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Global Asset Allocation

## The J.P. Morgan View: On to real asset inflation

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- **Asset allocation** — The market appears to be testing the Fed's tolerance for rising inflation expectations following its open ended QE3. We believe demand for US inflation hedges is set to rise, supporting commodity futures, stocks and currencies; depressing the dollar and government debt; and boosting real assets generally, including equities.
- **Economics** — Q3 growth is lowered to 1.7% due to China and Japan. 2012-13 global growth is lowered by 0.1% each to 2.4% and 2.6%.
- **Fixed Income** — Remain overweight MBS, after the Fed's aggressive shift in stance.
- **Equities** — Value continues to outperform growth in Europe, helped by banks. Stay OW.
- **Credit** — QE3 should support spread products. Stay long and focus on lower quality credits.
- **Currencies** — Open ended QE is very bearish the dollar.
- **Commodities** — Rising tensions in the Middle East keep us long energy as a hedge against a supply shock that would hurt our long risk portfolio.
- **Equities moved to new highs** this week following the Fed's ratcheting up of its asset purchases program to a new level. But unlike previous easing measures, this one produced a big sell off in bonds and a rise in inflation expectations. Real assets are rallying while nominal ones are being left behind or are losing outright value. **The US 10-year breakeven rate** -- the gap between the nominal and the real 10-year UST yield -- **jumped to within basis points of the highs set since TIPS started being issued in the late 90s** (Figure 1 p. 2). Gold is up \$150 from a month ago.

- Our investment strategy of the past few years has been based on **asset deflation**, brought on by delevering and tight fiscal policies that depress growth and induce super easy liquidity that in turn flows on to all positive-yielding financial assets. Low growth creates a bias towards deflation. This asset deflation benefits both bond and equities, and creates strong preferences for yield and carry strategies. Yesterday's aggressive Fed move to open-ended buying until the labor market improves "substantially", and to remain highly accommodative for a "considerable time after the economic recovery strengthens", raises US monetary easing to a new level, and in our view leads to the question whether the Fed will tolerate higher inflation in its quest to create jobs. If so, then we need to short most fixed income and move more aggressively into real assets.
- Our view is that the Fed is not moving wholesale to creating inflation as it judges this to be ultimately counterproductive to jobs and to create more harm than good to the economy. Most importantly, it would push up borrowing cost faster than actual inflation. At the same time, the stubbornly high jobless rate and low growth do appear, to this analyst at least, to make the majority at the FOMC to be more willing to take inflation risk, at the margin.
- In addition, with the new Fed QE only announced yesterday, it seems unlikely that the Fed will immediately squash any inflation speculation beyond general statements of principle. If, eg, the 10-year UST were to break 2.25% (not our forecast) and mortgage rates start to rise in coming weeks, the Fed will probably not at that point threaten to stop buying and would just ask the market to trust them.
- Hence, we think it **wise to add some inflation protection to portfolios**. Our *GMOS* model portfolio incorporates already a number of these. It includes being long equities versus bonds, staying long gold, and switching credit longs into spread positions, by hedging out underlying bond duration risk. In addition, last week, we covered shorts in AUD and CAD, and this week, we go further by being long commodity currencies such as CAD, BRL and NZD. Last week, we covered our short in industrial metals on the Chinese infrastructure announcement. In equities, we open an overweight in commodity equity sectors and REITs.
- Putting in inflation hedges in **fixed income**, through duration shorts and breakeven wideners, is the most direct way to hedge inflation, but they are not cheap anymore, in our view. As the chart to the right shows, the 10-year UST breakeven is near its all time high. And UST yields have just backed up to a 4 month high in yield and still benefit from ongoing QE and Operation Twist. We find it safer to hedge outright for rising inflation areas in markets where we believe the Fed will not object and will not interfere. In fixed income, such hedges should preferably be done through options.
- The downside on the US dollar means one should be careful in overweighting global equities to bonds. We are OW MSCI World against our Global Bond Index. The equity index has a much higher dollar component than the bond index, though, making us net long the dollar in this position. We add a short DXY position to hedge this dollar risk.

### Fixed income

- Bond yields tracked the stock market higher, as the Fed once more showed its capacity to surprise. US MBS were naturally the biggest beneficiary of the Fed's aggressive easing stance. Taken together with its existing program of reinvesting maturing MBS, the Fed is now set to buy over \$65bn of Agency MBS per month, more than half the available supply. This comes from the 40bn announced yesterday, on top of the ongoing reinvestment of coupons on existing MBS holdings. The Fed's open-ended buying, on top of negative net issuance and attractive carry, keep us overweight US MBS (Jozoff et al., *MBS Market Commentary*).
- For Euro area peripheral spreads, the week was a case of the calm after the storm. Our *European Client Survey* (Chordia, 14 September) indicates that bond managers have covered their shorts in the periphery for the first time since March, with the largest two-week increase in peripheral risk in the two-year history of the survey. A surge in peripheral bank bond issuance in the past two weeks appears further testimony to the impact of the ECB's aggressive shift in stance. In the Euro area, we remain positioned for a flatter Spanish curve, and for the rest of the core to outperform Germany.
- The Fed action has kindled inflation concerns, pushing breakevens higher, and the curve steeper. Please help us to gauge prospects for inflation by completing our *10th J.P.Morgan Inflation Expectations Survey*, on <https://www.surveymonkey.com/s/September2012InflationSurvey>.

### Equities

- Equity markets responded strongly to the Fed's press conference with the S&P500 and other DM indices reaching new post-Lehman highs. **The MSCI AC world index has risen by 15% since the early-June bottom, erasing fully the declines of last April/May.**
- Policy response has come through more forcefully than expected, boosting equity markets by almost 5% in two weeks. This raises the question of whether the equity rally has legs. We believe it does. For one, investors are long equities but not yet at overbought levels (see our sister publication *Flows & Liquidity*). In addition, the macro picture looks set to turn more positive as the Fed's QE is added to further Chinese stimulus and to a sharp improvement in financial conditions in Europe. As a result **we raise our target for the S&P500 to 1495 from 1475.**
- EM equities have started outperforming. But this outperformance is only two weeks old and EM equities have not even yet erased their August underperformance. Given still weak 2-month momentum, we are reluctant to OW EM vs. DM equities. We recommend investors to focus on **selected high-beta sectors within EM**, such as Mexican cement, Russian steel, Brazilian exploration and production, South African metals and mining.
- The **inflation fear factor** which is resulting from the Fed's open-ended QE is supportive of inflation-sensitive sectors such as commodity equities and real estate, in our view. We open an overweight in commodity equity sectors and REITs to position for this inflation fear theme.
- **Value continues to outperform growth in Europe, helped by banks.** We maintain this tactical trade in Europe as the post-ECB euphoria about European banks continues. Issuance of bank debt in Europe continued to climb this week, with both core and peripheral banks participating.

#### Credit

- **Spreads tightened further this week**, especially in Europe where two further potentially market disruptive events passed by without a hitch. The German constitutional court ratified the ESM and Dutch elections left the incumbent, pro-Europe party in power. These results were not totally unexpected but they help to further reduce Euro area tail risk, we believe. Yesterday's more aggressive than expected suite of policy actions announced by the Fed completed a bullish week for risk markets, pushing credit spreads across the board to their lowest levels for over a year.
- Our **down-in-quality** strategy for credit, which we outlined in *GMOS* at the beginning of this month, continues to perform well. **As we expected, the announcement of QE3 gave an immediate boost to US CMBS**, one of the core longs of our portfolio, and we expect this outperformance to continue.
- QE3 is not only positive for CMBS, in our view. Strong demand this year from real money has already resulted in a shortage of spread product and the more aggressive than expected MBS purchase plan will likely exacerbate this. Of course, this is precisely the goal of QE, to lower funding costs for the real economy and to push investors into riskier assets. This is one of the key reasons for very heavy overweight of credit in our portfolio and for our recent decision to focus our positions in lower quality, higher-yielding credits, which should continue to outperform.

#### Foreign Exchange

- **For the second time this year, the Fed and ECB have triggered a dollar collapse** through near-simultaneous commitments to ultra-easy money. The first episode occurred in late January, when the FOMC pushed its rate guidance from mid-2013 to late-2014 after the ECB promised two long-term repo operations. The current sell-off is occurring as the Fed commits to open-ended asset purchases just a week after the ECB has pledged unlimited buying of peripheral debt if and when countries enter an EFSF/ESM program.
- There could be something in this pattern for the conspiracy theorists and currency warriors alike, since Bernanke and Draghi were practically classmates and since several central banks seem to pursue currency debasement in tit-for-tat fashion. Leaving aside conjecture and hyperbole, their policies appear to be creating a tricky environment for carry trades which we, like most investors, are moving further into. Undeniably, the current liquidity environment seems highly dollar-negative and carry-positive given rare central promises to anchor funding rates, buy assets and contain tail risks, all at a time when investors are not short dollars. To our mind, the complications are that inflation expectations are so much higher now than at any previous QE launch, which politicizes the easing; the odds of growth lift are low given ongoing fiscal tightening in the G4 and rebalancing in China; and valuations on most high-yield currencies are poor.

- But those concerns will likely not be relevant until later this fall. For now, we would widen the set of trades benefitting from a weaker USD and less tail risk in Europe. – sell USD against a basket of currencies in cash (NZD) and options (CAD and JPY). Euro tail-risk continues to recede – having sold a EUR/SEK put last week, buy a bullish risk reversal in EUR/GBP as, in our view, sterling has few redeeming features beyond its anti-euro status. Stay long NZD/SEK as a joint play on central bank reflation and the unwind of tail-risk hedges in European safe-havens.

## Commodities

- **Commodities rallied 2% this week, led by base metals and energy.** Our oil strategists have raised their oil price forecasts due to stronger than expected demand and weaker than expected non-OPEC production. Our economists believe global growth to be bottoming and that it should pick up through the remainder of the year, albeit at a still below trend pace. This coupled with rising tensions in the Middle East should support oil prices and time-spreads over the near term. **We are long the GSCI energy index and Brent time-spreads** in our *GMOS* portfolio as a hedge to our overall long risk positions in equities and credit, which would likely suffer should a material conflict threaten oil supply. Our commodity strategist, Colin Fenton, has this week raised his probability of a conflict between Iran and Israel to 15% from 10%-15% previously (see *Commodity Memento*, Fenton, 13 Sep).
- Base metals have outperformed other commodities considerably this week following on from China's announcement of a large package of infrastructure investment and fiscal stimulus that came late last week. It was this news that made us close our bearish base metals position and turn more positive (*J.P.Morgan View*, 7 Sep). The Fed's announcement of more aggressive than expected QE3 also appears supportive of metals, both base and precious, given the ongoing expansion of their balance sheet and the likely weakening of the USD that could accompany these actions.

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