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 J.P. Morgan Logo

Global Asset Allocation

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## The J.P. Morgan View: How bad a correction?

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- **Asset Allocation** — The fundamentals behind the rally in risk have not really changed. This should limit a position squaring correction in equities to 5-7%. We maintain Q2 overweights in credit and equities.
  - **Economics** — Disappointing US Payrolls eliminate upside risk on US growth but would need to be repeated across a wide set of US data to make us lower growth projections and forecast QE3.
  - **Fixed Income** — With still no QE3 in our forecast, we retain a 2.5% 10--year UST forecast for mid year, and stay short duration in the US. We would add to the short if US yields fall further.
  - **Equities** — We do not see the reporting season acting as big catalyst near term. We remain medium-term long equities, overweighting the US.
  - **Credit** — We introduce a novel way to identify relative value between credit and equity volatility, based on statistical arbitrage. The signal is now neutral.
  - **Foreign exchange** — EUR/IUSD volatility is too low given fundings risk around Spain.
  - **Commodities** — Gasoline price pressures should ease over the next couple months as refinery maintenance comes to a close.
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- A disappointing US Payrolls report pushed equities down and bonds up in a week that was already in position squaring mood. By now, equities are about 3.5% down from the year high reached a few weeks ago. By itself, that is noise. Can it become a much more serious correction?
  - **The magnitude of the eventual correction** or reversal is a function of how extensive the overweight risk positions are, how much value has been exhausted, and how much the underlying fundamentals have or will still worsen. On each of these, we would judge the answer to be "**not much**," signaling that the eventual correction on equities will be mild and an opportunity for those not long risk yet to join the rally. To put a number on this is hard, but the rally since 2009 has seen many corrections of the 5%-7% order of magnitude when there was no serious worsening of the fundamentals. Let's review each of main determinants of the size of the correction — positions, value, and fundamentals.
  - **Positions** — We find that the closer market participants are to trading activity, and the more tactical they are, the bigger their long risk position is. As highlighted in our sister publication, *Flows & Liquidity*, aggregate net long positions in futures (CFTC) by those designating themselves as speculators — as opposed to hedgers — across riskier asset classes, minus those in safe asset classes have reached the highs seen before previous equity market corrections. And the rolling betas of macro hedges funds had shown them to have turned significantly long equities and short duration in bonds over the past month. But data on more medium-term investors suggest only modest longs in the case of asset allocators and still underweights of equities to bonds (largely credit) in the case of retail.

Many of the longs are of recent vintage, and thus do not have a lot of profit yet. We thus do not see a lot more position squaring from this point.

- **Value** — The main valuation advantage of equities and credit against cash and government debt has barely been exhausted by the rally of the past few months. Credit spreads have come down dramatically, but only in the case of high-yield have they come down to historic averages, though they remain wide for this point of the business cycle. High-grade spreads have only recently fallen below the 200+ range that we see in recession. Equity risk premia — the gap between earnings yields and real gov't debt yields — remain near three times their historic means. And the sell off in bonds through last week had barely made a dent in their extremely expensiveness. The importance of the lack of value exhaustion in risk markets is that any further sell off will induce renewed buying (on "dips").
- **Fundamentals** — For the correction to get momentum, it needs to be fed by a reversals in the fundamentals behind the earlier rally. Our interpretation of the rally in risk assets, and reason behind our longs, is that it is driven by fallen market volatility and fading downside risks on the economy, in the presence of super easy monetary policy. We did not rely on upside growth and earnings expectations, seeing stability instead (chart on right), but similarly are assuming no major downside surprises.
- In this context, the question arises whether today's disappointing **US Payrolls** report suggests that economic momentum has turned negative and risk is now biased on the downside. We don't think so for a number of reasons (see today's *GDW*). For one, the 210K payroll gain brings the 3-month average to the same level, down from 245K, a level that was high relative to our GDP forecasts. As such, it largely eliminates upside risks. In addition, we are not seeing similar weakness in other US economic data with the the weekly claims and ISM employment signaling strength instead. Furthermore, other countries, such as EM Asia, ex China and Japan have been surprising on the upside. This week, we raised our 2012 growth projection for Japan from 1.7% to 2.0%.

#### Fixed income

- **Bonds rallied this week**, punctuated by a weaker than expected US Payrolls report. US 10-year yields rallied 15bp on the week, moving it back to their YTD average. By our analysis, about one third of the rally was due to negative surprise in US Payrolls, and two thirds due to short covering (Terry Belton, *Payroll surprises and Treasury yields*, today). Given the holiday weekend, it is likely that many investors have not been able to cover this short duration position and will do so instead next week.
- The very near term is thus likely positive for bonds. But given how much bonds have reacted already to Payrolls and the lack of other signals to really turn negative on the US economy, we think any further follow through will be limited. With our view that US data still keep the probability of another bout of asset purchases (QE3) below 50%, we retain both our 2.5% medium-term forecast for 10-year USTs and our short duration recommendation for the US market. **If the 10-year UST were to reach 2% flat, we are currently of a mind to add to this short duration, all else constant.**
- Within **EM local bonds**, we are long Brazil, and South Africa but we close our previous long in Poland as our economists no longer see any rate cuts this year (see *Poland local bonds*, Mike Trounce, 4 Apr). We also open shorts in Thailand, Malaysia and Turkey. In Brazil the rally is likely to slow but we expect low inflation to allow the central bank to keep interest rates low for longer than the market expects. In EMEA EM, we stay with our OW in South Africa despite the recent backup in yields, given the downside surprise in the latest CPI reading. In Turkey, risks are skewed towards a more hawkish central bank going forward which should put upward pressure on Turkish rates (see *EM Cross Product Strategy Weekly*, Beinstein et al., 2 Apr).

#### Equities

- The pause in the equity rally, a natural reaction following double-digit gains in only three months, should be short lived. As explained above, the long-term forces of value and declining uncertainty are providing significant background support. We reduced the beta of our portfolio two weeks ago, but we hope to re-enter our Cyclical and EM overweights after we see a clear improvement in forthcoming Chinese PMIs or a strong policy response.
- The US reporting season kicks off next week. **How big of a driver is the reporting season likely to be?** The last quarter of 2011 saw the first sequential quarterly decline in the S&P500 EPS since the fourth quarter of 2008, post the Lehman crisis. The \$1 decline in Q4 EPS was driven by three headwinds: 1) very weak (1.6%) pace of global GDP growth in Q4, the weakest pace since Q1 2009; 2) a big 15% rise in commodity prices during Q4 2011; and 3) an appreciation of the dollar which lowered the dollar value of profits generated abroad.
- These headwinds did not go away in Q1, but they were less acute. Global real GDP likely grew by a 2.4% annualized pace in Q1, which is still below trend, but represents an improvement from Q4's 1.6% pace. Commodity

prices were up by 5% in Q1, less than the 15% seen during Q4 2011. And the trade-weighted value dollar has fallen modestly in Q1, in contrast to the rise seen in Q4.

- Overall, these arguments point to a smaller sequential decline in Q1. Indeed, the bottom-up consensus expects a \$0.5 decline in the S&P500 EPS in Q1, which is close to our own expectation. In all, we do not see the reporting season acting as a big catalyst for equity markets. But we do recognize that these sequential EPS declines over the past two quarters, coupled with a flattening in the US profit margin pattern, suggest that **the earnings surprise factor**, which has been a big support for equity markets over the past 3 years, **has turned to neutral**.

### Credit

- **Spreads were slightly wider on the week, even after Wednesday's characteristic sell-off on the back of peripheral underperformance.** As our favored trades, US HY was flat and US HG and EM \$ sovereigns were up about a basis point. Unsurprisingly, euro credit underperformed, consistent with the macro picture that has been the theme of late, widening around 5bp in HG and around 12bp in HY.
- We highlighted our monthly trade ideas in *GMOS*, out Wednesday. Among them, we introduce a novel signal that looks to identify the relative cheapness of credit vs. equity volatility based on the concept of statistical arbitrage. We describe a method that aims to create market-neutral, cross-asset trades which generate alpha. At present, the signal suggests a neutral position in credit vs. equity vol, but recently **the VIX has been moving towards looking cheap relative to the CDX.IG**.

### Foreign Exchange

- The dollar is completing a strong week but remains within a rather narrow two-month range of 80 to 82 on the J.P. Morgan index. The more pronounced trend is in correlations which continue to collapse across USD pairs, for reasons we have discussed before: there is no overarching global macro theme in 2012 comparable to the sovereign crisis in 2011, so several regional ones compete for attention, leading to significant differences in currency performance.
- Given that credit stress has been about the only force which has managed to weaken the euro in the post-Lehman years — US economic outperformance has never been enough to do it — Spain is a serious issue for EUR/USD. It's also a manageable one, though. Spain has two options: deliver on (or towards) its monthly fiscal targets, and suffer higher rollover rates for several months but retain market access; or fail to meet targets, lose access and seek external funding from the now enlarged EFSF/ESM and a soon-to-be-recapitalized IMF. The first scenario implies a volatile but trendless EUR/USD in the 1.30s. The latter implies EUR/USD in the 1.20s until a financing program materializes. Both imply higher EUR/USD volatility, which is strangely low compared to other currencies despite the funding risks from Spain and the political risks from France and Greece. Both also imply that the uptrend in EUR/commodity FX as Asia slows is probably over. Better to sell those currencies against USD or JPY unless Europe stabilizes.

### Commodities

- Commodities were close to flat this week. Precious metals were the worst performers with **gold down around 2.5%** as the Fed minutes further quashed hopes of QE3. Gold has also been hurt by new import duties on gold in India which have essentially curtailed retail buying in the second largest market for gold demand. Our Metals strategy team believes the impact of this will be temporary and that we will see strong retail demand from India and also China later in the year. **EM central banks also continued to buy gold over the last month**, a trend we expect to continue through the year. Positions are also cleaner following a sustained period of net selling by spec futures investors. **We stay long gold.**
- Crude oil has been slightly weaker over the past month but gasoline has rallied, keeping retail **gasoline prices** high. This is due to a number of recent refinery closures following a period of excess gasoline production capacity which pushed gasoline cracks — the spread above oil prices that the refinery earns for producing gasoline — to very low and even negative levels. These closures along with seasonal refinery maintenance tightened the gasoline market considerably. **We are currently about half way through the refinery maintenance period** and more gasoline production capacity should start to come back on line over the next month. This **should narrow the crack and help ease retail price pressures.**

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