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Global Asset Allocation

The J.P. Morgan View: More local, less global

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- **Asset Allocation** — Risk factors, from China to Europe and oil, are starting to lose some of their global bite as central banks are more ready than ever to prevent contagion. This implies one can focus on underweighting trouble spots, without having to tack back and forth between risk-on and risk-off in a global portfolio. We remain long equities and credit in our Q2 asset allocation, overweighting the US as the least troubled market.
- **Economics** — US Q1 is raised from 1.5% to 2.5%, but the UK is lowered from 2% to 0.5%. China Q1 slowed but came in close to expectations and March activity has started to pick up again. Importantly, our 2012 global growth forecast is upgraded for the first time this year, from 2.2% to 2.3%.
- **Fixed Income** — We are flat duration in Europe and EM, but still expect higher US Treasury yields over the next few months, as Operation Twist ends.
- **Equities** — We continue to OW US equities.
- **Credit** — We have moved to neutral on US high-grade.
- **Foreign exchange** — Commodity currencies to gain 1-3% by end of Q2 as Chinese growth bottoms.
- **Commodities** — Commodity prices should bottom over the coming quarter and begin to rebound as we head into Q3.

Risk assets continued to correct down while safer bonds rallied amidst average economic news from the US and China, but a sharp fall in EMU periphery asset prices.

Global equities are now down about 5% from their 2012 peaks from a few weeks ago — around what one could expect in response to simple profit taking after the straight-line rally from late last year. We suspect that many speculative longs have been covered now. **For equities, credit and commodities to fall a lot further, we need to see the fundamentals worsening significantly from here.** The US and China look pretty clean here, US earnings are coming in ahead of lowered expectations, while the imminent conflict risk in the Middle East is fading. That leaves a return of the EMU crisis as the real elephant in the room.

Market attention this week was focused on this morning's **Chinese** activity data. In recent weeks, investors had been preparing for downside risk given the ongoing contraction in residential real estate, pushing down assets most vulnerable to a hard Chinese slowdown — EM equities, industrial metals, and commodity currencies, such as AUD and BRL. In the event, Q1 GDP at 8.1% oya came in lower than the modal consensus, much lower than Thursday rumours that pushed up global equities, but well above the China-bearish views of many investors. Importantly, data on March retail sales, IP, and loans confirmed that activity has already started to grow faster, suggesting that Q1 is likely to have been the low point in China's quarterly growth profile. Over coming weeks, bearish attention will likely move from China to Europe.

The rolling set of **US** economic data continue to show an economy growing at a mediocre, two-handed pace, but a steady one. Low is not great, but steady is most important for markets that continue to embed high risk premia. **The**

US recovery from the last recession so far is both the weakest and the most stable one since WWII. If investors were to focus merely on US stability, global risk premia would be much lower than today, supporting our overweight of US equities (see equity section below). With respect to the adding up of Q1 data, the combination of recent inventory and trade data have pushed us to raise Q1 from 1.5% to 2.5%. Not seeing reason for payback in coming quarters and thus leaving the quarterly profile unchanged, this raises US 2012 growth from 2.2% to 2.5%.

European periphery spreads have been widening over the past month, but have only this week received broader attention as Spanish 10-year yields approached 6%. There was no obvious trigger this week for the return of the EMU crisis, except the troubling cycle of policy makers taking their eyes off the ball each time the crisis ebbs. ECB liquidity has bought EMU time, but this needs to be used well. Instead we get procrastination. Recent spread widening started with Spain seemingly declaring fiscal independence, much against the spirit of the Fiscal Compact. In our view, it is clear that another crisis is needed to speed up federal funding of government debt and fiscal coordination.

Adding up the **risk concerns** that keep investors in safer assets, the US is now quite neutral, if not a positive; China is close to neutral as recent activity data are accelerating; and oil has come off the boil as sanctions are drawing Iran to the negotiating table. Watch out how North Korea "celebrates" the 100th birthday of its eternal leader this weekend. EMU is heating up and will probably worsen in coming weeks. We remain short periphery bonds and overweight US equities.

From a **global point of view**, recent country forecast changes have pushed up our 2012 growth projection for the 1st time this year, from 2.2% to 2.3%. Combining with the above qualitative adding up of risk factors and still high risk premia, this keeps us net long equities and credit this quarter, even as we reduced beta this month. Importantly, we find that **local risk factors have lost some of their global bite**. Chinese growth fears over the past month led to underperformance of markets vulnerable to China, but this did not prevent global equities from reaching new highs. The same was true of the past month's worth of widening EMU spreads and concerns about armed conflict with Iran. One of the most important drivers behind this reduced contagion is surely central banks standing ready to prevent local shocks from becoming global liquidity crises. For us, it allows us to underweight local risks, without having to tuck back and forth all the time between risk-on and risk-off in a global portfolio.

Fixed income

Bonds rallied again, with German Bund yields hitting new lows, in keeping with the weaker tone in risk markets, especially in the Euro area periphery. With the market squarely focused on the difficulty of hitting austerity targets, we **retain a negative stance on peripheral bonds**. Renewed domestic bank demand and official intervention are the possible catalysts for a pullback in spreads. On the former, Spanish banks have yet to spend most of their LTRO2 borrowing, but will want to maintain a cushion against bond redemptions and possible deposit withdrawals. As to the latter, **ECB officials have hinted at renewed bond buying this week**, but that would likely only be triggered by further yield increases.

We are flat duration in Europe and EM, but still expect **higher US Treasury yields** over the next few months, partly on the upcoming end of Operation Twist, in June, and also because we think a move to **QE3 is unlikely**. Strong expectations of QE3 in some quarters have been one factor supporting US MBS, but they are also bolstered by negative net issuance, and subdued prepayment risk.

The increased fears of a Chinese slowdown have contributed to a **repricing of the Australian money market curve** to incorporate around a percentage point of easing over the next year. Though risks appear to be biased to some easing, we think that the sharp move creates an opportunity, best exploited though bearish positions in AUD 3yr swaps against NZD (Sally Auld, *The Antipodean Strategist*, 13 April).

Equities

Equities fell further this week bringing the **cumulative correction since the beginning of the month to 5%**. As discussed last week, we view this correction as short lived and a natural reaction following double-digit gains in only three months. The macro picture has not changed in our mind and the long-term forces of value and declining uncertainty are providing significant background support. As a result, we stay long equities.

This week's Chinese data news was positive on balance, but not decisive enough for us to re-enter our Cyclical and EM overweights. We exited these overweights and we reduced the beta of our equity portfolio three weeks ago in response to weak Chinese and Euro area flash PMIs (*JPMView* Mar 23).

The **US reporting season** kicked off this week. So far 31 of the S&P500 companies have reported and their EPS beat expectations by 4% on average. Revenues-Per-Share beat expectations by 1%. Weak global growth and higher

commodity prices are weighing on both revenue and EPS growth. But this **weakness is well telegraphed**. Indeed the consensus looks for 4% yoy growth in S&P500 Revenues-Per-Share and only 1% yoy growth in S&P500 EPS.

We continue to OW US equities within a global equity portfolio. While the typically higher beta of Euro area and EM equities makes this trade appear unattractive in a bullish environment, we believe that the risk return/tradeoff is still better for US equities. This year the S&P500 is up by 9.5%, 1% above the MSCI AC World \$ index. The Euro debt crisis will likely linger, creating more downside for European economies and equities into H2. And EM economies are also facing growth headwinds into 2012. EM industrial growth has not been able to decouple with the gap in EM vs. DM IP oya growth still below the 5% threshold which we identified in our previous research as a useful signal for trading EM vs. DM equities. The chart above shows that while EM IP growth has meaningfully exceeded that 5% threshold for most of the past 10 years, this has not been the case since Oct 2010.

Credit

Credit spreads widened this week in line with other risk markets. Credit fundamentals remain strong, but the sensitivity to EMU periphery spreads has induced our US HG credit strategist, Eric Beinstein, to switch temporarily back into neutral. The US HG spread has moved back to 200bp. We keep our yearend forecast at 175bp.

Foreign Exchange

Today, we published our monthly Key Currency Views which reviews our medium-term forecasts. Markets remain focused on two key risks. The first is **Spain's funding problems**, which are worrisome as credit stress is the only force that has driven sustained Euro weakness post-Lehman. In our view, Spain is a serious issue but manageable given the range of liquidity facilities available this year — unused LTRO cash; a larger and more flexible EFSF/ESM; ECB's SMP bond purchases; and a potentially recapitalized IMF. Our Q2 EUR/USD forecast is unchanged at 1.34, but risk bias is lower on spot and higher on vol.

The second risk concerns the possibility of a **Chinese hard-landing**. Our economists believe 1Q marked the bottom of the sequential growth path, with activity gradually recovering from Q2. The full-year 2012 GDP growth forecast remains 8.4% oya. Policy will likely become more stimulative and we expect the central bank to adopt 2-3 more RRR cuts this year, with the next move likely by the end of April. Although recent data have been mixed, the vast majority are inconsistent with the hard-landing scenario and several key releases have surprised to the upside (e.g., the NBS manufacturing PMI, exports, loan growth and construction activity, as well as steel and cement production). Commodity FX forecasts such as AUD and CAD show 1–3% appreciation by end of Q2 on the assumption of a more stable China later this spring.

Uncertainty regarding the above risks should continue to weigh modestly on EM FX, but country-specific factors should remain the key determinant of near-term performance. By year end, we expect a stronger MXN and a weaker INR. Our highest conviction short-term views are for a weaker BRL (as the government continues to push for a weaker currency) and a stronger RUB (as technical factors are supportive even with steady to slightly lower oil prices).

Commodities

Commodities were slightly down this week, led lower by base metals which suffered following mixed economic data from China. Q1 GDP growth came in slightly worse than expected although IP, credit growth and retail sales were all slightly better. Our China economist believes **Chinese growth bottomed in Q1** and will likely rebound strongly over the next quarter. We expect base metals to broadly follow this trend also. Prices should bottom over the next month and begin to move higher towards the end of the quarter. **We expect strong gains across commodities over the second half of the year.**

Crude oil continued to fall this week, with Brent down 2%. Inventories have built this past month, as supply has remained strong, while physical demand has weakened seasonally. Oil prices will likely come down further over this quarter. We expect inventories to peak in May and then to be drawn down as refiners come out of maintenance towards the end of Q2. Prices should rebound in Q3 as demand picks up and inventories fall back to the very low levels we saw at the end of last year (*Oil Market Weekly*, Eagles et al. 13 Apr).

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