

To: Undisclosed recipients:[@]
From: US GIO
Sent: Fri 7/25/2014 11:03:38 PM
Subject: The J.P. Morgan View : Risks and timing
JPM_The J.P. Morgan View_2014-07-25_1451182.pdf

J.P.Morgan

Global Asset
Allocation

The J.P. Morgan View: Risks and timing

- **Asset allocation** — Core views are tracking. The risks around them, from lower growth and disruption caused by Fed hikes, balance each other out. Fed disruption risk is to us further out and its impact uncertain. We thus do not put much emphasis on it, yet. The timing is to us not right to significantly cut overall risk assets now already.
- **Economics** — PMIs and monthly run rates keep us comfortable with a rebound to 3%+ global growth pace for Q3.
- **Fixed Income** — Trade bearish US view through UW vs TIPS and Bunds.
- **Equities** — Strong US and Japanese earnings support stocks.
- **Credit** — Backup in spreads is a sign of a matured credit rally.
- **FX** — We like the stronger dollar, even as the main move up should come later. We present five strategies to benefit with low vol range trading.
- **Commodities** — Supply/demand dynamics keep us long energy.
- [Click here for video.](#)
- **Equities** are up on the week, though effectively in a holding pattern this month near their new all-time high. Bonds have also barely moved. Credit spreads are tighter this week, but decently wider on the month. The dollar is up and EM continues to outperform in both equities and currencies.
- Overall, our main impression this week is simply that the **core views and strategy are tracking nicely** and do not clearly require retuning. Still, anytime we say that, we get nervous that we are missing something or that we are getting too complacent. Hence, **what are these core views, and what challenges are on the horizon?** Our conclusion would be that risks, from another growth shortfall and from earlier Fed hikes, are sufficiently balanced and, at least on the Fed, further out with uncertain

impact that they allow us to stay with our main, long risk, low vol view and strategy.

- On the **economy**, our view is that after a dismal first half, punctuated by a still somewhat unexplained contraction of US real GDP in Q1, world and US growth should again return to an above trend 3% handle from the current quarter on. There are almost no hard activity data yet on Q3, but the monthly run rate into the quarter and forward looking surveys are keeping us confident that we will finally get a quarter that meets or beats our forecast.
- Beyond the current quarter, the forecast is for world and US economic growth to remain at a cruising pace of 3% plus which would require monetary policy normalization first in the UK and then in the US, with most of the rest of the world staying on hold and Japan and Euro still with super easy money. Our US rate forecasts through 2017 are above forwards and thus bearish for bonds, but, in our mind, there is little nearer term that requires bond repricing. We still only have the first hike one year from now, and inflation, while having bottomed in our mind, is set to rise only very slowly and should not challenge the Fed.
- Our main discomfort on the economy is that the disappointment in H1, and the last three years, may signal that we are missing something fundamental on either unfinished post-crisis delevering or supply-side worsening from demographics or productivity. Our main defense is intense data watching, and postponing strong-growth trades, such as short duration.
- In **bonds**, we are positioning for range trading, carry, and cross market positions that exploit event risk differences. Our US rate forecasts are bearish, but we see little over the next 1-2 months that will support a short duration view. We are long euro rates against the UK and the US, long Australia and New Zealand against the rest of the world, overweight the Euro periphery, overweight US inflation linkers (TIPS), and long duration in Brazil. Each of these is performing this month.
- Our main discomfort or **risk** in bonds is if global growth continues to disappoint, the global story will focus increasingly on stagnation and deflation, boosting long duration bonds, and hurting growth assets such as equities, a position we currently do not have. We find this scenario sufficiently unlikely that we are not positioning for it, but it does keep us out of the short duration trade.
- On **credit**, we have argued frequently that we find the rally spreads mature, as we are near past cycle lows, the asset class has grown faster than others, and corporates are starting to relevel. The backup in spreads this month, despite better equity prices confirms to us this view. We are not UW credit, but have reduced our long to a minimal size. The real danger to credit probably comes from Fed tightening inducing a liquidity problem. But this risk is still a year away for us. Too early, and too expensive to short credit, in our mind.
- We stay long and bullish **equities** as we have for over five years on low macro risk, no return on cash, and now also improving earnings growth (see below). Active positions are likely quite long and this could bring a correction, but there is also likely a lot of money waiting to buy on such a correction. The main macro threats to equities are lower growth or volatility caused by Fed tightening. We downplay the first and find the second too far out, and so uncertain as to its impact that we are not positioning for it.
- We moved **long EM across asset classes since Q2 and stay there**. Negative macro momentum has switched from EM to DM. We like the superior risk premia on EM assets in a world that has so little left. The EM OW trade is working and gathering momentum. The Fed is again seen by many as the main threat, but as above, it is too far and too uncertain for us to position now.

Fixed Income

- Bonds did very little this week as there were no big surprises on the economy or policy. Next week, we get the **FOMC, but expect no fireworks**. The Fed will almost certainly taper another \$10 billion and

repeat the forward guidance that a “highly accommodative stance” remains appropriate (M. Feroli in *US Weekly Prospects* today). We will monitor closely what the statement says about the recent fall in the unemployment rate and whether this signals earlier rate hikes. Our assumption at this point is that this will not be the case.

- We retain **bearish US bond yield forecasts but trade these only indirectly, through spread trades and linkers**, as the negative duration view (p. 5) is based on the ultimate rate hikes by the Fed on which we are unlikely to get much supporting information in coming weeks if not months. We stay short 5-year USD rate against euros, on the risk around our Fed calls and Euro area economic data are again underwhelming. The position has become quite expensive in carry (as euro rates are much lower), but we cover this by also being long euro periphery against Germany.
- The second way we are indirectly short UST is by OW-ing TIPS versus nominal USTs. Demand for linkers is strong, as witnessed by this week’s TIPS auction, despite a weaker CPI print. We stay OW TIPS, targeting 2.35% for the 10yr break-even, versus 2.27% today (see K. Harano in *USFIMS*).

Equities

- Global equity markets were rather flat this week even as the S&P 500 touched a new historical high. The current earnings reporting season lends fundamental support with the earnings for the S&P 500 and Topix companies reported so far surprising by 6% and 4%, respectively. The earnings surprise for the euro companies (SXXP) that have reported so far has admittedly been a less impressive 1%.
- We have argued previously that lower risk perceptions and no return on cash have created a bullish environment for PE multiple expansion (risk premium reduction). Much of this reduction in fear has probably happened by now, **moving the onus to better earnings**. The current reporting season is delivering this robust earnings growth, making us more confident that the current bullish environment will be sustained into 2015 tracking a double digit annualized pace of equity price gains. The S&P 500 companies are reporting an 11% YoY earnings growth, meaning that earnings account for most of the 16% rise in the S&P500 index over the past year.
- **EM** equities have outperformed DM on the month and have experienced steady inflows since April. Positioning in EM is likely still not crowded as investors remain wary of political and policy risks in countries like Brazil, Russia and the Middle East. The negative growth forecast momentum that has bedeviled EM over the past two years appears to have shifted to DM. The July flash PMI for China also surprised on the upside supporting the current positive momentum in EM growth expectations.
- **Within EM**, an important political event was the presidential elections in Indonesia. This week, the Election Commission declared Widodo the winner with a good margin. Although presidential candidate Prabowo will likely contest these results, our strategists dismiss any constitutional intervention (*ASEAN Equity Strategy*, A. Srinath et al., Jul 13). We remain positive on the prospects of improved governance and structural reforms which should give a cyclical lift to Indonesian equities once the government is formed (see *Indonesia*, Sin Beng Ong, Jul 22).
- Fed Chair Janet Yellen’s monetary policy testimony before the Senate last week referred to equity valuations in certain sectors like small caps appearing stretched. We favor an underweight in US Small cap vs. Large caps for the remainder of the year because of recent loss in momentum and higher upside to earnings growth in large than small caps (*Global Smids Views*, Eduardo Lecubbari et al., Jul 3). In addition, we exploit value within small caps by overweighting Euro area small caps vs. their US and UK counterparts as we find valuations (P/Book) in the US and the UK high relative to their historical averages. The Russell 2000 index is down by around 4% this month whilst the MSCI EMU small caps were flat.

Credit

- **Credit spreads came in a bit this week, but remain wider on the month.** Some reports blame nervousness on the coming Fed tightening as driving some investors out of corporate bonds. This is possible and has some support from recent HY fund outflows, but is hard to square with dovish Fed talk and the lack of any sell off in UST yields. More likely, in our mind, given how much the world has accumulated in credit, some investors are simply trimming on the idea that much of the upside on credit is past us. We agree, and thus have only a small long left.

Foreign Exchange

- In a month some might label dull given tepid volumes (chart), the dollar index is doing something somewhat interesting: it is posting four consecutive weekly advances and its largest monthly gain since January. FX volatility has failed to decline on the month for only the second time this year. Whether the dollar is threatening new highs or just nestling back into its 2014 range depends on which dollar index one references: DXY seems to be doing the former while JPM's broader trade-weighted index including emerging market currencies is doing the latter. We still think advances in either index require higher US rates since there isn't enough policy or data drama outside the US to push many non-dollar currencies lower.
- Thus with full recognition of the complacency risk, we think **ranges persist for a few weeks longer.** But also acknowledging that many accounts ask what is worth doing in this environment (besides nothing), we review **five strategies for contending with low-vol markets**, the trades that fall mechanically from those frameworks, and our discretionary choices across the Macro, Derivatives and Technical portfolios.
- The obvious strategy is to reject the summer range and position for Q4 USD breakout. That is fine against currencies like EUR, JPY and CHF which do not cost to carry. Alternatively, focus on USD longs versus currencies with idiosyncratic risk, like NOK due to Norges Bank dovishness or GBP due to the Scotland referendum. The second strategy is to earn carry in cash markets. We only do this in emerging markets, since both absolute and risk-adjusted carry are much higher than in G10. CNY is our preferred trade. For vol carry, BRL and MXN are the top pairs. Another strategy is to trade short-term mean reversion where positions look stretched. Selling GBP is preferred, though BRL positions are also large (carry is too punitive, however). Finally, investors could consider removing the USD element and focus on cross-rates. We think there is enough inflation divergence within Europe to make this a rich source of trades, but we are mostly sidelined here for the moment except for a short in EUR/CHF. Instead, we like short CAD/MXN and long MXN/CLP as two cross-rate trades in our Technical Analysis portfolio.

Commodities

- Commodities were flat on the week as the gains in industrial metals were offset by a fall in agriculture. Month-to-date, front month Brent futures have weakened by around \$5/bbl, trading around \$107/bbl and are almost flat in the last week. The weak demand in the physical North Sea crude markets has continued to weigh on the front end of the curve, now in contango through Nov 2014. The combination of seasonal high in global refinery runs and upstream maintenance in the North Sea fields in August will likely lift the oil complex higher in coming weeks. Furthermore, we retain our cautious view on Libya's production potential – media reports suggest that one shipment from El Sharara field was exported last week but news on production restarts have been a mixed bag. US crude market fundamentals also appear supportive with US refinery runs higher YoY on a very strong 2013 baseline, and inventories in Cushing, where WTI is priced, are at their lowest level since November 2008. **We stay long GSCI energy.**

Click [here](#) for the full Note and disclaimers.





Visit [J.P. Morgan Markets](#) for more market-leading research and financial solutions across the full trade and investment lifecycle.

If you no longer wish to receive these e-mails then [click here to unsubscribe](#)

www.jpmorganmarkets.com

Analyst certification: I certify that: (1) all of the views expressed in this research accurately reflect my personal views about any and all of the subject securities or issuers; and (2) no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed herein. Important disclosures, including price charts, are available for compendium reports and all J.P. Morgan-covered companies by visiting <https://jpmm.com/research/disclosures>, calling 1-800-477-0406, or e-mailing research.disclosure.inquiries@jpmorgan.com with your request. J.P. Morgan's Strategy, Technical, and Quantitative Research teams may screen companies not covered by J.P. Morgan. For important disclosures for these companies, please call 1-800-477-0406 or e-mail research.disclosure.inquiries@jpmorgan.com.

J.P. Morgan does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

J.P.Morgan Securities Plc is a member of the London Stock Exchange and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Registered in England & Wales No. 2711006. Registered Office 25 Bank Street, London, E14 5JP.

Confidentiality and Security Notice: This transmission may contain information that is privileged, confidential, legally privileged, and/or exempt from disclosure under applicable law. If you are not the intended recipient, you are hereby notified that any disclosure, copying, distribution, or use of the information contained herein (including any reliance thereon) is STRICTLY PROHIBITED. Although this transmission and any attachments are believed to be free of any virus or other defect that might affect any computer system into which it is received and opened, it is the responsibility of the recipient to ensure that it is virus free and no responsibility is accepted by JPMorgan Chase & Co., its subsidiaries and affiliates, as applicable, for any loss or damage arising in any way from its use. If you received this transmission in error, please immediately contact the sender and destroy the material in its entirety, whether in electronic or hard copy format.

This email is confidential and subject to important disclaimers and conditions including on offers for the purchase or sale of securities, accuracy and completeness of information, viruses, confidentiality, legal privilege, and legal entity disclaimers, available at <http://www.jpmorgan.com/pages/disclosures/email>.