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Subject: FW: The J.P. Morgan View : What countries to buy or sell

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Inline-Images: image1.gif

Jeffrey

I think we should add another 2mm to that European equity basket. We went further overweight Europe.

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-----Original Message-----

From: Perlman, Daniel A

Sent: Friday, August 09, 2013 05:09 PM Eastern Standard Time

To:

Subject: The J.P. Morgan View : What countries to buy or sell

J.P.Morgan

Global Asset Allocation

The J.P. Morgan View: What countries to buy or sell

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- **Asset allocation** — An increasing part of our allocation exposure is now in country choices. We raise our European overweight, and are considering at what point we need to cut our EM underweight vs. Japan.
- **Economics** — Data are tracking the expected rebound in Global GDP growth, with balanced risk. But we are seeing increasing signs of a rebound in manufacturing. Europe Q2 is raised to 1%, but Russia and Mexican growth forecasts for 2013/14 are cut.
- **Fixed Income** — Bond duration should be traded on local conditions: short in US, Euro area and EM; long in Japan and Australia, neutral in the UK.
- **Equities** — Open a Cyclical vs. Defensive sector overweight globally. Cut by half the overweight in Japan vs. EM.

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- **Credit** — OW financials vs. non financials and Europe vs. the US.
- **FX** — We resist the rise in GBP and EUR vs. USD and expect them to fall back again within this year's range.
- **Commodities** — Take profit on OW energy vs. base metals and open an outright long in energy.
- [Click here for video.](#)
- Our top investment recommendation remains to be **aggressively overweight equities versus cash and fixed income**. But beyond that, we have concentrated much of our tactical risk on country and regional allocations. How do we allocate here? What is working, or not working? And where are we considering change?
- Our top regional allocation has been to **underweight EM against DM** across asset classes. The rationale has been predominantly fundamental in that we and the consensus have been forced to steadily lower our growth expectations in EM, outright and relative to DM. We do not yet have reason to change this assessment. The past few weeks of lower EM PMIs and the weak tracking of Q3 activity data versus forecasts leave us with further downside risks on EM growth projections.
- This week alone, we cut Mexico and Russia. EM policy makers on average will likely not provide much support, in some countries because inflation remains too high, and in others because capital outflows have put downside pressure on the currency that is preventing their central banks from easing rates. In addition, as reviewed in *Job gains to lag global growth lift*, Kasman et al., July 24, we see falling EM profit margins, in response to tight labor markets and rising wage costs, also depressing EM growth.
- That said, we will not remain underweight EM forever, as relative value is getting re-established, many active investors are already UW, and at some point, the rebound in DM should pull EM out of its funk. This week's data dump from China is providing support for our projected rebound in growth from H1's 6.5% to 7.5% in H2. EM equities are still underperforming this week, but at a slower pace now. EM is holding itself vs. DM in credit and FX over the past month.
- We think it too early to move back to OW EM asset classes, given still downside risk on EM forecasts, and are instead trimming UWs selectively, especially in fixed income and FX.
- Our **European** overweight is working nicely and is getting good support from economic data. This week alone provided upside surprises on economic activity data, allowing us to raise Q2 to 1% in the Euro area. The challenge we all face on Europe, after years of crisis and recession, is whether the rebound is a "dead cat bounce", born from a relief that Europe is at least not blowing up this year, or whether we can see Europe offering good value and economic upside over the more medium term.
- We are somewhere in the middle here, seeing the rebound a reflection of more rational policy making (more monetary policy support and a move from destructive austerity) and progress towards reducing EMU North South imbalances. Wage cost gaps between the core and periphery are shrinking and the periphery's current account deficit has virtually disappeared. The current quiet in euro financial markets, supported by the OMT and ESM, could thus last for years. We note that this does not mean that Europe will become an economic locomotive, as supply-side economics and macro stimulus are sorely missing. Overall, with a continued absence of a funding crisis, relative value and client flows will drive performance, in our view. We stay overweight European equities relative to EM, and credit against the US, as the great rotation has arrived in the US, but not in Europe.
- We have been overweight **Japanese** equities versus EM since Nov of last year, to position for Japanese reflation. This has performed well, but has lost money over the past month, as economic data have started to disappoint against our quite bullish expectations. We cut 2013 Japan growth from 2.2% to 2.0% today, and in *GMOS* this week took half profit on our OW. This is largely position management as we remain long-term bullish on Japanese reflation and equities.

Fixed Income

- Bond yields followed equity markets down this week. Globally, we retain a bearish bias on bonds, but do not see this as a structural short as the expected rise in yield is likely to remain uneven, and highly variable by country.
- In the US, we retain a bearish bias on momentum, the start of tapering next month, and evidence of investors switching broadly from fixed income to equities. We continue to execute this view by selling the belly of the curve 5s against 10s and 2s. In euros, we stay short 10-year Bunds on steadily improving economic data. In sterling, the move to rate guidance by the

BoE if anything increases uncertainty and we move from bullish to neutral. And in Japan, we remain positive duration. In Australia, we stay bullish as the RBA has further room to ease. We stay bearish in local EM bonds.

Equities

- The **prospective rebound in global manufacturing** is inducing us to open an overweight in Cyclical vs. Defensive equity sectors globally. Both our US and European equity strategists are currently favoring Cyclical sectors.
- It is true that the global manufacturing PMI has not yet staged a convincing rebound. But our economists are confident of a manufacturing rebound in the coming months, driven initially by DM economies but also pulling EM economies along on the way up. China's July activity indicators are adding conviction to this view.
- Is this a reason to reverse our EM equity underweight? We do not think so. **We think that a better trade to position for a rebound in global manufacturing is via a Cyclical vs. Defensive sector overweight rather than an EM vs. DM equity overweight.** This is because the driver of this manufacturing rebound emanates from within DM rather than EM.
- **Are depressed valuations a good reason to buy EM equities? We do not think so,** either. It is true that the PE gap between MSCI World and MSCI EM indices has been widening for two years now to well above historical averages, 3.8 pts currently vs. a historical average of 2.7. This 3.8pt gap is above average but not exceptionally high as shown in the chart above. Gaps of this magnitude could have been used as an argument to buy EM equities at the beginning of the year or in 1995/1996, but that would have proved a disastrous bet. In addition, the valuation gap between EM and DM equities narrows if one adjusts for the higher weight of commodity sectors in EM which typically trade at a lower multiple than other sectors.
- This is not to say that value is not useful. We do believe that value combined with a positive fundamental change provides a good reason to overweight a region or sector. And this is why we instead overweight Europe in our regional portfolio.
- **Japanese equities have stopped outperforming.** We reduced our overweight in Japanese vs. EM equities in our model portfolio in this week's *GMOS*. There is currently no policy impetus and the positive economic news is largely priced in. In addition, CFTC spec positions on Nikkei are drifting lower, suggesting that overseas investors have started taking profit on the Japanese equity trade.

Credit

- US **Financials** have outperformed Non-Financials recently and are now only 11bp wider in spread, close to the 8bp multi-year tight reached in May. We expect continued Financials outperformance due to stronger fundamentals, the recovery in Europe, and the deterioration of some non-Financial sectors driven by commodity trends, competitive environment and shareholder friendly activity (*CMOS*, Eric Beinstein et al., Aug 9). We are OW both US and European financials in our *GMOS* portfolio.
- In **Europe**, the improved economic outlook and continued strong demand for quality spread product are strong positives. At this point, we see more upside on our European growth forecasts than in the US. In addition, as we argued in last week's *Flows & Liquidity, Who is driving the great rotation?*, Aug 2, US investors are moving from fixed income into equities but we are not seeing this rotation in Europe, giving support for euro spread product relative to the US market. Euro spreads used to trade well below US spreads before the great recession (see chart on the right) and with some form of normality returning to the Euro area, we think there is reason to believe that euro spreads will again trade well below US spreads.

Foreign Exchange

- With US 10-yr yields side-winding around 2.6% for almost two months and FX volumes down to their typical August lows, the dollar index is freefalling. The trade-weighted currency (JPMQUSD) has declined for four of the past five weeks, and while moves have been inconsistent across pairs, some of this year's biggest losers (JPY, GBP, NZD, NOK, ZAR) have become this month's biggest gainers. When the dollar was rallying in late spring it seemed unreasonable to expect the move to be so broad and persistent throughout 2013, since that view assumed that only the US economy would perk up in Q2/Q3. Instead, selective USD strength has been our message for months. Now that the dollar is collapsing on a number of crosses, it also seems hasty to extrapolate. **The baseline view this fall for a higher USD vs Asia and some commodity currencies (AUD, ZAR) is unchanged,** even with better Chinese data. If China only manages to stabilize but US rates head higher this fall, commodity FX like AUD will probably decline.

- The euro and sterling have bounced 3% over the past month, moves which are middle-of-the-pack globally but nonetheless surprising given the forward guidance the ECB and BoE premiered or previewed on July 4. Since these banks were unveiling guidance in the context of economies exiting recession (Euro area) or sub-trend growth (UK), and since US rates seemed headed higher, our view then was that rate guidance would weaken EUR and GBP within their ranges but strengthen some Central European currencies like PLN. What explains EUR and GBP's rise? Growth surprises, mainly. More Euro area and UK releases than US ones have been beating expectations since May, despite a few high-profile beats in the US like Q2 GDP and PMIs/ISMs. And since bond markets tend to move as much on data momentum as they do on central bank policy, forward guidance may only be relevant once the consensus develops a more realistic view on European/UK growth, or until US data exhibit more consistency. Unless we have seriously misjudged the likelihood of a US acceleration this fall as fiscal drag fades, or unless we have underestimated the ability of Europe to deliver above-trend growth for a few quarters, EUR/USD and GBP/USD should revert lower by a few cents but remain within this year's range.

Commodities

- We have been **OW energy vs. base metals** since early April on downside risk in China while we expected more upside in oil, given tighter supply conditions and Middle East risk. This week has brought two significant upside surprises in the Chinese economic data, trade and IP. Additionally, our metals strategists expect an acceleration in physical metal demand from here due to better Chinese end user demand (see *Metals Monthly: China likely to lift metals in 2H2013*, Kaneva et al., Jul 31). These two data points are not yet enough to create upside risk on our Chinese GDP growth forecast, but they do remove a lot of the downside and given that metal prices are close to production costs, we think risks are probably more balanced now. Our position is up some 10% since inception and **we now take profit**. We also close our UW in base metals in our *GMOS* long/only portfolio, leaving us **OW energy vs. precious metals**.
- **We open an outright long in energy** in our long/short portfolio as we still think there is some upside risk in oil from here given improving US and European demand coupled with significant supply uncertainty in the Middle East (see *Commodity Markets Outlook and Strategy*, Colin Fenton, Aug 8). Additionally, tight supplies in energy have caused spot prices to be persistently higher than forwards, something we expect to continue. This backwardation of the curve (downward sloping) is currently pricing a more than 1% a month return from holding the front contract and rolling down into the second each month. This equates to over 12% a year only in roll/slide.

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