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Global Asset Allocation

## The J.P. Morgan View: Go East.

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- **Asset allocation** — The growth gap between East and West is widening, and has allowed us to join the Obama Pivot towards Asia. We stay long Japan and EM Asia in equities on stronger signs of an economic rebound in the East, while we again cut growth numbers for the US and Europe.
- **Economics** — Weaker activity data force us to lower Q4 for the US from 1.5% to 0.8% and the Euro area from -1.5% to -1.8%. But strong trade and industrial data in Asia, as well as more fiscal easing in Japan, have induced us to raise Japanese growth for the 3rd time in a row, and to signal upside risk on China.
- **Fixed Income** — Go long duration in the US as we see yields mean reverting and we are not quite high in the 6-month range.
- **Equities** — Strong retail buying is adding fuel to equity markets.
- **Credit** — Idiosyncrasies driving relative performance signals a welcome move-away from the one-factor-drives-all world of late.
- **Currencies** — Staying short JPY. Be also short USD but against AUD, RUB and KRW.
- **Commodities** — Our main trades are long industrial metals, US natural gas, and Brent time spreads vs. short agriculture.
- **Another good week for risk markets** with equities and credit rallying further, but this week without a selloff in bonds. Much of the rally in equities is likely the aftermath of the last minute escape from Fiscal Cliff 1 on December 31. But since then, we have also seen a sudden surge in equity fund inflows, which seem incongruous with lukewarm incoming data and thus may well come from investors who missed last year's stock market rally. In 2012, fund investors poured \$680bn into bond mutual funds and ETFs, while taking some \$23bn out of equity funds.
- Given the recent vintage of these equity fund inflows, they are unlikely to reverse quickly as there is not a lot of profit on them yet. **Near-term momentum thus remains good for stocks, in our view.** At the same time, the more bullish sentiment on stocks is now sending a contrarian signal. Last year, we based much of our long equity recommendation on our impression that most market participants saw more downside risk across the globe than we thought would become realized. This does not appear to be the case anymore, as the main remaining market concern is only about Fiscal Cliff 2. No more talk of Chinese hard landing or a Greek exit. Hence, the case for being long risk assets is more value based, rather than the reversal in risk perceptions which we think has largely happened by now. We would therefore describe our remaining longs in equities and credit as modest and medium term.
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- We could again be induced to move our equity overweight to an “aggressive” level, if there were to be reason to raise growth and earnings projections. All we have so far is improved forward looking indicators – largely PMIs and positive feedback from asset markets – that are signaling a pickup in growth this quarter. But so far, this is simply confirming our and consensus views on how the year is set to start. They are not allowing us yet to upgrade our global growth expectations (Chart on right).
- More ominously, the continued strong rallies in risk markets to new highs for the cycle are hiding the fact that recent hard data on Q4 activity have again forced us to lower our estimate of Q4 global GDP growth, now to 1.7%, largely due to the US and

Europe. The average global growth pace of the past 3 months has fallen to only 1.8%, barely more than half of trend. The expectation remains that Q1 should come in at 2.4% as both Japan and the Euro area exit recession.

- While staying overall long risk markets, both credit and equities at the moment, we have increasingly focused on tactical cross-market exposures, and in particular the underweight of US equities. In *GMOS* this week, we took profit on the overweight of Euro area equities against the US given the still very weak economy, with Q4 likely now the biggest GDP decline since the end of the global recession (We do stay overweight Euro periphery bond). But we **remain aggressively overweight both Japan and EM Asia versus the US**, with Japan currency hedged. The upside surprise on Chinese CPI today dented its equity market somewhat, but we think this will be temporary as it should not yet lead to monetary tightening. The recent set of strong trade and industrial data from China and the region are signaling to us significant upside risk on Q1 and 2013 growth projections.
- We have been long **Japanese** equities since Nov 16, which more by luck than skill defined the beginning of its equity rally. Topix is up 20% since then, almost straight line. We believe new PM Abe conviction and political power to reflate the economy are real. It has already helped the yen lose 10% versus the dollar. Given this move, faster fiscal easing and support from equities, we have raised our 2013 growth forecast for a 3rd time, this time to 0.8%. We stay long the Japanese reflation trade.

### Fixed Income

- Bonds recovered some of their losses from last week, but remain down on the year. We do not see the current surge in equities as a negative for bonds, yet, as equity inflows are not coming out of bond funds, and growth remains too weak to elicit an early end to QE. With USTs very much at the top of their 6-month trading range, we go tactically long duration, but would take profit soon on a decent rally. In the Euro are, in contrast, the continued flow into the periphery should remain negative for Bund and euro swaps. We retain a bearish bias here.

### Equities

- Equities are up again this week, helped by rapidly improving equity ETF inflows. **Strong buying by retail investors** is adding fuel to equity markets against a backdrop of rather subdued macro drivers, maintaining a positive-near term momentum. The reporting season is also helping with US companies beating so far by 2% the bottom up analysts' estimates at the beginning of the year.
- Our recommended equity portfolio focuses on regional and sectoral exposures. Underweighting US equities remains our main regional theme. This trade also protects our portfolio against looming debt ceiling risks. US equities had been the consensus overweight by equity investors for two years and their outperformance started reversing over the summer. **US equities have so far erased their 2012 outperformance but are far from erasing their 2011 outperformance.**
- We focus the **US equity underweight against EM Asia and Japan**. In *GMOS* this week, we took profit on our overweight in MSCI EMU versus S&P500 given looming Italian election risks into February, and still disappointing European economic activity data. We stay overweight in Topix vs. S&P500 currency hedged. Fiscal easing, financed via debt monetization, and coupled with structural reforms has the potential to sustain this trade beyond a 3-6 month horizon, in our view. This week's fiscal stimulus announced by the Japanese gov't appears supportive of the Japanese trade.
- Across sectors we favor Cyclical vs. Defensive sectors but have taken part profit as the pace of the improvement in the global manufacturing PMI slowed in December. We stay overweight the DJ US Home Construction Index and large mortgage banks (BKX Index) vs. the S&P500 to position for a continued recovery in US housing.

### Credit

- **High-grade spreads and yields were a few bps tighter this week**, although US and European high-yield continued to rally strongly. Double-digit spread tightening sent both to new all-time yield lows; now just 5.9% in the US and 6.5% in Europe. The clear outlier this week was EMBIG, the ill health of the Venezuelan president and a NY court ruling in favor of hold-out creditors in Argentina's 'pari passu' saga helped push spreads up 12bp. We believe such idiosyncrasies driving relative performance signals an uncharacteristic break-down in spread correlations and a welcome move-away from the one-factor-drives-all world of late.
- The strength of equity flows has caught our attention this week, but there is little evidence of a wider rotation out of bonds. There has indeed been some evidence of bond into equity fund flows in ETFs (best seen through our flow radars in *Flows & Liquidity*), but bond mutual funds continue to see inflows, which accelerated this week. Also, our client survey reports on-going demand for credit and new issues remain well bid (see *CMOS* and *F&L* for more details).

### Foreign Exchange

- 2013 has started with **bubbling optimism across global markets**. Equities are approaching five-year highs and credit spreads their five-year lows, while government bonds are selling off worldwide and inflation breakevens behave (outside the UK). And per the traditional pattern, the dollar is falling versus most currencies, except those which entered 2013 with enormous liabilities – the yen given Japan's full-throated commitment to looser monetary and fiscal policy, and the rand on sovereign credit and balance of payment concerns. EUR/USD has spiked since Thursday's ECB meeting but is underperforming much of the commodity complex (MXN, CLP, AUD, NZD) year-to-date, highlighting that China's data surprises this week count for as much as a less-worried ECB.
- These **country-specific issues are more powerful than systemic ones** for the moment, which is likely why correlations across dollar-based pairs have sunk to three-year lows. The yen story still looks to us the most unique – USD/JPY is the only major

asset globally where vols are up this year – and the one with broader consequences for neighbors (through EM Asian intervention policy). Hence, this week's focus in our *FX Markets Weekly* on two other dimensions of the bearish yen view: what is the currency worth if the BoJ successfully delivers 2% inflation, and how broad is the yen short.

- To those who believe in purchasing power parity (and we are not amongst them), USD/JPY could move to 100 on a credible BoJ. Realizing these extreme targets requires Japanese participation in this yen move, since international investors could reach their risk limits on yen shorts. So far domestics look fairly unconvinced. Japan has been posting net capital outflows (foreign purchases of JGBs minus Japanese purchases of foreign bonds) since mid-2011, but the pace of those outflows has not increased since then-candidate Shinzo Abe began calling for much looser monetary policy. Stay short yen on the possibility that locals join the move, but rotate exposure. Book gains on a KRW/JPY one-touch, a USD/JPY seagull and CHF/JPY cash. Stay long NOK/JPY and re-enter EUR/JPY (both in cash). Stay short USD vs a basket of AUD, RUB and KRW.

## Commodities

- **Commodities are up around 1% this week, with all sectors gaining ground.** In Wednesday's *GMOS*, we retained all our previous positions. Our main trades are long **Brent time spreads** (long front vs. third futures contract), long industrial metals, long US natural gas and short agriculture. Production losses in the North Sea should support our Brent trade, while the current economic rebound in China should push industrial metals higher. US **Natural gas** should benefit from the ongoing switch from coal to gas for power generation and 2013 should see the first slowdown in production since the boom began five years ago.
- The GSCI **agriculture** index has already reversed around 80% of its rise in summer 2012 as farmers have planted a much larger area, which means a higher likelihood of much higher future supply. **We stay short** for now as we think this downtrend has further to go. **We are also long gasoil vs. Brent.** Global inventories are very low and demand from Asia is picking up, consistent with the economic data, which we expect to improve further over the coming months. An expected cold snap should also help push demand higher through January
- We took profit on our long position in **gold** last Friday and year-to-date gold is down around 1%. We believe many investors had bought gold over the past few years to hedge against the risk of "QE unlimited." The recent FOMC minutes, however, have since raised the risk of an early end to QE, reducing to need to hedge through gold. The risk is thus that a number of market participants will reduce their gold hedges, pushing gold prices down further. We still like gold as a hedge against long-term inflation risks once global growth returns to trend and we would look to reopen the position at around \$1,550/oz..

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