3rd Quarter 2013 Investment Outlook

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Executive Summary

Reflecting upon the first half of 2013 is essentially a tale of two markets and two timeframes. The U.S. equity market generated surprisingly strong double-digit returns during this period while most other markets and asset classes struggled. Comments from Federal Reserve chairman Ben Bernanke on May 1 concerning the future direction of U.S. monetary policy caused investors world-wide to reassess their interest rate and currency forecasts and triggered a sharp rise in bond yields and financial market volatility in the ensuing months. Oftentimes policy transitions can prove challenging to investors, but we believe a return to an economy free of Fed policy stimulus is a natural and healthy sign that the economy is slowly improving and the longer-term benefits of faster economic growth and a more normal interest rate environment will ultimately be beneficial.

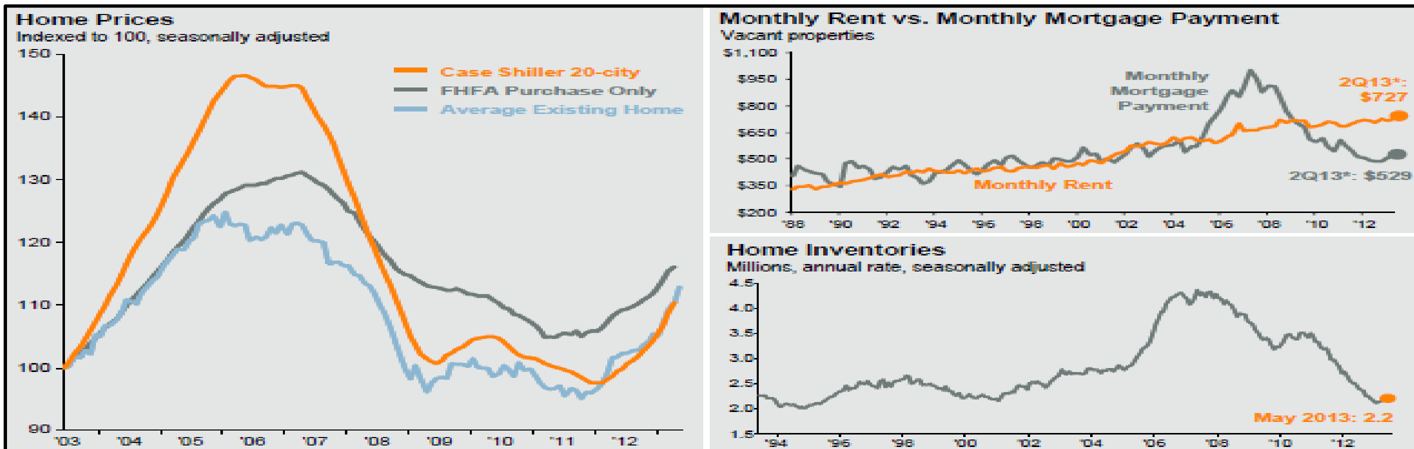
Key Considerations

- Even though growth remains sub-par, there are some encouraging signs in the economy, particularly housing and autos, while manufacturing has been more of a mixed bag. And the labor market finally appears to be showing steady and improving trends.

- The market now expects a change in monetary policy to occur before year-end believing the Fed will reduce the amount of treasury and mortgage backed bonds they have been purchasing each month. The pace of this "tapering," the phrase coined to describe the slow process of slowly reducing and ultimately ending the current round of quantitative easing (QE), will be debated upon the release of every important economic report in the months ahead.

- Emerging markets have been particularly hard hit during this policy transition and there are reasons for concern that risks will remain high, especially as China undertakes structural economic reforms. Japan's new economic prescriptions should continue to yield positive results and Europe may have bottomed as its focus on austerity wanes.

During the past year, the unemployment rate in the U.S. has declined to 7.6% from 8.2%. However, these statistics mask the underlying weakness that has existed in the labor market as the decline in the number of people in the labor force actually exceeded the decline in the number of unemployed in the past twelve months. More recently, there are signs of slow improvement as the labor force participation rate has stabilized and monthly job growth has averaged about 200,000 so far this year, while weekly jobless claims have been mostly below 350,000, pointing to the likelihood of continued job gains in the second half of the year. As indicated by the following charts, housing has been a particularly bright spot in the economy in the past year as extremely low mortgage rates and low home prices combined to support a recovery.



Sources: (Left) National Association of Realtors, Standard & Poor's, FHFA, FactSet, J.P. Morgan Asset Management. (Top right) Census Bureau, J.P. Morgan Asset Management. Monthly mortgage payment assumes a 20% down payment at prevailing 30-year fixed-rate mortgage rates; analysis based on median asking rent and median mortgage payment based on asking price. (Bottom right) Census Bureau, National Association of Realtors, J.P. Morgan Asset Management. *2Q13 rent and mortgage payment values are J.P. Morgan Asset Management estimates.

Data are as of 6/30/13.

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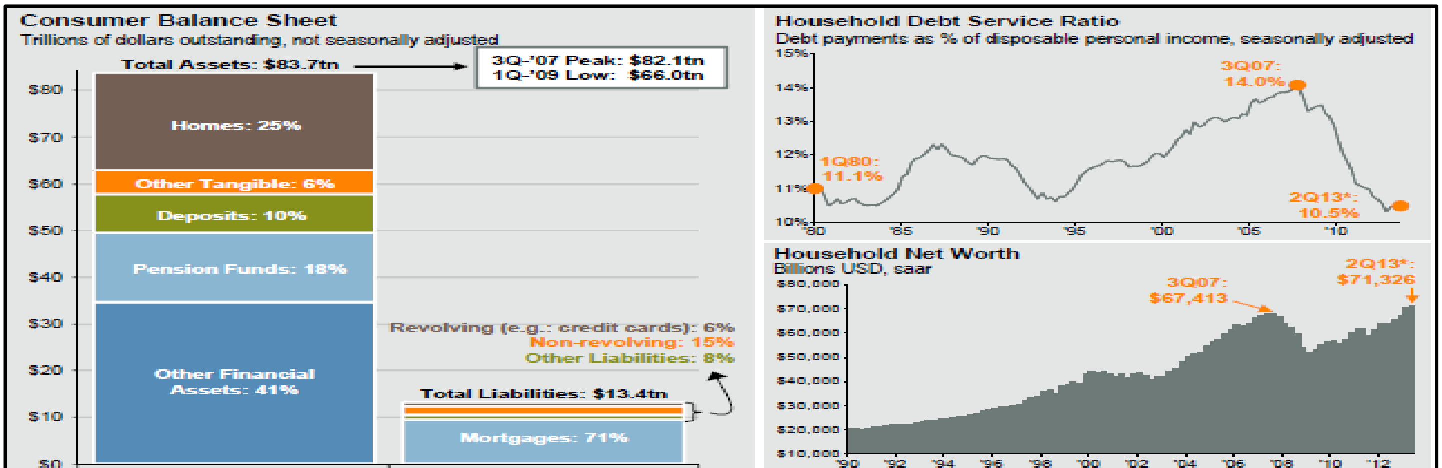
In addition, reduced inventories have helped the median price of existing homes to rise by 15.4% nationally in the past year. This, along with strong gains in stock prices, has bolstered consumer net worth and confidence as seen below:



Source: (Left) FRB, J.P. Morgan Asset Management. Data includes households and nonprofit organizations. (Right) BEA, FRB, J.P. Morgan Asset Management. *2Q13 household debt service ratio and household net worth are J.P. Morgan Asset Management estimates. Values may not sum to 100% due to rounding.

Data are as of 6/30/13.

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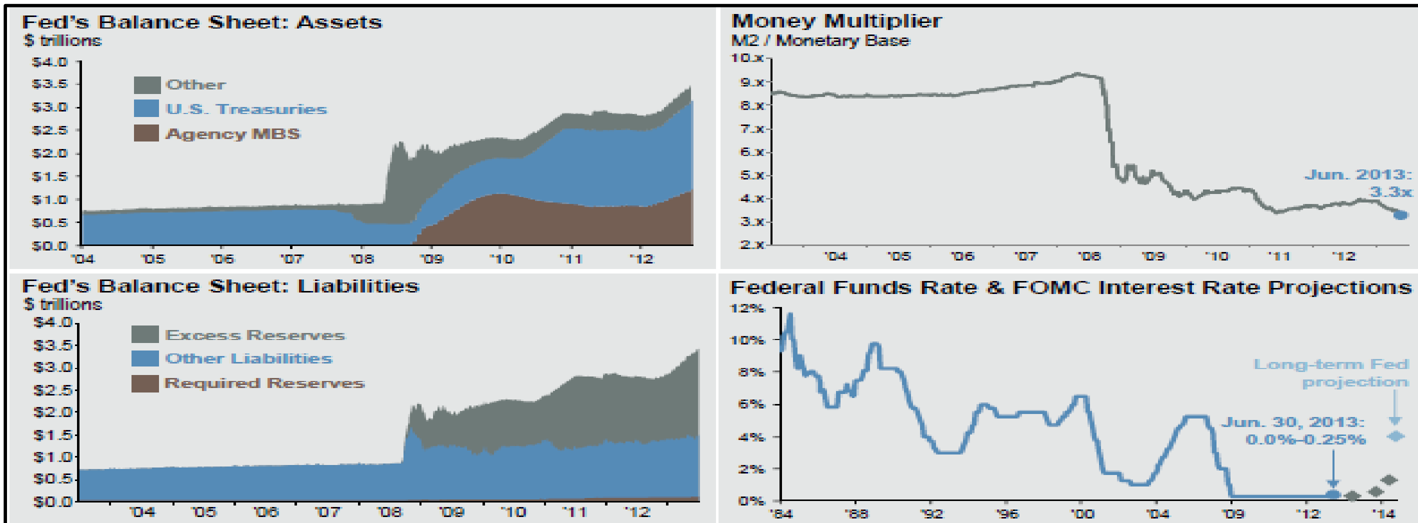
Manufacturing has been a bit more mixed recently as certain indicators have shown slowing results while others point to the likelihood of a soft patch as opposed to a sustained downturn. Although we are more inclined to believe in the soft patch idea, it is important to recognize that export growth has been slowing recently in line with a rise in the U.S. dollar index.

Changes in monetary policy have almost always been difficult transition periods for financial markets. Since the advent of the financial crisis in 2008, investors have experienced the singular Federal Reserve Bank focus on extreme monetary accommodation. The Fed's position has been to do whatever is necessary to prevent a deflationary spiral similar to the one which occurred during the Great Depression. Its policies include near zero short-term interest rates coupled with massive bond purchases via three rounds of quantitative easing

(QE) which ballooned the Fed's balance sheet by nearly $3 trillion since 2008.

These monetary policy prescriptions were never intended as long-term antidotes but as short-term emergency measures which would be removed once the economy was strong enough to stand on its own. Although the economy is still growing more slowly than normal, the Fed is expecting enough improvement in employment



Source: Federal Reserve, FactSet, J.P. Morgan Asset Management.
Monetary base is defined as the total amount of a currency that is either circulated in the hands of the public or in the commercial bank deposits held in the central bank's reserves. Money multiplier defined as M2 divided by the monetary base. Long-term Fed projection is based on average expectations of FOMC members. Other liabilities of the Federal Reserve primarily consist of the monetary base.
Data are as of 6/30/13.

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and GDP growth in the next year to begin preparing financial markets for a tapering and eventual ending of QE. The Fed's economic assumptions appear to be aggressive to many private economists who voice uncertainty regarding the actual pace of the wind-down of QE. In addition, Chairman Ben Bernanke made it clear that the Fed's zero rate policy was not likely to change until late 2014 at the earliest.

The most striking financial market implication of a change in Fed policy has been an increase in volatility. Fed tapering concerns have hit emerging market stocks and bonds particularly hard. Emerging market equities have produced the highest returns of any asset class over the past ten years on the back of improving fundamentals and faster economic growth. However, emerging market investments come with their own set of unique risks. With investors expecting further strength in the U.S. dollar certain risk-based trades are being unwound, causing weakness in emerging market currencies and stock markets. Additionally, weakness in emerging market currencies could create inflationary pressures and reduce the ability for some emerging market central banks to ease monetary policy. Rising interest rates in the U.S. may also cause investors to reallocate capital toward U.S. investments and away from emerging markets, further pressuring growth. In China, there are increasing indications that the new government is willing to sacrifice some near-term growth by implementing structural reforms in an attempt to transition the economy away from over-reliance on debt-fueled infrastructure development and more towards development of a consumer-driven economy. This transition could be difficult and take longer than expected to execute. Even though Chinese stocks look cheap, the market may continue to struggle until investors gain confidence about when and at what level China's economic growth stabilizes.

In Japan, the potential for economic revival is still in the early stages after new economic policies were implemented earlier this year. A massive quantitative easing program in Japan intended to devalue the yen was announced late last year and the positive effect on the economy has already been felt. With consumer

confidence and spending rebounding and export growth improving, first quarter real GDP accelerated to 4.1% and leading economic indicators in Japan suggest the potential for acceleration in future quarters. Although Japanese stocks have already surged higher this year, more gains are likely from current levels as corporate profit growth improves.

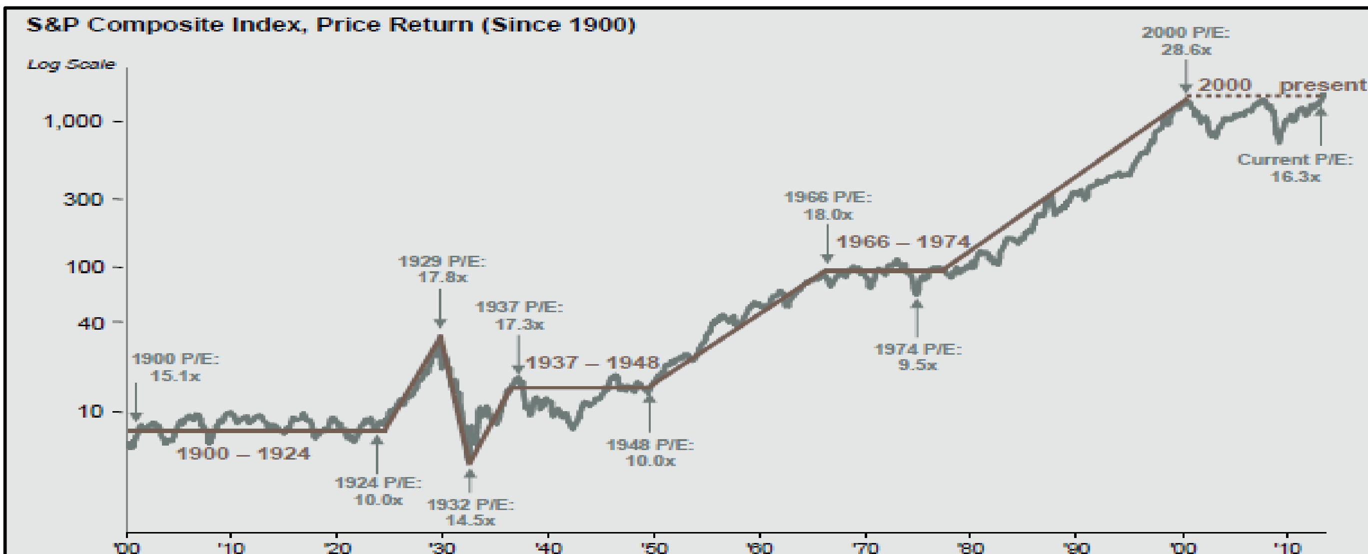
Investment Summary and Strategy

U.S. equity investors were treated to surprisingly strong results in the first half with all major benchmarks up better than 13%. Diversified investors were not quite as fortunate, as bonds, international stocks and commodities all produced negative results in varying degrees. The ten-year U.S. Treasury Note yield surged from 1.60% on May 1 to 2.70% as of July 5, producing one of the sharpest price declines in U.S. history. Longer dated bonds experienced even greater price declines. Foreign bonds were also hit hard as investors began to a reverse trades that worked so well for the previous ten-plus years. Foreign stock performance was highly dependent on locale as the Japanese market surged by 34% in yen terms and 17% in U.S. dollars. European stocks gained 4% but emerging markets lost nearly 10% in the first half. And while REITs were up 6%, commodities declined 10.5% with gold hit especially hard, down 27% year to date.

After more than a decade of slow growth and highly accommodative monetary policies, markets and investors are beginning to adjust to the possibility that the end of this era is in sight. We believe the process will take longer and be more drawn out than what is implied by the recent market volatility. We believe the Fed's economic growth assumptions are probably too high and that they will err on the side of maintaining monetary stimulus if economic data doesn't improve. In addition, when Ben Bernanke's term as Fed Chairman ends in January 2014, it is a good bet he will be replaced by someone, perhaps Vice Chairwoman Janet Yellen, who would be even more apt to maintain highly accommodative policies for as long as possible. However, the inevitable end of easy money policies where the Fed is artificially suppressing interest rates and a return to a more market-oriented environment is ultimately a good outcome. We expect periods of volatility and perhaps some financial dislocations in some market sectors or geographic regions. With this in mind, we believe that clients should maintain a diversified and disciplined approach to investing, closely tying their asset allocation to long-term objectives.

We recommend investors take advantage of any continued volatility in the months ahead to rebalance their asset allocations. We have been advocates of short duration fixed income bond portfolios for a number of years. When interest rates do begin to rise to more normal levels, we intend to replace allocations to some of the bond funds and other fixed income alternatives we've been using with a more traditional high-grade, intermediate-term laddered portfolio of individual bonds. We have also been strong emerging market advocates in recent years given their strong economic growth trends, attractive demographics, freer capital markets and more stable political systems. However, given the economic reforms in China, coupled with the improved trends in Japan and the Eurozone, we believe it is appropriate to adjust foreign equity positions. We will opportunistically reduce emerging market exposure and increase Japanese and European investments in the months ahead to reflect the changing environment.

We've focused much of this report on asset classes most influenced by modifications in monetary policy and where we believe portfolio policy changes may be necessary. The one asset class we believe is most attractive and requires the least amount of alteration is U.S. equities. U.S. consumers have proven once again to be resilient. Higher tax rates and the effects of the federal government spending cuts were digested and barely affected consumer spending. Improved conditions in housing and equity markets have caused consumer net worth to surge to record levels this year and helped drive consumer confidence levels higher. With this backdrop, consumers have felt comfortable reducing their savings rate back to 3.2%, the lowest level since the early months of the financial crisis. Corporations, while not as confident about future economic conditions, have much improved balance sheets and record profit margins. Any increase in real economic activity is expected to have a strong impact on corporate profit growth. After passage of tax and spending legislation earlier this year and, with divided government now firmly in place, the probability of additional fiscal policy changes in the next few years is pretty low. Strength in housing, autos, retail, healthcare and domestic energy should lead to attractive investment opportunities in those areas. In addition, U.S. manufacturers who benefit from low natural gas prices in the U.S. are well-positioned to gain global market share. We continue to find attractive investment opportunities in each of these sectors and believe U.S. stocks represent the safest and most desirable asset class during periods of less accommodative monetary policy. We hope to exploit these opportunities whenever the market allows during the volatile period we see ahead.



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

Data shown in log scale to best illustrate long-term index patterns. P/E ratios shown at price peaks and troughs use trailing four quarters of reported earnings and are shown as a one year average.

Past performance is not indicative of future returns. Chart is for illustrative purposes only.

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