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**Subject:** The J.P. Morgan View : Equity market rally relies on value not growth

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 J.P. Morgan Logo

Global Asset Allocation

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## The J.P. Morgan View: Equity market rally relies on value not growth

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- **Asset allocation** — Equities are the only major risk market rallying, and then not in all countries. The high equity risk premium relative to other risk markets, and the way US corporates are reacting to it by buying back shares financed with cash and debt are, in our view, a major factor as to why US stocks are doing so well, despite an uncertain economic outlook.
- **Economics** — Good US payrolls appear to confirm that US companies are not retrenching in response to fiscal tightening. We await Feb/Mar consumption data to gauge how the US consumer is reacting.
- **Fixed Income** — Focus on cross-market allocations: long EM vs DM, US vs UK, and Spain vs Italy.
- **Equities** — Open an OW in US Small Caps and Value stocks.
- **Credit** — ISDA is proposing to overhaul the standards governing credit-default swaps.
- **Currencies** — Buy CAD/JPY to reflect stronger domestic data in Canada and the yen's persistent vulnerability to higher global rates.
- **Commodities** — Be long base metals and natural gas and underweight gasoline, zinc and lead.
- **If you like the video, click on the picture in the upper right in the pdf.**
- **Equity markets are on a tear**, with the Dow and US small caps reaching new historic highs this week. But the **rally has been quite narrow** so far this year, with Europe and EM, as well as other risk markets such as credit, commodities, and EM FX barely participating (chart on right). And the rally has come without any upgrading of global growth and earnings expectations, aside from early signs that the forecast rebound in growth from Q4 is actually taking place. The narrowness of the rally is seen by many as a warning that US stocks in particular have gone out on a limb and are set up for a bad correction. We are more sanguine and see a good reason for equities doing better: This is where the real value is, in our opinion.
- Policy and position divergences across regions and asset classes help explain some of these performance gaps, but to us, the most important single explanation of why certain risk markets are doing better is **Value**, and the way investors are reacting to it. We have argued frequently that the foundation of our overweight in risk assets is not any economic

bullishness, but a belief that risk premia over rock-bottom safe yields are high relative to delivered volatility and fading uncertainty and tail risks. This is a general statement that hides the fact that not all risk premia are equally high or attractive. We reviewed different asset class risk premia relative to their own history in *GMOS* this week, and found that it is the **equity risk premium over both cash and safe government debt that stands out as most elevated relative to its own long-term history.**

- The table on p. 2 lists our perception of different risk premia, volatilities and expected returns to risk relative to historic means. Virtually each market has below average volatility currently, in line with record low macro volatility & the downside protection of global QE. But it is only equities that have record high risk premia against depressed yields on cash and safe government debt.
- The big flow by investors from safe assets into the broad credit and EM bond world has brought credit spreads to historic averages, even as they remain higher than at comparable points in past US economic cycles. Credit spreads and yields remain high relative to depressed volatility in fixed income, although this low volatility is unlikely to survive a market correction. Term premia on bonds and roll premia in commodities are just below average. Carry in currencies, both in EM and DM, are in turn well below historic means.
- The degree to which equity risk premia stand out relative to other asset classes in a world where there is no economic growth momentum is to us a major reason why equities have been beating other risk asset YTD. Obviously, positions, which are especially heavy in credit, matter also, but they are also the reason why some of the extra value in credit has been exhausted. Equity risk premia stand out because they have been the asset class that has been shunned by most investors so far this cycle.
- It has been argued by many that equities are not really cheap as their **multiples are near historic means.** That would appear correct, but to us not of great relevance as investors can only buy assets that are on their plate today and can't buy assets at yesterday's prices. The relative IRR between equities and all other assets and, in particular, safe cash and debt define the premium that investors can capture today by switching into stocks.
- In previous years we have made more use of **momentum** than **value** as a signal for tactical positioning, as the former provides better timing. Value can offer good timing, however, when and where it is supported by flow evidence. That is, one should buy cheap assets when one sees other economic agents starting to do the same. And it is here that we are seeing not only end investors in DM starting to prefer stocks over credit, but, more importantly, corporates who are reacting to the massive funding cost difference between debt & equities by issuing corporate debt to buy back shares, both their own and somebody else's through M&A. The last few weeks have seen the biggest pace of US buyback announcements over the past 3 years. As a result, while still holding on to credit spread positions in our model portfolios, we have a significantly larger overweight in equities, as this appears to offer more value.

## Fixed Income

- **Bond yields backed up hard, without hitting the headlines like the new highs in equities.** Treasuries underperformed, and the 10-year is now near the top of its range. We don't think today's upside payroll surprise is yet enough to change the Fed's stance, **and go long Treasuries.** In Europe, we stay bullish on German Bunds, but keep a bearish tilt on UK gilts, with uncertainty around the Bank of England's remit still brewing.
- We expect a new remit to be enshrined before new BoE Governor Carney arrives in July, explicitly giving the central bank more leeway in bringing inflation back to target. We also expect a Carney-led Bank of England to follow the trend in introducing **policy rate guidance**, although the experience of those central banks which have published policy rates forecasts for many years suggests that central banks are only marginally more successful than the market in predicting short rates more than a few quarters ahead (see *Monday's Rule-based fixed income monthly* for a discussion).
- We continue to focus most of our risk on cross-market trades: **OW EM vs DM**, on strong EM inflows and the broader theme of spread compression; **short UK vs US**, on BoE remit change; **short Italy vs Spain**, given continued uncertainty over the formation of a new Italian government, and as a counterweight to a positive medium-term view on Euro area peripherals; and money **market flatteners in New Zealand vs steepeners in Canada**, positioning for convergence in central bank tightening expectations.

## Equities

- Equities are up 2% on the week, more than reversing the small correction seen in the week post Italian elections. The rally this year brought the cumulative rise in the MSCI AC World Index to 23% since last June. **The MSCI AC World index has**

reached a new post Lehman high in dollar terms, marginally surpassing its previous May 2011 peak. Today's strong payroll report also helped although most of the rise in equities took place before the US payroll report.

- As explained in the front section, we are long equities in our model portfolio on valuation grounds. Within our equity model portfolio, which focuses on regional and sectoral trades we are **overweight EM equities vs. Euro equities**. As we explained last week, given rising appetite for US assets and rising risks to Euro area growth following the Italian election, we prefer to express the EM equity overweight vs. Euro area rather than US equities. This week's ratings downgrades of Italian government debt would seem to add justification to this call.
- Unfortunately, **neither our EM equity overweight nor our Cyclical overweight managed to add beta to our equity portfolio**. Not only YTD, but also since the equity rally started last June, EM equities have underperformed their DM counterparts and Cyclical sectors have underperformed defensive sectors globally.
- In fact given a decline in the global manufacturing PMI in February, we cut our Cyclical sectoral exposures. We instead **open an OW in small vs. large caps in the US**, i.e. long in Russell 2000 vs. S&P500 **to add beta** to our equity portfolio. The Russell 2000 index underperformed in 2011 but was flat last year. It is outperforming again this year (see top chart). Beyond beta, we view additional arguments to favor small vs. large caps as improving retail investor sentiment and valuations. The Russell 2000 is trading at a P/B ratio of 1.8 vs. 2.3 for the S&P500.
- We also **open an overweight in Value stocks to capture increasing investor focus on value**. Value stocks outperformed significantly since last June, raising the chance that a 5-year old previous underperformance might be coming to an end. The chart at the bottom shows the performance of Value stocks globally and within the US. Value stocks have followed similar patterns in both the US and globally. But the rebound of US Value stocks has been more pronounced more recently.

## Credit

- **In line with the rally in equities, spreads tightened significantly this week and high-yield sectors outperformed**. The flow picture into US high-yield mutual funds also improved after several weeks of outflows. Our credit portfolio performed well after a slow February (see this week's *GMOS*), helped by the **outperformance of European credit and the compression of financials to non-financials in US HG this week**. In fact, European high-yield CDS (-47bp) outperformed US high-yield CDS (-21bp) by the widest margin since October last year and US HG Financial spreads are now just 11bp wider than non-financials, down from 100bp one year ago. Momentum suggests that financials could trade at lower spreads than non-financials within weeks, which has not occurred since October 2007.
- **ISDA is planning to overhaul the standards governing credit-default swaps** in the most significant update of the CDS documentation 2009. Current proposals aim to make CDS contracts more robust to sovereign defaults and corporate mergers as well as standardize reference obligations (see *Proposed CDS Revamp* by Saul Doctor and Danny White for more details).

## Foreign Exchange

- Today's payrolls report is sustaining several of 2013's clearest trends: stronger US equities, rising US Treasury yields, a stronger trade-weighted dollar and mixed commodity currencies. The last link in this chain – year-to-date declines in AUD, NZD, CAD, RUB, COP and PEN – is the most surprising element given that so much else seems to be going right for commodity currencies. Asian economies (and for once, Japan) are accelerating, central bank balance sheets (ex ECB) are expanding and tail risks are showing more bark than bite (US budget sequester, Italian elections). Still, of the world's commodity currencies only BRL and CLP are up this year (4.8% and 1.5%, respectively), while all others are down 1%-4%. The easy answer for relative FX performance is the **rate story** – Brazil and Chile are on the verge of tightening while Australia, Canada and Russia are easing or turning dovish. That rate story likely has a bit further to run, but given that other supports for commodity FX are lining up in the background, this edition of FXMW puts a few catalysts on the radar. **Buy CAD**, since domestic factors are firming.
- Given the dominance of local rather than systemic factors, the portfolio strategy this year has had no dominant funding or investment currency. Instead, we have held a mix of USD longs versus currencies where central bank easing has been most imminent (GBP, JPY); commodity currency shorts where valuations have been most stretched (NZD); GBP shorts broadly (vs USD, EUR, SEK) given a unique combination of fiscal and monetary risks (possible rate cut/QE, budget slippage); and JPY shorts broadly (vs USD and EUR) for similar reasons. Normally, a US payrolls report like today's, which could heighten suspicions of a shift in Fed tone and/or policy at the March 20 FOMC meeting, would argue for broadening the basket of USD longs and JPY shorts globally. The caveat is that Canadian payrolls were outstanding too and China data are firming, so some currencies like CAD, Latam and Southeast might resist the dollar's pull. Thus the main portfolio shift is to

buy CAD/JPY to reflect an important Canadian catalyst (stronger domestic data) falling into place, as well as the yen's persistent vulnerability to higher global rates (note that 10-yr Germany is selling off too as JGBs rally ahead of the BoJ's duration extension on April 4). In EM FX, we also stay focused on idiosyncratic stories. BRL and IDR, where central banks are constrained by inflation pressures, should continue to deliver. Add to short JPY/KRW.

## Commodities

- Commodities are slightly up this week but down on the year in line with worries about the impact of Chinese real estate tightening that has also damaged stocks in the area. As an asset class, commodities have broken up with equities, likely in our mind as the equity rally is driven by value and not by any growth optimism in the world. As a result, we are modestly underweight commodities versus equities and credit in a long only portfolio as the latter offer better value, in our view. Within commodities, we position tactically on relative demand and supply conditions, by being long base metals and natural gas and underweight gasoline, zinc and lead. See this week's *Global Markets Outlook and Strategy* for details.

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