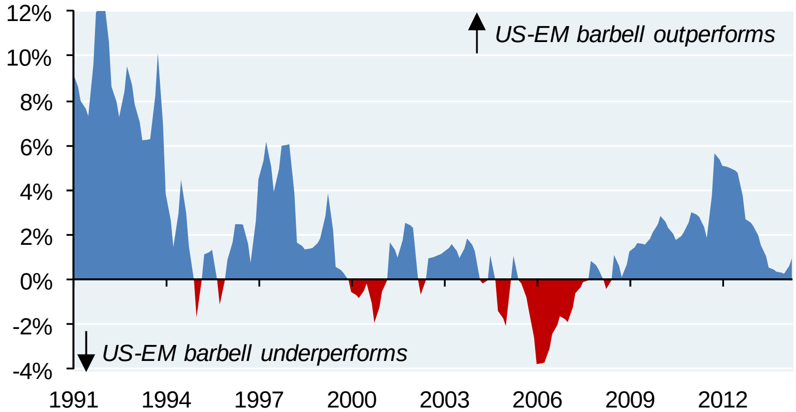
Topics: Will the US/EM axis keep outperforming Europe and Japan; China in one chart; How high are US corporate tax rates? Implications regarding actual and functional tax inversions

One of the more consistently profitable decisions to make as an investor over the last 25 years: relative to your normal allocations, overweight US and Emerging Markets equities vs. Europe and Japan. As shown below, this approach delivered consistent excess returns, with the only prolonged exception being the 2004-2007 period when the ill-fated Southern European consumption boom was in full swing. This strategy worked post-2011 despite balance of payments problems in EM economies like Brazil, Turkey and India; the growth slowdown in China; the rebound in European equities after ECB/EU bailouts; and the inception of more aggressive monetary easing in Japan. While some comparisons between Japan and Europe are overblown, this much is true: lumping them together in a regional barbell has made sense.

Benefits of overweighting US/EM and underweighting Europe/Japan, 3-year rolling out (under) performance, percent



Source: Bloomberg, JPMAM. Q2 2014. Quarterly portfolio rebalancing.

The holy grail for the US-EM barbell was the period in the early 1990's when the Nikkei collapsed. Since then, the net benefits of the barbell are attributable to under-performance in both Japan and Europe relative to the other two regions.

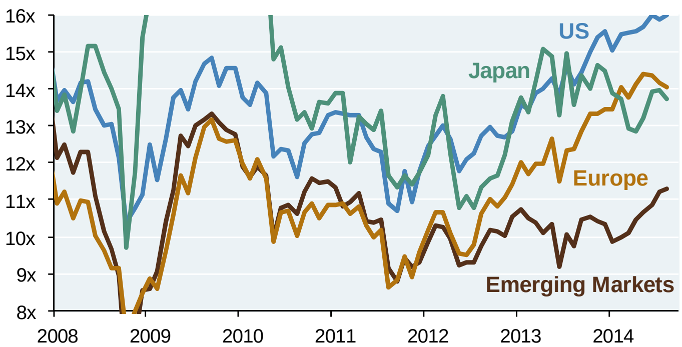
Where to from here for the US-EM barbell? From an economic perspective, outside the US, things look kind of stagnant. To get a real-time sense of growth rates before GDP reports are released, we look at "PMI output surveys" which do a good job of tracking GDP trends. A manufacturing output survey around 50 does not indicate recession, but it does not signal robust expansion either. Current levels imply slow, sub-trend growth. There are modest differences between regions in the "Global ex-US category", but none are substantially better than the average.

A real-time proxy for GDP growth shows the US on top
Global manufacturing output PMI Index, seasonally adjusted

Source: J.P. Morgan Securities, Markit. August 2014.

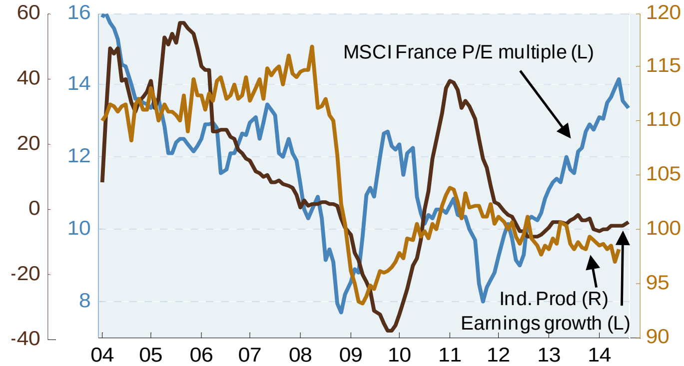
It would make sense to reconsider the barbell if Japan and/or Europe were particularly inexpensive from a valuation perspective. However, this is not the case: European valuations have risen along with the US since 2012 and, as shown in the second chart, in places like France higher valuations have not been accompanied by increased earnings growth or economic activity. While US valuations are at post-crisis highs, at least earnings and output are rising as well.

Regional price-to-earnings multiples
Forward price-to-earnings, market cap weighted



Source: MSCI, J.P. Morgan Securities LLC. August 2014.

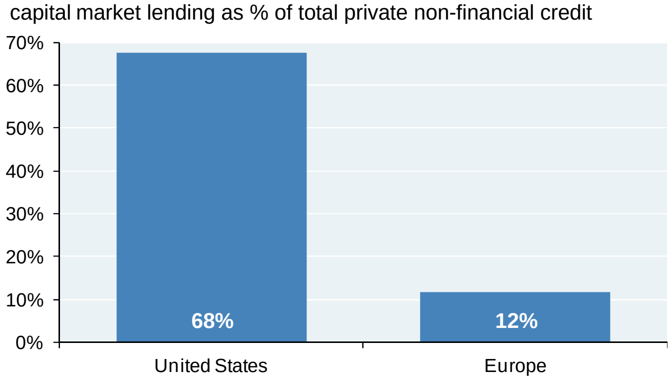
France: P/E multiples rise as profits/production stagnate
Vive La Difference!



Source: INSEE, MSCI, DataStream. August 2014.

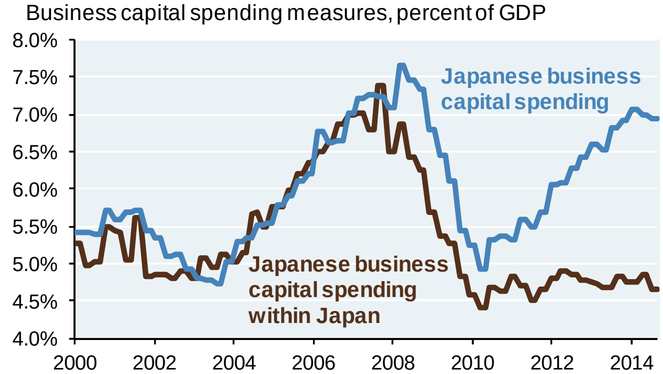
I would not make too much out of European politics in terms of market impact, but the emergence of a Euroskeptic party in Spain (Podemos) and strong polling by the National Front in France (beating Hollande in a recent poll if elections were held next week) suggest continued dissatisfaction with the slow recovery. Add in the overhang of the Ukraine, and one can envision another year of sub-trend growth in Europe. **A lot rides on the ECB's ability to channel liquidity to the private sector, and to weaken the Euro.** The challenges: the small size of European capital markets through which ECB programs operate (first chart below); the rally in credit costs for banks and governments that already happened; and the decline in bank loan-to-deposit ratios, reducing the need for emergency funding. **In other words, European banks are not liquidity constrained, and don't have much need for low-cost ECB loans if private sector demand growth remains weak.**

ECB capital markets interventions have less to work with
capital market lending as % of total private non-financial credit



Source: Federal Reserve, European Central Bank. Q1 2014.

Signs of limited domestic opportunity in Japan
Business capital spending measures, percent of GDP



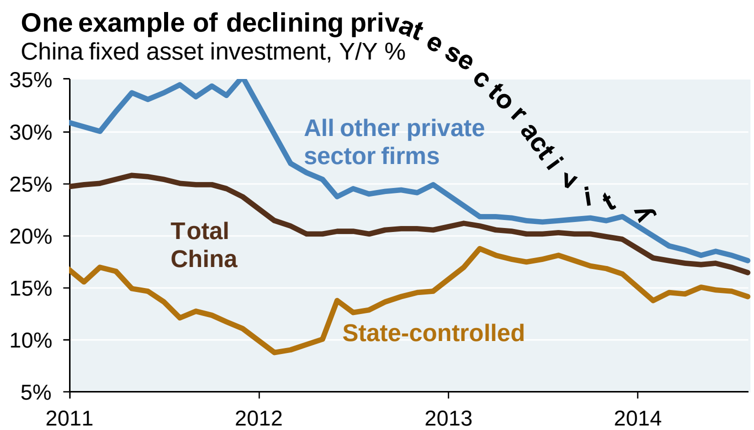
Source: Bridgewater Daily Observations. September 2014.

While Japanese P/E multiples are lower than in the US, Japan's Abenomics program has so far been more of an exercise in money printing than in reform. Growth is weak even after adjusting for the negative impact of the April increase in the VAT. Japanese companies are making plenty of money, and their debt/asset and interest cost/cash flow metrics are lower than in the US. However, they have been making a rising share of capital expenditures outside Japan, a sign of limited opportunities domestically.

All things considered, and even with substantial headwinds facing China (see next page), the US-EM barbell may pay additional dividends in 2015 relative to European and Japanese alternatives, particularly in US$ terms given the intention of Europe and Japan to aggressively ease monetary conditions.

China in one chart: the decline in private sector activity

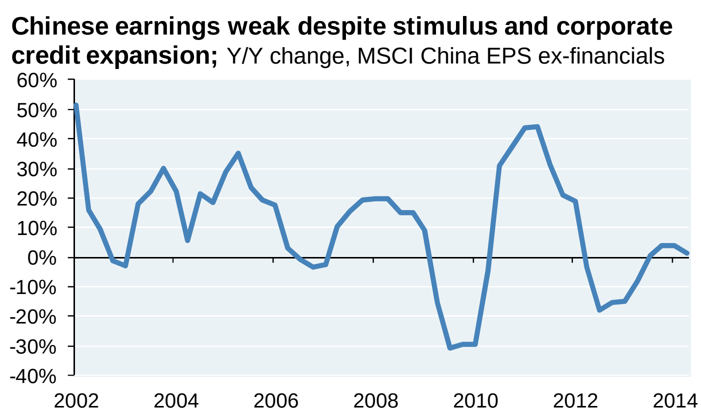
China is slowing, mostly due to a gradual, steady decline in private sector activity. One example: the decline in fixed asset investment (e.g., business capital spending) at private sector firms relative to firms that are state-controlled. Premier Li Keqiang's reforms are aimed at making it easier for entrepreneurs to start private sector firms, but in the current climate, private sector investment growth continues to fall.



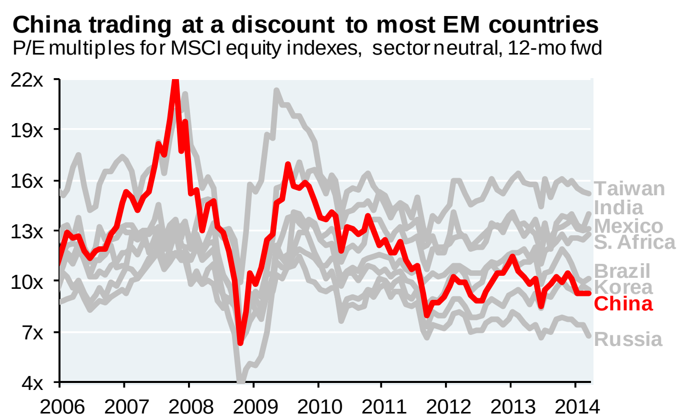
Source: China NBS, Gavekal Research, JPMAM. August 2014.

The Chinese central bank injected some liquidity into the domestic banking system recently, but it was only for 3 months and not meant to address the more structural issue of declining private sector demand. While export growth and job creation still look pretty good, the overall picture is one of an economy growing at 7%, and that's with the contribution from government spending. Government spending is set to slow in the second half of the year; the authorities continue to reduce the size of the shadow banking system which extends credit; and the overheated housing market is still in decline as well when looking at national home sales and a 70-city home price average. We expect continued weakness in Chinese data for the rest of 2014 and into next year as well.

A silver lining: I don't know any investors who haven't been aware of slowing Chinese GDP and earnings growth. Of the 8 largest EM countries (comprising 81% of the market cap of the MSCI Emerging Markets Index), only Russia has a lower equity P/E multiple than China. It has been a long time since China was priced at a premium to the rest of EM; the bloom has been off the rose since 2007.



Source: MSCI, J.P. Morgan Securities LLC. Q2 2014.



Source: MSCI, J.P. Morgan Securities LLC. September 2014.

China weakness has negatively affected EM commodity exporters such as Brazil, Chile and South Africa. We remain more positive on EM manufacturers with lower current account vulnerability and competitive labor costs: Philippines, Thailand, India, Malaysia, Indonesia, Korea, Mexico, Czech Republic and Poland.

How high are US corporate tax rates, and what do they imply regarding tax inversions?

As Congress debates legislation and as the Treasury and IRS issue notices designed to deter corporate tax inversions (re-domiciling which changes the country of incorporation for tax purposes), keep the following in mind**: if in fact US corporate tax rates were higher than equivalent rates elsewhere, the functional equivalent of inversions would happen all the time as new firms set up shop outside the US instead of in it; as US firms engage in transfer pricing to shift income elsewhere; and as foreign firms buy US firms and benefit from the rate differential[1].** As a result, inversion deterrence only addresses one part of the issue, and not the central question driving the fuller scope of cross-border investment and domiciling decisions by US and foreign firms: how high are US tax rates?

Tax rate analysis is complicated by the fact that statutory and marginal rates don't tell you much in a system with deductions, tax preferences and lots of complexities. For example, while the top US *statutory* personal income tax rate in 1979 was 70%, the corresponding *effective* rate was just 22% (and has ranged between 18% and 24% since, despite substantial changes in statutory rates). As a result, effective tax rates are generally what analysts look at.

On corporate taxes, looking at one year in isolation can affect the results due to where you are in the business cycle, large distortions from tax carry-forwards or carry-backs, changing tax rules, etc. A further complexity on corporate taxes: US companies receive credits for taxes paid overseas. As a result, if you divided US corporate tax payments by corporate worldwide income, effective tax rates would be understated since they would exclude foreign tax payments from the numerator. Both issues were present in a report from the Government Accountability Office released in 2013 on effective corporate tax rates, according to sharply worded critiques from the Tax Foundation and other analysts[2].

A cleaner, more straightforward way to do it that has been around since the early 1980's: derive an assumed after-tax return on corporate capital required by investors (between 5% and 6%); determine the pre-tax return a company would need in order to reach this after-tax target given all federal and sub-national income, sales and asset taxes, depreciation rules and other tax preferences; and then extrapolate the implied **marginal effective tax rate**. A paper published in 2014 by Jack Mintz from the University of Calgary in Tax Foundation Journal (see bio in Notes) did exactly that, comparing results across the OECD. **According to this analysis, the US has had the highest marginal effective tax rate on capital for the last seven years within the G-7 and within the 34 countries in the OECD[3].**

Marginal effective tax rates: US is #1 (and not in a good way)

	2013	2012	2011	2010	2009	2008	2007	2006	2005
United States	35.3	35.3	35.3	35.3	35.6	35.6	35.6	35.9	35.9
Canada	18.6	17.3	18.7	19.8	27.3	28.0	30.5	36.2	38.8
G-7	27.6	27.9	28.6	28.9	30.1	30.2	32.9	33.7	34.2
G-20	24.5	24.5	28.0	28.0	28.0	28.1	33.5	33.5	33.5
OECD (34)	19.6	19.5	19.7	19.6	19.8	20.1	21.0	21.6	22.4
U.S. ranking by METR (highest to lowest) within various groups of countries									
G-7	1	1	1	1	1	1	1	2	2
G-20	2	2	2	2	2	3	3	4	6
OECD	1	1	1	1	1	1	1	2	2

Source: "The U.S. Corporate Effective Tax Rate: Myth and the Fact", Mintz and Chen, Tax Foundation Special Report, Feb 2014

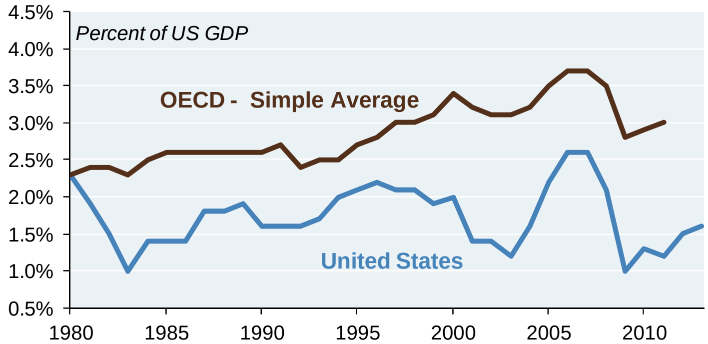
[1] Also, if this were true, few non-US companies would "tax invert" *into* the US. I have never heard of one.

[2] "*GAO Compares Apples to Oranges to Find Low Corporate Effective Tax Rate*", William McBride, July 2, 2013

[3] In addition to having high tax rates, the US also has a "Roman citizen" system that taxes worldwide income, compared to most of the OECD whose territorial tax systems only tax domestically earned income. The President's Bipartisan Fiscal Commission on Fiscal Reform in 2010 proposed a switch to a territorial system, as have the President's Export Council, the President's Manufacturing Council, and the President's Jobs Council, with the Fiscal Commission writing that "*the current system puts U.S. corporations at a competitive disadvantage against their foreign competitors. A territorial tax system should be adopted to help put the U.S. system in line with other countries, leveling the playing field*".

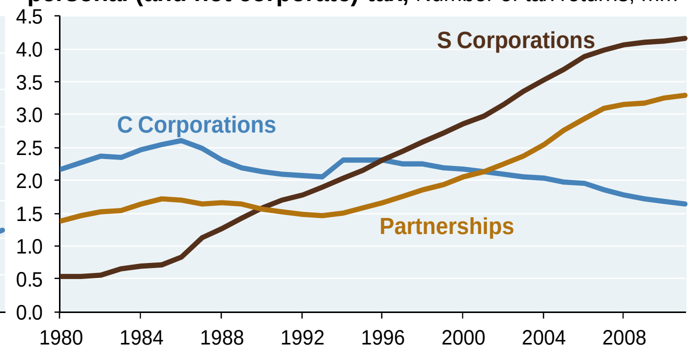
The counter-argument: US corporate income tax collections are low relative to GDP. Critics of the prior approach counter that US corporate income tax collections as a % of GDP have averaged 1.7% since 1980, compared to 2.9% across the OECD. How could the assertion of higher US tax rates and lower US taxes to GDP both be true? If higher US tax *rates* applied to a narrower *base* of corporate income. If so, it would dilute the argument that US tax rates are high in relative terms, and I do think base differentials may explain part of it. However, it's not clear that corporate taxes to GDP can be compared across countries, unlike the analysis on the prior page which incorporates country differences in a consistent way. Why? The use of S corporations and qualifying Partnerships has risen sharply since 1980, and both are subject to *personal* income tax rather than *corporate* income tax. **As a result, the US corporate tax to GDP ratio may not include all business taxes that other countries report as "corporate", and thus may not be an apples-to-apples comparison.**

Corporate income taxes to GDP: lower in the US than in the OECD, but they may not be entirely comparable...



Source: OMB, OECD. 2013.

...given the rise of pass-through entities subject to personal (and not corporate) tax, Number of tax returns, mm



Source: IRS. 2011.

Based on my understanding of this complex topic, the approach from the Calgary paper is the best (albeit imperfect) way to compare the taxes that corporations pay on their projects across countries, and the factors that influence their decisions. **As a result, I think it's fair to say that there are economic incentives in place for existing companies, newly incorporating companies and foreign companies to all act, on the margin, to minimize the impact of higher US corporate tax rates.** Tax inversion legislation appears to treat the symptom rather than the underlying issue itself.

There are arguments made about patriotism and loyalty to a country whose judicial system and other institutional support allowed US companies to thrive in the first place. They do resonate with me. However, for hundreds of years, countries evolved their legal, trade, labor, education, infrastructure and tax systems to adapt to changing global realities and compete. We had a chart a couple of years ago on the world's reserve currency since the year 1400, starting with Portugal, continuing with Spain, the Netherlands, and France, and concluding with Britain and the transition to the US dollar in the early 20th century. Part of all these transitions involved competition among empires for economic (and not just military) domination. In the modern era, providing a competitive fiscal backdrop is part of this process, and is not just an issue for New Jersey and New York[4], or Illinois and Wisconsin[5], to compete over.

In the next Eye on the Market: our annual energy piece. This year's topics: what the arc of history will look like with respect to renewable energy; an update on US energy independence; prospects for wind power without Production Tax Credits; the rising cost of nuclear power; prospects for natural gas vehicles; and the latest advances in electricity storage.

Michael Cembalest
J.P. Morgan Asset Management

[4] "*A Tug-of-War of Tax Breaks Tightens Across the Hudson*" (NYT, June 11, 2014) on efforts to retain BNY Mellon

[5] "*Illinois manufacturer to move to Kenosha, bringing hundreds of jobs*" (Milwaukee Wisconsin Journal Sentinel, Sept 11, 2013) on the migration of Illinois companies to Wisconsin resulting from competing incentives, including the phasing out of the Wisconsin corporate tax on income generated by manufacturing production.

Notes

Jack M. Mintz is the Palmer Chair in Public Policy at the University of Calgary and Director of The School of Public Policy. Jack serves as an Associate Editor of International Tax and Public Finance and the Canadian Tax Journal, and is a research fellow of CESifo, Munich, Germany, and the Centre for Business Taxation Institute, Oxford University. Jack also chaired the Canadian government's Technical Committee on Business Taxation in 1996 and 1997 that led to corporate tax reform in Canada since 2000. Regarding Canadian tax policy, Canada used to have higher marginal effective corporate tax rates than the US, in 2005. After substantial restructuring of its tax code, marginal rates in Canada are now much lower. The net result has been roughly a wash in terms of tax revenues to the Canadian government. However, Canada's tax base was broadened, and according to the Tax Foundation report, Canada benefitted by providing incentives for companies to domicile inside Canada instead of outside it, with associated gains in hiring, capital spending and growth

Acronyms:

ECB: European Central Bank; EM: Emerging Markets; EU: European Union; IRS: Internal Revenue Service;
MSCI: Morgan Stanley Capital International; OECD: Organization for Economic Co-operation and Development;
OMB: Office of Management and Budget; P/E: Price-to-earnings ratio; PMI: Purchasing Managers Index;
VAT: Value-added tax