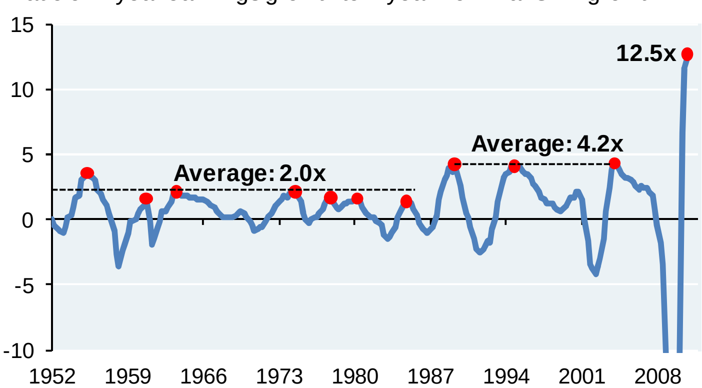
Retractions: US earnings growth, the Euro, and the primary catalyst for the US housing crisis

By May of each year, we get a sense for where we need to revise expectations. Several things panned out as we expected in January (stocks outperforming bonds; another good year for credit; an M&A rebound, benefiting certain hedge fund and mid cap equity strategies; Japan underperforming other regions; another leg to rising commodity prices; a rise in Asian currencies versus the dollar; and the resilience of municipal bond prices in the face of selling and notable skeptics [see EoTM Feb 14]). But this note is not about that, it's about expectations we need to revise. This week: a note on **Retractions of Prior Views**.

US large cap operating earnings growth in 2011 may exceed our 10% forecast

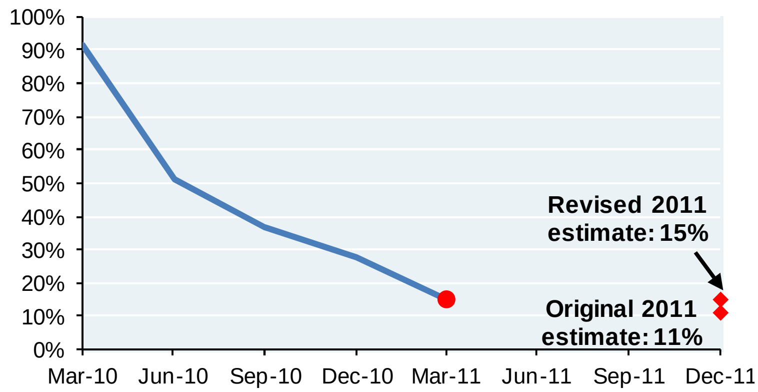
We showed the first chart below last week. It highlights how atypical this earnings cycle has been relative to weak nominal GDP growth. We had been forecasting 10% earnings growth for 2011, but now it looks like earnings growth will exceed these levels. To put this exercise in context, consider the second chart. After earnings collapse in a recession, they tend to rebound sharply, with earnings growth tailing off after a year or two. By the end of Q1, year-on-year earnings growth will have slowed to 15% from 90% in March 2010. Estimating earnings growth for all of 2011 is like projecting where a large boulder will stop rolling after having been released from the top of a hill. It now looks like it will roll a bit further than we thought.

US profits recovery outpacing economic recovery
Ratio of 2 year earnings growth to 2 year nominal GDP growth



Source: Standard & Poor's, Bureau of Economic Analysis. J.P. Morgan PB.

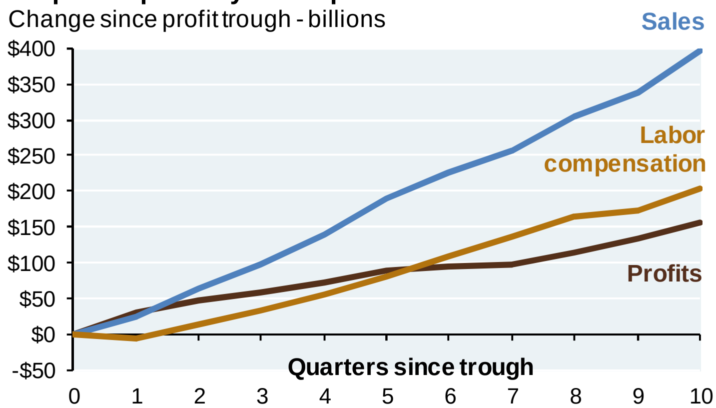
Where will the earnings boulder stop rolling?
S&P 500 quarterly operating earnings per share, % change - YoY



Source: Standard & Poor's.

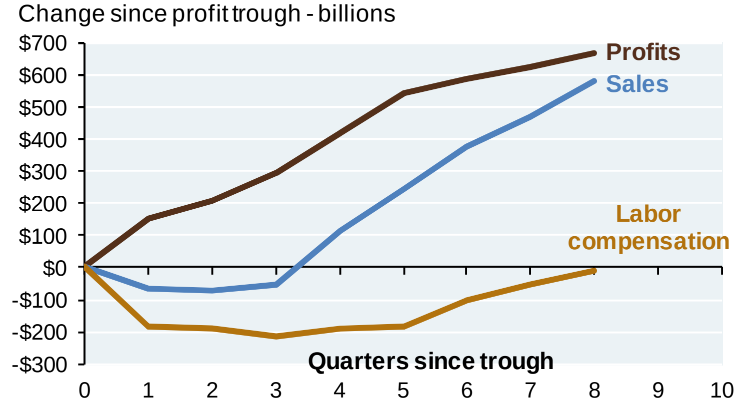
Before we discuss the implications of rising earnings projections, let's look one more time at the drivers of corporate profits during this recovery. In the 5 prior earnings recoveries, sales rose, labor compensation rose as well (though not as fast as sales), resulting in rising profits (see first chart). In the *current* cycle, labor compensation is unchanged after two years given the abysmal condition of the job markets (second chart). As a result, almost the entire increase in sales flows through to bottom-line profits. This is what is referred to as "*high incremental margins*", a topic we wrote about in April of 2010.

Corporate profit cycle - 5 past recoveries
Change since profit trough - billions



Source: Bureau of Economic Analysis, J.P. Morgan PB.

Corporate profit cycle - current recovery
Change since profit trough - billions



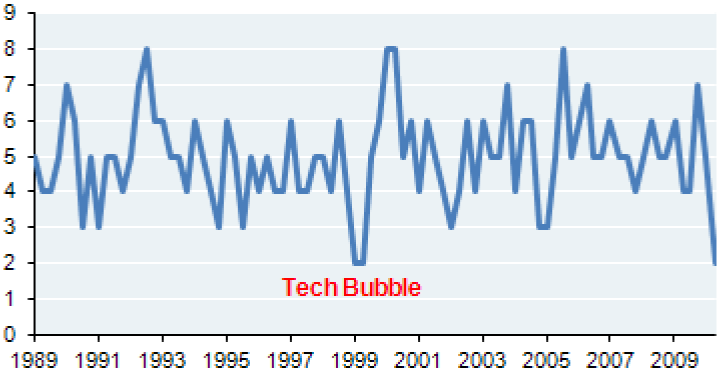
Source: Bureau of Economic Analysis, J.P. Morgan PB.

The profits recovery is not *entirely* a story of lower labor costs. As shown above, sales are rising. But the labor compensation picture, in our view, throws some cold water on the valuation implications of corporate profits right now. The reason: **weak labor compensation has resulted in outsized government transfers to households and businesses, and the largest fiscal deficits in decades**.

Retractions: US earnings growth, the Euro, and the primary catalyst for the US housing crisis

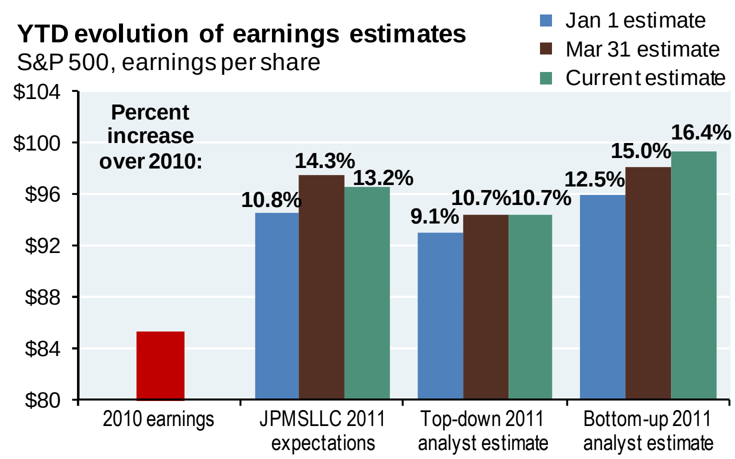
In terms of breadth, the profits recovery is spread across sectors. So far in Q1 2011, with 2/3 of companies reporting, 78% are outperforming estimates, with earnings beating estimates by around 5%. The outperformance is spread across all sectors, with the best performance (vs expectations) from Technology, Healthcare, Industrials, Materials and Consumer Discretionary. **Three cautionary notes, however**. First, rising energy earnings (up ~40% in Q1) may eventually have negative feedback loops for other sectors. Second, energy and industrials were the only sectors to outperform the S&P 500 on a price basis in Q1, resulting in the narrowest market leadership since 1999 (see chart below). And third, financial sector profits benefitted from the reduction in loan loss provisions, which is a lower-quality source of earnings than top-line increases in loan demand.

Number of sectors outperforming the S&P 500
Quarterly basis



Source: Bloomberg.

YTD evolution of earnings estimates
S&P 500, earnings per share



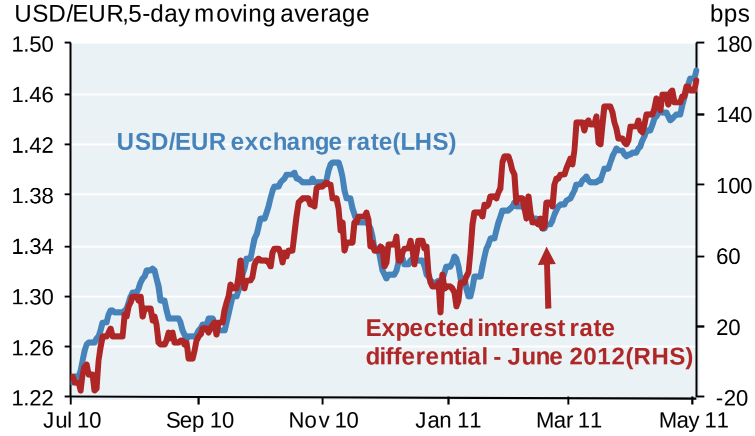
Source: S&P 500, J.P. Morgan Securities LLC, Bloomberg.

How much earnings growth should we expect in 2011? The second chart shows the evolution of earnings forecasts this year from company analysts, market strategists, and J.P. Morgan Securities. Even without factoring in any multiple expansion, earnings growth of 13% to 15%, times a forward P/E multiple of 14x-15x, yields an S&P 500 valuation range of 1,350 to 1,470. The higher end of earnings growth and P/E multiple ranges would result in 17% returns this year. While the 16% bottoms-up estimate looks high to us, 2011 earnings growth is likely to exceed the 10% expectations we had in January. M&A trends and stock buybacks are helping as well; global M&A volumes are up 18% from 2010, and announced stock buybacks are on pace to double. **There are still uncertainties related to energy prices, China slowing and tightening across the developing world, the collapsing dollar and the debt ceiling (now pushed to August due to better than expected Treasury tax receipts).** As a result, we are not making major changes to overall equity and hedge fund allocations from levels shown on April 18[1].

<u>The Euro continues to rally, reflecting widening Fed and ECB policy differences we did not expect</u>

We did not have a strong view on the US$/Euro exchange rate heading into 2011, but perhaps we should have. As shown, the Euro has been moving lock step with interest rate differentials between the two regions. Since January, these rate differentials widened again, and the Euro rallied from $1.30 to $1.48. Why are policy rate expectations for 2012 so much higher in Europe than in the US? Tight German labor markets[2], and a focus on rising energy prices and headline inflation by the ECB, mostly. On the other hand, the Fed appears content to sit tight and let Bernanke's "Portfolio Rebalancing Channel" (e.g., rising stock prices) run a bit more, since the Fed's reading of US *core* inflation is benign, and believes that rising energy prices are "transitory". When considered in local currency terms, European equities trail the US and Asia ex-Japan this year (as they did in 2010). But after factoring in the higher Euro, European equities generated the highest returns by region in 2011. Our view is that the ECB will not tighten as much as the markets expect (6 times by June 2012), which should slow the Euro's appreciation vs. the dollar.

Exchange rate has moved with interest rate expectations
USD/EUR, 5-day moving average



Source: Bloomberg, J.P. Morgan PB.

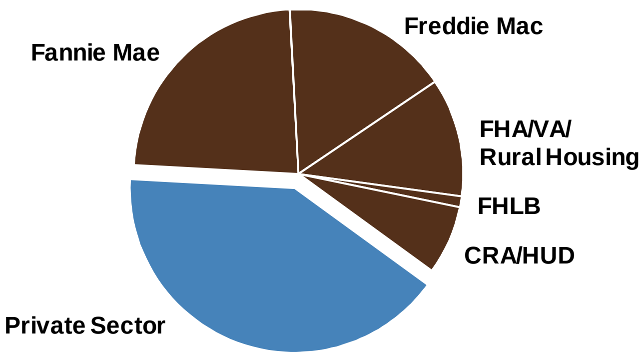
[1] For example, for appropriately sized Balanced portfolios we allocate 34% to public equities, 25% to hedge funds and 3% to private equity.
[2] Tight labor markets in Germany (a record number of job vacancies in April) and Spanish unemployment rising to 21.3%? With strong growth and an aging population, Germany needs around 400,000 immigrants per year to maintain labor productivity. For historical reasons, job-seekers are more likely to come from Poland than from Spain, highlighting structural tensions in the European Monetary Union.

Retractions: US earnings growth, the Euro, and the primary catalyst for the US housing crisis

<u>US Agencies played a larger role in the housing crisis than we first reported</u>

In January 2009, I wrote that the housing crisis was mostly a consequence of the private sector. Why? US Agencies appeared to be responsible for only 20% of all subprime, Alt A and other mortgage exotica[3]. However, over the last 2 years, analysts have dissected the housing crisis in greater detail. What emerges from new research is something quite different: government agencies now look to have guaranteed, originated or underwritten 60% of all "non-traditional" mortgages, which totaled $4.6 trillion in June 2008. What's more, this research asserts that housing policies instituted in the early 1990s were explicitly designed to require US Agencies to make much riskier loans, with the ultimate goal of pushing private sector banks to adopt the same standards. To be sure, private sector banks and investors are responsible for taking the bait, and made terrible mistakes. Overall, what emerges is an object lesson in well-meaning public policy gone spectacularly wrong.

Exposure to Subprime and Alt-A loans using AEI expanded definition, Percent of total as of June 30, 2008

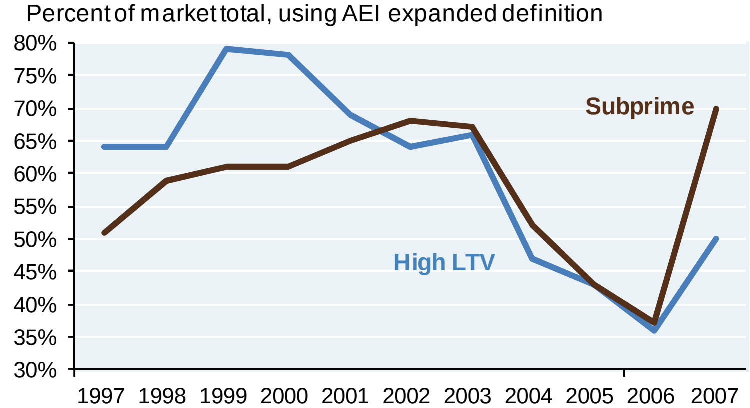


Source: American Enterprise Institute.

Sources

- Edward Pinto, "*Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study*", November 2010. During the 1980's, Mr. Pinto was Fannie Mae's SVP for Marketing and Product Management, and subsequently its Executive Vice President and Chief Credit Officer.
- Peter Wallison, "*Dissent from the Majority Report of the Financial Crisis Inquiry Commission*", published January 2011. Mr. Wallison, a member of the Financial Reform Task Force and Financial Crisis Inquiry Commission, worked in the US Treasury Department under President Reagan.

US Agency High LTV & Subprime loan exposure
Percent of market total, using AEI expanded definition



Source: American Enterprise Institute.

For Pinto and Wallison, this quote from the Department of Housing and Urban Development in 2000 is a **smoking gun of sorts, and lays out a blueprint for the housing crisis**:

"Because the GSEs have a funding advantage over other market participants, they have the ability to under price their competitors and increase their market share. This advantage, as has been the case in the prime market, could allow the GSEs to eventually play a **significant role in the subprime market.** As the GSEs become more comfortable with subprime lending, **the line between what today is considered a subprime loan versus a prime loan will likely deteriorate**, **making expansion by the GSEs look more like an increase in the prime market.** Since, as explained earlier in this chapter, one could define a prime loan as one that the GSEs will purchase, the **difference between the prime and subprime markets will become less clear. This melding of markets could occur even if many of the underlying characteristics of subprime borrowers and the market's (i.e., non-GSE participants) evaluation of the risks posed by these borrowers remain unchanged.**" (HUD Affordable Lending goals for Freddie Mac/Fannie Mae, Oct 2000)

The strategy worked, as shown in the chart**:** the Agencies took the lead in the 1990s and early 2000's in both subprime and high LTV (>=95%) loans, acquiring over $700 billion in non-traditional mortgages **before** private markets had even reached $100 billion. Then in 2002-2003, private sector banks took the bait and jumped in with both feet. According to Wallison, the distortion of the housing bubble from 1997 onward obscured what would otherwise have been rising delinquencies and losses. As a result, when investors, banks and rating agencies finally got involved in a substantial way, they ended up looking at under-stated default statistics on subprime, Alt A and high LTV borrowers.

---

[3] Why was it hard to figure this out in the immediate aftermath of the housing collapse? ***Creative Reporting.*** According to Pinto, Fannie Mae classified a loan as subprime only if the loan was originated by a lender specializing in subprime, or by subprime divisions of large lenders. They did not use FICO scores to report all subprime exposure, despite their use to define subprime as far back as 1995 in Freddie Mac's industry letters, and guidelines issued by Federal regulators in 2001. As Pinto notes, this had the effect of reducing its reported subprime loan count.

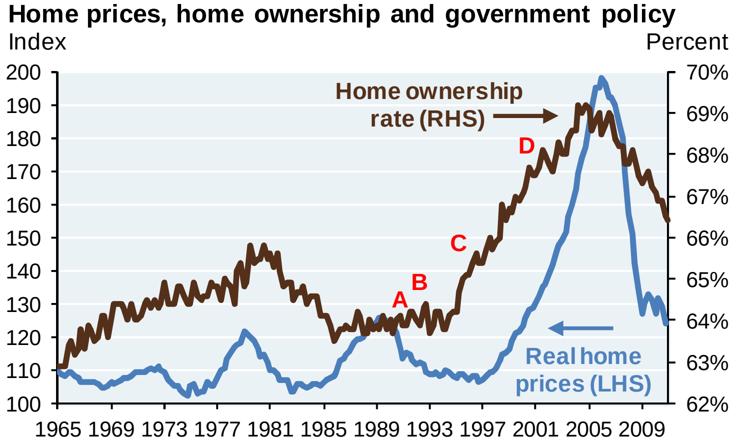
Retractions: US earnings growth, the Euro, and the primary catalyst for the US housing crisis

The Wallison/Pinto timeline of events looks something like this, and is best viewed when superimposed on home ownership rates and home prices (see first chart below), which had been stable for the prior 3 decades:

A: **Senate hearings in 1991** start the ball rolling with commentary from community groups that banks need to be pushed to loosen lending standards, and that Agencies must take the lead: "*Lenders will respond to the most conservative standards unless [Fannie Mae and Freddie Mac] are aggressive and convincing in their efforts to expand historically narrow underwriting.*"

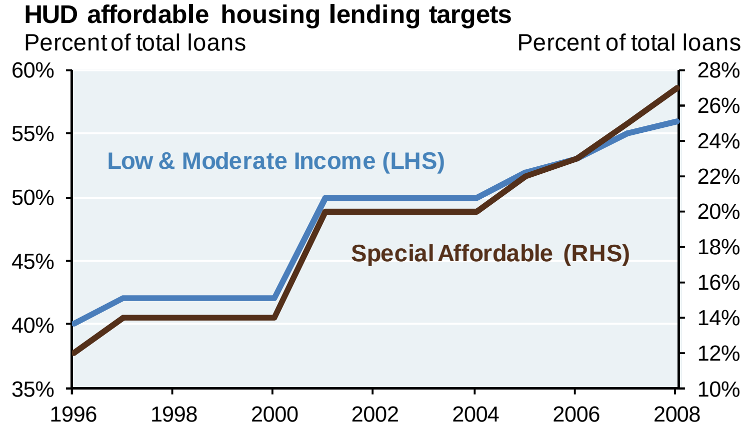
B: In 1992, **Congress imposes affordable housing goals on Fannie and Freddie** through the "Federal Housing Enterprises Financial Safety and Soundness Act of 1992", and become competitors with FHA. To meet these goals, the Agencies relaxed down payment requirements. By 2007, they guaranteed an estimated $140 billion of loans with down payments <=3% (after having done none at <=5% as of 1991). Half of these high LTV loans required no down payments at all. This was the driver behind a larger trend: by 2007, required down payments of <=3% were 40% of all home purchase loans.

Home prices, home ownership and government policy



Source: "Irrational Exuberance," Robert Shiller, 2005, U.S. Census Bureau.

HUD affordable housing lending targets



Source: American Enterprise Institute.

C: In its 1995 National Homeownership Strategy publication, HUD announces that while low down payment mortgages were already 29% of the market by August 2004, **they wanted more**: "*Lending institutions, secondary market investors, mortgage insurers, and other members of the partnership should work collaboratively to reduce homebuyer down payment requirements*".

D: **In 2000, HUD raises affordable lending targets again**. The chart above shows the escalation of lending targets for low and moderate income borrowers, and "Special Affordable"[4] borrowers. The problem for Agencies: the only way to meet these targets was to relax down payment requirements even more, and income verification/loan to value standards as well. When announcing even higher affordable housing targets in 2004, HUD made it clear that their purpose was to get private sector banks to follow suit: "*These new goals will push the GSEs to genuinely lead the market*". (HUD Press Release, Nov. 2004). Bad news: they did.

The rest, as they say, is history. Wallison and Pinto make a variety of assumptions in several hundred pages of research, some of which has unsurprisingly resulted in conservative and liberal policy groups disagreeing with each other. One point is not in dispute: dollar for dollar, **private sector banks and brokers made much worse loans than the Agencies**, when considering delinquency rates and losses per dollar of loan principal.

But Wallison and Pinto are not trying to find out who made the worst loans. They're trying to figure out why underwriting standards collapsed across the board; how policy objectives were designed to have private sector banks follow the Agencies off the cliff; and why Agency losses to taxpayers are estimated to be so large ($250-$350 billion). It's a hollow victory for Agency supporters to claim that their version of Alt A and Subprime was not as bad as private sector ones: the Agencies had almost no capital to absorb losses in the first place, given what their mandate was. According to the Financial Crisis Inquiry Commission, "**by the end of 2007, Fannie Mae and Freddie Mac combined leverage ratios, including loans they owned and guaranteed, stood at 75 to 1.**" After factoring out tax-loss carry-forwards, Agency capital ratios were probably below 1% on over $5 trillion of aggressively underwritten exposure.

US Agency Equity Capital Ratios December 2007

[4] "Special Affordable" goal: the percent of dwelling units financed by GSE's mortgage purchases be for very low-income families, defined as those with incomes no greater than 60-80 percent of median incomes.

Retractions: US earnings growth, the Euro, and the primary catalyst for the US housing crisis

The Wallison/Pinto research appears to be a well-reasoned addition to the body of work dissecting the worst housing crisis in the post-war era. It is convincing enough to retract what we wrote in 2009. As regulators and politicians consider actions designed to stabilize the financial system and the housing/mortgage markets, reflection on the role that policy played in the collapse would seem like a critical part of the process.

Michael Cembalest
Chief Investment Officer

<u>Acronyms</u>

HUD	Department of Housing and Urban Development
FHLB	Federal Home Loan Banks
VA	Veterans Administration
CRA	Community Reinvestment Act
FHA	Federal Housing Authority
GSE	Government Sponsored Enterprises (Freddie Mac, Fannie Mae)
ECB	European Central Bank
FCIC	Financial Crisis Inquiry Commission
LTV	Loan to Value