

The J.P. Morgan View

Signal versus noise

- **Asset Allocation** — Near-term momentum is negative for risk markets, but we find the signal from medium-term drivers more reliable and thus stay with our long risk assets for coming months.
- **Economics** — Fall in Global All-Industry PMI eliminates upside risks on growth, but is consistent with 2.2% global growth projection we have for Q2. Loss of US job momentum implies Q2 may come in closer to 2%.
- **Fixed Income** — End of BoE's QE next week a headwind for gilts.
- **Equities** — OW US vs. Euro area equities, DAX vs Eurostoxx50 and MSCI EM Asia vs. MSCI EM.
- **Credit** — Keep the focus on US credit.
- **Foreign exchange** — Remain risk neutral and focused on earning carry in cyclical currencies with low vol and non-threatening valuations (Scandinavia) while simultaneously selling upside on stretched commodity currencies.
- **Commodities** — Neutral outlook favours spread trades over next 3 months.

- **Equity markets this week gave back all their gains of the previous week** and have now fallen back to the low end of the range they have held over the past 10 weeks. Commodities and bonds yields continue to fall from the year highs seen in March. The dollar is up against most currencies
- **This week fall's in risk prices**, and the rally in bonds and the dollar, had for once little to do with Europe where periphery yields are down nicely. Instead, we are seeing a number of economic data releases, punctuated by today's US payrolls report, that show **fading momentum into the second quarter**. The magnitude of the negative surprises are not yet large enough to force downgrades of growth forecasts. Our global 2012 projection does slip back to the 2.2% forecast we held all through Q1, but this is largely a rounding issue caused by last week's US Q1 cut and this week downgrade of Taiwan.
- Market attention has focused on weaker **PMIs across the world and US jobs data**. Our April Global Manufacturing PMI edged back to the January level and is thus really unchanged this year. Our Global Services PMI, in contrast, fell 3 points, pushing our All-Industry PMI down 2 points and back to its November level. By themselves, these data are consistent with our 2.2% global growth forecast for Q2. They leave us with balanced risk on global growth, even as the drop eliminates the upside risk bias we had before this month.
- Similarly, the weaker US jobs data are signalling a loss of momentum into Q2 and make it more likely that US Q2 will come closer to 2% flat, compared with our 2.5% projection. At the start of the year, we expected average monthly jobs growth at 200,000. The first few months came in well above this, while the shortfall over the past 2 months brings the YTD mean exactly to 200,000. From

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YTD returns through May 3

%, 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 EUMH+ in \$.

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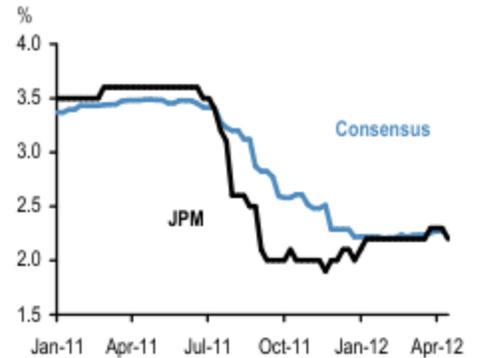
this point, there seems little to worry about, but we need to monitor activity data over the next month to check for a more meaningful slide in momentum. With economic drivers of spending, such as borrowing costs, gas prices, prices, lending standards, and profit margins, to name a few, not showing any deterioration and if anything modestly improving, we see no reason yet to get overly negative.

- The difficulty we all have on how to react to recent data prints relative to fundamentals and more medium-term trends is known as the **signal versus noise** issue: Are recent swoons in data and prices just noise around a more reliable trend, or are they the first sign that this trend is reversing? The answer must be that it depends on the strength of the new information relative to the medium-term forces. For that, we rely on our economists to sift through the data and on empirical evidence on what information over what “lookback” has most signal value. On the former, the stability of the 2012 forecasts, and the lack of any clear deterioration of global economic drivers — Europe excepted — induce us to “underreact” to recent activity data. For markets, we have found that 6-month momentum on market returns is a lot more reliable than following the last 1-2 months. On this basis, cash should remain the weakest asset class over coming months, keeping us long risk assets.
- **Euro micro sense, and macro non-sense.** Europe remains a risk and irritant to markets. We will not review elections and weaker activity data here. Instead, we like to make the single point that much of the Euro area’s problems appear self-inflicted and can be reversed, but only in Europe. In a nutshell, Europe appears to have reacted to its sovereign crisis with actions that make eminent sense at a micro level, but are disasters on a macro level. Demanding that countries should be responsible for their own debt; should not rely on other countries to repay their debt; should cut spending when their debt is too high; and should force their banks to have enough capital makes enormous sense, as that is what we demand from individuals and companies. But such rules have the perverse effect of making conditions worse when applied to all EMU member countries and banks at the same time. They destroy growth, bank lending, and the market for safe government debt all at the same time, in our view. A strategy to exit its crisis needs to focus on growth, recapitalizing the bank (Euro-TARP?), and make government debt into a desirable asset class again.

Fixed income

- **Bonds rallied on the week.** German Bunds are still on a tear, hitting all-time yield lows again. We remain flat duration. We do expect yields to increase from these very low levels over the next few months, but weakish economic data and Euro area uncertainties (including this weekend’s elections) make us reluctant to position for this at present.
- Instead we focus risk on exploiting a range of monetary policy crosscurrents. In the UK, we expect no further easing this year, with persistent inflation having prompted the BoE’s typically dovish Posen to withdraw his vote for more QE last month. That deterioration in the supply-demand imbalance argues for some gilt underperformance. We position for this by adding **10-year gilt swap spread narrowers**, with spreads at the wide end of their recent range.
- We see **upside risks to money market rates in both the UK and the US.** In 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 Srin 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.

UK, very weak growth would seem to rule out hikes in the near term, but we think the money market curve should steepen to incorporate a greater risk of a hiking cycle, say two years ahead. In the US, although the most likely course is for the FOMC to remain on hold through 2014, we think money market rates do not sufficiently reflect the significant tail risk that the unemployment rate falls much faster than expected, sparking an earlier hiking cycle.

Equities

- What are our main calls in equities? **OW US vs. Euro area equities:** as we argued last week, the large divergence between yoy EPS growth for the S&P500 (+8% yoy) vs. DJStoxx (-7% yoy) supports our OW in US equities. Both the absolute performance of the Q1 reporting season (yoy growth) and the relative performance vs. expectations (EPS surprise) were stronger in US relative to European equities.
- **OW DAX vs. Eurostoxx50:** This trade has performed well in both bullish and bearish environments. Although this position works well as a hedge against Euro risk, the main motivation is German growth outperformance. This theme is still in place as healthier German balance sheets — both private and public — allow the country to escape the painful adjustments that other Euro area countries have to make. German exports are cushioned by their large exposure to EM, even if a Euro area recession materialises. The period that this trade did badly was last August when the short sale ban forced sellers to use the DAX to express a negative view on Euro area equities.
- **OW in MSCI EM Asia\$ vs MSCI EM\$:** A better Chinese PMI raises confidence that the Chinese economy is in the process of bottoming out. The growth picture in EM Asia x China is also improving (see *Daily Economic Briefing*, David Hensley, May 2). It is encouraging that EM Asia equities outperformed in April. Admittedly, this is an exposure that may not perform immediately. There is perhaps more upside in the summer as we expect that around July/August, two to three months before leadership change in China, a large FAI spending program will be announced.

Credit

- **Spreads were moving tighter coming into today**, with US HG breaking out of the 2bp range it has held in recent weeks, and double-digit tightening seen in higher-beta sectors. But today's disappointing US job data hit risk markets and a lot of last week's gains could be undone. On a positive note, retail fund flows looked stronger this week, with US HY seeing a solid inflow (above \$1bn), having dropped off somewhat since February. Strong US HG flows continue unabated, as do EM hard currency flows.
- We published our trade recommendations in *GMOS* this week, with a general theme balancing towards US-based assets. As one of our preferred assets on a medium-term horizon, US HY has been outperforming US HG over the last few months, which is likely a function of three factors. 1) Defaults staying low. We keep our 1.5% forecast for 2012, relative to the 4% historical average. 2) The HG index is more exposed to Europe due to a higher weight of European issuers, as well as the more global nature of HG companies. 3) Financials have a much lower weight in the HY space, and they remain at the center of global concerns going forward. See today's *CMOS* for more details as well as a discussion about recent divergences in credit-related price trends.

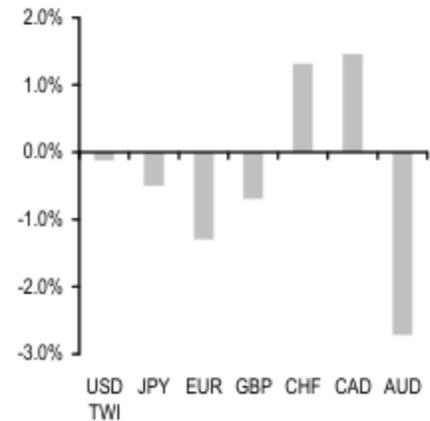
More details in ...

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.

Foreign Exchange

- The **EUR/USD** looks surprisingly indifferent to this weekend's French and Greek elections. The current level of EUR/USD is consistent with basic models linking the spot rate to US-European rate differentials and sovereign spreads, and the options market shows no extreme bid for euro puts at either the 1-week tenor or the 1-month horizon.
- This pricing is consistent with a view that pre-election campaign rhetoric may be quite pitched but post-election policymaking will not be so contentious. In France, there is little substantive difference in fiscal policy under Hollande versus Sarkozy, since both endorse a balanced budget — Hollande by 2017, Sarkozy by 2016. And while Hollande says he rejects the fiscal compact, in fact, he has simply argued for a growth pact to accompany it. Germany, Italy and Spain also endorse a growth pact, provided it is geared towards structural reform and public investment (financed through the European Investment Bank) rather than through deficit spending to fund public sector pay rises or pensions (the old, discredited European model). The more material risk to the Europe under Hollande could come if this new President fails to implement structural reform to raise trend growth, since weak growth undermines France's creditworthiness.
- Greek elections are more of a wildcard since both mainstream parties — New Democracy and Pasok — poll so low that more extreme elements may enter the new governing coalition. An even more fragmented, feckless government would raise tensions with the troika and runs the risk that Europe suspends the Greek financing program out of frustration with missed fiscal targets. Talk of expelling Greece from EMU would then resurface, even though this avenue is not legally permissible.

FX weekly change vs USD



Source: J.P. Morgan

Commodities

- **Commodities saw broad-based declines**, with oil (down around 6%) leading the way. The weakish tone to activity data, especially in Europe, has weighed on commodities as much as other risky assets. More broadly, oil has been challenged by the combination of strong supply (including from rapid progress in rebuilding Libyan and Iraqi output), and weaker demand due to refinery maintenance. Our expectation of stronger oil demand as the year goes on underlies our outlook for higher prices in H2.
- The **spread between Brent and WTI crude oil** has narrowed significantly over the past month. The Brent-WTI spread can be thought of as a proxy for the cost of moving surplus oil from Cushing, where WTI is priced, to the Gulf Coast. The reversal of the Seaway pipeline later this month will allow oil to flow south out of Cushing, and should narrow the spread from its current level of \$15/bbl towards \$6/bbl over time, reflecting the lower cost of transporting oil via the pipeline rather than by rail or barge. See last Monday's *Oil Market Weekly*, Eagles et al..
- Our overall commodity outlook remains **neutral**, and so favours **spread trades** in the near term. Today's *Commodity Market Outlook and Strategy* (Colin Fenton) examines how commodity spreading strategies have performed since 1970, depending on the month, inflation environment and weather. For May, this analysis suggests **owning natural gas, crude oil and corn, against sales in gasoline, wheat, and cattle**.

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	1.88	2.40	2.50	2.50	2.50	0.2%
Euro area	Refi rate	1.00	1.00	1.00	1.00	1.00	
	10-year yields	1.58	1.80	2.00	2.00	2.00	1.6%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.00	2.55	2.55	2.40	2.40	-1.1%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.88	1.15	1.05	1.05	1.15	0.9%
GBI-EM hedged in \$	Yield - Global Diversified	6.25			6.30		3.0%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	197	JPMorgan JULI Portfolio Spread to Treasury	3.7%
Euro high grade (bp over Euro gov)	262	iBoxx Euro Corporate Index	4.3%
USD high yield (bp vs. UST)	622	JPMorgan Global High Yield Index STW	7.0%
Euro high yield (bp over Euro gov)	852	iBoxx Euro HY Index	12.2%
EMBIG (bp vs. UST)	344	EMBI Global	7.5%
EM Corporates (bp vs. UST)	386	JPM EM Corporates (CEMBI)	7.4%

Commodities	Current	Quarterly Averages				GSCI Index	YTD Return*
		12Q2	12Q3	12Q4	13Q1		
Brent (\$/bbl)	113	112	120	125	125	Energy	7.8%
Gold (\$/oz)	1644	1825	1900	1925	1850	Precious Metals	5.8%
Copper (\$/metric ton)	8285	8500	8875	9000	8750	Industrial Metals	6.7%
Corn (\$/Bu)	6.20	6.70	6.50	6.60		Agriculture	0.0%

Foreign Exchange	Current	Jun-12	Sep-12	Dec-12	Mar-13	3m cash YTD Return*	
						index	in USD
EUR/USD	1.31	1.34	1.36	1.36	1.36	EUR	2.0%
USD/JPY	79.9	78	80	78	80	JPY	4.2%
GBP/USD	1.62	1.61	1.62	1.62	1.62	GBP	4.9%
USD/BRL	1.92	1.90	1.90	1.90	1.90	BRL	0.7%
USD/CNY	6.31	6.20	6.20	6.10	6.10	CNY	0.7%
USD/KRW	1132	1120	1100	1090	1090	KRW	3.0%
USD/TRY	1.76	1.80	1.77	1.75	1.70	TRY	10.4%

Equities	Current	YTD Return (local ccy)
S&P	1372	9.8%
Nasdaq	2964	13.5%
Topix	793	10.0%
FTSE 100	5655	2.9%
MSCI Eurozone*	134	3.8%
MSCI Europe*	1062	5.3%
MSCI EM \$*	1024	12.6%
Brazil Bovespa	60831	7.2%
Hang Seng	21086	14.6%
Shanghai SE	2452	10.9%

*Levels/returns as of May 03, 2012
Local currency except MSCI EM \$

Sector Allocation *	US	Europe	Japan	EM
	YTD	YTD	YTD	YTD (\$)
Energy	1.1%	-2.1%	2.9%	8.8%
Materials	8.9%	9.9%	7.4%	7.2%
Industrials	9.6%	9.3%	8.1%	14.7%
Discretionary	17.9%	18.2%	15.7%	14.2%
Staples	6.5%	7.1%	12.0%	12.9%
Healthcare	8.6%	4.7%	4.9%	13.8%
Financials	18.4%	5.5%	19.2%	12.6%
Information Tech.	18.4%	6.6%	9.0%	22.2%
Telecommunications	8.1%	-7.1%	-2.5%	11.0%
Utilities	-0.3%	-2.0%	0.3%	8.7%
Overall	9.8%	5.3%	10.0%	12.6%

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	4.6 ↓	4.4 ↑	4.1	4.4	3.8	7.2	6.4	6.2 ↓	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	4.5 ↓	5.7 ↑	5.7	4.5	4.5	6.7	5.0 ↓	5.0 ↓	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	6.4 ↓	7.1	4.6	8.0 ↓	6.7	7.2 ↑	7.3	7.0	7.0	4.9	3.9	4.3 ↓	4.8 ↓
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	1.2 ↓	3.0	4.0	5.5	6.0	3.0	3.5	5.7	4.4 ↓	3.5 ↓	3.4 ↑
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	2.6 ↓	2.9 ↓	3.5 ↓
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	2.4 ↓	5.0 ↑	-0.6	1.0 ↓	4.8	6.5 ↑	5.8 ↑	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	3.4 ↓	4.6	1.2	1.4	3.0	3.1	3.3 ↓	3.1 ↓	6.4	5.0	5.5	6.1
Bulgaria	1.7	1.5	2.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	1.7	-0.2	0.9 ↓	-0.5	-0.8	-1.0	1.0 ↓	2.2 ↓	1.1 ↓	-1.7 ↓	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														
Global	2.6	2.2 ↓	2.6	1.5	2.4	2.2	2.7 ↑	2.5	2.4 ↓	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	5.7 ↓	5.2 ↓	5.7	5.8	5.7	5.5	5.7	4.7 ↓	5.0 ↓	5.6

Source: J.P. Morgan

May 4, 2012

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