12 in 2012
What politics could mean for markets in the year ahead

IN BRIEF

- The coming 12 months will see more than a dozen key elections around the world, in countries representing nearly 50% of global GDP
- With global growth relatively fragile, politics and potential policy shifts will likely get heightened market attention
- Politics matters not just for respective countries’ markets but in some cases, for global financial trends
- Key politically related market risks we’d highlight into next year include: (1) potentially higher oil prices tied to supply worries; (2) Asian market volatility tied to regional geopolitics; and (3) unexpected shifts in Euro area politics impacting regional markets as well as global sentiment

2011 has been extraordinary in a number of respects, including the influence of politics on financial markets. Who could have ever imagined that domestic inter-party conflicts in countries such as Belgium or Slovakia could dominate global markets and investor sentiment? That revolutions would erupt across North Africa and the Middle East, taking Brent crude over $125/barrel? That the U.S. would lose its AAA sovereign rating partly on the back of domestic political infighting, spurring gold prices above $1,900/ounce?

The coming year seems unlikely to be much different.
In fact, the number of key elections and political transitions set for 2012—in countries representing nearly 50% of the global economy—combined with the fragile state of the world suggest that politics may play an even bigger relative role in market direction (Exhibit 1).

With that in mind, we want to explore a few issues. First, how does politics influence markets? We review our fundamental framework and where politics fits in. Next, we list the key political events slated for the year ahead and the “need to knows” for each event, including possible local market risks. Finally and most importantly, we consider how this broad political outlook may impact our key investment themes for the year ahead.

Politics and Fundamentals
Politics can influence investing frameworks in a number of ways and over different time horizons. Over the short-term, politics can impact sentiment and market positioning. Consider recent events in Greece. After Greek Prime Minister Papandreou unexpectedly called for a confidence vote and a referendum at the end of October, market uncertainty skyrocketed. In just one day, the VIX equity volatility index rose 20%. Investors sold European assets, with the German DAX index down some 5% on November 1 (Bloomberg data).

Politics also influences policy. Let’s stay with Europe for a minute. Events in the periphery have contributed to what we expect will be easier European Central Bank policy in the months to come. That in turn should weigh on the euro and push down core European government bond yields. Or think about the Arab Spring revolutions and the supply concerns that pushed up oil prices—they helped trigger the International Energy Agency’s policy decision to release strategic reserves.

Finally, and perhaps most importantly for long-term institutional investors, politics clearly plays a role in broader economic trends. The fact, for instance, that the U.S. Congress has not provided more clarity on tax, regulatory and/or healthcare issues to corporate America (in turn partly for positioning into 2012 elections) is one reason (alongside weak demand), we believe, that companies are holding so much cash on their balance sheets, rather than spending more of those funds. At the margin, this issue may be helping to limit broad U.S. economic growth.

EXHIBIT 1: HOW POLITICAL EVENTS’ INFLUENCE COULD REACH BEYOND BORDERS

- **Russian election:** Policy shifts could impact commodities, USD?
- **French, Spanish, Finnish elections:** Could shape next steps in broader EMU crisis
- **Egypt election:** May impact geopolitical sentiment in region; and indirectly, oil prices
- **U.S. and Chinese elections:** Likely to influence each other’s economies, markets
- **U.S. policies:** Impacting growth will likely influence Mexican and Canadian economies in particular

Source: J.P. Morgan Asset Management, October 2011
Elections Into 2012: The Logistics

Every year, dozens of countries around the world hold elections. Political change and uncertainty are nothing new for markets. However, 2012 stands out not only because of the relatively fragile, global economic backdrop going into these political transition periods, but also because of the number of significant elections coming so close to each other in time. The 12 countries we identified having political events comprise nearly 50% of global GDP. In chronological order, they are Spain (Nov. 20), Taiwan, Egypt and Finland in January, Russia and Hong Kong in March, France and South Korea in April, Mexico in July, China (the start of its leadership transition) and Venezuela in October, and finally the U.S. in November. We’re also likely to see elections in Greece and Italy in 2012, though there are not enough details at the time of writing to support much analysis. For the already announced elections, we summarize below the logistics and key issues to note (Exhibit 2).

**EXHIBIT 2: 2012 TIMELINE OF ELECTIONS**

<table>
<thead>
<tr>
<th>Month</th>
<th>Event Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>November</td>
<td>Finland: Parliamentary round 2</td>
</tr>
<tr>
<td>January</td>
<td>Taiwan: Presidential and Legislative</td>
</tr>
<tr>
<td>January</td>
<td>Egypt: Lower house (People’s Assembly) March 11</td>
</tr>
<tr>
<td>March 25</td>
<td>Hong Kong: Chief Executive</td>
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<tr>
<td>April 22</td>
<td>France: Presidential round 1</td>
</tr>
<tr>
<td>May 6</td>
<td>France: Presidential round 2</td>
</tr>
<tr>
<td>June 10</td>
<td>France: Legislative round 1</td>
</tr>
<tr>
<td>June 17</td>
<td>France: Legislative round 2</td>
</tr>
<tr>
<td>September</td>
<td>Hong Kong: Legislative</td>
</tr>
<tr>
<td>October 7</td>
<td>Venezuela: Presidential</td>
</tr>
<tr>
<td>November</td>
<td>USA: Presidential and Congressional</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit.
Spain

November 20, 2011 parliamentary election

Background

Originally scheduled for next March, Spain’s critical election was recently pulled forward to November 20. This November’s parliamentary election will be for 350 seats in the Congress of Deputies, which will determine who becomes the Prime Minister. Elections will also be held this November for the 208 directly elected seats in the upper house (Senate). The Prime Minister today is Zapatero (Socialist Workers’ Party, or PSOE). Zapatero announced this fall that he won’t run for a third term in the next election; the current deputy prime minister, Rubalcaba, will be the PSOE’s candidate. The main opposition party is the People’s Party (PP), under the leadership of Rajoy.

What’s at stake

The local economy will be at the center of the election, given the fact that close to five million Spaniards are out of work going into 2012 (Exhibit 3). Zapatero embarked on strict fiscal austerity policies over the last year, that are weighing on growth and creating tensions with unions (Zapatero’s government altered employment laws to make it easier for firms to make workers redundant). Even with the fiscal efforts, Spain seems likely to miss its 2011 fiscal target of 6% (budget/GDP ratio); we believe the deficit may end the year closer to 8% of GDP. Should the new prime minister continue to push with austerity, Spain could see additional protests or even social unrest in the year ahead.

What the polls say now

According to opinion polls published in early November, the Popular Party had a roughly 15-percentage-point lead over the ruling Socialists, which would give the party an absolute parliamentary majority.

Taiwan

January 14 presidential and legislative elections

Background

The ruling Kuomintang (KMT) party, led by President Ma Ying-jeou, supports closer political and economic ties with mainland China. Ma has been in office and his party has dominated the legislature since 2008. Taiwan has a popular vote for its president, elected every four years. The parliament (Legislative Yuan) has 113 seats and each parliament serves a four-year term. The main opposition party is the Democratic Progressive Party (DPP). Currently, the DPP is led by Tsai Ing-wen. Tsai has said that she will not end the economic links already established with China, but she has promised to submit existing and future agreements to the Legislative Yuan (parliament) in order to generate greater public debate.

What’s at stake

The main issue for markets is cross-Strait relations (Exhibit 4). Any surprise win by DPP could, at least near-term, raise fears about renewed China-Taiwan tensions, and could weigh on local assets (more Taiwan than China).

What polls are saying now

The results of a poll released by the Taiwan think tank Master Survey and Research Co. in early October showed 37.3% of respondents supported President Ma’s re-election bid, and 36.1% supported DPP presidential candidate Tsai. Bottom line: for now it looks like a close race.

EXHIBIT 3: EMU AVERAGE AND SPANISH UNEMPLOYMENT RATES

Source: JPMS as of November 2011

EXHIBIT 4: A TIMELINE OF CHINA-TAIWAN RELATIONS

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>Taiwan opens direct but limited trade and travel links with China</td>
</tr>
<tr>
<td>2003</td>
<td>First Taiwan commercial flight to China for more than 50 years arrives in Shanghai, but has to go via Hong Kong</td>
</tr>
<tr>
<td>2007</td>
<td>Taiwan bans 2008 Beijing Olympics torch relay from the island, after months of talks with China fail</td>
</tr>
<tr>
<td>2008</td>
<td>Beijing hosts two-day talks seen as the first step in new Taiwan President Ma Ying-jeou’s plan to reinvigorate ties</td>
</tr>
<tr>
<td>2011</td>
<td>U.S. confirms plans to upgrade Taiwan’s ageing fleet of F-16 US-built fighter planes</td>
</tr>
<tr>
<td>2011</td>
<td>Taiwan’s Cathay Financial signed a memorandum of understanding with Bank of China</td>
</tr>
</tbody>
</table>

Source: Reuters, As of November 2011.
Egypt

Before January 10, elections for lower house (People’s Assembly); between January 29 and March 11th, elections for upper house (Shura Council)

Background

The political situation in Egypt is especially challenging and fluid, following the resignation of President Hosni Mubarak on February 11. The Supreme Council of the Armed Forces (SCAF), consisting of 20 senior officers in the Egyptian military, was handed power when Mubarak left; the Council is expected to hold power until a new president is elected. SCAF dissolved parliament, suspended the Constitution and said it would support elections in the near-term. While official campaigning in Egypt started on November 2, the exact date of those elections remains unclear; most analysts believe parliamentary votes will be held in late 2011 or as noted above, in early 2012. The extended voting period is needed both because special supervisors must personally oversee voting stations and because runoffs are required in single-winner districts. Two-thirds of the members of both houses are set to be elected on the basis of party-lists (proportional representation) and the other third using the single-winner (first-past-the-post) system. A presidential election is not expected before late 2012 at the earliest.

What's at stake

Recent months have seen protests, debate and even violence tied to Egypt’s political transition. In a worst-case scenario, SCAF could point to the violence and call for longer military rule. We believe such an outcome would likely raise broader questions about Arab Spring transitions and the stability of the region. This, in turn, could trigger a relatively greater “risk premium” for Brent crude oil prices and potentially limit investor sentiment globally. For now, though, it appears that SCAF is trying to work with the political parties—indeed, it recently announced it would allow the lower house to convene soon after January elections, rather than delaying meetings until the upper house vote took place. Even should elections proceed on schedule, any outcome seen as overly favoring the former “establishment” could result in at least tactical protests and/or violence by parts of the population pushing for greater change.

Finland

January 22, presidential election (runoff, if needed, on February 5)

Background

2011 saw a critical change in the Finnish political landscape. April 17 parliamentary elections saw the True Finns emerging as the third-largest party, joining the traditional top parties: the Centre Party (KESK), the Social Democratic Party (SDP) and the National Coalition Party (Conservatives, or KOK). The True Finns are often described as populist and anti-Euro area. For the presidential election, the country’s former (KOK) prime minister, Niinistö, is seen as the front-runner. He was minister of finance between 1995 and 2003 and is credited with helping push local firms such as Nokia into the global spotlight. The True Finns leader, Soini, announced in late September that he will also run.

What’s at stake

Finland is the only Nordic member of the Euro area, and has seen increasing popular opposition to peripheral bailouts. Indeed, the coalition government responded to popular sentiment this autumn by insisting on collateral in return for Greek aid. The episode suggests further peripheral funds will not come easily and may face loud political debate. It is unclear what a Conservative government and head of state (unprecedented in Finland) would mean for policies affecting global issues but especially for the ongoing Economic and Monetary Union (EMU) crisis. Market worries tied to Finland could lead to pressure on European assets (including a weaker euro).

What polls are saying now

According to a poll published by Ilta-Sanomat on October 22, 58% of respondents would vote for the KOK’s Niinistö if the election were held that day. Support for the SDP’s Lipponen, The Finns’ Soini, Centre Party’s Väyrynen, and Green League’s Haavisto was around 10% for each.
Twelve in 2012

France

April 22, May 6 presidential election; legislative election by June

Background

France’s president, directly elected every five years, can heavily influence policy when, as is currently the case, parties loyal to him command a majority in the National Assembly (the lower house and more important of the two parliamentary chambers). Currently, President Nicolas Sarkozy and the lower house come from the center-right Union pour un Movement Populaire (UMP). However, when the presidential and parliamentary majorities conflict, the president is forced into “cohabitation” with a government not of his choosing. The result can be that in domestic affairs, the prime minister (now Francois Fillon) becomes a more influential figure than the president, whose role is largely reduced to a mix of head of state and leader of the opposition. UMP lost its majority in the Senate (the upper house) in September but continues to command a majority in the Assembly. At the presidential election, Sarkozy will face Francois Hollande, the Parti socialiste (PS) candidate (seen as a more “leftist” Socialist). For both elections, there are two rounds of voting. In 2012, it seems likely the presidential election will go to a second round. Critical for Sarkozy will be voter support for smaller opposition parties and in particular the far-right Front National, headed by Marine Le Pen. Support for Le Pen and the party’s “anti-globalization” policies could hurt the UMP. Also important for the outcome will be the TV debates, which historically have influenced swing voters substantially.

What’s at stake

How France’s domestic economy and the EMU peripheral crisis each evolve into the elections will clearly shape results. A possible loss of France’s AAA sovereign debt rating could shift voter sentiment, toward more fiscal austerity but also away from helping fellow EU members (focus at home first). Both Sarkozy and Hollande are expected to emphasize in campaigns the need to strengthen the country’s public finances. However, local commentators have noted that Hollande would likely need greater revenues (tax hikes?) to offset his proposals for higher public spending and public-sector jobs.

What polls are saying now

October saw an improvement in President Sarkozy’s approval ratings, up to 37% by early November according to pollsters LH2. However, he still trails Hollande in a number of opinion polls, suggesting a tough fight in April.

Russia

March 4 presidential election

Background

Speaking at the United Russia party Congress on September 24, Russian President Medvedev (elected in 2008) said that Vladimir Putin—his predecessor (2000-2008), prime minister and partner in the “joint leadership” since 2008—should be the party’s candidate in the presidential vote. Putin agreed, adding that he would likely ask Medvedev to become his prime minister after the election. Putin is eligible for two six-year terms; he could in theory rule until 2024 (when he will be 71).

What’s at stake

On one hand, knowing that Putin will likely lead Russia for the next several years removes an element of uncertainty from the country’s macro outlook. That would seem a positive. However, the idea of one person ruling, basically uninterrupted, for so many years also creates potentially negative comparisons with former, similarly long-ruling leaders (notably Stalin and Brezhnev). Such fears were supported recently when Finance Minister Kudrin, a perceived fiscal hawk, resigned, saying he would not work in a future government with Medvedev as prime minister in a swap with Putin. We believe Putin going forward will continue to focus on “national champion” firms and take a cautious approach to foreign direct investment into strategic sectors. In terms of global markets, we see commodities (especially energy and precious metals) as one potential transmission mechanism—Putin could manage commodity supply for political means, impacting global prices along the way.

What polls are saying now

Although opinion polls show support for both Medvedev and Putin as relatively high, numbers have moderated, apparently tied to a relatively weak economic recovery and corruption concerns. As of early November, Putin’s approval rating was down to 42%, his lowest since 2005. On December 4, Russia holds key parliamentary elections; those results will likely be examined to gauge the outcome of the March 2012 race.
South Korea

April, parliamentary election; December, presidential election

Background

Elections for the National Assembly (parliament) are due in April (date to be announced). The Grand National Party, or GNP, holds 169 seats out of 299 as well as the presidency (Lee Myung-bak). The conservative GNP has internal divisions which have been reflected in the party winning only one of the four parliamentary by-elections in April 2011. Lee, while not allowed to run for another term, will still try to attract greater voter support so the GNP can keep control of parliament and help the party's chances in the December 2012 presidential election. The main opposition party is the center-left Democratic party (DP), currently with 87 seats. Two smaller left-wing parties combined this past September to put up candidates for the 2012 elections. Key to their platform is North Korea, and specifically, taking a relatively harder line in terms of the transmission of power from Kim Jong-il to his son.

What's at stake

Normally, South Korean parliamentary elections are more focused on domestic issues, with international issues (including North Korea) a greater focus for presidential races. (Going into next year, it appears that welfare spending is likely to be an important local voter issue, with the opposition relatively more inclined to increase welfare spending more quickly.) That said, the April vote still merits watching, as its outcome could shape expectations for December. In addition, both April and December elections could have a greater North Korean focus this time around given some upcoming events. First there is the potential for a fresh round of six-party talks on North Korea's nuclear capabilities. Second, South Korea is hosting the second Nuclear Security Summit in March; the international conference (with a focus on North Korea) will take place just weeks ahead of the election. Third, April 15 will be the 100th anniversary of the birth of Kim Il-Sung, North Korea's founder and father of Kim Jong-il. Such anniversaries sometimes see military actions, in part to distract North Koreans from domestic shortcomings. The risk to watch here is potential verbal or actual North-South conflict into the spring but worse, any sense that China and/or the U.S. could be pulled into regional events.

What polls are saying today

South Koreans appear increasingly disenfranchised with main political parties, evidenced in an October mayoral election in Seoul, where the winner, Park, was an independent. According to a September poll by Hankook Research, 44% of voters agreed on the need for a new political party (nearly 50% of DP supporters and 29% of GNP supporters). Separately, a series of polls commissioned by the East Asia Institute showed that non-partisan voters increased from 22% in July to 32.5% in September. The support rates for the GNP and the DP declined from 38.6% and 28.8%, to 33% and 19.4%, respectively, over the period. The broad trends suggest risks that politicians can change course on key policies, or that smaller parties can gain momentum into the election.

Mexico

Legislative and Presidential July 1

Background

Mexican presidents are limited to a single six-year term. The end of the incumbent Calderon’s presidency—the second consecutive term for his centre-right Partido Accion Nacional (PAN)—next year is expected by pollsters to result in the main opposition party’s, Partido Revolucionario Institucional (PRI), return to power. Economic and security problems caused the ruling PAN to perform poorly in 2009’s mid-term elections, and Calderon’s preferred successor (former finance minister Cordero) is unpopular among many of the party’s rank and file. PRI has not made any significant internal changes since its last period in office (which spanned seven decades between 1929 and 2000), but dissatisfaction with PAN and a popular leading candidate in Enrique Peña Nieto give PRI a strong chance of regaining the presidency. Moreover, a working majority for PRI in the legislature is more widely expected, which may reinforce its ability to push through reforms. This could be crucial, as the absence of working majorities has been a recurring problem for successive Mexican governments since the country’s move to multiparty democracy in the late 1990s.
What’s at stake
Markets will likely focus on two main election issues: energy policy and security. Public disapproval of Calderon’s PAN has been centered on the weak economy but also on local drug cartel-related violence. Meanwhile, Mexican oil production has been stagnant to declining for several years, basically because PEMEX has not been able to invest enough, and efficiently enough, to develop new fields to replace the declining Cantarell. Most of their known resources are in the Gulf of Mexico, in deepwater sites that they just don’t have the capacity to access. PRI leaders including Peña Nieto have expressed some interest in opening up the sector for private-sector involvement. The PRI—having been in power during the nationalization of the 1940s and often seen as the expression of Mexican nationalism—has, unlike the PAN, the credibility with the electorate to move on this issue. So we could see a dramatic change in the orientation and productivity of the Mexican energy sector over time. Shifts in production expectations could influence sentiment toward Mexican assets more generally, and possibly at the margin influence oil prices.

What the polls are saying now
The PRI fared well in state elections held in 2010-2011, and recent polls point in the direction of a potential landslide victory next July. According to local polling firm Consulta Mitofsky, PRI’s Peña Nieto commands some 46% to 49% of the national vote, with over 85% of his own party backing him for the presidential nomination. By contrast, PAN’s Cordero has the backing of only 8% of party members, while even the more popular PAN candidates (Josefina Vazquez Mota and Santiago Creel) do not enjoy the same popularity as Peña Nieto, either within their party or among the broader electorate.

Hong Kong
Chief executive March 25; legislative (expected in September)
Background
Hong Kong’s current leader, Donald Tsang, has announced his intention to step down when his second term ends in June 2012, with a new chief executive to be elected into office in March of next year. The two front-runners for his succession both have strong ties to the government. Henry Tang has held posts as finance secretary and most recently chief secretary of the current administration; Leung Chin-ying, Asia-Pacific chairman of real estate advisory company DTZ holdings, is the current governor of the Executive Council (the top advisory body to the government of Hong Kong). Tang, the son of a former senior advisor to the Chinese National People’s Congress, is often characterized as representing business interests. Leung, meanwhile, comes from a more modest background, and is viewed as relatively more populist. The new chief executive will ultimately be chosen by the 1,200 member Hong Kong election committee, but Chinese influence also plays a role. Despite its autonomy in most executive areas, Hong Kong remains one of China’s “special administrative regions.” Indeed, the Hong Kong election committee itself includes a number of delegates to China’s National People’s Congress.

Elections to Hong Kong’s legislative council in 2012 will be significant due to the majority of officials that will now be appointed by popular vote. Currently, 30 of the 60 members are directly elected, with the other half chosen by narrower social and business interest groups. Following reforms made in 2012, an additional 10 members will now be chosen by the broad electorate. This should benefit pro-democracy groups at the margin, but they are nonetheless unlikely to hold an absolute majority.

What’s at stake
Domestic discontent over economic inequality and the high cost of living will feature prominently in the elections. In a recent policy speech, outgoing Tsang proposed the building of 17,000 additional subsidized housing units in order to quell social unrest over rising rents and property prices. While both candidates have pledged to support the underprivileged, Tang’s ties to the business community, support from Chinese officials and recent statements in opposition to public protests could make for a greater risk of a popular backlash should he be elected. Whoever assumes power will, nonetheless, continue to
China
Leadership transition beginning in Q4 2012

Background
Late in 2012 (likely around October), the Communist Party of China (CPC) will hold its 18th congress and select a new party leadership. This will be followed by the installation of new state leaders in early 2013 (Exhibit 5). Xi Jinping (the current vice president) is seen as likely to replace Hu Jintao as Party general secretary in late 2012 and president in early 2013, while Li Keqiang (currently a vice premier) is expected by most political watchers to take over the premiership from Wen Jiabao over the same period. Beyond these two names, however, little is clear in terms of China’s next leaders. We do know, in part because of the party’s retirement-age guidelines, that many top-level politicians will step down or change posts in 2012. Seven of the current nine members of the Party’s Central Committee Politburo Standing Committee (the top, and ranked, decision makers) will probably retire; so will up to 16 of 25 members of the Politburo. As people are promoted to fill these slots, vacancies will appear on the State Council’s Executive Committee. Similar turnover will happen throughout the central government and at the provincial and municipal levels, effectively all at once. Changes in the leadership are fairly

What the polls are saying
While Tang has been the long-standing favorite for the leadership role, both he and Leung are seen as being acceptable to the Chinese government, and the race is not a foregone conclusion. Indeed, the incumbent Tsang’s predecessor was forced to step down after local protests in Hong Kong against unpopular government decisions driven by the mainland. This suggests that leadership appointments are not completely divorced from public opinion, and Beijing will be reluctant to aggravate civil unrest. Nonetheless, despite falling popularity for Tang (according to the University of Hong Kong’s Public Opinion Program his public approval rate has fallen to just over 45% from around 65% when he took over as chief secretary in 2007), he remains the frontrunner.

EXHIBIT 5: DIGGING DEEPER INTO CHINA’S POLITICAL TRANSITION: “TRICKLE DOWN”

<table>
<thead>
<tr>
<th>Politburo Standing Committee (in order of rank)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hu Jintao (retiring)</td>
</tr>
</tbody>
</table>

Full Politburo, 25 members with 14-16 retiring
State Council, 35 members
National People’s Congress (NPC), roughly 3,000 members
Communist Party (CPC), 78 million members (~5% of China’s population)

Source: Economist Intelligence Unit.
orchestrated; little is left to chance in this enormous transition. That does not mean that personalities and ideologies do not figure into the event. Anecdotally at least, it seems that the Party (which represents roughly 5% of China’s population) is somewhat divided, with one camp looking more toward the coastal areas and business, and the other camp skewed toward inland modernization and more populist policy. Policy differences within the party over how to cope with income inequality have also gotten more vocal as the transition approaches.

What’s at stake
China’s political transition creates a host of both micro and macro risks to note. First on the macro, the likely up-and-coming leaders in China are from a different generation, and could well approach domestic politics differently in the years to come. Indeed, the composition of the next government could well shape whether China liberalizes more (politically and/or economically) or takes a harder stance. Into, during and immediately after the political transition, however, we expect China to take a “don’t rock the boat” approach to policy. We believe the goal will be stable growth, controlled inflation and limited volatility in local markets. Such a stance could also mean more frequent crackdowns on demon-strations and tighter censorship. Separately, we believe China will try to avoid any confrontation with Taiwan before the latter’s 2012 elections (China would prefer that president Ma remains in power, given the leader’s relatively friendly stance toward cross-Strait relations). Likewise, we believe China will try behind the scenes to prevent any sudden geopolitical shocks from Korea, especially if North Korean events threatened sudden migration into China. In the U.S., we think China would be likely to react should the U.S. pursue any perceived “anti China” policies (trade-related legislation, for instance). Such reactions could go through the World Trade Organization, but could also be “signaled” via a tactical slowdown in U.S. Treasury purchases. Chinese incoming and outgoing leaders would both want to demonstrate to local voters that they would stand firmly against any perceived U.S. political “aggression.”

On the micro level, one trend that appears firmly in place is promoting senior corporate heads to government posts. For instance, Zhang Qingwei, formerly chairman of the state-owned Commercial Aircraft Corporation of China, was recently named acting governor of Hebei. While we believe the exchange of experiences from corporate to public sector is positive for China, we also see risk that foreign concern over government links with state-owned enterprises (SOEs) will linger or even worsen.

Venezuela
October 7, presidential election

Background
President Hugo Chavez has stated his intention to seek a third six-year term when his current period in office expires in early 2013, but health problems (Chavez announced in June that he had been diagnosed with cancer) and growing public dissatisfaction over high crime rates, inflation and electricity shortages make the political outlook more uncertain than at any point since his near ouster in 2002. (It is worth recalling that in 1975, Venezuela was Latin America’s AAA-rating sovereign, only to decline in subsequent years due to poor economic governance, accentuated by Chavez’s policies.) Oil output has been flat to down as PDVSA has been politicized and deprived of the resources needed to invest in the resource-rich Orinoco belt. With this backdrop in mind, the main opposition alliance, the Mesa de la Unidad Democratica (MUD), has set February 2012 to stage primary elections for a candidate to run against Chavez next October, and has its best chance in years of taking the presidency. MUD overturned the incumbent Partido Socialista Unido de Venezuela’s (PSUV’s) two-thirds majority in 2010 parliamentary elections, winning the majority of the popular vote and taking 65 out of 163 seats (which allows them to block major bills). The alliance’s three leading contenders—state governors Henrique Capriles Radonski and Pablo Perez Alvarez, and former mayor Leopoldo Lopez—are all young (around 40 years old) and compelling candidates who could potentially match up well against Chavez and compete with him among his support base. It is worth noting that Lopez’s legal status to compete in the race remains in limbo after the Supreme Court made an ambiguous ruling on whether or not to reinstate his previously suspended political rights.
What’s at stake
While Venezuela’s influence in Latin America has waned in recent years, the country has maintained close geopolitical ties with Russia and China, both of whom have taken more important strategic roles in developing Venezuela’s massive heavy crude reserves. Securing strong oil revenues will remain important for education and healthcare programs that primarily serve the lower income segments of Venezuela. Though pre-election pump priming is likely to give the economy a boost ahead of the election itself, a victory for the incumbent would not bode well for the medium-term economic outlook, in our view. An opposition government would be biased toward a more free-market approach, and in our view could trigger a significant rally in Venezuelan external debt.

What the polls are saying
Despite slow growth and high inflation, the latest figures from local polling firm Datanalisis suggests that Chavez’s approval rating has moved above 50% due to higher government spending this year and public sympathy following the cancer diagnosis. While the president’s health remains the key wildcard, Chavez remains a formidable political figure and the leading opposition candidates will have a tough time competing with his strong institutional support and deep pool of funding.

United States
Presidential and Congressional election
November 6

Background
President Barack Obama will run for a second term on November 6 against the nominee from the opposition Republican Party. Both sides face a dissatisfied electorate, anxious over the state of the economy and disappointed with the performance of Congress, particularly following the summer debt ceiling debate and subsequent downgrade of the U.S. credit rating (Exhibit 6). The leading contenders for the Republican nomination (as of early November) include: former Massachusetts governor, Mitt Romney; the governor of Texas, Rick Perry; and businessman Herman Cain. During his term as Massachusetts governor, Romney crafted a universal healthcare plan for state residents; while popular among local constituents, the plan has put Romney at odds with some in the Republican Party base. Perry’s 10-year governorship of Texas, meanwhile, has been hailed as a success, with over one million jobs created and a current unemployment rate around a percentage point below the national average. But Perry’s approval ratings have suffered of late, in part because of perceived, lackluster debate performances. Another potential vulnerability is that his Texas roots could cause some voters to identify him with the unpopular (at departure) former president George W. Bush. Finally, Cain has topped a number of recent polls among Republicans, and his centerpiece 9-9-9 plan (9% federal income tax, 9% national sales tax, 9% corporate tax with no taxes on investment income) has drawn widespread party support. The weak economy will represent a significant challenge for Obama’s re-election prospects, but planned troop withdrawal from Iraq, the elimination of Osama bin-Laden and limited engagement in the controversial Libyan conflict may allow the administration to claim some successes on foreign policy.

What’s at stake
The state of the economy (and in particular the state of the labor market) will remain one of the— if not the—top issue going into the election. It is notable that no U.S. president since Roosevelt in 1936 has been re-elected with an unemployment rate of over 8%. As such, Obama will likely push to minimize the degree of fiscal tightening that occurs in 2012. However, the President’s jobs bill (which includes extending the 2010 payroll tax cuts, employer tax credits for hiring workers who have been unemployed for more than six months and around $200 billion in infrastructure spending and direct...
assistance) will still need to clear the Republican-controlled House; should it fail to do so, the chance of a recession in 2012 could rise. A victory for the Republican nominee in the Presidential elections could, however, boost the chances that the Bush income tax cuts are extended in 2013 (particularly if Republican gains extend to Congress), with cuts to corporate tax also a possibility under this scenario. Following the U.S. credit rating downgrade, entitlement reform is likely to be a major issue in the next presidential term for whoever takes control of the White House, but Republicans would be more likely to place this higher on the reform agenda, according to most political commentators. Obama's key reforms on the financial sector (the Dodd-Frank Wall Street Reform and Consumer Protection Act) and healthcare (the Patient Protection and Affordable Care Act) would likely also be back in focus should the Republicans assume greater control.

What the polls are saying
As of early November, three major polls (Real Clear Politics, Rasmussen Reports and Gallup) had registered voters favoring a Republican candidate over Obama. According to an October RCP poll, Obama's approval rating was just 44%, and the result of the special election in New York's Ninth Congressional District earlier this year (which went to a Republican for the first time since 1920) further hints at a growing dissatisfaction with the incumbent. Another RCP poll ranked the Republican presidential candidates, with Cain leading at 26%, Romney slightly behind, and Perry at 12.5%. However, with a full year to go before the elections, it is still too early to come to any firm conclusions as to which candidate will ultimately prevail.

Into 2012: Tying Politics to the Bigger-Picture Market Outlook
Looking toward 2012, it is quickly apparent that local markets are vulnerable to at least short-term volatility tied to respective political events. That said, we believe there are reasons why elections could have implications beyond national borders (Exhibit 7). In particular, we see three broader, politically driven market risks to note in the year ahead. First, we would keep watching oil, with politics biasing risks toward higher prices. Second, elections across Asia suggest heightened risks of geopolitical tensions, possibly weighing on regional assets, even if only temporarily. Finally, elections across Europe could impact the EMU and EU’s approaches to the peripheral crisis, with fallout possible not just within Europe but globally.

In the case of Europe, over the coming year, we will likely see elections (at least) in Greece, Italy, Spain, France and Finland—representing more than half of EMU nominal GDP in 2009 (JPMSI data). There are different national dynamics at work in each country. However, in aggregate, the need for politicians to curry favor with voters suggests risks that policy toward the periphery could be steered in directions it might not otherwise go, or that policy decisions at a pan-EMU or EU level might take longer than otherwise expected. These risks are heightened by the fact that the Euro area appears likely to experience at least a shallow recession into 2012, making voters even less happy with the status quo. For markets, we think this means continued uncertainty and volatility—not just in European local markets but potentially for global investor sentiment. We also believe, at the margin, this political uncertainty could limit the amount of

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Source: J.P. Morgan Asset Management, October 2011
fresh capital willing to go into the Euro area. Alongside what we expect to be a more dovish European Central Bank (ECB), we see risks biased toward at least a marginally weaker euro. Finally, while we believe longer-term that Europe will get through the peripheral crisis, we do not see that solution coming quickly or easily, in part given these political events.

One would think we have our hands full into next year alone with Europe. But we have other countries to keep a close watch on, and for a globally critical reason: oil. 2012 has scheduled elections in Russia, the world’s largest oil producer. There are also elections for Venezuela, Egypt, and potentially Libya, as well as heightened political risks in Saudi Arabia, Iran and Bahrain.

Why do we see oil prices biased higher here? After all, global demand should be softening with the slowdowns in developed-market economies in particular. While that’s true, we believe key oil producers, including Russia, will want oil sustained at or above certain levels to support budget surpluses. Those surpluses are needed in order for governments to continue subsidies that indirectly can help limit social unrest. Recall just this last February: Saudi Arabia, in an effort to appease an anxious public, spent some $130 billion over a two-month period.

Now Egypt is not a major oil producer but we included it here because it highlights the second reason we see oil prices biased higher—the potential for regional tensions to create worries over supply. Any unexpected strains tied to Egypt’s political transition could raise broader questions about Arab Spring transitions and the stability of the region. This, in turn, could trigger a relatively greater “risk premium” for Brent crude oil prices and potentially limit investor sentiment globally.

In Asia, we believe market risks, should they surface, are more likely to be regional, and tactical, than global and sustained in nature. Still, they are worth highlighting, again given the relative fragility of investor sentiment and the global economy heading into the new year. In the cases of South Korea and Taiwan especially, but even in the case of Hong Kong, the issue to watch is any change in policymaker biases toward mainland China. Should market fears rise that a less friendly approach to China could surface, we would not be surprised to see at least a temporary sell-off in regional equities and currencies (though central bank intervention would likely limit local FX weakness). Korea, of these countries, seems the relatively biggest wild card.

As noted earlier, there are number of key anniversaries and events that could prompt North Korea to stir up tensions with South Korea around the South’s key political races.

The United States’ and China’s elections are likely to have global implications even without specific cross-border issues at hand, simply given the size of these economies and their importance for global markets and growth. In the case of the U.S., policy shifts that influence sentiment toward U.S. growth are most likely to be felt in neighboring Canada and Mexico, given the strong trade ties between the countries (in both Canada and Mexico, around 80% of total exports are destined for the U.S.)

**Investment Implications**

How might all these political events impact our key investment themes as we look toward the year ahead? If 2011 has been any guide, we have to be aware that we could see policy surprises and very real impacts on markets, both in the short term but potentially also longer term as policy trickles through sentiment and down to real economic activity.

With equities, we believe valuations, broadly, remain attractive. However, this political uncertainty continuing and possibly increasing next year, coupled with more moderate global growth, suggests that broad-based equity gains will likely be limited. Within equity allocations, we prefer to focus on equity that can also generate income for portfolios—strategies focused on high-dividend stocks. We also want to focus on large-cap growth, as a means of capturing other sources of revenue growth, be they via innovation or revenues from emerging markets.

In fixed income, it seems quite clear, based on the Federal Reserve’s and European Central Bank’s latest meetings, that policy rates will remain low for long across the developed markets, with a strong bias that the ECB eases further in the months to come. It was interesting at the start of November that Fed Chairman Bernanke specifically noted that the Fed needed more help from politicians to stimulate the economy, but absent fiscal policy, the Fed will do what it can to support growth. With government yields low and likely to stay that way for some time, we want to seek other sources of yield for port-
folios. The good news is that we see a myriad of opportunities here: not only high-dividend stocks, but also strategies such as high-yield debt and emerging-market debt.

Alternative investments certainly can provide a source of income and in some cases, lower volatility in a world where politics may keep volatility at a premium. Real estate, infrastructure, mezzanine financing, emerging-market-focused private equity—these are a few of the strategies we think should be explored in a politically focused world.

Finally, for globally minded clients, politics always has, and certainly will continue to impact currency markets. While bouts of risk aversion, potentially tied to politics, may boost the U.S. dollar, longer-term we remain strategic dollar bears, especially against emerging Asian currencies and to a lesser degree, commodity-linked currencies. (We believe China in particular will continue to let the yuan gradually strengthen versus the dollar over the coming years, barring an unexpected global recession, in which case they would be likely to repeat 2008-2009, when USD/CNY simply held steady.) We believe politics and policy ahead will weigh on the euro—the question is just to what degree. And while it might be debatable, we would argue that this global political backdrop suggests a measure of support for gold prices at least in the year ahead, even from current elevated valuations.
Rebecca Patterson is Chief Markets Strategist for the global Institutional arm of J.P. Morgan Asset Management. In this role, Ms. Patterson provides market insights to help institutions, pension funds, endowments, foundations, and sovereign entities make well-informed decisions for their portfolios. She also heads the global Client Advisory Group, providing in-depth, customized solutions for specific client challenges, as well as thought leadership on relevant industry and investment topics. Some of Rebecca’s recent papers include “A New Fiscal World Order: Implications for Investors,” “Commodity Considerations in a New Fiscal World Order” and “Investing in China: Why Now and How.”

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