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Global Asset Allocation

The J.P. Morgan View: Can do vs that's all we have

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- **Asset allocation** — The uncanny similarity to the Q1-to-Q2 slowdown in data and equity markets of the past three years does indeed raise the risk of a correction. We stick to a medium-term strategy of overweighting US and Japanese equities over bonds as we consider value more reliable in this cycle than short-term signals.
- **Economics** — This week's central bank meetings are showing a stark gap between the do-what-it-takes-and-more attitude of the BoJ and the that's-all-we-have defense for inaction by the ECB. US Q1 is now tracking 4%. Weak-ish job data confirm the slowdown we are getting to 1.5% in Q2.
- **Fixed Income** — BoJ revolution heralds more bull flattening in Japan, and intensifies search for carry elsewhere.
- **Equities** — OW Japanese equities. UW Euro area equities.
- **Credit** — Hard-currency fund flows are supporting EMBIG.
- **Currencies** — Re-enter today JPY shorts vs USD, AUD and BRL.
- **Commodities** — Stay underweight vs. other asset classes. Within commodities, we focus on relative supply conditions.
- **Equities and commodities** pulled back this week and bonds rallied on disappointing US jobs, ISM, and ECB actions, with the aggressive BoJ actions having little impact beyond its own borders.
- We reiterate our 2013 theme that we are in an **idiosyncratic world** where local risks and forces are driving domestic markets, without much impact on others beyond the typical 1-2 days knee-jerk reaction. Return correlations within equities, commodities and across risk assets broadly have indeed fallen back to pre-crisis levels (charts on p. 2 and p. 4). We would argue that we are now back to more normal and more fundamental market behavior and that the post-Lehman 5-year risk-on, risk-off was the outlier.
- **Are bad US seasonals unnerving** investors? It has not gone unnoticed that equities have performed remarkably well in Q1 of each of the past three years, and poorly in each of the then following quarters. There is a suspicion that post-recession seasonal adjustment parameters are artificially boosting US Q1 activity data relative to Q2. Our Chief US Economist, Michael Feroli, has argued that this bias was likely very small and should be negligible this year. Still, the uncanny coincidence is surely inducing such risk investors to cut exposures.
- Weak US jobs are not inducing a downgrade of growth projections. In fact, the better trade reports are now boosting our Q1 tracking to 4%. This week's data confirm we will likely see the slowdown to 1.5% growth in Q2, which has been our forecast.
- **Is Japan for real?** Given the task at hand of battling 17 years of deflation and policy inaction, the chance of success of the new Japanese reflation policy was always going to be expressed in terms of maybe, hope, and you-never-know. But increasingly, we are finding now that the essential ingredients of success are in place: **motivation, will to act, power, and tools**.
- The political and economic ascendency of China as the pre-eminent power in Asia is likely the main factor that is suddenly motivating Japan to try and reflate its economy. PM Abe has made it clear he has the will and determination to act. And his majority

in the lower house and likely this summer also in the upper house, combined with high approval ratings and an opposition in disarray are showing us that Abe has the power to act. Finally, we believe the successful use of non-traditional monetary policies in the US is presenting Japan a model and a path out of deflation.

- Our **Japan** Equities Chief Strategist, Jesper Koll, has made a strong argument for success of the Japanese reflation policy and a structural bull market in Japanese equities (see *J on Japan - Vol.1, The case for Japan*, Mar 22). His metric of progress is whether Japan moves on from BoJ QE measures, which are there just to jump start the economy, to true actions to stimulate long-term growth, and signal rising confidence through higher consumer and corporate leverage. At this point, given upward momentum on growth expectations for Japan (Fig 6), **our main position is to be long Japanese equities, both outright and against the rest of the world**. We keep a smaller JPY short, but recognize that ultimately, a successful Japanese reflation policy will strengthen the yen.

- Can **Europe** exit recession and malaise? Over the past month, weak activity data in Europe have forced us to push out again to the middle of the year the expected end of the Euro recession, and to lower growth for the UK &EM Europe. In effect, we are finding that the OMT has not loosened credit conditions for the private sector in the periphery and that fiscal policy (austerity) remains too tight. Periphery sovereign debt has rallied due to the promise of the OMT, but this has had little if no impact on their economies. The chaos around the Cyprus bailout is further reducing confidence that the Euro Area has what it takes to pull itself out of recession & malaise. Euro policy makers & institutions appear to be showing the same lack of action, initiative, ambition, and can-do that kept Japan in deflation for so many years. The risk is thus rising that Euro equities could go nowhere for years to come.

Fixed Income

- Yesterday was a study in central bank contrasts, with the ECB sitting on its hands, while the Bank of Japan launched the **most aggressive easing at a single meeting by any G-4 central bank**. The BoJ surprise came in both the size of its programme — it will more than account for net issuance of JGBs over the next two years — and in a greater-than-expected focus on longer-maturity bonds. By comparison, we think the Fed and BoE will absorb roughly half of net domestic government bond supply this year, while the BoE has previously (2009, 2012) absorbed almost the entirety of UK government supply (see chart).

- The powerful rally in the long end of the Japanese curve is justified by the BoJ action. But the extreme volatility in Japanese rates, exemplified by a 30 basis point intraday range in 10-year yields today, appears to illustrate the disagreement among investors on how to interpret the policy news. **Our forecast is for JGBs to rally further from here**, with 10-year yields breaching the all-time low briefly touched yesterday, and 30-year yields getting below 1% (see today's *GFIMS* for an extensive discussion). If the Bank of Japan is successful in spurring inflation expectations, JGB yields will surely have to head significantly higher, but likely only over a multi-year horizon. BoJ buying of JGBs is also likely to push Japanese investors to buy higher yielding foreign bonds. This spillover effect will simply intensify the existing search for carry, in our view. So far, the impact has been most evident in the Euro area core, the focus of Japanese buying abroad over the past year. We add a carry-motivated **overweight in Spain**.

- In recent weeks, there has been a subtle shift in Fed communication, towards a discussion of tapering down asset purchases, setting the Fed apart from the direction of travel of other major central banks. Today's disappointing **US employment report** may put that shift on ice, removing what had been a building headwind for Treasuries.

Equities

- Global equities are down on the week due to weaker than expected US activity indicators. **The MSCI AC World index is down almost 3% from its mid March peak.** It is effectively unchanged since the end of January. The weakening of US activity indicators is very recent and difficult to say whether it represents the beginning of a more serious soft patch like the ones experienced in the second quarter of every single year over the past three years. But it is surely a worrying sign which makes us focus on relative rather than outright trades.

- Central bank actions this week appear supportive of our **Japanese equity overweight and our Euro area equity underweight.** The BoJ surprised investors with a massive duration withdrawal program while the ECB seems unwilling to act yet despite a contracting Euro area economy.

- A potential negative impact from the uncertainty emanating from the recent Italian election and the Cyprus crisis, could pose a serious threat for Euro area growth over coming months risking prolonging the current run of negative economic surprises for the region. Japan is the region we like the most. In our mind the Japanese equity trade has further legs not only due to the massive BoJ balance sheet expansion but more importantly due to a reform agenda to be unveiled into the summer.

- **EM equities are suffering from renewed policy tightening in major EM economies** such as Brazil and China. Investors have bitter memories of previous property tightening measures in China. In addition, Asian exporters are suffering from loss of competiveness due to a weaker yen. As within DM, we see a lot of divergences within EM and prefer to focus on under-owned markets with good domestic demand story such as Mexico and Malaysia. On the contrary we underweight export oriented countries in Asia such as Korea and Taiwan.

Credit

- Spread moves were mixed this week, as local themes continued to dictate market moves. Most notably, negative surprises in the US data flow, culminating in today's payrolls miss, led US spreads wider. However, European credit tightened against the recent run of play, and the rally in government bonds helped push the highest-grade sectors, EU HG and GBP HG, to new all-time yield lows.

- EMBIG - the worst performing credit market YTD - outperformed in spread terms, as hard-currency EM funds saw their largest weekly inflows since January, also bucking the recent trend. Otherwise, the flow picture was little changed on last week, with dollars directed towards US HG and leveraged loan funds. This dynamic continues to highlight investor's concern about duration risk, as HG demand is focused on the short-end, which is also driving credit curves steeper (see today's *CMOS* for more details).

Foreign Exchange

- Last quarter was defined by several trends: US and Japanese growth outperformance; broad USD strength on higher rates; collapsing correlations across and within asset classes; and diverging trends in volatility. Q2 should look similar in some ways, different in others. The global economy should still stagnate despite a few stand-out economies; global liquidity should remain enormous; and the dark side of QE (asset bubbles) can only be found in systemically-unimportant markets. Four differences in Q2 could be the following: (1) US outperformance is fading; (2) anemia outside the US and Japan is largely discounted; (3) Japan could re recognized as a regional growth engine rather than a source of currency contagion; and (4) Japanese investors should finally go global. All these should put a lid on the trade-weighted USD and preserve the low-correlation environment where local themes still dominate.
- **Japan remains the most interesting market**, since BoJ might finally induce substantial capital outflows by domestic (Japanese) investors, so extend the yen's slide. We estimate that a fall in 10-yr JGB yields should push USD/JPY above 100. In the macro portfolio, we were stopped out of short JPY intra-month; **re-enter today vs USD, AUD and BRL**. We keep a basket of GBP shorts vs EUR, NOK and USD.
- EUR/USD can stay around 1.30 despite a region in recession. The Fed is nowhere near tightening, and Europe's balance of payments (record surplus) is stronger than the US's. And if Japanese investors prefer government bonds and cannot meet yield targets domestically, the only liquid, high-yield alternative would be Italy.

Commodities

- **Commodities sold off sharply this week, with all sectors posting large declines.** In this week's *GMOS,* we stay underweight commodities relative to other asset classes, given the lack of a yield and policy tightening in select EM. Similar to the fall in cross equity correlations, and supporting our view of a more idiosyncratic world, we are seeing a dramatic fall in cross commodity correlations (chart on right). Here too, correlations have moved back to pre-crisis levels, and are thus more "normal", where local supply and demand conditions drive prices. We are short gasoline vs. Brent, short lead and zinc vs. base metals and long palladium vs. platinum. We also have small outright long positions in US natural gas and in Brent, as well as in commodity carry.
- We expect the gasoline spread to Brent to narrow further over the coming weeks as refinery maintenance season comes to an end and demand for gasoline falls seasonally. We are long palladium vs. platinum given that most of the demand for both metals comes for the auto sector, with Europe dominating platinum demand and the US/EM dominating palladium demand. The better economic activity in the US relative to Europe should support this trade as well as relative supply conditions, which leave the palladium market more supply constrained than the platinum market. We recognize the downside risk to demand growth given the weak payroll number but we think the selloff in oil is overdone and expect Brent to recover.

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