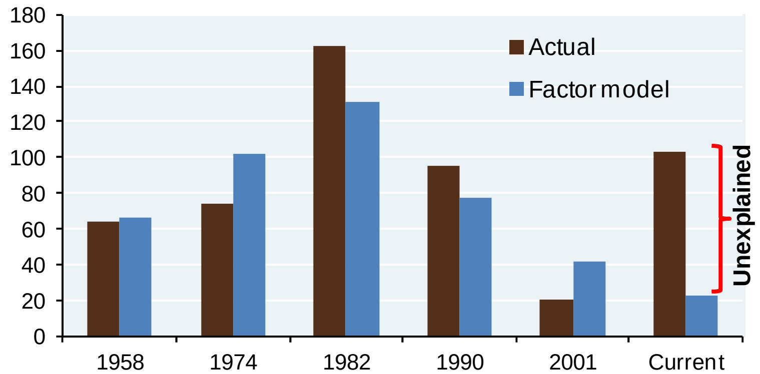
Ben-edictions on the economic and profit cycle; Syria and the US national interest

Benedictions

1:1 In the beginning, Ben Bernanke hath said, let there be liquidity.
1:2 And so didst the Federal Reserve reduce the cost of money to zero, and increase its balance sheet four-fold, buying one third of the US Treasury market.
1:3 And for one thousand days and seven hundred, so didst the Federal Reserve keep short term interest rates at zero, depriving the moneylenders of their profit.
1:4 The cheapness of money made all the stocks in the land, whether beast or fowl, look attractive to the people. And so didst the equity markets rise by 100% since December 2008, bringing joy to all investors who hath owned them.
1:5 And when the people studied prior recessions and recoveries, they discovered that the stock market's current rise could not be fully explained by improvements in corporate profits, manufacturing surveys, interest rates and inflation, as in the past. They believed that a higher power hath watched over them.
1:6 **And so each among them sayeth the following benediction**: "May the Fed bless you and keep you; may the Fed extend its balance sheet to shine upon you; and may the Fed lift up asset prices and protect you from harm".

Equity market returns: actual vs. predicted
S&P 500 total returns, from profits trough to 54 months later, %



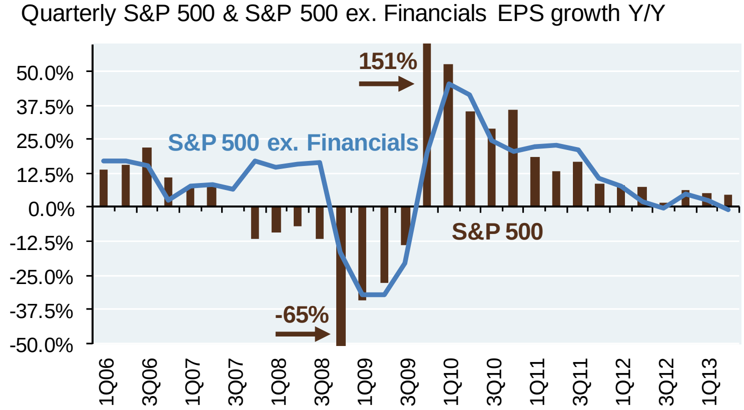
Source: JPMAM, Robert Shiller data set.

Predicting equity market rallies during a recovery
Rising equity markets are usually a consequence of improved profit and economic conditions. We estimate the market's rise based on improving profits, GDP growth and manufacturing surveys, and changes in the yield curve, inflation and the dollar. As shown, the model does a good job estimating prior post-recession stock market rallies, but this time, there's a large gap that our selection of market and economic variables cannot explain. The Fed's Quantitative Easing program, which represses the value of cash and other low-risk forms of savings, is a likely explanatory factor. The unusual outperformance of defensive, higher-dividend stocks vs. the market since December 2008 is one example of QE's impact on equity markets.

Profits/Prophets

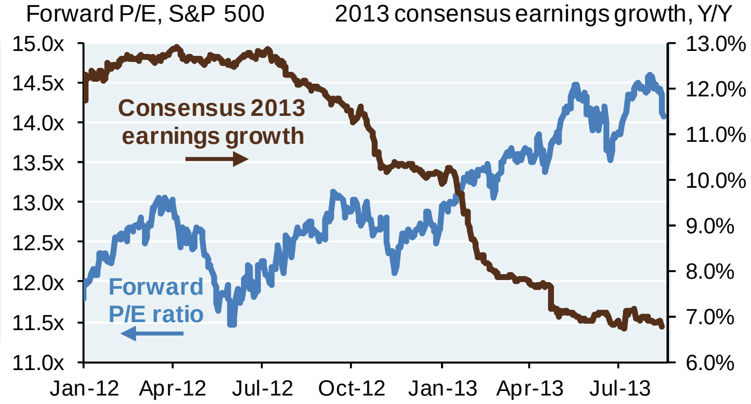
2:1 And it came to pass, that the stock market rally outpaced the growth in corporate profits. Profits growth in H1 2013 was only 4.5% in 2013 compared to H1 2012[1], and close to 0% ex-financials. And so for four hundred days, P/E multiples rose[2].
2:2 When the shepherds hath separated the wheat from the chaff, they found that after stripping out stock repurchases and loan loss reserves released by financial institutions, there was only 0.8% profits growth left to feed the hungry shareholders.

Earnings growth tapering off
Quarterly S&P 500 & S&P 500 ex. Financials EPS growth Y/Y



Source: Deutsche Bank. August 2013.

P/E multiples rising, earnings expectations falling
Forward P/E, S&P 500 2013 consensus earnings growth, Y/Y



Source: Bloomberg, Factset. August 2013.

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[1] Over the last few quarters, profit estimates declined in advance of the quarter by 3%-5%, and were then exceeded by a similar amount when companies reported. As a result, the earnings season ends up looking like a success even though earnings growth is stagnating.
[2] P/E multiples are typically quoted on a trailing or forward-looking basis. As of August 2013, forward-looking P/E multiples for the S&P 500 were 14x based on consensus earnings expectations for the next 12 months. On a trailing basis, P/E multiples are 16x using earnings from Q3/Q4 of 2012 and Q1/Q2 of 2013. Either methodology is reasonable as long as each is charted separately and not combined.

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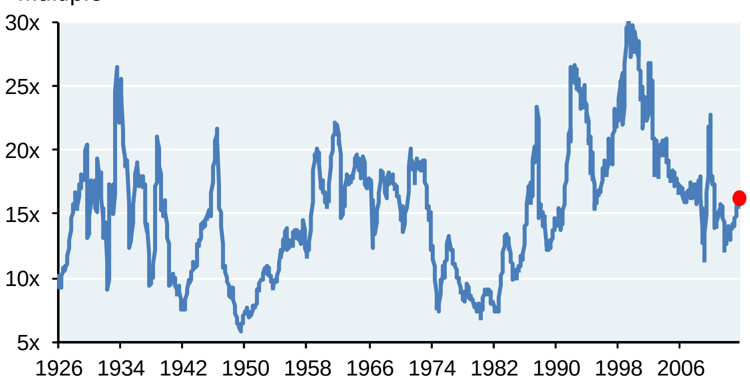
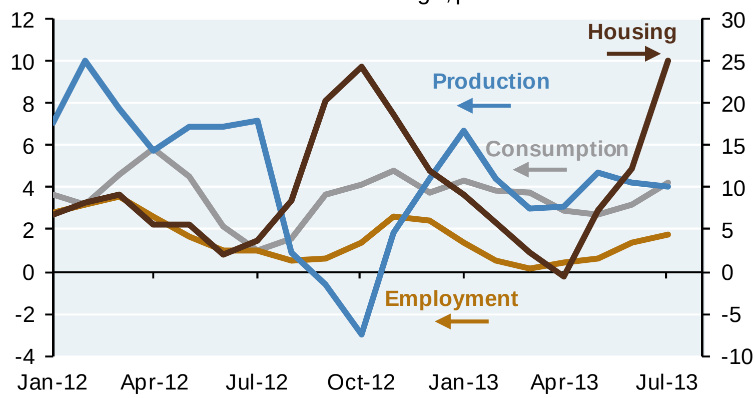
2:4 The elders asked to see some history on stock market valuations, to see if the people had lost their way.
2:5 And so the scribes showed the trailing price to earnings ratio of the S&P 500 since the year one thousand nine hundred and twenty six, and found that while multiples had risen, they were roughly average on a long term basis.
2:6 Yet while P/Es are median and profit margins are high, profits growth hath risen on the back of the laborer, whose compensation as a share of revenues and GDP is at a post-war low. Top-line revenue growth during this cycle is weaker than the prior five.

S&P 500 trailing price to earnings ratio
Multiple



Source: Bloomberg, Empirical Research Partners. August 2013.

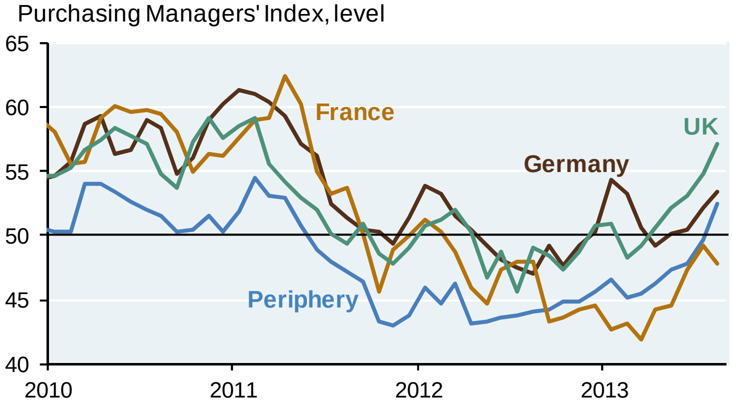
US growth firing modestly on all cylinders
Three month annualized rate of change, percent



Source: NAR, BLS, BEA, Census, JPMAM. July 2013.

2:7 So the scribes surveyed the world to see what layeth on the horizon that could drive earnings higher. They found that the four pillars of the US economic temple were improving (housing, consumption, production and employment), as the US survived the de-leveraging of household balance sheets, higher income and payroll tax rates, rising oil prices and one of the largest budget deficit adjustments in the last 50 years.

A summer rebound in European manufacturing surveys
Purchasing Managers' Index, level



Source: Markit, J.P. Morgan Securities LLC. August 2013.

China and Japan manufacturing surveys
Purchasing Managers' Index, level

Source: Markit, J.P. Morgan Securities LLC. August 2013.

2:8 And the scribes found that in the land of the Romans, the Iberians, the Saxons and the Franks (but not the Gauls), manufacturing conditions were finally improving, and that in the Eastern lands, conditions were stabilizing as well.
2:9 And they found that a measure of global manufacturing orders relative to inventories is rising, heralding a period of higher growth in industrial production.
2:10 Should these positive trends continue into 2014, ye may see revenue and profits growth rise from their current stagnation, justifying the faith of the believers.

Ratio of global manufacturing orders to inventory
From the Purchasing Manager's survey

Source: J.P. Morgan Securities LLC. August 2013.

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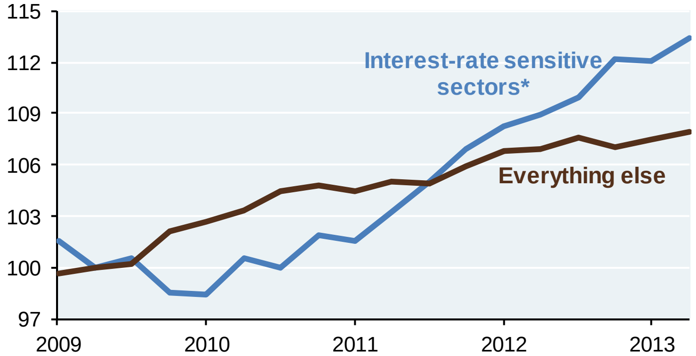
Ramifications

3:1 And it came to pass that the Fed looked at prior cycles, and saw that conditions were still too weak to raise policy rates.
3:2 And so shall the Fed keep the cost of money low, probably below 1%, for another couple of years.
3:3 But what the Fed giveth, the Fed also taketh away. The Fed shall soon commence its tapering of fixed income securities purchases, which hath numbered in the tens of billions each month.
3:4 Thus will the people see what happens to an economy whose modest improvements have rested heavily on interest rate-sensitive sectors and the low cost of money[3].
3:5 The rise in the yield curve may result in bitter fruit for the Risk Parity investor, whose portfolio hath consumed many Treasury, Agency and credit positions financed with substantial leverage[4]. If so, the Risk Parity investor may end up disrupting the bond markets in return, as he hath done in June of this year.

When the Fed tightened during prior cycles	Prior 5 cycle average	Current cycle
Core inflation	3.1	1.7
Unemployment rate	6.2	7.4
Capacity utilization vs. history	-0.3	-3.0
GDP growth vs. potential	1.8	-0.3
Output gap % of potential	-0.9	-5.8
Private sector credit growth	9.2	3.1

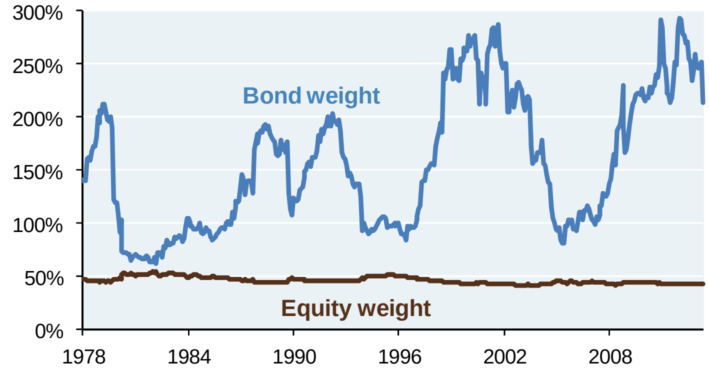
Source: BLS, FRB, BEA, CBO, JPMAM. July 2013.

The importance of low interest rates to the recovery
GDP contribution, Index, 2009: Q2=100



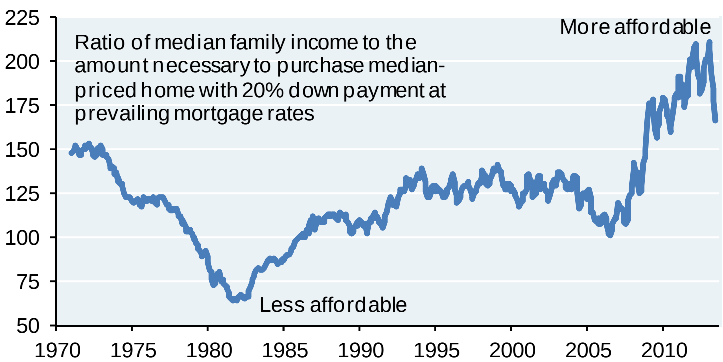
Source: BEA, JPMAM. *Durable goods consumption plus structures. Q2 2013.

A stylized risk parity portfolio shows a lot of leverage applied to fixed income, Percent



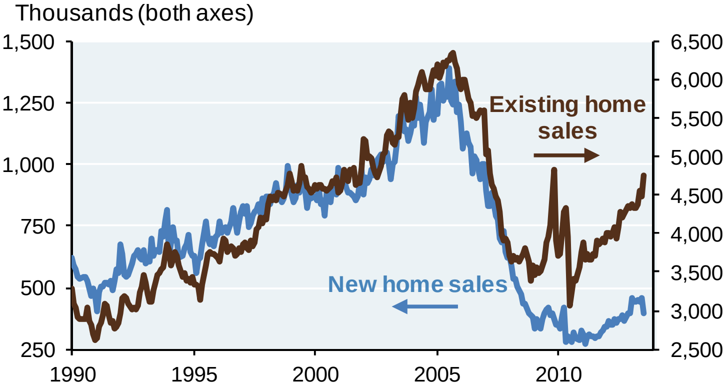
Source: Datastream, J.P.Morgan Securities LLC. Q2 2013.

US housing affordability index
Level



Source: National Association of Realtors. August 2013.

New and Existing Home Sales
Thousands (both axes)



Source: Census Bureau, National Association of Realtors. July 2013.

[3] **Will housing hold up in the face of higher interest rates?** Modestly higher interest rates and higher home prices have made housing slightly less affordable than at its peak last year, but affordability is still high. There has been a dip in pending home sales and new homes sales, while existing home sales, buyer traffic, building permits and buyer intentions are stable. Goldman Sachs estimates that ~60% of 2012-13 home sales were all-cash, compared to 20% pre-2008. Such buyers (often funds buying to rent) are presumably less sensitive to higher rates. We will know more in a few months, but our base case is that housing momentum in 2014 will slow vs. 2012-2013.

[4] **In short, Risk Parity portfolios target the same risk as a traditional 60/40 stock/bond portfolio, but using a different means of achieving that risk**. Typically, risk parity portfolios own leveraged government bond and credit positions as a substitute for unleveraged equity risk. From 2008 to 2012, a simplified Risk Parity portfolio would have substantially outperformed a traditional 60-40 stock/bond portfolio, as explained in a research note from J.P. Morgan Securities: "*The Risks of Risk Parity*" [July 3, 2013, Global Asset Allocation Group]. However, as shown above, the leverage held by such investors to achieve these returns may be quite high, and sensitive to abrupt changes in the yield curve as Fed policy eventually normalizes.

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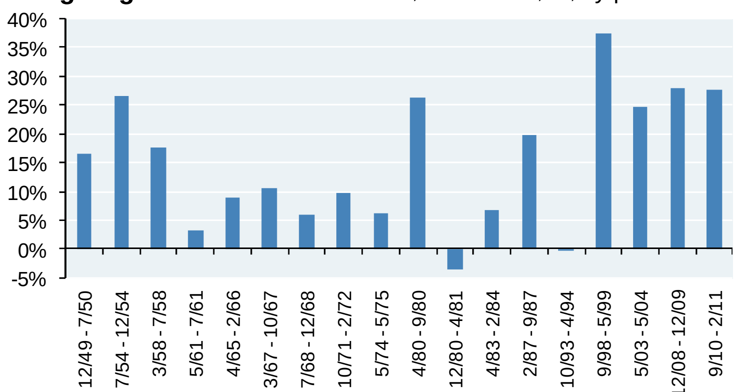
Lamentations

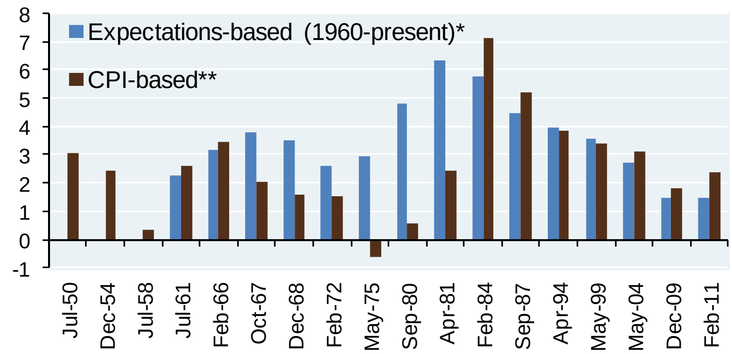
4:1 And the people asked, hath not prior periods of rising interest rates yielded bountiful returns for equity investors?
4:2 And the scribes said, yes: rising and steepening yield curves have usually been associated with improving economic conditions for households and for companies, and strongly positive returns on equities.
4:3 But the scribes cautioned, they had never seen the hand of the Federal Reserve laid so heavily before, and knew not the consequence of its withdrawal. Based on historical measures of where 10-year interest rates settle in a recovery relative to inflation, the 10-year Treasury could rise to 4% - 5%, compared to its current level of 2.8%.

The strong performance of the S&P 500 during periods of rising long term US interest rates, S&P return, %, by period



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

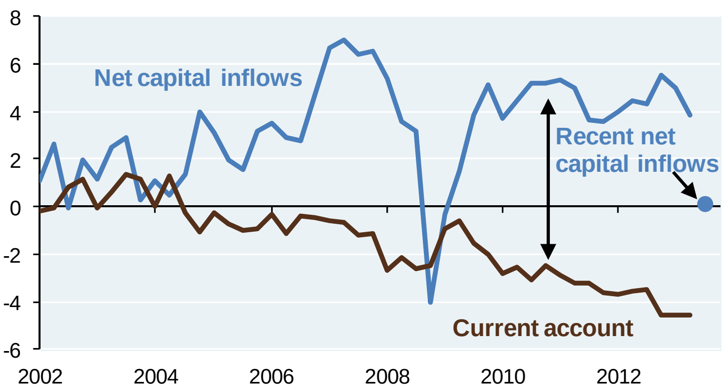
Real interest rates during prior recoveries
Real 10 year rate using both actual and expected inflation



Source: FRB, BLS, JPMAM. *Based on 10yr ahead inflation expectations. **Based on 2yr trailing annualized core inflation. August 2013.

4:4 **And the people asked, why must the emerging economies suffer so from the exodus of Federal Reserve liquidity?**
4:5 And the scribes answered, "because EM growth hath slowed sharply, which hath concerned foreign investors who did not expect this to be so". The latest reading of EM household demand growth is now roughly the same as in the developed world.
4:6 And so net capital inflows into debtor nations such as Turkey, Indonesia, Brazil and India hath reportedly fallen to zero, causing painful interest rate hikes and currency declines. And so shall they suffer from the end of the "carry trade".

Rising vulnerability to capital outflows in EM debtor nations (Brazil, Turkey, Indonesia, India), % of GDP



Source: National central banks, JPMAM. Dot denotes Q3 estimate.

EM debtors: 5-year interest rates on local currency bonds
Percent, average of Brazil, India, Indonesia, and Turkey

Source: Bloomberg. August 2013.

Prognostications

5:1 Ye hath been told that this would be another year of feast for investors, and famine for laborers. From the introduction to the 2013 Eye on the Market Outlook: "**In all, 2013 looks to be another year of markets outperforming what economic growth conditions alone would imply**". Rising multiples, rather than rising profits, is the reason why.
5:2 The people rejoiced in their 10% YTD returns on global equities and prepared to wander, waiting to see the contours of a world in which the Fed will have in part forsaken them. Yet the greatest monetary story ever told is coming not to an abrupt end but a gradual one. The Fed's balance sheet started at $900 billion, is now at $3.6 trillion, and will peak at over $4 trillion and remain there as the Fed reinvests interest and maturing principal (even though new purchases will have ended).
5:3 Retain some risk in thy portfolios, but prepare for lower returns than those seen since the end of 2008.

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On Syria, a century of civil wars, and the US national interest

The US intervened 11 times over the last century in foreign civil wars: Korea (1950's); Laos, Vietnam, Cambodia and the Dominican Republic (1960's); Lebanon (1980's); the Yugoslav Wars/Kosovo, Haiti, Somalia and Iraq (1990's); and Libya (2011). The success of these interventions, difficult as they are to assess, is mixed at best with Korea and Kosovo as examples of where positive outcomes occurred (in Haiti, a descent into complete chaos was perhaps prevented). Some turned out worse, given what followed.

The list below shows something different: civil wars in which (a) the US did *not* get involved or limited its involvement to aid, training, arms support and military personnel used exclusively for purposes of evacuating civilians; **and** (b) in which the casualty rate was higher than in Syria (either in absolute terms or as a percentage of population)[5]. We pulled this together when thinking about civil wars, how the US defines its national interest, and why Syria would qualify for direct intervention while others conflicts did not. On a purely humanitarian basis, Syria's tragedy is exceeded by many conflicts that the US abstained from participating in.

Name of Conflict	Inception	Est. casualties	Est. casualties as % of total population	Direct US military involvement	Assistance, Training, Arms support and Evacuation
Chinese Civil War	1928	6,000,000	1.2%	No	No
Spanish Civil War	1936	600,000	2.5%	No	No
Greek Civil War	1946	158,000	2.1%	No	Yes
La Violencia (Colombia)	1948	200,000	1.8%	No	No
First Sudanese Civil War	1955	750,000	7.3%	No	No
Guatemalan Civil War	1960	200,000	4.8%	No	Yes
Congo Crisis	1960	100,000	0.7%	No	Yes
North Yemen Civil War	1962	100,000	1.9%	No	No
Chadian Civil War	1965	37,500	1.1%	No	Yes
Zimbabwe Liberation War	1965	34,000	0.8%	No	No
Nigerian Civil War	1967	2,000,000	3.8%	No	No
Bangladesh Liberation War	1971	1,500,000	1.2%	No	Yes
Ethiopian Civil War	1974	579,000	1.8%	No	No
Mozambican Civil War	1975	1,000,000	9.4%	No	No
Angolan Civil War	1975	700,000	10.5%	No	Yes
Afghan Civil War	1978	1,800,000	13.6%	No	Yes
Nicaraguan Civil War	1979	78,000	2.5%	No	Yes
Salvadoran Civil War	1979	75,000	1.6%	No	Yes
Ugandan Civil War	1981	500,000	3.9%	No	Yes
Second Sudanese Civil War	1983	1,900,000	9.0%	No	Yes
Sri Lankan Civil War	1983	100,000	0.6%	No	No
First Liberian Civil War	1989	150,000	7.0%	No	Yes
Rwandan Civil War	1990	1,000,000	13.9%	No	Yes
Georgian Civil War	1991	30,000	0.6%	No	No
Sierra Leone Civil War	1991	70,000	1.7%	No	Yes
Algerian Civil War	1991	200,000	0.7%	No	No
Civil War in Tajikistan	1992	50,000	0.9%	No	No
Burundi Civil War	1993	200,000	3.3%	No	No
First Chechen War	1994	100,000	7.9%	No	No
Republic of the Congo Civil W	1997	19,000	0.7%	No	No
Second Congo War	1998	5,400,000	12.0%	No	No
Second Liberian Civil War	1999	300,000	10.9%	No	Yes
Second Chechen War	1999	75,000	5.9%	No	No
War in Darfur	2003	400,000	6.7%	No	No
Syrian Civil War	2011	110,000	0.5%	?	?

Source: J.P. Morgan Asset Management. Various Country Souces.

Michael Cembalest
J.P. Morgan Asset Management

[5] Well-known civil wars that the US did not get involved in on a direct military basis and which were excluded above due to a lower casualty rate than Syria: Peru (Shining Path), Cyprus (1960's), Argentina Dirty War (1970's), and Nepal (1996-2006).

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