

The J.P. Morgan View

The paradox of austerity

- **Asset Allocation** — The shallowness of the correction in risk assets and the lack of a convincing reason to go short will likely pull investors back in, creating further upside over coming months.
- **Economics** — Data are tracking a mild deceleration of global growth in Q2, driven by excess inventories. Solid consumption data are telling us this slowdown should be temporary and are setting us up for better growth in H2.
- **Fixed Income** — Flat duration, bearish on Euro area peripherals.
- **Equities** — The reporting season is delivering significant positive surprises in both the US and Europe.
- **Credit** — We move to marketweight EM \$ sovereigns overall although NEXGEM sovereigns offer a good investment opportunity.
- **Foreign exchange** — BoJ easing should keep USD/JPY in low 80s.
- **Commodities** — Central bank buying still supporting gold.

- **Risk markets rebounded** this week on continued good US earnings, a supportive FOMC, and an OK Italian bond auction. The dollar eased modestly in line with its safe-asset image, while bonds are largely unchanged. Global equities remain about 2% below their YTD peak in March.
- Given the news flow this week, which contained a lot of political fireworks from Europe and an upside surprise on US claims, one would have expected risk markets to have traded lower this week. We like to interpret the upmove as supporting our view that the main driver of this year's rally in credit and equities will not be a surplus of good news, but a lack of enough bad news relative to the risks that already priced into markets. To put this into Finance jargon, risk is high, but risk premia are even higher.
- This strategy depends on the **Value** force which we know does not work reliably from week to week, but has to be assessed on a 3-12 month basis. A lot of more tactical players have covered their longs in risk assets recently, on event risk in Europe, and so have many of our product strategists. We understand the reasoning, but also find that most investors retain a positive medium-term view on equities and credit and will thus be looking for point to re-enter the market. Our medium-term strategy, therefore, stays long risk.
- The **prevalence of defensive positions** — in cash and safe debt — are largely due to concerns about US growth, a fiscal gridlock at year end (the so-called "fiscal cliff"), military conflict in the Middle East, the Chinese economy, and Europe. We judge that the sum total of these risks has become less acute, even as it is too much to say that they are fading away. The US continues to

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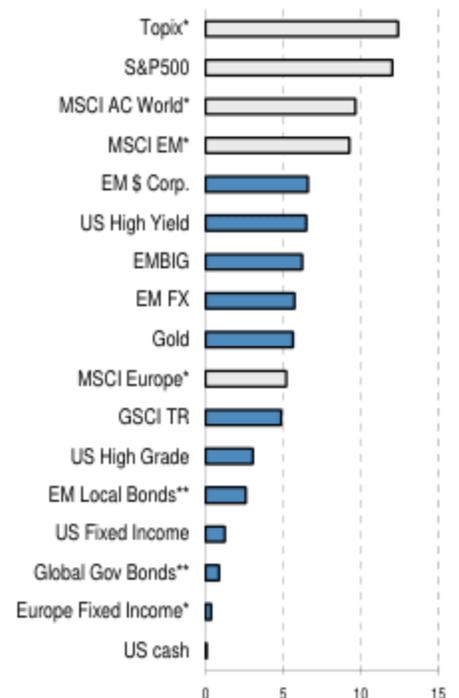
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YTD returns through Apr 26

%, equities are in lighter colour.



Source: J.P. Morgan, Bloomberg. Returns in USD. *Local currency. **Hedged into USD. Euro Fixed Income is Iboxx Overall Index. US HG, HY, EMBIG and EM \$ Corp are JPM indices. EM FX is EUMI+ in \$.

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be in a stable 2-handle growth path with little volatility. Q1 came in a bit weaker than we thought last week, but better than we thought a month ago. There will be no information about what compromise the two sides of the US aisle will make late this year to prevent a fiscal crisis or recession until after the elections. The risk of a worse slowdown in China is receding with each passing data release. And risk of a new war in the Middle East this year is similarly rapidly fading, as evidenced by the recent fall in oil prices. That leaves Europe.

- The European political news is showing strong resistance, in both periphery and core, to more austerity. This is not mere short-sighted complacency, but a **conviction that austerity is not working** and may even be counterproductive. At the country level, signs that a government is slacking on its austerity commitments tend to push its debt and equity prices down. But evidence that EMU wide austerity is depressing its economic activity are also a negative. This is of course nothing other than the Paradox of Thrift, the economic application of what is known as the Fallacy of Composition in logic. What is right and good for the individual — to save more — is not necessarily right and good for the group — a recession. You can't have your cake (austerity) and eat it too (growth).
- **The experience of non-EMU countries (US, UK, Japan) is instructive** on how markets will and should react to austerity. The US and Japan are clearly showing even less fiscal discipline than Spain or Italy, while the UK is showing more, in our view. But the US and Japanese economy are growing and their equity markets have produced double-digit returns YTD. The UK economy, in contrast, is flat on its back and its equity market is barely up on the year. But each of their government bond markets has performed better than the euro periphery as their central banks are active buyers of their debt. **If you have your own central bank, then equity markets do not like excessive austerity.**
- To judge euro asset prices, we do not merely look at whether countries are serious in pursuing austerity. Instead, we look at evidence that EMU members are working together and coordinating fiscal policies and funding, whether towards more or less austerity. A go-it-alone strategy by individual member countries away from their fiscal commitments, is a clear negative. A go-it-together strategy by member countries towards a growth strategy and away from pure austerity should be a positive for euro assets if it is combined with more cooperation on funding. We do not see it is a negative that there is a heated discussion, and disagreements on austerity in Europe. This is what should happen and is happening among parties in the same country. By Washington standards, the spat between Merkel and Hollande is genteel. Maybe this debate is simply evidence that the Euro Area is growing into a political unit, exactly what is needed to make EMU work.

Fixed income

- **Bonds edged a little higher**, with German and Australian benchmarks recording new all-time yield lows, in a week of data disappointments. Intra-EMU spreads held in despite a wobble both at the start of the week, on the fall of the Dutch government, and its end, on the Spanish downgrade. We maintain a **bearish outlook on peripheral bonds**, with the slowing of bank buying leaving the balance of supply and demand precarious.
- One factor supporting bonds even at these low yields has been **strong buying from bond mutual funds**, which even based on incomplete data posted the

2012 global GDP growth forecasts: JPMorgan and Consensus



Source: J.P. Morgan, Consensus Economics. Consensus Economics forecasts are for regions and countries that we averaged using the same 5-year rolling USD GDP weights that we use for our own global growth forecast.

More details in ...

Global Data Watch, Bruce Kasman and David Hensley
Global Markets Outlook and Strategy, Jan Loeys, Bruce Kasman, et al.

US Fixed Income Markets, Terry Belton and Srinivas Ramaswamy

Global Fixed Income Markets, Pavan Wadhwa and Fabio Bassi

Emerging Markets Outlook and Strategy, Joyce Chang

Key trades and risk: Emerging Market Equity Strategy, Adrian Mowat et al.

Flows and Liquidity, Nikos Panigirtzoglou et al.

strongest inflows since 2010 in Q1. Flows into both bond and equity funds are strongly related to past returns, and with capital gains on bonds surely limited from here, this source of bond demand seems likely to slow over the rest of the year.

- Euro money market rates fell on the week, so much so that they now imply a reasonable likelihood that the ECB will cut not just its main policy (refi) rate, but also its deposit rate, which sets a floor for unsecured rates. We think any such move is more likely to come this summer than next year and so recommend euro **money market steepeners** (see *GFIMS Derivatives*, Wadhwa and Bassi). We remain flat duration overall, with weakish data, supportive central banks, and Euro area jitters counterbalancing the low level of yields.

Equities

- Equities are up on the week despite negative macro/political news. The **reporting season is becoming an important catalyst** in both the US and Europe, something we and our clients had underestimated a few weeks ago.
- With more than half of the S&P500 companies having reported so far, 75% have beaten expectations and the S&P500 Q1 EPS is up 8% vs. bottom-up analysts' expectation at the beginning of the month (based on Bloomberg data). The \$1.5-\$2 surprise in the Q1 S&P500 EPS creates upside to our 2012 EPS forecast of €106.4 according to our US Equity Strategist Tom Lee.
- We have a similar but less impressive picture in Europe. Mislav Matejka, our European Equity Strategist, calculates that from the 124 companies of the DJStoxx600 index that have reported so far, 54% have beaten expectations with an average EPS beat of 4%. As we argued before, in absolute terms, there is little reason to celebrate, especially in Europe where yoy EPS growth is coming in at -7%. But this weakness, the result of very weak growth in Europe, is well telegraphed.
- **The large divergence between yoy EPS growth for the S&P500 (+8% yoy) vs. DJStoxx (-7% yoy) is another metric that supports our OW in US equities.** In other words, both the absolute performance of the Q1 reporting season (yoy growth) and the relative performance vs. expectations (EPS surprise) look a lot better for the US compared to European equities.
- **EM equities continued to underperform their DM counterparts this month.** We remain neutral tactically in our model portfolio. EM equities are hostage to the Chinese growth story and there are no catalysts yet to resolve this story. However, for investors wanting to take a stance on EM, we would recommend a long EM vs. DM position. We expect Chinese growth to gradually bottom out in coming months and the MSCI EMS index is currently trading at the low end of its historical range vs. MSCI World\$.

Credit

- **US High-grade credit has been in a stasis over the past two weeks, showing remarkably low volatility around current spread levels.** It has traded in a 2bp range since Apr 10 (200-202bp), even as 3-4bp were shaved off Treasury yields and equities rallied 3% over this period. Clearly weaker economic data on the one hand, which pushed down Treasury yields, are being offset by a positive earnings season, which is highlighting the strength of corporate credit metrics, on the other. **US HY** which is far less sensitive to Treasury yields, has been

More details in ...

EM Corporate Outlook and Strategy, Warren Mar et al.

US Credit Markets Outlook and Strategy, Eric Beinstein et al.

High Yield Credit Markets Weekly, Peter Acciavatti et al.

European Credit Outlook & Strategy, Steven Dulake et al.

Emerging Markets Cross Product Strategy Weekly, Eric Beinstein et al.

enjoying some of earnings upside registered by equities, tightening by almost 20bp and returning 1% during this time-frame.

- **In EM we downgrade the EMBIG to market weight**, as the coming period of political stress in the Euro area is likely to keep risk markets nervous and sentiment, as highlighted by our IMF/World Bank Spring meetings in Washington, is less sanguine towards the asset class. **Next Generation sovereigns (NEXGEM), which make-up less than 9% of the EMBIG by market cap, appear to offer the best investment opportunities heading into YE** (See Joyce Chang, *Highlights from the IMF/World Bank Spring Meetings*, Apr 24).

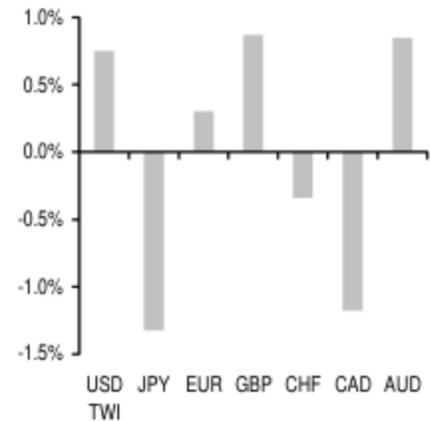
Foreign Exchange

- Strange for a week in which shocks abounded — French elections, Dutch coalition collapse, Spanish downgrade, UK re-entered recession — the **dollar is down versus all currencies** but ARS and INR; the broad indices (DXY, JPMQUSD) hit their weakest levels in a month; and FX volatility has fallen to a new four-year low (9.3% on VXY Global). The greenback's range versus the euro isn't so surprising given that pervasive pessimism has led to near-record euro shorts. The causes of dollar weakness versus the rest of the world are less obvious but neither have these currency moves been very large — the trade-weighted dollar remains within the ranges its has traced for three months as most of the low-intensity regional dramas offset one another.
- **Is risk mispriced?** Yes, but only by about 1 vol on VXY Global, which is half of the undershoot witnessed before last summer's deleveraging and a fourth of the pre-Lehman bubble. Also, this year FX carry has underperformed even the higher, predicted level of FX vol, probably because most FX high-yielders are commodity exporters, so too exposed to China's slowdown. This gap between vol performance and carry trade returns does not exist in other asset classes such as credit, which suggests that China has been a constraint unique to FX. Europe still poses a risk of higher vol, but even controlling for a bounce in VXY, FX carry still has scope to catch up if Chinese data over the next two weeks continue the transition from bad to stable which began in April. This dynamic favours modest moves higher in commodity FX, though still within recent ranges.
- The **Bank of Japan** delivered more asset purchases than expected but failed to increase its inflation target, which should make investors question whether it is as serious about delivering currency weakness as others such as the Swiss National Bank or Central Bank of Brazil. With the Bank of Japan having taken a detour on the road to Damascus — assuming it ever intended to make that journey — **USD/JPY should keep to the low 80s**. An uptrend still requires a hawkish Fed or a meaningfully higher oil price, neither of which this global economic stagnation can support.

Commodities

- **Commodities rose on the week**, in tandem with higher equities, with energy, agriculture and metals all gaining. That included a tick up in gold, to the middle of its recent range. Central bank buying is an important factor underlying our bullish view on gold, and this week the IMF reported that a number of central banks, including Russia's and Mexico's, took advantage of lower prices to add to their gold holdings in March (see Michael Jansen, *Base and Precious Metals Daily*). Also supportive of gold is that speculative positions, as measured by the CFTC, are at the bottom end of their range of the past few years. **We stay long gold.**

FX weekly change vs USD



Source: J.P. Morgan

More details in ...

FX Markets Weekly, John Normand et al.

Commodity Markets Outlook & Strategy, Colin Fenton et al.

Oil Markets Monthly, Lawrence Eagles et al.

Metals Review and Outlook, Michael Jansen

Global Metals Quarterly, Michael Jansen

Interest rates		Current	Jun-12	Sep-12	Dec-12	Mar-13	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	1.94	2.40	2.50	2.50	2.50	0.0%
Euro area	Refi rate	1.00	1.00	1.00	1.00	1.00	
	10-year yields	1.70	1.80	2.00	2.00	2.00	1.2%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.13	2.55	2.55	2.40	2.40	-1.3%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.89	1.15	1.05	1.05	1.15	0.7%
GBI-EM hedged in \$	Yield - Global Diversified	6.29			6.30		2.6%

Credit Markets		Current	Index	YTD Return*
US high grade (bp over UST)		202	JPMorgan JULI Portfolio Spread to Treasury	3.1%
Euro high grade (bp over Euro gov)		269	iBoxx Euro Corporate Index	3.7%
USD high yield (bp vs. UST)		639	JPMorgan Global High Yield Index STW	6.1%
Euro high yield (bp over Euro gov)		868	iBoxx Euro HY Index	11.1%
EMBIG (bp vs. UST)		351	EMBI Global	6.3%
EM Corporates (bp vs. UST)		396	JPM EM Corporates (CEMBI)	6.6%

Commodities	Current	Quarterly Averages				GSCI Index	YTD Return*
		12Q2	12Q3	12Q4	13Q1		
Brent (\$/bbl)	119	112	120	125	125	Energy	7.0%
Gold (\$/oz)	1665	1825	1900	1925	1850	Precious Metals	5.6%
Copper (\$/metric ton)	8454	8500	8875	9000	8750	Industrial Metals	5.5%
Corn (\$/Bu)	6.27	6.70	6.50	6.60		Agriculture	-1.5%

Foreign Exchange	Current	Jun-12	Sep-12	Dec-12	Mar-13	3m cash YTD Return*	
						Index	in USD
EUR/USD	1.33	1.34	1.36	1.36	1.36	EUR	2.6%
USD/JPY	80.5	86	84	83	82	JPY	4.7%
GBP/USD	1.63	1.61	1.62	1.62	1.62	GBP	4.7%
USD/BRL	1.89	1.84	1.82	1.80	1.80	BRL	1.8%
USD/CNY	6.31	6.20	6.20	6.10	6.10	CNY	0.6%
USD/KRW	1135	1120	1100	1090	1090	KRW	2.3%
USD/TRY	1.76	1.80	1.77	1.75	1.70	TRY	10.0%

Equities	Current	YTD Return (local ccy)
S&P	1403	12.3%
Nasdaq	3068	17.4%
Topix	804	11.6%
FTSE 100	5777	5.1%
MSCI Eurozone*	136	4.4%
MSCI Europe*	1064	5.2%
MSCI EM \$*	1016	11.6%
Brazil Bovespa	61974	9.2%
Hang Seng	20741	13.9%
Shanghai SE	2396	9.3%

*Levels/returns as of Apr 26, 2012

Local currency except MSCI EM \$

Sector Allocation *	US	Europe	Japan	EM
	YTD	YTD	YTD	YTD (\$)
Energy	2.4%	-1.5%	3.0%	8.5%
Materials	10.6%	10.3%	9.4%	7.8%
Industrials	10.4%	9.0%	11.4%	13.4%
Discretionary	16.5%	16.0%	18.8%	12.7%
Staples	6.2%	6.4%	13.3%	13.6%
Healthcare	8.7%	3.4%	5.6%	13.1%
Financials	19.9%	6.7%	23.5%	12.0%
Information Tech.	20.2%	7.7%	12.5%	18.7%
Telecommunications	6.4%	-6.6%	-2.1%	7.5%
Utilities	-0.3%	-1.3%	2.3%	8.8%
Overall	12.3%	5.2%	11.6%	11.6%

Source: Bloomberg, Datastream, IBES, Standard & Poor's Services, J.P. Morgan estimates

Global Economic Outlook Summary

	Real GDP			Real GDP						Consumer prices				
	% over a year ago			% over previous period, saar						% over a year ago				
	2011	2012	2013	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	4Q11	2Q12	4Q12	2Q13
The Americas														
United States	1.7	2.4 ↓	2.2	3.0	2.2 ↓	2.5	3.0	2.0	1.5	2.3	3.3	2.1 ↓	1.8 ↓	1.6 ↓
Canada	2.5	2.3	2.5	1.8	2.1	2.6	2.3	2.4	2.7	2.4	2.7	1.7	1.7	2.0
Latin America	4.3	3.8	4.0	2.4	3.7	5.1	4.3	4.1	4.4	3.8	7.2	6.4	6.3	6.9
Argentina	8.9	4.5	4.0	3.2	0.0	5.5	6.5	5.0	3.0	4.0	9.6	10.0	10.0	11.0
Brazil	2.9	3.1	4.5	1.3	2.6	5.7	5.5	5.7	4.5	4.5	6.7	5.1	5.1	5.3
Chile	6.0	5.0	4.5	8.2	5.1	4.9	4.6	4.7	4.5	4.4	4.0	4.2	3.9	3.4
Colombia	5.9	5.0	5.0	5.4	4.5	4.9	4.1	3.0	5.7	6.0	3.9	3.6	3.3	3.0
Ecuador	7.8	4.0	4.0	4.1	2.0	3.5	4.0	4.0	4.0	4.0	5.5	5.3	4.7	4.7
Mexico	3.9	3.8	3.5	1.7	5.1	3.9	2.0	3.2	4.9	2.8	3.5	4.2	4.0	3.8
Peru	6.9	5.5	7.0	2.8	5.2	5.8	6.2	7.3	8.0	8.0	4.5	3.9	3.1	3.0
Venezuela	4.2	4.0	1.0	3.5	6.0	6.0	4.0	-3.0	0.0	0.0	28.5	23.9	23.4	31.7
Asia/Pacific														
Japan	-0.7	2.0	1.3	-0.7	2.8	2.0	1.4	1.2	1.0	1.2	-0.3	0.1	0.1	-0.1
Australia	2.0	3.0	3.3	1.7	3.1	1.9	3.7	4.1	4.5	2.0	3.1	2.5	3.3	3.0
New Zealand	1.4	2.9	2.7	1.4	5.1	2.1	3.7	3.0	0.9	3.4	1.8	1.2	2.5	2.7
Asia ex Japan	7.0	6.5	7.1	4.6	8.3 ↑	6.7	7.1 ↓	7.3 ↓	7.0	7.0	4.9	3.9	4.4	4.9
China	9.2	8.2	9.1	8.8	6.8	7.8	9.5	10.0	9.1	8.7	4.6	3.3	3.6	4.6
Hong Kong	5.0	2.8	4.2	1.6	3.0	4.0	5.5	6.0	3.0	3.5	5.7	4.5	3.6	3.2
India	7.0	7.1	7.3	3.8	13.0	5.5	6.3	6.5	6.7	7.5	8.4	7.8	8.2	8.5
Indonesia	6.5	5.3	5.5	9.9	5.0	5.0	4.5	5.0	5.5	5.5	4.1	3.9	7.4	7.3
Korea	3.6	3.3	4.0	1.3	3.7 ↑	4.0	4.5	4.0 ↓	4.0	4.0	4.0	3.0	3.5	3.8
Malaysia	5.1	3.9	3.2	4.8	5.0	2.0	2.0	2.5	4.0	4.5	3.2	2.6	2.2	1.8
Philippines	3.7	4.3	4.8	3.5	4.3	4.9	5.7	4.9	4.5	4.5	4.7	3.9	4.0	4.0
Singapore	4.9	3.7	4.0	-2.5	9.9	6.6	3.2	2.0	4.5	4.5	5.5	4.6	3.4	2.8
Taiwan	4.0	3.3 ↑	4.8 ↓	-0.6	6.0 ↑	4.8	5.0 ↓	5.3 ↓	4.5	4.6	1.4	1.3	1.7	1.2
Thailand	0.1	5.1	3.5	-36.4	45.0	20.0	2.0	0.5	5.0	6.5	4.0	3.7	3.5	3.2
Africa/Middle East														
Israel	4.8	2.9	4.4	3.2	0.8	3.2	6.1	7.4	4.5	2.8	2.5	2.3	2.5	2.1
South Africa	3.1	2.7	3.6	3.2	2.3	2.6	2.8	3.2	3.8	3.5	6.1	6.0	6.2	5.9
Europe														
Euro area	1.5	-0.4	0.4	-1.2	-0.5	-0.8	-0.5	0.3	0.5	0.5	2.9	2.4	2.2	1.7
Germany	3.1	0.6	1.4	-0.7	0.3	1.0	0.8	1.3	1.5	1.5	2.6	2.3	2.1	1.7
France	1.7	0.3	0.7	0.6	0.0	0.0	0.3	0.5	0.8	1.0	2.6	2.6	2.3	1.9
Italy	0.5	-1.9	-0.7	-2.6	-2.5	-2.5	-1.5	-1.0	-0.5	-0.5	3.7	3.6	4.0	3.6
Norway	2.7	1.4	1.8	2.5	0.0	0.0	1.0	1.0	2.0	2.5	0.9	0.9	1.4	1.7
Sweden	4.0	-0.3	1.7	-4.4	-0.5	-0.5	0.5	1.0	2.0	2.3	2.3	1.1	1.1	1.5
United Kingdom	0.7	0.1 ↓	1.9	-1.2	-0.8 ↓	-1.0	2.5	1.5	2.0	2.0	4.6	3.0	3.0	2.7
Emerging Europe	4.8	2.8	3.5	4.6	1.2	1.4	3.0	3.1	3.5	3.2	6.4	5.0	5.5	6.1
Bulgaria	1.7	1.5	2.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	1.7	-0.2	1.7	-0.5	-0.8	-1.0	1.1	2.3	3.3	-1.3	2.4	2.7	2.9	2.5
Hungary	1.7	0.5	1.5	1.2	-0.3	0.3	1.0	1.5	1.5	2.0	4.1	5.8	5.9	3.8
Poland	4.3	3.2	3.0	4.5	2.8	2.0	2.5	3.0	3.0	3.0	4.6	3.9	3.5	2.8
Romania	2.5	0.8	2.7	-0.8	-1.2	-1.5	0.8	2.4	2.5	3.0	3.4	3.3	4.4	4.0
Russia	4.3	3.7	3.7	6.4	1.5	2.0	4.0	3.5	4.0	4.0	6.8	3.9	6.1	6.8
Turkey	8.5	2.5	4.5	...	...	...	...	...	...	...	9.2	9.0	6.8	8.8
Global	2.6	2.3	2.6	1.5	2.4 ↓	2.2	2.6 ↓	2.5	2.5	2.6	3.6	2.7 ↓	2.7 ↓	2.7
Developed markets	1.3	1.2 ↓	1.5	0.6	1.2 ↓	1.0	1.5	1.3	1.3	1.5	2.8	2.0	1.8 ↓	1.6
Emerging markets	5.8	5.0	5.6	4.0	5.8 ↑	5.3	5.7	5.8 ↓	5.7	5.5	5.7	4.8	5.1	5.6

Source: J.P. Morgan

Apr 27, 2012

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