The J.P. Morgan View

Equity multiple compression already exceeds an average recession

Cross-asset Strategy: The S&P 500 has seen its second sharpest P/E de-rating of the past 30Y, exceeding the typical compression seen during prior recessions. While the current equity multiple is in-line with the historical median, we believe it is better than fairly valued given the shift in industry mix to higher quality companies. Although the activity outlook remains challenging, we believe that the risk-reward for equities is looking more attractive as we move through 2H. Historical downgrade cycles also suggest the worst for EM equity EPS and returns is likely behind us. We initiate longs in 5Yx5Y US breakeven wideners as Powell's dovish tone reduces the downside risks to breakevens. Inflation and gas concerns prompted downward revisions to our Euro area growth forecasts, where we now expect a mild GDP contraction in 4Q22-1Q23. As data reveals the extent of the economic slowdown, all-in corporate bond yields might not move much, but rather drive a redistribution of interest rate and credit risk. We revised our YE spread targets wider for Euro HG and HY, but expect a slower widening path given cautious investor positioning. In FX, incremental Fed dovishness isn't likely to pose a threat to the dollar, as USD typically does well in recessionary environments. We stick with USD net length, and add to JPY vs EUR. Natural gas shortages in Europe may trigger gas-to-oil switching and boost oil demand, but this is offset by normalized Libyan supply, keeping our oil forecast unchanged. Record heat evaporates the Freeport storage cushion, producing asymmetric upside risk for US natural gas prices.

JPM Clients' View: Click here to take this week's survey. This week we poll investors on a US recession, the Fed, and housing prices, in addition to our running sentiment questions. Last week's survey results indicated: (1) equity exposure/sentiment is ~44th percentile on average; (2) 58% plan to increase equity exposure, and 56% to decrease bond duration near-term; (3) 64% believe the recent mortgage suspensions in China pose significant downside risk for housing; (4) 95% expect limited gas pipeline supply to Europe over the rest of the year, but not a complete halt; (5) respondents expect the ECB base rate to peak this cycle at 1.6% in 1H23 on average.

Whether it's earnings or the Fed, we see a reset of investor expectations: Last week's more dovish Fed meeting that saw the base rate raised close to neutral, along with softening inflation expectations and declining bond yields, indicate peak hawkishness is likely behind. Risk markets are rallying despite some disappointing data releases, indicating bad news was already anticipated/priced in.

New Trades: RV trade ideas in Credit Derivatives (Doctor); post reporting trade ideas (Silvestrini); bought 1Yx1Y HICP (Diamond).

Upcoming catalysts: earnings & Fed speak (all-week); global manufacturing PMIs (8/1); RBA (8/2); global services PMIs & BCB (8/3); BoE (8/4); non-farm payrolls & RBI (8/5).

Global Markets Strategy

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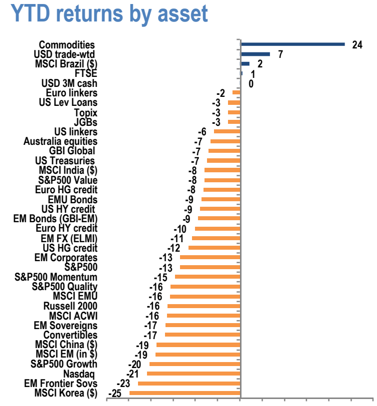
YTD returns by asset



Source: J.P.Morgan

Cross-Asset Strategy

Macroeconomic Outlook

Europe is now expected to slip into recession in 2H22. Despite a stronger-than-expected 2.8%ar 2Q22 Euro area GDP reading, the latest surge in natural gas prices and slide in business confidence lead us to now expect the Euro area to contract later this year. Absent rationing, we project a mild contraction in GDP and modest rise in unemployment rates. If rationing of natural gas occurred this winter, a deep contraction would likely take hold.

The US is expected to skirt a downturn, but margin-slide risks a labor market break. We still expect the US to skirt recession despite posting a second consecutive GDP decline last week. There are some encouraging details in the disappointing GDP report as firms sharply slowed their pace of stockbuilding, and real consumption eked out a gain in June as households continue to cushion inflation shocks with a lower saving rate. With signs that consumer price inflation is set to drop sharply and government spending is poised to rebound from its recent slide, we forecast the US economy rebounds to a 1%ar growth pace in 2H22. The sharp income rotation away from profits has been a notable signal of vulnerability and we look for it to prompt a moderation in labor demand. We expect next week's July report to see job growth soften to 200k.

EMU inflation stays hot while RoW to see relief. We expect Euro area inflation to remain at a 9%ar this quarter, boosted by upward pressure on food and energy prices. At the same time, we look for a sharp deceleration in headline inflation elsewhere: we expect a drop in US CPI energy to lower headline gains to 0.2%m/m, and a moderation in food price pressures should hold EM CPI gains to 0.3%m/m this month, less than half their average rate of increase thus far this year (*GDW*, Jul 29).

Equities

Given the significant market pullback, investors are increasingly asking about equity valuation and how it compares to historical cycles. S&P 500 has seen the second sharpest P/E de-rating of 6.7x (vs. average of 4.5x compression seen during prior recessions). While the current equity multiple of 16.9x is in-line with historical median, we believe it is better than fairly valued given the shift in industry mix to higher quality companies over the last two decades. While equity valuation is a poor timing signal in the short term, it can help frame the upper/lower trading range of the market over the medium term. Post the "Great Inflation" period (since 1980s), there has been a negative relationship between equity multiples and bond yields. Historically, when the 10yr bond yield was at ~3%, S&P 500 equity multiple was also ~16x. Looking at longer history (since late 1800s) and differentiating across various growth regimes, we find an inverse "U" relationship between equity valuation, economic growth, and rates. In short, during periods where real GDP growth was low (e.g., 1-2%), S&P 500 multiples were supported until 10yr bond yields reached 3.5-4% (*Global Equity Strategy*, Jul 28th).

The phase of bad data being interpreted as good is gaining traction, while the call of peak Fed hawkishness, peak yields and peak inflation is playing out. Although the near term activity outlook remains challenging, we believe that the risk-reward for equities is looking more attractive as we move through 2H. The weak Q2 US GDP print was taken positively by the market as this will open the doors to a more balanced Fed. The gap between breakevens and yields has largely closed and could lead to a softer USD. While we reduced growth and EPS forecasts, we expect equities to be meaningfully higher at YE (*Equity Strategy*, Aug 1st).

EM earnings estimates have been in a downgrade cycle since February, declining 12% since then. A comparison with past EM EPS downgrade cycles suggests the worst is behind us. The current cycle's EPS decline has reached 64% of the historical median and the equity price decline has already exceeded the median decline in previous cycles. EM equities tend to bottom before EPS downgrades, and in past cycles EM equities on average bottomed at 70% of the cycle. We expect EM EPS to bottom out in 2H, led by recovery in China that should support sentiment for EM equities. Our top-down model points to 2022 EPS growing 7ppt points above consensus for MSCI EM (*EM Lighthouse*, Jul 28th).

Bonds

Bonds market yields were lower last week amid growing recessionary risks (as the US economy contracted at a 0.9% annualized pace in Q2) and a somewhat dovish FOMC meeting. Powell's dovish tone reduces the downside risks to breakevens from here, and we recommend initiating longs in 5Yx5Y breakeven wideners. In nominals, we believe it's clear that valuations are somewhat rich at these levels, which makes us lean towards low beta ways to get short.

In the Euro area, the inflation shock and gas concerns prompted downward growth revisions to our forecasts. We now expect a mild GDP contraction in 4Q22-1Q23 and the unemployment rate to increase modestly in 1H23. Meanwhile, Euro area data offered surprises both on the growth and inflation front on Friday. We expect the ECB to deliver a 50bp hike in September, followed by a pause in October as by that time it may be clearer that the Euro area economy is heading into outright contraction. In the **UK**, we expect the BoE to deliver a 50bp hike at the August MPC meeting, but we see some chance of a 'dovish' delivery, given increased recessionary concerns. Hence, we keep Aug/Nov MPC OIS flatteners, take profit on short 5Y UK vs. 5Y Germany, and close 5Y swap spread narrowers.

In **EM**, rates have rallied following core rates as markets focused on the growth downside. This overlooks the still high inflation environment, with negative real rates in most countries. We remain MW in EM rates via UW Czech, Hungary, Chile and Peru, but neutralize duration exposure via an overlay (*EM FI Focus*, Jul 29th).

Credit

Sequencing, all-in yields and balancing credit and interest rate risk. 2023 could be shaping up to be much better year for risk markets than 2022, credit included. Right now, however, sequencing is important; we're in that phase where there are still some hikes ahead of us and where the high-frequency data will reveal the size and extent of the economic slowdown. All-in corporate bond yields might not move much during this phase, but rather we see a redistribution of interest rate and credit risk. Typically, the correlation between credit and rates markets is negative – corporate bond yields are often sticky with higher rates being absorbed into credit yields through lower spreads. This relationship does sometimes break down, as we saw in March and June of this year (*Credit Watch*, Jul 28th).

In Europe, we revised our YE spread targets wider to 250bp in HG and 750bp in HY. This implies 45bp and 110bp of widening over the remainder of the year. That said, valuations have run ahead of credit metrics and investor positioning is cautious already, implying a slower path to wider spreads. Risk markets have been supported by expectations for an earlier pause in central bank tightening. With inflation running at c.9%, rate futures are now pricing fewer hikes than our economists expect (*European Credit Weekly*, Jul 29th).

Currencies

We do not see lower US rates on any incremental Fed dovishness as a threat to the dollar amid rising recession risks. USD typically rises in recessions, even as the Fed cuts aggressively, and is principally rooted in economic weakness outside the US that is largely Fed invariant. Business surveys are sliding in Europe, and are coupled with another sharp rise in natural gas prices. In China, the Politburo meeting disappointed hopes of big bang policy stimulus.

We stick with our USD net length, reflecting first and foremost ongoing global growth softness. But if growth concerns continue to weigh on yields, JPY can perform. We increase long JPY exposure in options vs EUR. Adding JPY is also consistent with our late-cycle framework and August seasonality. We remain short euro bloc (via EUR/USD, GBP/USD & EUR/CHF); long USD vs high-beta; long JPY vs KRW & NZD; long AUD/NZD, and UW EM FX (*FXMW*, Jul 29th).

Commodities

A recession is not yet priced in oil markets. Historical evidence suggests that demand is well supported as long as global growth remains positive, but oil price tends to fall in all recessions by 30 to 40%. Oil prices are down ~20% from their March peak, but we believe much of this is due to a re-pricing of the likelihood of worst case scenarios for Russian export volumes. Under a 1.5% global growth scenario, slower oil demand growth would cause stocks to normalize back to 2015-19 average levels by the end of 2023. That pace of stock builds could not only eliminate the price support provided by low inventories, but also cause the Brent forward curve to shift from its current steep backwardation into contango. Shortages of natural gas in Europe and the resulting spike in global LNG prices should trigger significant switching to other sources of energy. We increase our estimates for oil demand from gas to oil switching over the winter, which is offset by normalizing Libyan supply, resulting in a largely balanced global oil market in 4Q22, followed by a 1 mbd stock build in 1Q23. We keep our price forecast unchanged and see oil in the low-$100s in 2H22 and high-$90s in 2023 (*Oil Weekly*, Jul 27th).

Near-term relief rally in Metals to eventually fade as winter brings intensifying demand woes and another push lower in prices. The recent firming in base metals prices is likely to extend near-term on improving China demand, but will likely prove temporary as ex-China demand risks continue to escalate. We see prices ultimately moving lower to bottom out in 4Q22 and 1Q23 at ~$6,500/mt for copper and ~$2,250/mt for aluminum, given weaker demand and risks of oversupply (*Base Metals*, Jul 29th).

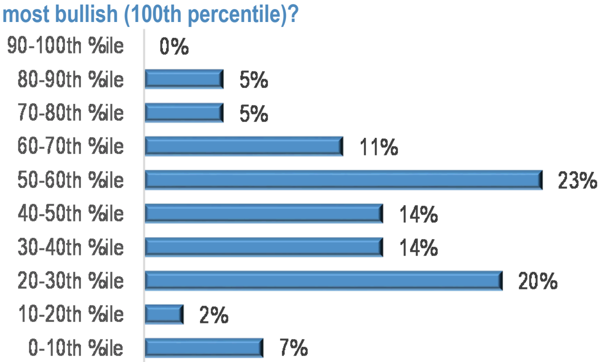
Record heat evaporates Freeport storage cushion. Asymmetric upside risk is very much a part of the US natural gas narrative for the remainder of summer until demand destruction will manifest. We maintain our current outlook for US natural gas price: $7.75/MMBtu average for 3Q22 versus the quarter averaging ~$7.50 so far, with relative price weakness likely to manifest for summer 2023 (*Global Commodities*, Jul 28th).

JPM Clients' View

[Click here to take this week's survey]

This week, we poll investors on a US recession, the Fed, and housing prices, in addition to our running survey questions on equity positioning/sentiment, and intentions for near-term changes to equity allocation and bond duration. The results from the last survey are shown below[1].

Figure 1: What is your current equity positioning or sentiment in historical terms, expressed from most bearish (0th percentile) to most bullish (100th percentile)?

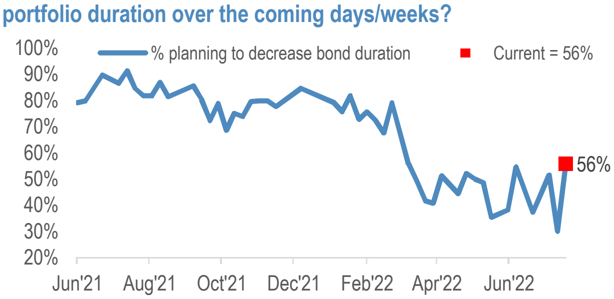


Source: J.P. Morgan.

Figure 2: Are you more likely to increase or decrease equity exposure over the coming days/weeks?

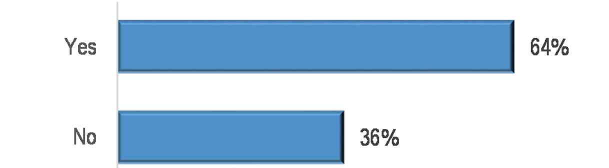
Source: J.P. Morgan.

Figure 3: Are you more likely to increase or decrease bond portfolio duration over the coming days/weeks?



Source: J.P. Morgan.

Figure 4: Do you think the recent mortgage suspensions in China will pose significant downside risk for Chinese housing?

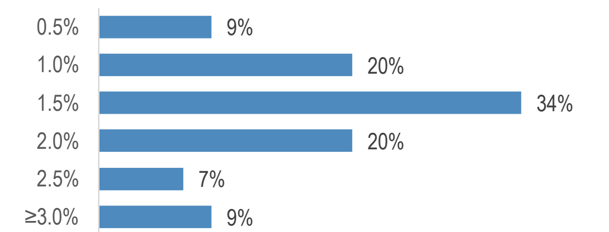


Source: J.P. Morgan.

Figure 5: What do you expect will happen for European gas pipeline imports over the rest of the year?

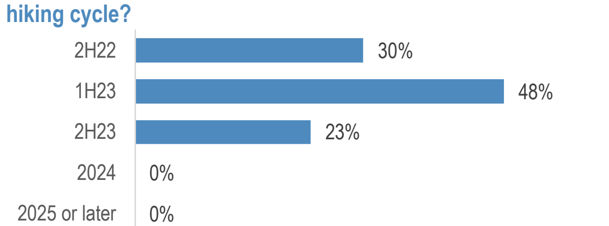
Source: J.P. Morgan.

Figure 6: At what level do you think the ECB rate hiking cycle will peak?



Source: J.P. Morgan.

Figure 7: When do you think ECB rates will peak in the current hiking cycle?



Source: J.P. Morgan.

[1] Results are based on 44 responses received from clients in our survey conducted Jul 25-Aug 1st

Whether it's earnings or the Fed, we see a reset of investor expectations

Risk markets were up last week while Bonds yields moved lower. Despite a weak activity dataflow (e.g. US 2Q GDP), Equities globally moved up (MSCI ACWI +2.2%) helped by lower Bonds yields, strong earnings releases and technicals (bearish sentiment/defensive positioning). In DM, the US (+4%) outperformed, while Latam stocks were top performers within EM. Credit spreads were generally tighter. A somewhat dovish FOMC meeting together with higher Gas prices in Europe (front TTF contract around 200 EUR/Mhw) intensifying growth risks in the region weighed on Bonds. 10Y yields fell in Germany (-20bp) more than in the US (-12bp). At the same time, inflation breakevens moved higher, driven by the front-end. The price rally in the Commodities complex was broad-based and led by Agri (+3.6%) and Industrial Metals (+3.9%). The trade-weighted dollar was down for a second week amid some notable strength in JPY, NOK and GBP. Finally, volatility remains elevated but moved lower across the board.

Not a true pivot but a sign that peak hawkishness could be behind. As expected, the FOMC last week raised the funds rate target range by 75bp to 2.25%-2.50%, but what was more surprising for markets were the hints that we're closer to the end than the beginning of this tightening cycle. The Funds rate is now at the Committee's estimate of neutral and during the meeting the Chair mentioned that "at some point it will be appropriate to slow down". The FOMC also acknowledged signs of growth slowing and while a true pivot will still need "compelling evidence" of inflation moving down, Powell indicated that growth data will also play into their decisions. Overall, we feel comfortable with seeing another 100bp in hikes by the end of this year, but it's also important to acknowledge how market expectations are evolving (Figure 8). Compared to mid-June, OIS swaps now anticipate a lower peak in Fed Fund rates and a quicker and deeper reversal of hikes. At the same time, the Fed June Dot plot is more in line with mid-June OIS markets than the latest market pricing, so it will be interesting to see if this will spur some changes to the Dot plot in September.

Certainly there is no lack of fundamental reasons for some reassessment. For starters, the normalization process has already brought policy from highly expansionary to neutral and not far from what's implied by a simple Taylor rule with unemployment and inflation expectations (Figure 9). Hence, the urgency and scope for tightening policy should now be lower. At the same time, both market-based and some survey-based inflation expectations readings signal a moderation in realized inflation in the US. Historically, they had a decent predictive ability in leading realized inflation (Figure 10). Further, the economy is losing momentum and our recession probability models are picking up the increased likelihood of a recession. Last week, 2Q GDP at -0.9% in the US disappointed expectations and was the second consecutive quarter of negative growth. Perhaps not even the last if one believes the Atlanta Fed GDP nowcast, which currently points at -1.2% in 3Q22. This could reinforce speculation that the economy is already in recession, which for us is odd given that job growth averaged 375,000 per month last quarter. That said, the silver lining if the economy enters into a recession could be an inflation dividend (Figure 11).

Inflation shock and gas concerns prompt downward growth revisions in Europe. Despite a strong (and above expectations) 2.8% ar 2Q GDP gain in the Euro area, we revised downward our growth projections for the region and now expect a mild GDP contraction in 4Q22-1Q23 (-0.5%q/q ar). Meanwhile, last week's surprises on both the growth and inflation front should allow the ECB to deliver a 50bp hike in September, followed by a pause in October as by that time it may be clearer that the Euro area economy is heading into outright contraction. These changes reflect that the outlook for gas supply to the region has become even more uncertain, US recession fears have increased, and, more recently, Italian political uncertainty rose. Our projections assume gas prices at €150/MWh, which likely requires that gas flows through Nord Stream 1 hold at around 40% of normal. However, the situation is fluid and unpredictable, as the latest announcement of a cut of Nordstream flows to 20% of normal suggests (Figure 12). For context, in 2021, the share of total primary energy consumed in Europe coming from gas was about 25%. Out of the about 400bcm of gas consumed in a year, roughly 300bn are imported and 50% of that came from Russia (155bcm). Right now gas storage is around 70% and looks in line with previous years (a positive); however, storage generally doesn't cover more than a quarter of consumption, so it remains to be seen where gas flows ultimately settle. Even if the disruptive scenario of gas rationing is avoided, consumption may be somewhat constrained. The latest contingency plans from the EC goes into the direction of coordinated gas savings.

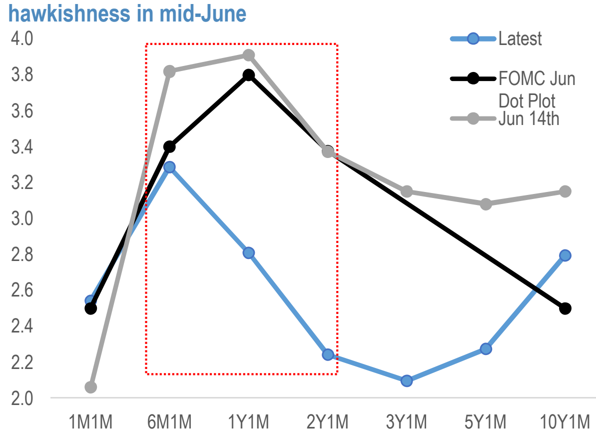
Hence, we stay cautious on Europe despite the fact that many European markets already discount substantial pessimism. This pessimism is visible in relative valuations. For example, in Equities, valuations (based on 12m forward P/E ratio) for US large caps are in line with their long-term median while they sit in the bottom 20%ile for EMU stocks (Figure 13). In Credit, the differential between EUR and US BBB spreads is now at close to 10Y highs and back to levels last seen during the EMU sovereign crisis (Figure 14). Finally, EUR/USD is also close to 20Y low. That said, risk premium don't seem excessive and there hasn't been any substantial improvement to the outlook so far. Hence, for now, we would only buy front-end breakevens and like to stay OW duration in Europe vs US.

Despite bears expecting earnings to drop sharply to reflect a slowdown, stocks have bounced since the start of the earnings season, an indication that the recent worries have been fully digested. Earnings overall surprised on the upside from the consensus, even as many were sure that consensus will not be met. Stocks are outperforming despite the earnings season appearing to be a slight disappointment relative to recent quarters. As to why the market has done well despite the middling results, there has been the sense that earnings have to ratchet down to be more in line with the economic slowdown or recession worries. In fact, in some respects, earnings have sent a positive signal with good results in Consumer Discretionary indicating the consumer is not in such bad shape, despite consumer confidence at lows. The slowdown has been fairly gradual so assuming the Fed takes this into account, the risk of crashing the economy and financial market is less now. The consensus was that the slowdown may be more abrupt, so by comparison, a gradual slowing is incrementally good news.

The equity decline YTD is entirely due to multiple compression rather than negative earnings. Arguably a good portion of the adjustment in earnings has already happened, with the good results in Energy masking softness in other sectors e.g. Financials, Consumer, Communications. To put things into perspective, US, earnings and sales beats have rolled over to the historical averages compared to the highs we saw in 2021 (Figure 15). However, the reaction function has only worsened, with beats producing a 1d performance of +0.4% and misses resulting in -2.3%, i.e. a shorter carrot and a longer stick than recent years (Figure 16).

Relating earnings season to key concerns for the stock market, such as the strong dollar, inflation, and Fed hawkishness, we are sympathetic to the idea that the worst days are behind us. While our FX team is bullish the dollar to year-end, thanks to interest rate differentials and a slowing global economy, their forecast for the DXY is roughly back to current level in 9-12 months. As for inflation, we note the strong ECI print at 5.1% affirms the concern that wage growth will eat into margins. We acknowledge this erosion will happen, albeit gradually, and with a starting point for margins at high levels. As for the Fed, the first 75bp hike in June was more difficult to digest on the back of a hot jobs and CPI print, but the second 75bp hike presupposes an activity slowdown as a given. The bull steepening during the post-meeting press conference indicates the market believes the Fed will slow its pace of hikes into the fall. The hope of a more balanced Fed has seen the MOVE index roll off its highs and the VIX break through multi-month lows. In the meantime, global yields have rolled over meaningfully, thanks to recessionary worries. Effectively, the stock vs bond risk premium has widened for the wrong reasons, i.e. growth concerns. A well-behaved roll-down in the jobs numbers into year-end and a moderation in inflation would indicate the Fed has achieved its objective, whereas a sudden upward jolt in the claims numbers would send a bad message. The cross asset valuation metrics reflect this balance of risks, and the positive interpretation of the resulting wider stock vs bond risk premium is that it can revert as cross asset volatility levels decline, which seems warranted as the Fed's path seems clearer. Whether it's earnings, the Fed, or the economy, the recent headwinds are fully priced in which should reset investors' expectations, moderate volatility, thus allowing the currently wide risk premia to come in.

Figure 8: Market expectations have changed a lot from peak hawkishness in mid-June

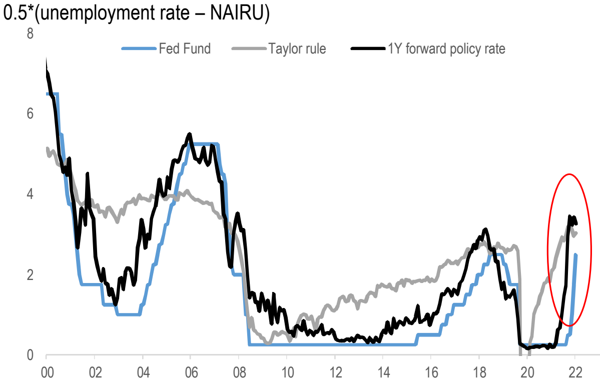


Source: J.P. Morgan

Marko Kolanovic, PhD; Nikolaos Panigirzoglou; Bram Kaplan, CFA; Thomas Salopek; Federico Manicardi; Mika Inkinen; Amy Ho

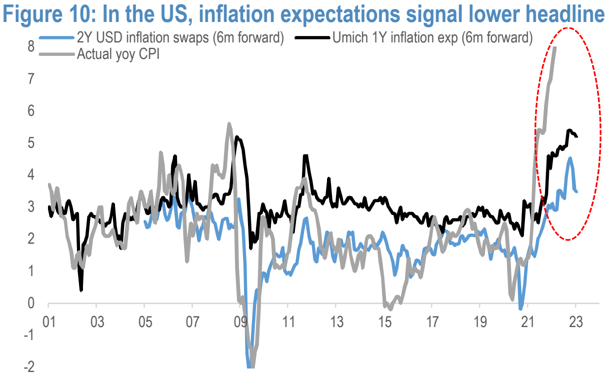
Figure 9: Market expectations are close to implied rates

Taylor rule = 2% + neutral real rate of interest + 0.5*(10Y exp inflation – 2%) - 0.5*(unemployment rate – NAIRU)



Source: J.P. Morgan

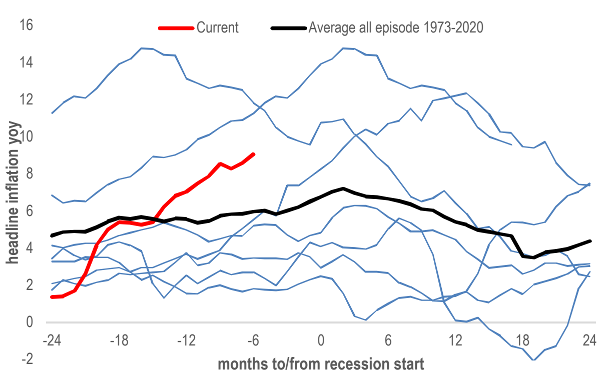
Figure 10: In the US, inflation expectations signal lower headline



Source: J.P. Morgan

Figure 11: The inflation dividend from recession

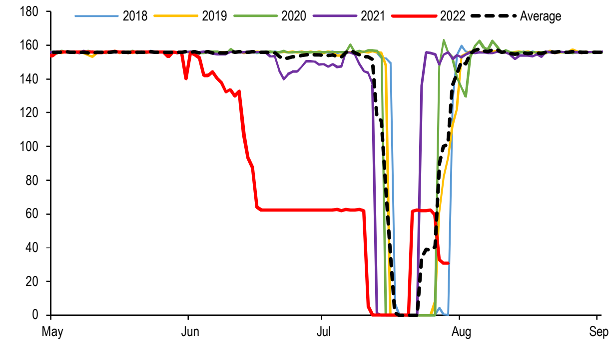
yoy headline inflation around start of US recession.



Source: J.P. Morgan

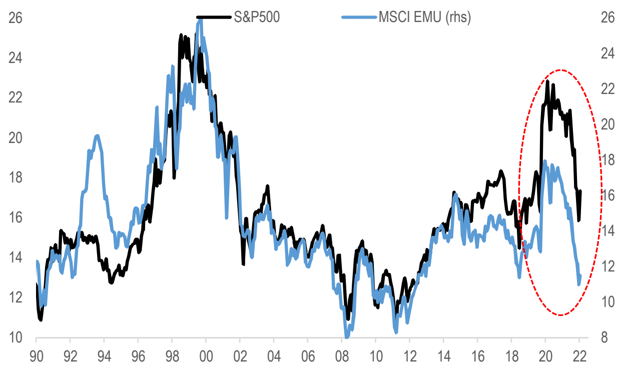
Figure 12: Gas flows remain near 20% capacity

NordStream gas flows



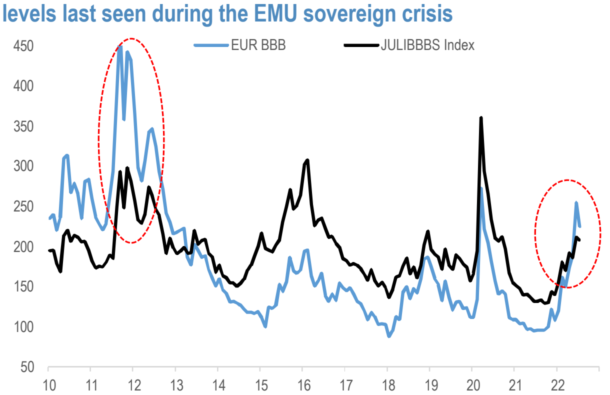
Source: J.P. Morgan

Figure 13: US valuations are in line with long-term median while EMU stocks are in the bottom 20%ile.



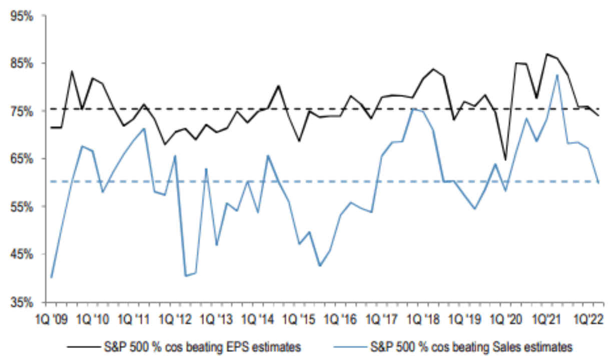
Source: J.P. Morgan.

Figure 14: In relative terms, EUR vs USD BBB spreads are to levels last seen during the EMU sovereign crisis



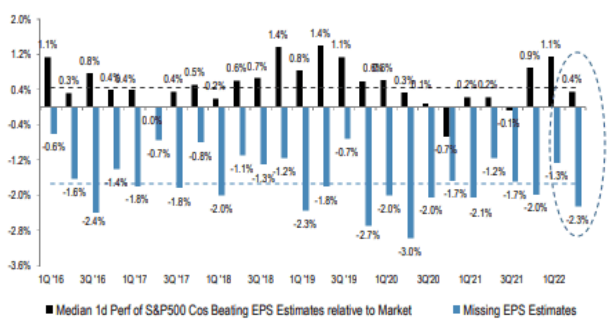
Source: J.P. Morgan.

Figure 15: % of S&P500 companies beating quarterly EPS and sales estimates



Source: J.P. Morgan.

Figure 16: US stock price reaction* to quarterly EPS beats/misses



Source: J.P. Morgan.

Global Research Digest

Macro & Cross-Asset Views

Global Equity Strategy: Equity Valuation - Multiples vs. Rates and Growth, Dubravko Lakos-Bujas

The current equity multiple of 16.9x is in-line with historical median and we believe the market multiple is better than fairly valued given the shift in industry mix to higher quality companies over the last two decades. S&P 500 has seen the second sharpest P/E de-rating of the past 30 years at -6.7x (vs. average of -4.5x compression seen during prior recessions) and traded as low as ~15.5x during June. Further, the equity decline has been entirely due to multiple compression rather than negative earnings. While equity valuation is a poor timing signal in the short term, it can help frame the upper/lower trading range of the market over the medium term. Historically, during periods where real GDP growth was low (e.g., 1-2%), S&P 500 multiples were supported until 10yr bond yields reached 3.5-4%.

Flows & Liquidity: High cash balances seem unsustainable, Nikolaos Panigirtzoglou

We believe that similar to 2017/2018, the overall lack of competition for deposits among banks should make the transmission of the Fed policy rate to bank deposit rates rather slow in the current juncture, especially if, similar to 2019, the Fed starts reversing its policy rate in 2023 as rate markets currently suggest. Cash will continue to offer close to zero yield overall despite the Fed policy rate likely to exceed 3% by year end. Combined with higher bond and equity yields, this implies that the opportunity cost of holding cash has risen markedly this year, making it more difficult to sustain current high cash balances.

China Macro, Banks & Property: Media-reported RE rescue fund would be marginally positive, but unlikely a quick fix to ease concerns, Katherine Lei

Recent media reports on mortgage payment holiday, special bonds on shanty-town development, and RE rescue fund may suggest that the Chinese government is actively considering different proposals. If the stabilization fund materializes, we think it would be marginally positive for developers as this shows the central government is starting to address the issue; and this marginally eases the liquidity issue of distressed developers. This development, if confirmed, would be positive for banks with higher developer exposure or banks that have underperformed peers since the mortgage suspension movement.

Global Economics and the Recovery from COVID-19

Global recession risks visible in the not-so-goods sector, Joseph Lupton

Diminished purchasing power through the past year due to constantly rising inflation has led to an outright contraction in final demand recently, and as a result global factory output has declined in the last quarter. While the ongoing reversal in the COVID related slump in China and boost to US purchasing power from falling gasoline prices could be a tailwind for global goods sector in the current quarter, any lift may not be sustainable. A sharp slide in consumer & business sentiment, along with a slowdown in the pace of stock building in response to fading orders could also weigh on the global goods sector.

An odd year keeps getting odder, Michael Feroli

The US economy contracted at a 0.9% annualized pace, disappointing expectations, and the details in the report shows the economy is clearly losing momentum. Much of the weakness can be attributed to interest sensitive categories of final demand that includes housing, consumer durables, and business spending. However, the much-weaker-than-expected number for inventory accumulation implies more potential lift from stock-building in 3Q. Finally, if there were such a thing as a “productivity recession” there would be no debate that we are in one; after contracting at a 7.4% pace in 1Q, nonfarm business output per hour looks to be down at a 6.0% rate last quarter.

Powell gets nicer at neutral, Michael Feroli

As widely expected, the Fed hiked 75bp to 2.25-2.50% in response to continued high inflation prints and we feel comfortable seeing another 100bp in hikes by the end of this year, consistent with the dots. As for the September meeting, the two headline CPIs between now and then should be a little cooler (due to energy prices) and it’s reasonable to expect slowing in the pace of monthly job growth. Given the outlook, we continue to expect the Fed to hike 50bp for the September meeting, even though the Chair left open the door to 75bp.

Euro area: Expansion runs out of gas, Greg Fuzesi

We expect GDP growth to slow to 0.5%ar in 3Q22 (previously 2%) and contract -0.5%ar in 4Q22 and 1Q22 considering higher European natural gas prices (€150/MWh), reduced gas supply, and Italian political risks. Provided the GDP contraction is mild and shortlived, we expect unemployment to rise modestly by 0.3%-pt to 7%, with slow declines resuming later in 2023. The core inflation momentum is also likely to moderate to 2% by end-2023, possibly setting up a move to slightly below target in 2024.

US: New home sales disappoint in June, Daniel Silver

As demand for housing has come off, we think the rate of home price appreciation should cool, and the weakening in the data on new home sale prices is somewhat consistent with that idea. The new home sales declined by 8.1% in June slightly above its April 2020 trough. Furthermore, more reliable gauges of house prices (i.e., FHFA and Case-Shiller) showed stronger readings through May.

Global Market Implications

The late-cycle FX playbook: A summary, Patrick R Locke

We refresh our late-cycle FX playbook as global momentum continues to wane and note that USD, CHF, JPY & SGD are historically the top performers around recessions. Recent USD strength is consistent with a global slowdown but does not appear to bake in a large risk premium for a deeper recession, while JPY presents the most value as a late-cycle hedge when considering positioning, valuation and growth sensitivity. We are strategically long USD & CHF. We hold long-JPY, but on crosses and primarily through longer-dated, deep OTM tail-risk hedges. We hold core shorts in NZD in cash and options.

EM Fixed Income Focus: Signs of complacency emerging in local markets following a relief rally, Jonny Goulden and Saad Siddiqui

Negative real rates in EM during a time of worsening global growth, sky-high inflation, tightening financial conditions and EM portfolio outflows suggest complacency and will likely keep pressure on EM currencies and the very front end of local rates curves despite a more supportive longer-end duration environment in countries with lower vulnerabilities that can trade with DM. We are still defensively positioned and into low summer liquidity we are running a reduced EM FX short, with a MW view in EM rates and EM credit.

Credit Watch: Fast But Less Furious - Sequencing, all-in yields and balancing credit and interest rate risk, Stephen Dulake and Saul Doctor

Typically, the correlation between credit and rates markets is negative – corporate bond yields are often sticky with higher rates being absorbed into credit yields through lower spreads. This relationship does sometimes break down, as we saw in March and June of this year. The existence of liquid credit ETF options along with CDS and Rate Swaptions allows us to see the markets forward-looking view of correlation. We also now see a differential between how the investment grade and high yield markets are viewing future rates-credit correlation.

Sector Level Views

Coinbase and Robinhood: The Ongoing Cost to Shareholders of a 70%-75% Decline in Stock Price – a Matter of Dilution, Kenneth B. Worthington, CFA

We expect Coinbase and Robinhood will reduce the equity granted to employees in the form of RSUs, but we estimate share creep from RSU issuance will drive dilution to a still substantial 7% pace annually in coming years. While equity remains a large component of compensation, we estimate that level of share issuance and dilution would reduce that value of each company to existing shareholders by 30% were 7% dilution to persist for five consecutive years.

Machinery Sector: FA Industry: Emergence of New Demand and Corporate Innovation During Downcycle, Tomohiko Sano

We believe the current downcycle for the factory automation (FA) subsector could highlight key issues in various industries and encourage solutions and innovations, creating an ideal time for testing and improving new areas of automation demand and corporate innovations, and offering good entry points for high-quality companies. Our preference order is Keyence, SMC, Yaskawa Electric, THK, and finally Fanuc.

Uniper: Where is the support?, Vincent Ayral

With the recent Russia/Ukraine developments, Uniper's Russian assets may end up stranded depending on the outcome, and the utility's Russian c.200TWh pa gas supply contracts have been partially curtailed. We attribute a zero valuation to Unipro (Russian generation) and assume zero valuation to future potential synergies which could be unlocked by a domination from Fortum as this scenario seems unlikely for the time being. We downgrade our recommendation to UW.

Strategy & Forecasts

GAA Long Only Model Portfolio

Asset Classes		Active Weights	UW | OW
Equities		12%	
Govt. Bonds		-9%	
Corp. Bonds		-8%	
Commodities		7%	
Cash		-2%	
Sectors		**Active Weights**	**UW | OW**
Equities	US	-3%	
	EMU	-3%	
	Japan	0%	
	UK	1%	
	EM	5%	
	Other	0%	
Govt. Bonds	US Nominal	-4%	
	US TIPs	0%	
	Europe Core	3%	
	Europe Periphery	-1%	
	Japan	2%	
	UK	0%	
	EM Local	0%	
	Australia	0%	
Corp. Bonds	US HG	0%	
	Europe HG	-2%	
	UK HG	0%	
	US HY	2%	
	Europe HY	-1%	
	US Loans	1%	
	EM Sovereigns	2%	
	EM Corporates	-2%	
Commodities	Energy	4%	
	Industrial metals	0%	
	Agriculture	2%	
	Precious metals	-4%	
	Livestock	-2%	

Equity sector recommendations and YTD returns

	US		Europe		Japan		EM	
Energy	38%	OW	22%	OW	32%	N	-25%	OW
Materials	-14%	N	-12%	OW	-6%	N	-18%	OW
Industrials	-12%	N	-16%	OW	-4%	OW	-11%	N
Discretionary	-25%	N	-16%	N	-5%	OW	-16%	OW
Staples	-2%	UW	-2%	UW	1%	N	-11%	UW
Healthcare	-6%	OW	2%	UW	0%	UW	-20%	UW
Financials	-15%	OW	-10%	OW	12%	OW	-8%	OW
Technology	-20%	N	-23%	N	-17%	N	-27%	N
Comm Service	-29%	N	0%	OW	12%	UW	-24%	N
Utilities	4%	UW	-4%	N	33%	UW	-2%	UW
Real Estate	-13%	UW	-22%	UW	9%	N	-17%	N
Overall	**-15.0%**		**-7.9%**		**-2.0%**		**-18%**	

Source: J. P. Morgan, Bloomberg Finance L.P.

JPM Forecasts

Rates	Current	Sep-22	Dec-22	Mar-23	Jun-23
US (SOFR)	2.28	2.45	3.20	3.30	3.30
10-year yields	2.63	3.25	3.10	3.00	2.85
Euro area (depo)	0.00	0.25	0.75	1.25	1.50
10-year yields	0.82	1.20	1.00	0.95	0.90
Italy-Germany 10Y (bp)	221	180	200	210	170
Spain-Germany 10Y (bp)	110	95	100	100	85
United Kingdom (repo)	1.25	2.00	2.25	2.50	2.75
10-year yields	1.86	2.30	2.35	2.15	2.00
Japan (call rate)	-0.10	-0.10	-0.10	-0.10	-0.10
10-year yields	0.18	0.25	0.25	0.25	0.25
EM Local (GBI-EM yield)	6.93		7.05		
Currencies	**Current**	**Sep-22**	**Dec-22**	**Mar-23**	**Jun-23**
JPM USD Index	130	132	133	133	133
EUR/USD	1.02	0.95	0.97	1.00	1.02
USD/JPY	133	138	140	139	138
GBP/USD	1.22	1.14	1.15	1.16	1.17
AUD/USD	0.70	0.68	0.7	0.72	0.74
USD/CNY	6.74	6.75	6.80	6.85	6.95
USD/KRW	1299	1320	1340	1360	1360
USD/MXN	20.39	20.00	20.25	20.50	20.75
USD/BRL	5.19	5.10	5.30	5.25	5.25
USD/TRY	17.92	19.00	20.00	21.00	22.00
USD/ZAR	16.65	16.00	16.25	16.50	16.75
Commodities	**Current**	**Sep-22**	**Dec-22**	**Mar-23**	**Jun-23**
Brent ($/bbl, qtr end)	104	104	101	95	94
WTI ($/bbl, qtr end)	98	101	98	91	90
Gold ($/oz, qtr avg)	1,773	1,800	1,720	1,670	1,550
Copper ($/ton, qtr avg)	7,771	7,700	6,500	6,500	6,700
Aluminum ($/ton, qtr avg)	2,464	2,500	2,250	2,250	2,350
Iron ore (US$/dt, qtr avg)	117	140	125		
Wheat ($/bu, qtr avg)	8.1	12.5	12.5	12.0	11.5
Soybeans ($/bu, qtr avg)	14.9	17.0	16.5	16.3	16.0

Credit		Current	Dec-22
US High Grade (bp over UST)	JPM JULI	170	175
Euro High Grade (bp over Bunds)	iBoxx HG	204	250
US High Yield (bp vs. UST)	JPM HY	549	525
Euro High Yield (bp over Bunds)	iBoxx HY	641	750
EM Sovereigns (bp vs. UST)	JPM EMBIGD	544	575
EM Corporates (bp vs. UST)	JPM CEMBI	404	375
Equities		**Current**	**Dec-22**
S&P 500		4,124	4,800
MSCI Eurozone		231	275
FTSE 100		7,423	8,150
TOPIX		1,940	2,100
MSCI EM ($)		998	1,300
MSCI China		69	116
MSCI Korea		746	980
MSCI Taiwan		584	780
MSCI India		1,969	2,000
Brazil (Ibovespa)		103,682	125,000
Mexico (MEXBOL)		48,256	54,400
MSCI South Africa (USD)		420	521

Source: J.P. Morgan, Bloomberg Finance L.P., Datastream.