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J.P.Morgan

Global Asset Allocation

The J.P. Morgan View: Who did it? US, EU, or both?

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- **Economics** — Further downgrades in global growth projections, largely following our US and EU cuts. Early indicators of July activity have surprised on the upside, but not enough to offset downdraft from lower stock prices.
- **Portfolio strategy** — Markets need an end to bad news on both US economy and EMU crisis. Neither are on the immediate horizon, but if one comes, US is more likely to surprise first.
- **Fixed Income** — Add overweights in German Bunds, this week's underperformer, and retain selective longs in EM.
- **Equities** — The most likely positive catalyst for equity markets in the near term is US economic data. Our US EASI is the signal to watch.
- **Credit** — We are underweight US HG credit and marketweight on EM credit.
- **Foreign exchange** — JPY and CHF to benefit most from crisis.
- **Commodities** — Own commodities geared toward Asia, but underweight those anchored to the US.

Volatility spiked this week to levels rarely seen outside recessions. The four 4%+ daily moves this week in the S&P500 have happened only 5 times before this past century. **Uncertainty about the economy and the euro have reached dangerous levels** and have induced money managers to sell all positions to hide into cash plus some government bonds. The risk is that consumers and companies do the same, pulling the economy down along with them.

What will end the carnage and push risky assets up again? The four forces that can drive a reversal are **Value** (risk assets have become so-o-o cheap); **Positions** (everyone who wants to sell has done so); **no further bad news**; and/or **Policy** actions to change the negative fundamentals.

On **Value,** the crash of the past few weeks has obviously made risk markets a lot cheaper, and arguably more attractive. By our reckoning, US equities, credit, bonds and metals are about midway between the levels we see during US expansions and those in a recession (see Nikos Panigirtzoglou et al., *How much of a US recession is priced in?,* Aug 11). Our economists and much of the consensus see only a 1/3 chance of a recession over the next year, but clearly the markets needs extra protection against that risk.

Positions are not yet a support for risk markets. Only three weeks ago, stock markets were just 1% off cycle highs. The collapse since is similar in speed, if not yet in size, to the Lehman crash. This means that most investors have not had time to adjust their portfolios to the rise in uncertainty. Many will likely use any rebound to get out with still half their shirt on. Our technical strategists, thus, signal more downside in coming weeks on riskier asset classes (see Mike Krauss and David Cohen on morganmarkets.com). Positions will likely be adjusted eventually, but even when they are, we find that Positions and Value have little timing sense. If the new information hitting the market remains bad, then no value or position force can push asset prices up.

Most important for a turnaround in asset prices, as we learned many times, is a combination of **no more bad news and policy actions** that create upside. And here things get a bit murky as there is no agreement on what events really caused the crash. **To exaggerate for a moment, market participants on the US side believe this is all about the worsening EMU debt crisis, while those on the other side of the Atlantic primarily blame the rising risk of a US recession.** An unchanged USD/EUR suggests both are equal culprits. Equity prices have followed 2012 global and US growth expectations quite closely.

We commented last week that policy makers are running out of ammunition, and that the bullets they have may be blanks. Nothing has changed here. On the data, **neither US growth nor the EMU crisis seem set to provide positive news** in coming weeks. On the margin, though, we suspect that **if any good news arrives, it is more likely to come from the US.** Activity data through June have forced serious cuts to US growth projections, but those for July — payrolls, claims, retail sales, car sales, Asia trade — have so far surprised on the upside. None of this is enough to make us more optimistic on US growth as confidence has collapsed to recession levels, and the August crash in equity prices must still pass through spending data. The **ECB** has started a shock strategy of buying Italian and Spanish debt, but the market is not over-awed, given disagreements within the ECB and the fact that previous ECB buying of smaller periphery countries did not turn spreads around. The market is sensing the approaching moment of truth where the Euro area has to choose between disintegration or closer fiscal solidarity. Given much greater losses from EMU disintegration, investors are hedging against this downside.

How does one invest in extreme uncertainty? Our strategy at the start of the month was to neutralise equities and to invest as far away from the EU and US crisis points, towards EM and smaller DMs. The latter strategy has not worked as massive de-risking has pushed investors out of these safer markets also. Short term, we can see more downside, but 1-2 months out, we still feel that investing into stronger economies remains the right strategy.

Fixed income

Bonds rallied amid remarkable volatility, taking their cue from the gyrations of the equity market. Measured on an intraday high-low basis, bond volatility has approached post-Lehman levels in the past two weeks (see Chart). A key driver was central banks' decisions to fire some of the few bullets they have left. The Fed's low-for-two-years commitment drove Treasury yields towards all-time lows, while SNB liquidity injections pushed the Swiss money market curve into negative territory. Perhaps boldest was the ECB's decision to step in to support Spanish and Italian bonds.

Plainly the ECB steamroller can cap Spanish and Italian yields while buying continues at this week's brisk pace (we estimate €14-20bn on Monday alone). The question is how long the ECB is prepared to support the market, and whether the EFSF can smoothly replace ECB buying. **We retain a wary outlook on the Euro area periphery**. A pooling of fiscal sovereignty will surely be needed to defuse the crisis, yet only much deeper funding problems seem likely to push EU leaders in this direction. For now, we recommend taking advantage of dislocations within Spanish and Italian bond markets created by the ECB's purchases (see today's *GFIMS Euro Cash* for details).
Positive price momentum, negative economic momentum, supportive central banks, and Euro area tail risk argue for duration longs. Against that are the very low level of yields, and the climate of extreme volatility. We add over-weights in German Bunds, this week's underperformer, stay flat elsewhere in DM, and retain selective overweights in EM local markets (e.g. South Africa).

Equities

The slump in equity markets over the past two weeks is extreme both in terms of its magnitude (-13%) but also its speed. Rising perceptions of a US recession and persistent European stress continue to create a negative mix for equity markets. **What can stop this negative momentum?**

The needed great leap forward by Euro area's policy makers is unlikely to come soon. The most likely positive catalyst for equity markets in the near term lies with US economic data. This is not happening yet. Our **US Economic Activity Surprise Index** remains in negative territory, following a two-day break at the end of July (see top chart).

Do equity markets price enough risk of a US recession? The answer is yes. Equity markets appear to be pricing in a 60% chance of a typical US recession. A mild earnings recession, when earnings typically fall by 8%, appears to be fully priced in (*How much of a US recession is priced in*? N. Panigirtzoglou et al., Aug 11). Our economists see only one in three odds of a US recession over the next year, making equities appear attractively. Is this a good reason to buy equities now? Not in our view. Value is rarely a good near-term signal especially when uncertainty is high.

How should investors position in the current highly uncertain environment? Our preference is for relative rather than directional trades. The relative trades we highlighted last week are to overweight the countries that are least vulnerable (Germany) or furthest (Japan) from the problematic spots of Europe or the US. In particular, we recommend that investors buy **DAX vs. Eurostoxx50** and **MSCI Japan$ vs. MSCI World$**. Across EM, we avoid BRICs and focus exposure on ASEAN countries, i.e. **long MSCI South East Asia$ vs MSCI China$**. ASEAN countries are in a sweet spot with inflation below the central bank target zone, strong currencies and healthy growth.

Credit

Credit spreads widened considerably this week given the market-wide sell-off of risk. We believe that spreads currently reflect about a 1/2 probability of a new US recession, comparable to other risk assets. The High Grade JULI Index widened 20bp to 211bp, yet our US HG strategists think that **spreads are headed wider still to 225bp by year end**. On balance, we believe that the effects of falling US growth trends and the risks from Europe on prices will overshadow solid corporate credit metrics over coming months.

The **US HY** cash index widened 35bp to 727bp and HY loans heavily underperformed on the back of the Fed's commitment to keep interest rates low. $1.5bn of outflows from loan funds, double the previous weekly record, were a significant reversal to the inflows seen over the last 12 months. Strong corporate liquidity suggests that in the event of a recession (or very weak economic growth), default rates will not spike much. However, the negative technical picture may well remain weak for some time.
In **emerging markets,** EMBIG spreads have not been immune, widening 19bp to 369bp. However, inflows into EM debt over the past month registered $5bn whilst other asset classes typically saw net outflows. Our **EM strategists recommend a marketweight position** given no clear signals of significant selling; rather a down-drift on limited trading volumes.

Foreign Exchange

Currencies appear to price in less risk of recession than other markets, as judged by several metrics. Vol premia — the difference between implied and realized volatility — are indeed at recession levels, but positions still price a decent recovery. All three common measures of USD exposure — IMMs, currency manager betas, macro hedge fund betas — still indicate USD shorts, whereas in recessions investors typically move from short USD to long USD as they buy back funding currencies. Perhaps this cycle is different for the reason we have discussed before — US fiscal policy creates no incentive to hold dollars during a global expansion and less incentive to hold them during financial crises. But even if investors retain USD shorts during this downturn, we still suspect that cyclical currencies such as commodity FX and high-yielders should fall further to reflect lower commodity prices and worse equity market performance during a downturn. Thus we are **short NZD vs USD.**

JPY and CHF can benefit in August and even beyond the crisis. Obviously, they benefit from deleveraging if data worsen or Fed/ECB policy fail to settle credit markets, perhaps due to doubts that monetary policy can revive growth when rates are already at very low levels. But even if Fed/ECB liquidity stabilise markets, low-for-long rates in the US and Europe mean that Japan and Switzerland will have little incentive to recycle their current account surpluses into other countries for higher yields. As a consequence, their currencies to drift higher. We are long **JPY vs USD and GBP, and long CHF vs EUR.**

Commodities

In a volatile week, commodities are up around 1% with losses in base metals being offset by gains in precious metals and agriculture. Growth expectations continue to be revised lower and our US economic surprise index remains in negative territory. **We recommend investors overweight those commodities more geared towards emerging markets**, i.e. Brent, gasoil, gold, sugar, copper, corn and wheat, **and underweight those anchored to US consumption** i.e., WTI, US gasoline, aluminium, zinc and US natural gas (see *Commodity Phase Shift: What does the US debt downgrade mean for commodities?*, Colin Fenton, Aug 8 for more details).

This week grains rallied another 2% as the USDA revised lower their estimate of crop yields in the US. We have expected this for some time now as we have pointed out many times before that the USDA forecasts appeared far too optimistic. We continue to expect prices to move significantly higher through the year in order to balance demand with the very low level of inventories. Stay **long corn and higher protein wheat** (see *Agriculture Weekly*, Jonah Waxman, Aug 11 for more details).

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