From: US GIO <[redacted]>
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Subject: J.P. Morgan Macro Skinny: more signs of stabilization in the global cycle
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Inline-Images: image001.jpg; image002.png; image003.png; image004.png; image005.png; image006.png; image007.png; image008.png; image009.png; image010.png; image011.png; image012.png

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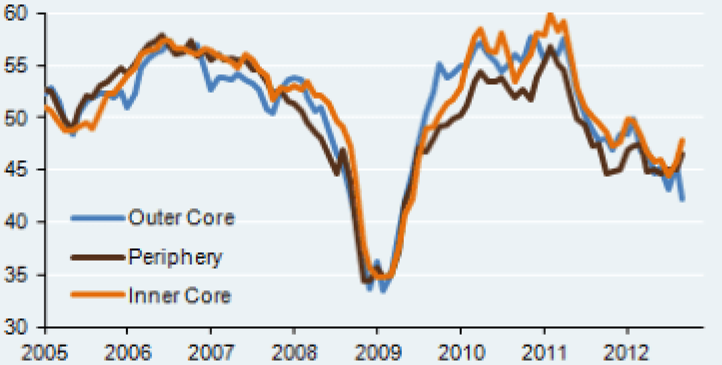
Macro Skinny J.P.Morgan

October 3, 2012

More signs of stabilization in the global cycle

1/ Back in July, we were looking for more signs of stabilization in two of the macro risk factors we regularly watch. First, we argued that the ECB policy shift had the potential of reversing some of the cyclical damage from the European crisis. Second, we thought the substantial drag on US growth from domestic-related manufacturing (largely from the auto sector) was about to fade[1]. As for the third risk factor—China—we argued that the case for a hard landing would weaken substantially once the damage to Chinese manufacturing from the European crisis waned. We have seen important progress: **a modest ECB-led improvement in global manufacturing is finally visible on the chart, and independently, domestic US activity is bottoming out as well. These moves are still small, but very important nonetheless.**

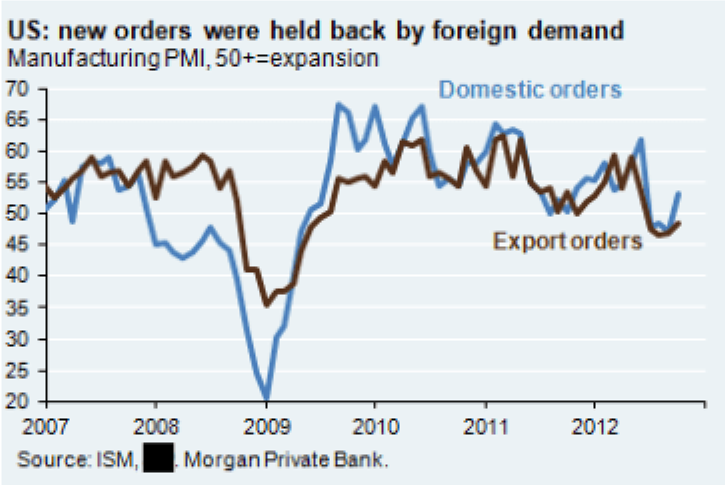
Still on track for a modest ECB-led sentiment recovery
Manufacturing PMI, 50+=expansion
Source: [redacted]. Morgan Securities LLC, Markit.

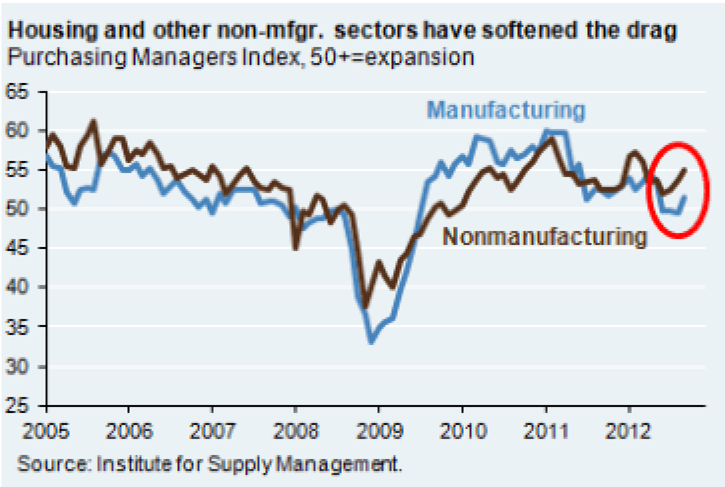


Sentiment improving in most of the Euro Area
Manufacturing PMI, 50+=expansion
Source: [redacted]. Morgan Private Bank, Haver Analytics.

2/ European business indicators are still 'all over the place', but with a generally better undertone. September PMIs indicate a meaningful recovery in sentiment within the 'inner core' (Germany and Netherlands) and the periphery. However, the 'outer core' (France and Austria) shows a material deterioration in business sentiment (second chart above). Germany sentiment appears to be mixed as well–the Ifo index, a competing indicator to the PMI—has continued to fall. But there are good reasons to discount the negatives: the German Ifo tends to lag the German PMI around turning points[2], and sentiment in France was probably held back by recent tax hikes, rather than reflecting a deepening slowdown. **On the whole, ECB policy is finally starting to lift European business sentiment from very depressed levels. The state of European growth should gradually emerge from 'recession' to 'anemic'.**

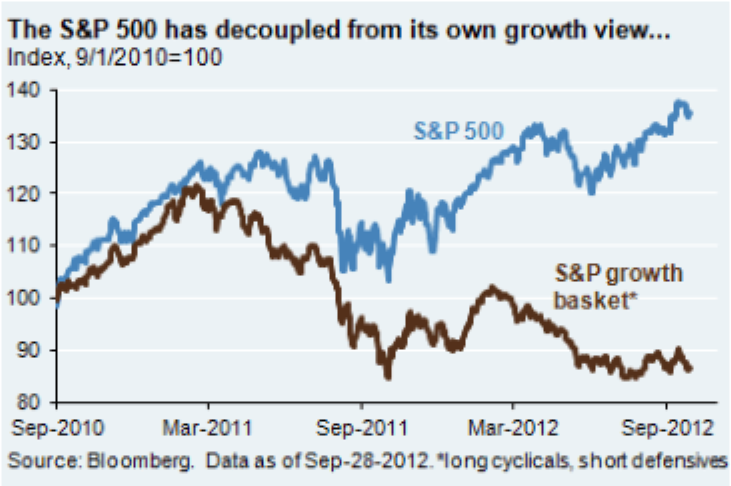
3/ US data are equally messy, but here too things look slightly better beneath the surface. On the negative side, durable goods orders have now collapsed to recessionary levels, and hiring remains very weak. A closer look, however, suggests that the weakness in these two key areas is not domestic-related but largely a reflection of weak external demand caused by the European crisis[3]. Based on the September ISM surveys, domestic-related manufacturing, as well as domestic services and construction are all improving at a moderate pace. And as Europe normalizes somewhat, external demand will likely provide an extra lift to US manufacturing going forward. The labor market stands to benefit too. **Bottom line: US activity will likely be stronger in the coming months, without the help of Europe (yet). Growth however is unlikely to move sustainably above 2%--our notion of trend growth, particularly as fiscal cliff issues still loom.**





4/ At some point the fiscal cliff will move to the forefront and start interfering with the ECB-led cyclical improvement. Our baseline is that after the elections a lame duck congress will push the cliff out from year-end to the March-June period. Clearly one cannot guarantee that this process will be smooth enough to keep markets calm around year-end; we will just have to live with a chance of political brinkmanship. Unlike late last year, when congressional discord was partly motivated by the upcoming elections, we may see less political posturing after November 6th. **Our baseline scenario calls for a meaningful fiscal drag on US growth in the second half of next year. On this basis, we anticipate growth will average around 1.5% in 2013.**

5/ Cyclical markets, such as industrial metals and emerging markets (fx and equities) have started to price a bottoming out scenario for the global industrial cycle. This move is consistent with recent signals of improving momentum from depressed levels of economic activity. Interestingly though, **US equities are somewhat more hesitant in interpreting the recent macro news as the start of a 'cyclical lift', though they should continue to benefit from the 'monetary lift'.** On Monday, Bernanke reiterated the importance of purchasing high-duration securities as a means of pushing investors to rebalance towards corporate bonds, stocks and housing. Financial wealth is the new 'Fed Funds Rate', it appears. Not surprisingly, our models suggest that in recent quarters the outperformance of the US stock market, above and beyond what was justified by the cyclical picture, has been predominantly explained by the amount of duration 'scooped up' by the Fed.



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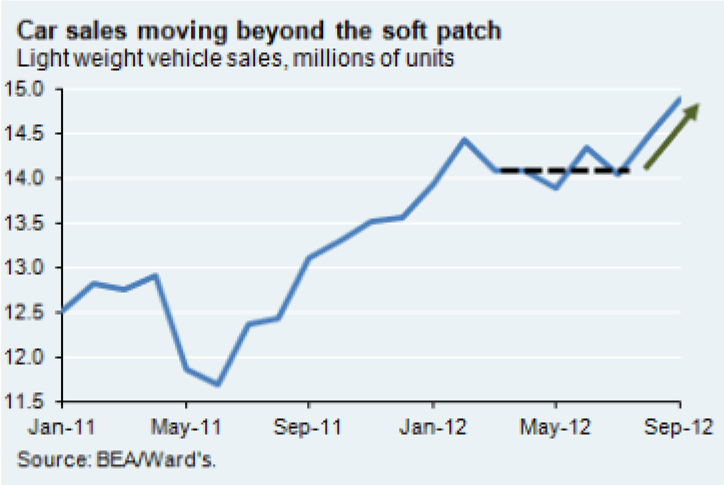
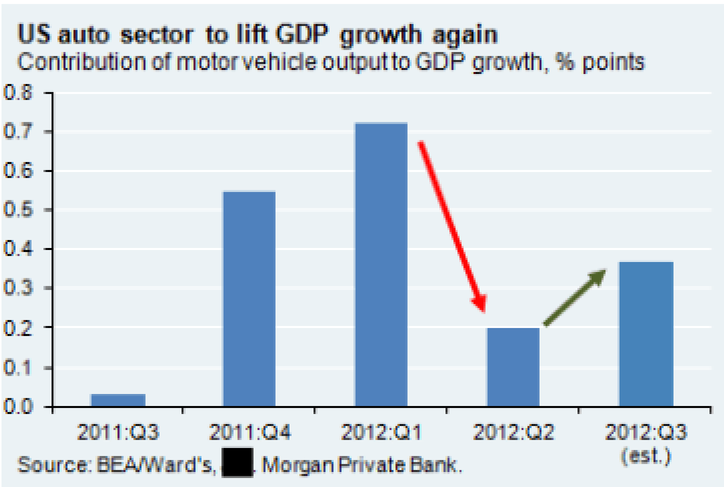
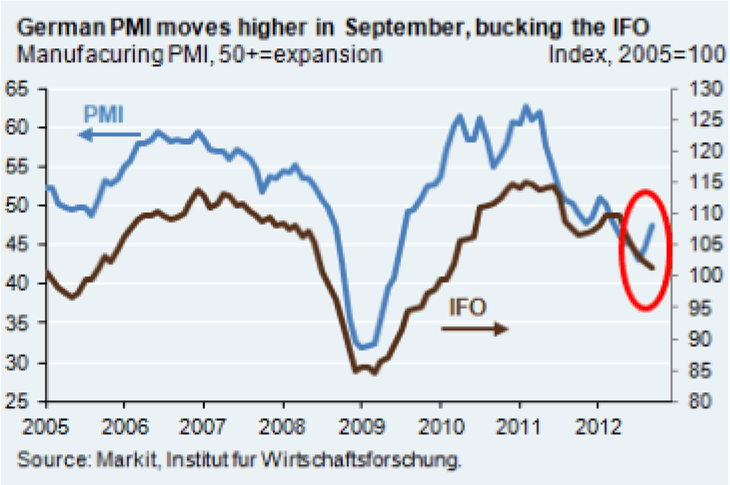
Acronyms:
ECB – European Central Bank
ISM – Institute for Supply Management
LTCM – Long-Term Capital Management
PMI – Purchasing Managers Index
QE – Quantitative Easing

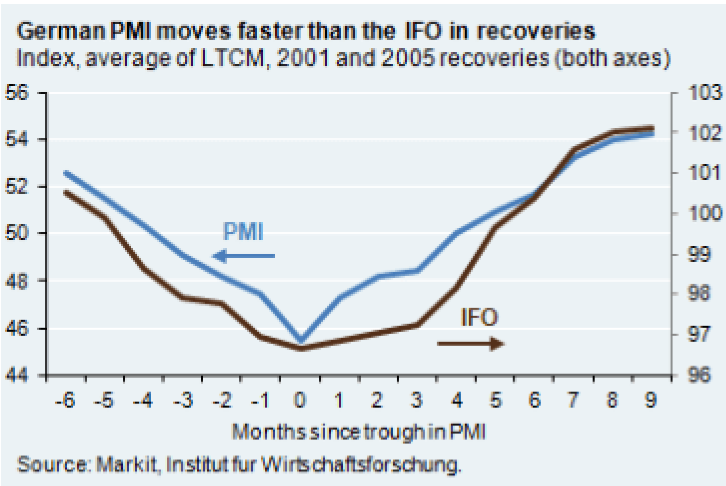
[1] The auto sector geared up production earlier this year, 'unaware' that most of the auto demand was related to last years' supply shortage (due to the Japanese earthquake). The resulting boom-bust in auto production generated a significant growth drag in Q2/early-Q3, which is now turning (see charts below).



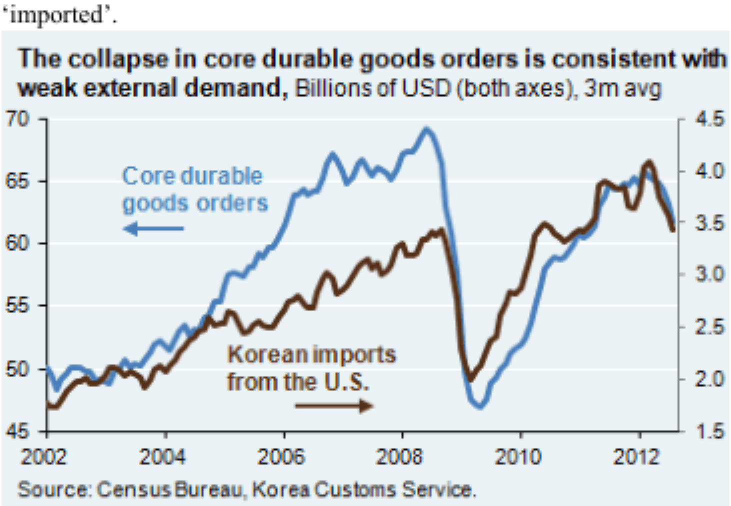


[2] The mixed signal from the German Ifo and the German PMI (left chart) is hard to reconcile as these two sentiment indicators are equally 'credible' over the long sample. That said, around turning points, the PMI appears to lead the Ifo (the post-Lehman trough is excluded, but there too, the PMI led the Ifo).





[3] The slowdown in US manufacturing goods exports in July supports this thesis, but the August export data are not yet available to confirm it. The more-timely Korean trade data offers a good hint: Korean imports from the United States plummeted in August, broadly in line with the sharp decline in durable goods (chart below). This too supports our thesis that the cyclical weakness in the US was largely 'imported'.



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