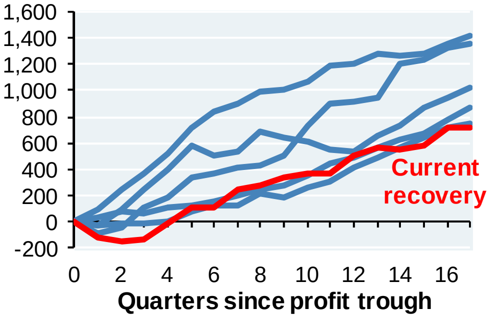
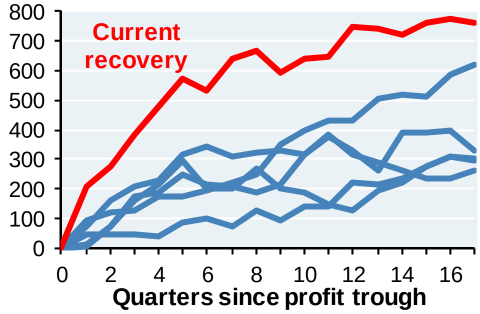
**The Haves and the Have-Nots in the US, Emerging Markets, the tech sector, Europe and Africa**

***To Have and to Have Not.*** To a greater degree than in the past, rising equity markets reflect the triumph of the haves (owners of corporate profits and real estate) over the have-nots (bondholders and labor). As a result, equity market corrections tend to happen when the disconnect between them becomes too great; that's what is happening now. To be clear, the correction in the S&P since its peak is quite modest, and common; similar ones have taken place in 80% of all years since 1950. To get a sense for the have/have-not issue in the US, consider the 4 charts below on the US profit cycle. The current increase in corporate *revenues* is the weakest of 6 post-war recoveries [A]. However, the corporate *profits* recovery has been by far the strongest [B].

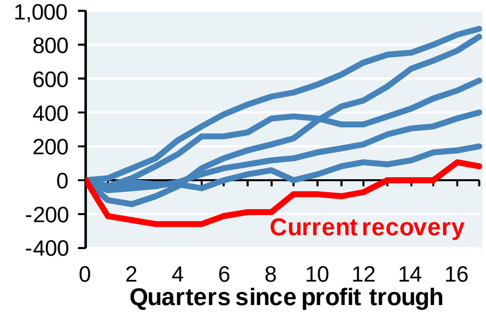
**[A] Revenue**
Billions of 2005 USD




**[B] Profits**
Billions of 2005 USD



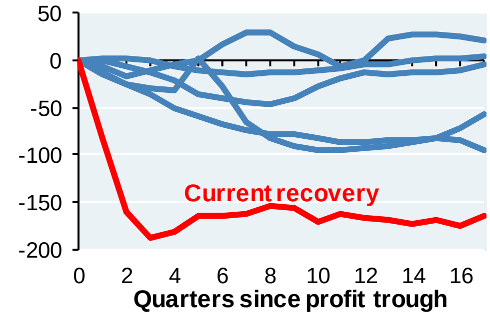

**[C] Labor compensation**
Billions of 2005 USD




Source: BEA, JPMAM. June 2013.

How can [A] and [B] co-exist? The largest explanatory factor is the anemic recovery in labor compensation [C], followed by the decline in interest expense [D], mostly a function of the Fed-engineered collapse in the yield curve.

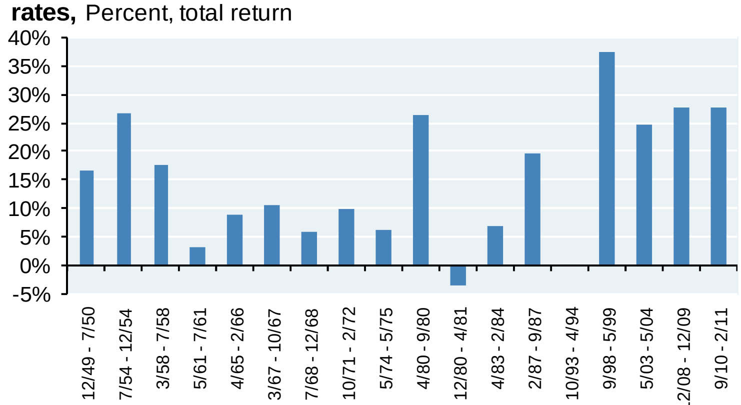
**[D] Interest expense**
Billions of 2005 USD




**Equity markets often ignore problems affecting bondholders and workers as long as profits are rising**. However, though profit *margins* are high, sequential profits *growth* is slowing, and problems affecting bondholders and workers are manifesting themselves through rising interest rates and GDP growth that is still below escape velocity. Rising rates are also causing problems for dividend-paying stocks, a risk we have been mentioning for some time. US housing and spending are improving, but even after the impact from the sequester and income/payroll tax hikes fade, we're still looking at 2.5% US GDP growth rather than the 4.2% average which prevailed during prior recoveries (recent consumer strength is also more a function of declining savings rates than rising earned income). We still expect US equities to outperform economic conditions this year, and to outperform other regions; but it's worth noting how this recovery differs from prior ones.

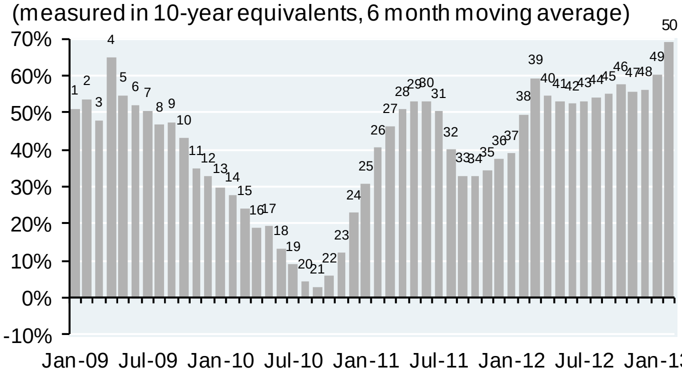
**As for Bernanke's comments which triggered rising yields,** the history of equity market returns during periods of rising yield curves is actually good, as shown below (left). The caveat: prior episodes did not follow the disentanglement of a trillion-dollar romance between the Fed and US bond markets, an unorthodox tryst we chronicled in *Fifty Trades of Grey* (February 19, 2013). Bernanke aims for a graceful separation, perhaps to avoid having his legacy tarnished the way Greenspan's was, by perceptions

**S&P 500 performance in periods of rising LT interest rates,** Percent, total return




Source: Bank of America Merrill Lynch , JPMAM. June 2013.

**Fifty Trades of Grey: Fed purchases of Treasury and Agency securities,** percent of total net supply issued (measured in 10-year equivalents, 6 month moving average)

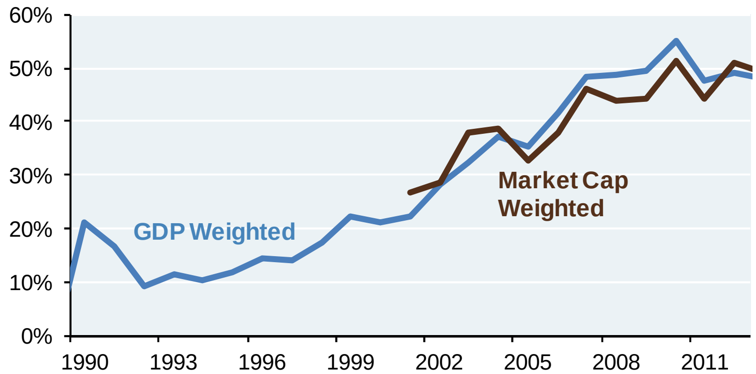



Source: Nomura Securities, J.P. Morgan Securities, LLC. As of Feb 2013 that easy money contributed to boom-bust cycles. However, markets aren't ready for the End of the Affair. **As I wrote in February about the risks of the Fed's exit from the markets: love knows not its own depth until the hour of separation.**

## China and the have-not tractor beam

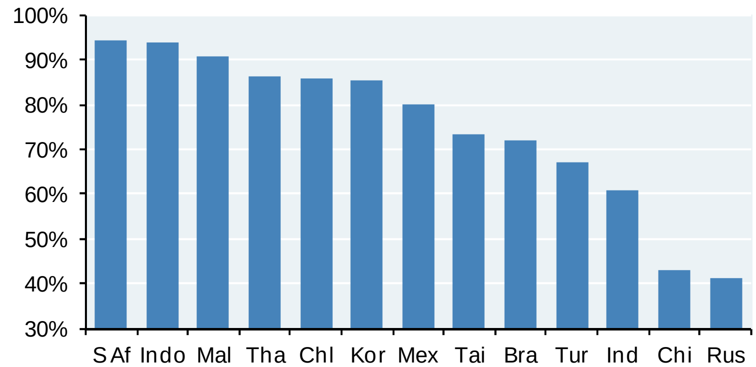
The big disappointment this year has been emerging markets equities. To be fair, EM equities outperformed Europe, Japan and the US handily from 2007 to 2012, but that's ancient history now. The source of the problem may be China. The first chart shows how over the last 20 years, EM countries are exhibiting higher growth correlations to China. In other words, when China grows or slows, so do they. This may reflect rising import/export relationships, particularly following China's entry into the WTO in 2001. The second chart explains the market consequences of the first: in many EM countries, there's a tight connection between GDP growth and equity market returns. This connection is low in China itself, but higher elsewhere. **To summarize**: China grew at only 6.6% in Q1, and this is impacting other EM countries, now growing at ~3%, down from 8% in 2010. These slowing EM economic trends are having their expected impact on EM equity markets.

**EM GDP growth increasingly converging to China**
10-year correlations of GDP growth in 20 countries vs. China




Source: International Monetary Fund. June 2013.

**In many EM countries, GDP growth and equity market returns are closely linked,** 10-year correlations



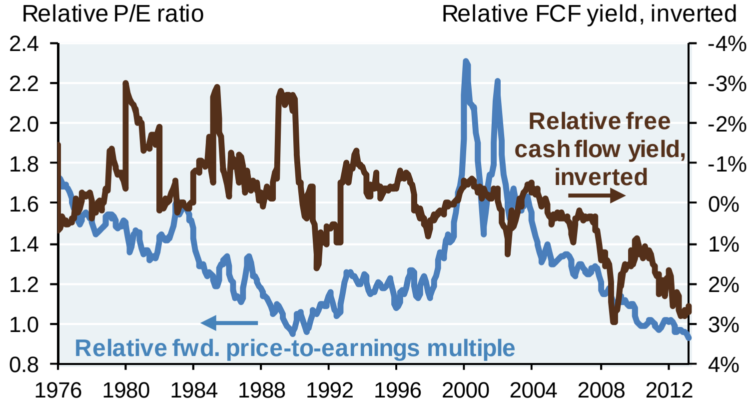

Source: IMF, Bloomberg, JPMAM. February 2013.

Will China speed up later this year? The Chinese government has plenty of levers to pull, but has been focused on excessive build-up of credit in the shadow banking system and rising real estate prices. Conventional monetary easing would help growth, but cause problems in these two areas. If anything, in the latest liquidity squeeze, the government seems to be trying to shake out weaker, over-leveraged entities to avoid a bigger problem down the road. China seems destined for 6.5%-7.5% growth, which is lower than what I expected a few months ago, dampening the prospects for a near-term EM equity recovery.

## Technology stocks: a sharp divide between the haves and the have-nots

Tech stocks seem cheap on paper: the first chart shows tech valuations relative to the market using both P/E multiples and free cash flow yields. Tech stock P/Es are now roughly the same as the overall market, while their free cash flow yields are 2.5% higher. Both measures suggest that tech stocks are cheaper in relative terms than they have been in decades. This phenomenon is partly explained by investors piling into defensive stocks with higher dividends in a zero interest rate world. It may also be partly explained by the second chart: outside of recessions, tech earnings growth is usually ~20%, and now it's close to zero.

**US tech stocks priced very cheaply to the market**
Relative P/E ratio | Relative FCF yield, inverted




Source: Empirical Research Partners. May 2013.

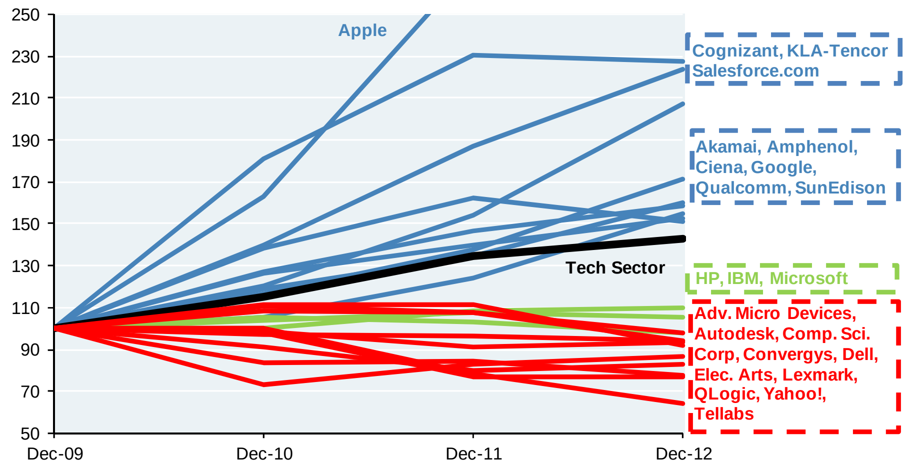
**Tech earnings stalled, unusual for non-recession**
Trailing 12-month earnings per share growth, percent change, YoY


Source: Bloomberg, JPMAM. May 2013.

**The Haves and the Have-Nots in the US, Emerging Markets, the tech sector, Europe and Africa**

**The challenge with technology companies: there are a lot of haves and have-nots**. The chart below looks at rolling annual revenue growth since 2009. The blue lines are the fastest growers, and the red lines are the slowest[1]. We added some bell-weather names in green as well. We are obviously mixing a lot of things here: companies dependent on overall business capital spending trends; companies whose revenues depend on other companies' product releases (game consoles, tablets, etc); companies negatively affected by the migration to cloud/mobile computing; and companies affected by the US government sequester. **But that's partly the point: sector-level valuations may be less useful when looking at technology companies than when looking at sectors with more homogenous revenue performance.** The specific products and services tech companies sell often overwhelm whatever macro/industry trends may be taking place. As a counter-example, **almost all US companies targeting high-end consumers in S&P's Luxury Index grew revenues over the same time frame**.

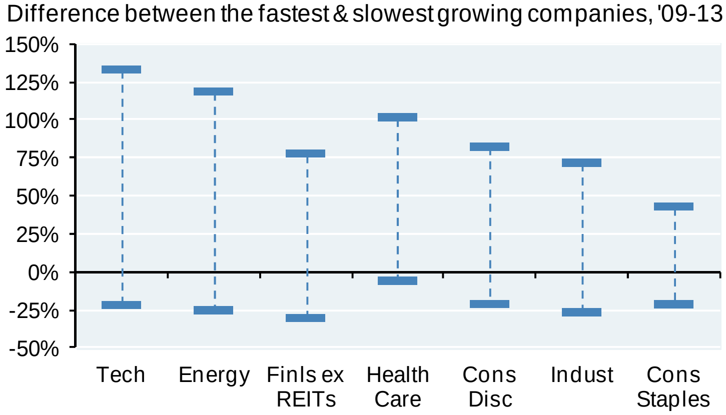
**S&P 500 Technology sector: companies with best and worst revenue growth**
Index




Source: Bloomberg, JPMAM. June 2013.

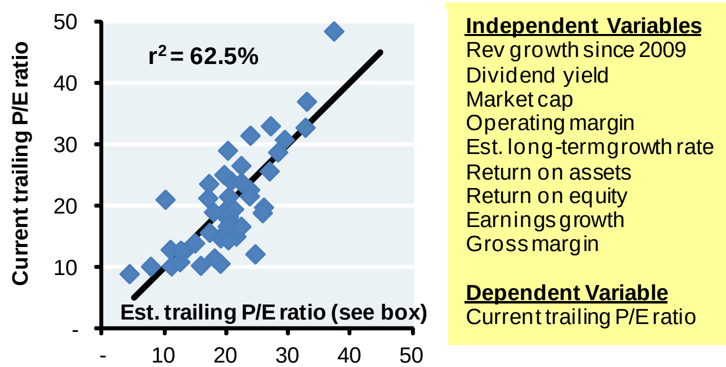
Revenue dispersion between technology haves and have-nots since 2009 is wider than in most other sectors, with only energy being similar. Investment strategies designed to exploit these divergences are worth a look: long-short technology funds, or technology funds that have the ability to hold concentrated positions rather than having to track an index.

**S&P 500 intrasector revenue growth dispersion**
Difference between the fastest & slowest growing companies, '09-13




Source: Bloomberg, JPMAM. March 2013.

**On an intrasector basis, tech valuations seem to reflect company-specific fundamentals**




Source: Bloomberg, JPMAM. June 2013.

Given this high revenue dispersion, it may not be very informative to look at sector-level tech valuations. **Instead, a closer look at individual S&P 500 tech stocks shows that their multiples may not be that mispriced, at least relative to each other.** The chart above (right) uses 9 variables related to revenues, earnings, margins, dividends, etc. to estimate current tech stock P/Es. The model does a pretty good job estimating P/Es ($r^2$=62.5%) given how company-specific P/E multiples are. In general, larger companies with lower gross margins and lower earnings growth are the ones with the lower P/E multiples.

We separately looked at "size", and found that today's large tech companies are twice as big relative to the overall economy as they were during the 1990's. This may explain lower P/Es on megacap tech stocks: can they continue to grow at the same pace, either organically or via acquisition? **Tech stocks may offer better long-term value than the defensive dividend-payers whose prices have been bid up, but are not as universally cheap as the sector-level chart suggests**.

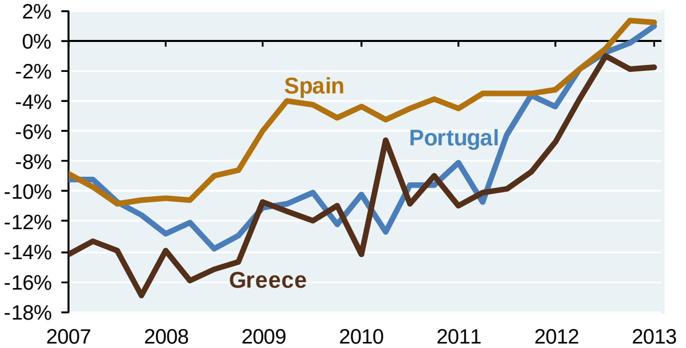
[1] Technology companies are active in terms of acquisitions. As a result, we made some adjustments which incorporate forward-looking analyst estimates to account for circumstances when revenues might be materially impacted by M&A activity.

**The Haves and the Have-Nots in the US, Emerging Markets, the tech sector, Europe and Africa**

**<u>Are the have-nots of Europe ready to grow again?</u>**

The current account deficits in Spain, Italy, Portugal and Greece have now closed. In prior crises, this development usually meant a broadening recovery was on the way. There are signs that manufacturing and service sector activity is picking up in the Periphery; car registrations and consumer confidence are also rising off of extremely depressed levels (see charts).

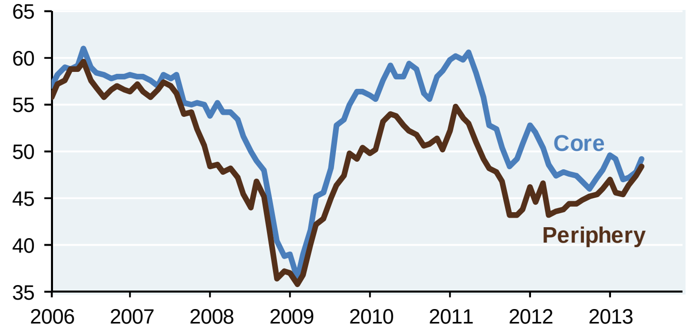
**European Periphery current account balances now closed,** Percent of GDP




Source: Banco de España, Banco de Portugal, Bank of Greece. March 2013.

**Manufacturing and services surveys**

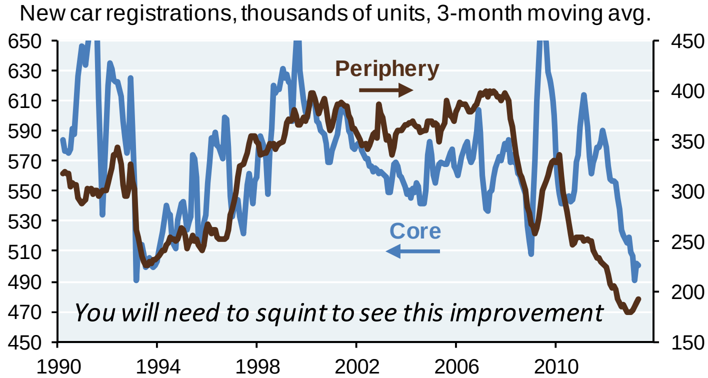
Composite PMI (mfgr.+ services), 50+=expansion




Source: Markit, JPMAM. Core is proxied by France and Germany. Periphery is proxied by the rest of the Eurozone. PPP-GDP weighted. June 2013.

**Car sales**

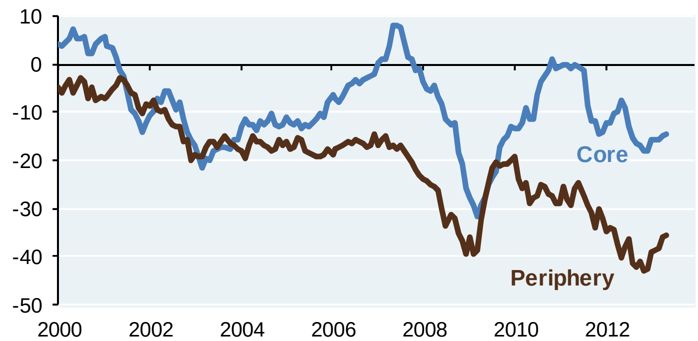
New car registrations, thousands of units, 3-month moving avg.




Source: ECB. Data as of May 2013.

**Consumer confidence**

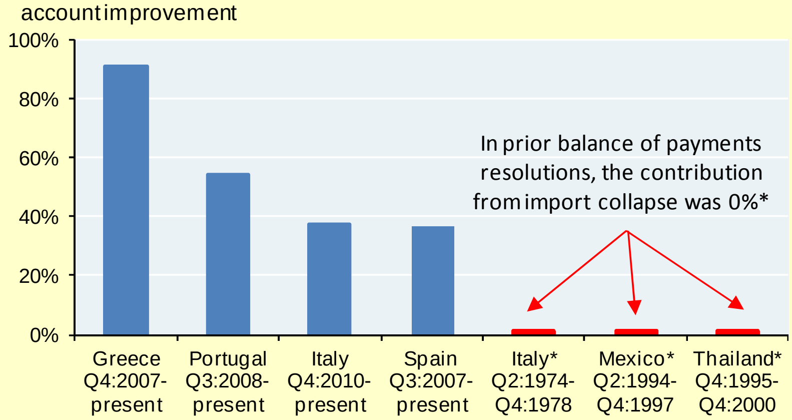
Consumer confidence indicator, % balance




Source: European Commission, IMF, JPMAM. PPP-GDP weighted. May 2013

**So, are closing European current account deficits as positive an omen as in the past?** Such deficits typically close almost entirely due to rising exports. That's not the case this time, as an import collapse flatters the overall improvement. Some clients mentioned that once in a while, the EoTM should be written for liberal arts majors. Considering that recommendation, here's a chart on the import collapse with a sonnet to explain it. Europe's ability to endure this remains a question mark.

**The contribution from collapsing imports (and collapsing demand and employment) to the improvement in current account deficits, past and present,** import collapse as % of current account improvement




Source: JPMAM, Haver. *In prior cycle examples, imports *grew* in Italy, Mexico, and Thailand, and improving exports outstripped rising imports.

*<u>A Matter of Import in Portugal, Spain, Italy and Greece</u>*

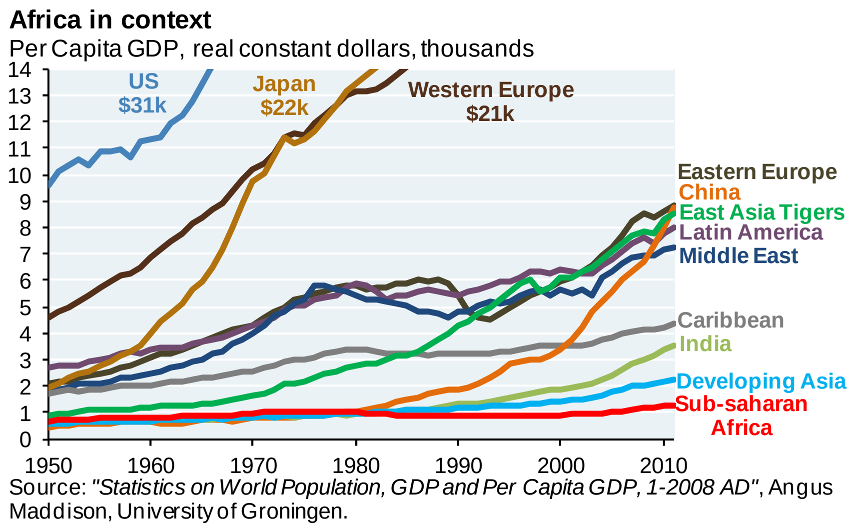
"I read somewhere that their current accounts
Improved by impressively large amounts
If so, they'll soon be recovering fast
At least that's what's been observed in the past.
But something's amiss in that deficit chart -
The harlot's cheek, beautied with plastering art*
Is how I'd describe anyone's allusion
To crises resolved; it would be a delusion
Since the main thing here is **import collapse**,
Not jobs or exports or growth, perhaps.
Unlike other recov'ries seen or felt
This one is mostly a tightening belt.
So before you think an economy's healed
Consider an adage herein revealed:
Current accounts of zero can mean success
Or that everyone's under tremendous stress."

** Hamlet, Act 3, Scene I*

**The Haves and the Have-Nots in the US, Emerging Markets, the tech sector, Europe and Africa**

**A future for some of the world's have-nots, using business expertise rather than reliance on foreign aid**

I attended a presentation the other night about ways of alleviating poverty in Africa that was very interesting[2]. Start with a community of people who produce crops like coffee, typically in locations with limited internet, hospitals or other infrastructure, and who sell their products through local community networks at very low prices. For many, their living conditions have been unchanged for decades as they fall further behind the rest of the world.



Source: *"Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD"*, Angus Maddison, University of Groningen.

TechnoServe brings in experts to reside on-site and work with local producers on the following:

- developing premium brands at higher prices
- designing business plans to secure capital equipment loans from local banks
- employing modern agricultural practices related to crop rotation and proper fertilization
- establishing larger regional marketplaces and exchanges on which to sell their goods
- building brand awareness and securing purchase agreements from companies which dominate the global coffee markets

In other words, apply best practices to improve the supply chain, cost structure and pricing equation. The projects I heard about in Mozambique and South Sudan sounded promising. It may be worth a look if you are considering a philanthropy that leaves behind expertise, know-how and a commitment to market solutions rather than aid and its associated cycle of dependence.

**Final thoughts**

In our 2013 Outlook in January, I wrote the following:

- the bar for markets was higher in 2013 than in 2012, given how far valuations had already run, so as a result, we expected modestly lower returns and higher volatility
- a portfolio of risky assets should generate modestly positive returns by the time the year is over
- the incremental benefit of monetary stimulus on the global economy has been fading, while household balance sheets and demand are improving
- we are living through the largest policy experiments of the last 300 years, with considerable market uncertainty about its eventual withdrawal
- Europe still has a lot of problems, although rising default risk on sovereign and bank debt is no longer one of them

Not very much has changed since then.

Michael Cembalest
JP Morgan Asset Management

Notes
WTO = World Trade Organization; BEA = Bureau of Economic Analysis
*To Have and to Have Not* was a 1937 novel by Ernest Hemingway.

[2] My wife Rachel is on its advisory board, and has been on some amazing trips to see their projects in Kenya, Nicaragua and Haiti. She worked for U.S. Aid in Zimbabwe during the 1980's, but claims no responsibility for the hyper-inflation seen there since.

**The Haves and the Have-Nots in the US, Emerging Markets, the tech sector, Europe and Africa**

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