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Global Asset Allocation

The J.P. Morgan View: Local forces are dominating

J.P. Morgan View Video
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- **Asset allocation** — Local risks and opportunities trump global forces in driving investment opportunities. Cross-market correlations to remain much lower than in recent years.
 - **Economics** — US activity data are coming in better than hoped, but we need another 1-2 months to see how consumers are responding to higher taxes.
 - **Fixed Income** — Search for carry to trump Euro area jitters over time.
 - **Equities** — Japan remains our main country overweight.
 - **Credit** — We OW covered bonds in the Euro periphery over senior bank bonds and subordinated vs senior bank bonds in the core.
 - **Currencies** — Cyprus to have minimal further impact on EUR, but a ECB rate cut would push it a few cents lower versus the dollar.
 - **Commodities** — Stay long Brent and short gasoline.
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- **US stocks continue to gain, with the benchmark S&P500 breaching its all time high level** today in a gentle fashion. Bonds are generally up this week on dovish comments from both the Fed and the BoJ. Commodities have gained also, but credit remains the troubled asset class with spreads wider in most markets, especially in EM external debt.
 - **Our overall investment theme remains that there is no overarching global investment theme** anymore this year but instead a number of **unrelated local forces that have largely local impact**. The generalized **asset deflation** we saw last year, with risk premia coming down consistently across the globe and asset classes, was due to a gradual fading of tail risks that has since been largely completed. **“Risk-on, risk-off is so last year”**.
 - In addition, we are seeing **no momentum either way in global growth, price or earnings expectations** that could put us into a bullish or bearish growth story. Our 2.4% projection for 2013 world economic growth is unchanged since November. YTD activity data for the world are tracking our 2.6% forecast for Q1, comfortably up from the dismal 1.6% in Q4 of last year. Amidst offsetting up- and downside surprises in the US and Japan versus Europe, there has been no reason yet to raise the growth profile for the year as a whole. We hope, but need evidence first.
 - Without a global growth or fading-of-tail-risks force, we are left with a set of local issues and opportunities that are having a local impact, at the regional, asset class and company level, that should leave the rest of the world largely unmoved. In this environment, **correlations across regions and risk markets should remain significantly lower** than in past years. Various markets may seem to behave “inconsistently” with others, but we caution against expecting simple mean reversion, given our view of the reduced impact of global factors. Active investors should pay more attention to local fundamentals while long-term investors can expect to achieve greater gains from cross-market and international diversification.
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- Local issues must be monitored and understood, though, to decide how to allocate capital and risk. Just to review a few, **Japanese** policy makers continue to present a concerted plan to reflate their economy through monetary, fiscal and structural measures. The

strong control of the government and its high approval rating are steadily raising the chance of success. We stay overweight Japanese equities and grow wary of the short yen trade, as capital inflows and rising growth expectations (chart of right) are ultimately bullish for the currency. Watch next week's BoJ meeting, led by newly appointed Governor Kuroda, for new reflationary measures.

- The **Euro area** economy remains in recession, while policy makers are making little effort to reverse the contraction. We monitor signs of any large deposit flight post Cyprus over coming weeks and months to judge whether the bailout may actually be worsening conditions in the Euro. Economic forecast momentum remains negative (chart of right). These are good reasons to underweight the Euro area, if not all of Europe, across asset classes, against the rest of the world.
- The **US**, in contrast, is seeing better spending from both corporates and consumers than we could have expected post Fiscal Cliff and sequestration. But given the huge amount of fiscal drag, which is a fact, we want to see another 1-2 months of data before extrapolating the good news. It did support US equities in recent weeks, which continue to benefit from US corporates issuing debt to buy their own shares and others', through M&A. This corporate rotation from debt to equities is almost exclusively a US flow, which helps explain US equity outperformance.
- Across risk assets, we are similarly seeing huge delinking, with **equities** rallying greatly and **commodities and credit** seeing no gains (chart p. 1), very much unlike last year. Commodities are delinking as there are no growth upgrades in EM, and inflation concerns are concentrated on two countries, UK and Japan. Credit is delinking as most investors are massively overweight credit versus equities, as evidenced by the disparity in buying flows in 2011-12. Relevering by US corporate and the Fed debating the end of QE are signaling that the 3-decade long rally in bonds is likely over. Investors are starting to dollar-average away from bonds to equities.

Fixed Income

- Bonds rallied again, except for Euro area peripherals, the source of this week's market concerns. The imposition of capital controls on **Cypriot** deposits is to be sure a watershed moment, but for now not one we expect to spark significant deposit withdrawals elsewhere. Meanwhile, the most likely outcome to the Italian impasse appears to be new elections in the autumn. With seemingly little prospect of a material rise in yields on the safest assets, we think the search for carry evident across the full gamut of asset markets will see peripheral spreads narrow over time.
- Ten-year **JGB** yields have rallied to within a few bps of their all-time low, ahead of next week's inaugural meeting for the new BoJ leadership. We do indeed expect aggressive easing, with JGB purchases out to 30 years, but think this will be trumped by profit taking in JGBs after the fiscal year end.
- Our latest Inflation Expectations Survey (F. Diamond, K. Gupta) was out yesterday. One interesting result is that almost 90% of respondents believe the BoJ has less than a 50/50 shot of hitting its 2% inflation target in two years, a reflection of the formidable challenge of sparking inflation expectations after two decades of falling prices.

Equities

- The global rally in equity markets slowed this week, but did not reverse, on continued concerns about the fallout from a poorly executed Cyprus solution. The Euro area underperformed again, for a second week in a row. As discussed last week, we view Cyprus as a local problem that we address by **underweighting Euro area** equities in a global portfolio. A potential negative feedback loop from markets to the economy poses a serious downside risk for Euro area growth over coming months prolonging the current run of negative economic surprises from the region.
- **Japan** is the region we like the most. In our mind the Japanese equity trade has further legs not only due to prospective BoJ balance sheet expansion but more importantly due to a reform agenda to be unveiled into the summer.
- **EM** equities are suffering from renewed policy tightening in major EM economies such as Brazil and China. Investors have bitter memories of previous property tightening measures in China. As within DM, we see a lot of divergences within EM and prefer to focus on under-owned markets with good domestic demand story such as Mexico and Malaysia. See "Consensus Asset Allocation", Adrian Mowat and team, Mar 26th. Open overweights in Mexican and Malaysia equities vs MSCI EM.
- For long-term investors we just released our quarterly publication "**Trade opportunities for long term investors**" Mar 27. We monetize risk premia in Value stocks via a long in S&P500 Value vs S&P500 ETFs. It appears that a five year long underperformance of Value stocks has come to an end. We take profit on trades that monetize skew risk premia in S&P500 due to sharp contraction over the past quarter. We continue to monetize equity risk premia via buying high dividend yield equity ETFs against USTs. Our preference is to buy ETFs which track the S&P US Preferred stock due to its high yield, around 6%, and its high weight on Financials.

Credit

- The news flow from the **Cypriot bailout continued to push spreads wider and vol higher this week**, with European Financials underperforming as creditor bail-in risks returned to the forefront. iTraxx senior and subordinated financials indices widened 20bp as investors sought to hedge via CDS rather than sell bonds. European credit continued to underperformed US credit.
- The fact that Cypriot banks debt is only 1.3% of total liabilities was a key factor in the decision to bail-in depositors. Yet events surrounding the banking sector restructuring **also suggest that keeping senior unsecured bondholders immune from costly bail-**

outs is politically untenable. This removes the implicit 'cover' that senior bonds holders have enjoyed and has increased speculation that implementation of the bail-in proposals under the EU's Resolution & Recovery Directive (RRD) will be brought forward to 2015 from the current 2018 time-frame.

- As such, our colleagues in European Credit have examined the implications of changing recovery rate expectations across the bank capital structure. Assuming that covered bonds remain outside the scope of the proposals, we expect senior bank bond spreads to widen relative to covered bonds **and prefer being OW covered bonds vs senior bonds in the periphery**, particularly in Spain where covered bonds have first claim over the entire mortgage book of the bank. From a relative value point of view, we also suggest owning **subordinated bank bonds vs senior bank bonds in the core** as, under the new RRD regime, there is a higher probability than before that senior bank bond holders will lose money and this risk is, in our mind, not yet in the price (*Rethinking the capital structure*, R. Henriques et al., Mar 27).

Foreign Exchange

- Today's research note, *Sacrificing Cyprus*, examines several presumptions which have arisen over the past two weeks due to the Cyprus crisis, and scores them on a scale of truths, half-truths and falsehoods. There are indeed some right conclusions to draw from this experience, but also some wrong ones. As examples, it is true that capital controls have created a two-tier euro, but very unlikely that Cyprus is exiting EMU. And while it is true that markets deserve a risk premium for policy uncertainty, the size of the premium should be much lower than in previous crises due to backstops like the OMT.
- For example, during the first Greek crisis in May 2010 EUR undershot by 10% relative to cyclical conditions at that time, and during Greek elections in May 2012 the currency undershot by 5%. The combination of Italian and Cypriot events have eliminated the euro's overvaluation from early 2013, when the currency spiked to the high \$1.30s on a presumption that LTRO funds would be repaid rapidly, driving European rates higher. The currency is now close to fair value, so carries no risk premium for contagion. The message is similar in vol markets: the 1% premium for 3-mo implied versus realized vol is far less than the 5% premium witnessed during previous crises.
- While there is no evidence that the EUR/USD cash or options market carries a risk premium, it is also true that the required premium should probably be far less than in previous crises given that a sovereign funding backstop like the OMT is in place. We are thus **reluctant to extrapolate this mini-crisis into a systemic event which triggers broad deleveraging**, or to forecast trend euro weakness. The currency could trade down a couple of cents around an ECB rate cut, but assuming that fears around Cyprus contagion pass in a month or two, the currency should reverse its recent decline by the summertime.

Commodities

- **Commodities rallied this week, up almost 2%, led by energy.** We went tactically **long Brent** in last week's *J.P. Morgan View* as we believed that the correction in oil markets had brought prices too far below our price forecast of \$112/bbl. Since then Brent is up around 1.5%. We stay long and expect further price appreciation over coming months. We are also **short gasoline vs. Brent**. Gasoline cracks (the premium for gasoline over crude prices) spiked over the first three months of the year due to a combination of low inventories and refinery closures that came during refinery maintenance season. As refinery maintenance comes to a close and demand falls seasonally, gasoline prices should fall relative to Brent.
- We went long **Soybean time spreads** late last year (*GMOS*, Dec 5) on a view that much higher Brazilian supplies would find it difficult to leave the country due to logistical constraints. Since then we have seen a record number of ships planning to load soybeans in Brazilian ports and this number is still rising. The average waiting time before loading is also rising, now 38 days compared to 26 days a month ago. This has caused the front Soybean contract to rally while longer maturity contracts have been depressed by the much higher than normal supply inside the country. The spread between the May-13 and Jul-13 contracts has doubled since we put the trade on in December. **We stay long** as we think these logistical issues are unlikely to be resolved anytime soon.

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