J.P.Morgan

MARKET INTELLIGENCE & POSITONING INTELLIGENCE: MACRO Q&A

JULY 27, 2021

In this note, we provide views on four themes:

1. What is driving yields lower and has positioning cleared out
2. Insights into GDP growth and the earnings outlook
3. Latest views, flows, and positioning on US Rates, curves, and breakevens
4. Views on US Equities vs. Non-US Equities, including sector views and positioning

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This contains a brief macro update and some trade ideas for clients to investigate around the investment hypotheses described in the document.

TRADES OVERVIEW

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Near-term a barbell approach is how we would be positioned. Institutional investors may consider the following:

- Long FAAMNG names or NDX via QQQ
- Long Banks via XLF or the JP Morgan Delta-One Buyback Index (JP11BNKB Index)
- Long Energy via XLE or our JP Morgan Delta-One Energy Outperformers Index (JP66ENOP Index)
- Long Retails via XRT or our JP Morgan Delta-One Retailers Index (JP1RTL Index). The Delta-One Index removes exposure to Autos, Drugs, and Internet names.
- Potential hedges include broad market indices such as the SPX as well as IG Credit, which can be utilized via the LQD ETF.
- For more defensive-oriented investors, consider these longs:
    - Consumer Staples via XLP or the JP Morgan Delta-One Staples Index (JP1STP Index); and,
    - Healthcare via XLV or the JPM Delta-One Custom Healthcare Index (JP1CHC Index)
    - In both cases, the Delta-One indices reduce the top weightings to under 4%.

For more information, institutional investors may contact our Delta-One team (email).

THEME 1: YIELDS

The move lower in yields has been driven by (i) a recalibration of expectations surrounding the Fed's rate hike "liftoff"; (ii) shifts in inflation expectations; (iii) crowded short positioning; and, (iv) growth concerns.

I. At the June FOMC meeting, we saw a change in the Fed's dot plot, indicating stronger views that rate hikes would occur more quickly than the market had previously thought. This includes pulling forward rate hike expectations into 2022.

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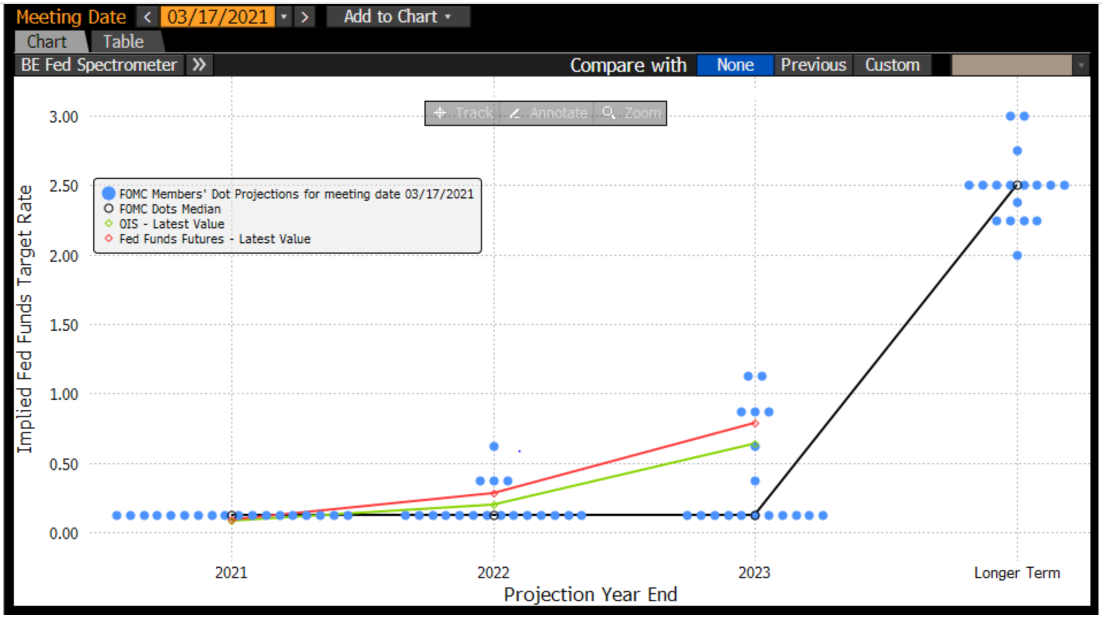
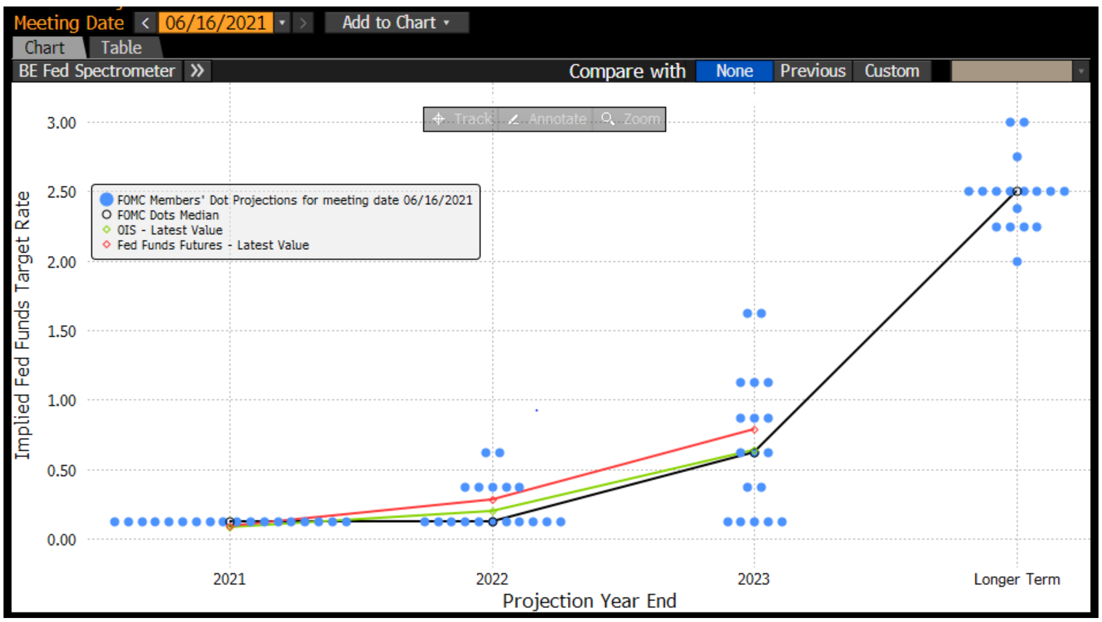


Source: Bloomberg



Source: Bloomberg

II. Typically, rising inflation expectations drive breakevens and inflation swaps higher more quickly than nominal yields. This year, 5Y5Y inflation swaps peaks on May 14 and 5Y & 10Y breakevens peaks on May 17. On May 12, CPI printed +4.2% YoY vs. +3.6% survey/+2.6% prior. This represented the first large CPI print. Later that day, Fed Vice-Chair Clarida and Atlanta Fed Pres. Bostic both spoke on the transitory nature of inflation. This message was

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repeated by 2 Fed speakers on May 13, and one more on May 14. Clarida again spoke on May 17 and Kaplan on May 18.

5Y BREAKEVEN vs. 10Y BREAKEVEN

5Y/5Y INFLATION SWAP vs. 10Y YIELD

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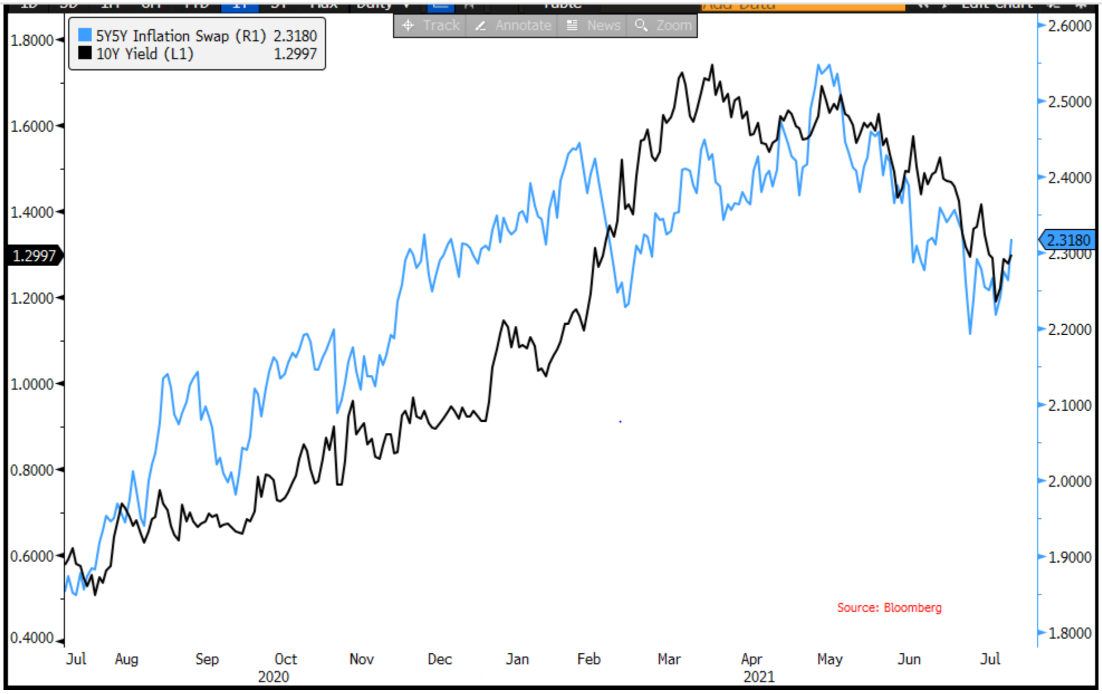
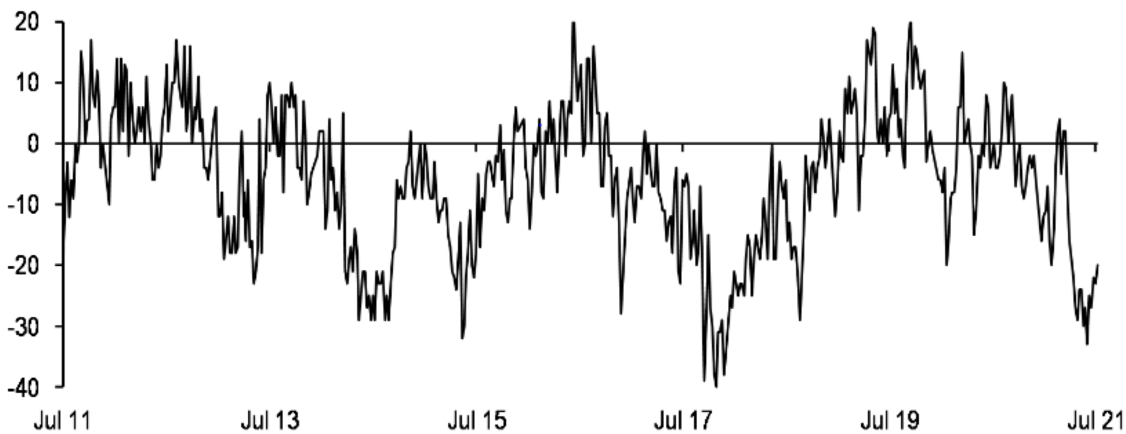


III. Coming into 2021, longer-duration US yields were a consensus short. From early June through last week, the July 19 [JP Morgan Treasury Client Survey] indicates that ~40% of that short base has been covered. Currently, we are seeing the fewest net shorts in approximately 3 months. Further, one of our Markets Strategists, Nikos Panigirtzoglou, believes that these [Treasury market moves have been exacerbated by low liquidity].

Exhibit 1: Our survey indicates that 40% of the short base has been covered since just before the June FOMC meeting

Net longs in J.P. Morgan Treasury Client Survey; %



Source: JP Morgan Rates Strategy

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IV. The Delta-variant has certainly had a negative impact on growth. Regionally, the headwinds to growth were witnessed first in Asia-Pacific, then Europe, and now those concerns are approaching the US. While the variant is more contagious it has lower lethality. That said, vaccine hesitancy leaves a considerable portion of the US population vulnerable despite there being sufficient vaccine supplies. Behaviorally, Asia-Pacific has reinitiated lockdowns. In the UK/EU there is debate surrounding a new set of lockdowns and had previously delayed the reopening in the UK. In the US, we have seen Los Angeles county institute mask mandates and the CDC considering enhanced federal guidance. Overall, the risk-off sentiment accompanying the Delta-variant has created demand for US yield products; most of the global Rates universe has negative yields making the US attractive on a relative value basis.

Overall, the move in yields makes bond such as the 10Y overvalued, by ~30-35bps. Currently, the Treasury market is pricing in negative growth next based upon the framework used by JPM Rates Strategists, Jay Barry and Phoebe White. The 2022 FY GDP growth estimate is +4.0% (*Global Data Watch*; 7/23/21).

What is the catalyst to move yields higher? Labor Markets. US Market Intelligence wrote about labor markets in this week's *Macro Week Ahead*. Below is an excerpt from the publication:

Given the ability of the Fed to talk long-term inflation expectations lower (more on that in the next section), the yield curve has primarily reacted to employment data. NFP is the biggest driver but is only a monthly number, with the next two releases coming on August 6 and September 3. The market may need to see both of those prints come in above the previous release, +850k jobs, to move sustainably higher. Also, we are seeing the weekly jobless data having the ability to inject volatility into the yield. Yesterday, jobless claims printed 419k vs. 350k survey and 368k prior. The 10Y moved from ~1.27% to 1.23% and then closed at 1.28%. The Equity market reaction saw the RTY go from a position of outperforming SPX, NDX futures pre-market to underperforming SPX and NDX on the day by, 179bps and 225bps respectively. Two other labor market variables to keep an eye on, (i) impact of ending federal unemployment, (ii) lifting of the eviction ban.

THEME 2: GDP / EARNINGS OUTLOOK

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The JPM House View is that the US achieves “peak macro” in 2021Q3; but, this does not mean that we see peak earnings growth. Our Chief US Equity Strategist, Dubravko Lakos-Bujas, increased his EPS and SPX year-end forecast on July 20, 2021.

Dubravko sees 2021 EPS of $205 (up from $200), 2022 EPS of $230 (up from $225; consensus is $214), and 2023 EPS of $250 (consensus is $233). He increased his 2021 year-end SPX target to 4,600 from 4,400. In Dubravko’s own words, “This revision is largely due to global reopening which is delayed and bound to release further pent-up demand, inventory replenishment, rising profitability for Energy companies, and ongoing policy actions (childcare, infrastructure, etc). We expect cumulative revenue growth of ~30% by 2023 relative to pre-COVID (FY 2019), ~150bp net income margin expansion to a record high at over 13%, and gross buybacks nearing an annual pace of ~$1T during this period.”

Regarding the current earnings season, so far we have seen ~25% of the SPX report with 88% beating EPS estimates (5-year average is ~75%). The 88% number would be the highest since major data providers began tracking this metric. EPS reports are 19% above estimates (5-year average is 8% above estimates). On the revenue side, 86% of companies have beaten estimates (5-year average is 65%). Companies are beating estimates by 4% (5-year average is 1.2%). Similar to EPS, if the 86% number holds this would be the highest since the data has been tracked.

	%q/q, saar								%q4/q4			%y/y		
	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	2020	2021	2022	2020	2021	2022
Gross domestic product														
Real GDP	33.4	4.3	6.4	8.0	8.3	3.0	3.5	3.0	-2.4	6.4	2.8	-3.5	6.3	4.0
Final sales	25.9	2.9	9.2	8.6	2.2	3.7	3.6	3.7	-2.7	5.9	3.2	-2.9	5.7	3.6
Domestic	29.8	4.4	10.5	7.8	4.7	4.8	4.3	3.9	-1.5	6.9	3.4	-2.7	7.0	4.3
Consumer spending	41.0	2.3	11.4	9.6	4.5	4.5	3.0	2.8	-2.7	7.5	2.4	-3.9	7.7	3.6
Business investment	22.9	13.1	11.7	9.7	10.0	7.5	7.3	6.0	-1.4	9.7	5.4	-4.0	9.4	7.0
Equipment	68.2	25.4	15.0	14.4	12.0	7.0	6.0	4.0	3.5	12.1	3.7	-5.0	16.9	6.4
Structures	-17.4	-6.2	-2.0	5.1	6.0	6.0	8.0	7.0	-16.1	3.7	6.7	-11.0	-4.7	6.7
Intellectual property products	8.4	10.5	15.3	5.6	9.0	8.5	8.5	8.0	2.1	9.6	6.9	1.7	8.7	7.9
Residential investment	63.0	36.6	13.1	-11.0	7.0	7.0	5.0	4.0	14.3	3.6	3.5	6.1	11.8	4.0
Government	-4.8	-0.8	5.7	3.5	0.4	3.4	6.9	6.8	-0.5	3.2	5.8	1.1	1.7	4.9
Net exports ($bn, chained $2012)	-1019	-1122	-1212	-1199	-1330	-1398	-1444	-1468	-	-	-	-	-	-
Exports (goods and services)	59.6	22.3	-2.1	8.7	3.0	5.0	5.5	5.5	-10.9	3.6	5.2	-12.9	4.6	5.2
Imports (goods and services)	93.1	29.8	9.5	4.0	18.0	11.0	8.5	6.0	-0.6	10.5	5.9	-9.3	14.6	8.5
Inventories (ch $bn, chained $2012)	-3.7	62.1	-87.0	-114.8	169.5	138.2	133.4	101.5	-	-	-	-	-	-
Prices and labor cost														
Consumer price index	4.7	2.4	3.7	8.4	7.2	3.0	2.4	2.3	1.2	5.6	2.3	1.2	4.4	3.4
Core	4.0	1.8	1.2	8.1	6.9	2.9	2.5	2.4	1.6	4.7	2.4	1.7	3.6	3.4
PCE deflator	3.7	1.5	3.7	6.5	4.1	2.7	2.1	2.0	1.2	4.2	2.0	1.2	3.4	2.7
Core	3.4	1.3	2.5	6.1	3.8	2.6	2.2	2.1	1.4	3.7	2.1	1.4	3.0	2.7
GDP chain-type price index	3.5	2.0	4.3	6.5	3.3	1.9	2.0	2.0	1.3	4.0	2.0	1.2	3.5	2.4
S&P/C-S house price index (%oya)	5.9	9.4	12.1	10.5	8.8	7.0	6.2	5.4	9.4	7.0	3.7	6.0	9.5	5.0
Employment Cost Index	2.0	2.9	3.7	3.6	2.2	2.1	2.3	2.3	2.5	2.9	2.3	2.6	2.9	2.3
Productivity	4.2	-3.8	5.4	3.5	2.3	0.5	0.5	0.5	2.6	2.9	0.7	2.6	2.8	1.0
Other indicators														
Housing starts (mn units, saar)[1]	1.440	1.575	1.599	1.568	1.570	1.580	1.600	1.605	-	-	-	1.397	1.579	1.608
Industrial production, mfg.	55.8	11.1	2.3	3.7	12.0	9.0	2.5	1.8	-2.5	6.7	1.8	-6.6	7.1	4.6
Light vehicle sales (mn units, saar)[1]	15.3	16.1	16.8	17.0	17.1	17.2	17.2	17.3	-	-	-	14.4	17.0	17.4
Unemployment rate[1]	8.8	6.8	6.2	5.9	5.4	5.1	4.7	4.4	-	-	-	8.1	5.7	4.4
Payroll employment (ch, '000s, samr)[1]	1342	213	518	567	650	425	425	275	-	-	-	-785	540	250
Nominal GDP	38.3	6.3	11.0	15.0	11.8	5.0	5.6	5.1	-1.2	10.6	4.9	-2.3	10.1	6.5
Current account balance ($bn)[1]	-172.4	-175.1	-195.7	-191.9	-201.2	-215.5	-219.9	-234.4	-	-	-	-616.1	-804.4	-936.8
% of GDP	-3.3	-3.3	-3.5	-3.4	-3.4	-3.6	-3.6	-3.8	-	-	-	-2.9	-3.5	-3.8
Federal budget balance ($bn)[1]	-	-	-	-	-	-	-	-	-	-	-	-3131.9	-3000.0	-1350.0
% of GDP	-	-	-	-	-	-	-	-	-	-	-	-15.0	-13.0	-5.5

1. Entries are average level for the period. Federal balance figures are for fiscal years.

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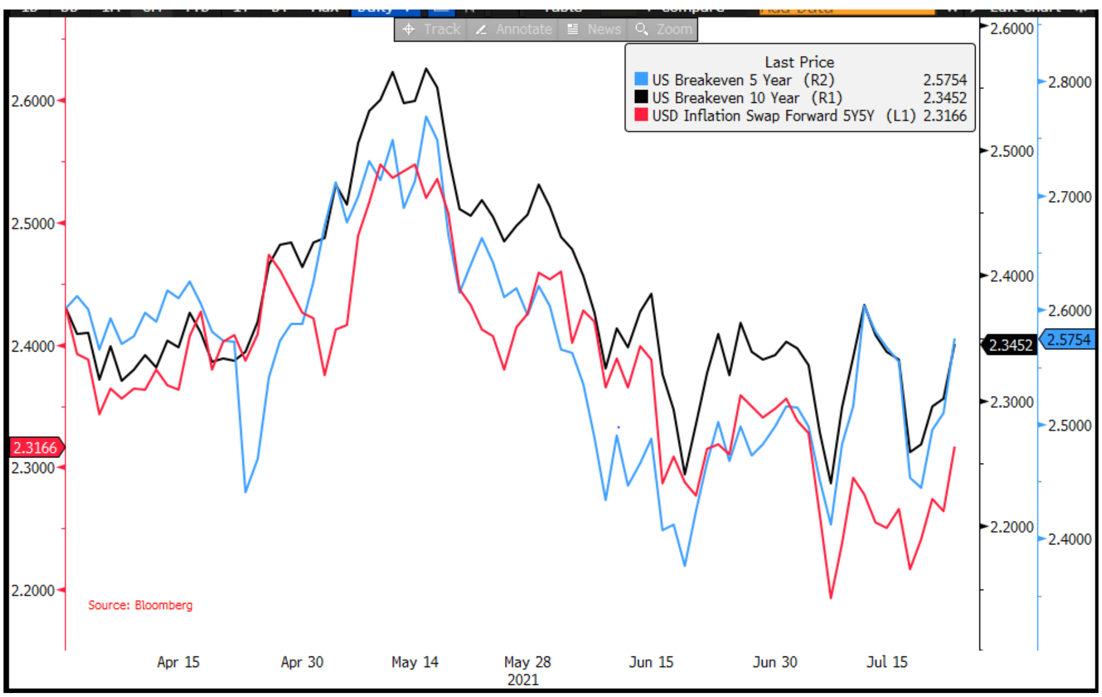
Source: JP Morgan Economics

THEME 3: US RATES

On Rates, the view is that they remain overvalued but that there is a lack of catalysts to normalize rates. With the yield curve primarily reacting to labor markets Jay Barry, Head of US Government Bond Strategy, thinks it takes two or more strong NFP prints to get yields into the 1.60% - 1.70% range. The next NFP data releases are August 6 and September 3. **Jay still likes the 3s/7s steepener and a 10Y short but recognizes time horizon of investment and cost of carry may work against investors.**

With breakevens, we saw the 5Y breakeven move from 2.453 to 2.575 on the week and the 10Y breakeven move from 2.259 to 2.345 on the week. Neither the 5Y nor the 10Y appear cheap and Phoebe White, Rates Strategist and Inflation Specialist, **took profits on her 5Y5Y inflation swap long**.

5Y BREAKEVEN vs. 10Y BREAKEVEN vs. 5Y/5Y INFLATION SWAP



THEME 4: GLOBAL EQUITIES & POSITIONING

US EQUITIES

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Longer-term, the picture for stocks remain rosy. The combination of the Fed being active for at least another 9 months, strong corporate balance sheets, increasing buybacks, potential for M&A/Private Equity buyouts, and the healthiest consumer financial profile in our lifetimes should continue to support a move higher in Equities. The question is whether, or rather when, Equities start a sustained move given the signals given off by the bond market.

The US Market Intelligence hypothetical portfolio would utilize a barbell approach, including both Growth and Value elements. Currently, I would have a heavier weighting towards Growth. The market is having a larger reaction to EPS this season and Tech earnings make up the bulk of SPX earnings while some of the Cyclical/Value sectors will have the more impressive percentage beats.

The 6-month view would include longs in FAAMNG (or NASDAQ 100), Banks, Energy, and Retailers; and, would consider hedging using a mix of the SPX and IG Credit. Tactically, as we see COVID concerns infiltrate all risk assets, there is an opportunity for Staples and Healthcare to outperform vs. shorts in Materials and Industrials. Generally, would remain cautious on the epicenter reopening plays such as Airlines, Casinos, Cruise Lines, and Hotels.

NON-US EQUITIES

- **UK / EMEA** – the regional has ceded its outperformance as the Value trade has unwound. As we get past Delta-variant concerns, see yields curve resume bear steepening, then the regional should start to appreciate. This view is driven by a relatively higher growth prospects that filter down to stronger earnings performance. However, the downside risk to the UK/EMEA outperforms the US call is that the Delta-variant is more likely to trigger lockdowns in this region than in the US. While both regions are seeing growth forecasts downgraded, the EU has more downside risk to these cuts. So, the aforementioned growth/earnings differential may become a 2022 story rather than a 2021 story. As markets exhibit caution, moving funds to Secular Growth, the US becomes the best region given its mix of Tech companies. This phenomenon is exacerbated when considering the recent price action of Chinese Tech companies.

Range 12/31/2020 - 07/23/2021 Period Daily No. of Period 204

	Security	Currency	Price Change	Total Return
1)	SPX Index	USD	17.46%	18.40%
2)	NDX Index	USD	17.25%	17.71%
3)	RTY Index	USD	11.89%	12.43%
4)	UKX Index	GBP	8.78%	10.84%
5)	SXXP Index	EUR	15.66%	18.13%
6)	SX5E Index	EUR	15.66%	18.04%

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Source: Bloomberg

- **ASIA-PAC / EM** – The view from JPM Strategy is to maintain a pro-risk allocation in our EM model portfolio and focus on benign drivers that should support rotation towards Value / Cyclical sectors and Ex-North Asia allocation (*Key Trades and Risk; 7/22/21)*. Our allocation towards cyclical sectors remains with a targeted focus on investment themes related to reopening and reflation trades. We also continue to see possible drivers to make the relative case of EM / DM equities more compelling into 2H21: (1) the phase-out of US exceptional strength; (2) a higher commodity price tailwind; and (3) favorable positioning and valuation relative to DM equities.
  - **US MARKET INTELLIGENCE:** From a macro perspective, the comparatively worse vaccine distribution has had growth lagging DM. India is the only country whose Q3 GDP is expected to surpass the United States. USD strength has hurt the bull case. The view from FX Strategy is for USD appreciate to continue; they are long USD versus both low-yielding currencies and high-beta currencies (*Macro Trade Recommendations;* 7/23/21)
  - Much attention has been paid toward Chinese Tech companies and the shifts in the regulatory regime. The region and EM are dependent on China. Near-term, it is tough to see regulation and the USD breaking in the right way. However, with China Tech names down ~40% from their highs, this could be an attractive entry point for longer-term investors.

JPM USD INDEX vs. DXY INDEX

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NASDAQ GOLDEN DRAGON INDEX vs. MSCI ASIA-PACIFIC

FLOWS & POSITIONING

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US vs. NON-US EQUITIES – US Equities is the market where positioning remains highest vs. its own history as both EMEA and APAC have seen positioning fall from earlier 2021 highs. Flows over the past 12 months reflect this as well. That said, it appears HFs have been marginally more willing to sell US equities and buy other regions lately.

- From a US vs. EU perspective, the recent buying of EU and selling US appears to be similar to what we saw into mid-May when Europe had underperformed the US and then bounced back.
- In Asia, the buying has been most consistent in Japan over the past 2 months as gross exposures more generally have been added back from a very low base. But the risk in other parts of Asia (esp. China/HK/ADRs) is that the selling earlier this month has not been large enough to suggest capitulation, and there have even been a few days over the past week of buying in HK and China last week (prior to Tuesday at least). Basically, from a flows and positioning perspective, there's further potential for exposures to decrease

SECTOR VIEWS

- **N. AMERICA**: Quality growth + value-cyclical barbell seems like it could make sense still. On the quality growth side, Mega Cap Tech had seen relatively strong buying in May and June, but then was sold in 1H July. However, flows turned more positive last week and longer term positioning is still relatively low (net exposures about -1z vs. data since Jan 2018) so it's possible that strong earnings could continue to drive flows into these stocks. On the Value-Cyclical side, positioning and flows have been relatively negative in parts of Financials (Banks net exposures have reversed dramatically) and Energy. Furthermore, the selling of Value stocks has slowed dramatically in recent months and it seems that there are signs HFs are starting to warm up once again to Value after selling it a lot in 2H May through June.

- **EUROPE**: Over the past few months, **Cyclicals net positioning has been falling from peaks**, while Defensives have been rising. With that said, most of the industries that have higher net exposures are more cyclical in nature, while many of the industries with low net exposures are more defensive—thus the **bias is still fairly tilted towards Cyclicals** over Defensives. From a flows perspective, the groups most sold over the past 2 weeks have been mainly in Cyclicals and Tech, while parts of Staples have been most bought
  - Additionally, there's a view from Krupa Patel (Head of EMEA Market Intelligence) that **EU Energy** looks attractive at this point, partly due to positioning. From her:
    - **Buy EU Energy - more oversold than re-opening, still low positioning and EPS/FCF upside into Q2 earnings.** Despite continued uncertainties over the

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fundamental backdrop for stocks, there are certain pockets of the market which post Monday's sell off are looking like a bargain with much cleaner positioning. **While the temptation might be to go back into the re-opening theme especially given the last couple of days' rebound, we think a better area of the market to play oversold technicals + low positioning is European Energy.** The sector is **even more oversold in relative RSI terms compared to our re-open Indices**, still looks **massively disconnected vs the oil price**, has **EPS/FCF upside into the majors' Q2 reports over the next week** and **hedge fund positioning continues to look low vs history** on our *Positioning Intelligence* team's data (-0.6SD vs last 3.5 year history – chart below). A good way to play this sector is through our D1 team's Energy basket - JPEENR Index, which is a cleaner way to position for EU oils companies compared to SXEP which includes Green energy names (e.g. Vestas, 4th biggest in the index). See chart below which shows the **relative RSI of this basket is now at 33, near the most tactically oversold levels since October 2020.**

- **ASIA**: Over the past couple weeks, there had been a bias towards buying Cyclicals stocks.
  - In AxJ we had seen net buying of Energy and Industrials over the past 2 weeks (as of EOD Thurs, so prior to the big sell-off in HK/China on Fr-Mon). Financials had also been bought. However, on a 1-month basis, only Industrials had seen a meaningful buy skew (the other Cyclicals were more mixed).
  - In Japan, the Cyclicals bias in the flows has been more consistent over the past 2 months with Cons Disc, Energy, and Materials most bought over the past month. **Japan Tech** (**JPJBTECH**) had also seen large buying in June that continued into 1H July and put net positioning at highs. Similar positivity can also be seen in the **JPM Japan COVID Recovery basket (JPJBTOUR Index) flows**, where HFs have started ramping up long positions since late-May. This has pushed net exposure to the basket to their highest level since Jan-2018, prior to a recent pullback from highs
  - More generally across **APAC industry groups, net positioning** is high and has increased in Materials, Autos, and Commercial & Prof. Services (part of Industrials), while it's low in FBT, Insurance, Telcos, Div Fins, and Real Estate
  - From a **thematic standpoint**:
    - **ESG/renewables:** In **Japan**, we've seen positioning in **Renewables (JPJBRNEW)** tick back up towards highs over the past quarter. In contrast, AxJ ESG Winners (JPAJESGL) have been sold into strength recently

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- **Asia Chip Shortage Beneficiaries (JPAASCHP)**: Saw selling from mid-April to late May, but flows and positioning have started to rebound. That said, net positioning remains well below early 2021 highs

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