Topics: the heat on the Federal Reserve; 2014, playing out as expected; update on European malaise; USSR 2.0; Acipenser Transmontanus

Percolating. Things are getting a bit hotter for the Federal Reserve regarding the tradeoff between growth and inflation. For the last few years, a zero rate policy was put on autopilot given excess labor and industrial capacity. Both are shrinking now, and when looking at a broad range of variables, some are clearly mid-cycle. If so, in a few months Fed governors[1] will have to jump out of the 0% interest rate pot and remove some of the liquidity that it has infused into the US economy; and they may have to do so at a quicker pace than what markets are pricing in. **Some of the flames below (e.g., inflation at 2%) are not unsustainably high in *absolute* terms, but are ranked as "hot" since they're back to normal while Fed policy rates are not.** In other words, if the US economy is at mid-cycle levels, then policy rates should be at mid-cycle levels too and not zero, particularly since rising inflation is a late-cycle dynamic that the Fed would presumably seek to preempt. To a central banker, surveys of corporate wage-hike intentions and current job openings are arguably just as important (if not more so) than trailing measures of wage inflation over the prior year.

The heat on the Fed to raise policy rates from 0% (*click on each item in the list for the associated chart*)

- **Job opening rate at high of prior cycle (JOLTS)**
- **More rapid pace of decline in unemployment rate**
- **Elevated risk-taking in credit markets**
- **Structural decline in credit market liquidity**
- **Inflation (median, core, PCE) now rising, at ~2%**
- **Rise in capacity utilization back to normal levels, with rebound in durable goods orders and business capex**
- **ISM prices paid signals at 60 for both manufacturing and services (clearly expansionary)**
- **Limited signs of rising labor force participation**
- **Volatility in equity markets at prior cycle lows**
- **M&A deal volumes rising, M&A purchase multiples rising above highs of the prior cycle**
- **Healthy employment gains across most sectors**
- **Rising small business plans to raise worker comp**
- **Rising manufacturing and service sector surveys**
- **Healthy growth rate in corporate loans**
- **Small uptick in employment cost index to 2.0%**
- **Early signs of rising industrial metals prices**
- **Inflation expectations in TIPS markets below 1.5%**
- **Weak residential mortgage demand**
- **Average hourly earnings growth still very low, at 2%**
- **Measures of un- and under-employment still high**
- **Import prices mildly disinflationary (flat y/y)**

To be clear, the Fed might not define things like credit market liquidity and investor risk-taking as factors that should explicitly influence policy rates (although retiring Fed governor Stein has mentioned credit market distortions as something the Fed should be concerned about). But when you combine these factors with the rest of the picture (a recovery in growth, gradually rising inflation and shrinking excess capacity), it is harder to justify the "emergency policy rates" now in place. **One thing is for sure: monthly wage and consumer price inflation reports are going to be very closely watched from here on out, adding a source of volatility to US equity markets.**

[1] In the pot, we included the more dovish members on the Fed's Federal Open Market Committee who have been there for at least a year. The other frogs on the FOMC would presumably already be jumping out of the 0% pot if they controlled the decision.

Historically, equity markets have undergone modest corrections when Fed hikes began. **When the dust cleared and it became clear that sufficient growth accompanied higher wage and price pressures, and that the Fed was going to keep inflation under control, equity markets rebounded**. The size and complexity of the monetary experiment is much different this time, so we need to be prepared for outcomes that vary from the standard script. But as a starting point, early Fed hikes tend to introduce volatility rather than bear markets per se, as shown in the table below.

2-year Treasury and S&P 500 reactions to Fed moves during tightening cycles

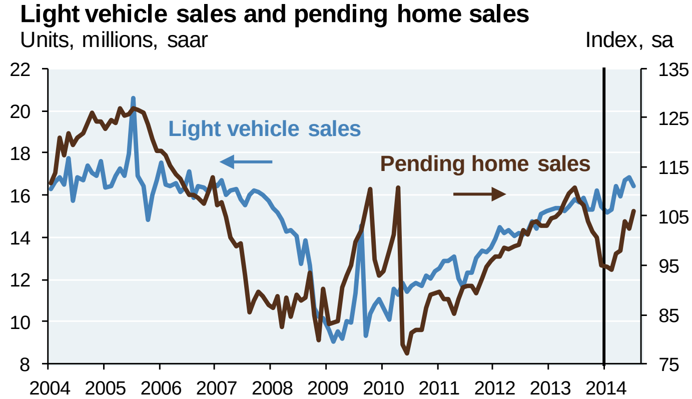
Two-year Treasury change in yield, bps	1987	1988-1989	1994-1995	1999-2000	2004-2006
Initial market reaction to first Fed rate hike	27	43	30	80	137
Subsequent market reaction to remaining Fed hikes	200	136	291	114	224
Total market reaction to all Fed hikes	227	179	321	194	361
S&P 500 price return					
Initial market reaction to first Fed rate hike	-5%	-8%	-9%	-7%	-8%
Subsequent market reaction to remaining Fed hikes	32%	27%	7%	18%	20%
Total market reaction to all Fed hikes	26%	17%	-2%	10%	11%

Sources: Federal Reserve Board, The Wall Street Journal, US Treasury, J.P. Morgan Asset Management. August 2014.

2014, playing out as expected in the US

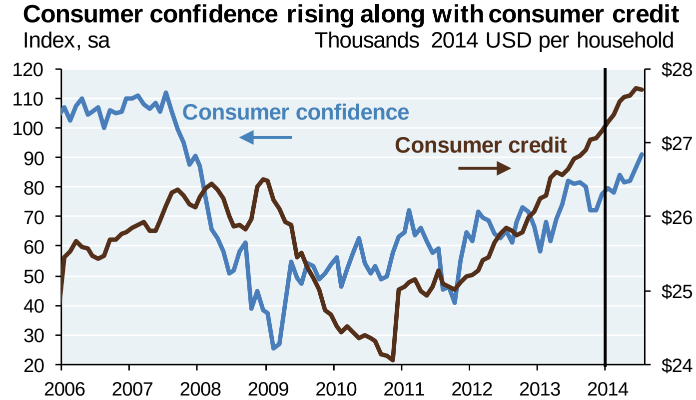
In some years, things turn out substantially different than what we were anticipating. 2014 is not one of those years, and is playing out according to the script outlined last January in our Outlook. At the start of the year, we felt that US growth would start to pick up more meaningfully. By most accounts, this is starting to happen. In addition to the items shown in the Frog Pot List, durable goods and business capital spending rebounded after weakness in Q1, and there have been increases in vehicle sales, pending home sales, consumer confidence and consumer credit. We also expected a pick-up in S&P 500 earnings and revenue growth after a weak 2013; that's happening as well in 2014, albeit modestly. Profit growth expectations of 8-10% seem reasonable for 2015 as higher revenue growth and the benefits from increased capital spending are offset by rising labor and interest costs.

Light vehicle sales and pending home sales



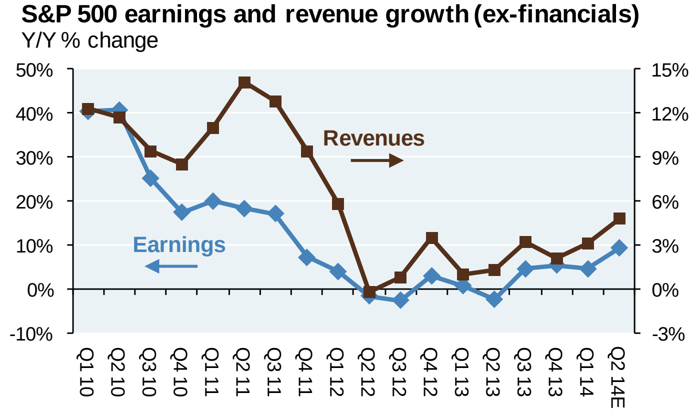
Source: BEA. National Association of Realtors. July 2014.

Consumer confidence rising along with consumer credit



Source: The Conference Board. Federal Reserve Board. July 2014.

S&P 500 earnings and revenue growth (ex-financials)

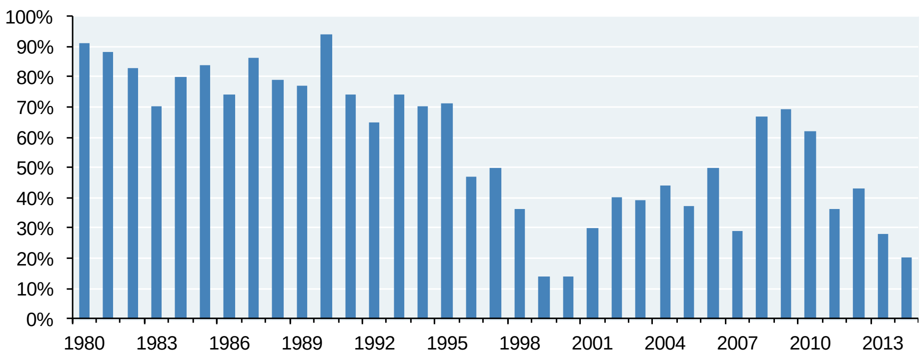


Source: S&P, Compustat, Thomson Financials, FactSet, UBS. August 2014.

The current M&A boom generates a lot of excitement, but for investors, I don't think it's that bullish of a *long*-term signal; first, it tends to be a late cycle event, and second, most mergers don't work out that well for shareholders in the long run[2]. More broadly, **while it's good to see growth and profits recovering, as we wrote last January, markets were already pricing in some of this good news** (that was the theme of the cover of the Outlook). The "animal spirits" of investor confidence are in full force these days; here are two more examples.

- **the percentage of tech IPOs that are profitable is almost as low as during the tech bubble of 1999-2000.** The lifespan of issuing tech companies is longer than it was then and price-to-sales ratios are nowhere near 1999 levels, so there has been some maturation in the tech IPO market. But these profit measures imply plenty of appetite for risk

Remembrance of things past: low percentage of technology company IPOs with profits, percent of technology companies with positive net income at IPO

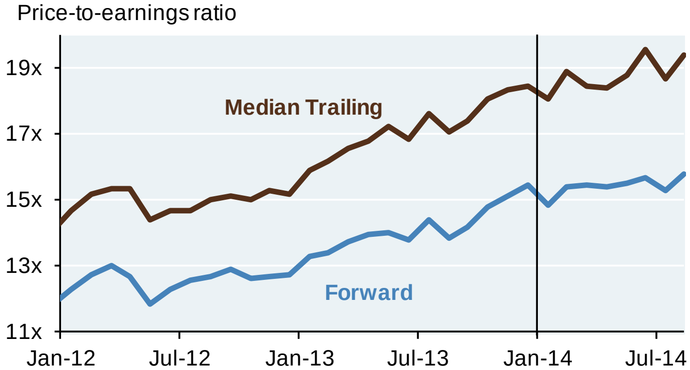


Source: : *"Initial Public Offerings: Technology Stock IPOs"*. Ritter (University of Florida). July 2014.

- The pricing of core real estate looks pretty rich: Norway's Sovereign Wealth Fund (the world's largest) purchased an interest in a 4-acre parcel in the Mayfair District of London at a 2.5% yield, part of its plan to increase real estate holdings by $10 billion per year over the next 3 years

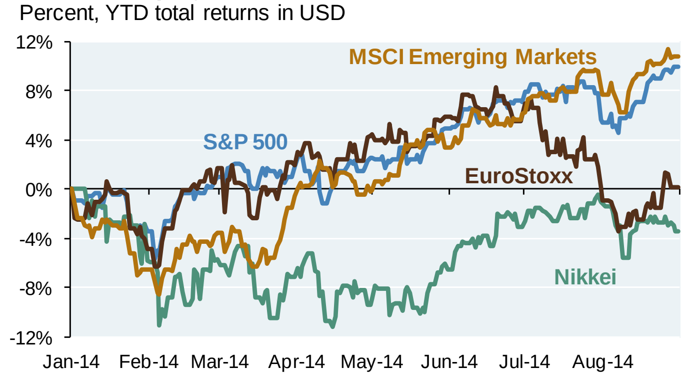
What has happened so far? Since January 2014, S&P 500 price-to-earnings multiples have flattened out (in contrast to the multiple expansion in the prior 2 years), leaving earnings growth as the driver of equity market returns; junk spreads have risen from very low levels; the cost of buying downside protection has risen, and the total return on US equities is in high single digits. **An 8%-12% outcome for the S&P 500 seemed likely to us back in January, and it still does today.** We expect a similar outcome in 2015, with rising earnings as the primary driver of US equity market returns.

S&P 500 P/Es: Forward and median trailing
Price-to-earnings ratio



Source: Deutsche Bank. August 26, 2014.

2014 YTD equity market returns
Percent, YTD total returns in USD



Source: Bloomberg. Data as of August 29, 2014.

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[2] The earliest analyses performed in the US and Europe in the 1970's found merger and acquisition failure rates of 40%-50%. More recent estimates are over 50%. Wharton's "*Why Do So Many Mergers Fail*" cites professor Robert Holthausen, whose failure rate estimates range from 50%-80%. A 2010 study from McKinsey estimates failure rates of 66%-75%. And in a 2010 book from Mitchell Lee Marks (of San Francisco State University and an advisor in 100 mergers and business transitions), failure rates are estimated at 75%.

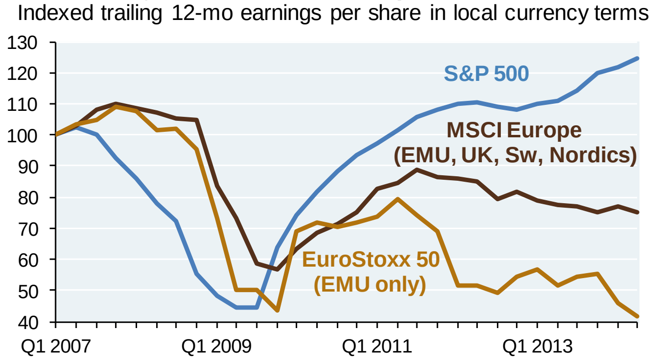
Europe: it looks like the Intermission is over

While there's some good news in Spain (2.3% y/y growth in Q2)[3], European private sector credit growth is weak, wage/price inflation across Europe is falling to ~1% and Italy is in recession again. An equally concerning issue for investors: weak trend earnings growth (see first chart below). Last year, MSCI Europe P/E multiples rose from 11.5x to 13.5x in anticipation of a recovery and easy money from the ECB. By December 2013, the European P/E discount vs. the US was as small as it had been in the last decade, despite profit margins that are 2%-3% below US levels.

However, Europe has not delivered this year: Q2 GDP growth was less than 1%, the rise in Q2 profits measured on a y/y basis is mostly a function of a very weak 2013, and top-line Q2 sales growth was negative. Perhaps with manufacturing surveys in modestly expansionary territory and a weaker Euro, earnings will pick up later this year. All things considered, however, the burden of proof is on the optimists at this point. In our 2014 Outlook, we referred to last year's improvement in European equity and credit markets as an Intermission in a longer melodrama, the second act of which has now apparently begun. It is important to note that activity isn't collapsing, just stagnant.

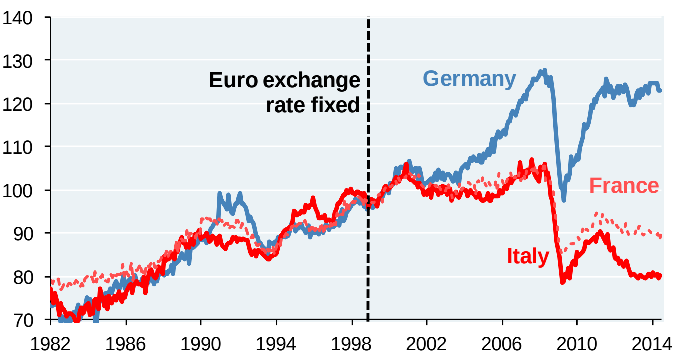
There is pressure on the ECB to conduct large-scale asset purchases (it hired BlackRock to advise on such a plan), or conduct exchange rate intervention (weakening the Euro) to combat competitiveness problems and structurally low growth in France and Italy. As we reviewed in a February 2013 EoTM, trend GDP growth in France and Italy is as weak as it has been in well over 100 years, other than during wartime. The ongoing malaise has now resulted in a modest equity market rally as investors price in some kind of ECB action on interest rates and/or the Euro (e.g., bad enough = good).

The earnings divide, US vs. Europe
Indexed trailing 12-mo earnings per share in local currency terms



Source: Datastream, Standard & Poor's. Q1 2007=100. As of Q2 2014. EMU = European Monetary Union

Death in Venice
Industrial Production Index, 12/31/1999 = 100



Source: respective national economic agencies, GaveKal. June 2014.

European banks may continue to reduce leverage, extend less credit and shed non-performing loans. At the same time, a wall of corporate debt obligations is approaching, with bond and loan maturities growing each year to 7x 2014 levels by 2018. Even with ECB lending programs that incentivize European banks to not cut back credit too quickly (the TLTRO program beginning in September 2014), liquidity may be a scarce commodity for some European companies. In similar circumstances in the past, such conditions were favorable for distressed debt buyers, industry consolidators able to improve profits through restructuring, and providers of private credit.

We have addressed **Emerging Markets** in prior notes. While we are still wary of the adjustment process to come in Brazil and China, currency declines to-date in the big 4 EM debtor countries have been substantial, and marked bottoms in industrial production and equity markets in prior cycles. Non-commodity export countries are more attractive (India, Indonesia, Malaysia, Philippines, and Mexico).

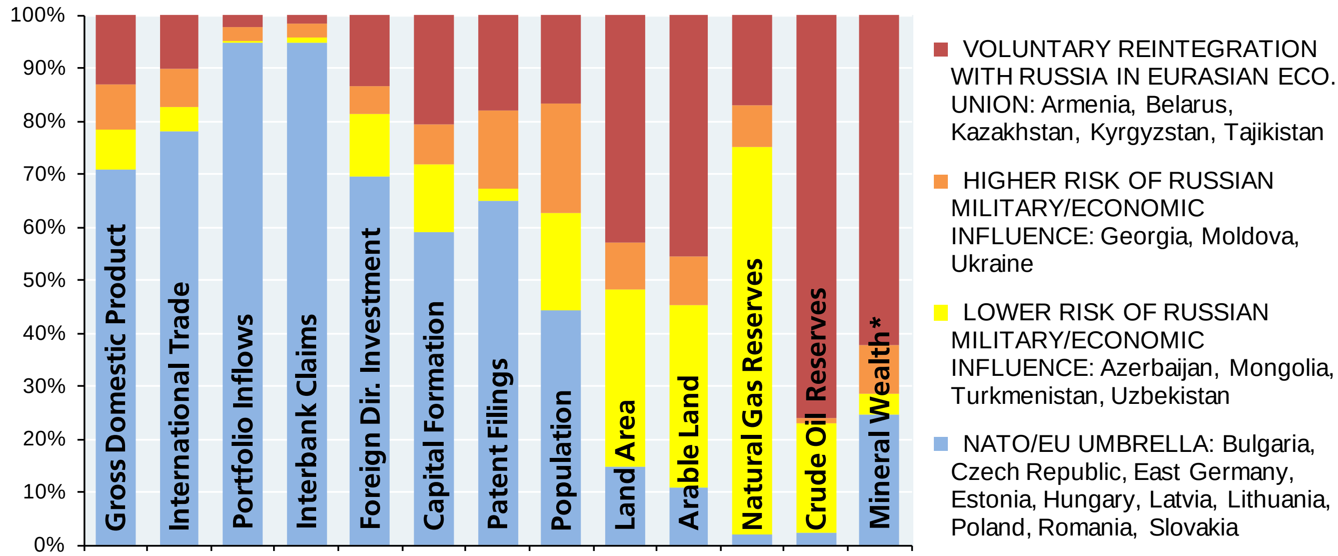
[3] At the risk of over-simplifying, the **economic recovery in Spain and continued stagnation in France and Italy correspond to their respective labor cost adjustments vs. Germany**. Declines in Spanish productivity-adjusted unit labor costs since 2008 have unwound two thirds of their rise vs. Germany from 2000 to 2007. In France and Italy, the same measures have only retraced 10% of the relative appreciation vs. Germany seen over the same period. See link for chart.

USSR 2.0? More thoughts on geopolitics

In our last EoTM, we showed a table indicating the degree to which countries at war account for percentages of global population (a lot), GDP (a lot less), and trade/profits/capital flows (even less), and reviewed the (limited) linkage between US equity markets and geopolitics since 1950. This week we address a specific question we have gotten: given the 2008 Russian invasion of Georgia and escalating conflict between Russia and the Ukraine, **where is Russia on the road to recreating something like the Soviet Union as an economic, political and financial counterweight to the West?** This is more art than science, but I think there are ways of quantifying it. Let's take all Warsaw Pact/ CoMEcon/Soviet orbit countries of the 1980s (this is a big region; its current GDP is similar to Russia, and its trade is 2.5x larger). Some have willingly and enthusiastically re-entered the Russian sphere of influence, such as early entrants and applicants into the Russian-sponsored Eurasian Economic Union (e.g., Belarus, Kazakhstan). At the other end of the spectrum, there are countries that exist under the umbrella of NATO and/or the European Union (Poland, Baltic States, etc). In the middle, there are 2 variations: countries with their own political and economic ambitions, but which differ in terms of the risk of being subject to Russian military and economic influence. We then examine economic, human capital and geologic indicators and figure out how much of each has re-entered the Russian orbit. For example, when looking at the first bar showing the current GDP of countries in the old Soviet Bloc, ~70% now falls under the NATO/EU umbrella, and another 8% is at low risk of Russian influence.

USSR 2.0? Russia's sphere of influence in context

Percentage of 1980's Warsaw Pact/CoMEcon/Soviet Bloc value ranked by current Russian orbit category



*Mineral Wealth commodities: Bauxite, Chromium, Coal, Copper, Gold, Iron, Lead, Manganese, Nickel, Potash, Tin, Uranium, Zinc
Source: IMF, United Nations, BP, EIA, MSCI, Bloomberg, BIS, World Bank, WTO, WIPO, J.P. Morgan Asset Management.

While today's Russian orbit countries interact with more economic independence than the "vassal states" of the old USSR, let's assume for the sake of argument that this orbit functions as a coordinated bloc. As shown in the chart, the Russian orbit now includes much of the fossil fuel and mineral wealth of the old Soviet Bloc, and in the case of oil, most of it. There have also been substantial Russian orbit gains in arable land. **However, when looking at broader measures of economic strength (GDP, trade, capital formation, portfolio investment, patent filings/ innovation), most has either been integrated with the West or with China (e.g., Mongolia), or is in my (subjective) view at low risk of an "unwilling" integration with Russia.** While the Russian Federation may be plotting an increasingly divergent course from the West, the economic and political independence achieved by most Soviet Bloc countries in the early 1990's does not appear at risk of being meaningfully reversed or morphing into USSR 2.0.

Acipenser Transmontanus
This Pacific Sturgeon (caught and released in the Fraser River in British Columbia in August) was 7 feet long and weighed over 200 pounds. I am wearing the orange hat.

Fraser River, Fraser River Lodge, Agassiz, BC, Canada

Michael Cembalest
J.P. Morgan Asset Management

On the USSR 2.0 chart and East Germany calculations

The USSR 2.0 analysis required estimates for East Germany. For land, population and GDP, such data are obtainable directly from government sources. For economic, market and portfolio variables, we estimated East Germany amounts from German government sources that are reported by state (GDP, gross value added, exports, fixed capital formation, bank lending, and bank deposits/borrowings). Our East Germany estimates generally range from 9% to 13% of total Germany levels by variable. For Berlin (now reported as a single state in government sources), we estimated 40% as being allocable to the original German Democratic Republic (East Germany), with the remainder assumed to already be part of the Federal Republic of Germany (West Germany) before1990. East Germany has been the beneficiary of 2 trillion Euros of investment from West Germany since unification; its economic gains have not come without a cost to West Germany.

Acronyms:

BEA: Bureau of Economic Analysis; BIS: Bank for International Settlements; BLS: Bureau of Labor Statistics; BP: British Petroleum; CoMEcon: Council for Mutual Economic Assistance; ECB: European Central Bank; EIA: Energy Information Administration; FOMC: Federal Open Market Committee; IMF: International Monetary Fund; JOLTS: Job Openings and Labor Turnover Survey; MSCI: Morgan Stanley Capital International; NATO: North Atlantic Treaty Organization; NFIB: National Federation of Independent Business; OECD: Organization for Economic Co-operation and Development; PCE: Personal Consumption Expenditure; S&P: Standard & Poor's; TIPS: Treasury Inflation-Protected Securities; TLTRO: Targeted Long Term Refinancing Operation; WIPO: World Intellectual Property Organization; WTO: World Trade Organization