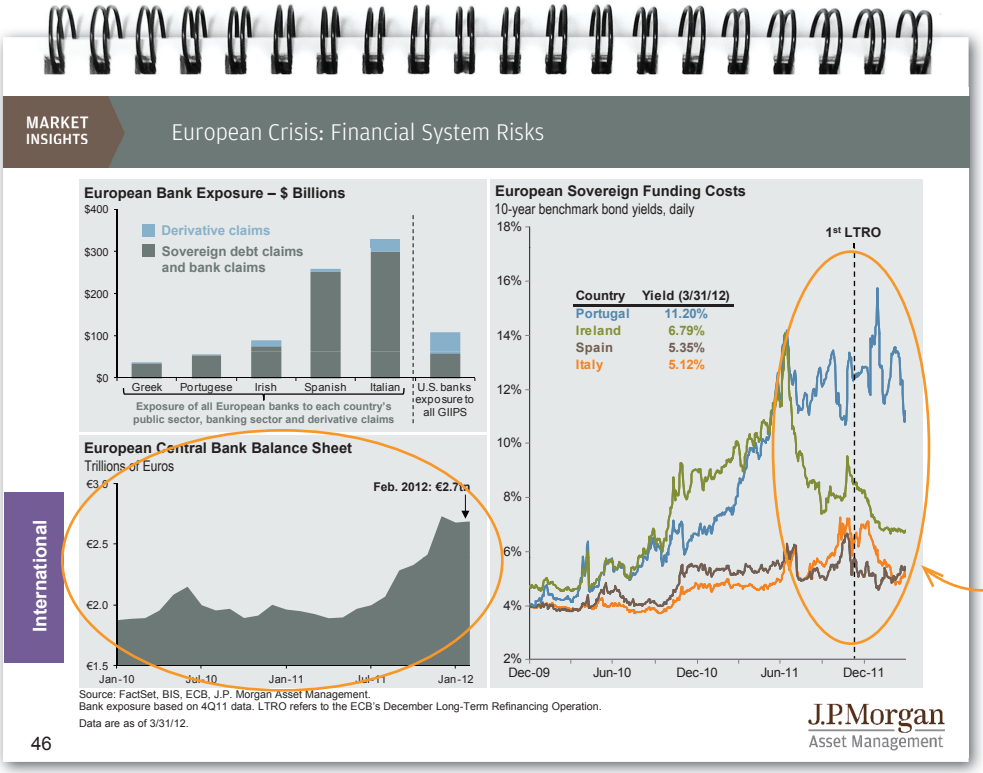
Going forward, inflation will be important to monitor. However, inflation is not yet a threat due to U.S. economic slack and cautious bank lending. That being said, if banks lend more aggressively and the system is flooded with cash, inflation could spike. This would drive interest rates higher, possibly impacting the Fed's profitability by pushing the interest they pay on excess reserves above the yields on the securities they hold.

The European Central Bank

Similar to the Fed, the ECB slashed short-term policy rates and implemented non-traditional policies to combat the recession. Although these programs were temporarily discontinued as things improved in 2009, many were reinstated as the European sovereign debt crisis took hold in 2010.



- Similar to the Fed, the ECB expanded its balance sheet, purchasing sovereign debt and offering unlimited liquidity to banks.
- This action was successful in bringing down the yields on the debt of struggling peripheral sovereigns.

Guide to the Markets, page 46

The ECB faces similar predicaments to the Fed; however, some are unique to its situation. One similarity is that an expanded European monetary base could cause inflation to spike; like in the U.S., there is sufficient economic slack to prevent this from happening, but debt monetization and differences in growth rates between core and peripheral countries both pose risks. If inflation were to spike, the ECB could be forced to pay higher interest rates on reserves. However, high-yielding government securities purchased by the ECB should generate sufficient income to offset this, ideally preventing it from posing a significant threat.

Emerging Markets

Monetary policy in emerging markets is less extreme than in developed markets, leaving EM central banks with a wider array of policy tools at its disposal. Historically, EM central bankers have focused on exchange rates and capital controls to keep their economies competitive, while simultaneously working to control inflation. Although EM central banks and economies are maturing, barring a major policy error, developed market central banks will likely continue to dictate the direction of global monetary policy due to their dominant currency status and uniform policies.

Investment implications

Following extraordinary action over the past few years, central banks around the world have been left in uncharted territory. To maintain credibility, they will eventually be forced to normalize policy and allow inflation and interest rates to be functions of growth and economic slack.

- Balance and diversification remain essential.
- The prospect of higher rates supports an allocation to equities and low duration fixed income.

2 Will oil be kryptonite for the economy?

Overview

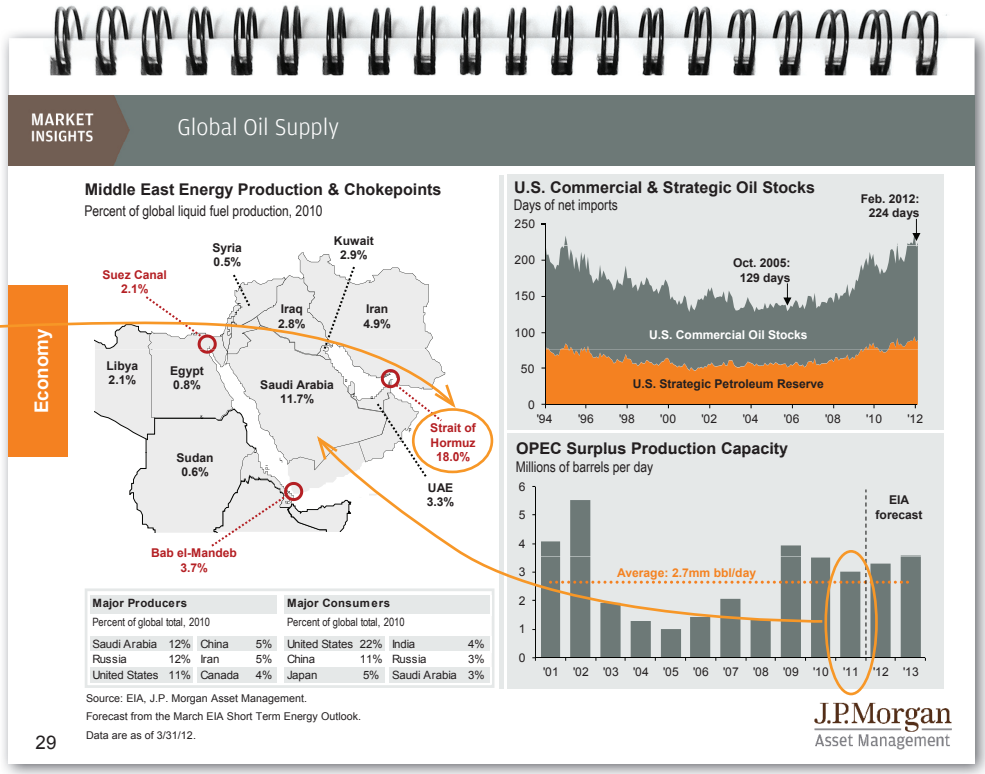
Oil and its byproducts fuel the global economy, leaving us acutely susceptible to disruptions in its supply and shocks to its price. The current standoff between Israel and Iran has magnified the public's preoccupation with oil prices, particularly given the range of impacts a conflict could have around the world as energy costs rise.

Global supply considerations

In the last two years, political and military conflicts in the Middle East and Northern Africa have caused intermittent disruptions in the supply of oil, first with the Arab Spring uprisings in 2011 and now with rising tensions over Iran's nuclear ambitions. Two particular concerns:

1. The direct impact to supply caused by sanctions placed on Iranian exports of oil.
2. Given the concentration of global production in the region, along with potential chokepoints along shipping routes, a major supply disruption is possible.

- This 18% equates to 30% of all floating crude oil.
- Most of the OPEC spare capacity is in Saudi Arabia, so the Strait of Hormuz is critical.



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OPEC's role

The structure of oil markets is heavily influenced by the Organization of Petroleum Exporting Countries (OPEC), a cartel of oil producing nations that collude to adjust oil production levels and control prices. This can be a delicate balancing act, as OPEC's members want to sell their oil for a profitable price, but not one that is high enough to result in demand destruction. Together, OPEC's members are responsible for about 40% of global crude production, and as such, their decisions directly impact prices.

Presently, OPEC doesn't produce every drop of oil that it can. Instead, the cartel actually has spare production capacity equal to roughly 3.7% of global production. This is key, as production can be increased to help offset a decline in supply in the event of a major supply shock.

Chokepoints

Importantly, most of the OPEC spare capacity is located in Saudi Arabia. This is a concern given its proximity to the narrow Strait of Hormuz, a key waterway and potential chokepoint through which roughly 30% of the world's seaborne crude flows, and also which Iran has threatened to blockade, as shown in the *Guide to the Markets* chart on the previous page.

While all of the pieces of the current Israel/Iran dispute don't come together easily, particularly given the volatile politics involved, one thing that does seem clear is that neither the U.S. nor the rest of the oil-reliant world would tolerate a stop to the flow of oil supply through the Strait of Hormuz. The U.S. and others would likely act quickly to establish control of such chokepoints and get oil flowing again. But this could take time and require the use of reserves to meet the world's oil needs.

Inventory and reserves

Many oil importing countries hold both strategic oil reserves and commercial inventories. In the U.S., those combined stocks stand at about 224 days worth of imports. While these sources could be drawn on to buy time and maintain the flow of oil to the economy, it is instructive to revisit 2011, when President Obama released 30 million barrels of oil from the strategic reserve to combat rising oil and gasoline prices. Almost immediately, crude prices fell 8%. However, within one week's time, oil markets had retraced these losses, suggesting only a limited ability of reserves to help.

The economic impact of oil

Oil prices have captured so much attention because they impact consumer wallets and sentiment, inflation and economic growth. The U.S. imports about 45% of its crude oil and as such, higher priced oil means greater imports, which widens the trade deficit and is therefore a direct drag on GDP. Gasoline and heating oil are also parts of the consumption basket used to calculate headline inflation, so higher crude prices will push inflation temporarily higher until oil prices stabilize or decline.

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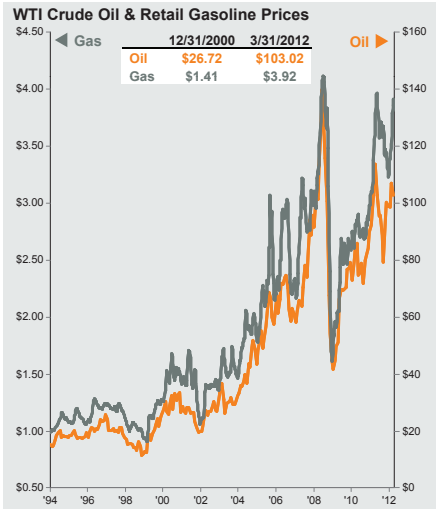
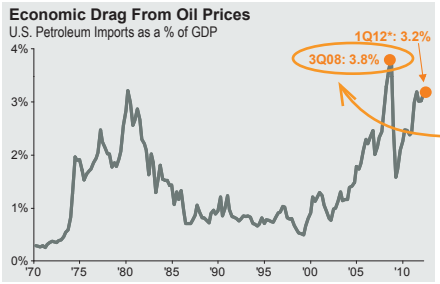
Oil and the Economy

Economy



Source: U.S. Department of Energy, FactSet, J.P. Morgan Asset Management. Price of gas based on U.S. retail national average of all formulations and WTI for crude.

Data reflect most recently available as of 3/31/12.



Energy Spending by Income Level
% of after-tax income

	Lowest 20%	2nd	Middle 20%	4th	Top 20%
Natural Gas	2.4%	1.4%	0.9%	0.7%	0.5%
Electricity	9.5%	4.6%	3.1%	2.2%	1.2%
Fuel Oil & Other Fuels	0.9%	0.4%	0.3%	0.2%	0.2%
Gasoline & Motor Oil	10.1%	5.9%	4.8%	3.7%	2.2%
Total Energy	**22.9%**	**12.3%**	**9.1%**	**6.8%**	**4.0%**

Source: (Top) BEA, FactSet, J.P. Morgan Asset Management. (Bottom) BLS, J.P. Morgan Asset Management.

*1Q12 drag from oil prices is a J.P. Morgan Asset Management estimate.

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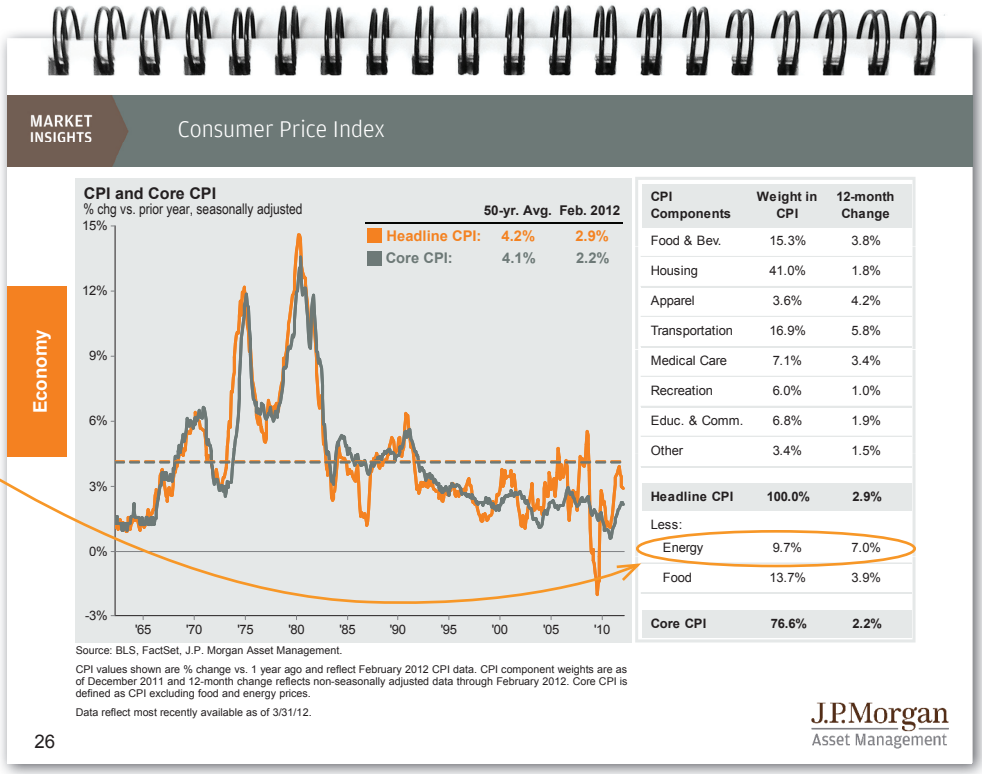
- Importing 45% of our oil subtracted 3.8% from our GDP in 3Q2008.
- Lower income families are hit harder by higher energy prices because it accounts for more of their overall spending.

Guide to the Markets, page 28

Another way oil prices impact the U.S. economy is through the consumer, which accounts for more than 70% of the economy. Gasoline prices are felt every day by the public as they fill up at the pump, and in this way, higher crude oil and gas prices act as a tax on consumer spending. This "tax" tends to both negatively impact consumer sentiment and, if persistent, can ultimately be deflationary as consumers cut back on spending elsewhere, dragging down economic growth.

- Rising energy prices can boost headline inflation temporarily.
- Core inflation still seems under control despite headline fluctuations.



MARKET INSIGHTS — Consumer Price Index

Economy

CPI and Core CPI
% chg vs. prior year, seasonally adjusted

	50-yr. Avg.	Feb. 2012
Headline CPI:	4.2%	2.9%
Core CPI:	4.1%	2.2%

CPI Components	Weight in CPI	12-month Change
Food & Bev.	15.3%	3.8%
Housing	41.0%	1.8%
Apparel	3.6%	4.2%
Transportation	16.9%	5.8%
Medical Care	7.1%	3.4%
Recreation	6.0%	1.0%
Educ. & Comm.	6.8%	1.9%
Other	3.4%	1.5%
Headline CPI	**100.0%**	**2.9%**
Less:		
Energy	9.7%	7.0%
Food	13.7%	3.9%
Core CPI	**76.6%**	**2.2%**

Source: BLS, FactSet, J.P. Morgan Asset Management.

CPI values shown are % change vs. 1 year ago and reflect February 2012 CPI data. CPI component weights are as of December 2011 and 12-month change reflects non-seasonally adjusted data through February 2012. Core CPI is defined as CPI excluding food and energy prices.

Data reflect most recently available as of 3/31/12.

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Conclusion

Higher oil prices are decidedly negative for the U.S. economy, but investors should not forget the resiliency of the economy in the face of a 16% rise in crude oil prices in 2011. In addition, persistently elevated oil prices tend to cause demand destruction (carpooling, public transportation, etc.) and help spur innovative technology to find alternative sources of energy. A conflict in the Middle East has the potential to seriously disrupt oil supplies and is without question a risk – but a risk that can be managed through careful diversification and appropriate asset allocation.

Investment implications

- Short-term inflation caused by higher oil and gasoline prices emphasize the need for inflation protection in a portfolio.
- The risk to economic growth from an oil supply disruption along with current valuations point to a balanced or neutral allocation between stocks and bonds.
- A wide range of outcomes given the geopolitical nature of this risk suggest that greater diversification across asset classes should help minimize volatility.

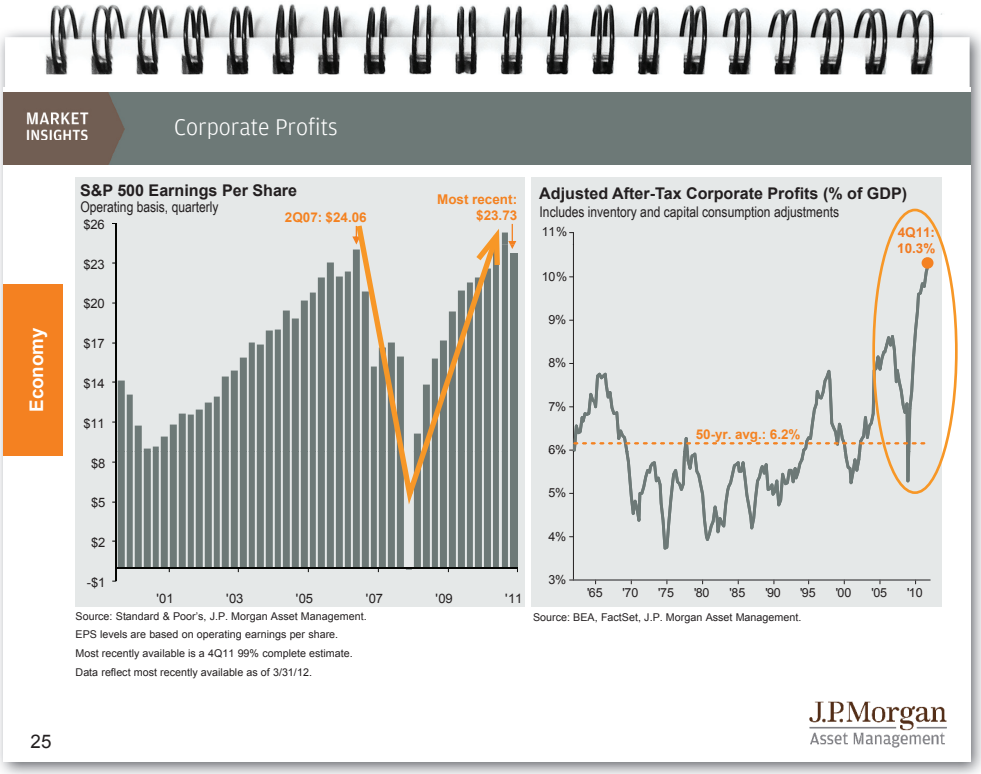
3 Earnings growth, margins and the opportunity in equities

Overview

Corporate profits reached an all-time high of $25.29 in 3Q 2011 before falling to $23.73 in the most recent quarter. With many beginning to wonder if the rise in profits has come to an end, we hope to shed some light on the sharp increase in EPS growth over the past two years and offer a framework for thinking about equity returns in the years to come.

From the depths of the earnings recession in 4Q 2008, corporate profits have had an amazing run. After hitting an all-time low of -$0.09 and subsequently rising to an all-time high of $25.29 just three years later, earnings growth has been astounding. Page 25 from the *Guide to the Markets* highlights the trajectory of quarterly operating earnings in the S&P 500, where the v-shaped recovery in corporate profits has been particularly clear. In 4Q 2011, however, it seems that earnings took a step in the wrong direction, with the first sequential decline in quarterly EPS since this recovery began three years ago. While the downward move shouldn't be overanalyzed as there were a few anomalies that led to this decline, the slowdown in growth has lead many investors to question the direction of earnings going forward, as well as opportunities in the stock market.

- Note the v-shaped recovery in profits.
- See the sharp increase in margins over the past two years.

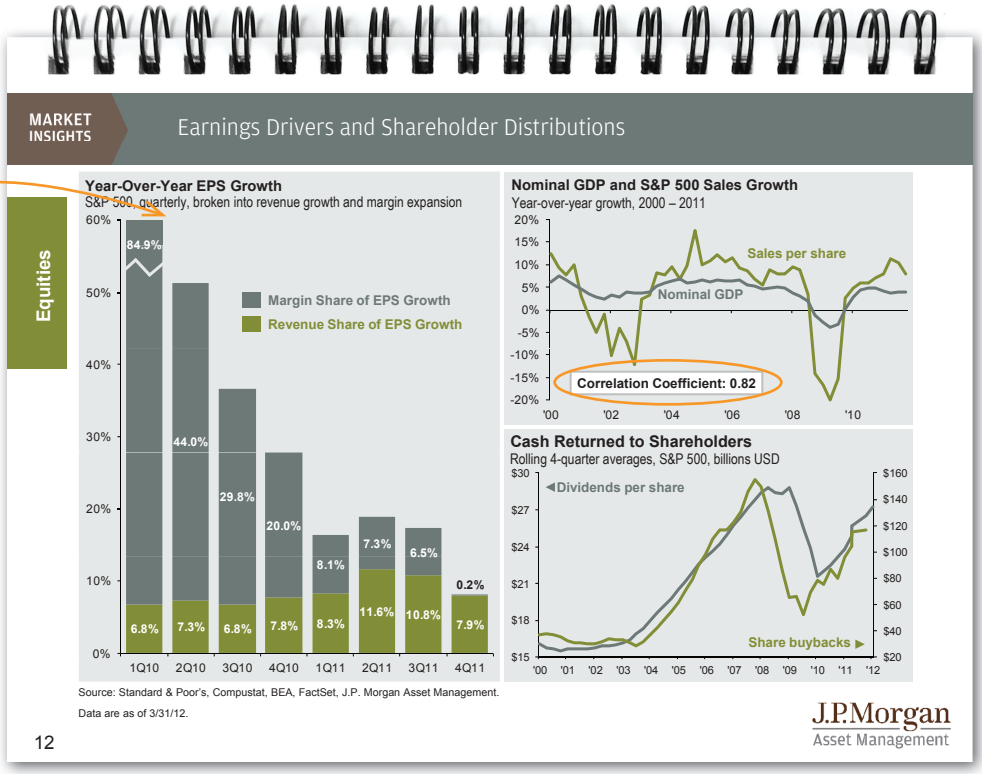


Guide to the Markets, page 25

Taking a look at the rally in earnings, it's important for investors to understand what has contributed to the sharp increase in earnings growth throughout the recovery. Page 12 from the *Guide to the Markets* illustrates year-over-year earnings growth for the S&P 500 over the past two years. What's unique about the chart on the left, however, is the breakdown of earnings growth into two separate components; the earnings growth that can be attributed to revenue growth and the earnings growth that can be attributed to margin expansion. It is clear that the overwhelming increase in year-over-year earnings growth we've seen throughout the recovery has come primarily from expanding margins; companies have managed to keep their costs exceptionally low relative to their increase in revenues, thereby boosting operational leverage. It is also clear that betting on earnings growth derived primarily from rising margins is an unsustainable strategy – at some point, companies will have squeezed all they can out of their expenses, and from that point on, the majority of earnings growth will likely only come from revenue growth. Based on what we see from the chart on the left, that point in time may be upon us.

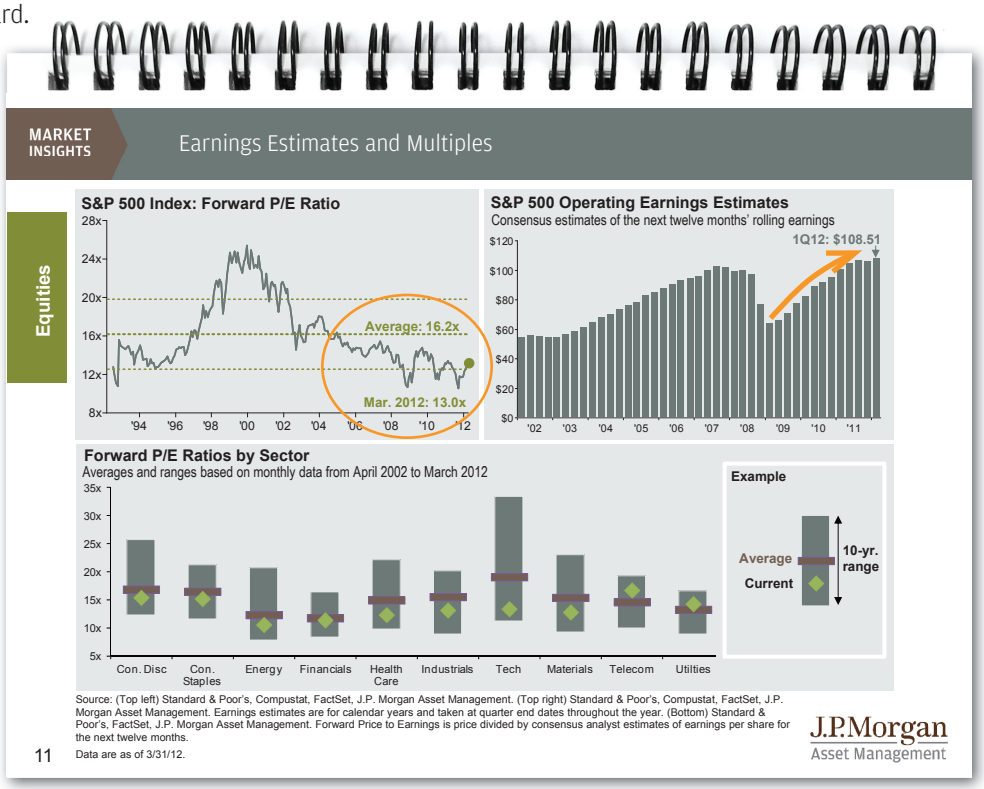
This begs the question, if revenue growth is likely to drive earnings growth over the near term, what drives revenue growth? The chart to the right highlights the relationship between nominal GDP growth in the U.S. and revenue growth for the S&P 500. (Note the strong correlation coefficient of 0.82.) Essentially, this means that revenue growth, and ultimately earnings growth, should continue to rise at roughly the same pace as nominal GDP growth in the U.S. As such, it's important that investors temper their expectations about future EPS growth.

- The portion of EPS growth that has come from rising margins vs. revenue growth.
- The strong relationship between nominal GDP growth and revenue growth in the S&P 500 suggests that EPS growth may decelerate to the pace of nominal GDP growth.



Guide to the Markets, page 12

So, if EPS growth is likely to grow at a more normalized pace, what opportunities lie ahead for equity market investors? The top of page 11 from the *Guide to the Markets* highlights the two variables whose product combines to make up the price of the S&P 500, expected earnings and forward P/E multiples. While we have discussed that earnings growth is likely to decelerate but remain positive, it should seem clear that the opportunity in equities moving forward lies in multiple expansion. Given the rally we've seen in the markets year-to-date, P/E ratios have risen off their October 2011 lows, but still are priced at a discount relative to the average P/E ratio over the past 20 years. While we may not reach a P/E ratio of 16x anytime soon, the top chart on page 31 of the *Guide to the Markets* highlights the relationship between multiples and consumer sentiment. As confidence continues to improve on the back of a healing labor market, stronger economic growth and diminishing tail risks from the European debt crisis suggest that multiples will gradually expand, driving positive returns for the equity market going forward.



Guide to the Markets, page 11

- Valuations are still attractive.
- Earnings growth is likely to decelerate, but improving sentiment should provide support for multiples.

Investment implications

- Earnings will likely continue to grow, but at a much slower pace relative to what we've seen over the past two years.
- Multiple expansion is likely to be the main driver of equity returns moving forward.

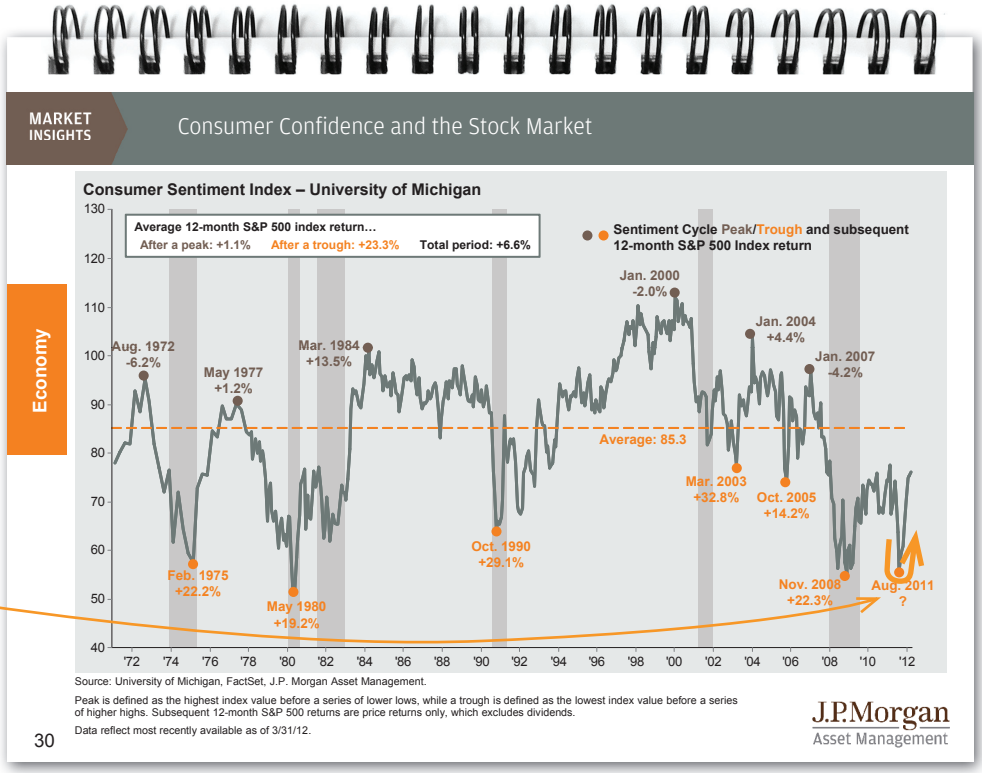
4 The recent up-trend in consumer confidence

Overview

The American consumer is arguably the most powerful economic force in the world, with U.S. consumption driving 70% of domestic GDP and 13% of global GDP. But often, our spending and investment decisions are based on how we feel – as opposed to a thoughtful analysis. Because of this, measures of consumer attitudes will be important indicators to watch in gauging the path of the economy and markets.

What's behind the recent gains in confidence

After plunging to multi-decade lows last summer in response to the toxic debt limit debate and subsequent S&P downgrade of U.S. long-term debt, measures of confidence have recovered to pre-downgrade levels (as indicated in the *Guide to the Markets* chart below). A combination of better news on jobs and the economy, a stronger stock market and somewhat diminished anxiety about politics have helped to provide the boost.



Guide to the Markets, page 30

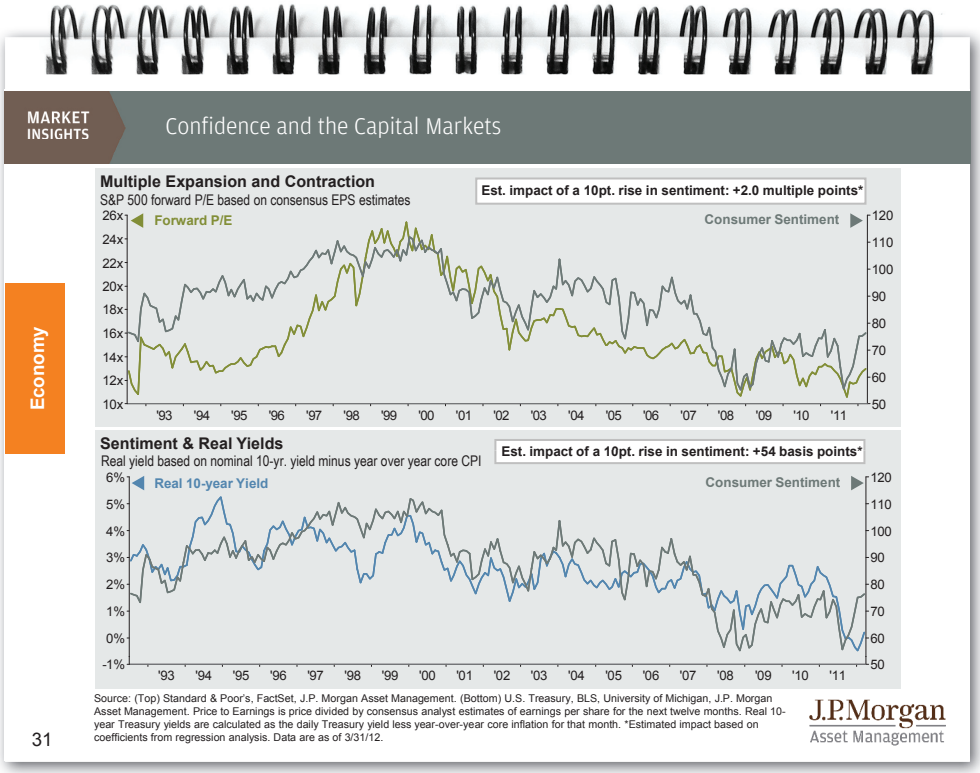
An improving economy has helped Consumer Sentiment to recover following last summer's debt downgrade. However, a list of uncertainties continue to suppress the overall level of sentiment.

It's not all good news

Despite the improvement, it doesn't take a market strategist to understand why sentiment and confidence still remain at historically subdued levels (especially for this stage of an economic recovery). Depressed home values, a still-high unemployment rate, higher gasoline prices at the pump and uncertainty about Europe and the upcoming election may continue to keep a lid on confidence.

Why this matters

In an economy that depends on consumption for 70% of its GDP (like ours), it goes without saying that a confident consumer makes for stronger growth. But the impact of confidence also has an impact on capital markets. The chart below (page 31 of *Guide to the Markets*) highlights the influence confidence has had on both the stock and bond markets. The top chart looks at the relationship between sentiment and P/E multiples[1] while the bottom chart looks at sentiment and bond years.



Guide to the Markets, page 31

- Sentiment has a big impact on what investors are willing to pay for stocks or their desire to own bonds. When consumers feel confident, they are willing to pay more for earnings, driving stock prices higher.

Over time, the way people feel has been a key driver of both P/E multiples and bond yields. This matters greatly because if consumer confidence continues to climb, investors could be willing to pay a higher premium to own stocks and find themselves less compelled to hunker down in the perceived safety of bonds. Of course, any setback in confidence could push P/E ratios (and prices) lower, while providing a boost to bond prices.

Conclusion

Consumer confidence and sentiment have recovered nicely following a brutal summer last year. Better economic data, steps to address the crisis in Europe and higher stock prices have helped consumers to feel a bit better. However, headwinds like rising oil prices, concerns about Europe's ultimate path and the upcoming presidential election continue to be a drag. Going forward, confidence will be key; for better or worse, consumer spending and investment decisions are often driven by the way people feel.

Investment implications

- **U.S. Equity:** Improving economic conditions could spur further gains in confidence. This could lead to increased consumption and even strong growth, but also multiple expansion and higher stock prices.
- **Short-duration or "absolute return" fixed income:** Improvement in confidence also may be a negative for traditional fixed income. With economic improvement can come higher interest rates, and rising rates can hurt bond holders.

[1]Note: P/E is an often-used measure of valuation to determine if the stock market is attractive or not by measuring the amount investors are willing to pay (P) for each unit of earnings (E) generated by a particular company or index.

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Past performance is no guarantee of future results.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Bonds are subject to interest rate risks. Bond prices generally fall when interest rates rise.

International investing involves a greater degree of risk and increased volatility. Changes in currency exchange rates and differences in accounting and taxation policies outside the United States can raise or lower returns. Also, some overseas markets may not be as politically and economically stable as the United States and other nations.

Investments in emerging markets can be more volatile. The normal risks of investing in foreign countries are heightened when investing in emerging markets. In addition, the small size of securities markets and the low trading volume may lead to a lack of liquidity, which leads to increased volatility. Also, emerging markets may not provide adequate legal protection for private or foreign investment or private property.

The price of equity securities may rise or fall because of changes in the broad market or changes in a company's financial condition, sometimes rapidly or unpredictably. These price movements may result from factors affecting individual companies, sectors or industries. Equity securities are subject to "stock market risk," meaning that stock prices in general may decline over short or extended periods of time.

Investing in alternative assets involves higher risks than traditional investments and are suitable only for the long term. They are not tax efficient and have higher fees than traditional investments. They may also be highly leveraged and engage in speculative investment techniques, which can magnify the potential for investment loss or gain.

Securities rated below investment grade are called "high yield bonds," "non-investment-grade bonds," "below investment-grade bonds" or "junk bonds." They generally are rated in the fifth or lower rating categories of Standard & Poor's and Moody's Investors Service. Although these securities tend to provide higher yields than higher rated securities, there is a greater risk that the price will decline.

For some investors, income from municipal bonds may be subject to the alternative minimum tax. Any capital gains are federally taxable.

Investments in commodities may have greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss.

Real estate investments may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate investments may be subject to risks including, but not limited to, declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The Russell 1000 Growth Index® measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 1000 Value Index® measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The NAREIT EQUITY REIT Index is designed to provide the most comprehensive assessment of overall industry performance, and includes all tax-qualified real estate investment trusts (REITs) that are listed on the NYSE, the American Stock Exchange or the NASDAQ National Market List.

The MSCI Value and Growth Indices℠ cover the full range of developed, emerging and All Country MSCI Equity indexes. As of the close of May 30, 2003, MSCI implemented an enhanced methodology for the MSCI Global Value and Growth Indices, adopting a two dimensional framework for style segmentation in which value and growth securities are categorized using different attributes – three for value and five for growth including forward-looking variables. The objective of the index design is to divide constituents of an underlying MSCI Standard Country Index into a value index and a growth index, each targeting 50% of the free float adjusted market capitalization of the underlying country index. Country Value/Growth indices are then aggregated into regional Value/Growth indices. Prior to May 30, 2003, the indices used Price/Book Value (P/BV) ratios to divide the standard MSCI country indices into value and growth indices. All securities were classified as either "value" securities (low P/BV securities) or "growth" securities (high P/BV securities), relative to each MSCI country index.

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Unless otherwise stated, all data are as of March 31, 2012, or most recently available.

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