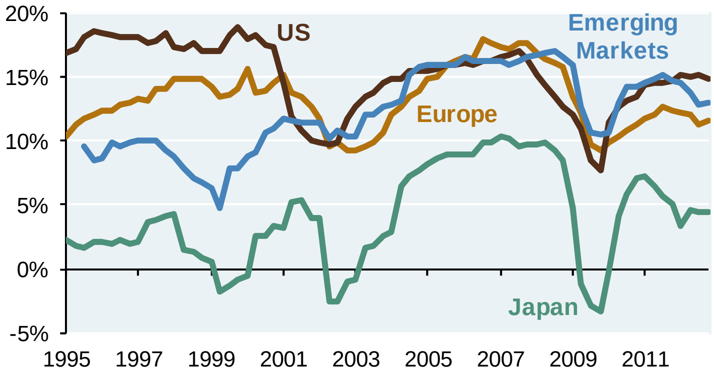
Topics: The long run benefits of owning the US and Emerging Markets over Europe and Japan; the Social Fabric

Equities: the benefits of owning the US and EM over the Axis Powers

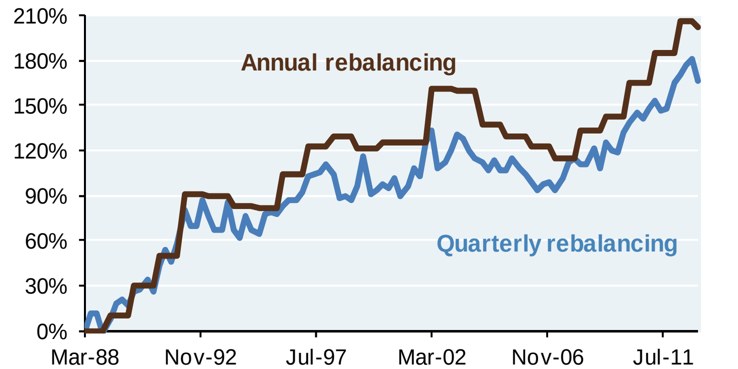
Over the last few years, we have often had a regional equity preference for the US and Emerging Markets over Europe and Japan. One primary reason starts with the first chart below. It shows the **return on equity** by region since the mid-1990's. As a general barometer, it's a good starting point for positioning a portfolio, since it tells you about returns companies generate for shareholders. It does not tell you how much investors *pay* for these returns, since RoE is based on book value, not market value. For example, last June, European stocks traded at an all-time low discount to US stocks in terms of price-to-book, price-to-earnings and price-to-dividends. It also does not tell you whether RoE differentials are affected by greater leverage in some regions. Even with these caveats, the relative strength of EM and US RoEs has been a valuable investment signal. Such profitability differentials are often as important to us as any regional macroeconomic differences.

Return on Equity
Percent



Source: Datastream. Data as of 12/31/2012.

Cumulative benefit of being overweight the US and EM and underweight Europe and Japan, Percent



Source: Bloomberg, J.P. Morgan Asset Management. Data as of 12/31/2012.

Did the barbell work? The second chart is one way to measure it. The analysis measures the cumulative outperformance of a portfolio with $67 in US equities and $33 in EM equities over a portfolio with $67 in European equities and $33 in Japan. The outperformance shown has been large (~4% per year) and pretty consistent, other than during the European periphery over-consumption phase (2002-2007) which led to the European debt crisis. 2013 may be a year in which Europe and Japan equity markets benefit from the search for higher dividend yields outside the US, and the pending Japanese monetary expansion. However, many of the structural growth and corporate profit issues have not changed, suggesting that a preference for the US/EM over the Axis Powers (allowing for some literary license in using the name) may still make sense over the long run.

No question, debt markets are improving in Europe. With the veil of ECB support in place, demand for Spanish and Portuguese government bonds was 3-4 times the 10 bn that was issued last week. Furthermore, European banks in Q1 may repay ~30% of monies borrowed from the ECB during the Long Term Refinancing Operations. I thought that these loan balances would be *increasing* in 2013, and they are falling. There has also been an increase in retail deposits in periphery banks after months of declines. However, markets have mostly priced reduced default risk in the European financial system: the price to book ratio of the Bloomberg Europe Bank Index has risen from 0.5x last June to 0.85x. These latest valuations are only slightly below US levels (0.9x price/book) despite European banks having half the capital of US banks (i.e., tangible common equity to tangible assets), and only a modestly higher level of loan loss reserves in an environment of weaker growth and higher unemployment. Across all sectors, European stocks traded at a 20% P/E discount to the US last June; that discount today is just 10%.

Forget about Europe for a moment; **the more interesting case is Japan**. The last time Japan consistently generated 3% nominal growth and 2% inflation (PM Abe's proposed targets[1]), it was 1990, as shown on the following page. Can such conditions be recreated? My view is that Japan must either (a) run "flagrant monetization", which entails very large spending-oriented deficits funded directly by the Bank of Japan; or (b) have the BoJ purchase tons of equities, REITs and corporate bonds. Anything incremental (simply financing leftover deficits) probably won't get it done. We will find out more later this year when the new political appointments are in place. The amazing thing is that the BoJ has *already* been buying around ¥46 trillion per year in JGBs (Japanese government bonds), which is almost equal to annual new issuance. Without (a) or (b), I would not expect a sustained multi-year rally in Japanese equities, but if either should take place, it would make a lot of sense to move back to a normal weighting. The best news for Japan: corporate and banking sector leverage is close to 20-year lows, so if the BoJ can

[1] Abe's other policies include reductions in corporate tax rates to restore competitiveness, reductions in social problems and the number of public employees, and a re-assessment of the DPJ's plan to phase out nuclear power. This latter point is no surprise, given the enormous costs and uncertainties associated with offshore wind and other renewables proposed as alternatives to nuclear (see EoTM 10-22-2012).

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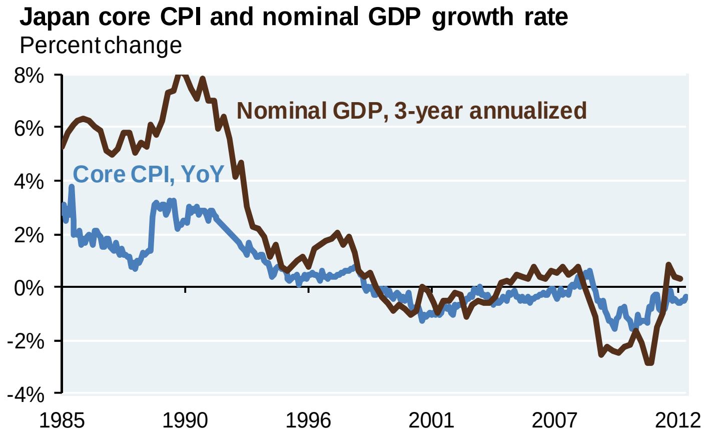
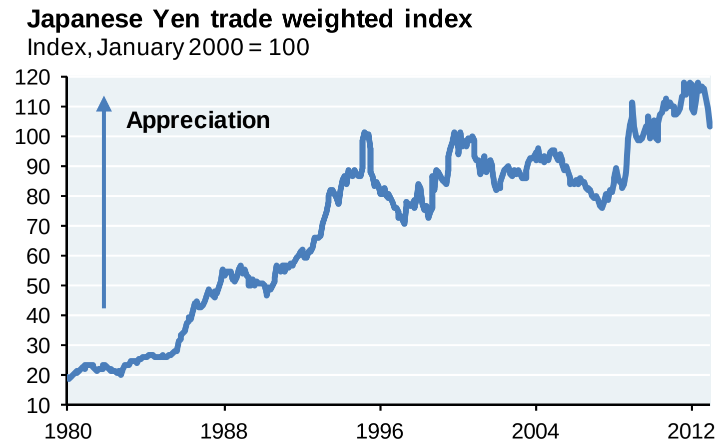
jump-start inflation, there is plenty of balance sheet capacity to put to work. One estimate I saw indicated that corporate cash flow coverage of interest in Japan is over 11 times, enormous by any standards, and a sign of under-leveraged balance sheets.



Source: Ministry of Internal Affairs and Communications, J. P. Morgan Securities LLC, Cabinet Office of Japan. CPI adjusted for changes in tax rates.



Source: Goldman Sachs & Co., Bloomberg.

Many of Japan's challenges are related to fewer people in the workforce to support a growing social burden, a consequence of low fertility and longer life expectancies. Can Japan encourage women in child-bearing years, the elderly and foreigners to enter the workforce? It would take a new set of policies that we have not seen so far. On gaining a currency advantage, Japan is trying to thread a needle: weaken the Yen but not have it fall through ¥105/$, or the rising cost of imports could become a problem. The chart above shows the trade-weighted value of the Yen, which rose sharply after other central banks cut their policy rates in 2008. However, the recent jaw-boning by the incoming government has been sufficient to reverse a great deal of it already. As we wrote in the Outlook in early January, **Japan (rather than Europe) is more likely to break the Axis Power underperformance trend, at least in 2013, if the BoJ follows through on Abe's platform.**

Random thoughts on the social fabric in Europe

This does not relate directly to investments, but I thought it was worth mentioning. Over the last couple of years, we have been watching the social fabric in Europe given 18% unemployment (and rising). With little growth on the horizon, it's not clear how jobs will improve much, and what the long-term social implications will be. Whether it's Europe in the 1930's or the US during the same period (conflicts between strikers, the National Guard and armed militias), unemployment can create a powerful cocktail of unrest. So far, European demonstrations have been fewer than what one might have expected given the situation.

Could a mitigating factor in Europe be a better starting point vs. other countries? "Quality of life" is hard to measure. There are organizations that give it a shot: the most detailed version we have seen is from the OECD. There are clear patterns in the OECD data: on issues related to work-life balance, life expectancy, environment, personal safety[2], family support network and life satisfaction, the Eurozone ranks ahead of the US[3]. However, the recession does seem to be taking its toll: fertility rates, which were finally rising in Europe during the prior decade, declined sharply in 2011; according to the UK Economic and Social Research Council, suicides have been rising in Italy and the UK due to economic stress; and in Spain, there has been an increase in observed depression, anxiety and mood disorders (as per the *Red de Actividades Preventivas y Promoción de la Salud en Atención Primaria*). The imposition of regressive VAT taxes has also widened income disparities in many countries. Some of the same trends are observed in other countries which experienced a large recession, like the US.

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[2] On personal safety, some data may explain why Europe ranks better than the US: with the exception of Estonia, homicide and incarceration rates are 5x-7x higher in the US than in the Eurozone. Countries with homicide rates comparable to the US include Liberia, Haiti, the Ukraine and Lebanon. Further out on the spectrum, there are countries with homicide rates that are 3x-4x higher than US levels: Brazil, many countries in Africa and Central America, and Venezuela, which has practically the highest homicide of all countries measured. Coincidentally, per capita gun ownership is 3-5x higher in the US than in the Eurozone. However, as I was reminded by some colleagues, many studies contest the notion that gun ownership leads to greater violence. One example is from the June 2006 Harvard Journal of Law and Public Policy entitled "*Would Banning Firearms Reduce Murder and Suicide?*" The authors state that the evidence is clearly against this view, and assert that "the determinants of murder and suicide are basic social, economic, and cultural factors, not the prevalence of some form of deadly mechanism. In this connection, recall that the American jurisdictions which have the highest violent crime rates are precisely those with the most stringent gun controls." **I read the paper, but somehow I still have trouble believing their conclusion**.

[3] The US ranks ahead of Europe on factors related to household income and housing, but US measures include the benefits of government transfers which may not be sustainable.

Topics: The long run benefits of owning the US and Emerging Markets over Europe and Japan; the Social Fabric

While there may be increasing cracks in the social fabric, so far, concrete political manifestations have been limited. Despite the complaints that show up in Eurobarometer surveys, Eurozone citizens appear committed to persevering with the Euro despite the hardships. With the ECB doing the heavy lifting instead of national parliaments making large fiscal transfers, the perceived costs of the regionwide bailout seem low. No political party that clearly advocates Eurozone withdrawal have done well in national elections, not in the surplus countries in the North, nor in the deficit countries in the South (the closest would be the *Movimento 5 Stelle*, or M5S, in Italy). We have noted in the past the modest rise of rightist parties in some countries, but **so far the political status quo is holding better than I thought it would.** This is particularly true in Germany, where opposition parties are also pro-Eurozone, if not moreso. I suppose there's still a long way to go, and that the impact of a generation of disenfranchised, jobless youths will take time to appear.

In 1992, the author of the German Constitutional Court opinion on Maastricht wrote the following: "*A Europeanisation without a prior European consciousness and therefore without a European people with a concrete capability and readiness for common statehood would be, in terms of the history of thought, un-European*"[4]. Could it be that the social fabric in Europe is stronger than many perceive it to be, and that "Europeanization" has advanced a lot since 1992? Perhaps; but I am equally tempted to believe that Europeans simply recognize the financial and economic dangers of immediate dissolution, and remember the words of Benjamin Franklin: "**We must all hang together, or most assuredly we shall all hang separately!**"

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[4] Written by Paul Kirchhof, as per Bernard Connolly of Hamiltonian Global in his 2003 essay on the European Monetary Union.