

BOND MARKET OUTLOOK

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1Q14 saw downward revisions to growth and inflation forecasts but revisions were confined to 1H14 & EM, and the medium term story remains positive in Euro area and US

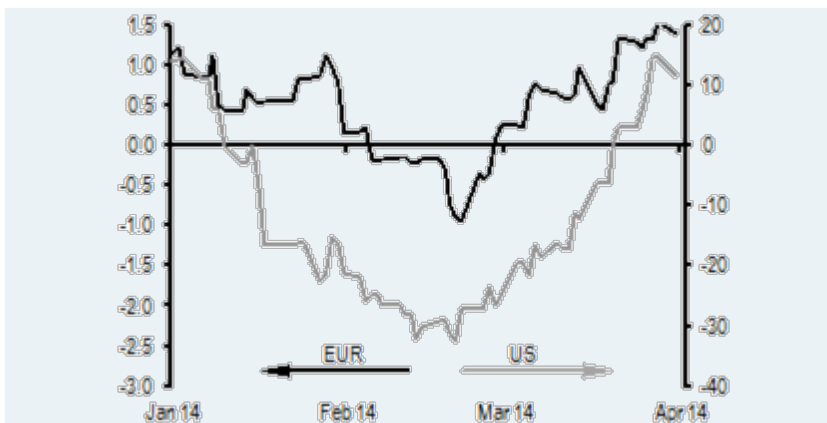
Revisions to growth and inflation have mostly been confined to the first half of the year and to EM

Change in J.P. Morgan growth and inflation forecasts since 29 November 2013 (%)

	Real GDP; q/q saar				Inflation	
	1Q14	2Q14	3Q14	4Q14	2Q14	4Q14
Euro area	-	-0.5	-	-	-	-0.1
US	-1.0	-	-	-	0.1	0.2
EM	-1.0	-0.4	-	0.1	-0.4	-0.2
Global PPP weighted	-0.6	-0.2	-0.1	-	-0.1	-0.1

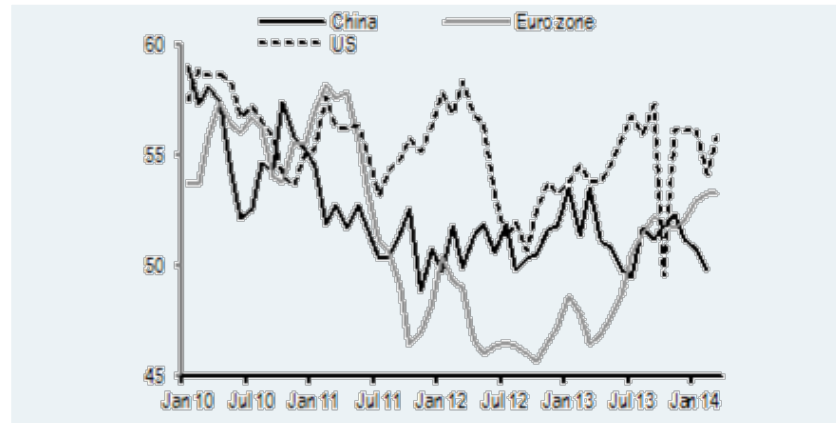
The data flow has improved in the last few days of the quarter

J.P. Morgan EASI (economic activity surprise index) for Euro area and US (index)



Euro area and US PMI have been on an upward trend for a while whereas Chinese PMI has declined over the past few months

Evolution of composite PMI in Euro zone, US and China (index)



Source: Markit and HSBC

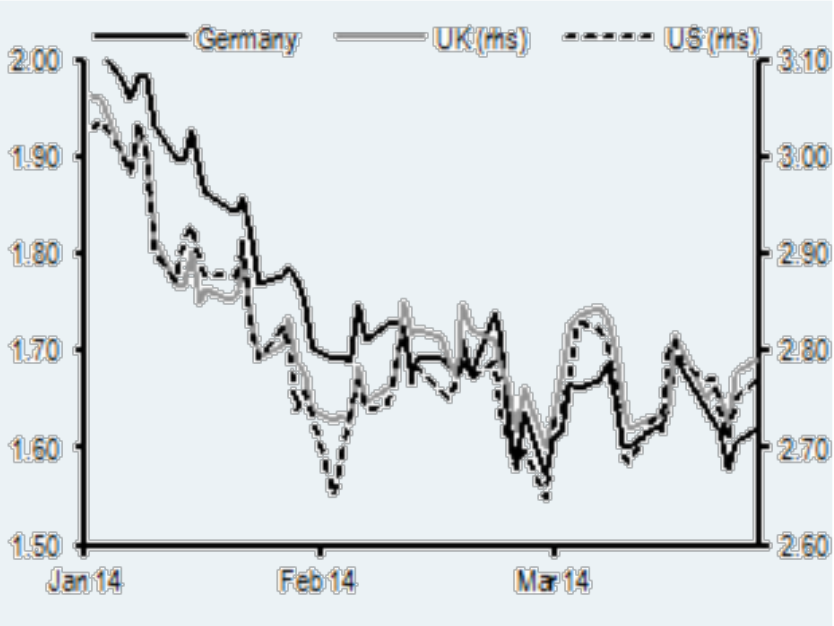
Contrary to expectations, long-end yields rallied in 1Q14

Contrary to expectations, long-end yields rallied globally in 1Q14

In Germany the rally in long dated forwards has been driven by the US, but stronger expectations of low-for-long in 3Y 2Y forwards are a domestic phenomenon

YTD changes in different segments on Germany and US curve; par rates used (bp)

YTD changes in different segments on Germany and US curve; par rates used (bp)

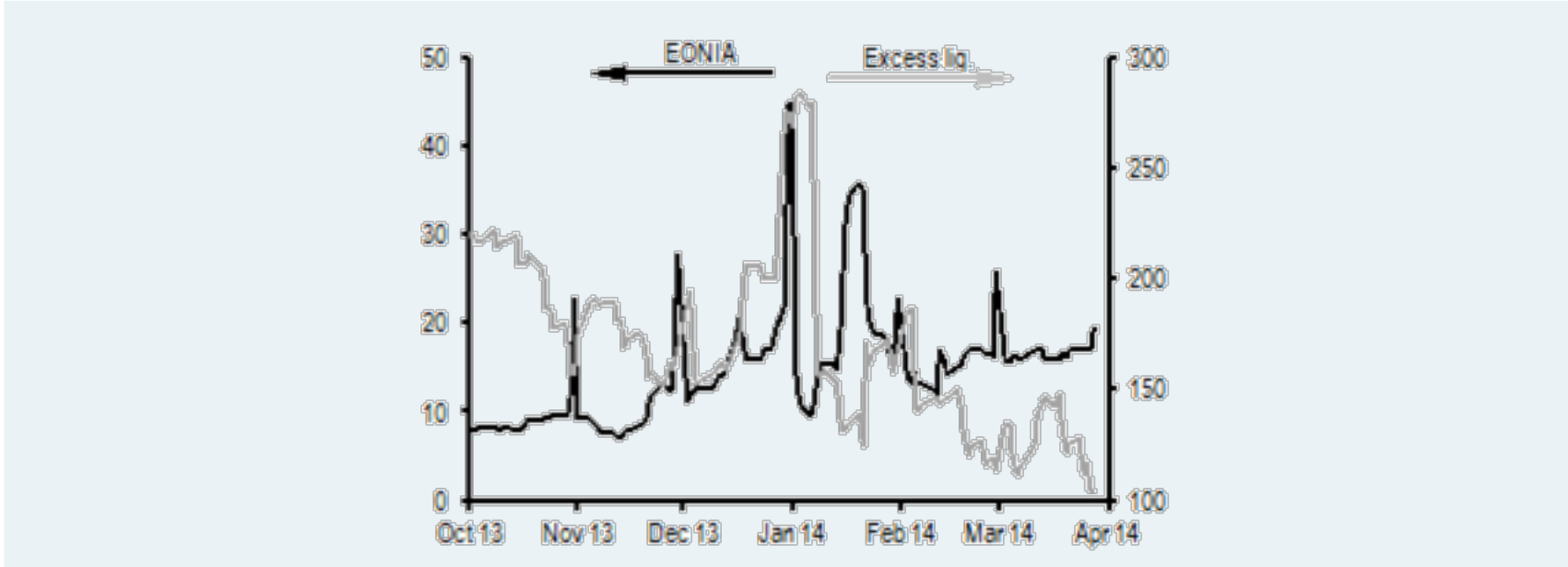


	2Y	3Y 2Y fwd	5Y 5Y fwd	20Y 10Y fwd
Germany	-8	-52	-47	-26
US	6	-17	-69	-55
Difference	-13	-35	21	29

In the last few weeks EONIA fixings have stabilised despite a further decline in excess liquidity

EONIA volatility has been muted over the past few months despite the ongoing decline in excess liquidity

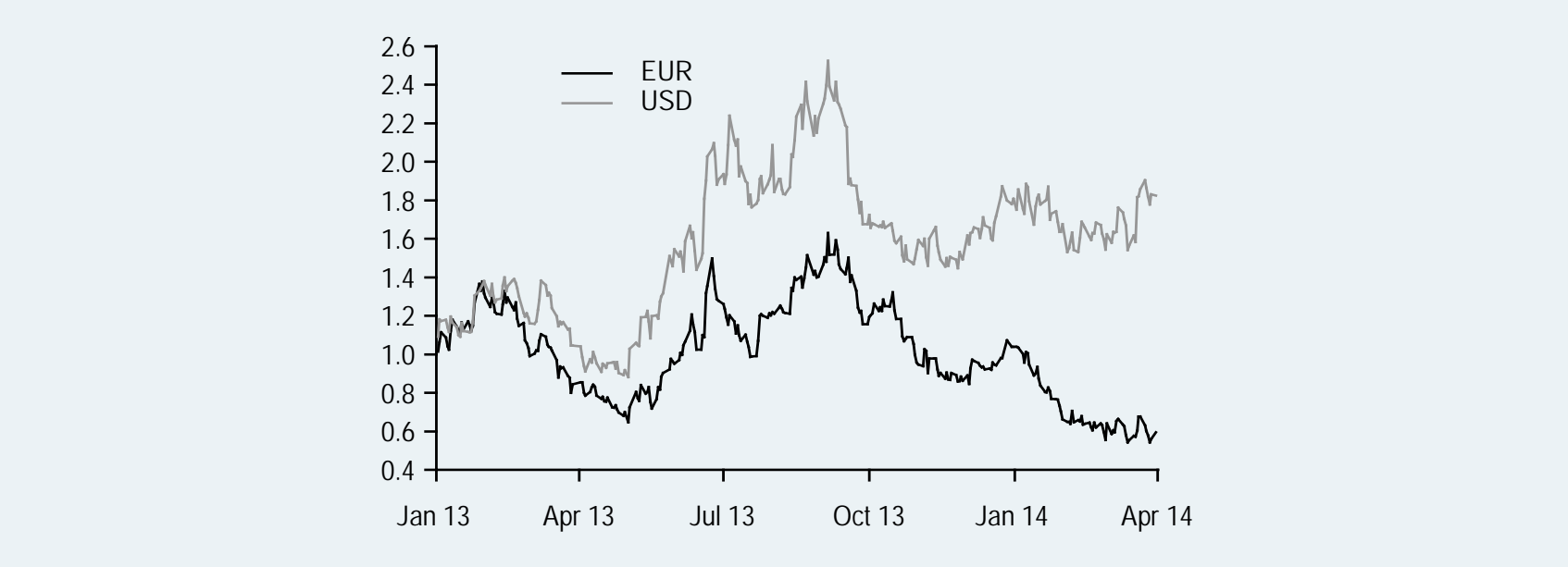
EONIA fixings and excess liquidity (€bn)



Money markets are pricing divergence in EUR and USD policy rate paths

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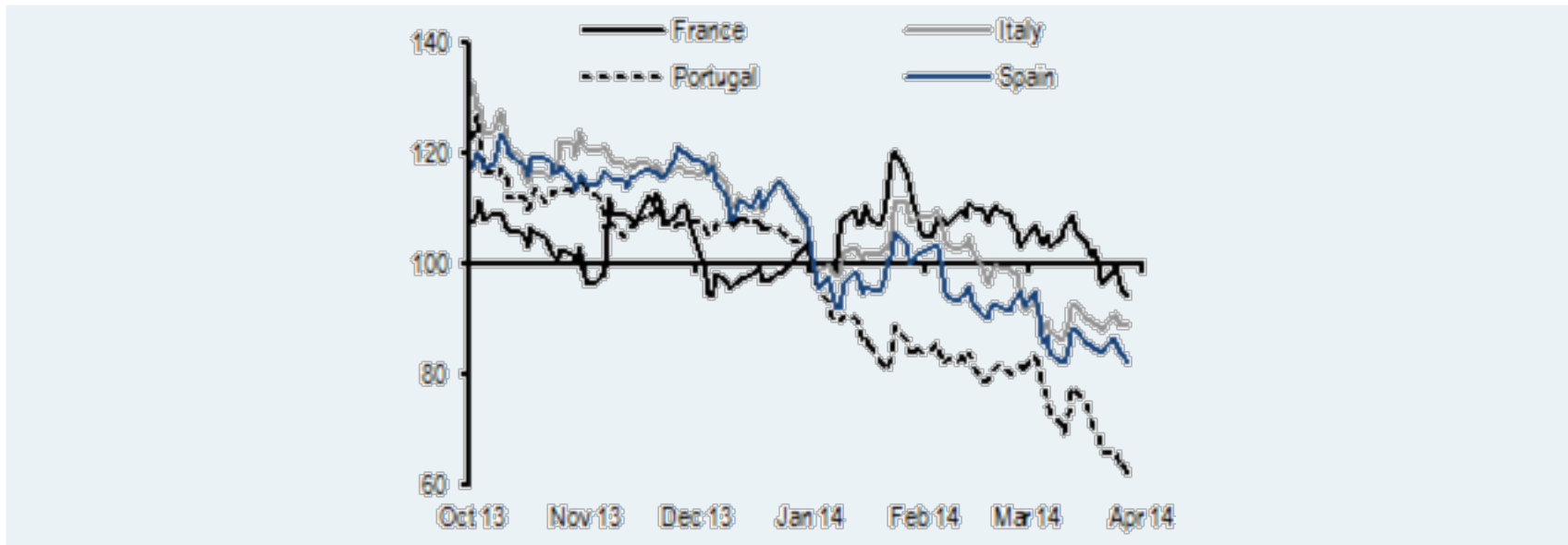
EUR and USD Dec16 OIS rate (%)



Peripheral spreads continued to tighten in 1Q14

Peripheral spreads continued to tighten in 1Q14 and core spreads moved side ways

10Y curve adjusted spread to Germany for France, Italy, Portugal and Spain (%)



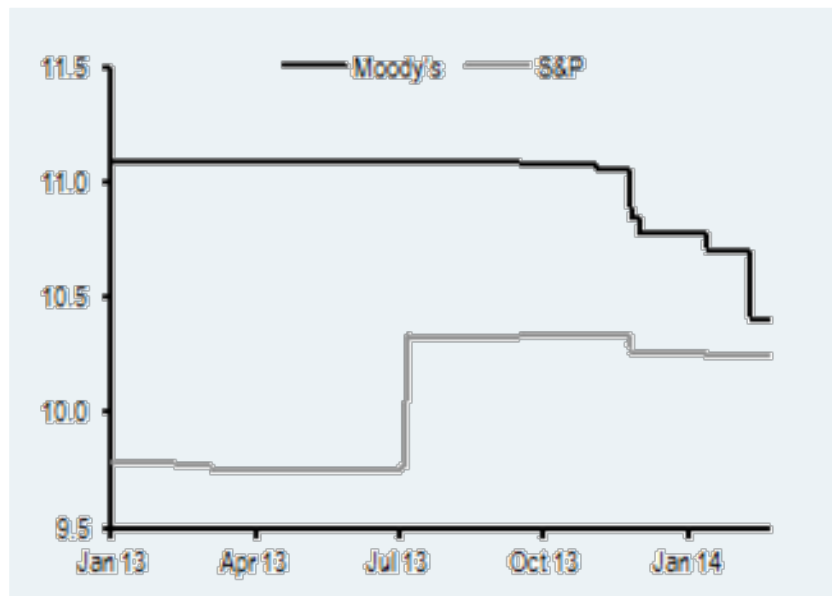
- Constructive peripheral view is predicated on
 - Positive macro developments
 - Limited headline risk
 - Favourable technicals

Headline risk is manageable and the rating cycle has turned

- At the start of the year investors were concerned about the potential negative impact of AQR/stress tests, German constitutional court ruling on OMT and a legitimacy crisis following the European elections. Investors are less concerned now
- Positive surprises came from Moody's
- EM has seen many flare ups: Argentinean currency devaluation, Venezuelan civil unrest, Turkish political crisis, Ukraine-Russia crisis. However, the impact of these events on Euro markets has been short-lived

Rating actions have been positive over the past few months

Weighted average peripheral sovereign rating index¹ for Moody's and S&P



Source: Bloomberg, J.P. Morgan

¹ Rating index: AAA/Aaa=1, AA+, Aa1=2, negative outlook =1/3, neutral outlook=0, positive outlook=-1/3, negative watch=2/3. Peripheral countries' rating indices are weighted by the size of their outstanding bond market

Update on supply/demand trends—Impressive front-loading and maturity extension in Spain

Euro area countries have already covered nearly 1/3rd of their 2014 conventional bond funding needs, based on our forecasts

Gross conventional bond issuance in 2014

	1Q14 (€bn)	Proj. 2014 (€bn)	Front-loading	Avg. front-loading 2008-2013	Current - Average
Germany	43	161	27%	27%	0%
France	55	175	32%	30%	2%
Italy	52	155	34%	27%	6%
Spain	45	128	35%	31%	4%
Netherlands	21	50	43%	37%	5%
Belgium	14	33	42%	34%	9%
Austria	4	25	15%	46%	-32%
Greece	0	4	0%	-	-
Finland	4	12	33%	32%	1%
Portugal	6	14	45%	-	-
Ireland	5	10	48%	-	-
Total	249	767	32%	30%	2%
Core	141	456	31%	30%	1%
Peripheral	108	311	35%	30%	4%

Note: We track supply on auction date basis rather than on settlement date basis

Spain's maturity extension has been very aggressive in 2014

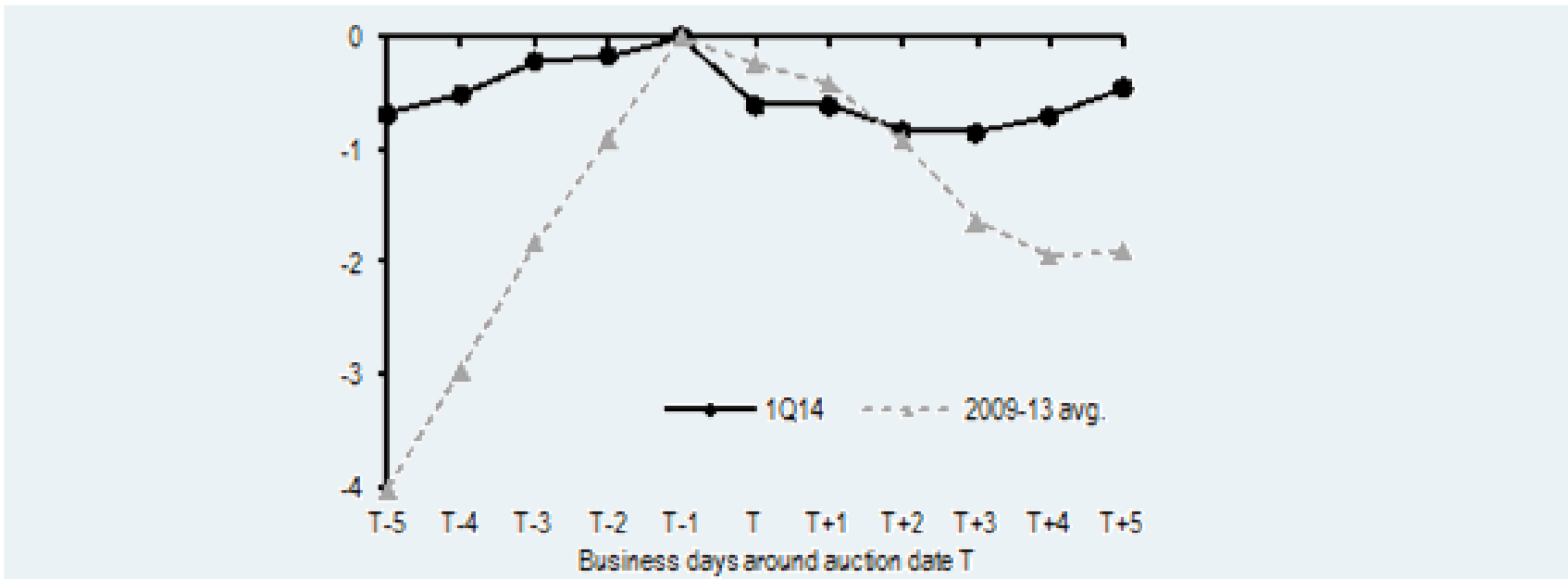
Outright and 10Y duration equivalent Bono issuance in 1Q of 2012, 2013 and 2014; Spain maturity extension was impressive

	Total size (€bn)	Wtd. average maturity of 1Q14 supply (years)	10Y duration eq. size (€bn)
2012	37.9	5.5	23.3
2013	41.1	7.2	29.5
2014	44.6	8.3	35.3

Update on supply/demand trends—No concession into supply

Another indication of healthy technicals in 2014 is the lack of concession to absorb supply

Evolution of top 11 Euro area countries' ex Germany bond spread to Germany¹ around supply adjusted for cross-market spreads²; 2009-2013 average and 2014 (YTD) (bp)



¹ If a new bond is issued, the bond with the closest shorter maturity is used

² (Bond yield – m/m German par yield) – Beta * weighted Euro area countries maturity matched spread to Germany in the sector of the curve (weighted by the size of their outstanding bond market). The beta between the country spread to Germany and the weighted spread to Germany is calculated as the ratio of (Bond yield–m/m German par yield) and weighted Euro area countries maturity matched spread to Germany at T-5 days

Update on supply/demand trends–Healthy syndicated stats

10Y Spanish syndicated deal had a record book size of €40bn

Statistics of syndicate deals in peripheral countries in January 2013

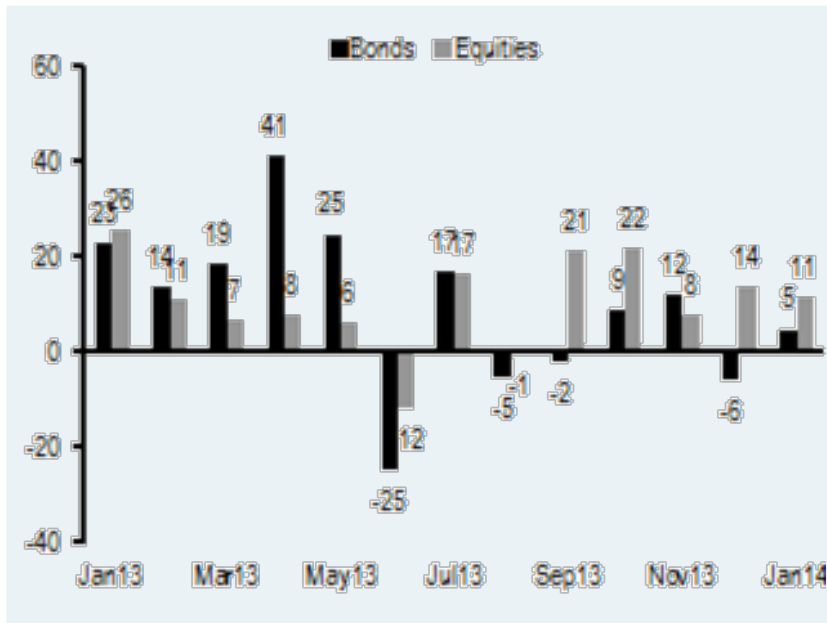
	Belgium		Ireland		Portugal				Spain			Slovenia			
	10Y		10Y		4-5Y		10Y		10Y			\$ 5Y and 10Y			
Syndicate date	10-Jan-13	14-Jan-14	13-Mar-13	07-Jan-14	23-Jan-13	09-Jan-14	07-May-13	11-Feb-14	22-Jan-13	15-May-13	22-Jan-14	02-May-13		10-Feb-14	
New/Tap	New	New	New	New	Tap	Tap	New	Tap	New	New	New	New	New	New	New
Maturity	Jun-23	Jun-24	Mar-23	Mar-24	Oct-17	Jun-19	Feb-24	Feb-24	Jan-23	Oct-23	Apr-24	May-18	May-23	May-18	May-23
Book size	7	11	13	14	12	11	10	10	23	21	40	\$16+		\$16+	
Deal size	4	5	5	4	3	3	3	3	7	7	10	\$1	\$2.5	\$1.5	\$2
Pricing	MS+62bp	MS+49bp	MS+240bp	MS+140bp	MS+395bp	MS+330bp	MS+400	MS+320	MS+365bp	MS+278bp	MS+178bp	MS+414bp	MS+419bp	MS+269bp	MS+268bp
% International	91%	93%	82%	83%	93%	88%	86%	83%	59%	48%	61%	100%	100%	100%	100%
Book size/Deal size	1.8	2.2	2.6	3.7	4.8	3.4	3.3	3.2	3.3	3.0	4.0	-	-	-	-

Source: National Treasuries

Update on supply/demand trends—Pick-up in mutual fund flows into bond funds and return of Japanese investors to periphery in late 2013

Inflows into Euro area bond funds resumed in October 2013 after a halt of few months

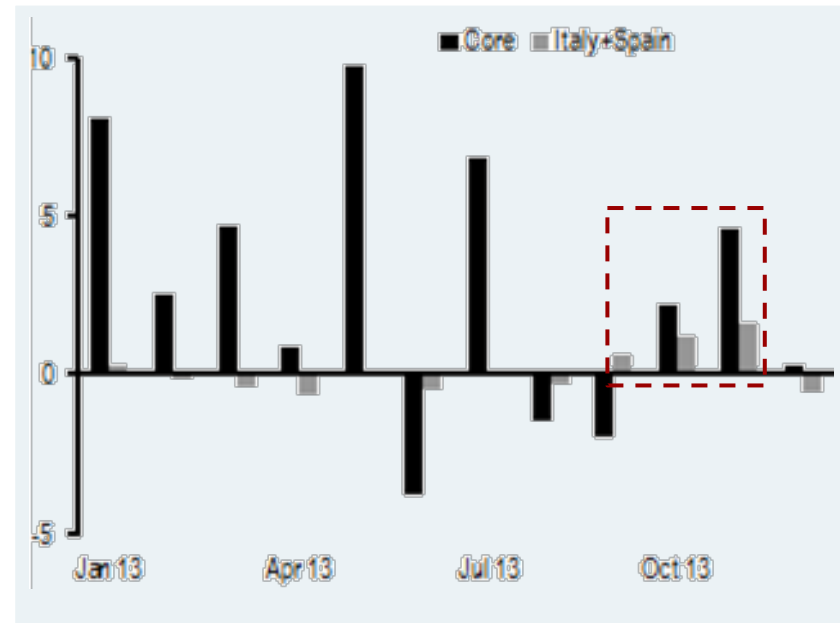
Monthly flows into bond and equity funds in the Euro area (€bn)



Source: ECB

Japanese investor flows show some interest in the periphery in late 2013

Monthly net purchases of debt securities* issued by core Euro area countries and Italy + Spain in 2013 (€bn/month)

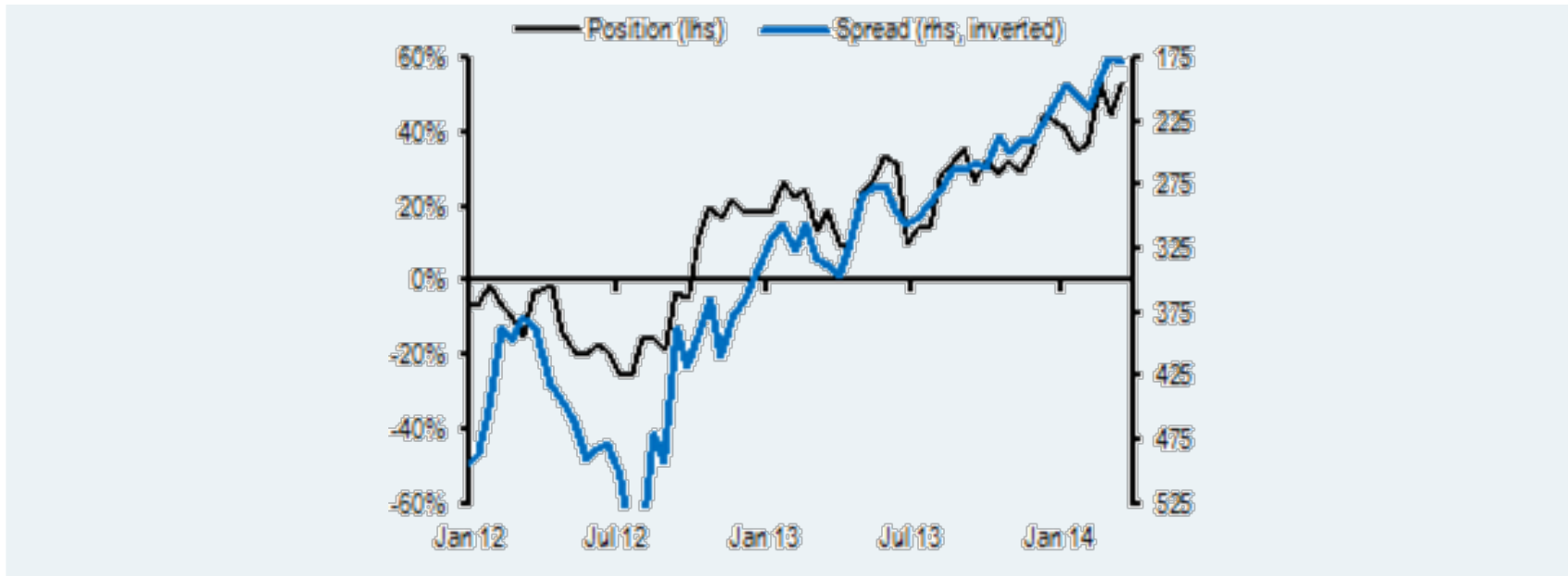


Source: BoJ Balance of Payment
* Includes non government securities

Update on supply/demand trends – Benchmarked investors have been OW peripherals for 17 months now

Over the past six months OW peripheral vs. core positions have become heavier as spreads tightened

Net exposure of Euro area investors to peripherals vs. core and average 10Y Italy and Spain spread to Germany (%bp)



Source: J.P. Morgan European Client Survey

- Trend of re-inclusion of Italy and Spain in the benchmarks

Update on supply/demand trends—Part of bank selling of government securities in December 2013 was reversed in January 2014

Part of bank selling of government securities in December reversed in January, with France and Spain being the most aggressive

Change in government securities portfolio held by monetary and financial institutions¹, by jurisdiction (€bn)

	Jan-14	Dec-13	Avg. Jan flow (1999-2012)	Avg. Dec flow (1999-2012)
Austria	-1	1	1	-1
Belgium	1	0	-1	-3
Finland	4	2	0	0
France	19	-21	9	-13
Germany	0	-1	5	-5
Greece	0	0	0	-1
Ireland	3	-3	1	-2
Italy	-7	-16	4	-7
Luxembourg	4	-1	0	0
Netherlands	2	-1	0	-1
Portugal	2	-4	0	0
Spain	20	-22	1	2
Euro area	48	-66	22	-25

Source: ECB, J.P. Morgan

¹ October and November 2010 removed in Germany and March 2011 in France due to structural breaks in the time series

- In February, Italian banks increased their government securities holdings by around €7bn and the Spanish banks reduced their holdings marginally (-€2bn)

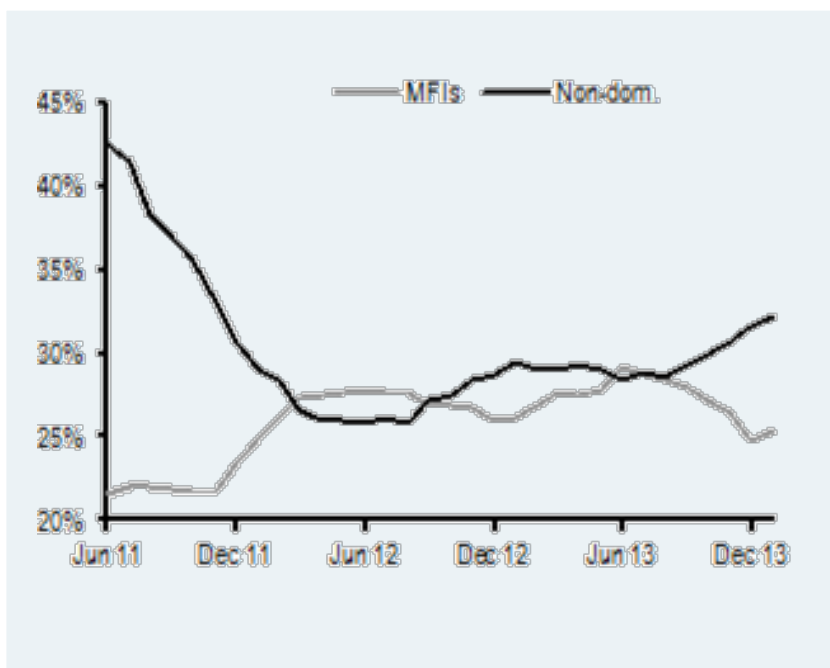
Update on supply/demand trends–Rotation in peripheral demand in 2H13

Non-domestic investors have increased their pace of buying Italian and Spanish securities over the past 6 months...

...thereby compensating for the decline in MFI holdings over the same time

Evolution of non-domestic and domestic MFIs holdings of Italian and Spanish (average) government securities¹; general government for Italy and central government for Spain (% of total)

Net purchases of Italian and Spanish government securities by investor type; general government for Italy



	2013	2012	2011
Italy			
Credit institutions	47	90	13
Other domestics	2	24	128
Non-domestics ¹	41	-67	-183
SMP	-10	4	98
Total	80	51	56
Spain			
Credit institutions	-7	20	50
Other domestics	15	18	36
Non-domestics ¹	63	22	-75
SMP	-1	2	42
Total	70	61	54

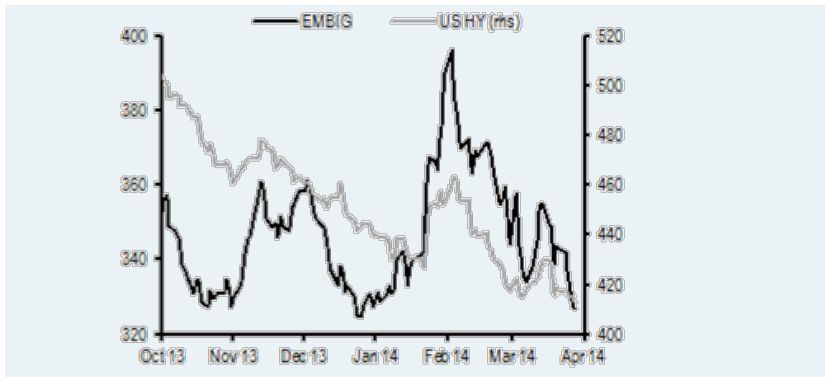
Source: National central banks, national debt agencies, ECB, J.P. Morgan
¹ Non-domestic holdings exclude ECB SMP holdings. For Italy, it also excludes Italian securities held abroad but attributable to Italian savers. (see Shedding some light on non-domestic investors in Italian and Spanish government bonds, Gianluca Salford et al., 31 Aug 2012 for details)

Source: National central banks, national debt agencies, ECB, J.P. Morgan
¹ Non-domestic holdings exclude ECB SMP holdings. It also excludes Italy's securities held abroad "but attributable to Italian savers" (see Global Fixed Income Markets Weekly, 6 Dec 2012 for details)

Credit/EM spreads are back to end of 2013 levels after a temporary spike in 1Q14

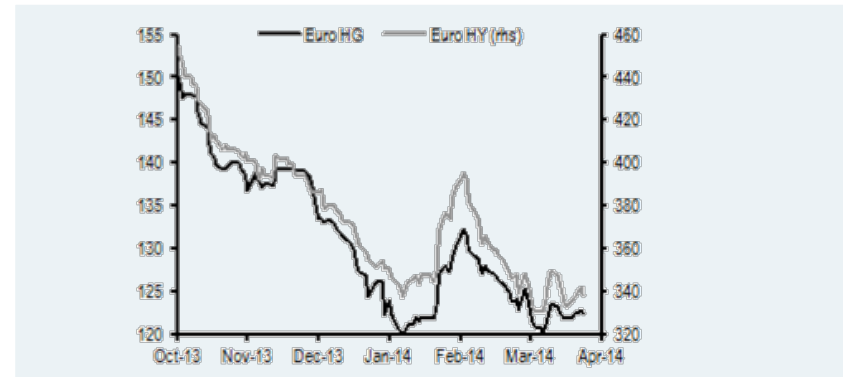
EM bond and US HY spreads have tightened back to end of 2013 levels after a temporary spike in early 1Q14...

J.P. Morgan EMBIG spread to US Treasury and J.P. Morgan US HY spread to US Treasury (bp)



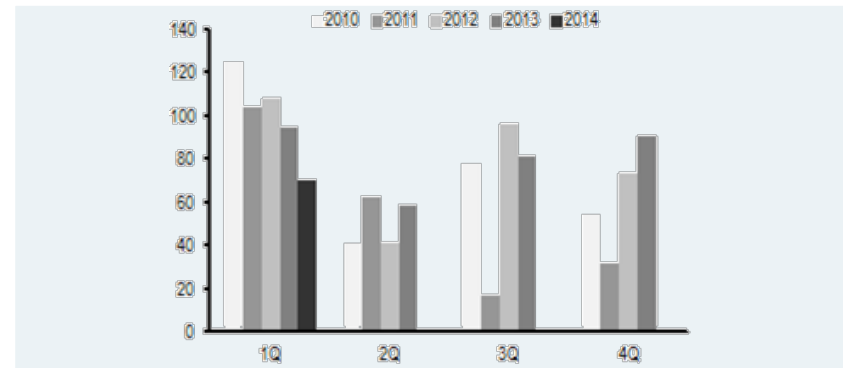
...a trend observed in European credit markets as well

iBoxx Euro HG and HY spread to Euro benchmark (bp)



Euro denominated high grade issuance in 1Q14 was lower than seen in 1Q over the past few years

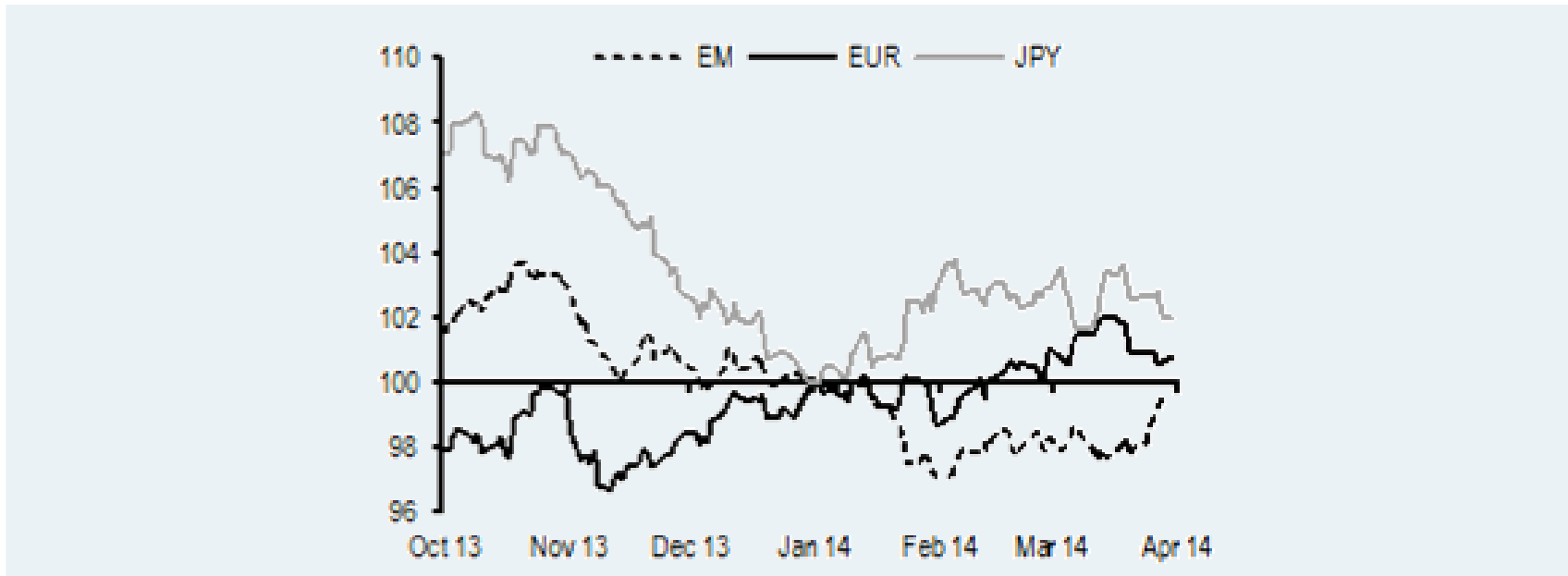
Euro denominated high grade issuance; benchmark size deals (€bn)



FX: EUR outperformed in 1Q14

In 1Q4, EUR and JPY outperformed

FX indices showing performance vs. USD; 31 Dec 2013 = 100



- The trend started to reverse at the end of the quarter on the back of a more hawkish Fed and soft verbal intervention from ECB members

We forecast Bund yields above 2% by the year end and peripheral spreads to tighten further

We project higher rates globally in 2014

J.P. Morgan 10Y benchmarks forecasts; %

	02-Apr	2Q14	3Q14	4Q14	1Q15
US	2.80	3.00	3.25	3.40	3.50
Germany	1.62	1.80	1.95	2.10	2.20
UK	2.78	3.15	3.35	3.50	3.65
Japan	0.62	0.60	0.70	0.80	0.85

We project a rise in 10Y Bund yields above 2% by the end of the year

German benchmarks unless otherwise stated; %

	02-Apr	2Q14	3Q14	4Q14	1Q15	2Q14 vs. fwd (bp)	4Q14 vs. fwd (bp)
ECB refi	0.25	0.25	0.25	0.25	0.25	n/a	n/a
2Y	0.19	0.15	0.15	0.20	0.25	-5	-10
5Y	0.68	0.75	0.85	0.95	1.05	-3	-1
10Y	1.62	1.80	1.95	2.10	2.20	10	25
30Y	2.50	2.70	2.80	2.90	3.00	18	33
2s/10s (bp)	143	165	180	190	195	15	35
10s/30s (bp)	88	90	85	80	80	8	8

We expect peripheral spreads to continue tightening in 2Q and core spreads to move broadly sideways

J.P. Morgan forecast of 10Y intra-EMU curve-adjusted spread to Germany*; bp

	02-Apr	2Q14	3Q14	4Q14	1Q15	4Q14 vs. fwd.
Austria	29	30	25	25	25	-5
Belgium	60	65	60	60	60	1
Finland	27	30	30	30	30	7
France	49	55	55	55	55	7
Ireland	139	150	140	130	125	-9
Italy	167	165	160	140	130	-54
Netherlands	30	30	30	30	30	5
Portugal	236	220	205	190	175	-88
Spain	163	160	150	140	130	-47
Wtd. peri. spread**	168	165	158	142	132	-51

* Adjusted for maturity mismatch by taking the difference in maturity-matched swap spreads.

** Weighted peripheral spreads computed against Germany for Ireland, Portugal, Italy and Spain (weighted by the size of their outstanding bond market).

Points for discussion/risks

- US growth–pick-up in 2H14?
- ECB reaction function to continued decline in inflation?
- China slowdown?

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