Topics: what's getting better and what's getting worse; US tax progressivity

Brief market update. I get the sense that some people are disappointed that equity markets sold off recently. A little context is in order here. While global equities were up 15% YTD in early September, this is not the kind of year in which such returns should be expected. Anything in the neighborhood of 8%-10%, where they are hovering now, should be considered a victory given the headwinds in place. Such a result would still validate the strategy of sticking at or slightly below normal equity allocations. It might seem like a volatile year, but 13% (so far in 2012) is right on the long-term average.

As we head into the US fiscal cliff saga, there are a wide range of potential outcomes. My best guess is that whether people like it or not, the President has gained leverage over House Republicans, evidence of which is seen in the Clintonesque statements from the latter about agreeing to raise tax *revenues* but not tax *rates* (through substantial reduction of deductions and exemptions applied to AGI > $250k). The President's opening bid this week was pretty high: $1.6 trillion in tax revenues raised over ten years mostly from the top two brackets, and also from businesses; we'll see where it goes from here. The upshot: if the bulk of the fiscal cliff is defused (from 4% of GDP to around 1%), US growth will not have as much of a headwind next year (good news), but the rating agencies will face the dilemma of whether to reflect this in its credit ratings of US debt (the potentially bad news). Anything more than 2% could risk throwing the US economy into reverse for a couple of quarters.

A Star is Born. I began to work on our 2013 outlook this week, and was looking at some of the improving and deteriorating trends around the world. In doing so, I was reminded of *A Star is Born*, in which an aging alcoholic whose career is in a downward spiral helps a young aspiring actress on the way up who passes him by. So, this week, a *Star is Born* assessment of what's getting better and what's getting worse. What is notable: the weakest links in the US (housing, consumer finances) are improving. In Europe, the weakest links (Greece, Spain) continue to get worse in terms of employment and growth, but are showing some improvement in balance of payments data. As a starting point, 2013 looks like it may be a repeat of 2012: many of the same trends affecting markets, and household and corporate cash looking for returns amidst the collapse in interest rates.

Norman Maine : a binge-drinking has-been on the way down

The Norman Maine charts cover trends that don't look so good. Recently, we showed how Spanish growth is at its weakest level since 1850, exceeded only by the Spanish civil war collapse in 1937-38 (Oct 1st EoTM), and how recessionary conditions may be developing in France. This week, a chart on the modest weakness in Germany: consensus growth for 2013 is just 1%, inventories are rising, profit expectations are falling and hiring intentions are falling as well; not a good mix. Next, a table on Greece. How bad is it in Athens? A decline of 20% in real GDP is an abstract thing, so I went looking for the largest real GDP declines over the last 50 years for context. The result: **the Greek economy is declining at a pace only exceeded by countries going through civil/foreign wars and isolation (Iran during its 8-year war with Iraq, Peru's Shining Path era), or the collapse of the Soviet Union after 70 years of a command economy** (see box on next page). There was an episode in Venezuela around the 2002 failed nationwide strike to oust Chavez, but it was quickly reversed when the strike failed and oil prices rose. As for Greece, the IMF is apparently insisting on official sector debt forgiveness, but this does not seem likely until after German elections. The IMF will have to accept the fact that it has little influence on the process, and has sanctioned yet another crippling austerity program with poor results. Until substantial debt forgiveness by the IMF, EU and/or ECB, Greece will remain a failed state with unsustainable debt (~180% of GDP) within the presumably respectable confines of the OECD.

Decline in German business surveys and manufacturing orders, Percent change, YoY

Source: Bloomberg.

Country	5 yrs ending	Real GDP decline	Cause
Ukraine	03/31/97	-50.8%	Soviet/satellite economies collapse- see box
Bulgaria	06/30/94	-37.1%	*See box on page 2*
Venezuela	03/31/03	-31.5%	Failed PDVSA strike to oust Chavez
Romania	12/31/92	-30.6%	*See box on page 2*
Peru	09/30/92	-27.8%	Shining Path civil war, hyper-inflation, nationalization
Russia	03/31/97	-26.4%	*See box on page 2*
Kazakhsta	03/31/97	-25.4%	*See box on page 2*
Iran	09/30/88	-20.8%	Isolation after '79 revolution, 1980-1988 Iran-Iraq war
Greece	**12/31/13**	**-20.8%**	**Eur. Mon. Union boom-bust**
Latvia	03/31/97	-19.2%	*See box on page 2*

Source: Country sources, IMF, OECD

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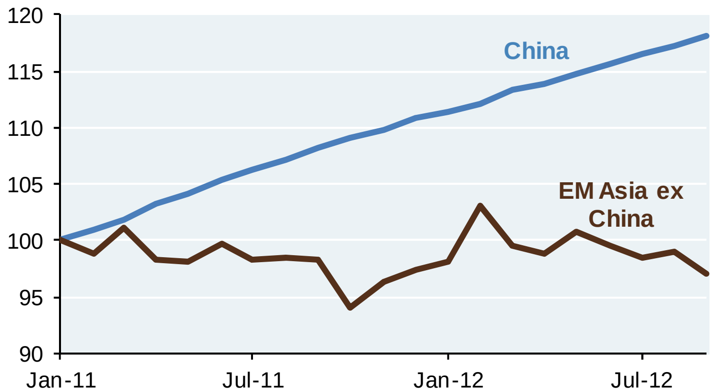
Reasons for the spectacular output collapse when the Soviet Union disintegrated:

- The entire integrated payments system and inter-enterprise settlement system completely broke down. The consequences were painful given highly concentrated production pipelines. As one example, of 65 major items of equipment used by a large agri-business, 34 were produced by just one firm for the entire Soviet Union.
- Budgetary subsidies were eliminated. Central Asian republics received up to 30% of GNP in transfers from the Soviet Union.
- $60 bn of annual energy subsidies were eliminated, several oil and gas pipelines were closed, and formal customs, transit and trade barriers were introduced
- Air traffic volumes plummeted, power grids collapsed and integrated water systems deteriorated due to lack of investment
- Over 3 million Russians left the republics, leading to civil wars and refugee problems (Georgia, Armenia, Tajikistan)
- Internal trade within the former Soviet Union declined by 84% from 1991 to 1993, freight traffic fell 42% and mail traffic fell 83%

Source: "Economic Disintegration Matters: The Soviet Collapse Revisited", Johannes F. Linn, Brookings Institution, October 2004

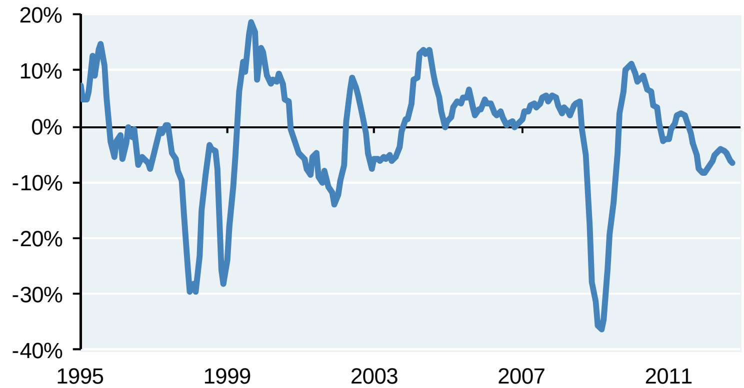
For all the worries about China, we have more concerns about EM Asia *ex*-China. As shown, outside of China, Asian manufacturing has barely budged, which is showing up in negative earnings revisions. The decline in 2012 wasn't that big, but surprising at a time of easy monetary policy. Just last month, Taiwanese and Korean exports picked up and forward-looking manufacturing surveys improved, suggesting that this mini-spiral may come to an end in the spring of 2013.

EM Asia manufacturing output
Index; Jan 2011 = 100



Source: J.P. Morgan Securities LLC.

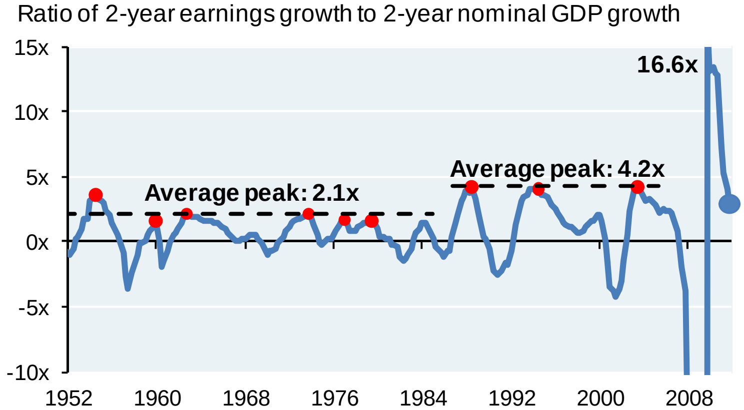
MSCI EM earnings revisions
6 month percent change



Source: IBES.

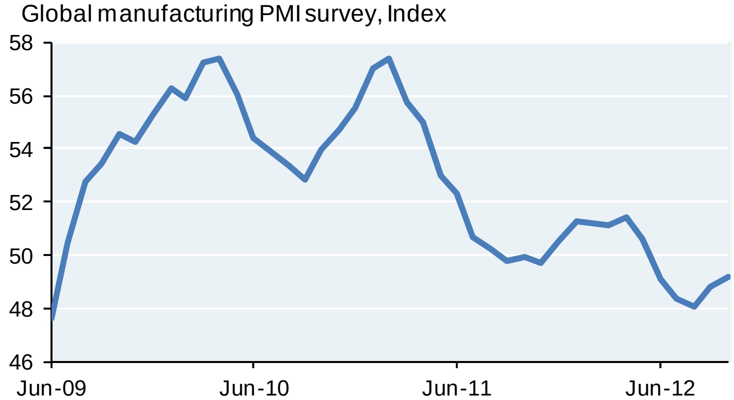
The last two charts also have a Norman Maine feel to them: the slowing pace by which profits are outperforming nominal GDP growth in the US, and the fading boost from stimulus as measured by the smaller peaks in the J.P. Morgan global survey of manufacturing activity. Our sense is that the weakness in Europe lay behind the deterioration in both charts. While Europe is addressing its balance of payments problems through money-printing, a European growth revival looks like a very remote event.

Unusual period of earnings outperformance ending
Ratio of 2-year earnings growth to 2-year nominal GDP growth



Source: S&P, BEA, JPMAM.

Fading growth benefits from stimulus
Global manufacturing PMI survey, Index



Source: J.P. Morgan Securities LLC.

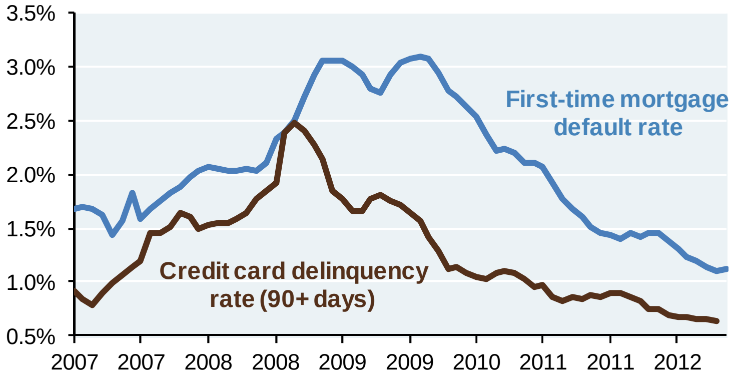
Honorable Mention negative trends: the decline in US durable goods orders and shipments, almost any economic statistic from Japan, and the rising Federal debt of the United States which is now over 100% of GDP (gross) after a 7% deficit in 2012.

Topics: what's getting better and what's getting worse; US tax progressivity

Esther Blodgett: a rising star with humble beginnings

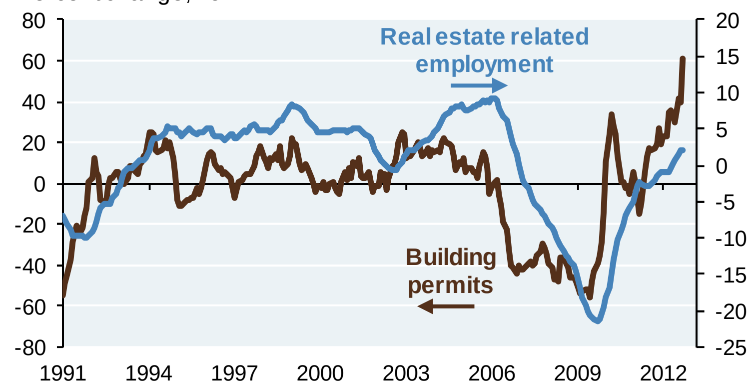
The Esther Blodgett charts cover trends that are improving, many of them after prior weakness. The weakest links in the US have been housing and consumer finances, which are both improving. There are a lot of charts one might show. I have included two: the improvement in consumer delinquency rates (which are now back to 2007 levels), and the recovery in states most impacted by the housing crisis, measured by building permits granted and housing-related employment. This suggests that the recent improvement in US retail sales is not a fluke, and that we should downplay any weak storm-related readings this winter.

Consumer delinquencies back to pre-crisis levels
Percent



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

Arizona, Nevada, Florida and California: Phoenix rising
Percent change, YoY



Source: BLS, Census, Empirical Research Partners.

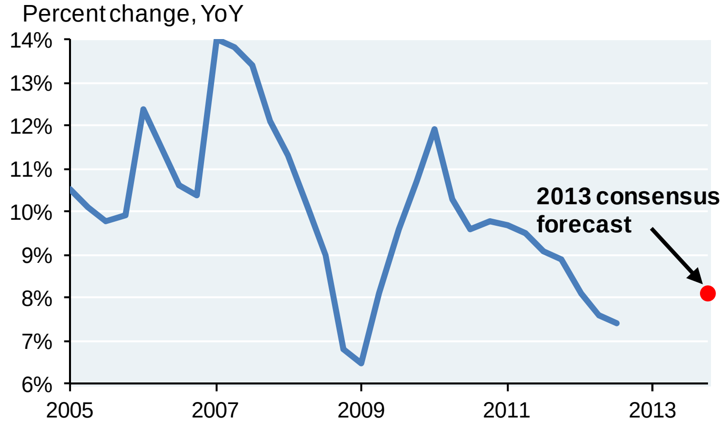
On China, we are fairly confident that next year's consensus GDP forecasts are achievable. First, the forecast is for 8%, which acknowledges that growth is slowing after the end of the capital spending boom. Second, as shown in the grid, corroborating measures of growth have picked up, so we are not just relying on the Chinese National Bureau of Statistics. The most recent industrial production data show a gain of 15%, on par with the 10-year average, and real retail sales are rising by 15% p.a. as well. We expect China to be a positive surprise next year after all the skepticism and gloom surrounding its economic situation.

High-frequency complements to Chinese GDP data

Data	Latest read
Cement production	Moderately improving
Container throughput	Flat vs large gain in '11
Electricity consumption	Moderately improving
Exports	Moderately improving
Floor space started	Very volatile, weak after summer rebound
Highway freight	Flat since Sep
HK Luxury sales	Small improvement in Sep vs large gains in '09-'11
HSBC Manuf. survey	Small improvement in Sep/Oct
Macau gaming revenue	Flat vs large gains in '09 -'11
Passenger car sales	Still weak after large gain in '09 and smaller gain in '10 and '11
Rail freight	Improvement after summer collapse
Steel production	Moderately improving
Waterway freight	Flat since Sep

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

Chinese real GDP growth
Percent change, YoY



Source: China National Bureau of Statistics, Bloomberg.

On Europe, you will have to search far and wide to find positive data on growth, employment or sentiment. But what you *can* find are examples of how the ECB and EU balance sheet expansion (and promise of more to come[1]) has stabilized capital flows, credit spreads and banking system data. Retail bank deposits stopped falling last month in Spain, Italy and Greece; Italian and Spanish credit spreads have declined from 6% to 3%; capital flight from Spain has been negligible for the last 2 months; and as shown below, the weakest links are not plummeting any more (debt issued by Periphery banks, and Italian and Spanish sovereign debt held by foreigners). Some of the improvements are admittedly very small. **I don't know if these improvements can last if the economic data remains as bad as it is, but global markets should get a respite from European sovereign and bank default risk for a few months**. This in turn should allow growth in the US and China to proceed at its own pace (whatever it may be) without being hijacked by Southern Europe on a weekly basis.

[1] Bridgewater estimated the size of the European firewall at 2.25 trillion Euros this week, *if* the EU subordinates its aid in the form of first-loss guarantees to future bondholders. So far, the EU has insisted on being senior to the private sector, so this would be quite a shift.

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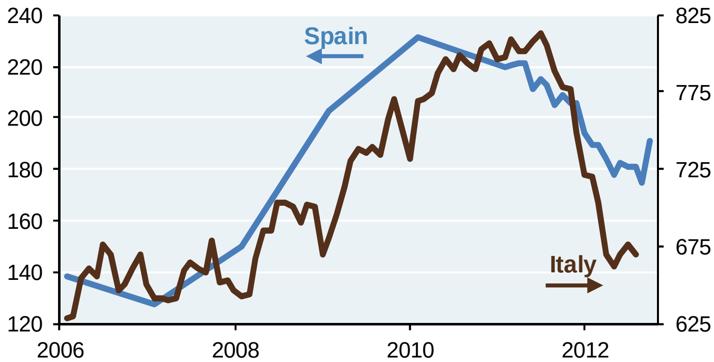
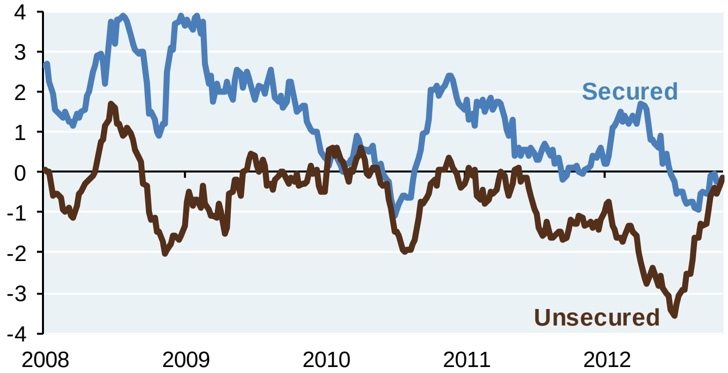
Foreign holdings of Spanish & Italian government debt
Euros, Billions



Source: General Secretariat of the Treasury and Financial Policy, Banca d'Italia.

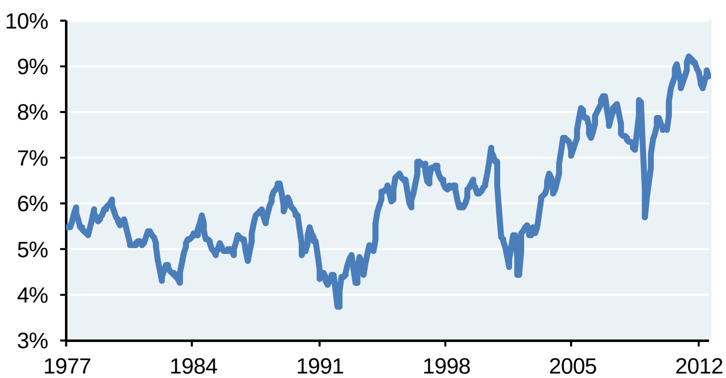
Periphery bank debt issuance
EUR billions, 3-month moving average



Source: J.P. Morgan Securities LLC.

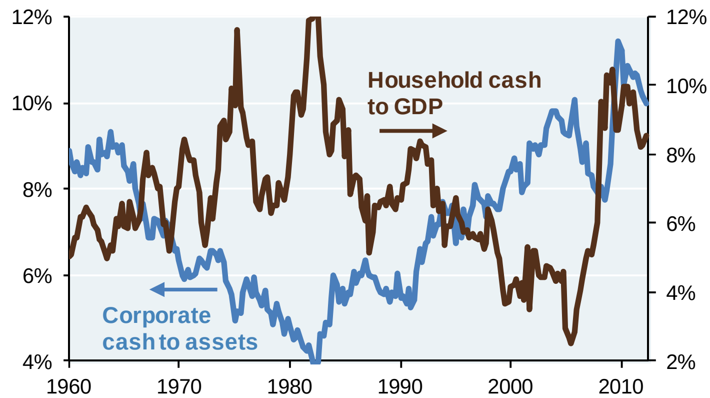
Last Blodgett chart: it's not improving per se, but the trend of elevated US profit margins has remained stable in the face of widespread predictions of a decline. We expect Asian and Brazilian growth to rebound in 2013 given falling EM interest rates, and for US labor compensation to remain weak even as US payrolls improve. As a result, we expect the elevated profit margins of a globalized S&P 500 to persist into 2013**.**

S&P 500 ex-financials net profit margin
Percent



Source: Empirical Research Partners.

The Walls of Cash



Source: Federal Reserve Board, BEA.

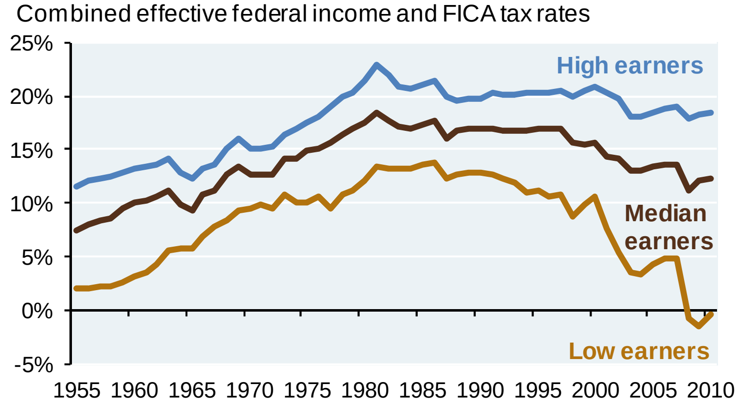
Honorable mention positive trends: rising US domestic crude oil production (a topic addressed in our annual energy piece on October 22nd); and the improvement in Tier 1 bank capital ratios and loan-to-deposit ratios in the US, Europe, the UK and Japan.

Conclusions, and some comments on tax progressivity

The trends described above collided this year to generate a 10% gain on global equities (so far). As a starting point, 2013 may not be that different, with the exception that P/E multiples are slightly higher than they were in January 2012, and the caveat that US fiscal cliff outcomes could be quite negative if no agreement is reached. If the fiscal cliff is pared back *and* something is also done about the long-term US Federal debt outlook, the piles of household and corporate cash shown above may have a reason to start moving again.

On the budget deficit, families with adjusted gross income above $250k are in the crosshairs of the debate. Higher tax payments by this demographic appear a foregone conclusion, but let's look at the data anyway. The chart to the right shows the progressivity of the US income tax code; the dispersion between effective tax rates by income category has *increased* over time. Not exactly the Dickensian system it is sometimes described to be, is it?

What a progressive income tax system looks like
Combined effective federal income and FICA tax rates



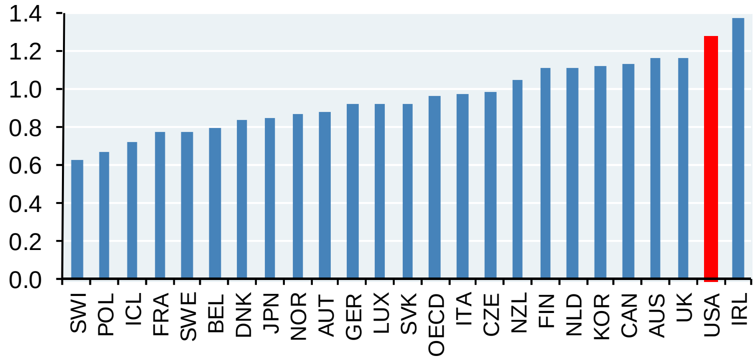
Source: Tax Policy Center.

Topics: what's getting better and what's getting worse; US tax progressivity

The last chart shows how the US stacks up vs. other OECD members. The author's methodology incorporates income concentration in addition to tax concentration (in other words, how progressive is the system after accounting for unequal distribution of income) Even after doing so, the US tax system still emerges as one of the most progressive, although you might not get anyone in Sacramento, Albany or Omaha to acknowledge it. The US does not tax citizens as much as other countries do, but of the tax dollars raised, they are raised in a comparatively progressive fashion. Progressivity can of course be increased further, but it would be unlikely to solve the budget issues by itself. What will the President do then?

Michael Cembalest
J.P. Morgan Asset Management

Tax progressivity by country, from low to high
Concentration coefficient of household taxes divided by Gini coefficient (concentration of earned income)



Source: *"Income Distribution and Poverty"*, OECD, Chapter 4, 2008.

A Star is Born

The first film version of *A Star is Born* appeared in 1937 starring Fredric March and Janet Gaynor, and the second version appeared in 1954, starring Judy Garland and James Mason. Both received several Academy Award nominations. The 1976 version, on the other hand, was a train wreck, receiving some very harsh reviews that are fun to read if you like satire (e.g., John Simon of the National Review, Pauline Kael at The New Yorker, Rex Reed). The male co-star was quoted as saying that acting in the film cured him of wanting to appear in movies, and one of the songwriters accepting a Grammy thanked his doctor for prescribing enough Valium to get him through the experience.