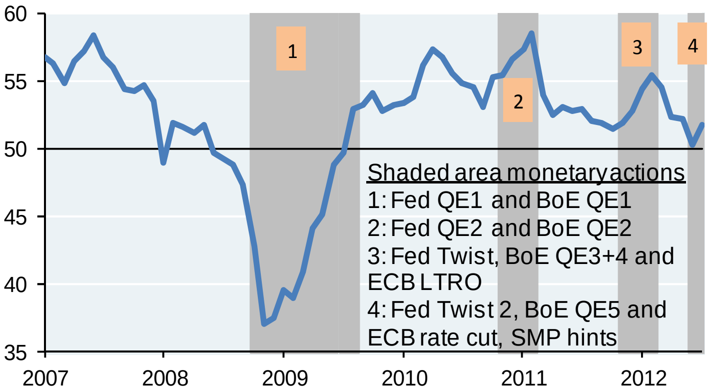
A brief note on US equity markets, which are up 13% despite lackluster economic news this year

It's not unheard of for stocks to rally when economic conditions are weak (see page 2), particularly when corporate profits are doing well; Q2 marked a new all-time high run rate of S&P profits. As a result, the 13% gain in the S&P this year is not a complete anomaly. But in prior cycles, "weak economy" stock market rallies were predicated more on the view that a private sector recovery was just around the corner, rather than the current view that more Central Bank stimulus is just around the corner (1st chart). The other notable aspect of the rally is that it took place as earnings forecasts for 2012 and 2013 have been falling, and as Q2 revenue growth slowed. To paraphrase what's going on, I'd say that **Bronze is the new Gold**: expectations are so low[1], that anything better than recessionary data can be well-received by markets. Here's one example: on August 3rd, the US payroll report was released. Around 160,000 jobs were created, and the S&P 500 rallied by more than 2%. In this instance, **markets awarded a gold medal to a bronze medal performance.** That payrolls beat low expectations explains part of it, but in the past, 2% rallies on payroll day only happened when payrolls really took off. The 2nd chart shows each time since 1966 that the S&P 500 rallied more than 2% on payroll day[2]. As you can see, 160,000 jobs is at the low end of historical catalysts[3].

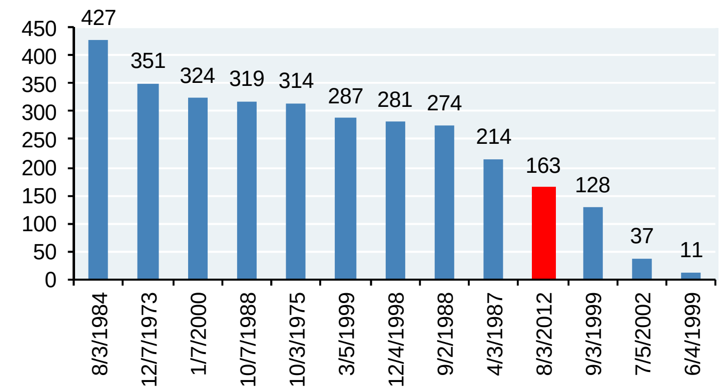
Global economy very reliant on monetary stimulus

Global PMI survey, a measure of manufacturing activity and sentiment



Source: J.P. Morgan Asset Management, Markit, J.P. Morgan Securities LLC.

Instances when payroll gains resulted in same-day S&P 500 gains of > 2% (1966-2012)



Source: BLS, Philadelphia Federal Reserve, Bloomberg, JPMAM.

Another way to think about this: there's so much pessimism around, that a positive surprise can have a positive short-term effect on markets. It's hard to measure pessimism; people try, using investor surveys; put-call pricing differentials in options markets; short interest in cash and futures markets; hedge fund net risk exposure; and the amount of cash on corporate, mutual fund and household balance sheets. I would add a 2% stock market rally on mediocre payroll gains as another indication of elevated investor pessimism[4]. I remember reading some academic papers showing that the stocks in the Dow rated "sell" by Wall Street analysts generally outperform "buy"-rated stocks, and that the same holds true for tech stocks. In other words, capitulating after all the bad news is out can be a bad strategy. **Maintaining normal allocations to US equities acknowledges that paradigm; US stocks began the year at a P/E of 11.5x, which already incorporated a lot of problems in the economy**.

US companies have a lot of cash (*note: the largest tech, pharma and industrial names hold around 70% of it overseas*), and we are seeing a pick-up in announced buybacks and M&A. But demand isn't strong enough to merit much of an increase in hiring trends or capital spending. We expect payrolls to average around 150k, and roughly 2% GDP growth. It's a stable, mediocre trend whose durability will depend to some extent on the election and the outcome of the fiscal cliff debate. On the latter, markets appear to be assuming that the large legislated tax drag on GDP of ~4.5% will be negotiated down to ~1.5%.

Of course, the other factor behind the recent rally is the prospect of unlimited bond purchases (and other financing schemes) by the European Central Bank, as it absorbs the hundreds of billions in sovereign and bank debt exposure that

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[1] The ECRI, which has a reasonably good track record in forecasting US recessions, says the US is already in one (we disagree).

[2] Since the US population has grown a lot since 1966, we normalized the payroll numbers to reflect that. In addition, we used payrolls as reported at the time (and not after subsequent BLS revisions), since we want to look at contemporaneous market reactions.

[3] **There were 3 payroll reports that were even weaker than the recent one, and which still resulted in 2%+ equity gains.** Two were in 1999, when it didn't matter if the economy was going anywhere, since most investors were more focused on the rising shares of Global Crossing, JDS Uniphase and theGlobe.com (one omen the dot-com bubble was about to end: in 1999, the CEOs of theGlobe.com were invited to speak at J.P. Morgan's annual MD conference). The other instance: there was a 3.7% rally on July 5, 2002, since markets were concerned about a terrorist attack occurring on July 4th. In other words, the weak payroll report that day was overshadowed by other things. That weak payroll report eventually had its day in court, however, as markets fell again later that fall, bottoming in November 2002.

[4] Some news sources have reported that the recent rally was on low volume. We can't find evidence of that. Dollar-weighted volumes across cash equity markets, index options, futures and ETFs all look pretty constant over the last few months.

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investors don't want anymore. Let's use a science fiction lens here. Swallowing an alien is one surefire way to get rid of it, but then you have to wonder what happens once it gets digested. Color me very nervous on how this all turns out in the end; more on the European experiment in early September. For now, enjoy the rest of the summer. We wrote a piece on "*Big Data*" investing two weeks ago if you have nothing left to read.

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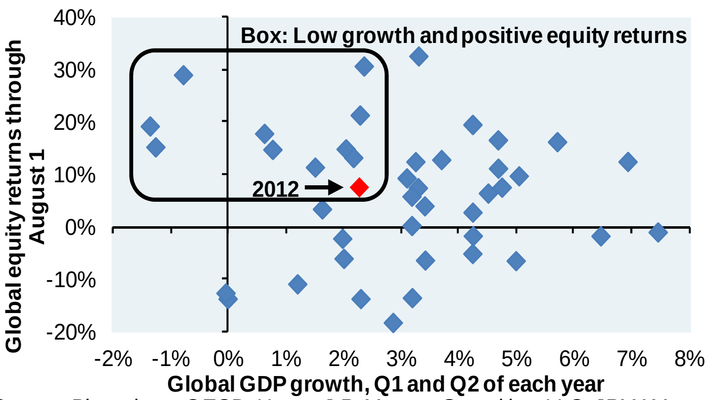
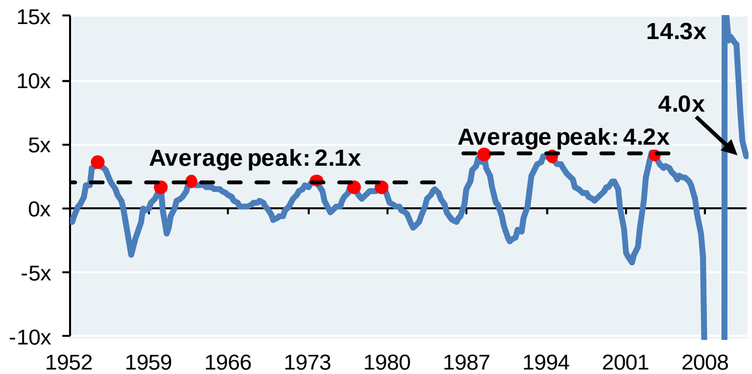
Appendix: global equities vs. global GDP, and US earnings growth vs. nominal GDP growth
In the first chart, we look at global equity returns each year through August 1st, and global GDP growth through Q2 of each year. In many years, positive equity returns coincide with 3%-6% global GDP growth. But there are also years like this one, when stocks generate positive returns despite disappointing economic growth (box). One reason is that earnings can perform much better than the economy (the S&P 500 has a much greater weight to manufacturing than the US economy, for example). The second chart shows how US corporate profits have been outstripping nominal US GDP growth by more than the usual degree. The weakest labor compensation in the last 50 years explains much of the strength in profits, and weakness in growth.

Global equities and global growth, 1970-2012



Source: Bloomberg, OECD, Haver, J.P. Morgan Securities, LLC, JPMAM.
Equity return: 12/31 to 08/01; GDP: 1H annualized.

Earnings still outperforming the economy
Ratio of 2-year earnings growth to 2-year nominal GDP growth



Source: Standard & Poor's, BEA, J.P. Morgan Asset Management.

ECRI: Economic Cycle Research Institute
BLS: Bureau of Labor Statistics
ETF: Exchange-Traded Fund
QE: quantitative easing
LTRO: Long-Term Refinancing Operations
SMP: Securities Markets Program
BoE: Bank of England
ECB: European Central Bank
HBM: Happy Birthday Mary

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