

From: US GIO <[REDACTED]>

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Global Asset Allocation

The J.P. Morgan View: Game changers or new games in town?

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- **Asset allocation** — We stay with significant overweights of equities and credit over cash and bonds. We prefer the bond UW over the short duration trade as we do not see an early Fed QE exit.
- **Economics** — Better activity data and PMIs are comforting, but they still only support the expected grinding up in growth rates towards trend by midyear, and are not enough to upgrade growth prospects, in our view. We do raise Japan by a notch to 0.5% given a weaker yen.
- **Fixed Income** — We are fading the early QE exit trade and go flat duration, even as we remain UW bonds vs credit and equities.
- **Equities** — EM equities continue to outperform their DM counterparts for four straight months helped by strong flows.
- **Credit** — Stay long but hedge duration risk.
- **Currencies** — Remain short JPY.
- **Commodities** — We close our long gold position. We would look to reopen the position around \$1,550/oz.
- **Risk markets started the new year in a strong fashion**, and bonds fell badly, as US Congress clinched a last-minute deal to avoid much of the fiscal cliff tax hikes, and the FOMC minutes showed the committee discussed an early exit from QE.
- At issue for investors are now whether the new-found compromise in Congress and hawkishness at the Fed are true game changers, or only short-term tactical market games that will soon fade. The same can be asked about the Japanese reflation and the EMU yield convergence trades that were put in the later months of last year. To this analyst, the Japanese reflation trade – or ‘Abenomics’ – has the highest chance of becoming a game changer, followed by EMU, with the new Washington compromise or Fed hawkishness more in the camp of shorter-term tactical games.
- Starting in **Japan**, new PM Abe has strong convictions, incentives, and we believe the ability to push true fiscal stimulus financed by massive QE. Expectations of Japanese reflation have driven down the yen 10% vs the dollar since mid November and pushed up the Nikkei 23%, three times the gain in the S&P500. For Japanese reflation to become a true

game changer, though, we believe the policy needs to be implemented and needs to produce results. There seems little doubt about implementation, with Abe co-opting the BoJ to raise its inflation target to 2%, and then replacing the top 3 people at the BoJ at the end of the quarter. Expect rapid action on fiscal policy also. Results will likely be harder to come by. The 10% drop in the yen vs the dollar will only have a small impact on domestic inflation. But it is helping us to raise growth expectations with calendar year growth raised from 0.4% to 0.5% (see discussions by Kanno and Adachi in today's GDW).

- **In the Euro area**, we continue to see the beneficial impact of the ECB's promised OMT, even as no cent has been spent yet, with liquidity for sovereigns and bonds continuing to improve. But so far, there have been little of these gains showing up in overall credit supply or the economy. And EMU policy makers are not exactly using the relative quiet productively at the moment, in our view. Euro equities have been outperforming the US for the past 6 months, and we keep the Euro OW, but this is one trade we are eyeing nervously for the right time to take profit.
- **In the US**, the December 31 budget deal came in largely as expected and thus does not require any change in economic forecasts. But this was likely the easy part. Now Congress has to work on deciding what to do with the debt ceiling that will effectively be breached within 2 months, the automatic spending cuts in entitlements and the military coming from sequestration that now start on March 1, and the expiring of the continuing resolution that expires on March 27. It would indeed be a game changer if both sides of the aisle recognize that governing is all about the art of compromise and that both the health of the economy and the country's finances require a combination of still higher revenues and lower spending. The body language and new composition of Congress give us no such confidence. Expect thus an ugly 2 months of difficult negotiations even, as we expect an ultimately last minute deal to prevent default and shutting down of the government.
- A last and most tantalizing potential game changer was raised by yesterday's **FOMC Minutes** from its Dec 11-12 meeting. The minutes were quite surprising as they showed members again discussing the timing of an eventual exit from QE large-scale asset purchases in terms of calendar guidance, instead of the economic objectives that they told us they were moving to. The range of likely QE exit timings was shown to be mid-to-late this year and thus well before the early 2014 that we have assumed. The bond markets reacted badly to this, but equities have been largely ignoring it. We retain a best guess that the Fed will keep buying until early next year, as our 2% Q4/Q4 GDP growth projection is well below the FOMC's forecast of 2.7%. That is, we think the FOMC will see a weaker economy than it currently expects and thus be induced to extend its purchases. That said, the Minutes probably also show that the FOMC is a bit more hawkish than we or the market had assumed.
- **How do we position on these new games in town?** Our overall strategy remains long equities and credit against cash and bonds on the argument that equity and credit risk premia provide greater compensation for risk than are likely to be realized. Low delivered risk and continued asset reflation from QE were also our major themes for 2012. We accept that these drivers are getting spent and are thus not as powerful anymore this year. The major tail risks a year ago – China hard landing, EMU exits, Middle East war, and US fiscal crush – did not get realized. From here, investors probably do not have as many fears and have thus likely reduced a decent part of their safe asset allocations. We do not go as far as to say that the market has become complacent, but it is surely not as driven by fear anymore. Our long in risk assets is more a broad value and momentum consideration rather than outright bullishness on the world economy, earnings, or event risk.
- The four mini game changers, and more likely new tactical games in town, keep us overweight Japanese and euro equities against the US, and short the yen. We fade the "Feds are coming" short-duration trade by taking profit on our shorts in the euro area, and staying neutral in the US. At the same time, given we are only in the first week of the year, the early QE exit trade probably has a bit further to go, as managers do not yet have a lot of profit to show. We thus tactically exit our long gold, and wait for a lower re-entry point. Our overall long equities to bonds should also benefit from any further backup in bonds yields, as we do not see yields going up to a level that threatens the economy and equities. (If they did, the Fed would likely send a quick message it has been misunderstood). And finally, we continue to hedge the duration of our longs in credit (except HY) by selling government debt against them.

Fixed Income

- **Bonds backed violently this week**, both due to the US Fiscal Cliff deal and the hawkish FOMC minutes. Technically, and because most traders only went short over the past 24 hours, yields will likely rise further near term. We are not changing yield forecasts, as we need to see significant growth upgrades for us to become confident of an early Fed QE exit. In the meanwhile, we cover shorts that we still had on in the Europe. Be short duration, here.

Equities

- Equity markets rose sharply over the past month with the MSCI AC World index making a new high for the past year to a level that is only 3% below its May 2011 peak. The rally in equities over the past month may seem excessive given the lack

of upgrades of earnings or growth expectations. But the rally is consistent with the steady fading of tail risk fears that kept some investors on the sidelines. In our GMOS model equity portfolio, we continue to focus on **regional and sector allocations**: UW US equities, OW home builders and banks within the US, and OW commodity equity sectors.

- **EM equities have been outperforming their DM counterparts for four straight months.** The improvement in EM equities is reflected in flows. Over these four months close to \$40bn was injected into EM equity funds. For the year as a whole, we estimate that flows into EM equities improved by almost \$90bn in 2012 relative to 2011 (see today's *Flows & Liquidity*).
- And that flow improvement is providing strong support to EM equities. Indeed, the chart at the top shows that the relative performance of EM vs. DM equities, i.e. between MSCI EM and MSCI World, correlates well with EM equity flows. The flow trend should remain positive into 2013 helped by stabilization in Chinese growth following two years of downshifting and by a steady improvement in overall bank lending conditions in EM. We capture the EM theme via a long in MSCI EM Asia vs. S&P500.

Credit

- **Spreads have come in significantly this week**, both on the US budget deal and the backup in government yields. We stay long, focused on crossover, EM and HY, but hedge duration risks. We do not expect an imminent rotation from credit to equities until investors start upgrading significantly their growth and earnings projections.

Foreign Exchange

- The dollar is starting 2013 quite mixed – higher vs EUR, JPY and GBP but lower versus AUD, CAD and most of Latin America and Asia. Thus, there has been little trend in the broad dollar, despite the 18bp backup in US Treasury yields this week. There may be some optimism towards the US economy and the dollar given how little fiscal tightening Congress has delivered and how recent Fed minutes suggest less commitment to unlimited asset purchases, but we do not think the first week of trading is indicative of much. All of our short-term fair-value models and position indicators were suggesting that the dollar was entering 2013 slightly cheap/oversold versus all currencies but the yen, so it is natural that this week's Treasury sell-off has prompted some short-covering. Note, however, that the sell-off in US bonds is no more extreme than that of several other government bond markets (Germany +22bp, UK +29bp, Australia +17bp). When government bond sell-offs reflect a global rather than a solely US phenomenon, USD rallies tend to represent corrections rather than trend shifts.
- Last week, we **raised our USD/JPY forecasts** from a 2013 range of 75-85 to a range of 80-90. We have always been sceptical that the Bank of Japan would be able to drive up Japanese inflation and drive down real yields versus the US to power USD/JPY higher throughout 2013, but there is no denying the pair's momentum. There is also no denying that USD/JPY continues to rally well beyond what shifts in US versus Japan interest rate spreads would imply, such that the yen is about 7% weaker than Fed versus Bank of Japan policy implies. This is a massive disconnect relative to the occasional overshoots of FX relative to rates, and would appear to reflect a growing consensus that this time is different. We suspect the consensus will be disappointed but not until later this spring when BoJ policies likely prove ineffective. In the interim, we remain short the yen versus a basket of USD, EUR, CHF, NOK and KRW, which was one of the top trades from the *2013 Global FX Strategy Outlook*.

Commodities

- **Gold** sold off sharply yesterday following the release of the FOMC minutes, which suggested that the Fed's open-ended asset purchase program could end as early as June. Many investors had put on long gold positions based on a view of unlimited QE for the foreseeable future and we think the FOMC minutes mean gold will fall further as more of these trades are unwound. We still like gold as a hedge against future inflation once global growth returns to trend, but we do not expect this anytime soon and so **we tactically take profit on our gold position** and wait for a better entry point. **We would look to reopen a long in gold at around \$1,550/oz.**
- **Our commodity strategists have published their 2013 outlook and expect a 10% total return for the GSCI index for the coming year.** Energy is forecast to make the largest gain with close to 14%, closely followed by base metals and precious metals with 12% and 9% respectively. Our oil strategists see Brent at \$120/bbl by year end, driven by higher demand as the global economy should improve sequentially towards the end of 2013. Agriculture prices are expected to continue to fall, losing another 5% in total return terms by year end (see *Commodity Markets Outlook and Strategy*, Colin Fenton et al., Dec 18, 2012).

[Jan Loeys](#)

([REDACTED])
[REDACTED]

[John Normand](#)

([REDACTED])
[REDACTED]

[Nikolaos Panigirtzoglou](#)

([REDACTED])
[REDACTED]

[Seamus Mac Gorain](#)

([REDACTED])
[REDACTED]

[Matthew Lehmann](#)

([REDACTED])
[REDACTED]

[Leo Evans](#)

([REDACTED])
[REDACTED]

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