J.P.Morgan

Global Asset Allocation
J.P.Morgan Chase Bank NA, J.P. Morgan Securities Ltd.
Feb 3, 2012

The J.P. Morgan View

Any escape from risk-on, risk-off?

- **Asset Allocation** — We stay in risk-on mode, and add USD shorts and EM equity overweights. The risk-on, risk-off tyranny is not going away. We would like to hear your thoughts on how to escape its clutches.
- **Economics** — Strong US data, but we need to see more confirmation in real data to upgrade growth projections.
- **Fixed Income** — Bearish on core markets, with bonds still resilient to improvement in economy and risky assets.
- **Equities** — Open OW in EM vs DM equities. Flows and 2-month return momentum have turned positive.
- **Credit** — We close remaining bearish trades and raise risk in all three regions. Open outright longs in US HY, EMBIG and iTraxx Senior Financials.
- **Foreign exchange** — Move to long euro versus USD.
- **Commodities** — High Chinese metal inventories and weak physical demand keep us bearish on base metals.

- **Week five and risk assets continue to gain**. The week started well with a more successful EU Summit, and ended with fireworks from a strong US labor report. Our long-risk strategy started two months ago, not because we felt bullish, but more in reaction to universal pessimism and defensive positions. Over the past month, the rally has received fundamental support from improving growth prospects and the reloading of monetary bazookas across the world. We accept that we remain in a low-growth environment, with our world growth forecast still only at 2.2% for 2012, versus 2.1% a month ago, but the change is what is important, because markets, as present value calculators, react more to change than to levels.

- The Euro Summit delivered an agreement by 25 out of 27 EMU member countries to pass a new *Treaty on Stability, Coordination and Governance*. We like to call it, only slightly tongue in cheek, **Stability Pact II**, as the Treaty seems similar to the original Stability and Growth Pact that was ignored by all EMU members and thus did not prevent the steady buildup in fiscal leverage in what is now known as the EMU periphery. We are not confident that the new Stability Pact will do any better, but for the moment, it takes the wind out of the German opposition's sails in terms of enlarging the ESM and other sovereign funding mechanisms.

- **We retain a broad overweight in risk assets,** from equities, to credit, EM currencies, and gold. In recent weeks, we added short duration in DM, and OW EMU periphery, and this week add an outright short USD vs the euro. We do not feel challenged by positions as most investors we meet are clustered around neutral-to-small longs. Global equities remain almost 10% below last year's peak. The S&P500, in contrast, is within touching distance of the cycle

The certifying analyst is indicated by an AC. See page 7 for analyst certification and important legal and regulatory disclosures.

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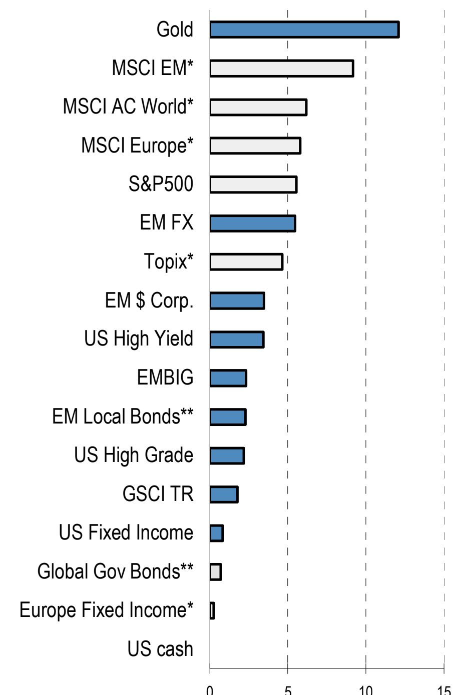
YTD returns through Feb 2
%, equities are in lighter colour.



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 ELMI+ in $.

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peak (April 2011), but rolling EPS is up 10% in the meanwhile, thus not making us worried about value exhaustion. In our monthly *GMOS* (Feb 2), we moved to an overweight of EM equities on momentum in prices and flows. We switched from UW European credit to OW (senior bank debt), but refrain from going OW European equities vs the US, as EMU event risk has not gone away.

- Where are the **risks**? The **Greek** debt restructuring talks are getting more complicated and less voluntary. We think the market and we are prepared for the messy and involuntary, but not the chaotic, where Greece just walks away. In the **US**, we still need to get the payroll tax cut and unemployment benefits extended beyond this month. We think both sides of the aisle are willing and able to agree to this extension, but we will likely see this only decided at the last minute (end of this month).

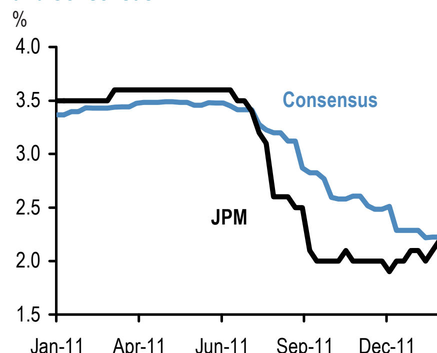
- One growing problem for all market participants is the rising **tyranny of global risk-on, risk-off**, or the fact that all risk assets — equities, credit, commodities, EM, and the dollar reversed — are trading as a single asset class. That is, we are either in risk-on or risk-off. Once you have that choice right, most other aspects of investing — selection of region, sector, product and security — do not matter anymore as they all trade on their risk-beta. The second chart shows that the correlation across risk asset classes has been rising for almost a decade, and is now even higher than during the Lehman crisis. Many forces have contributed to this, but most come down to the increasing convergence in objectives, constraints and behavior of global corporates, policy makers, and investment managers. Each of these three operate in the same way, are trying to achieve the same objectives, are sharing the same information, and are making the same mistakes at the same time. That will not go away. Hence, there is no escape. You have to take a stance on whether you are in risk-on or risk-off.

- Some diversification, tactical and strategic, is still possible, though. For one, bond duration is not yet the mirror image of risk-on. In addition, beyond the cyclical/defensive divide, managers can still pursue beta-neutral sector and security selection trades. Beyond these, we would like to invite from you, our readers, to **send your ideas on how to escape the risk-on, risk-off** tyranny to jan.loeys@jpmorgan.com. I will summarise your suggestions in one of the next few weeks.

Fixed income

- Bonds shifted lower, but are still proving fairly resilient to the equity rally and the better tone in macro data. **We retain value-based shorts** in the UK, Germany and the US, where long bond manager positioning is also supportive of higher yields. Even so, it is difficult to envisage a significant bear market with monetary policy so supportive. Indeed, we expect another £50bn from the Bank of England next week (down from £75bn, in the light of the better economic outlook). We also expect **Euro area peripheral spreads** to continue to tighten near term, if not at the breakneck pace of the past few months, with Greece the principal risk to this view.

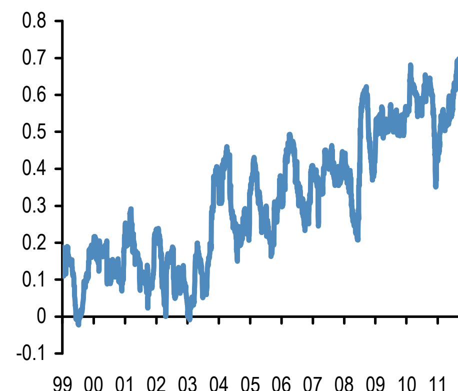
2012 global GDP growth forecasts: JPMorgan and Consensus



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.

Average correlation between risky assets

Average pairwise correlation of monthly returns between S&P500, DXY (inverse), GSCI, EM FX, MSCI EM and US HY credit.



Source: Bloomberg, J.P.Morgan

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 Srini 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.

- A challenge for investors positioning for yields to correct from their historically low levels is to identify bearish trades without onerous negative carry. One option is weighted curve steepeners, with the long money market leg chosen so as to bring positive carry. See *GFIMS Euro Derivatives* for details.

- The Eurozone crisis has brought some renewed focus on **Japanese sovereign risk**, though JGBs have remained rock-solid at sub-1% yields. We expect Japan's current account to fall into deficit by 2015, requiring foreigners to finance the fiscal deficit, but see a gradual rise in JGB yields, towards 2%, as more likely than a sharp shock. See Takafumi Yamawaki, *What if Japan's current account falls into deficit?*, 3 Feb, for the best ways to position for this.

Equities

- **Stay long and add exposure to EM equities.** Investors are returning to EM, as suggested by the $11bn injected into EM equity funds in January. Although we recognize that there is a significant beta element to overweighting EM vs DM equities, we take encouragement from our EM vs. DM 2-month momentum trading strategy, which has switched to an overweight.

- The Greek PSI and a potential disappointment with the take up of Feb's 3y LTRO represent the main near-term risks. **OW US equities is an efficient way to protect an equity portfolio against these events.**

- **OW German vs. Euro area equities** performed strongly in January. This trade can work well even in a bearish environment. The DAX outperformed the Eurostoxx50 index during the market selloffs of both early September and early November, despite the difficulty that the short sale ban creates in directly implementing this trade.

- The increase in the global PMI index in January keeps us comfortably long **Cyclical vs. Defensive** sectors. See *REVISITING: Using the Global PMI as trading signal*, N. Panigirtzoglou, Jan 12). The 2-month change in the global manufacturing PMI is the signal we follow to trade Cyclical vs Defensive equity sectors.

- Convertible bonds posted a strong gain in January. We stay long as US **convertible bonds are still at the bottom of their 2-year range vs. the S&P500** (top chart). Convertible bonds are hybrid instruments with debt and equity-like features. As an asset class they benefit from both the rally in equities and credit.

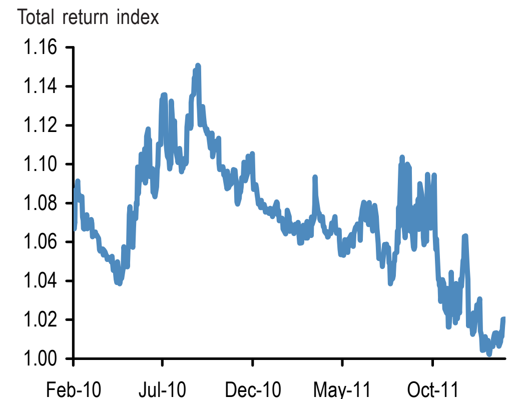
Credit

- Spreads continue to rally unabated. Through January, in local currency terms, EU HY saw 6% returns, US HY and EM $ corps saw 3% returns, EU HG, US HG and EM $ sovereigns all saw near 2% returns; more than the average January by a factor of up to 3. **European credit is outperforming the US,** the catalyst for which has been two-fold. 1) The surprising impact of the LTRO and 2) the resolve for EU decision makers to move some form of fiscal compact forward**.**

- In this week's *GMOS* we outlined a change in strategy in our credit portfolio. Events risk still lies ahead on the road in Europe, but tail risks relating to bank

US convertible bonds vs. S&P500

Total return index



Source: Datastream, J.P. Morgan

More details in ...

EM Corporate Outlook and Strategy, Warren Mar et al.

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

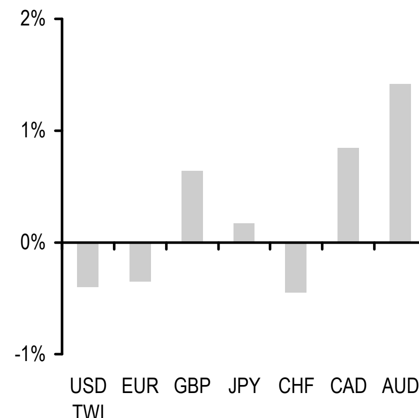
High Yield Credit Markets Weekly, Peter Acciavatti et al.

European Credit Outlook & Strategy, Steven Dulake et al.

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

funding have surely subsided. In the low interest rate, low(ish) growth rate and low default rate we envisage in H1, **credit is an attractive sector in which to add risk**. As such, we raise our risk profile in all three regions by closing our remaining bearish trades, reducing our overweights in US vs. Euro credit to market weight, and adding **outright longs in EMBIG** and **iTraxx Senior Financials** to our preferred sector, US HY (see yesterday's *GMOS*).

FX weekly change vs USD



Source: J.P. Morgan

Foreign Exchange

- Currencies are entering February with extraordinary momentum. The dollar is down almost 3% trade-weighted and versus every currency in the world bar Argentina. Its decline has been particularly precipitous versus emerging markets, where rallies in currencies such as HUF, INR and MYR over the past month exceed two sigmas. The reasons are well known – extraordinary ECB liquidity, unusual Fed transparency and a global upturn in activity data. We argued last week that this environment could create a carry trade revival (i.e. across-the-board USD weakness) comparable to 2009 were it not for the event risks from a clumsy Greek PSI deal. Those risks remain but are looking like a speedbump rather than a roadblock given how broadly activity data are rising. **Increase USD shorts again** this week but avoid the commodity currencies, which are showing the clearest signs of overshooting.

- In the **macro portfolio,** add long EUR/USD to existing shorts in USD/SEK (cash) and USD/JPY (options). Take profits on long EUR/GBP but stay short GBP/NOK and long NOK/SEK. Also take profits on EUR/NOK range binary. In the **derivatives portfolio**, hold straddles on GBP/USD (2-yr) and EUR/CAD (1-yr) outright, and NZD/USD vs USD/CLP vol swaps (3-mo). Hold risk reversals in EUR/USD (6-mo) and EUR/JPY (6-mo). Sell calls on USD/TRY (6-mo) and hold a suite of long high-beta G-10 vol vs. short LatAm vol spreads in relative value. In the **technical portfolio**, stay s**hort** EUR/KRW, NZD/CAD, PLN/HUF and EUR/INR.

Commodities

- Commodities fell slightly this week as **base metals gave back some of their recent gains**. Our Metals analyst has slightly lowered his forecasts across metals this week. **We now expect copper prices to average around $8000/mt over the first quarter which means prices should fall from current levels** (*Metals Review and Outlook*, Michael Jansen, 30 Jan). Both the LME and Shanghai copper curves are in contango (upward sloping), suggesting ample inventories and physical premia (spot vs. futures) are at multi month lows, suggesting weak physical demand. **We would need to see Chinese inventories start to draw down before we change our bearish view.** The latest data point on Chinese inventories was out yesterday and showed a further inventory build.

- Energy also fell this week but this masks a renewed divergence between the price of Brent and WTI. The spread between the two widened out to $16/bbl from only $8/bbl at the end of last year. Brent/WTI should reflect the marginal cost of moving oil from Cushing (where WTI is priced) to the US Gulf Coast. However, storage capacity has increased over the last few months which means there is now the option of storing the oil and shipping it later in the year when costs will be lower due to the reversal of a pipeline which will allow oil to flow south from Cushing.

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	Mar-12	Jun-12	Sep-12	Dec-12	YTD Return*
United States	Fed funds rate	0.125	0.125	0.125	0.125	0.125	
	10-year yields	1.94	2.25	2.50	2.50	2.50	0.3%
Euro area	Refi rate	1.00	0.75	0.50	0.50	0.50	
	10-year yields	1.93	2.15	2.00	1.95	1.90	-0.2%
United Kingdom	Repo rate	0.50	0.50	0.50	0.50	0.50	
	10-year yields	2.18	2.25	2.10	2.00	2.00	-1.0%
Japan	Overnight call rate	0.05	0.05	0.05	0.05	0.05	
	10-year yields	0.95	0.90	0.95	1.10	1.15	0.2%
GBI-EM hedged in $	Yield - Global Diversified	6.22	6.70				2.3%

Credit Markets	Current	Index	YTD Return*
US high grade (bp over UST)	211	JPMorgan JULI Porfolio Spread to Treasury	2.2%
Euro high grade (bp over Euro gov)	297	iBoxx Euro Corporate Index	2.5%
USD high yield (bp vs. UST)	673	JPMorgan Global High Yield Index STW	3.1%
Euro high yield (bp over Euro gov)	899	iBoxx Euro HY Index	7.5%
EMBIG (bp vs. UST)	412	EMBI Global	2.3%
EM Corporates (bp vs. UST)	431	JPM EM Corporates (CEMBI)	3.5%

		Quarterly Averages					
Commodities	Current	12Q1	12Q2	12Q3	12Q4	GSCI Index	YTD Return*
Brent ($/bbl)	113	105	110	115	120	Energy	2.0%
Gold ($/oz)	1742	1725	1825	1900	1925	Precious Metals	12.1%
Copper ($/metric ton)	8322	8000	8500	8875	9000	Industrial Metals	9.4%
Corn ($/Bu)	6.40	6.70	7.00	6.80	6.30	Agriculture	0.7%

Foreign Exchange	Current	Mar-12	Jun-12	Sep-12	Dec-12	3m cash index	YTD Return* in USD
EUR/USD	1.31	1.30	1.34	1.36	1.38	EUR	1.7%
USD/JPY	76.5	76	76	74	72	JPY	1.1%
GBP/USD	1.58	1.54	1.56	1.57	1.58	GBP	2.0%
USD/BRL	1.72	1.87	1.85	1.81	1.80	BRL	9.3%
USD/CNY	6.30	6.23	6.15	6.10	6.05	CNY	0.7%
USD/KRW	1118	1120	1080	1060	1040	KRW	3.2%
USD/TRY	1.75	1.88	1.85	1.80	1.80	TRY	8.4%

Equities	Current	YTD Return (local ccy)
S&P	1344	7.0%
Nasdaq	2907	11.3%
Topix	761	4.4%
FTSE 100	5901	6.0%
MSCI Eurozone*	142	8.2%
MSCI Europe*	1084	5.8%
MSCI EM $*	1044	14.1%
Brazil Bovespa	65505	15.4%
Hang Seng	20757	14.8%
Shanghai SE	2330	7.2%

*Levels/returns as of Feb 02, 2012
Local currency except MSCI EM $

Sector Allocation *	US YTD	Europe YTD	Japan YTD	EM YTD ($)
Energy	2.5%	1.3%	0.8%	**18.8%**
Materials	**11.8%**	**15.1%**	4.1%	**18.9%**
Industrials	**8.1%**	**9.1%**	**6.0%**	**17.5%**
Discretionary	6.1%	**13.4%**	**7.7%**	10.9%
Staples	-0.5%	-2.1%	0.1%	7.2%
Healthcare	3.8%	-0.9%	-0.2%	12.3%
Financials	**10.5%**	**14.2%**	**14.1%**	**16.3%**
Information Tech.	**8.9%**	**6.4%**	0.5%	11.8%
Telecommunications	-2.0%	-2.8%	-2.8%	4.9%
Utilities	-3.5%	1.2%	-1.6%	10.1%
Overall	**7.0%**	**5.8%**	**4.4%**	**14.1%**

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

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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	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	4Q11	2Q12	4Q12	2Q13
The Americas														
United States	1.7	2.3	2.2	1.8	2.8	2.0	2.5	3.0	2.0	1.5	3.3	1.8	1.4	1.4
Canada	2.3	2.2	2.5	3.5	1.7	2.1	2.6	2.3	2.4	2.7	2.8	1.7	1.7	2.0
Latin America	4.3	3.4	4.1	3.2	2.5	2.7	5.1	3.7	3.5	4.6	7.2	6.5	6.6	7.1
Argentina	9.2	3.2	5.5	4.5	6.5	0.0	2.0	3.0	4.0	6.0	9.5	10.0	11.0	11.0
Brazil	2.8	3.1	4.5	-0.2	1.5	2.6	5.7	5.5	5.7	4.5	6.7	5.1	5.1	5.0
Chile	6.3	4.0	4.8	2.6	2.1	4.0	4.5	6.0	6.0	4.5	3.6	3.6	3.4	3.2
Colombia	5.7	4.0	5.0	7.1	2.8	2.8	3.7	3.9	4.1	5.5	3.9	3.0	2.9	3.0
Ecuador	8.0	4.0	4.0	7.1	1.0	2.0	3.5	4.0	4.0	4.0	5.5	5.3	4.7	4.7
Mexico	4.0	3.3	3.5	5.5	2.8	2.5	5.5	0.6	1.0	5.0	3.5	3.5	3.5	3.8
Peru	6.7	4.5	7.0	6.5	2.7	2.4	4.1	6.5	7.6	8.5	4.5	4.1	2.8	2.9
Venezuela	4.0	4.0	1.0	6.8	2.5	6.0	6.0	4.0	-3.0	0.0	28.8	29.1	30.3	36.5
Asia/Pacific														
Japan	-0.9	1.3	1.3	5.6	-0.6	1.8	1.0	1.2	1.2	1.2	-0.1	-0.5	-0.5	-0.4
Australia	1.9	3.1	3.2	3.9	1.8	2.8	2.9	3.5	3.7	3.3	3.8	3.2	3.3	3.0
New Zealand	1.7	2.5	2.9	3.2	2.9	1.0	4.4	2.4	1.8	1.0	2.9	2.2	2.5	2.7
Asia ex Japan	7.0	**6.5** ↑	7.2	6.3	5.1	**6.7** ↑	**6.8** ↑	**7.5** ↑	**7.8** ↓	7.3	4.9	3.9	3.8	4.1
China	9.2	8.4	9.1	8.4	9.2	7.2	7.8	9.5	10.0	9.1	4.6	3.0	3.1	3.9
Hong Kong	5.0	3.0	4.2	0.4	**1.2** ↓	**2.5** ↓	4.0	5.5	6.0	3.0	5.7	**4.5** ↑	**3.6** ↓	**3.2** ↓
India	7.0	7.3	8.0	7.5	6.5	6.7	7.2	7.7	8.0	8.3	9.0	8.5	7.8	7.6
Indonesia	6.3	5.2	5.4	6.2	5.5	5.0	4.5	5.0	5.0	5.5	3.2	3.6	4.0	4.0
Korea	3.6	3.3	4.0	3.3	1.4	3.0	4.0	4.5	5.0	4.0	4.0	3.4	3.5	3.5
Malaysia	4.0	**2.0** ↑	3.2	5.8	0.0	**2.5** ↑	1.0	2.0	2.5	4.0	2.4	1.5	1.3	1.4
Philippines	3.7	3.8	4.8	**3.4** ↑	**3.5** ↓	2.8	4.9	5.7	4.9	4.5	**4.7** ↓	3.9	4.0	4.0
Singapore	4.9	1.2	5.2	1.9	-4.9	-0.4	7.4	6.1	6.1	4.5	5.4	3.9	3.0	3.0
Taiwan	**4.0** ↓	**2.9** ↑	5.1	**-0.8** ↓	**-1.0** ↑	**3.3** ↑	4.8	5.8	6.5	4.5	1.4	1.3	1.7	1.2
Thailand	1.0	**5.2** ↑	**3.5** ↑	2.1	-25.0	**35.0** ↑	**15.0** ↑	**2.0** ↑	**0.5** ↓	5.0	3.5	2.8	1.4	1.4
Africa/Middle East														
Israel	4.3	2.9	4.4	3.5	1.3	0.8	3.2	6.1	7.4	4.5	2.8	2.3	2.5	2.1
South Africa	3.1	2.7	3.6	1.4	3.9	2.3	2.6	2.8	3.2	3.8	6.1	6.0	6.2	5.9
Europe														
Euro area	1.5	-0.4	0.3	0.5	-1.0	0.0	-1.5	-0.3	0.3	0.5	3.0	2.0	1.8	1.6
Germany	3.0	0.6	1.3	2.0	-1.0	1.0	0.0	1.0	1.0	1.5	2.6	1.7	1.6	1.4
France	1.6	-0.1	0.3	1.2	-0.5	0.0	-1.0	0.0	0.0	0.5	2.6	2.1	1.6	1.2
Italy	0.3	-1.8	-0.7	-0.6	-2.5	-2.5	-2.5	-1.0	-1.0	-0.5	3.7	2.9	3.2	2.8
Norway	2.5	1.1	1.8	3.4	1.0	0.0	0.0	1.0	1.0	2.0	1.2	1.2	1.4	1.7
Sweden	4.7	1.1	1.7	6.6	1.0	-0.5	-0.5	0.5	1.0	2.0	2.5	1.2	1.1	1.5
United Kingdom	0.9	0.6	1.9	2.3	-0.8	1.0	-1.0	2.5	1.5	2.0	4.6	2.5	2.0	1.8
Emerging Europe	**4.8** ↑	2.7	3.5	3.5	4.6	2.0	1.2	2.5	3.7	3.3	6.3	4.9	5.4	5.9
Bulgaria	2.2	2.5	3.3	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	1.9	0.5	1.7	-0.3	-0.3	0.0	0.8	2.0	2.0	1.5	2.4	2.7	2.9	2.5
Hungary	1.5	0.5	1.5	2.2	-0.3	-0.3	0.3	1.0	2.0	1.5	4.1	4.9	5.1	3.6
Poland	**4.3** ↑	2.7	3.0	4.1	3.0	2.0	2.0	2.5	3.0	3.0	4.6	3.3	3.3	2.9
Romania	2.7	0.8	2.7	7.4	-0.5	-1.2	-1.5	0.8	2.4	2.5	3.5	3.3	4.4	4.0
Russia	**4.3** ↑	3.5	3.7	3.5	7.0	3.0	1.5	3.0	4.5	4.0	6.8	4.4	6.3	6.8
Turkey	8.2	2.5	4.5	...	...	...	...	...	...	...	9.0	8.1	6.2	7.9
Global	2.6	2.2	2.6	2.9	1.7	**2.2** ↑	1.9	2.7	2.6	2.5	3.6	2.5	2.3	2.4
Developed markets	1.3	1.2	1.5	2.1	0.7	1.2	0.7	1.6	1.3	1.3	2.8	1.7	1.4	1.3
Emerging markets	5.8	**4.9** ↑	5.7	**5.0** ↑	4.3	**4.8** ↑	**5.4** ↑	5.6	6.0	5.9	5.7	4.7	4.8	5.2

Source: J.P. Morgan

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