Click picture to enlarge

Topics: Market update; Commodities; US Pensions; Patagonia

On January 1st, we released the Eye on the Market Outlook for 2014. The cover art conveyed our central thoughts for the year:

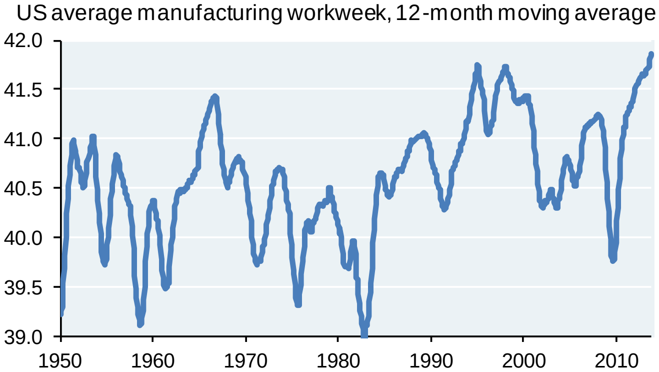
- **Financial markets had an extraordinary run from 2010 to 2013, and were due for a breather (pit stop) as growth and profits catch up**
- **We expect better news from developed economies than from developing ones. The emerging market debtor nations are in for another tough year (their car is off-road and up on the blocks)**
- **Developed market equity returns will be positive but lower than in recent years, and volatility will be higher**

January has seen all three. Emerging markets are down 5% this year, with Latin America generating the weakest returns. News from developed countries has generally been good (see box), but much of it was already priced into equity markets. One example is the US, where P/E multiples are back to 16x forward earnings and 18x trailing earnings (higher when excluding the cheapness of the tech sector). This is also the case in France and Spain, where P/E multiples have risen from single digits back to pre-2007 levels (chart A1). By the end of 2013, fear disappeared from equities when looking at the cost of out-of-the-money put options (chart A4). When valuations are higher and there's less fear in place, market corrections are more frequent. In 2014, we expect earnings growth to drive returns in developed markets. The Q4 earnings season looks OK so far; 68% of companies beat revenue and earnings estimates, and earnings are on track for an 7%-9% y/y gain.

Catching up: positive economic data from developed economies

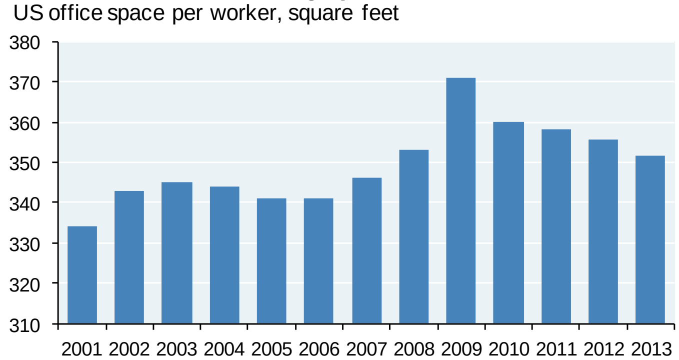
- Global industrial production rose by 5% at year-end, the highest pace since the recovery began
- Global auto sales edged up to a new record high in December
- US household demand ended the year in good shape, and Q4 US GDP growth is tracking 3.5%
- US small business optimism continues to rise: survey respondents indicate the highest level of capital spending and planned compensation increases in 5 years (chart A3). US companies report rising demand and backlogs for steel rebar, electrical and industrial systems, flooring, etc.
- Weak December US payrolls (< 100,000 jobs) appear to be an outlier given improving labor indicators elsewhere. JOLTS/NFIB surveys show fewer firings and more positions small businesses are unable to fill.
- The US manufacturing workweek is at the highest level in 60 years, and companies are putting more people into the same amount of office space, reducing square footage per worker. Eventually, this process creates the need for more hiring and commercial construction (see charts below)
- Japan: inflation, consumption, worker earnings, employment and domestic manufacturing orders picked up in December, perhaps a by-product of Yen weakness. Last week's Tankan survey shows business confidence in manufacturing and services extending past the planned consumption tax hike in April.
- European data improved from November through January: retail sales, bank deposit rates in the periphery, consumer confidence, German industrial production/IFO surveys, manufacturing output, and forward-looking PMI business surveys (even in France). Spain exited recession and is growing @1%

Highest workweek in over 60 years
US average manufacturing workweek, 12-month moving average



Source: Bloomberg, Conference Board. December 2013.

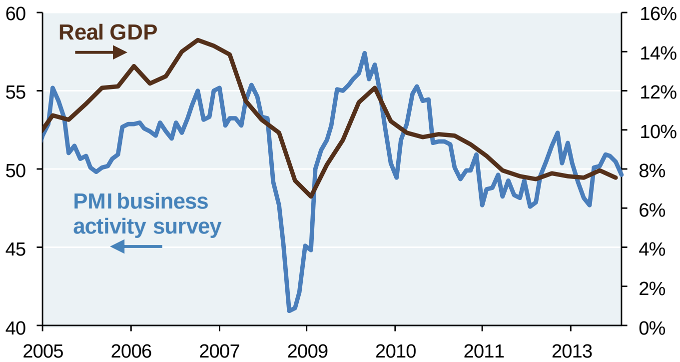
Continued infill of existing space
US office space per worker, square feet



Source: "*Estimating Office Space Per Worker*", Norm Miller, 2012. Empirical Research Partners estimates for 2012 and 2013.

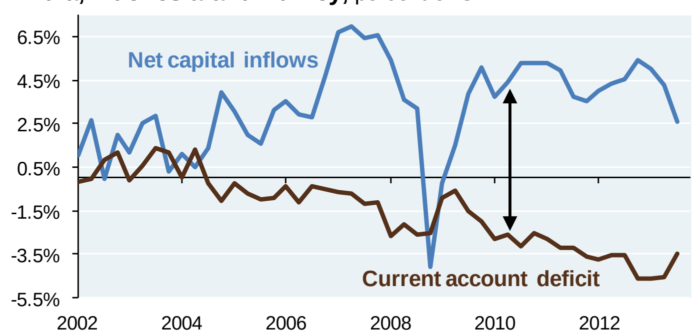
As for developing economies, there are two separate headwinds. First, China is slowing down from 9% q/q in Q3 to 7.5% in Q4, and the most recent manufacturing surveys were on the weaker side. This is a consequence of slowing exports and deliberate monetary tightening by the Central Bank. Credit growth (loans, bonds and shadow banking) is finally slowing, which the government was aiming for. This is not a catastrophic outcome, and I am surprised at the assertion that slowing Chinese growth is responsible for the recent global equity selloff, since I'm not sure that's right.

China slowdown mild so far
Markit manufacturing PMI, level | Y/Y % change in real GDP



Source: China National Bureau of Statistics, Markit. January 2014.

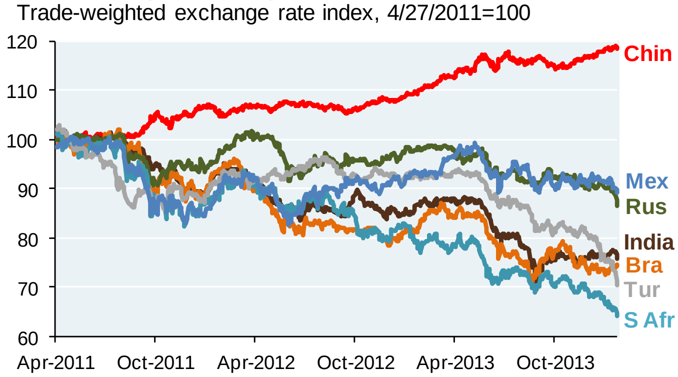
EM debtor nations coming off 7 years of plenty: Capital inflows and current account deficits in Brazil, India, Indonesia and Turkey, percent of GDP



Source: National Central Banks, J.P. Morgan Asset Management. Q3 2013.

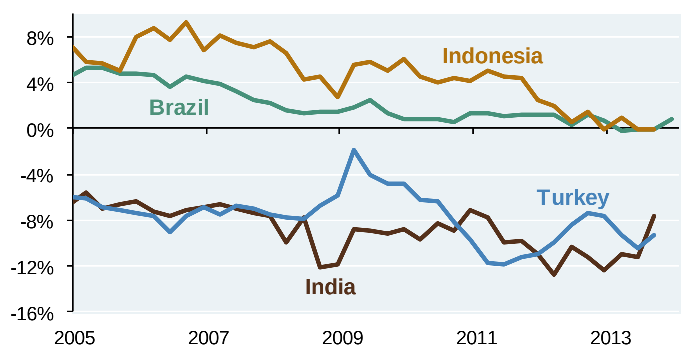
A bigger issue in my view is the balance of payments problems in EM debtor nations (Brazil, India, Indonesia and Turkey). We discussed this in the Outlook, and won't repeat it all here. The simple version: after a period of substantial capital inflows, growth is slowing, interest rates are rising and FX rates are falling (despite central bank intervention). There are signs that foreign capital that piled in is now piling out, and that domestic money is leaving as well. While long-term foreign direct investment played a bigger role than "hot money" flows in recent years, FDI is still mobile, and EM debtors got used to a steady supply of capital which is now slowing.

Balance of payments pressures result in FX declines
Trade-weighted exchange rate index, 4/27/2011=100



Source: J.P. Morgan Asset Management. January 2014.

EM debtor nation trade balances stabilizing
Percent of GDP



Source: Various central banks and statistical agencies. Q4 2013.

EM debtor trade balances have stopped getting worse (courtesy of FX declines and lower imports), which is part of the normal adjustment process. Unfortunately, countries like Brazil need to finance service sector deficits and not just trade deficits (chart A5), and more broadly, EM debtor nation equity market P/Es are not at rock-bottom valuations yet (they're currently around 12x). Weakness in commodity prices isn't helping either, as described in the next section. Approach with caution.

Commodities: exploration boom and slower Chinese growth weigh on prices

We didn't have enough room in the Outlook to address every portfolio topic. If we had included a section on commodities, it would not have been an optimistic one. At the risk of over-simplifying, Chinese growth has been a large driver of many commodities (50%-60% of base metals and 25%-50% of many agricultural commodities), and our medium-term outlook for stable Chinese growth in the 7% range does not correspond to robust commodity price increases as per the first chart below.

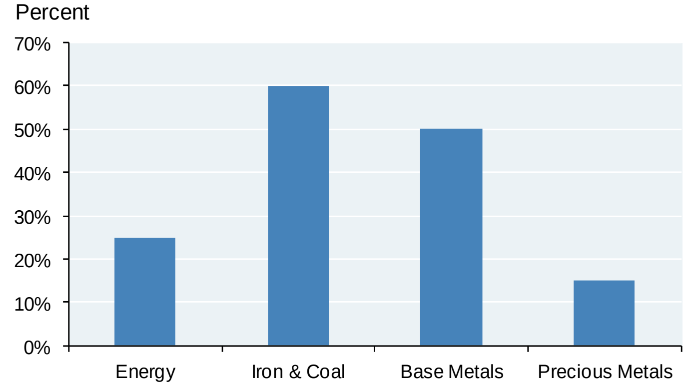
More fundamentally, many base metals, precious metals as well as iron and coal have seen some of the largest capital investment booms in decades. Production is beginning to outstrip demand in some cases, and companies are just beginning to cut capital spending budgets (BHP, Vale, Rio Tinto, etc. announced 15% declines in capital spending budgets for 2014, concentrated in base metals and bulk commodities). Even with the global growth rebound we expect, there could be additional weakness and volatility in commodity prices as future supply comes online.

Silver lining: lower commodity prices often result in lower US spending on food/energy as a % of total spending, which in turn has corresponded to a stronger dollar and higher P/E multiples.

Commodity prices and Chinese growth

Source: Bloomberg, China National Bureau of Statistics. December 2013.

Projected commodity supply growth through 2020

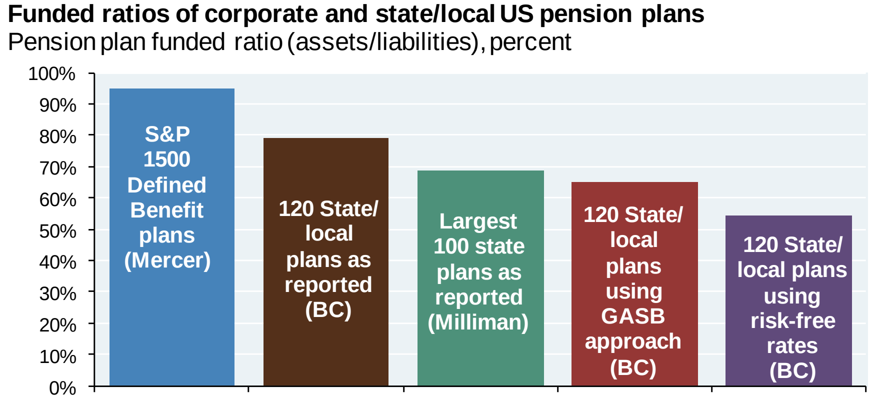


Source: Bridgewater Daily Observations. January 2014.

On US private sector and public sector pension plans: diverging risk appetite

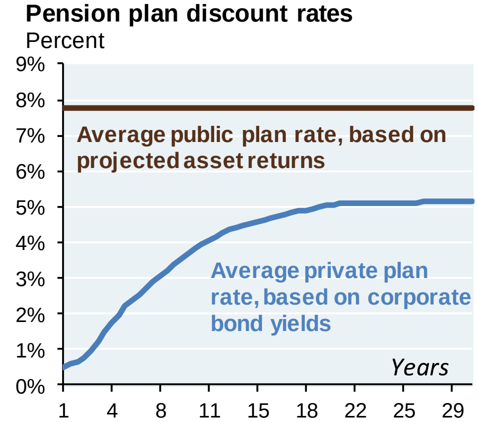
US corporate and public defined benefit plans are roughly the same size ($2.4 and $2.8 trillion, respectively), and both benefited from strong portfolio results in 2013 that averaged 12%-15%. According to Mercer, 2013 was one of the best years on record for improving funding ratios of corporate plans, a function of high returns on assets and rising discount rates applied to liabilities. For corporate plans, 80% of the post-crisis funding gap has been eliminated, and the average plan funding ratio for the S&P 1500 is now ~95%. **As a result, for economic and accounting reasons, we see many corporate plans de-risking portfolios (or planning to), which generally means less equities and more bonds.** Public plans, on the other hand, face larger funding gaps despite strong returns in 2013. The largest public plans are funded at 70%-80% (depending on the universe used), and that's with a methodology that uses higher discount rates to value future liabilities than corporate plans. As per Boston College's Retirement Research Center, proposed GASB changes (lower discount rates, no smoothing of returns, etc.) could reduce public plan funded ratios by another 10%. To complete the picture, according to the BC report, these ratios would be ~55% using discount rates similar to those used by corporate plans. Given longer time horizons, less sensitivity to accounting and balance sheet issues and significantly lower funding ratios, **we see few signs of de-risking by public pension plans;** their risk appetite generally remains high.

Funded ratios of corporate and state/local US pension plans



Source: Milliman, Mercer, Center for Retirement Research at Boston College (BC), J.P. Morgan Asset Management estimates. 2013.

Pension plan discount rates

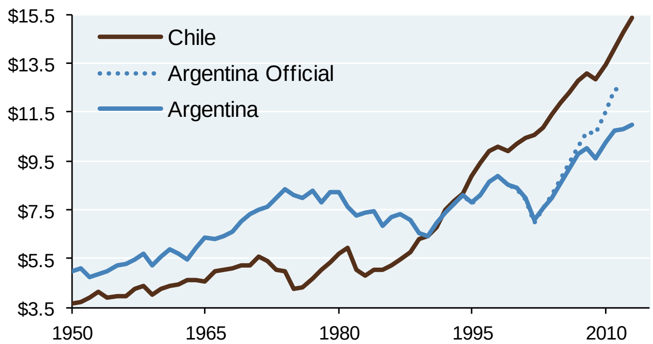


Source: Milliman, Citi Group. 2013.

Patagonia

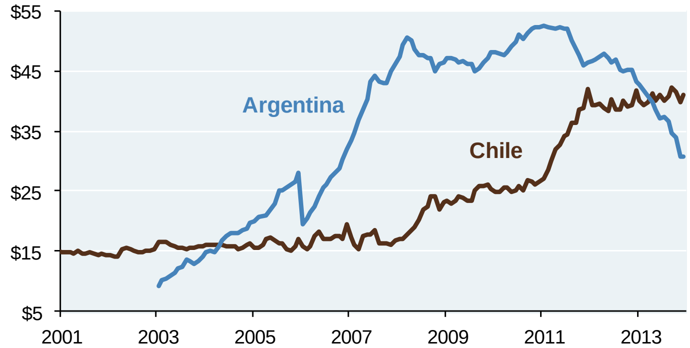
We took a family trip to Southern Patagonia in late December. The first decision to make: Patagonia in Argentina or Chile[1]? Argentina is facing difficult times: electricity outages in major cities, petrol shortages, strikes and other problems. The facts on the ground are worse than official data suggest (Argentina has been cited by the IMF for its reporting inaccuracies); non-official sources show a lot more inflation and less growth than government sources do. Argentine and Chilean real per capita GDP and foreign exchange reserves are shown below, and the differences are pretty stark. One oddity connecting growth and reserves: Argentine data over-estimation could be an expensive indulgence, requiring it to pay an extra ~$3 billion from its reserves on government bond warrants in 2014. Payment on these warrants is linked to its reported growth.

Western Patagonia faring better than Eastern
Per Capita GDP, real constant dollars, thousands



Source: Conference Board, Argentine Ministry of Economy and Finance. 2013.

Foreign exchange reserves
Billions of USD

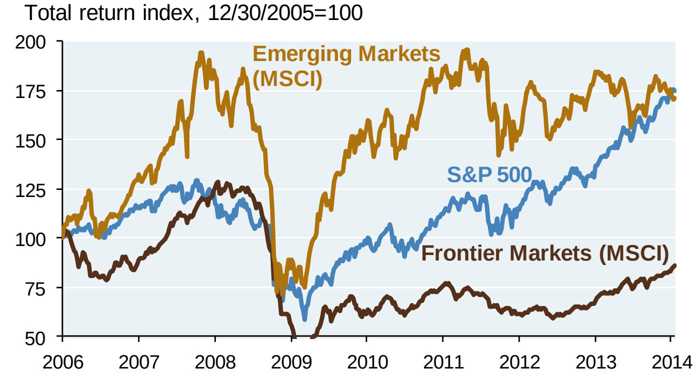


Source: National Central Banks. December 2013.

A few months ago, the ruling Peronist Front for Victory (FpV) party suffered a sharp setback in midterm Argentine elections. The remnants of Argentina's stock market rallied on the news as investors saw declining fortunes of the FpV as a positive sign (the next Presidential elections are in 2015). However, **most emerging market equity managers don't own much in Argentina**: equity index creators MSCI and FTSE removed Argentina from EM benchmarks in recent years, a reflection of shrinking liquidity, capital controls, dual exchange rates and a lack of protection for investors. Argentina is now grouped, along with countries like Trinidad, Jamaica, Ukraine, Pakistan, Kenya and Zimbabwe, as a "Frontier" equity market. It doesn't end there: Argentina might get demoted further. In 2012, FTSE cited the possibility of delisting Argentina from Frontier status due to "*stringent capital controls imposed on international investors and the perceived lack of an independent regulatory authority to protect shareholder rights*".

Last week, the Argentine government reacted to the rising gap between official and black market exchange rates. The government expanded the ability of Argentine citizens to access dollars at the official exchange rate to either invest or spend outside the country (the latter category still being subject to a 20% exit tax). This resulted in a 10%+ decline in the Peso's official rate, which is now down 50% vs. the US$ since 2010. A new administration and a move away from orthodox Peronism might improve the inflation and growth outlook, but it will take time.

US, Emerging and Frontier equity markets
Total return index, 12/30/2005=100



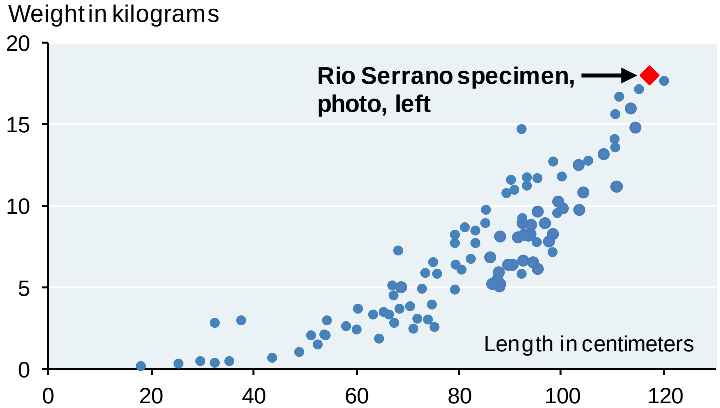
Source: Bloomberg. January 2014.

[1] Both Chile and Argentina made sporadic attempts to colonize Patagonia in the early 19th century. Chilean historians point to maps left by the Spanish which indicate that Patagonia was part of Chile at the time. Chile was forced to cede much of Patagonia to Argentina at the end of the War of the Pacific in 1881, when Argentina demanded Patagonia as a concession for not joining on the side of Bolivia and Peru against the Chileans. Ever since, the boundaries have been roughly what they are today. A papal intervention was needed in 1978 to settle the matter of the Cape Horn islands, which remain Chilean.

With Argentina's challenges in mind, Chilean Patagonia seemed like a more sensible place to go. One highlight of the trip was a substantiation of the incursion of Northern Pacific Chinook salmon in Patagonian waters. Chilean fish farming began in the 1970's, and a few escapees from the farms made it into the wild (rainbow trout, Coho salmon, Atlantic salmon and Chinook salmon). Of all non-native species, Chinook have established themselves most vigorously, migrating out to the Pacific Ocean to feed and then returning to freshwater rivers after 3 to 8 years to spawn (and then die). I was able to land the one shown below with a spinning rod, 12 pound test and a Rapala "Tail Dancer" lure, and released it after a couple of quick photos. This 40-pound (18-kg) specimen is in line with length-weight characteristics of Patagonian Chinook as reported in the *Revista Chilena de Historia Natural.* The success of Chinook salmon in Patagonia contrasts with its gradual decline in the Northern Pacific (Canada, Alaska and Japan) where habitat destruction, over-harvesting and hydropower are negatively affecting them.

Chinook Salmon, Rio Serrano, Torres Del Paine National Park, Chile, December 2013

Patagonian Chinook salmon observations
Weight in kilograms



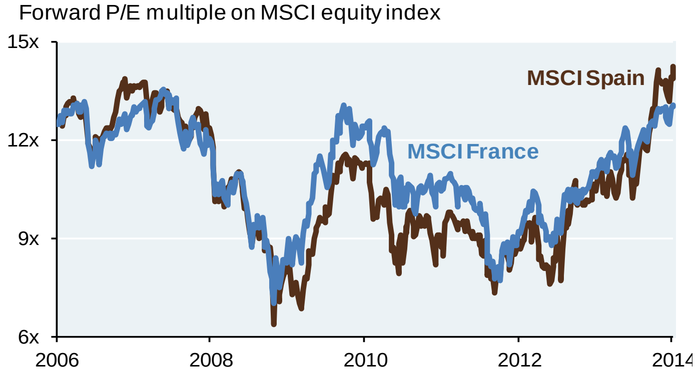
Source: "*Establishment of Chinook Salmon in Pacific Basins of southern South America*", Chilean Magazine of Natural History, 2007.

Michael Cembalest
J.P. Morgan Asset Management

Appendix: market optimism on Spain/France, improving US capex/comp signals, fear and Brazil

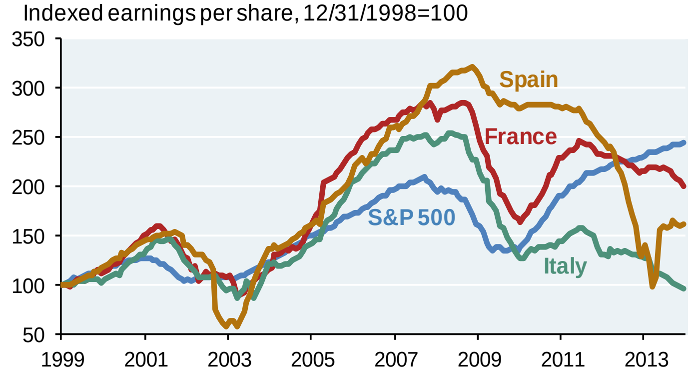
While P/E multiples are back at pre-crisis levels in France and Spain, earnings are still well below them. This contrasts with the US, where earnings exceed pre-crisis levels. On paper, this suggests upside in European equities if earnings recapture part of what they lost. **However, the challenge in Europe is figuring out what trend earnings will be.** The 2003-2007 period coincided with a doomed Southern European leverage/consumption boom that has few chances of recurring, and the GDP growth rebound in the Eurozone is closer to 1% than 3%. We expect 8-10% European earnings growth in 2014, which is on the low end of the "earnings recapture" scale.

A1: France and Spain back at pre-crisis valuations
Forward P/E multiple on MSCI equity index



Source: MSCI, J.P. Morgan Securities. January 2014.

A2: How much of an earnings recovery in the Eurozone?
Indexed earnings per share, 12/31/1998=100

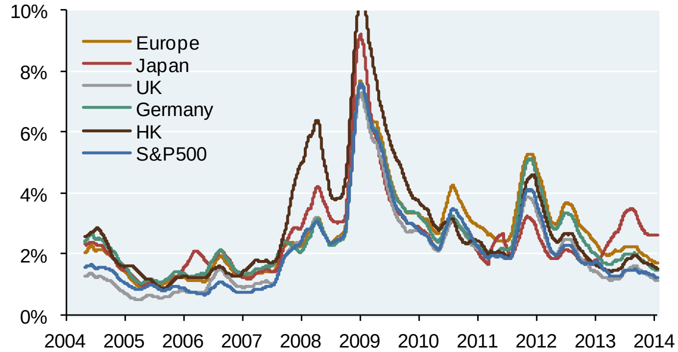


Source: Datastream, IBES. January 2014.

A3: US small businesses making capital expenditures, and planning to increase compensation, % of respondents

Source: National Federation of Independent Business. December 2013.

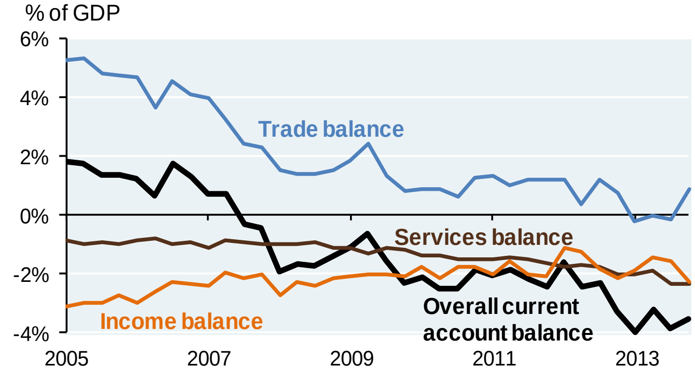
A4: The price of fear almost back to pre-crisis levels
Price of a 5% out-of-the-money put (as % of index level), 3mma



Source: Bloomberg, J.P.Morgan Securities LLC. January 2014.

While Brazil's trade balance is now showing a modest surplus, Brazil still needs a lot of foreign capital. A country's trade balance only captures the net exchange of tradable goods. Brazil also needs foreign exchange to facilitate its net services balance (e.g., tourism and financial services), and its net income account (payments of interest and dividends on foreign investment in Brazil). Both of these balances are significant contributors to Brazil's overall current account deficit. As a result, there may be additional weakness ahead in the Brazilian Real, which is still overvalued in real terms vs its trading partners.

A5: Decomposing Brazil's current account deficit
% of GDP



Source: BCB, IBGE, JPMAM. 2013:Q4.

BIS	Bank for International Settlements
GASB	Governmental Accounting Standards Board
IMF	International Monetary Fund
JOLTS	Job Openings and Labor Turnover Survey from the Bureau of Labor Statistics
NFIB	National Federation of Independent Business
OECD	Organization for Economic Co-Operation and Development

The FpV is the **Frente para la Victoria**, the ruling party of Argentina. It received 32.5% of the national vote in recent elections, a decline of ~20% from 2011. The ruling party lost in all large provinces (Buenos Aires Province, Buenos Aires City, Córdoba, Santa Fe, Mendoza).

MSCI (Morgan Stanley Capital International) and FTSE (Financial Times Stock Exchange) create passive, market-cap weighted benchmarks that are used to assess active equity performance.

- "*2013 the best year on record for US pension gains; sponsors now acting to protect their winnings*", Mercer/Marsh & McLennan, January 3, 2014
- Milliman 2013 Public Pension Funding Study, November 2013
- "*The Funding of State and Local Pensions, 2012 – 2016*", Center for Retirement Research at Boston College, Number 32, July 2013
- "*The commodity investment cycle*", Bridgewater Associates, January 9, 2014
- "*Argentina listed for possible demotion in new country classification review*", FTSE Global Markets, October 19, 2012
- Deutsche Bank US Equity Insights, January 24, 2014

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