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Global Asset Allocation

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## The J.P. Morgan View: Amidst near-term fog, focus on medium-term value.

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- **Asset allocation** — The near-term outlook has become more uncertain as risk positions have built, and US economic data should see softening as a result of fiscal tightening. We accept higher correction risk near term, but keep average overweights of equities and credit on excellent medium-term value. All our credit longs are duration hedged.
- **Economics** — End of Euro Area recession is delayed to next quarter. Softer US spending data over the coming 2 months raise uncertainty on 2013.
- **Fixed Income** — We cover our MBS overweight as it is suffering from bond managers selling on fears of an early end to QE buying of MBS.
- **Equities** — We cover our Cyclical overweight as the next manufacturing PMI risks moving down.
- **Credit** — Investors signal they reduced risk in EM fixed income in our survey.
- **Currencies** — Mid-year forecasts raised to stronger dollar vs JPY (97) and GBP (1.47). Cross-currency correlation has collapsed.
- **Commodities** — Gasoline prices should move lower over the coming month.
- After powerful growth-bullish moves in January, **investors and markets are now hesitating** and are cutting positions as they wonder whether the widely forecast economic rebound is really coming. Equities are slightly down this month, while commodities fell badly this week, giving back much of their January gains. Bonds are gently up this week, while the dollar spiked against most currencies. Credit is again sitting in the middle, not liking the fall in equities, but benefiting from lower government bond yields.
- We have signaled upside **risks on our global forecasts** in recent weeks on higher global PMIs and a strong run-rate on both consumer and business spending at the end of last quarter into Q1. But so far, this has not yet led to significant upgrades on our or consensus modal growth projections for this year (charts on p. 2). The best we can say is that the steady

reductions in 2013 projections stopped 3 months ago. The good news is that we are seeing enough evidence to signal that Q1 global growth should be a percentage point uptick from Q4, which was itself the weakest since the end of the financial crisis mid 2009.

- Several factors are holding us back from upgrading growth. One is that we had to accept last week that the US Congress is unlikely to prevent the full spending cuts under Budget Control Act sequestration. And a second is that this week's European PMIs forced us to delay the likely end of Euro area recession to early next quarter. But all this is so far only taking out some of the upside risk on Q1.
- The implications is, though, that we will likely will see softer US spending data over the next two months in response to the rise in gasoline prices, the delayed impact of higher social security taxes, and likely full sequestration spending cuts from March on. Given the rapid move up in equities of recent months, this could create the **risk of a correction**. At the same time, the value proposition (risk premium) of equities and credit spreads versus safe assets remains exceedingly compelling to us on a more medium-term basis. How does one position on this?
- Each of our equity strategists – including Tom Lee, Mislav Matejka, Adrian Mowat, and Jesper Koll – has signaled correction risk in recent weeks, and advises buying some protection. We cannot disagree. But we would not advise going outright short or underweight on equities and credit spreads as the downside from any correction is very difficult to gauge. In this analyst's mind, there is too much of a risk that when it becomes clear that one should go long again, the market will be higher than when it was sold. Downside protection buying, while staying long, make sense. In our model portfolio, we dealt with near-term risk by reducing the size of our longs to a strategic average. This month, we moved part of our risk long into the asset class that is relatively under-owned (equities instead of credit). And with much of the risk to credit coming from an earlier end to monetary stimulus, we hold all credit longs on a duration hedged basis, by selling same maturity USTs against them.

#### Fixed Income

- **Government bond markets edged up** this week and most major 10-year benchmark yields are down a few basis points, largely on weaker equity markets and a few disappointing data points. In the US, we keep a **tactical long duration position** as we believe the sell off in USTs this year is based of fears of an early withdrawal of monetary stimulus that is in our mind unwarranted. Sequestration risk to growth and a prevalence of short-duration positions among bond managers similarly keep us long duration in the US.
- This week's FOMC Minutes confirmed to us that the majority of voters at the FOMC are convinced that it is too dangerous at this point to signal a coming end to large-scale asset purchases. Our guess is that Chairman Bernanke will confirm this at next week's **Humphrey Hawkins** testimony in Congress. We stay with QE ending only early next year, although the Minutes do appear to signal an increasing chance that the Fed will start tapering off its buying pace late this year. Clearly, some FOMC members are actively discussing an H2 end to QE, but they appear to work with significantly higher growth assumptions than ours.
- US mortgages (**MBS**) have steadily underperformed USTs this year, by 18bp on the basis, as bond managers are reducing MBS overweights given a perceived risk of an early end to QE buying of mortgages. We went overweight recently, but with manager selling overwhelming even the Fed, we are forced to exit our overweight until manager positions come back to neutral
- Euro periphery bond are mixed this week, with Spanish bonds up on good budget news and Italian down on event (Berlusconi) risk in this weekend's elections. Our long Spain to Italy trade performed well. Short-term investors have likely covered into this weekend. The consensus and our view is that a group around Bersani and Monti will win the elections.

#### Equities

- Global equities are slightly down again this week, though still up nicely YTD, probably on concerns regarding early US stimulus withdrawal and signs the rebound in global manufacturing is fading. The MSCI All-Country World Index of equities has edged down for a third straight week.
- This week's flash PMIs in the Euro area and the US make it likely that the final PMI to be released at the end of next week will post a decline for the month of February. The Euro area and US surveys together would lower the global PMI by around 0.5pts. This would represent the first monthly decline since the global manufacturing started rebounding last September. It is likely too early to say whether this month's decline is the beginning of a more serious retrenchment. Our PMI signal for trading Cyclical vs Defensive equity sectors is based on a two-month change in the global manufacturing

PMI and this two-month change still appears set to stay positive even with a 0.5pts decline in February. But admittedly our OW in Cyclical vs Defensive equity has been suffering for two straight months and given this week's flash PMIs we find less reason to OW Cyclicals. We recommend **cutting the OW Cyclicals exposure in half**.

- Our OW in EM vs US equities has stopped underperforming in February following a sharp decline in January. Macro signals favour EM over the US. One of these macro signals is profit margins, which, as explained in today's *Flows & Liquidity*, appear to be rebounding in EM and at best flattening in the US. The main risk to this trade, in our view, stems from EM Asia exporters suffering from a weaker yen. We protect our portfolio against a weaker yen by OW Topix against Korea and Taiwan currency hedged.

### Credit

- **Spreads were a few basis points wider this week**, although government bonds rallying helped to keep all-in yields around 30bp off their all-time lows in most markets. EMBIG once again underperformed, led by wider spreads in Argentina and Venezuela, but this was more a function of their betas in a week where spreads moved wider, rather than significant news in these countries. **Our EM client survey** this week highlighted a broad risk reduction, particularly in the sovereign space and further showed that only 31% of respondents hedged UST duration risk (see *EM client survey*, Trang Nguyen), which helps explain the asset class's recent underperformance.
- **US high-grade bonds continue to trade in an astonishingly tight range**, with spread volatility approaching a multi-year low of just 1bp/day over the last month. This is even more remarkably over a week where the VIX went from a low of nearly 12 to a high of over 16 and then settled back down to 14.6 today. It is hard to pin down cleanly why spread volatility has collapsed, but some equal and opposite force on spreads is counteracting the improvement in growth expectations that have fed into equities and bonds this year. If nothing else, this, we believe, highlights the diversification benefit of having high-grade credit in a global portfolio. Within US HG, our overweight of financials vs non-financials continues to do well as the spread between the two has narrowed to 17bp, its lowest level since November 2007 (see *CMOS*).

### Foreign Exchange

- **Today's Key Currency Views presents our FX forecasts, including changes to USD/JPY, EUR/GBP and USD/BRL.** USD/JPY targets have been raised to 94 for end Q1, 97 for Q2, 97 for Q3 and 96 for Q4. EUR/GBP is now 0.895 for Q2, which lowers GBP/USD over the same horizon to 1.47, since the EUR/USD forecast is unchanged ahead of Italian elections (1.32 at end Q1 and Q2, 1.34 in Q3 and Q4). We are not raising USD/Asia simply due to yen weakness (USD/KRW still 1060 and USD/CNY 6.25 in Q2), nor are we revising USD/MXN due to a possible rate cut (still 12.30 in Q2). USD/BRL is now projected at 1.90 by mid-year from a previous 2.03. Aside from the yen, the currency most likely to depreciate over the next few months is INR (USD/INR target is 55.5 in Q2).
- The dollar has shown traded-weighted, but patchy strength this year. The currency is up 1.4% on our JPMQUSD index, reflecting huge gains versus JPY GBP and parts of EM Asia but losses versus EUR, Scandinavia and Latam. These regional divergences have various causes – Bank of Japan policy and yen contagion in Asia, growth disappointment in UK, less sovereign stress in the Euro area and hints of monetary tightening in Brazil – but they are nonetheless leading to the least correlation across global currency markets is almost a decade. The average correlation across USD-based pairs has dropped to 24% in the G-10 and 19% in the emerging markets, which would appear to render somewhat pointless for the moment much top-down discussion of the dollar view. It's all bottom-up until a driver with global impact re-emerges (like a significant US slowdown on fiscal tightening).
- **Risks around the EUR/USD forecast are balanced.** The 1.32 targets for Q1 and Q2 have always incorporated two risks: that the Euro area's exit from recession could prove protracted in aggregate and uneven across countries (note France), and that political risk would rise in late February/early March due to Italian elections. As a reminder of how much the return of sovereign stress could weaken EUR/USD, every 50bp of spread widening in the periphery (based on 5-yr rates) weakens the currency by 2 cents, as does every 10bp decline in ECB rate expectations versus the Fed. Thus, in an adverse scenario in which sovereign spreads widen 50bp and 2-yr German yields return to mini-crisis levels near 0%, EUR/USD would fall about 5 cents. On a favorable outcome (center-left victory by a wide margin), EUR/USD's upside is probably limited to 3 cents since German yields are unlikely to rise much in Europe's weak growth environment.

### Commodities

- Wholesale **gasoline** prices rallied some 15% between mid Jan and mid Feb, causing concern around the potential impact on consumer purchasing power in the US. The spike itself appears to have been driven by a combination of unexpected refinery closures and low inventories, which came during the refinery maintenance season, and led to a temporary spike in

the premium charged for gasoline over crude prices. We expect these supply related issues to be resolved over the coming month as refinery maintenance season comes to a close. Providing there are no further unexpected refinery outages or closures, **gasoline prices should continue to correct lower and the spread above crude should narrow.**

- We opened a **long Mar-13 vs. short Jul-13 soybean time spread** in *GMOS* (5 Dec, 2012) on the view that logistical issues in Brazil would widen the spread between the two contracts once exports started in Feb/Mar 2013. Historically high prices due to last year's very poor harvest led farmers to plant much more than normal. However, Brazilian logistical infrastructure appears unlikely to be able to cope with this increased volume, meaning that even though the crop will likely be much higher, it will not necessarily find its way out of Brazil in a timely fashion. Industry sources show that the number of vessels planning to load Soybeans in Brazilian ports is already starting to rise substantially and YTD the Mar-13/Jul-13 spread has almost doubled. **We now roll the long leg of the trade from the March to the May-13 contract.**

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