Postscripts on our portfolios; credit investing; S&P earnings; equity manager alpha; and Europe/Italy/UniCredito

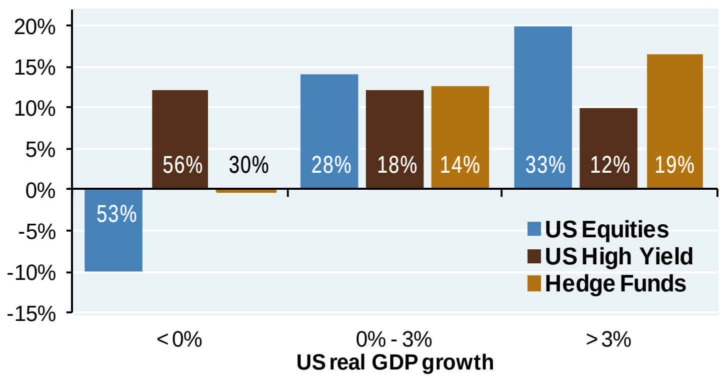
Last week we published our Outlook for 2012. The latest data confirm some of the trends highlighted in the piece:

- Better economic data in the US (fueled by an expansion in consumer credit and a modestly better labor report, even after accounting for an anomaly in courier payrolls), but no progress on long-term fiscal consolidation
- Slowing growth in China, rising hopes for easier monetary policy as inflation crests, and government “encouragement” for Chinese pension funds, insurance companies, national endowment funds and housing funds to buy more Chinese equities. We will focus in greater detail on the implications of the China slowdown in a future note.
- Weakness in Europe, the severity of which is mitigated by the ever-expanding European Central Bank (Gargantua) and US dollar swap lines from the Federal Reserve (Pantagruel)

This week, some follow-ups to the 2012 Outlook, with a focus on portfolios and markets.

Portfolio positioning. Given our view that growth will be below trend in the US (and elsewhere), our portfolios are designed to reflect that. In the first chart, we break down returns on equities, high yield and hedge funds in different growth environments since 1989. It would have been better to have more history here, but hedge fund and credit market returns before 1989 are not reliable proxies for investment results. Since 1989, during 0%-3% growth periods, returns were similar for all three categories. There is considerable dispersion within each bar (shown by the standard deviation of each bar’s returns). Equities have the highest return dispersion, but are often more tax-efficient than either credit or hedge funds, so all of that is baked into our portfolio allocations. We now hold a bit more credit and hedge funds and less equities than usual, for reasons explained above, and in the 2012 Outlook. Within equities, our positions are overweight the US. The sum of all three categories (public and private equity, high yield and hedge funds) ranges from 60% to 70% in our Balanced model portfolios across jurisdictions.

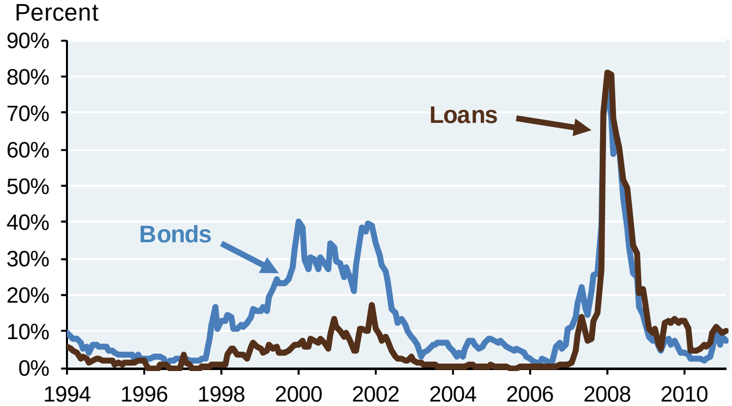
US equity, high yield & hedge fund performance since 1989
Average annualized return, percent, with standard deviations



Source: S&P, BAML, HFRI, BEA, Bloomberg, J.P. Morgan Private Bank.
*Standard deviation of returns listed inside each bar. Computed quarterly.

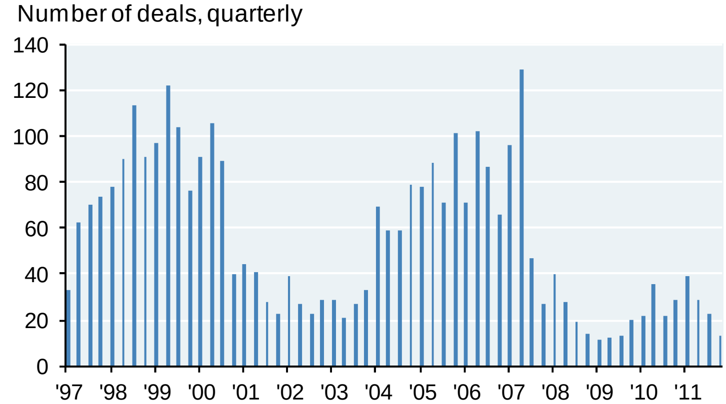
Credit investing: distressed debt vs. high-coupon “mezzanine” lending. Does distressed debt investing still make sense? Right now, there’s not as much distress as in 2008-2009, at least when measured by prices on non-defaulted high yield bonds and leveraged loans (see chart). Only 10% of the HY and loan markets are priced below 80 cents on the dollar. Even so, our distressed debt managers refer to ample opportunities: 10 percent of a $2 trillion combined HY/loan market is still $200 billion to choose from. That is perhaps why their average position prices range from 65 to 75 cents on the dollar. But to me, it seems axiomatic that the sweet spot for distressed debt is when markets are emerging from recession; that’s why distressed debt had its best years (relative and absolute) in 2003-2004 and 2009-2010. For that reason, we consider private lending an interesting complement. The chart on the right shows the number of bond issues from mid-market firms (defined as those with less than 50 million in annual cash flow before interest, taxes and depreciation). While debt markets are receptive to issuance from large well-known companies, mid-market companies are no longer welcomed as they were during the last two bull credit markets. This is what creates the opportunity for high-coupon private lending, a strategy we outlined in the 2012 Outlook in chart c62. Our current exposures are roughly 2-1 in favor of mezzanine lending over distressed debt.

US HY bonds and loans trading <= 80% of face value
Percent



Source: J.P. Morgan Securities LLC, Standard and Poor's, S&P/LSTA Leveraged Loan Index.

Debt issuance by mid-market firms (EBITDA <=$50mm)
Number of deals, quarterly



Source: Standard & Poor's LCD.

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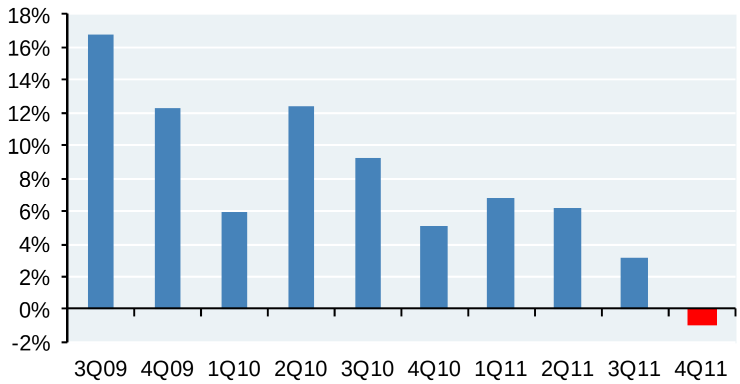
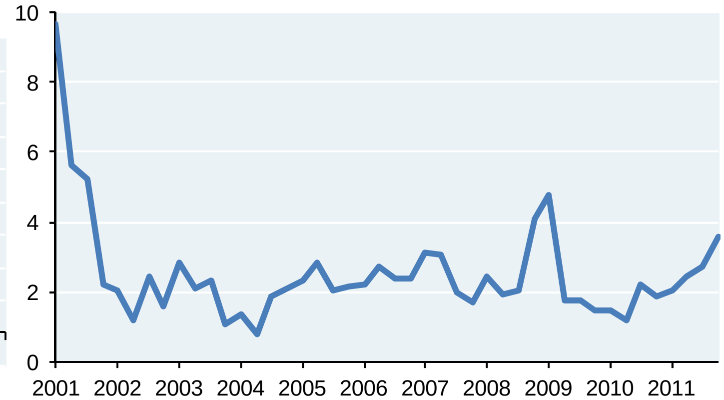
Earnings. Wall Street sometimes has a habit of saying that good news is good news, and that bad news is also good news. Case in point: in Q4 2011, companies reporting prior to Alcoa ended their streak of beating consensus earnings (first chart), and at the same time, there was a sharp rise in negative pre-announcements (second chart). However, many equity research reports point out that over the last decade, **S&P 500 performance in quarters that follow rising negative pre-announcements have been pretty good (see table)**, perhaps due to resetting of earnings expectations that companies then beat. I am not sure that this theory is any more robust than the "*year 3 of the Presidential cycle is a good one for the S&P*" that failed last year. Either way, we are penciling in 2012 S&P profits at $102-$104 for 2012, which when superimposed on 12x-13x multiples, results in expectations of a single-digit return year. History has a habit of defying single-digit return expectations in both directions (see third chart below), but that's what things look like to us right now.

S&P 500 quarterly results prior to Alcoa
Actual earnings vs. consensus



Source: Factset, Thomson Reuters, Morgan Stanley.

S&P 500 negative to positive pre-announcements ratio



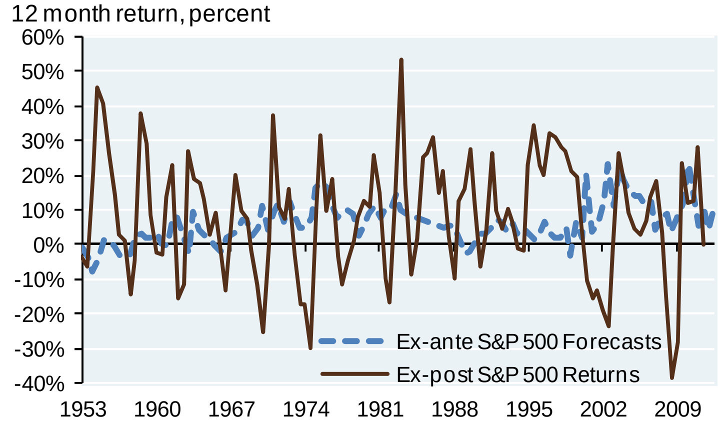
Source: Standard and Poor's, J.P. Morgan Securities LLC.

Equity performance and pre-announcements since Q1 2001

Quartile	Negative/Positive pre-announcements ratio (median)	Median S&P500 Perf. +1Q	Average S&P500 Perf. +1Q
Quartile 1	3.1	5.5%	4.2%
Quartile 2	2.3	0.9%	1.9%
Quartile 3	2.0	-0.4%	-1.7%
Quartile 4	1.4	-0.5%	-2.2%

Source: Standard and Poor's, Thomson ONE, J.P. Morgan Securities LLC.

S&P 500: reality swamps expectations
12 month return, percent



Source: RBC Capital Markets, Federal Reserve Bank of Philadelphia.

Equity manager performance. 2011 was a difficult one for many active equity managers. As shown in the table on the following page, stock dispersion within S&P 500 sectors was lower than average, and in the case of the shaded sectors (consumer discretionary, staples, industrials, materials and utilities), dispersions were close to the lowest levels of the last 20 years. With lower stock dispersions, opportunities for active managers shrink. That's what is shown in the second chart, which plots the average dispersion of stocks within the S&P 500 alongside the percentage of Large Cap Core managers beating their benchmarks[1]. The relationship is not air tight; in 2005, managers did a better job despite low levels of stock dispersion.

The key question here is whether there is a structural decline in the potential for equity manager alpha. There are reasons to wonder whether Reg FD disclosure requirements (imposed in 2000), the advent of exchange-traded funds, high-frequency trading robots and other technical changes have changed the landscape for active equity managers. However, the industry has been through a similar trough in the mid-1990s, and rebounded. The unique circumstances of 2011 (first US ratings downgrade in 100 years, unraveling of the European Monetary Union, etc.) argue against making too many inferences from what was a very difficult year for active management in 2011. This year is an important one for the industry to regain momentum.

[1] For large cap *growth* managers, industry data was worse: only 11% outperformed benchmarks in 2011.

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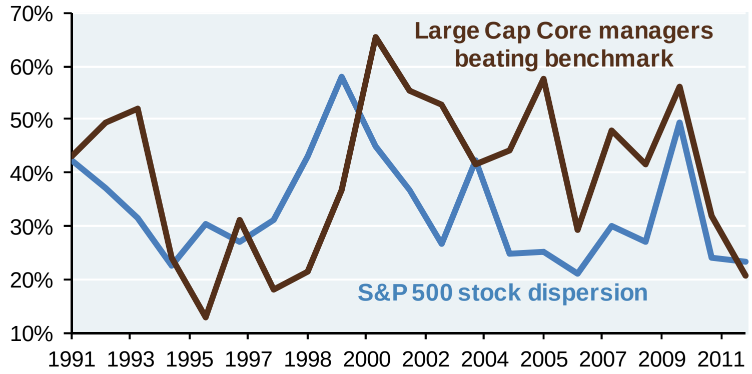
Stock dispersion in 2011: slim pickins
Dispersion of calendar year stock returns by sector, percent

	2011	Avg.	20-Year Max.	20-Year Min.
Cons. Disc.	23	33	58	22
Cons. Staples	16	22	34	15
Energy	26	26	52	14
Financials	22	26	59	13
Health Care	24	31	56	16
Industrials	17	27	38	14
Info. Technology	26	46	95	21
Materials	20	29	56	19
Telecom	23	27	115	11
Utilities	14	23	61	12
S&P 500	23	34	58	21

Source: Standard & Poor's, Factset, Bloomberg.

Stock dispersion and active equity management
Percent

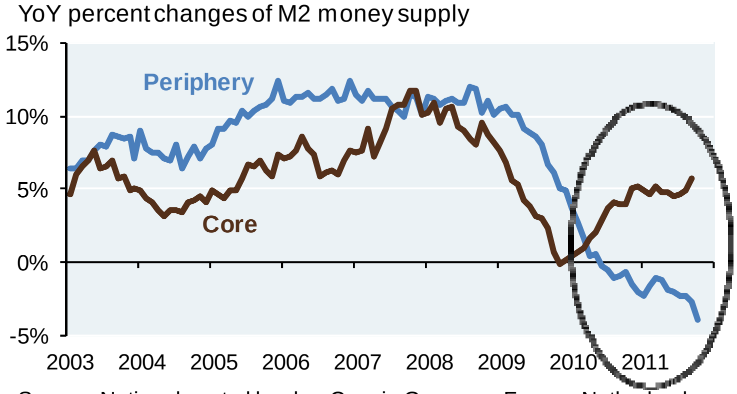


Source: Standard & Poor's, Morningstar, Factset, Bloomberg.

The latest from Europe: strange days

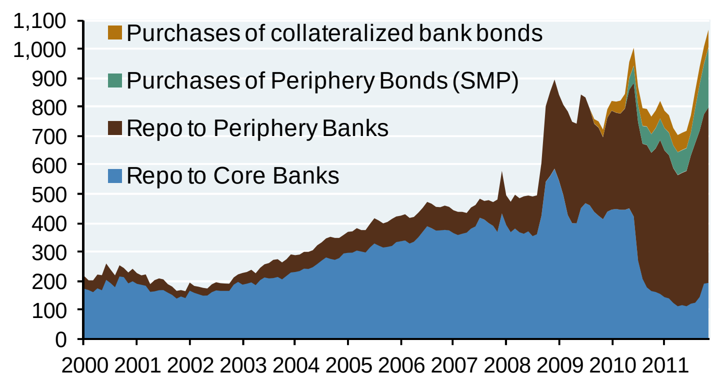
There are bizarre things happening in Europe. A proxy for intra-European capital flight and monetary conditions (first chart) shows an implosion in the Periphery, and a rise in the Core. Meanwhile, like Rabelais' *Gargantua*, the ECB balance sheet continues to rise (second chart). So far, European banks don't seem inclined to increase government bond exposure like they did after the first round of longer-term ECB repo facilities were announced in 2009 (third chart). **Were it not for the ECB, countries like Italy and Spain would probably have left the Euro already, given what is going on with domestic credit and capital flows**. Is this good news? If this process allows time for Italy and Spain to morph into Mediterranean versions of Germany, then yes. But if all this is doing is shifting eventual losses from the private sector to the ECB, I'm not as sure.

A proxy for intra-European capital flight
YoY percent changes of M2 money supply



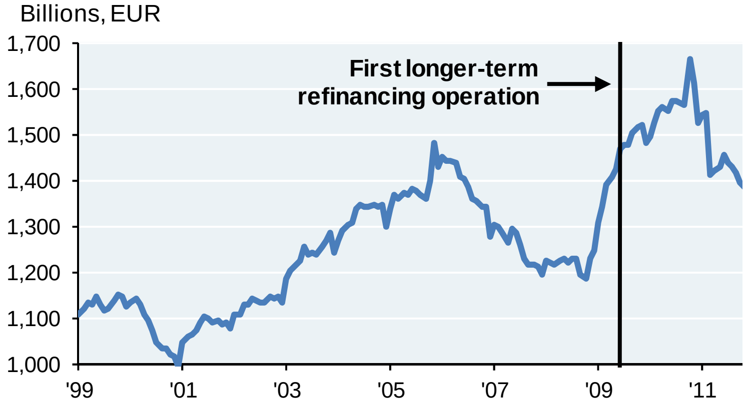
Source: National central banks. Core is Germany, France, Netherlands and Finland. Periphery is Portugal, Ireland, Italy, Greece and Spain.

ECB support to European banks and sovereigns
Billions, EUR



Source: National central banks, ECB, Bloomberg.

Holdings of government bonds by Euro area banks
Billions, EUR



Source: European Central Bank.

ECB protection for the Periphery, version 2

Gustave Doré, Scene from "Gargantua", 1875
Watercolor over pencil on paper, 13 1/16 x 19 1/2"
The Frances Lehman Loeb Art Center, Vassar College, Poughkeepsie, New York, Gift of Mrs. R. Kirk Askew, Jr., 1983.40.1

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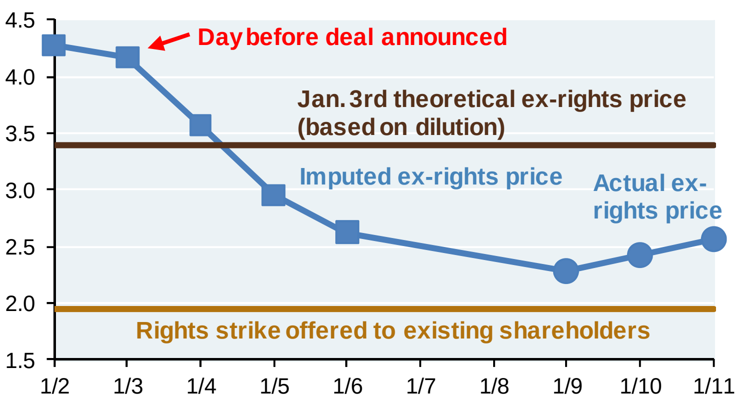
As for capital raises by EU banks, UniCredito sends a tough message in terms of what it might take. The math gets tricky here, since companies usually do not engage in secondary offerings that amount to 60% of their entire market cap. UniCredito's stock price collapsed after their rights offering was announced, but some of this is to be expected given the dilution to existing shareholders. Here's how we see it: the stock traded at 6.33 on the close of January 3rd, the day before the rights announcement. Given the number of existing shares, the new shares issued in the rights offering, the market cap on January 3rd and the new capital raised, the stock should have declined to 3.40 (the "theoretical ex-rights price", or TERP), assuming no change in the company's outlook, and just based on the mathematical dilution. The rights price offered to existing shareholders of 1.94 looked attractive, at a 43% discount to the TERP. **What was interesting to us**: what reward would UniCredito get from the markets for reducing perceived insolvency risk, and how stable was the 43% discount offered to existing shareholders.

Now that UniCredito's share price reflects its capital raise, we can evaluate both questions. On the first point, the stock price has fallen to 2.57 (see below), below the level that would have been predicted simply by the amount of dilution. Some of this may be a consequence of a massively in-the-money rights price putting downward pressure on the stock; if so, it may be premature to draw too many conclusions. Even so, **it does not look like the markets are giving UniCredito much credit for raising 7.5 billion Euros**. [*In contrast, consider the stock price reaction shown below to Regions Bank in 2009, when it also raised equity equal to 60% of its pre-deal market cap*]. The UniCredito outcome is unsurprising, given their 35-40 bn Euros of exposure to Italian government bonds. On the second point, what looked like a 43% discount for existing shareholders has fallen to 20%, with another two weeks to go before the rights offering period ends.

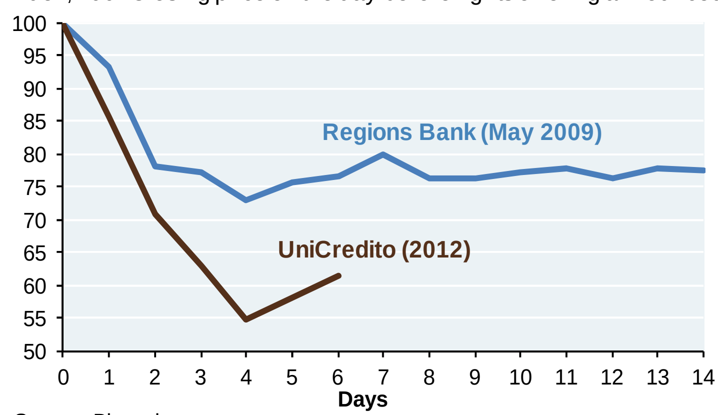
The bottom line here is that the reward required for underwriters and investors to recapitalize European banks is very high, and potentially destabilizing on its own. This is likely to be the case until risks surrounding sovereign debt are resolved.

UniCredito gets no credit (for capital raise)
Ex-rights stock price, EUR



Source: Bloomberg, J.P. Morgan Private Bank.

Reactions to "emergency" capital raises of 60% of market cap
Index, 100=Closing price on the day before rights offering announced



Source: Bloomberg.

Michael Cembalest
Chief Investment Officer

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