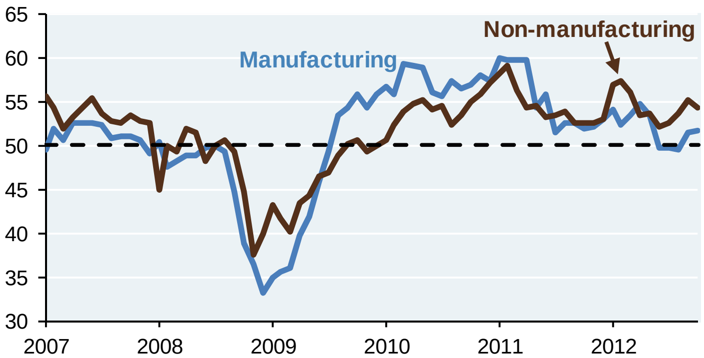
Immediate post-election thoughts; France, a worker's utopia; more storm stuff

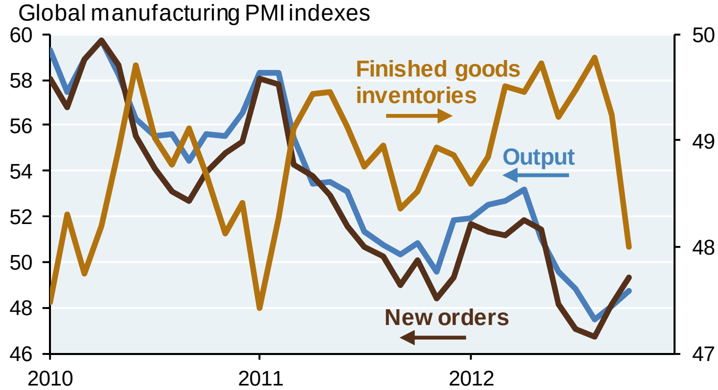
[A] For investors, the business cycle matters most In the US, business cycles tend to swamp elections in terms of their impact on the economy and financial markets, so let's start there. US manufacturing and services are treading water at levels consistent with 2% GDP growth, rather than sharply improving or decelerating as some expected. Last week's payroll report was pretty good; it certainly surprised the 91 economists surveyed in advance, not one of whom anticipated a number as high as what was reported. Wages and hours worked lagged the improvement in jobs created. **Overall, US data is more good than bad, as improvements in housing, spending and credit are finally reinforcing each other somewhat (propelled generously by a Federal government 7% fiscal deficit)**. US business spending is the laggard, as explained below. As for the world as a whole, there has been a bounce off the bottom in output and new orders (2nd chart). The drivers: most Chinese leading indicators are stabilizing (see last week's write-up on indicators we look at as complements to officially reported data), and EM Asia ex-China is beginning to show improvement after a slowdown in manufacturing and services all year long. Europe and Japan are still a mess. Global inventories have been pared back, so the stage is set for some growth improvement in the spring. It will take a few things to go right to jump-start the global economy; in the US, it starts with the fiscal cliff now that the election is settled.

US manufacturing and non-manufacturing PMI surveys
Purchasing Managers Index, 50+=expansion



Source: Institute for Supply Management.

A modest bounce in global orders and production
Global manufacturing PMI indexes

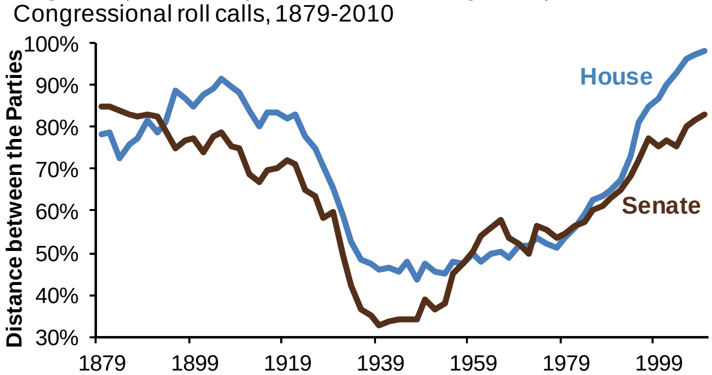


Source: J.P. Morgan Securities LLC.

Earnings update: the slowdown in 2012 took its toll on earnings expectations, particularly non-US sourced profits. Q3 S&P 500 earnings were down just 1% vs 2011 and profit margins were stable at their post-war peak of 9%, but most companies that provided guidance for Q4 gave a mildly negative outlook. Top-line revenue growth was weak at ~1%, offset by companies managing expenses well and buying back stock (S&P share count declined for the 5th quarter in a row). Markets expect ~$114 per share in 2013, which is 11% growth vs. 2012 and probably too high. Trailing P/E multiples of 14.5x are below the long-term average of 16x, although that average doesn't mean much: since 1954, multiples have usually been higher (>17x) or lower (<12x). As a reminder, **global equity markets did not need more than 2.5% GDP growth this year to advance by 13%, given the walls of cash and pessimism, and low multiples to start the year**.

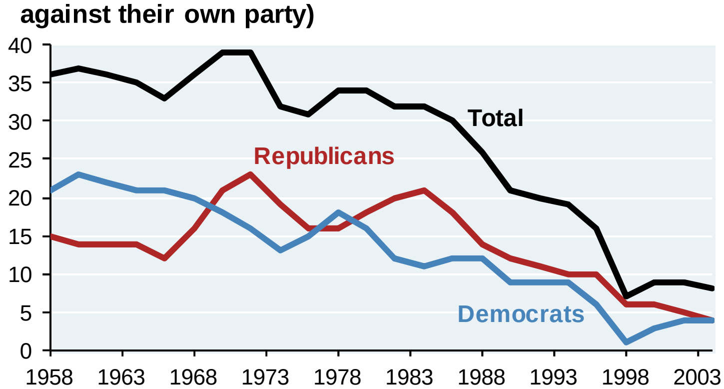
[B] The election: expect 4 more years of a divided America I would not expect any changes to the trends shown below, charts which we have included before. Moderates like Blue Dog Democrats and Rockefeller Republicans are now artifacts in the Natural History Museum, having given way to their more ideological offspring (through retirement or after having been beaten in primaries). If anything, the House may become even more partisan after apparent losses by moderates in both parties.

Congressional polarization at an all time high
Degree of partisanship as measured through analysis of all Congressional roll calls, 1879-2010



Source: Keith T. Poole, University of California - San Diego, January 2011.

Party non-conformists in the Senate (Senators who vote against their own party)



Source: *The Creation of an Endangered Species: Party Nonconformists of the U.S. Senate,* Richard Fleisher and Jon R. Bond, 2005.

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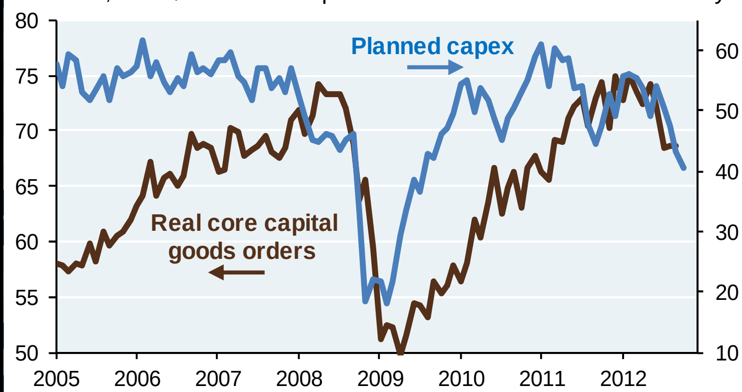
[C] After a better than expected night for Democrats given Senate results, the fiscal cliff looms With the status quo maintained, a divided government goes back to work to solve the Mutually Assured Fiscal Destruction problem. The President may have picked up some leverage over House Republicans who still have to run again, but we'll see. The fiscal cliff does not have to get resolved by December 31, since some items can be resolved in the spring and back-dated. Defusing the cliff (see options #1 and #2) would help growth in 2013, and perhaps reignite business capital spending, which has stalled (see chart). It would also help avoid a relapse in personal consumption, which is growing at a 2% real rate before any fiscal belt-tightening.

Fiscal cliff options, in billions and percentage of GDP

Increased Revenues from:	Legislated	#1	#2
Expiring payroll tax holiday	115	115	115
Expiring personal tax provisions	27		
Expiring business tax provisions	75		
New healthcare taxes	24	24	24
Alternative Minimum Tax	40		
Expiring 2001/2003 Upper Income tax relief	83	83	
Expiring 2001/2003 remaining tax relief	171		
Total increase in revenues	**535**	**222**	**139**
Reduced Expenditures from:			
Lower Medicare physician reimbursement	14		
Ending extension of unemployment benefits	33	33	33
BCA spending reductions (Sequester)	85		
Total expenditure reductions	**132**	**33**	**33**
Total fiscal adjustment	667	255	172
Total fiscal adjustment (%GDP)	**4.3%**	**1.6%**	**1.1%**

Source: Tax Policy Center, CBO, J.P. Morgan Asset Management.

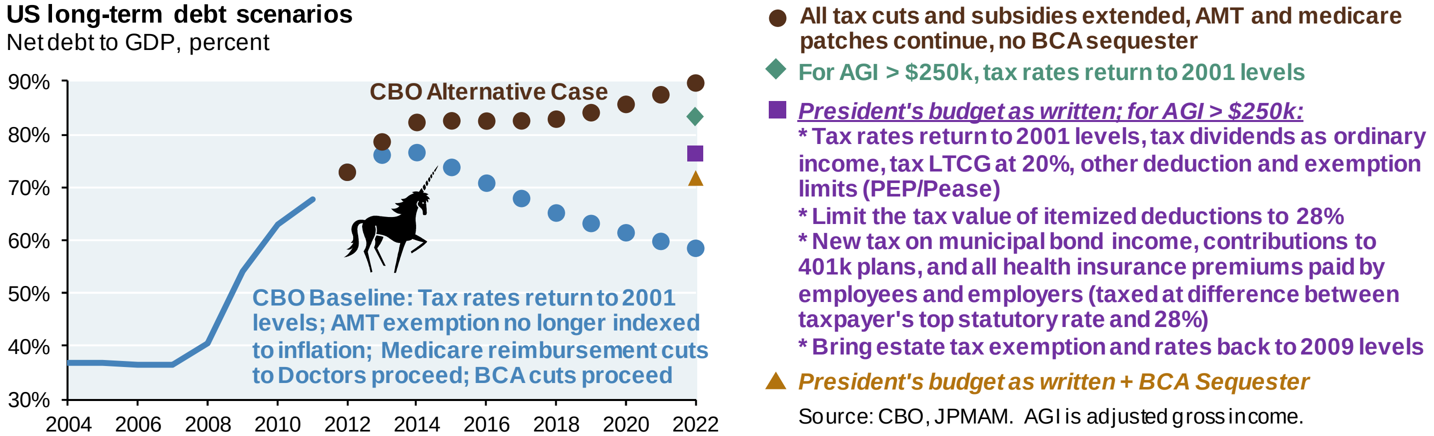
Capital spending slows; fiscal cliff responsible?



Source: KC, NY, Philly, and Richmond Feds, Census Bureau.

However, defusing the cliff contributes to rising Federal debt unless the growth payoff is huge. In recognition of that reality, 80 US CEOs published a letter calling for Washington to strike a long-term fiscal "grand bargain" that includes higher tax revenues (but not in 2013). Here's our latest Federal debt chart as a way to visualize the problem. The contours show the Congressional Budget Office Baseline Case and Alternative Case. As explained last week, while the Baseline Case represents "current law", it has become increasingly preposterous, since it includes items that Congress passed but has been deferring for a decade (changes to the Alternative Minimum Tax and Medicare), and a wholesale resumption of 2001 tax rates that Congress has no intention of implementing. The CBO should put a unicorn next to it as an indication of how likely it is to happen.

US long-term debt scenarios



Source: CBO, JPMAM. AGI is adjusted gross income.

What might a second Obama administration do on the debt? Nothing is urgent now, given plenty of public and private sector demand for Treasuries at sub-2% rates. **However, we will have to watch how rating agencies react if the Budget Control Act Sequester is unplugged**. The President's proposal (purple square) stabilizes the Federal debt over a ten-year horizon as per CBO forecasts, almost entirely through higher taxation on those with more than $250k in adjusted gross income (via tax increases and large reductions in allowable deductions and exemptions). The plan does not appear politically feasible given Republican control of the House. If the President only passes increases in tax rates on the top two brackets, then as shown by the green diamond, the debt does not stabilize. House Republicans could push for more discretionary spending cuts along with tax increases, but after the caps set in the Budget Control Act, discretionary spending is already projected to be very low (1st chart on next page). The elephant in the room is the 2nd chart on the next page: close to 100% of US tax revenues are already eaten up by mandatory spending on entitlements and other programs, and interest. **However, electoral results suggest the country is in no mood to address entitlement issues right now, will defer them to another day, and continue to shift towards a high-Federal debt economic model that bears some resemblance to Europe and Japan.**

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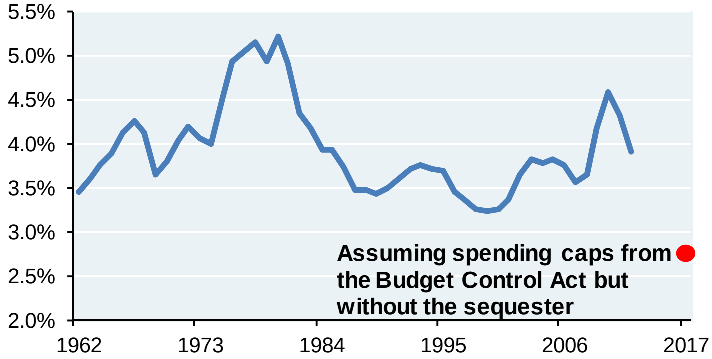
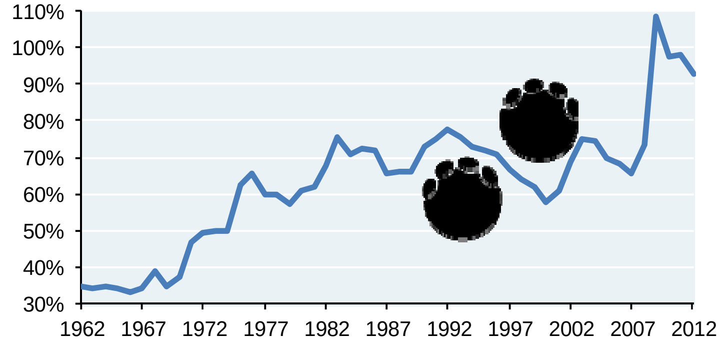
Non-defense discretionary spending: already low after BCA kicks in, Percent of GDP



Source: CBO, OMB.

The elephant in the room: entitlements and interest are crowding out everything else, Percent of federal government revenues committed to mandatory programs and interest



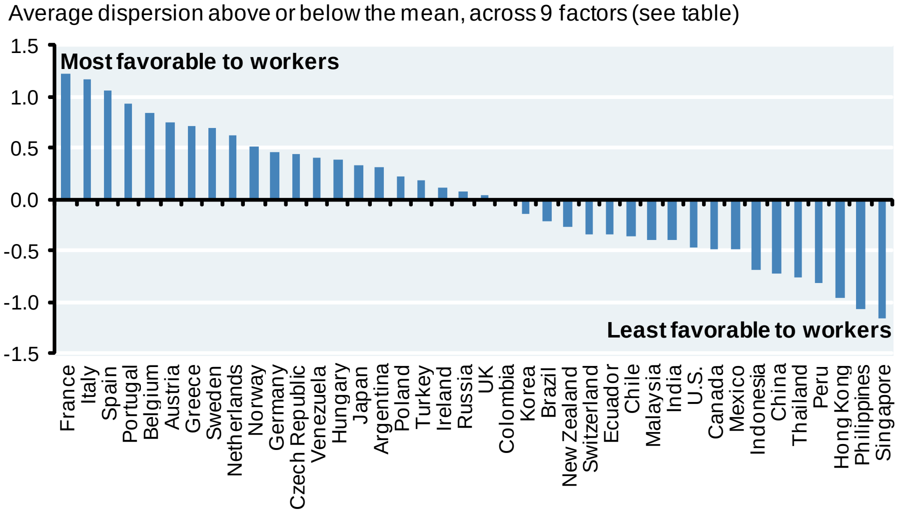
Source: CBO, J.P. Morgan Asset Management.

As noted last week, in the 1950's, the solution to 80% Federal debt was not taxation, austerity or inflation, but growth. Will the President pursue a pro-growth agenda? George McGovern, who passed away recently, wrote a 1992 editorial about a post-Senate investment in the Stratford Inn ("*A Politician's Dream is a Businessman's Nightmare*"), its bankruptcy, and how he wished he had known more about the private sector and the impact of government before he took office. He wrote: "*Today we are much closer to a general acknowledgment that government must encourage business to expand and grow. Bill Clinton, Paul Tsongas, Bob Kerrey and others have, I believe, changed the debate of our party. We intuitively know that to create job opportunities, we need entrepreneurs who will risk their capital against an expected payoff. Too often, public policy does not consider whether we are choking off those opportunities*." The capital spending decline and piles of corporate cash suggest that businesses are reacting to a slow-growth world, but may also be waiting to see which strain of the Democratic Party is embodied by a 2nd Obama administration, and its partners in the Senate. **Something tells me that the ghost of the now-disbanded Democratic Leadership Council, composed of pro-growth centrists like Nunn, Robb, Breaux and McCurdy, is not about to reappear.**

<u>[D] France sits atop the Worker's Utopia Index</u>

Last week, we showed a chart on declining economic indicators in France. I also mentioned that France is the closest thing to a worker's utopia. Well, here is our worker's utopia index, inspired by research from Bridgewater that I read a couple of weeks ago. The idea is to measure the degree to which workers rely on the government to supplement income through household transfers; how much non-workers rely on workers to sustain their lifestyle; rules around hiring, firing, retirement ages and vacations; the link between pay and productivity; employer-mandated contributions to social security, etc. We computed z-scores for each variable and country, and averaged them to create the index. **To be clear about this, I do not believe that we are born on this earth to be wage slaves, and there is something about the European balance of life and work that is undeniably good for the soul. The question is whether Europe, and France specifically, can generate the national income necessary to maintain it and service its debts**, particularly as France loses competitiveness to Germany (see EoTMs May 21 and October 1). France may be a large obstacle to a broader European recovery in 2013.

Workers Utopia Index: La Vie en Rose
Average dispersion above or below the mean, across 9 factors (see table)



<u>Indicators used in the Worker's Utopia Index</u>	
Government expenditures to GDP	IMF
Labor force participation rate	WB
Ease of hiring and firing	WEF
Retirement age as % of life expectancy	WB
Working hours per year	OECD/ILO
Average number of vacation days	Mercer
Linkage between pay and productivity	WEF
Unemployment benefits as % of wages	IMF
Employer contribution to social security	SSA

IMF International Monetary Fund; WB World Bank; WEF World Economic Forum; OECD Organization for Economic Cooperation and Development; ILO International Labor Organization; SSA US Social Security Admin.

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[E] The Bloomberg endorsement, the storm, 20/20 hindsight, and the American Recovery and Reinvestment Act

Mayor Bloomberg endorsed the President, citing climate change as the primary reason and referencing Hurricane Sandy. I began to wonder: if climate change and associated flooding is a risk; and since NYC ranks #2 in the world regarding assets at risk from coastal flooding; and since NYC has the *lowest* flood protection standard in the world (see tables); **why was almost none of the $8 bn spent in NYC and $17 bn spent in NY State from ARRA proceeds allocated to flood protection of its energy, commercial or residential infrastructure?** Perhaps nothing could have been done for beachfront communities, but the flooding of a Con-Ed substation, partly responsible for plunging lower Manhattan back to 18th century living conditions last week, seems somehow avoidable. Our understanding is that the substation has a seawall, but it was breached and inundated too quickly to avoid damage to switchgear, and had to be powered down. As for the suburbs, many of which are still without power with a cold front approaching, I could not find examples of ARRA funds spent burying power lines (which costs 4-6x more than overhead lines), or on grid re-routing (which is cheaper), but plenty of examples of Federal buildings renovation.

Flood protection standard
worst storm per # of years

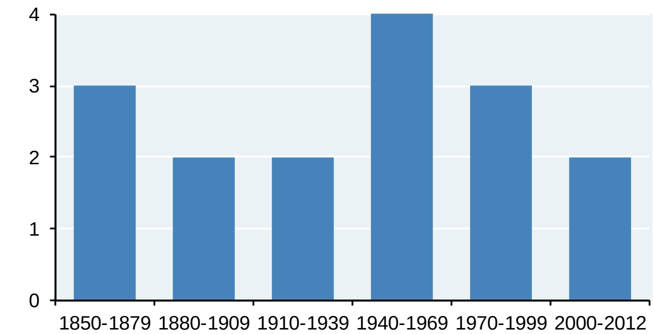
Amsterdam	1:10,000
Rotterdam	1:10,000
Shanghai	1:1,000
London	1:1,000
Tokyo	1:1,000
Osaka	1:300
New York	1:100

University of Southampton and OECD; see sources

Cities ranked by assets exposed to coastal flooding (bn, 2007$)

Miami	416
New York	320
New Orleans	234
Osaka-Kobe	216
Tokyo	174
Amsterdam	128
Rotterdam	115
Nagoya	109
Guangzhou	84
Shanghai	73

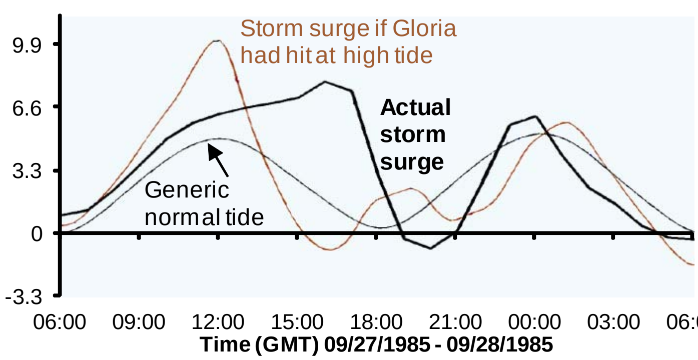
Hurricanes impacting New York's coast
Number of hurricanes



Source: National Hurricane Center, American Meteorological Society.

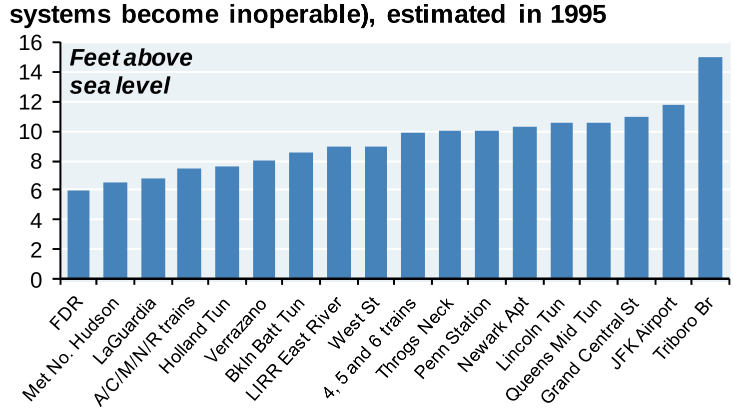
Before you say, "*how could a storm surge this severe have been predicted*", it was. The chart above shows how hurricanes have hit NY roughly once a decade since 1850, and before then, there's evidence of some giant ones in 1693, 1785, 1788 and 1821. Hurricane Gloria (1985) was also a clue as to how bad it could get: in the chart below from a seminar held by the American Society of Civil Engineers in 2009, Gloria storm surges in the Battery would have been 10 feet and not 7 if they had occurred at high tide. At the same seminar, 20-foot storm surges were estimated for New York City as being once per 150-year events, not once per 15,000. And back in 1995, the US Army Corps of Engineers, the Federal Emergency Management Agency and the National Weather Service published "critical elevations" for NYC infrastructure. Critical elevations refer to the height of a storm surge at which infrastructure becomes inoperable. As shown in the last chart, even an 8-foot surge creates huge problems; at 10 feet, you'd have quite a mess. **The bottom line is that it has been known for a quite while that a large storm surge in the Northeast is not a completely freak occurrence, and that it could be very damaging**. That's why other cities around the world have spent 4-8 years building protective barriers after 20-30 years of planning.

Hurricane Gloria (1985): the luck of the tides
Water level in feet



Source: "*Storm Surge Modeling and Climatology for the New York City Metropolitan Region*", Brian A. Colle, Stony Brook University.

Critical storm surge elevations by location (at which systems become inoperable), estimated in 1995



Source: US Army Corps of Engineers, FEMA, National Weather Service.

There are low-tech solutions (bigger inland seawalls and dykes), but large ocean-based storm surge barriers are what other coastal cities have opted for. They would be expensive, for sure; one estimate is $6.5 billion for a barrier north of the Verrazano Bridge. Where might the money come from? Absent the ability to raise taxes infinitely (the highest state and local income tax rates in New York City are already 12.7%), government finances are a series of difficult choices. The City's website indicates that less than 5% of ARRA proceeds were spent on infrastructure, and that the largest amount was spent on Medicaid (31%). On the latter, New York Medicaid expenses per capita of $2,700 are by far the highest in the nation and 35% higher than the next closest state, so perhaps the answer doesn't rely on reducing entitlements, but on delivering them more effectively. The tie-ins to the debates at the national level on growth, productivity, entitlements and taxes are unmistakable.

Michael Cembalest
J.P. Morgan Asset Management

Sources

"*Ranking of the world's cities most exposed to coastal flooding*", 2007, and "*A global ranking of port cities with high exposure to climate extremes*", 2009, both from the OECD and the School of Civil Engineering and the Environment, University of Southampton (UK)

The following links track state and city-level ARRA projects: www.recovery.gov/Pages/TextView.aspx?data=stateInfoTafs&state=NY and www.nyc.gov/html/ops/nycstim/html/summary/summary.shtml. Con-Ed projects mentioned were designed to address system efficiency and reliability (e.g., the Smart Grid, integration of renewable energy), but did not mention flood protection or disaster recovery.

"*Storm Surge Modeling and Climatology for the New York City Metropolitan Region*", Stony Brook University, prepared for the American Society of Civil Engineers conference in 2009 entitled, "*Against the Deluge: Storm Surge Barriers to Protect New York City*"