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EM Asia Macro Strategy

Tactically long bonds in EM Asia

Emerging Markets Asia

Bert Gochet AC
(852) 2800-8325
bert.j.gochet@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong

Daniel Hui AC
(65) 6882-2216
daniel.hui@jpmorgan.com
JPMorgan Chase Bank, N.A., Singapore

Jason Mortimer AC
(65) 6882-1638
jason.j.mortimer@jpmorgan.com
JPMorgan Chase Bank, N.A., Singapore

Ying Gu AC
(852) 2800-8329
ying.k.gu@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong

Venkatesh Sivaraman AC
(91-22) 6157-3417
venkatesh.sivaraman@jpmorgan.com
JPMorgan India Private Limited

- The outlook for EM local markets remains bleak as outflows continue. As current account trends are not inspiring confidence either, we remain broadly bearish therefore on Asian FX. But in local bonds, there is tactical value for idiosyncratic and technical reasons.
- In local bonds:
  - Hold **long 10Y INDOGB** tactically for carry, as the issuance completion rate is faster than at anytime in last 5 years.
  - Be **long 5Y THAIGB** on a dovish monetary policy outlook (next week BOT cut)
  - Open a new position **long 10Y GPN**, on CPI leveling off, cheapness to RPGB, and FX hedge-ability
  - In India, **hold 5y IGB** for a possible 25bp gain, as technicals are good
  - Continue to U/W MGS on low yields and rising inflation.
  - In Korea, **exit long 10Y KTB and received 5y5y IRS**, as the new BOK appointee is not as dovish as we had expected
  - In China, **take losses on a paid 3y CNH CCS** as the large dim sum pipeline depresses CCS yields
- In rates, we hold
  - In Korea, **receive 2Y KRW** IRS for carry.
  - In Malaysia, **hold a 1/5s IRS curve flattener**. We earlier took profits on paid 5Y IRS as yields had risen significantly and Malaysian structured product risk was less than expected.
- In FX:
  - China - hold **long 3x6 CNH points**, as the spot will remain volatile. Await good entry level to sell USD-CNH outright as the medium-term view for a stronger renminbi remains
  - South-East Asia FX will continue to suffer from lack of bond inflows. Stay **short MYR and PHP** in 3M NDFs.
  - Taiwan - Be **short TWD** as a RMB-proxy, through a USD-TWD 3.60 2M digital call
  - India - stay **bullish INR** on the election outlook.

See page 23 for analyst certification and important disclosures.

Bert Gochet
(852) 2800-8325
bert.j.gochet@jpmorgan.com

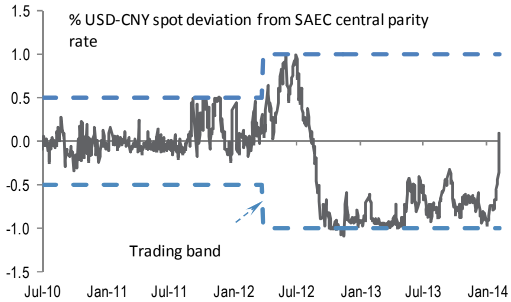
Outlook: A few opportunities to be long bonds, but remain wary of FX

Engineered CNY volatility worsens the already uncomfortable FX outlook

The past month has seen a turn in RMB FX policy to deliver more volatility to induce less speculation, but not trend depreciation. Following an 18-month period of low-volatility trend appreciation, RMB abruptly reversed, depreciating by as much as 1.8% in two weeks, and unwinding more than the past half year's worth of steady appreciation. This reversal appeared entirely policy driven – not only has the daily PBoC fixings (which sets the midpoint of the daily trading band and widely seen to be a barometer of RMB policy) has shown a weakening bias since late January (by our model estimates delivering 0.6% of the weakening), but the additional move appears to have been driven by official intervention flows, rather than market position adjustments. Official rhetoric suggests that this engineered volatility is an attempt to induce greater two-way movement of the currency to more fully utilize the 2% trading band, and in doing-so disincentivize the large one-sided speculative activity that had intensified since last year. A widening of the trading band may follow in the coming months to reinforce this new more volatile phase of the RMB exchange rate regime.

However, it still is unlikely that what has occurred is the start of period of trend depreciation: the fundamentals and flows do not support it, and policymakers are more interested in ongoing liberalization, deepening, and internationalization of the regime, rather than using the FX as a policy tool to support growth. We therefore hold on to our year-end CNY forecast of 5.95.

Chart 1: CNY has moved to the topside of the trading band



So far this has been mostly an isolated RMB drama, but further dislocations in the offshore RMB market, or more persistent trend deprecation could turn contagious. In Asia, the RMB has long been an anchor for the broader EM Asia FX complex. Asian central banks already regularly smooth against excessively quick currency strength, and this intervention policy could easily turn more aggressive if China were perceived to be on a more policy of delivering stimulus through depreciation. Historically North Asia FX is the most sensitive in terms of trade relations and historic correlations, but SGD and MYR in South-east Asia would be equally as impacted. **We currently long USD-TWD in our trade recommendations**.

EM Asia FX: Bearish bias remains, but focus on carry and the idiosyncratic for now

In Asia FX, we remain bearish in the medium-term, but are very selective in where this core view is expressed, with our focus more on carry and idiosyncratic stories. With $6.5bn outflows from retail local currency bond funds year-to-date (according to EPFR), the BoP backdrop is challenging for South-East Asia's bond-driven currencies and despite some encouraging adjustment having taken place, these currencies remain very vulnerable to global funding conditions. We keep core shorts where the absence of carry costs give holding power (**hold PHP and TWD** with implied yields of 1.24% and -0.82% respectively in 3m), while close shorts where high carry costs are too onerous to hold onto (closed **IDR**), and exiting and hedging against carry trades that were too crowded (we took profit on **CNY** last month).

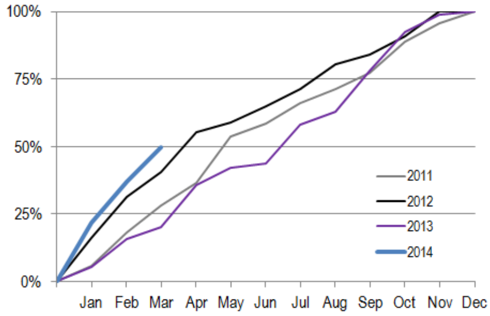
Outside these bearish views, India and Korea remain bright spot in Asia. We are constructive on the medium-term outlook for **the rupee**, believe that it is an attractive carry play (+7% implied yields) which offers additional upside once positive political outcomes are realized after the elections. We also remain medium-term constructive **KRW** on valuation, and corporate positioning, though are currently not expressed long KRW while RMB spillover risks remain heightened, and seasonal factors (including geopolitical ones) remain in play near-term.

EM Asia rates: Tactically long for now

In EM Asian rates, there are **a few tactically constructive stories**, although we temper our enthusiasm for EM Asian rates performance during a year where we are structurally bearish on US treasuries.

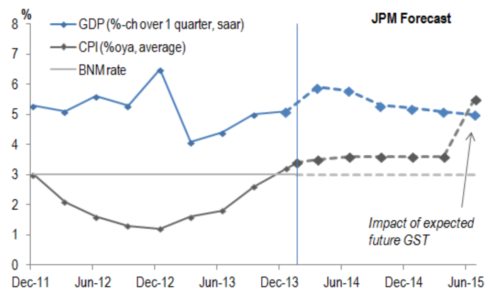
Among the trades we like, the high yielders stand out. We are overweight or long INDOGB 10Y, IGB 5Y and GPN 10Y. **Indonesian** government bonds are benefiting from a faster-than-expected supply pipeline, an improved BoP (although the jury is still out if that is sustainable), and until recently significant investor underweights. In **India**, we like the 5Y IGBs. India CPI inflation will remain in the mid-8% range, technicals will be positive for bonds until May (large redemptions), while the start of a new fiscal year will bring new appetite to build long bond positions. In **Philippines**, we also add an overweight on GPNs, as they trade cheap vs onshore RPGBs. Phils' inflation appears to be topping out (at 4.3% for Feb), and hence the pressure on BSP to tighten rates will ease in the near-term. Finally, add that PHP FX-hedging costs are cheap (at 1.2% implied yields in 3M NDFs).

Chart 2: Indonesia will have completed 49% of its annual supply target by end of 1Q (*)



* Assume IDR15tri INDOGB auctions for March, and a EUR1bn sovereign issue

Chart 3: Malaysia will see increasingly negative real rates during 2014



Within the low-yielder bond markets of Asia, we continue to hold **overweight in THAIGB vs underweight in MGS**. Bank of Thailand will cut rates next week, as growth declines further on polictical unrest. In Malaysia, CPI is still on an uptrend, and the negative real policy rates keep us wary of the MGS market. In **Korea, we exit an existing long 10Y KTB** position, as the new BOK governor appointee is not the dovish candidate that we expected.

Among IRS trades, we like a **1/5s MYR swaps flattener**, as the front-end risk premium can rise. We also curve **steepener in 1y1y vs 10Y TWD swaps**, as the Taiwanese economy is strengthening. Finally, we stay **received 2Y in Korea**.

Bert Gochet
(852) 2800-8325
bert.j.gochet@jpmorgan.com

Asian Local Markets GBI-EM and Leveraged model portfolio

GBI-EM (Real money portfolio)				
Country	**Comment**	**FX**	**Duration**	
Malaysia	*Underweight duration on rising inflation. Underweight FX*	UW	UW	
Thailand	*Overweight duration on steep curve, BOT cut. Neutral FX*	Neutral	OW	
Indonesia	*Overweight duration on supply completion. Neutral FX as BOP not out of woods.*	Neutral	OW	
Philippines	*Overweight GPN duration (not RPGB). Underweight FX on E&O outflows.*	UW	↑ **OW**	

Leveraged Portfolio

		FX Offshore	**Entry** Level (Yield)	Date	**Mark** Level	**PNL** % Chg	Mil $	**Notional** $mil	**Targets** Profit	Stop
	Long	USD/PHP 3m NDF	45.10	1/15/14	44.75	-0.78%	-0.39	50		
	Long	USD/MYR 3m NDF	3.313	1/16/14	3.277	-1.10%	-0.55	50		
	Buy	USD/CNH 3m/6m DF Steepener	143	2/18/14	150	7	0.03	250		
		Net					**-0.91**			

Leveraged Rat		**Rates/Bonds** Offshore	**Entry** Level	Date	**Mark** Level	**PNL** bp	Mil $	**Risk** $k DV01	**Level** Target	Stop
	Buy	THB 5y THAIGB LB196A (FX hedged)	3.57	12/11/13	3.16	+41	1.23	30		
	Buy	INR 5y Govsec (FX hedged)	8.92	12/11/13	8.98	-6	-0.12	20		
New	Buy	INDOGB 10Y (FR70)	8.40	2/18/14	8.08	+35	2.63	75		
New	Receive	2Y KRW IRS	2.75	2/12/14	2.78	-3	-0.15	50		
	Steepener	TWD 1y1y vs 10y Curve (ND-IRS)	69	12/11/13	70	+1	0.04	50		
	Flattener	MYR 1s5s NDIRS	63.5	2/7/14	58	+6	0.17	30	40	75
		Net					**3.78**			

	FX Volatility Offshore	**Entry (% price)** Price	Date	**Mark** Price	**PNL** bp px	Mil $	**Notional** $ mil	
Buy	USD/IDR 6m 1x1 CALL SPREAD (k=12000/13000)	2.00%	9/16/13	0.06%	-216	-0.65	30	
Buy	USD/TWD 3M 33.60 DIGITAL CALL	0.26%	3/6/14	0.00%	-26	-0.20	75	
Buy	USD/INR 6m 1x1 PUT SPREAD (k=64/61)	1.82%	12/4/13	2.63%	+81	0.41	50	
	Net					**-0.44**		

	Rate Volatility Offshore	**Entry (bp px)** Level	Date	**Mark** Level	**PNL** bp	Mil $	**Notional** $ mil	
Buy	KRW 5y10y ATM PAYR (K=3.65%)	338	12/4/13	298	-40	-0.10	25	
	Net					**-0.10**		

		Closed Trades *(trades closed in January are hidden)*	**Entry (bp px)** Level	Date	**Strategy**	**PNL** bp / pip / tic	Mil $	**Risk / Size** DV01 / $mil	**Exit (aged)** Level	Date
	Short	10Y KTB futures	110.90	12/4/12	Rates	-20	-1.00	50	112.14	2/6/14
	Steepener	KRW 3s10s KTB Curve (Futures)	58	6/21/13	Rates	+4	0.40	100	69.3	2/6/14
	Buy	JPY/KRW 2m 1x1 PUT SPREAD (k=10.38/10.10)	0.93%	12/4/13	FX Vol	-93	-0.70	75	0.00%	2/6/14
	Pay	MYR 5y ND-IRS	3.96	12/4/13	Rates	+10	0.50	50	4.06	2/7/14
	Rec	KRW 1y1y ND-IRS	3.03	12/4/13	Rates	+20	1.00	50	2.83	2/4/14
	Long	USD/IDR 3m NDF	12450	1/30/14	FX	-4.61%	-0.92	20	11876	2/14/14
Close	Flattener	CNY 1s5s NDIRS	12	1/27/13	Rates	-5	-0.25	50	17	2/21/14
Close	Short	MYR/KRW 6m NDF	328.79	12/4/13	FX	1.08%	0.54	50	325.25	2/21/14
Close	Long	INR/IDR 3M Fwds	195.0	1/27/14	FX	-3.45%	-0.86	25	188.5	2/21/14
Expired	Buy	USD/CNY 3m/6m NDF Steepener	25	12/4/13	FX	147	0.28	100	172	3/4/14
Closed	Rec	KRW 5y5y ND-IRS	3.64	2/6/14	Rates	+4	0.20	50	3.60	3/5/14
Closed	Buy	KRW 10y KTB 3.375% 2023 (FX hedged)	3.54	2/6/14	Rates	-1	-0.03	30	3.55	3/5/14
Closed	Buy	KRW 3m10y ATM RECR (K=3.32%)	100	2/12/14	Rates	-26	-0.20	75	74	3/5/14
Close	Pay	CNH 3y CCS	1.81	12/4/13	Rates	-33	-0.99	30	1.48	3/4/14
		Net (All closed trades YTD)					**-1.02**			

TOTAL	**1.32**	

*Upsized trades/hedges use weighted average of entry and upsize level. **PNL of trades entered into last year were cut off at zero on 1Dec13

Bert Gochet (852) 2800-8325
Daniel Hui (65) 6882-2214
Ying Gu (852) 2800-8329

Jason Mortimer (65) 6882-1638

Engineered CNY Volatility: Be careful what you wish for

This note was originally published 24 Feb 2014.

• PBOC's shift to an upward bias in CNY fixings and spot intervention has caused USD-CNH to spike by 1.3% in three days.

• We assume the PBOC is trying to flush out long RMB speculative positions, but we do not expect a large sustained depreciation

• Heavy long-CNH option positioning introduces non-linear risk to the market. The greatest risk comes from ~USD100bn of 'target redemption" structures (TARNs). If spot or forwards rise towards 6.20, TARN holders will start to experience negative gamma. The risk of this scenario occurring highly depends on how much the PBOC is willing to push up the fixings.

• Unlike all previous instances of CNH volatility, the USD-CNH forward curve has not steepened. The move up in spot so far is driven by the PBOC's fixes and not by corporate hedging. But if PBoC succeeds in reducing RMB speculation, back end forwards would also begin to rise

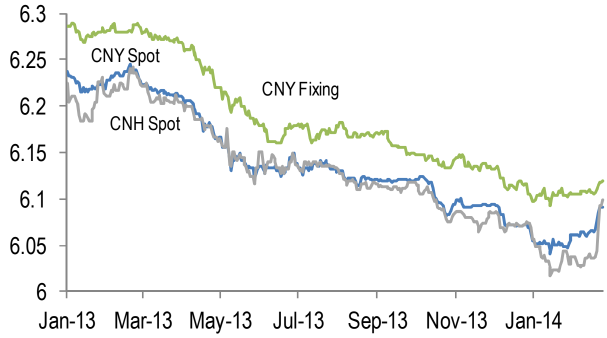
• In vol space, CNH FX gamma has risen while vega remains almost unchanged at low levels, as option dealer desks are being delivered vol when TARN's expected life extends.

• Strategy: Stay neutral spot CNH, until the fixing bias disappears at which point we will se USDCNH again. For now, hold 3x6 forward point steepeners in CNY and CNH, and also stay paid 3Y CNH CCS while PBOC tries to reduce speculation.

Sudden 1.2% depreciation in CNH Spot

Until a week ago, CNH had been on a 19-month, almost one-way appreciation trend. Since August 2012 the currency has ratcheted stronger in a low-volatility manner, reinforced by ever-stronger CNY fixes (set by PBOC), defying last year's EMFX selloff and culminating in an appreciating of 5.9% over the period. But that abruptly ended on 20 February, when CNH turned, and in the space of three days, spot CNH weakened as much as 1.3% on an intraday measure. (chart 1).

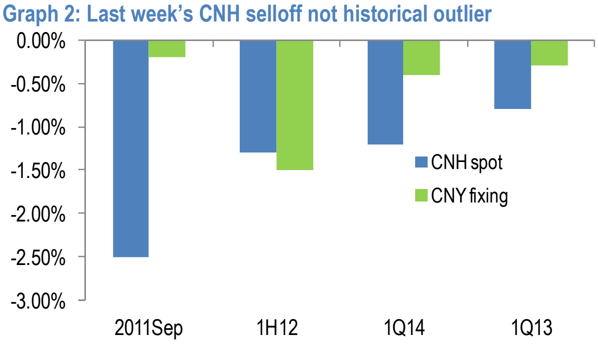
Graph 1: Steady appreciation in CNY until recent reversal



What happened to create this sharp turn-around? Briefly put, evidence is accumulating that the PBOC's daily mid-band fixes have reversed from an idiosyncratic appreciation bias (vs a DXY-based regression model) to a depreciation bias. We flagged this depreciation bias in a note on Tuesday last week (see "*Fixing bias shifts away from appreciation"*, Dan Hui, 18 Feb 2014). The market took note of the bias-change as the PBoC amplified the bias for depreciation the next day, more directly pushing onshore spot CNY weaker by buying dollars. Heavy positions turned and especially spot and short-dated USD-CNH forwards were bought.

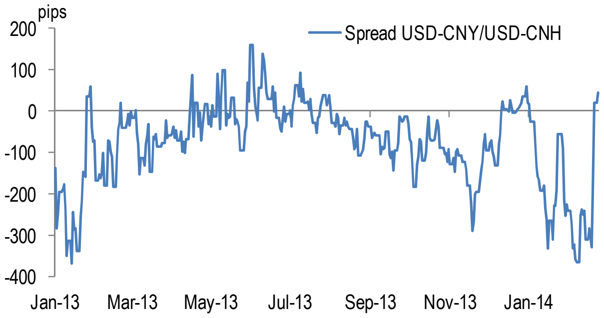
The depreciation of 0.4% in the CNY fixing and 1.2% depreciation in CNH spot of this turnaround are still within the range of historical trend-reversals. As chart 2 shows, in spot terms the current CNH depreciation is the third-largest such jump since 2011. But the move in the fixing is actually still small when compared to previous episodes.

Graph 2: Last week's CNH selloff not historical outlier



Nevertheless, in just one week CNH has reversed five months of low-volatility gains. Why was the move in spot so much larger, proportionally to the move in the fixing than we had observed in the past? We see three reasons. First, the DXY has weakened 1.7% MTD in February, which makes the underperforming fixing (weaker by 0.16% MTD) more stark in this context (if not in outright terms). Second, there are large positions in RMB-carry trades (of which more below). Finally, USD CNH spot was trading historically wide ie. 300pips below the onshore USD-CNY level1. (see chart 3)

Graph 3: Spread between CNY and CNH widens to >300pips before it turns sharply into negative



What are the PBOC's possible motivations for weakening the fixing?

Last year's large inflows and reserve accumulation are probably the main reason for PBOC to re emphasize two-way risk in currency. Especially after demonstrating resilience of the CNH trade against the sharp summer EM selloff, inflows have intensified since the turn of the year. The PBoC likely wanted to both reduce the current speculative positioning, and discourage the scale of future long RMB speculation. **The growth drag from deleveraging and potential corporate financial stress makes persistent REER appreciation less palatable.** Last month we recommended taking profit on the CNH appreciation trade, partly because we expect the corporate sector will continue to de-lever and this may lead to bankruptcies onshore. Against a backdrop of 7%-handle GDP growth, authorities may want to play it safe and appreciate less in 2014 than last year when the outlook was brighter. This is especially relevant now, given how RMB's REER has outperformed in the past year, amid significant depreciations elsewhere in EM. This puts additional pressure on exports.

Finally, a shakeout of speculative positioning could be a precursor to band widening, although this is unlikely the primary motivation. If capital flows stabilize as a result of the new fixing bias and spot CNY and CNH are better in-line with the midpoint fix, then this would present better conditions for PBOC to widen the trading band from 1% to 2% around the mid-point in 1H. While this is a reasonable scenario, it is unlikely a primary motivation for the recent depreciation moves. A PBoC report last week reiterating medium-term plans to widen the band (among other previously stated goals), was a coincidence in timing rather than a statement intended to explain the recent moves in RMB.

Ultimately though, we do not see PBOC introducing a persistent devaluation trend, for two reasons. First, a strong devaluation may trigger capital outflows against a backdrop of Federal Reserve tapering. The risk of capital outflows remains is increasingly a key concern for China policy makers as China's cross-border flows have become more cyclical in recent years. Second, a trend depreciation will dry up domestic liquidity and this will have a downward knock-on effect on mainland credit growth (and asset prices). By any standard, China has been over-borrowing (J.P. Morgan economists estimate China's total debt-to-GDP has surpassed 200%). It is not in PBOC's interest to inflame systematic banking risk this year.

Will Hong Kong or mainland authorities stop CNH from significantly depreciating beyond CNY?

So far mainland authorities have been nonplussed by depreciation seen so far. Finance Minister Lou over the weekend stated that recent CNY moves were "within normal range" and called the recent FX behavior "small volatility". This is not surprising, given that officials had instigated the move in the first place.

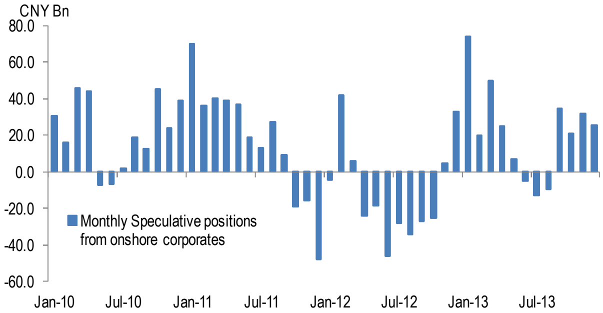
HK authorities will likely retain their laissez-faire approach, regardless of where CNH trades. There have been two instances of official response to large CNH-CNY divergence. In October 2010, HKMA activated their RMB swap line with PBoC when excessive offshore RMB demand pushed USD-CNH 2.5% below onshore spot. A year later in October 2011, USD-CNH spiked 2% above onshore on a position adjustment, and the HKMA announced a doubling of the clearing bank quota. In both instances, authorities backstopped the regular functioning of the offshore RMB system which had hit cross-border quota constraints. Thus, it was through allowing onshore-offshore arbitrage to resume that the CNY-CNH spread normalized, rather than through directly intervening in the CNH rate. We would expect HKMA to continue to only respond to functional market stress, but not price stress.

How large are the street's long RMB positions?

A key risk for CNY are the large long positions that have built up on back of 2013's one-way appreciation trend. In table 1, we 'guesstimate' the size of the positions that are currently long the currency. **We stress that these estimates are not scientific, and that there is substantial room for error around our numbers.** However, we think that our numbers are useful to highlight stress points around a weaker currency and how the various actors may act in case USD-CNH keeps rising.

Graph 4: Monthly speculated positions from onshore Corporates remain broadly positive, with an accumulated CNY600bn

(FX spot/Forward positioning data adjusted for trade balance)



The largest 'CNY long' positions are held by onshore Chinese corporates. We estimate their total at $614bn. To be sure, these positions have existed for many years given that trade flows still dominate China's cross-border FX transactions, however they rose strongly during 2013 (chart 4). Generally, onshore corporates hedge their USD trade receipts and payments at a pace that is variable and that reflects their RMB outlook. Since the financial crisis, corporates have generally increased their USD-CNY shorts, with the exception of 2012 when the fear of a China hard landing and the Eurozone crisis lead to these positions being unwound (chart 4). Our estimate of a current position of $614 of USD shorts is based on corporate FX spot+forward positioning data, adjusted for the size of the trade balance. This number may look large at first instance, but we note that China's reserves rose by more than $1 trillion over the last few years.

Offshore, the largest long CNH/CNY positions are held in option form by private banking clients and corporates. We estimate this position of an order of magnitude of $125bn. There are three types of option structures that have been popular, but the product that dominates is the so-called target-redemption structure ('TARN'). The majority of these are 6M-2Y in maturity, but can be longer. We go into more detail on TARNs in the following paragraphs. Another structure that has been popular is a double-knockout structure (ie. a structure that accrues carry unless it is knocked out on the USDCNH top or downside). Some clients have also sold naked topside calls on USD-CNH, but this is the minority. Note that in recent years, these option structures were done mostly in CNH and less in CNY NDFs (with a mix of 80-20% in our view). Liquidity and steeper forward curves benefited the issuance of CNH-based structured notes over CNY.

Besides from option structures, we also guesstimate that there are various speculative CNH and CNY spot and forward longs for a total of up to $100bn.

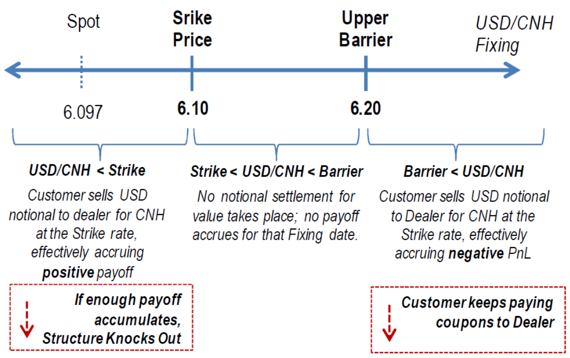
Risk from the CNH option structures: Watch out for 'TARN'-ado?

The popular CNH target redemption notes (TARN) pay off to clients if USD-CNH declines (while allowing for an occasional spike-up in spot), but they are not safeguarded against a sustained rise in USD-CNH. A typical TARN structure is set with a 1-2 year tenor, and designed to accrue a high coupon as long as CNY (CNH) is appreciating ie USD/CNH is falling. It accumulates this high coupon until USD/CNH reaches a target level of appreciation. Once reached, the structure knocks out and the client pockets the high coupon and recoups the notional. During the one-way appreciation of renminbi in 2013, TARNs would regularly reach their target redemption levels quickly, and knock out usually in about 3 months.

Table 1: 'Guesstimated' long RMB positions from onshore and onshore actors

On/offshore	Market	Community	Size $bn	Source/Data/Methdology
Onshore	Spot & forward CNY onshore	Corporates	614	*Corporate spot & fwd flow data*
Onshore	Options	Corporates	10	*minus trade data*
Offshore	CNY NDF outright forwards outright	Institutional Investors	25	*Estimates*
Offshore	CNH spot & forward outright	Institutional Investors	75	*Estimates*
Offshore	CNH options & structures (mainly TARN)	Private Bank/Corporates	100	*Estimates*
Offshore	CNY NDF options & structures (mainly TARN)	Private Bank/Corporates	25	*Estimates*
		Total	*849*	
		% of C/A (2013e)	*452%*	
		% of FX reserves	*22%*	

Table 2: TARN payoff example



There are two stages of risk to buyers of TARNs. The first is that appreciation of CNH slows down or the USD/CNH rate stops falling, in which case the structure's coupon can continue to accrue but at a generally slower pace. The relative level to determine if the coupon is accrued is the TARN's Strike rate, which will typically be set around the 1y forward USD/CNH rate when the note is printed. Therefore, when spot USDCNH moves up around 1% as we have seen in the previous week, then the client accumulated payout is merely set back by a few months (assuming a resumption of appreciation) and there is no accrual until spot USDCNH is back below the Strike rate again. Year-to-date, typical strikes were in the 6.10-6.15 range.

The second (and greater) risk comes if spot keeps rising above a predetermined 'Upper barrier'. The most recent barriers have typically been set at 6.20. If spot rises above this level then the structure will accrue negative PnL at a loss that increases with the level of the USD/CNH fixing. Table 2 illustrates an example, showing where the product accumulates positive and negative payoffs relative to the Upper Barrier strike levels. Effectively, TARN end-buyers are short USDCNH calls at 6.20.

As long as USD-CNH does not approach 6.20, TARNs do not intrinsically add to volatility in the market. In fact, a 'small' rise in USD-CNH from 6.03 to 6.10 as we have seen last week dampens volatility in the market: the expected life time of the TARN extends from roughly 3 months to as much as the full tenor of the note (as knockout expectations are priced further in future). In the process TARN dealers are delivered implied volatility in the 1Y-2Y bucket, while becoming shorter in the shortend of the volatility curve (1m-3m). This explains the out-performance of short end FX implied volatility versus long-end FX implied volatility over the past week (see below). This also explains why TARN dealers themselves were not forced buyers of long end USD/CNH in the up move, ie. dealers were not overall adding to realized volatility as a result of negative gamma.

The TARN structured product market would start adding significantly to realized and implied volatility once USD-CNH approaches 6.20, in our view. If such levels were reached, end-buyers of TARNs (who are short USD-CNH calls) would probably step up hedging their exposure, either by buying USD-CNH forwards outright, or by buying high-strike (say 6.40) calls, or by being stopped out of their TARNs by their dealer.

Who will sell if USD-CNH rises further?

We think three actors would sell into a further rising USD-CNH, but only up to a point.

First, the option structures such as TARNs will continue to get printed for the time being, even with USD-CNH at 6.10 or above. In fact, one can argue that the spike in spot gives better entry levels to such structures.

Second, **onshore corporates** who typically sell USD-CNY onshore will switch to selling USD-CNH offshore if spot USD-CNH rises above spot USD-CNY. Exporters can effectively choose whether to buy CNY or CNH depending on which one is cheaper.

But these actors would not continue to sell under all conditions. If PBOC fixings were to start showing a CNY depreciation trend, say to 6.15 or above, then at first option structures and eventually also mainland corporates would stop selling into the USD-CNY uptrend.

Third, hedge fund and option dealer desk holders of high-strike USD/CNH vanilla calls or straddles will have positive and rising gamma as forwards move higher to the option's strike prices. Long option gamma on these calls reaches a maximum when forwards are equal to the strike price, and begin falling (while remaining positive) once forwards exceed the strike price.

Strategy conclusions

Conclusions on CNH outright: Wait to re-sell $CNH

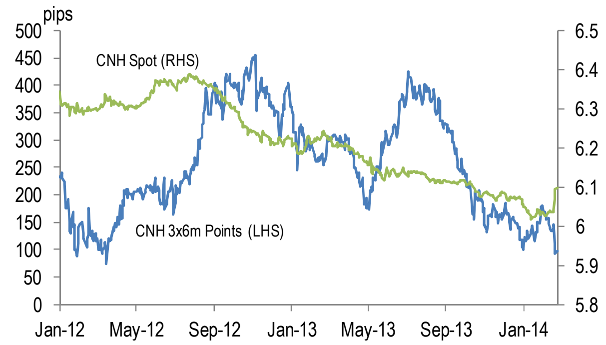
All eyes on the fixing. With negative gamma of existing option structures not a major risk until spot approaches 6.20, and with continued selling interest in forwards by corporate and through new option structures, we would not be buyers of USD-CNH unless PBOC shows a stronger inclination to push the fixing significantly higher than the current 6.1189. **In our strategy recommendations, we went neutral CNH (and CNY) about a month ago, and we stay with this view.**

Our bias is to re-sell USD-CNH at some point when the fixings stop showing a depreciation bias versus our DXY model. We have not changed our year-end target of 5.95 on spot. But it still remains to be seen the extent to which PBOC wants RMB to demonstrate "two-way volatility". Until that becomes clear (with a more neutral pattern of fixings and less upward bias in onshore spot), it is too early to fade the move.

Conclusions on the CNH forward curve: Stay with steepener

CNH forward curve was not steepening last week. Unlike in previous periods of CNH stress, the forward curve did not steepen last week. As chart 5 shows, the 3x6 forward points rose to 400 pips when short USD-CNH were being unwound during 2012. But this week, the curve remained flat (at 110 pips). We believe that some corporates are still selling (1Y-2Y) forwards into the rally, as a knee-jerk reaction from those who are long-term bullish CNY.

Graph 5: The flat shape of the 3x6M points curve

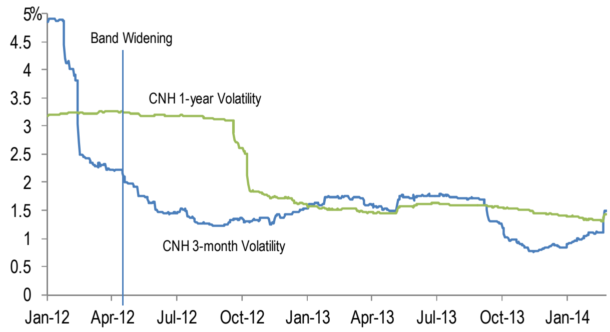


But we stay with our 3x6 steepener positions and also with our paid 3Y CNH CCS trade. In December, we advocated paying 3Y CNH CCS at 1.80% as a hedge for any long CNH position, and this trade is roughly unchanged at 1.70%. Also, last week, we suggested to pay CNH 3x6 forward points, with a target of 300 pips. If PBOC's bias to raise the fixing persists, ultimately the flows that have flattened the forward curve will stop and steepen up the curve. We reiterate that we are very near the lower limit of the flatness of these curves, as earlier periods of curve inversion (which reflected negative implied RMB yields) are no longer relevant for comparison, given the development of the offshore RMB market in the past two years.

Conclusions on CNH volatility: Too expensive to buy gamma

Dealers are currently being delivered USD/CNH vol in the 1-2y (vega) bucket while losing vol in the short end 1-3 month (gamma) bucket. This situation will persist as long as USD/CNH spot remain below the 6.20-6.30 level. As a result, last week long end 1-2y CNH vol did not rise from the lows, even as (1-6m) short end FX gamma performed strongly on dealer's TARN extension and realized volatility in spot. Focusing only on the first round structural risks from the TARN market, we believe that long end USD/CNH FX forwards will not be bought as a direct result of negative gamma hedging until spot reaches the 6.20 level, which by extension means that 1-2y FX realized and implied vol will also not rise much until this level is reached. Therefore 1-2y USD/CNH FX vega at current levels may indeed be very low priced relative to FX gamma, but will not necessarily perform unless significantly higher levels of spot are reached, triggering actual hedging flows.

Graph 6: CNY 3M gamma spikes, but 1Y vol does not.



What will be the impact of band widening on vol? Widening the band has not historically resulted in a spike in vols, and is not a reason in and of itself to buy FX vol, in our view. We note that the last band widening (from 0.5% around the midpoint to 1% in April 2012) did not result in a rise in volatility, as chart 6 shows.

In sum, we do not recommend buying vol at current levels. Gamma has richened already, and vega will not richen unless the structured product negative gamma kicks in.

Bert Gochet (852) 2800-8325
Daniel Hui (65) 6882-2214
Ying Gu (852) 2800-8329

Jason Mortimer (65) 6882-1638

Engineered CNY Volatility Part 2: Answers to commonly asked questions in response to last week's CNH report

This note was originally published 4 Mar 2014.

• Our recent report Engineering CNY volatility: Be careful what you wish for generated many common questions which we answer here.

• On policymaker intent, we believe Beijing is aiming at changing market psychology more than positioning for near-term band widening. Last week's rise of USD-CNY to the trading band topside mainly signals a new phase of policy-directed volatility.

• If the PBoC's behavior during the CNY volatility of 2012 is any guide, we believe it would be premature to start fading the move by re-entering fresh USD-CNH shorts (we closed our recommendation in late January).

• Strategy #1: However, for real money investors who can withstand a further 2% spot volatility over the coming months, we recommend not reducing short USD-RMB risk, at these levels. We continue to hold our 5.95 year-end target for spot.

• Strategy #2: For investors that are concerned about specific non-linear risks in CNH TARN structured products, we recommend buying a 2m USD-CNH 6.20/6.30 call spread at 0.15%.

• Strategy #3: RMB FX forward curves have flattened because the maturity extension of TARNs has triggered large supply of long-dated vol and points. Close 3Y CNH CCS payer, but hold long 3m-6m points steepeners.

• Strategy #4: Within the region TWD remains the most exposed currency to RMB depreciation contagion, and we are long a USD-TWD digital call. Other spillover candidates are MYR, SGD and KRW. We are underweight MYR for a variety of reasons, and have recently closed our KRW overweight.

1. Are mainland policymakers sensitive to non-linear risks that are embedded in the CNH structured product market?

As we highlighted in last week's note, there are approximately $125bn of $CNH structured products outstanding that are effectively short a USD-CNH call with 6.20-6.30 strikes. Are mainland authorities aware that a rise in spot towards 6.20 could trigger hedging of negative gamma by the structures' end-users?

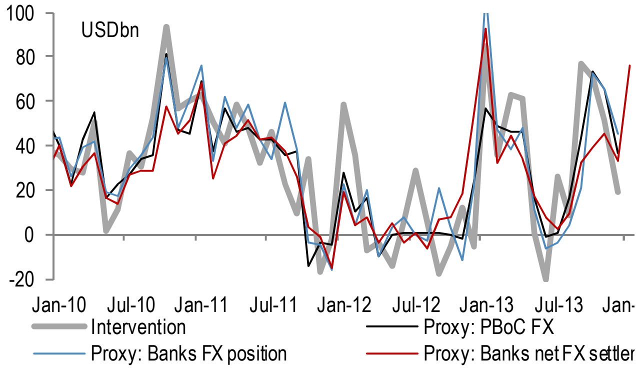
We think not. We believe that policy makers are far less concerned with the offshore RMB market than with the onshore market. CNH is not explicitly regulated by China (only cross-border RMB transactions are) and CNH technically does not involve any onshore participants (only perhaps their offshore entities). Also, HKMA has at times commented that they will take a laissez-faire attitude to the CNH market.

Meanwhile, it is uncertain how much PBOC are aware of the CNH options-related risk, but presumably they are at least partially aware given the noise and in the press last week. And while we do believe that policymakers would want to avoid triggering systemic tail events in $CNH, there is a risk of accidental unintended consequences in our view, particularly given that Beijing's new set of leaders have shown greater risk appetite in tackling structural issues more directly and preemptively (of which massive RMB speculation might be considered one).

2. RMB speculation has been strong since 2013. Why did authorities not flush out positioning earlier?

In fact, in early May last year, authorities did attempt to flush out RMB speculative positioning. After evidence emerged of large carry positions being put on by onshore corporates in 1H13, authorities attempted to trigger an onshore sort USD-CNY squeeze through NOP regulation, while tightening surveillance against so-called "fake export receipts" (see RMB FX Update: Tactically take profit on short USD-CNH, but stay constructive medium-term, 6 May 2013). However, this initiative seemed to fade shortly as tapering expectations of a broadly stronger dollar emerged, and as the policy focus turned towards the shadow banking system and interest rate liberalization.

Figure 1: Third highest net inflows seen in January – the catalyst for the latest policy response?

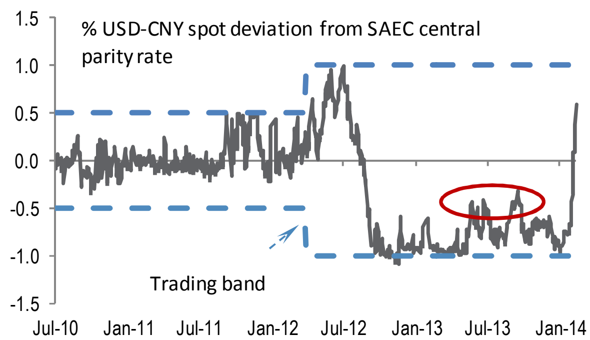


New data showing speculative inflows surging again may have driven this recent re-focus on the exchange rate regime. Last Monday SAFE released data showing January's net FX purchase and sales by banks. A common proxy for net inflows and PBoC intervention, **this printed USD76bn inflows in January, the third such highest print on record**.

3. Is this simply an exercise to push USD-CNY spot back to the mid-point ahead of band widening? If not, then what is the objective?

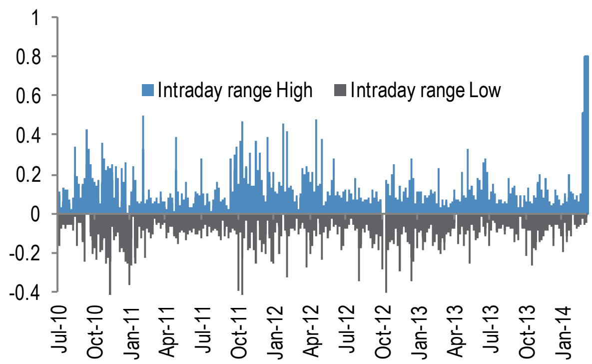
No - we believe the primary objective is to flush out speculative positioning and to engineer more two-way volatility, with band widening a secondary objective. A scenario of a more benign "re-centering" adjustment ahead of band-widening had been a popular explanation for this recent sudden shift in RMB policy. But CNY's overshoot of the midpoint last week to test the band ceiling puts paid this more benign hypothesis. (Figure 2).

Figure 2: This episode has gone far beyond merely re-centering spot at the midpoint



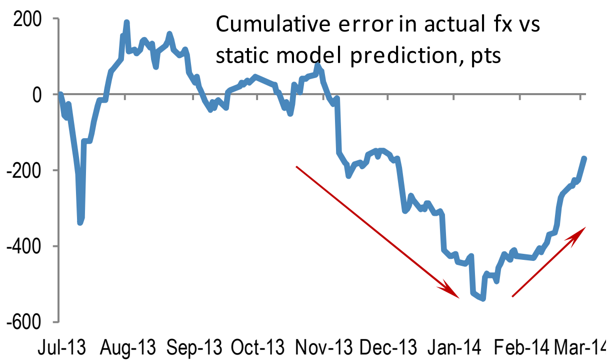
Authorities have acted more aggressively than in the past, suggesting they seek a much more substantial change in RMB market dynamics. These actions have probably included the first example of direct intervention to move the USD-CNY spot rate intraday of any meaningful magnitude. Moreover, this has driven unprecedentedly large intra-day moves (Figure 3). Meanwhile, the fixings continue to show a substantial weak-side bias against the DXY model (Figure 4), which since mid-January has moved the USD-CNY fixing cumulatively 0.6% higher than where the historic DXY relationship would have put it otherwise.

Figure 3: Last week saw unprecedented moves in intraday spot, most likely driven by official intervention…



Most recent PBoC rhetoric continues to emphasize that this recent volatility should be seen as "quite normal". This and the fact that the USD-CNY upmove was policy driven, suggests that the authorities are signaling what the new normal for RMB could look like: more frequent full utilization of the full range of the trading band. If the PBoC persists in engineering this outcome, <u>then short-end realized volatility must permanently rise, and near-term carry-to-vol will become much less attractive.</u>

Figure 4: …and a continued weak-side bias in the recent fixes have driven the USD-CNY midpoint 0.6% higher than otherwise



4. Would band widening be a signal to re-short USD-CNH?

No. Based on the experience of 2012, band widening was in fact the start of a move higher in USD-CNY and USD-CNH spot, fixings, and points. Ultimately in 2012, **the catalyst for the reversal from higher USD-CNY was a sharp policy triggered drop in USD rates**. This move was what created the very attractive onshore carry, which ultimately put into motion the strong onshore USD-CNY selling flows that have driven the hitherto 18-month trend of steady trend appreciation.

Figure 5: RMB weakened to the top of the band following the last band widening

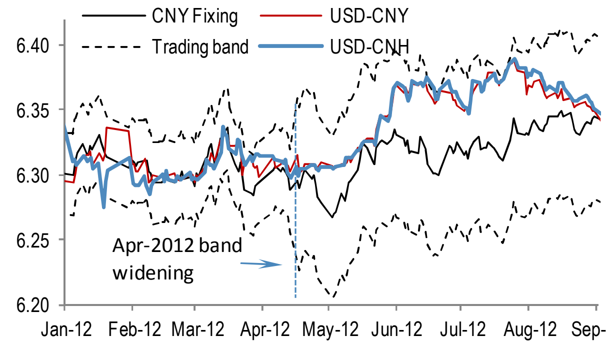
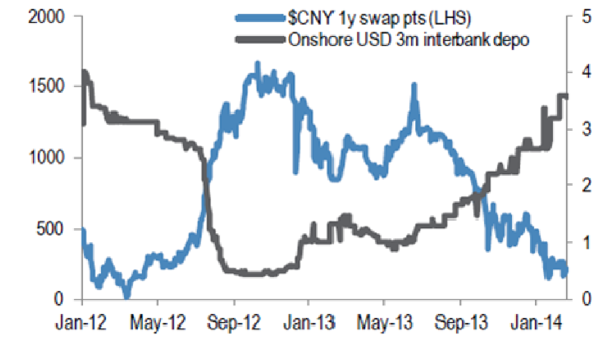


Figure 6: It was a policy drive of onshore USD rates lower which triggered the reversal and initiation of trend RMB appreciation in 2012



Moreover, with spot now trading well into the weak-side of the band, band widening now may actually reinforce near-term RMB weakness, if this is seen as a way to for the authorities to push for even more near-term weakness versus the fix (i.e. greater utilization of the weak-side of the trading band).

5. Why have implied forwards declined in the long-end?

CNH FX forward curve flattening is driven by maturity extension of Target Redemption Forwards and Notes (TARNs), as we explained in our earlier note. These Target Redemption products typically come with a 2 year nominal tenor, but usually knock out in only about 3 months from the time they are printed. When CNH spot and forwards rise, these structures extend in duration out to the full term of the note as the target redemption knock out becomes less likely to occur.

This has the effect of **dramatically lengthening dealers' gamma profile from the 3 month bucket to the 1-2 year bucket**. Given the size of the outstanding TARN market (which we estimate to be USD125bn), the net effect of dealers all simultaneously getting delivered FX vega and 1-2y FX gamma has the effect of forcefully dampening both long end FX implied and realized volatility. As a function of the TARN's extension and dealer's long-end gamma extension in a rising USD/CNH market, delta rises and desks become increasing long the long end forward FX points. The overhang of these forward points thus keeps the long end of the forward FX curve low and flat relative to spot and short end forwards, where dealers are actually net losing gamma.

Another reason to explain the FX flattening dynamic (and underperformance of 1-2y CNH FX implied vol) is that **FX vol desks would likely be highly motivated to shed their accumulated long FX forward points and vol if USD/CNH were to resume a downward trend or even just stabilize at current levels** in order to protect long-gamma trading profits.

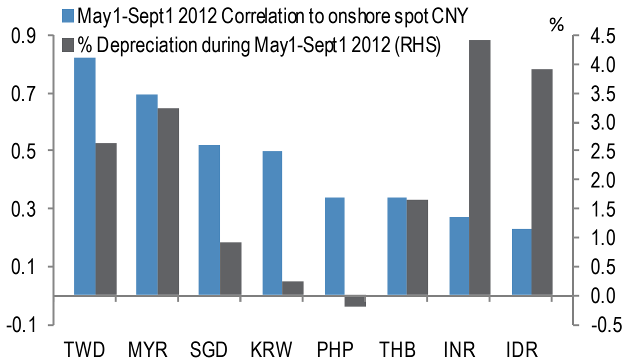
Our earlier recommendation of long 3x6 points in USD-CNH and USD-CNY ND forwards, was predicated on a reversal of positioning, and underappreciated the impact of exotic structure hedging flows. Ultimately, if we are correct that PBoC's primary objective is to break the one-sided speculative market psychology, this will imply lighter and less persistent speculative positioning in the forwards, and more normalized (steeper) FX curves. Indeed a further sustained rise in USD/CNH will likely not cause significant further TARN extension (which is already at/near a maximum) so further exotic desk hedging flows will be for less forward point selling.

However, **the risk in the near-term is that the curves at the long-end continue flattening before then. We close our receive CNH CCS 2y recommendation.**

6. Who is most vulnerable in Asia to RMB weakening?

TWD remains our top play for RMB depreciation contagion. Figure 7 presents Asia FX correlations during the mid-2012 episode where CNY depreciated 1.7% and the fixings depreciated 1.3%. Then, TWD showed the highest correlation and we would expect a similar reaction this time. The macro linkages are obvious, CBC intervention has been a primary driver of TWD weakness recently, and Taiwan has perhaps shown the most concern for currency competitiveness in Asia. We reiterate our long USD-TWD at-expiry digital call recommendation which continues to present particularly attractive risk-reward (a 3m 30% at-expiry digital call today can be struck at approx 30.5).

Figure 7: TWD and MYR the most correlated to CNY in mid-2012

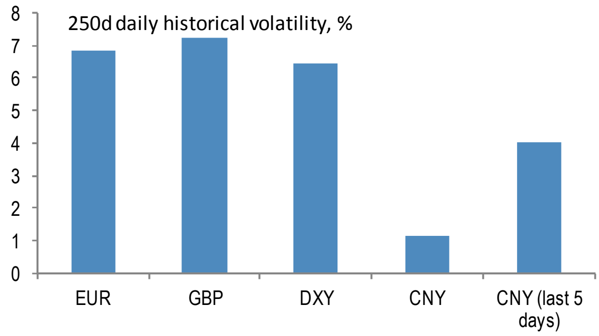


So far at these levels, there has been little spillover into the rest of Asia EM - that may change if non-linear higher USD-CNH forces are triggered above 6.15. Besides the particularly uncorrelated and idiosyncratic EM FX environment at present, the lack of contagion so far is likely due to the USD-CNY squeeze being more policy than position liquidation. However, if this move extends, and particularly if higher USD-CNH triggers non-linear position unwinds, it is hard to imagine that it would not spillover into the rest of USD-Asia.

7. Doesn't China need a appreciating, or at least stable fix to promote RMB as a internationalized and reserve currency?

While expectations of material and persistent appreciation were an important incentive to promote the accumulation of offshore RMB in the early stages of internationalization**, it is far less relevant now**. RMB has arguably gained critical mass offshore, with the CNH deposit base now USD1.2trn, with cross-border RMB trade settlement now accounting for 15% of total Chinese trade, real offshore asset markets (in the form of dim sum bonds), and importantly growing channels of cross-border investment back into China.

Figure 3: As a potential reserve currency, CNY is not volatile enough



In fact, **unusually low volatility and persistent appreciation is not a normal characteristic of reserve currencies**. The more important prerequisite for China in promoting a competing global reserve currency is to develop a deep, liquid, and sophisticated FX market. It is likely that authorities saw the large and growing speculative flows and positioning as being a greater threat and hindrance to the development of the FX market, and a complication to capital account opening. **Therefore these actions could be seen as promoting RMB internationalization and reserve currency status in the longer-run**.

8. Does this change your medium-term forecasts for CNY?

No. We keep our year-end forecast at 5.95. As described above, we believe the primary objective is to change near-term volatility dynamics (and thus, indirectly the carry-to-vol and return-to-vol incentive of speculative RMB trades), in an attempt to improve the functioning and behavior of the market. While this may put our near-term quarterly forecasts at some risk, we do not see an end to continued modest appreciation over time . Medium-term drivers of ongoing RMB strength remain intact, including the trade surplus and capital inflows. We also do not believe that Beijing is ready to use trend depreciation as a cyclical policy tool.

Strategy: Add new hedges against disorderly moves higher in USD-CNH

- **Buy a 2m USD-CNH call spread (k=6.2/6.3) at 0.15% net premium**

We open a CNH FX option trade to hedge against a move of USD/CNH to 6.20-6.25 range in the near term (which we assign a low probability of 25% chance of happening). We buy a 2m USD/CNH Call spread struck at 6.20-6.30 at a 0.15% net premium. Using a 1% OTMF for the low strike and a 1.6% strike spread, the Call spread has a maximum payoff ratio of 10.75 for a spot expiry of 6.30, although we would expect no more than a 5x payout ratio, assuming that USD/CNH would not exceed 6.25 for any long period of time. The short dated call spread has several advantages: the payoff ratio is still attractive for an option even with the most recent move higher in short dated FX vols, the short-dated expiry reflects our belief that a sharp move higher in the USD/CNH rate is either going to happen soon or not at all (at least not before FX forwards and FX vols decline first). We also avoid taking a large position in the recently elevated short end FX vols with the short expiry and option spread. The upfront cost of 15 bps is also low enough to be attractive for a wide-range of investors looking to position for/hedge against a limited adverse outcome in the CNH market with a reasonable chance of realization.

India rates strategy: Tactically long 5yr as technicals supportive

This note was originally published 3 Feb 2014.

• After last week's surprise RBI rate hike, policy rates will now stay on hold until the (April/ May) national election.

• Bonds will be supported in the next two months. The fiscal deficit is reigned in, supply is negative until March-end, OMO purchases by RBI to offset increased currency in circulation are likely before the election.

• Further out, a clear mandate to a national party in the central elections will entail better fiscal expectations, a pick-up in FII inflows and a stronger INR that will reduce the pressure on RBI to tighten.

• Strategy: Tactically buy 5yr bond at 8.92% targeting 25bp lower in yield. However, in case of a favorable outcome in central elections target 50bp lower in yield.

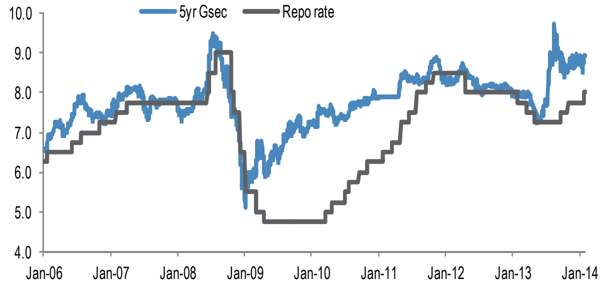
• The main risk to this trade is that rupee sells, and that RBI would come under further pressure to tighten. But in our main view, INR should range-trade.

No change to policy rates expected until June

RBI unexpectedly raised repo by 25bp to 8.0% in the policy last week. However, for now it sees the current policy rate as sufficient to curb the headline CPI to 7.5% -8.5% by 1Q15 which is the target band for inflation in one year according Dr. Urjit Patel committee report. We expect RBI to stay on hold on the April 1st policy meeting and for any further rate action to occur only post the result of the central elections results in the June policy meet.

The 1 year OIS at 8.71% is currently pricing in roughly 40bp of hike in policy rate from current level. But, it can also be argued that instead of a hike, 1 year OIS is pricing in call to stay in repo for 60% of the time and at MSF for 40% of the time. Our liquidity projection for remainder of 1Q puts call at MSF for a meaningful period in absence of any action by RBI.

Exhibit 1: The 5yr Gsec is trading at 92bp spread over the repo which is high as compared to similar period when RBI rate is at similar level

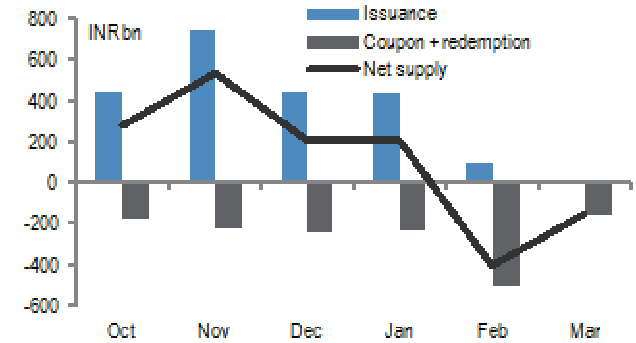


Source: J.P. Morgan estimates

Net supply to be negative until March

There is only one more Gsec auctions scheduled for the remainder of the FY14 ending in March which is on Feb 7th (INR100bn). This is assuming that the INR150bn auction deferred on Jan 17th is not brought back on the table. This supply will be more than offset by the redemptions on Feb 16th (INR50bn) and Feb 24th (INR152bn) and coupon payments over the next two months (Feb INR298bn & Mar INR153bn). Thus the net Gsec supply from now to FY14 end will be negative INR554bn.

Exhibit 2: Net supply is significantly negative from now to March end

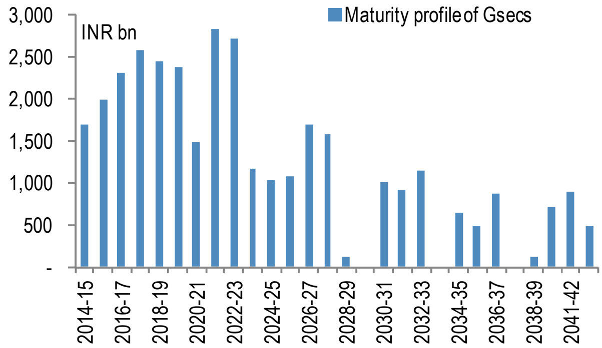


Debt swap, even if conducted, should not affect the 5yr

There is still little clarity on the planned INR500bn debt switch program which would involve buying short-end and selling longer-dated bonds to spread out redemptions to future years. There have been comments by the deputy governor Mr. H.R. Khan that the switch may not be carried out in the current fiscal year. However, even if the debt switch were to be carried out it is likely that it is conducted off market.

Venkatesh Sivaraman
(91-22) 6157-3417
venkatesh.sivaraman@jpmorgan.com

Exhibit 3: RBI will likely spread out redemptions beyond 2019 as there are already significant amount of bonds maturing until then



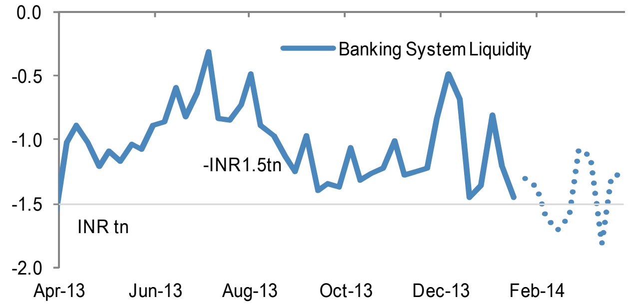
In the long end it is likely that RBI supplies bonds maturing in FY21, FY24, FY25 and FY26 given this will help in smoothening the maturity profile as compared to other years. Hence 5yr bonds will be unaffected even if the debt swap were to be conducted.

RBI will conduct OMO as currency in circulation increases before election

Over the past month RBI has shown its intent to keep overnight call close to repo rather than MSF by active liquidity management. For example, in the past three weeks RBI increased the limit for the term repo twice and the conducted an OMO to ease liquidity. Currently amount of INR liquidity available at overnight repo is INR400bn, at term repo is INR690bn and at export credit refinance is INR480bn. So the total amount of liquidity that can be drawn from RBI before borrowing at MSF rate is close to INR1500bn.

We expect the liquidity deficit to be in excess of INR1500bn in mid February and again in mid March. This is after taking into account INR480bn of liquidity infusion due to expiry of oil swap and an equal amount of drain due to disinvestment until March end. In this period overnight call will be pushed to MSF 9% in absence of additional accommodation by RBI. We expect RBI to address the temporary liquidity tightening because increase in government surplus by increasing in term repo limit. However, drain in liquidity due to increase in currency in circulation, which is expected given we are headed for central government elections, will be offset by OMO's. We expect at least one more OMO before FY14 end. (See Exhibit 5: Liquidity projection table)

Exhibit 4: Overnight call will close to MSF 9% when liquidity deficit is higher than INR1.5tn



Fiscal deficit to be reigned in but this is already consensus

We expect the 4.8% target for fiscal deficit to be comfortably met for FY14 and even foresee a likelihood of a marginally lower print. . The deficit target is likely to be achieved by running up arrears on subsidies, pushing Plan expenditures (to the tune of 1% of GDP) into the next fiscal year, and garnering higher-than–budgeted, one-off, non-tax revenues. As the fiscal looks comfortable we expect the INR150bn of auction deferred on Jan 17th to be cancelled. However, we note that there is little upside from the fiscal as this is largely priced in.

As % of GDP	Budgeted	Estimated
Receipts	9.9	9.1
Tax	7.8	7.1
Non Tax	1.5	1.6
Dividends & profits	0.6	0.8
Telecom license & Fees	0.4	0.3
Disinvestment	0.5	0.4
Others	0.6	0.4
Expenditure	14.6	13.8
Non plan	9.8	9.8
Plan	4.9	4.0
Deficit	-4.8	-4.7

Trade Strategy:

- **Strategy #1**: Tactically buy 5yr bond at 8.92% targeting 25bp lower in yield. We recommend buying the 5yr bond which will benefit over the next two months due to 1) favorable the demand supply dynamics, 2) possible OMO purchases and 3) stable policy rates. Further out, if BJP were to get a clear mandate in the central election as predicted in the recent opinion polls then the fiscal expectation for the next year would improve meaningfully. A strong fisc coupled with a strong INR because of increased in FII inflows will reduce the pressure on RBI to tighten which present a bigger upside to a long bond position.The main risk to this trade is that US treasuries yields back up sharply and/or rupee sells off again.

Venkatesh Sivaraman
(91-22) 6157-3417
venkatesh.sivaraman@jpmorgan.com

Exhibit 5: Liquidity projection for 1Q14

+ indicates money market liquidity will improve -- all amounts in INR billion												
1	2	3	4	5		6	7	8	9	10	11	12
Week ending	Change in currency in circulation	Coupon flows, redemptions	Auction outflows	Net discretionary govt spending (includes tax)	Oil cos payment + advance tax	Divestment + Dividend	Net fx intervention	OMO buyback	CRR /NDTL changes	Change of liquidity	**System Liquidity (+ = surplus)**	Liq (% of NDTL)
5-Jul-13	-32	147	-260	530	-60		-8			317	**-314**	-0.4
12-Jul-13	-68	161	-270	-73	-130	-9	-132		-2	-523	**-837**	-1.1
19-Jul-13	81	178	-150	83			-178	-25		-11	**-848**	-1.1
26-Jul-13	128	100	-330	208			23			129	**-720**	-1.0
2-Aug-13	50	184	-300	388		-5	-78			239	**-480**	-0.6
8-Aug-13	-157	174	-270	-330	-150		325			-407	**-888**	-1.2
16-Aug-13	-63	207	-500	289			-12			-79	**-966**	-1.3
23-Aug-13	97	248	-490	41		-3	-115	62		-159	**-1126**	-1.5
30-Aug-13	100	173	-616	264			-110	62		-127	**-1253**	-1.7
6-Sep-13	-89	619	-520	299			-26			283	**-970**	-1.3
13-Sep-13	-96	184	-203	205	-450		-73			-433	**-1403**	-1.9
20-Sep-13	68	590	-120	-343	-150		20			66	**-1337**	-1.8
27-Sep-13	130	205	-522	331			-173		-5	-34	**-1371**	-1.8
4-Oct-13	-51	120	-352	472			120			309	**-1062**	-1.4
11-Oct-13	-233	179	-270	104	-140		1	100		-259	**-1321**	-1.8
18-Oct-13	-117	418	-349	103			-2			52	**-1269**	-1.7
25-Oct-13	90	386	-177	-223			-23			53	**-1216**	-1.6
1-Nov-13	-190	123	-280	484			73			210	**-1006**	-1.3
8-Nov-13	-244	295	-340	-63			79			-272	**-1278**	-1.7
15-Nov-13	-34	199	-270	253	-150		32			30	**-1247**	-1.7
22-Nov-13	94	142	-366	-47			141	62		25	**-1222**	-1.6
29-Nov-13	-93	47	-280	291			429			394	**-829**	-1.1
6-Dec-13	-107	188	-369	428	-140		350			351	**-478**	-0.6
13-Dec-13	-58	264	-120	-211		-71	20		-25	-201	**-680**	-0.9
20-Dec-13	37	140	-372	138	-700		-18			-774	**-1454**	-1.9
27-Dec-13	61	127	-270	73			106			96	**-1357**	-1.8
3-Jan-14	89	196	-220	593	90		-191			557	**-800**	-1.1
10-Jan-14	-176	176	-220	-1	-194					-415	**-1215**	-1.6
17-Jan-14	-110	184	-70	-55			-190			-241	**-1456**	-1.9
24-Jan-14	88	114	-70	45			-28			149	**-1307**	-1.7
31-Jan-14	11	110	-220	206		-170				-63	**-1370**	-1.8
7-Feb-14	-151	211	-280	122	-160	-110	130			-238	**-1609**	-2.1
14-Feb-14	-66	144	-130	1		-50				-100	**-1709**	-2.3
21-Feb-14	0	270	-130	-90		-50	130		-25	105	**-1604**	-2.1
28-Feb-14	68	316	-130	328		-50				532	**-1071**	-1.4
7-Mar-14	-147	133	-140	171	-160	-50	130			-62	**-1134**	-1.5
14-Mar-14	-51	136	-140	-52	-650			80		-677	**-1811**	-2.4
21-Mar-14	9	168	-140	350			130			517	**-1294**	-1.7
28-Mar-14	-23	156	-140	47					-5	36	**-1258**	-1.7

Bert Gochet
(852) 2800-8325
bert.j.gochet@jpmorgan.com

Jason Mortimer
(65) 6882-1638
jason.j.mortimer@jpmorgan.com

Malaysia Rates: Take profits on paid 5y ND-IRS and hold U/W duration in short end MGS, switch to 1s5s ND-IRS flatteners

This note was originally published 7 Feb 2014.

• Malaysian long end rates have risen since November: 10y MGS yields at 4.18% are higher by 58 bp and 5y ND-IRS at 4.06% is up 43 bp. Yield curves have bear steepened: 3s10s MGS rose to 93 bp and 1s5s ND-IRS to 63.5 bp.

• Long end yields may find it hard to rise from now: We expect domestic real-money buying of MGS to increase from the current 4.18% through 4.50%.

• Shorter end yields are richest on the curve: We forecast CPI will rise to 3.8% this year and 5.2% in 2015, yet 3y MGS yield spreads to the policy rate are low for a rising CPI environment, and the trend of MYR FX depreciation will remain as global EM bond outflows continue.

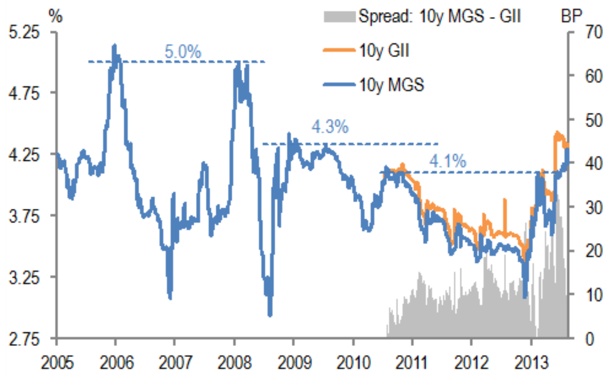
• One risk is that PM Najib could feel pressure to slow down the pace of subsidy reduction, with implications for our CPI and fiscal reform expectations.

• Strategy: Take profits on Paid 5y ND-IRS now at 4.06%. Enter a 1s5s ND-IRS Flattener at 63.5 bp for the next leg of Malaysian yield normalization. Maintain underweights in Malaysian duration for the GBI-EM portfolio, but focus on the short end 3y MGS where valuations are richest as the curve is expected to flatten.

Tactically take profits on 5y paid ND-IRS, back end Malaysian yields may stabilize

We tactically take profits in our latest paid MYR position (5y ND-IRS entry 3.96% 12/4/2013, exit at 4.06%), at 5y IRS has risen 43bp since late October. Malaysian yields have risen across the board during this time in line with depreciation in the currency, and have remained elevated even against a 35bp pull back in the 10y UST yields since the start of January. **For the GBI-EM portfolio, we maintain our Underweight duration stance in Malaysia, but look for further yield increases to mainly be expressed around the short end (3y) of the MGS curve**, as long end (10y) MGS yields have already risen 58bp since the October lows to briefly touch 4.30%. **We now switch into 1s5s ND-IRS flatteners at 63.5bp** to wait for the next leg up in Malaysian yields while fully neutralizing carry/rolldown costs.

Chart 1: MGS 10y yields have not exceeded the 4.30% level since 2009. The 10y GII (government-guaranteed sukuk that are 98% domestically owned) began to rally and outperform MGS after hitting 3.4% yields in December, Indicating domestic interest in these absolute levels of yield



Domestics may take greater interest in bond yields around the 4.25-4.5% level

One reason to take profits on outright paid ND-IRS positions and shift underweights to the short end of the MGS curve now is because domestics are expected to be more aggressive buyers if MGS yields rise to the 4.25-4.50 range. The 10y MGS yields (now 4.18%, as high as 3.295% last week) has only twice in the past decade risen above 4.50% (in 2006 and 2008). The 3s10s MGS curve (now 93bp, as high as 104 bp last week) has also generally not exceeded 100bp since 2009.

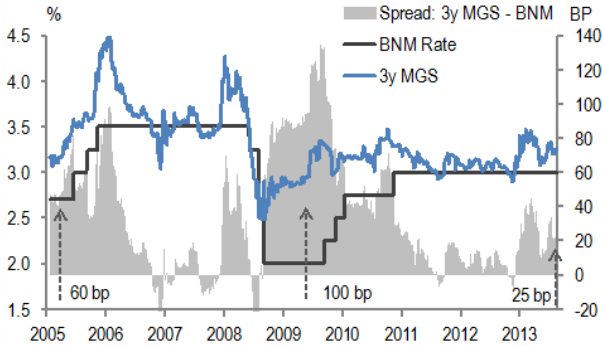
This week, for example, **domestic real money accounts have begun taking advantage of these levels and have bought in the 7-10y MGS sector.** Also, negative carry and roll-down costs have become a concern (-6.1 bp/3m in 10y MGS and 8.2 bp/3m in 5y ND-IRS). We believe rates will eventually exceed previous levels, but after the latest run-up in Malaysian yields (and especially against the backdrop of much reduced UST yields) we prefer to move down into richer parts of the curve to wait for the next move.

Short end most vulnerable to CPI expectations and curve bear flattening risks

We remain bearish on Malaysian rates, which will continue to rise as domestic growth remains robust, real yields will be increasingly negative in 2014 (even without subsidy reduction, see below), and global flows to low-yielding EM bond markets are unlikely to be sustained. **However we now see the richest valuations in the short end of the curve, where 3y MGS at 3.25% is only 25bp over the BNM policy rate** with no chance of BNM cuts and a depreciating currency.

While a BNM hike is not in our base case, the spread of 3y MGS over the BNM rate has typically been 60-100bp around six months before the start of policy rate hikes over the past decade, and we cannot justify why foreigners (who own 44% of the MGS market) will be aggressive buyers at these yields considering the JPM end of 2014 forecast for 10y UST is 3.65%. In fact, most foreign bond positions in Malaysia are concentrated in the short end of the curve as long MYR FX proxies or as part of basis trades versus the NDF, putting even more potential pressure on the short end sector.

Chart 2: The spread of 3y MGS over the BNM policy rate is typically 60-100 bps six months before any BNM policy hikes begin. The current spread 25bp does not compensate investors, in our view

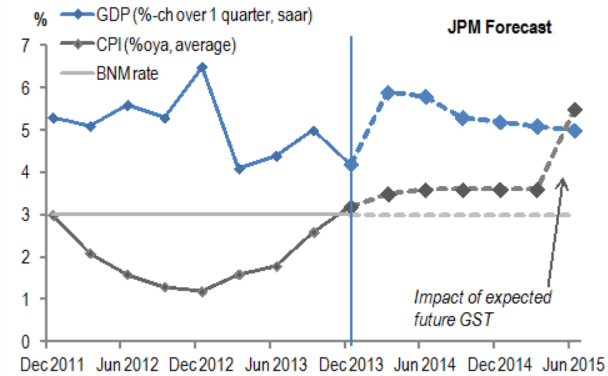


In the MYR ND-IRS market, the 1y ND-IRS at 3.42% is 13bp over the 3m KLIBOR fixing, which itself has risen 10bp since September 2013. **This level looks much less challenging to us than the 5y ND-IRS (now 4.06%)** at a 11bp spread over the onshore 5y IRS and a 76 bp spread over 3m KLIBOR – near the highest since 2011. **Therefore we prefer to express underweights in the richer short end of the MGS curve, and switch paid 5y ND-IRS to a 1s5s ND-IRS flattener at 63.5** (which is inherently less bearish than outright paid positions) to ride out any period of stabilization in yields while neutralizing carry and roll-down costs to effectively zero.

Risks forming around Malaysia CPI rise view another reason to switch out of outright pay trades

One risk factor has arisen that further prompts us to tone down our bearishness on Malaysian rates. Essentially, rising food prices have started to put PM Najib under political pressure not only from the opposition but also from within his own party. **This dynamic creates a risk that the PM will not follow through with subsidy rationalization as per our base forecasts** (subsidy rollbacks in April and October, with GST implementation in April 2015). Without any further subsidy rationalization, average CPI would only average between 2.8-3.0% in 2014 instead of our current forecast for 3.5-3.8%, with December 2014 YoY CPI declining to 2.0% instead of our currently estimated 4.2%.

Chart 3: JPMorgan base case assumption for growth and CPI has both rising in 2014. The rise in CPI from the 2% range in 2013 to nearly 4% in 2014 calls into question the attractiveness of short end MGS



We are not changing our base case inflation forecasts on this development, but recognize the potential market risk to paid Malaysia IRS trades coming from a downward CPI shock if our base case subsidy rationalization assumptions are not realized. The downside market risk of bond investor disappointment at a slower pace of fiscal reform would be secondary to the bullish impulse on the market from lower inflation, in our view. Therefore we would expect any backtracking on fiscal consolidation to be better expressed through an underweight in the currency.

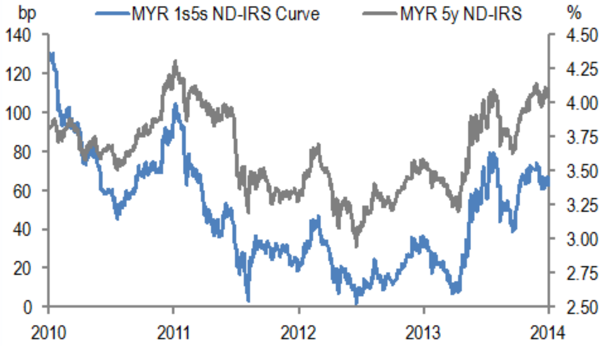
Bert Gochet
(852) 2800-8325
bert.j.gochet@jpmorgan.com

Jason Mortimer
(65) 6882-1638
jason.j.mortimer@jpmorgan.com

Trade strategy

- **Take profits on paid 5y ND-IRS, replace with 1s5s ND-IRS flatteners. Stay U/W Duration in the short end where valuations are richest:** We take profits on paid 5y ND-IRS at 4.06% (entered 3.96% on Dec 4, 2013), and switch to 1s5s ND-IRS flatteners at 63.5bp, targeting 40 bp. We remain Underweight Malaysian duration, but now focus on the richness of the short end 3y point of the MGS at 3.25% curve rather than the 10y at 4.18%.

Chart 4: The MYR 5y ND-IRS rate may have peaked out for now at 4.06%, we switch to 1s5s ND-IRS Flattener at 63.5 bp for the next leg of MYR rate adjustment



Bert Gochet
(852) 2800-8325
bert.j.gochet@jpmorgan.com

Daniel Hui
(65) 6882-2216
daniel.hui@jpmorgan.com

IDR: Tactically buy INDOGB on quick issuance progress

This note was originally published 17 Feb 2014.

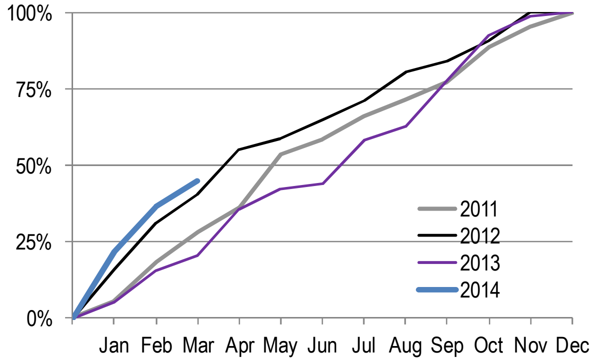
• We now turn more constructive on INDOGB:
- **By the end of February, we estimate Indonesia will have issued 36% of its entire 360tri annual supply target. This is the fastest pace of issuance in 4 years**
- **J.P. Morgan economists revised this year's BOP forecast to a surplus, and only expect at most one further 25bp BI rate hike (which is priced in)**
- **The 5/20s INDOGB curve at 130bp is now 30bp steeper than at the start of the year, giving better entry levels to buy long-dated bonds.**

• Strategy: We expect 10Y yields (now 8.40%) to trade in an 8-9% range. Open a small, tactical INDOGB duration overweight in the model portfolio, mainly for carry. For absolute return investors, we suggest 10Y FR70 for liquidity.

• The risks to overweighting INDOGB duration are: the presidential elections (May-July), and a sudden rise of UST yields back above 3%.

Chart 1: Indonesia has had the fastest start to issuance in last 4 years

Percentage completion of Indonesia's target bond supply



Indonesia's bond issuance has been completed much faster than expected this year…

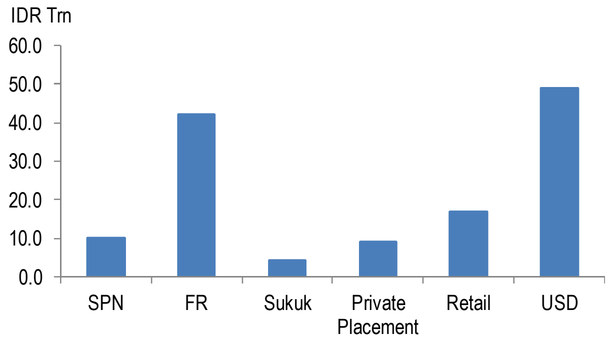
Indonesia has made strong progress year-to-date towards its supply targets. By the end of February, DMO will have issued 130tri out of its 360tri annual supply target. To calculate this total, we have assumed that the planned retail sukuk auction due by 28 Feb raises IDR17tri. In other words, **after just two months of the year, Indonesia will have fulfilled already 36% of the entire year's target.** Making assumptions for planned auctions in March, we estimate that the percentage completion rate will be at 45% at the end of 1Q. This would be the fastest completion rate in at least 4 years (see chart 1).

… on large auctions and private placements

How has Indonesia achieved such a rapid issuance completion rate in a volatile period for EM debt markets? First, DMO has issued almost maximum amounts during all of its auctions YTD. In other words, the sovereign has focused on upsizing deals and not on minimizing costs in order to get a supply headstart before the presidential election season (May to July). The $4bn USD denominated sovereign deal in January was a good example of this strategy. Also, in regular INDOGB auctions the DMO has often sold the maximum IDR15tri allocation rather than the 'regular' 10tri. Finally, IDR9tri of private placements have been executed YTD. Private placements are a new feature in the DMO's debt strategy this year. (See chart 2 and Table 1)

Chart 2: Diversification supply strategy has benefited pace of issuance

YTD sovereign debt supply, categorized in IDR tri



BOP projections revised to surplus for 2014

Last year Indonesia raised interest rates by 175bp and reduced fuel subsidies while also tightening credit via other policies. The resulting macro adjustment has been surprisingly effective. J.P. Morgan economists have now **revised this year's BOP forecast up to a US$0.8bn surplus (from an earlier deficit)**. The C/A deficit has been revised to US$20bn (2.4% GDP) from $25bn previously, reflecting both a larger trade surplus and a lower invisibles deficit, in part from slower domestic demand. In line with the reduced C/A deficit projections, we have tempered expectations for further BI tightening, and now expect at most a single 25bp hike during 1H. This limited degree of tightening is already reflected in the price of the bonds (eg. 5Y INDOGB at 7.90% trades 200bp above the onshore funding rate).

Table 1: Year-to-date supply details

Actual data to 18 Feb, and projections for the retail auction that closes 27 Feb

Issue Size IDR Trillion	SPN 3m/9m	SPN 1y	FR69 5y	FR70 10y	FR71 15y	FR68 20y	PBS Sukuk	SPN-S 6m	SDHI Private	Retail	RI USD	**Total**
January (Actual)	**1.0**	**4.0**	**2.1**	**10.9**	**5.0**	**2.2**	**0.6**	**1.0**	**3.0**	**-**	**48.9**	**78.5**
February (Actual & Forecast)	**1.0**	**4.0**	**3.2**	**8.3**	**5.4**	**5.4**	**0.8**	**2.0**	**6.0**	**17.0**	**-**	**51.5**
Total	**2.0**	**8.0**	**5.3**	**19.2**	**10.4**	**7.5**	**1.4**	**3.0**	**9.0**	**17.0**	**48.9**	**131.5**

The 5/20s curve has steepened

INDOGB auction sizes have risen to IDR12-15tri (see chart 3) this year compared to an average of IDR8-9tri last year. Because of this front-loading of the issuance calendar, the INDOGB curve has steepened sharply since the start of January. We note that the 5/20s INDOGB curve was trading around 100bp or less in 2H13. It is now at 130bp (chart 4). **Reduced expectations for further BI policy rate tightening** have also steepened the yield curve.

Chart 3: Auction sizes are being frontloaded to start the year

Amount issued per auction, in IDR tri

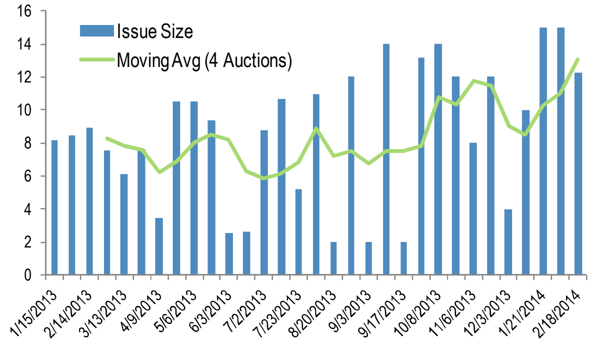
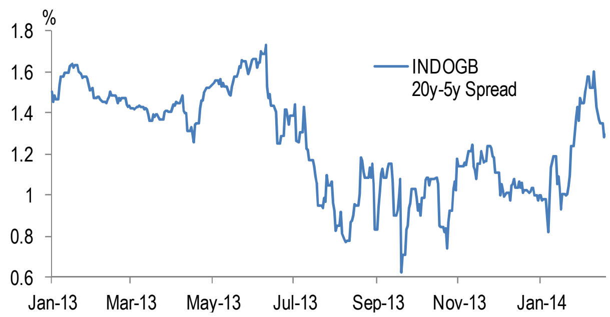


Chart 4: INDOGB 5/20s curve has steepened at the start of the year

bp spread between 5Y and 20Y INDOGB



Strategy

We recommend a small overweight position in Indonesian rates for a global GBI-EM portfolio. However, we do not think that the bonds will rally a great deal, so this is best thought of a carry trade. With 10Y INDOGB yields at a similar level to for example South Africa, the C/A improvement that Indonesia has achieved makes INDOGB more appealing on a relative basis and in this framework we expect that Indonesia should hold its own versus other high-yielding "CAD peers". **For absolute return investors, we suggest 10Y FR70 for liquidity.**

Naturally there remain macro risks to owning INDOGB and at some point yields may well rise again. Presidential elections will take place in May-July period, and there is little clarity over who will be the winner let alone what economic policies will be after the election. Also, if US treasury yields rise above 3% again, then INDOGB yields would also move higher. For now though, we expect 10Y (FR70) to trade in a range of 8.00-9.00%, making it sensible to capture carry from an overweight position, especially relative to the lower-yielders in EM Asia.

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