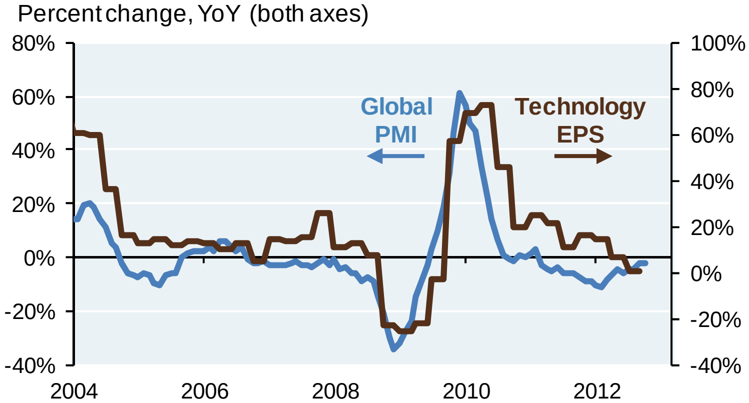
Topics of the week: the slight upturn in US leading indicators and the implications for profits; the magnitude of the US housing recovery; Europe's prize; and US energy independence

We are working on our annual energy issue, which will come out next week. In the meantime, topics that *True Believers* have written about that we found interesting: assertions that recent improvement in leading indicators heralds better things ahead for the global economy and for profits; an article by Roger Altman arguing that the US housing recovery will contribute to a robust US expansion next year; the belief that the US can become energy independent within 10-15 years; and the view from Oslo that the European Union merited a Nobel Peace Prize. More below.

<u>The recent improvement in leading indicators: better news for profits and growth ahead?</u>

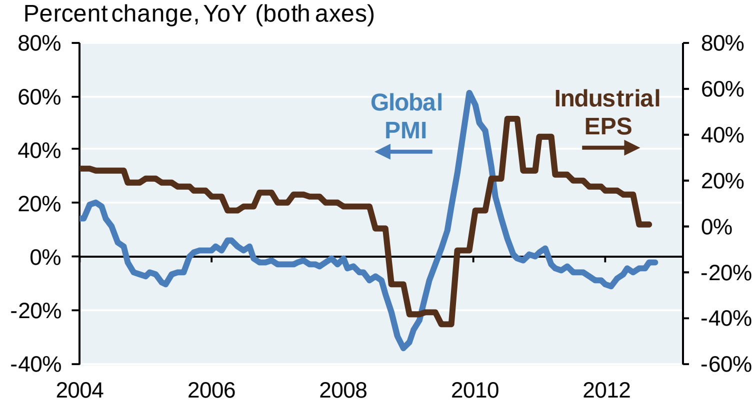
US and global purchasing manager surveys (PMI surveys) weakened during the summer, but have recently picked up modestly. Some argue that these changes could arrest the decline in earnings growth in sectors like technology and industrials. This seems plausible to us, and we believe it is more likely than another leg down in the global economy, which if it happened, would raise the risk of recession next year. PMI surveys are usually shown as an index level; in the two charts below, we show year on year changes to get a sense for the turns in the cycle. They tend to precede changes in earnings.

Technology earnings and Global PMI survey
Percent change, YoY (both axes)



Source: Bloomberg, J.P. Morgan Securities LLC.

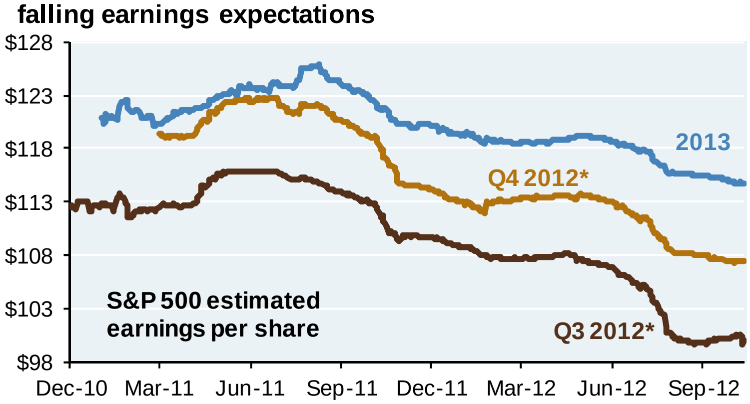
Industrial earnings and Global PMI survey
Percent change, YoY (both axes)



Source: Bloomberg, J.P. Morgan Securities LLC.

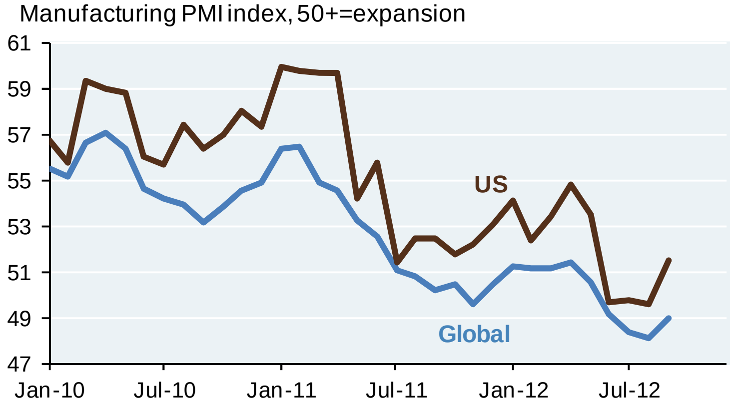
Most leading indicators suggest that the world is stuck in a period of low but positive growth, rather than a period of deteriorating conditions. If so, the recent trend of downward revisions to earnings may come to an end as well, particularly if leading indicators keep improving. Last week, we discussed competing valuation models on US equities which describe them as being either very cheap or very expensive. We think the reality is somewhere in between, and that perceptions of value are more influenced by the lack of fixed income returns than at any time we can remember. This year's equity market gains already factor in an improvement in economic conditions, profits and politics. On the latter point, markets appear to assume that the US legislated fiscal consolidation ("fiscal cliff") will be renegotiated from 4.3% of GDP to 1.0%-1.5% of GDP. Our contacts indicate that this may be premature; we won't know for sure until the lame ducks are quacking.

Positive turn in leading indicators may signal an end to falling earnings expectations



Source: FactSet. Data as of October 2012. *Annualized EPS.

Global and US manufacturing activity stabilizing
Manufacturing PMI index, 50+=expansion



Source: Institute for Supply Management, J.P. Morgan Securities LLC.

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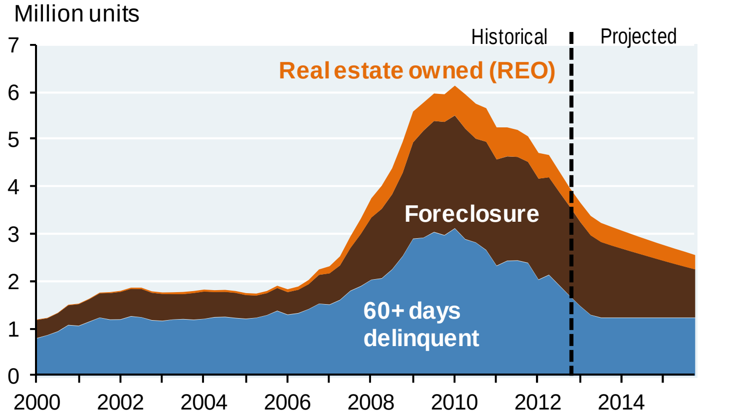
How large a US housing recovery?

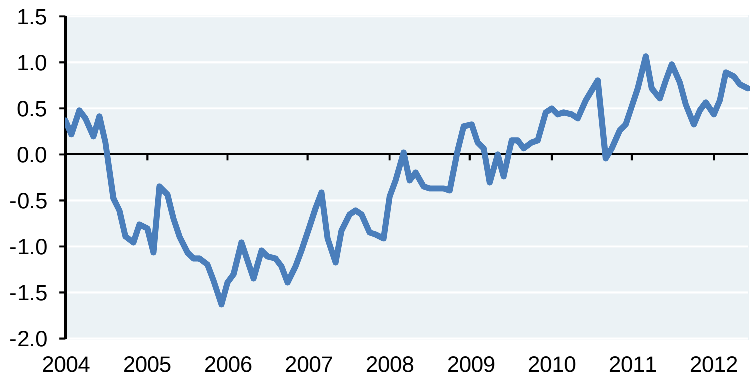
Roger Altman, a former Treasury official and founder of Evercore Partners, wrote an article in the Financial Times arguing that the US housing recovery would boost the US economy. What caught our eye was the view that housing would contribute 1-2 percentage points to US GDP growth and spark a growth rebound above the Fed's 5-year forecast of 2.5%. To get started, here are some charts on things we agree with him on: the decline in measured and shadow inventories; an increase in pent-up demand due to the slowing of household formation relative to population growth; the rise in the affordability of housing compared to renting; and the increase in the number of banks reporting a rise in residential mortgage demand. We also agree that census data shows that population growth in the 55+ category (with the highest home ownership rates) is at a 70-year peak.

"Shadow inventory" is steadily declining
Million units



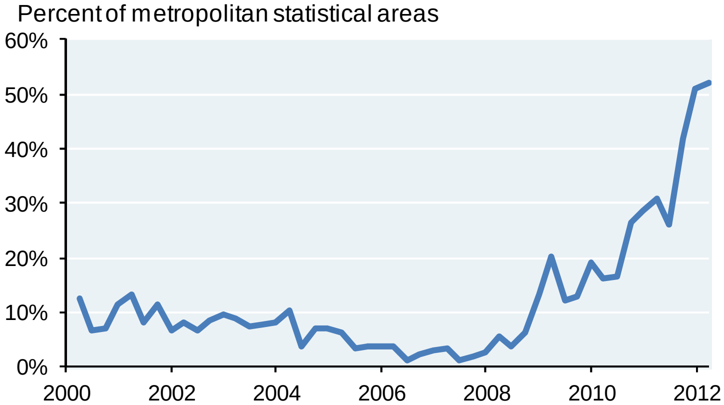
Source: J.P. Morgan Securities Loan Performance, MBA. Data as of Q2 2012

Pent-up demand has accumulated
Pent-up demand for housing, millions of units



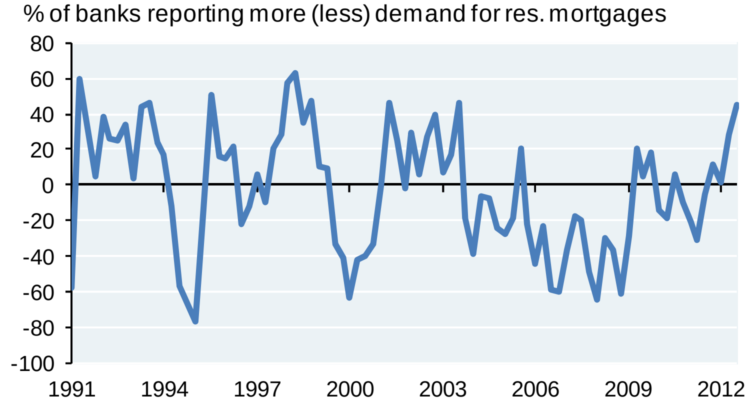
Source: JPMAM, Census Bureau.

Where buying is cheaper than renting
Percent of metropolitan statistical areas



Source: J.P. Morgan Securities LLC, AxioMetrics, CoreLogic, FHLMC.

Demand for residential mortgages is improving
% of banks reporting more (less) demand for res. mortgages



Source: Federal Reserve Board.

However, we are having trouble making Altman's math work when it comes to the contribution to overall GDP growth. As shown in the first chart below, there are only a couple of times when housing contributes 1-2 percentage points to growth, the most notable being the post-war period of rapid household formation by returning war veterans. Even during the 2000's housing boom, it was only around half a percentage point. Part of why Altman's forecast may be difficult to hit is the decline in the share of housing in GDP, shown in the second chart below. Altman cites a Barclay's forecast that Case-Shiller home prices will reach their pre-crisis peak by 2015 (3^{rd} chart). Anything is possible, but given tighter credit standards (4^{th} chart), a recovery in prices will have to rely more on income growth than a rapid expansion in credit. This is highlighted by the divergence between reported home sales (rising) and the mortgage application index (still close to its lowest levels, no sign of a rebound).

We appreciate the multiplier benefits that could be derived from a continued recovery in housing, but are keeping expectations in check for next year. Even if legislated fiscal tightening for 2013 is postponed, GDP growth substantially above 2.5% seems like a tall order. By the way, **there are interesting opportunities in the rental markets for investors**: in some regions, the gap between current rental yields and after-tax 30-year mortgage costs is the highest on record (since 1971).

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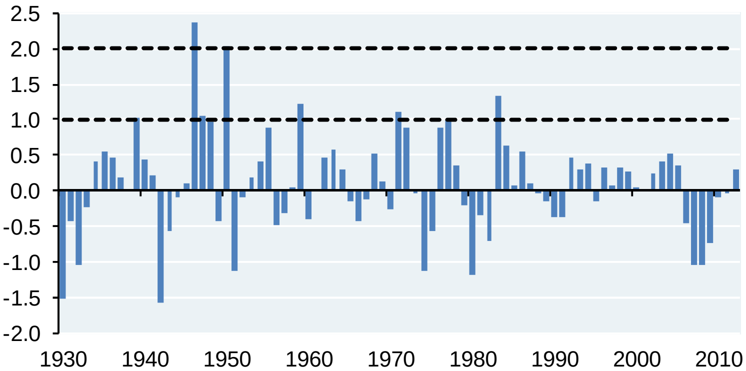
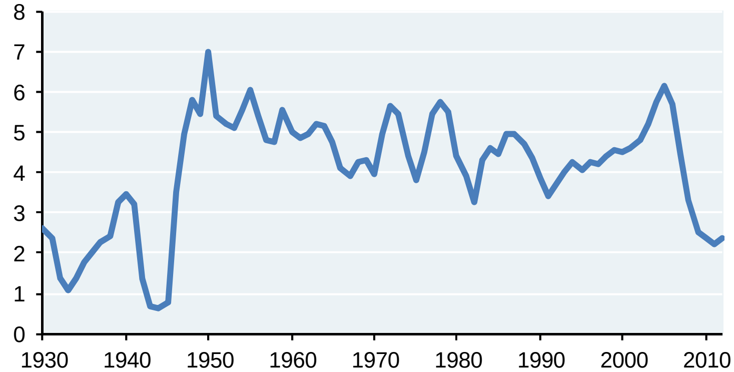
Housing rarely contributes 1-2 % points to GDP growth
Residential investment contribution to real GDP growth, ppts



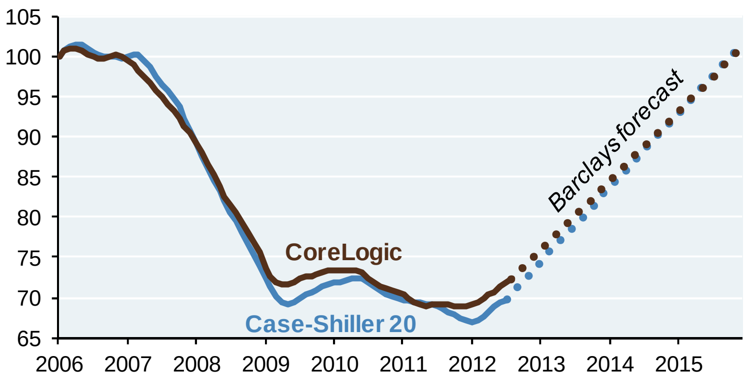
Source: BEA.

Share of housing in GDP at lowest levels since pre-war era
Residential investment, percent of GDP



Source: BEA.

Barclays home price forecast cited by Altman
Index, 2006m1=100



Source: Federal Housing Finance Agency, S&P, CoreLogic.

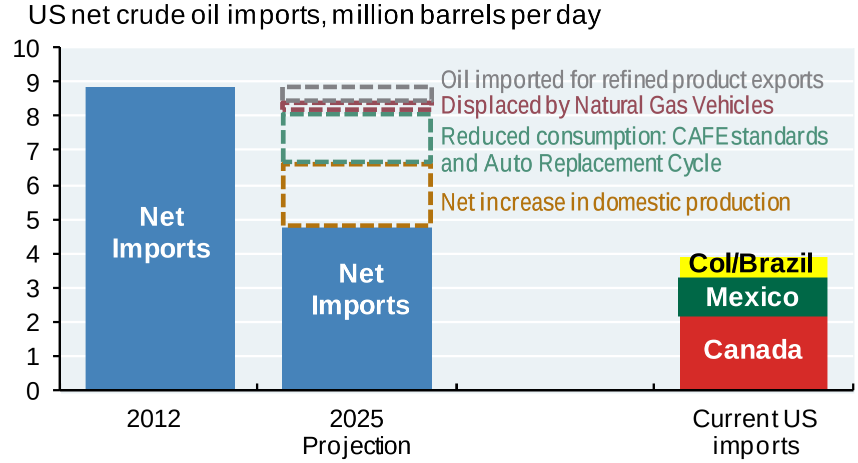
Higher FICO scores required for obtaining a new mortgage
Average FICO score of mortgage originations

Source: J.P. Morgan Securities LLC, McDash Online. Data as of August.

<u>US energy independence within the next 10-15 years? Yes, it's possible, depending on how you define it</u>

More on this next week, but depending on your definition of energy independence, a combination of supply and demand factors has the potential to substantially reduce US oil imports. The chart shows our estimates of these factors. Reduced US oil import needs that can be sustained by neighboring countries may result in: (a) the era of US foreign policy being heavily dictated by energy security coming to an end, and (b) substantial growth, employment and currency benefits from a shift to domestically sourced production. We are not arguing that such trends will bring down oil *prices*, since other consumers (e.g., China) are likely to see continued increases in demand. Next week, we will walk through each segment of the chart in detail as part of our annual energy outlook, along with a look at how Europe and Japan are defining energy independence quite differently, with much greater planned contributions from renewable energy (specifically, offshore wind). Also, an update on the latest news on electric cars (which in 2012 was not very good).

What US energy independence might look like
US net crude oil imports, million barrels per day



Source: US Energy Information Administration, JPMAM.

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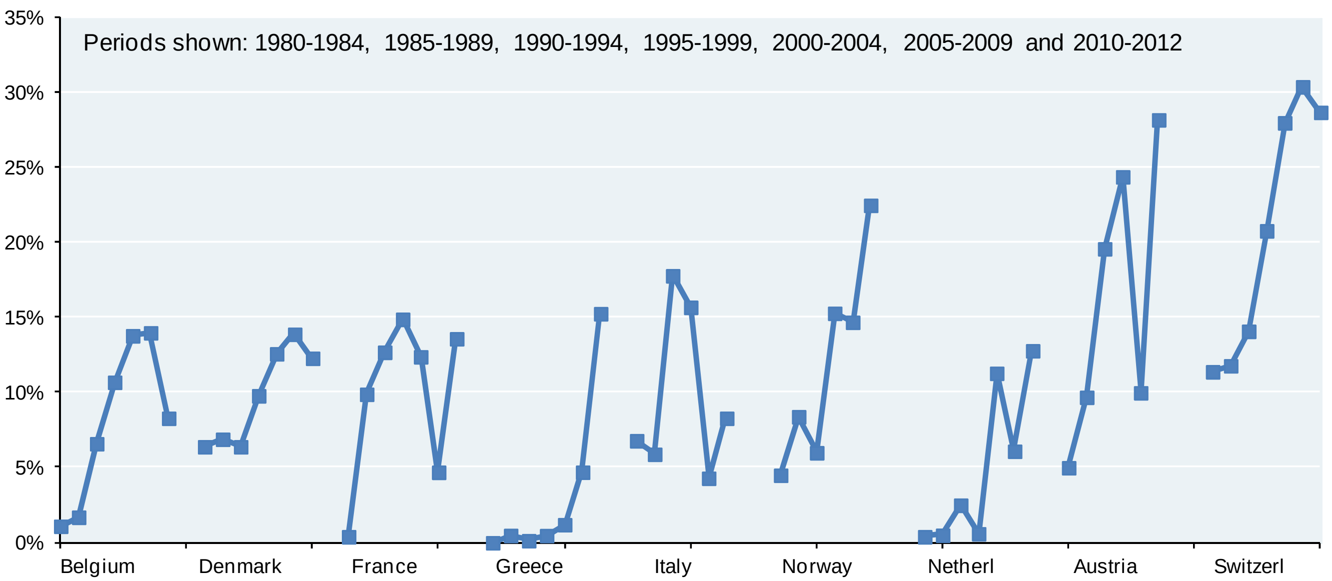
The European Union, the latest winner of the Nobel Peace Prize

Normally, peace prizes lay outside the realm of investment discussions. But in this case, politics and economics collide. The Nobel committee lauded the European Union for bringing peace to a continent at war. An understandable point of view, but it is this kind of thinking that elevates the Euro to a project that must be preserved at all costs. Such arguments have always puzzled me. By 1954, Germany had *already* become a stable, liberal, democratic society, one of the most amazing transformations in history given what preceded it ten years earlier. One can argue whether the Marshall Plan, in avoiding the reparations policies following WWI, paved the way for this or not. In any case, it seems indisputable that **conditions for a lasting peace in Europe were already in place by 1954**, a point of view explained by Stanford's James Sheehan in "*Where have all the soldiers gone: The Transformation of Modern Europe*". The notion that the Euro is needed to cement these gains appears to be more about the ambition of specific political movements in Europe/Brussels than anything else. Nevertheless, Europe soldiers on with its project, out of the belief that a single-currency monetary union must exist in order to reap the benefits of a common European consciousness. The irony of the Nobel Peace Prize for Europe is that as shown below, it comes at a time of rising social stress. There are of course those who believe that the Euro itself has contributed to these developments: it distorted the regional current accounts and encouraged consumption not funded by national income in the South, exaggerated the severity of the recession, and then prevented currency adjustments which mitigated Southern European recessions in the past.

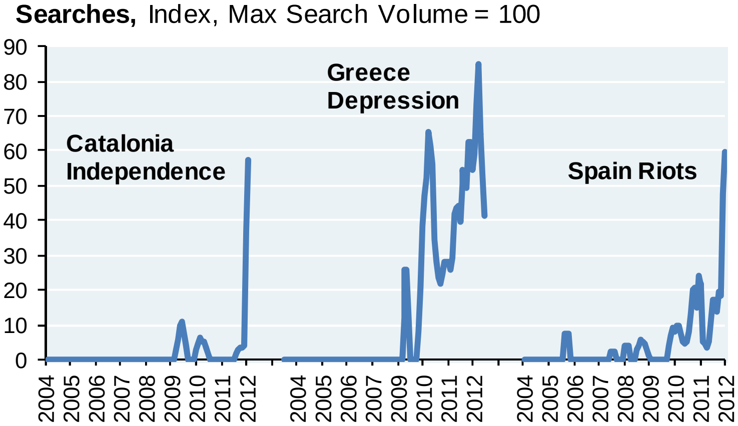
Europe's Nobel Peace Prize comes at a challenging time for the region

Election results of extremist right-wing parties in selected EU member countries, national parliamentary elections
Using the definition of extremism as applied by the Friedrich Ebert Foundation in its 2011 analysis; see notes below.



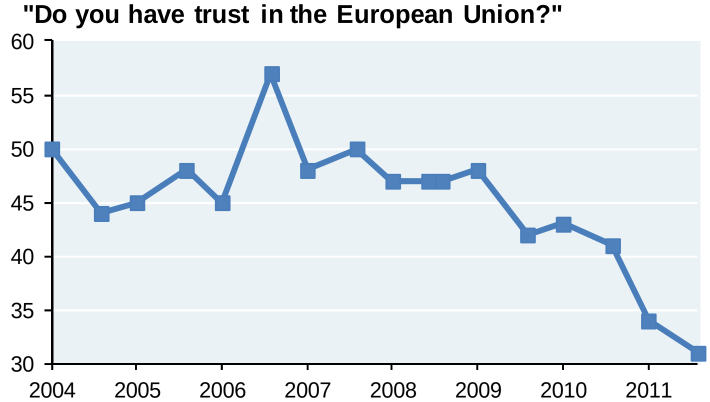
Source: Using FES party definitions and electoral results for 1980-2009; our updates for 2010-2012. FES paper: *"Is Europe on the Right Path? Right-wing extremism and right-wing populism in Europe"*, Langenbacher and Schellenberg, Friedrich Ebert Stiftung (Friedrich Ebert Foundation), 2011. Established in 1925, the FES is the political legacy of Friedrich Ebert, Germany's first democratically elected President, and has offices in 90 countries worldwide.

Measuring the social fabric in Europe through Google Searches, Index, Max Search Volume = 100



Source: Google Trends.

A poll of European citizenry, conducted by the EU: "Do you have trust in the European Union?"



Source: *"Public Opinion in the European Union"*, Standard Eurobarometer 77, Spring 2012.

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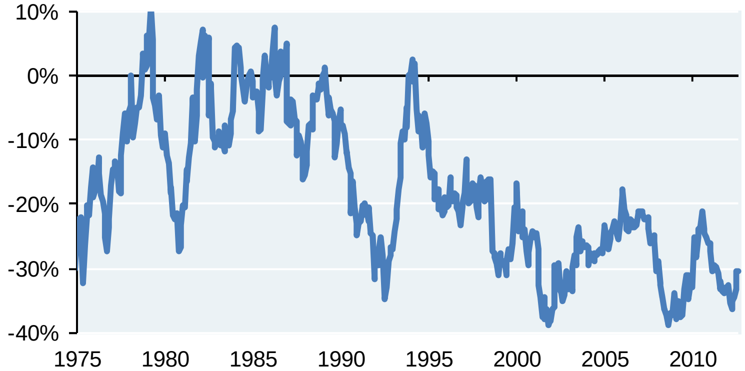
An investments perspective: the improvement in European credit and equity markets has been substantial in recent weeks, a reaction to the ECB plan to effectively prevent any sovereign or bank defaults by printing money and monetizing government debt. However, in the absence of a full fiscal transfer union funded by Germany, prices for equity, credit and real estate in Europe need to be low enough to compensate for the risk that growth does not return soon enough. Case in point: we didn't start looking at European equities as being interesting again until earlier this year, when they reached a 40-year low in terms of relative valuation vs US equities (see composite price-dividend, price-earnings and price-book chart). After the recent rally, this gap has narrowed, but not by very much.

European equity discount to US: as bad as it gets?
Composite premium/discount using P/E, P/B and P/Dividend



Source: MSCI, J.P. Morgan Securities LLC.

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