The mediocrity factor and the market selloff

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Markets priced for terrific outcomes will eventually suffer a correction if mediocrity follows. That's the best way to put the 7% selloff in US large cap stocks and 14% selloff in non-US and US small cap stocks in context, particularly given underperformance of cyclical stocks and declines in industrial metals prices. There are contributing factors related to multiple hedge funds pursuing similar strategies and compounding the situation when it goes wrong (e.g., August 2007 statistical arbitrage hedge fund liquidations). However, the dominant driver is that after a huge rally in 2013, **equity markets were priced for a robust recovery in profits and economic growth this year, and in most places we see mediocrity instead, particularly outside the US.** Add in weak hands from markets that haven't had a correction in a while (August 2014 bullish advisory and investor surveys were among the highest readings since July 1987), and you have the recipe for another one. I don't think the world is headed back into recession, and there are stabilizers ahead in the form of lower energy prices and the benefits of global demand which is holding up better than output. There's an important difference between mediocrity and recession: the first argues for lower valuations which are in line with reality, while recession implies a more damaging bear market. The bottom line: markets had run ahead of fundamentals, which was the theme of our 2014 Outlook and its cover. The correction to-date brings US and some emerging economy equity markets closer to fair value; questions remain in Europe and Japan.

Percentile of equity market valuations, 1979-October 2014

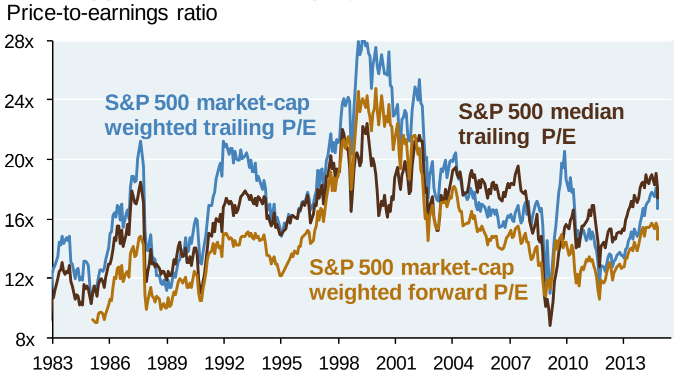
	2014 peak	Current
Median P/E	89%	66%
Mkt cap P/E	69%	55%
Forward P/E	74%	56%

Note: 100% equals highest valuation.

Charts from the 2014 Outlook and from a July 2014 Eye on the Market help illustrate the situation. The first chart and the table show three approaches to US equity valuation. For example, **the trailing P/E of the median stock in the S&P 500 peaked at 19.1x earlier this year, ranking in the 89th percentile of expensiveness** (i.e., pricing in a very favorable view on future growth). After the selloff, the median P/E of 17.4x is now in the 66th percentile, and other measures are closer to the 50th percentile. US small cap valuations have come in as well, from the 90th percentile of expensiveness to the 63rd. For long-term investors in US equities, these levels allow for global GDP and US profit growth to be less than perfect, which is a good way to describe the latest data:

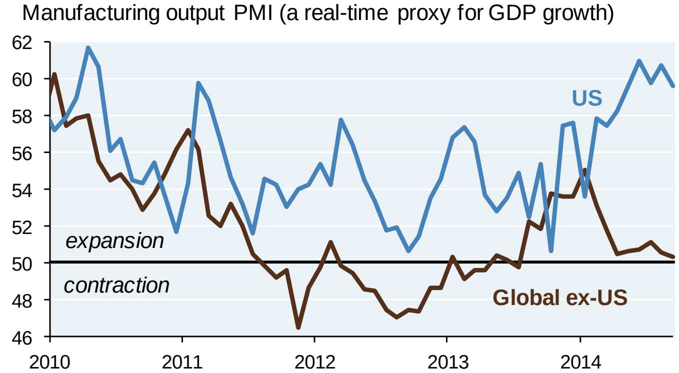
- S&P 500 earnings look like they will rise 4%-7% y/y in Q3 2014, with similar increases in 2015
- While **the US economy is growing** (on Friday, there were positive reports on rising US industrial production and capacity utilization, with the caveat that it takes a deeply negative real cost of money to generate such results), **non-US economies are a pinnacle of mediocrity**

Three approaches to US equity valuations
Price-to-earnings ratio



Source: Deutsche Bank, JPMAM. October 17, 2014.

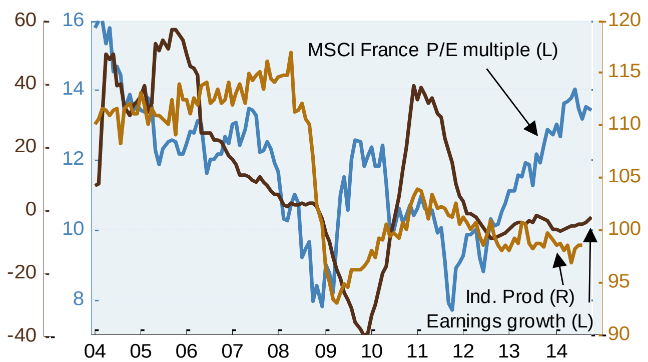
Outside the US, a return to mediocrity
Manufacturing output PMI (a real-time proxy for GDP growth)



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

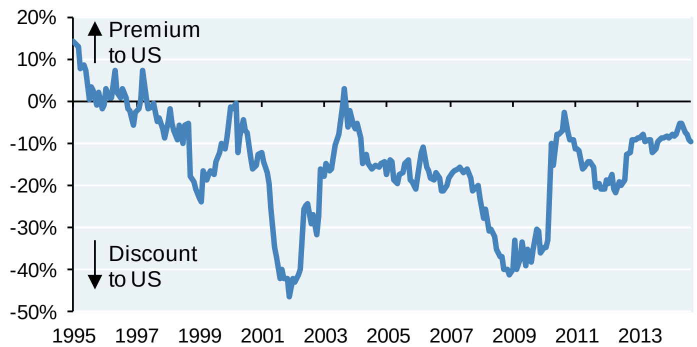
No man is an island in today's world, and US equities are impacted by developments elsewhere, given the 30%+ contribution of foreign-sourced profits to US corporations. In the US, optimistic valuations were at least accompanied by rising profits and signs of a self-reinforcing recovery. **The same cannot be said for Europe, where valuations rose without most of the latter.** We published the first chart below in June of this year; it shows how equity valuations in France have soared since June 2012 despite practically no improvement in French industrial production or corporate earnings (the only thing we see rising in France other than P/E multiples are the polling results for the National Front party). The second chart shows how the discount for European equities vs. US equities has fallen a little, but is still close to the tightest levels of the last 15 years, despite lower economic European growth and European ROE's that are 4% lower than US levels. European equities are flat this year in local currency terms, with losses for non-Euro investors based on the decline in the Euro vs. their respective home currencies. Given current valuations, **stagnant European profits** and the ECB's intention to debase the Euro over any Bundesbank objections, it is unclear to me how this situation will improve much in 2015.

France: P/E multiples rise as profits/production stagnate
Mind the gap



Source: INSEE, MSCI, DataStream. October 2014.

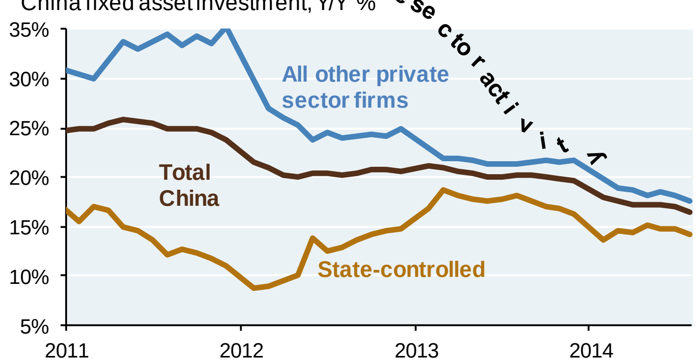
European equity discount to the US
Europe P/E ratio divided by US P/E ratio



Source: MSCI. J.P. Morgan Securities LLC. October 17, 2014.

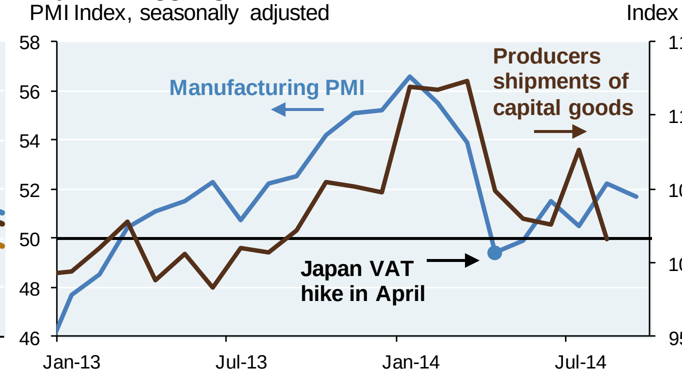
Disappointments in Europe are not the only mediocrity clouds on the global scene. Chinese GDP growth is slowing, in large part due the inevitable shift away from 25% annual gains in capital spending (particularly by the Chinese private sector), and a banking sector hangover after **an explosion in Chinese corporate debt.** This is having a knock-on effect across Southeast Asia and in commodity exporting countries around the world, from Australia to Chile to Canada to South Africa. In fact, China's growth slowdown is having a bigger impact on EM commodity exporter equity markets than on China itself, given how cheaply Chinese equities were already priced. In Japan, while markets were aware in advance of the VAT tax hike which took place in April, the economic hit was greater than consensus expectations. The same holds true for the slowness of the post-VAT tax recovery. To reiterate a theme, these economies are not imploding or in recession; the issue is that markets were priced (particularly in Japan) assuming that they would be getting better and not stagnating. That's what the markets are now pricing in: a greater risk that the current stagnation is more permanent.

One example of declining private sector activity
China fixed asset investment, Y/Y %



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

Japan struggling to recover after VAT hike
PMI Index, seasonally adjusted



Source: Markit. Japanese METI. September 2014.

Where to from here?

- **We expect the poor economic data in Germany to reverse**. There was a strange collapse in vehicle production related to the timing of factory closings which appears to be reversing this month. Almost the entire 1.7% decline in European industrial production in August was related to the decline in German auto production. Germany is undergoing a slow expansion but not a contraction (employment, wages and consumer large purchase intentions are rising).
- Announcements may come in Europe, although I don't know what the purpose of heavily-debated ECB purchases of government debt would be at this point, since bond yields are already low; and I'm not the only one who thinks so (see following page). There's talk of 300 billion Euros of public and private investment in the real economy over the next three years channeled through the EIB, but the details of plan are still unclear. **Stay tuned for another "European Growth Summit"; I will wake you if something comes out of it.** Within Germany, a debate on stimulus revolves around whether to run a 0.1% or a 0.0% budget surplus.
- **Declining commodity prices should eventually help US consumer spending** (a $10 drop in oil usually results in a 0.2% US GDP growth increase the following year). However, there's an offset in terms of weaker S&P earnings and capital spending, both of which typically decline after netting corporate and household consequences of lower oil prices. All things considered we expect a 3% private sector US recovery, 4%-7% large cap earnings growth and another year of positive single digit returns on US equities in 2015. One speed limit: the slow pace of housing demand financed through mortgages, a reflection of both economic and regulatory issues (we wrote a special *Eye on the Market* on the subject here if you are interested in reading it).
- The Fed's (reportedly) preferred measure of market expectations for future inflation has fallen **well below 2.5% again.** However, market volatility is not yet severe enough to change the Fed roadmap (end QE this fall, tighten monetary policy in mid-2015). The rally in treasury yields appears to be related more to technical factors than to investor fears of deflation
- We expect **emerging market manufacturers**[1] to continue to outperform EM commodity exporters. Markets will remain nervous about **China**, particularly given a new Conference Board report predicting that Chinese growth will fall to 3.9% as productivity falls and as structural reforms are not enacted. Some optimism on **Japan** continues to rest on the impact of a plan requiring government-run pension funds to increase their allocations to Japanese stocks (much of which is priced in)
- **In the long term, the most important stabilizing factor will probably be the pace of global final demand and retail sales, which are now running ahead of production, factory output and inventory accumulation.** Continued growth in the former should lead to a recovery in the latter later this year. If so, equity markets should stabilize first in the regions where these economic gains are taking place (e.g., the US, and the EM manufacturing exporters other than China).

German motor vehicle production rebounding
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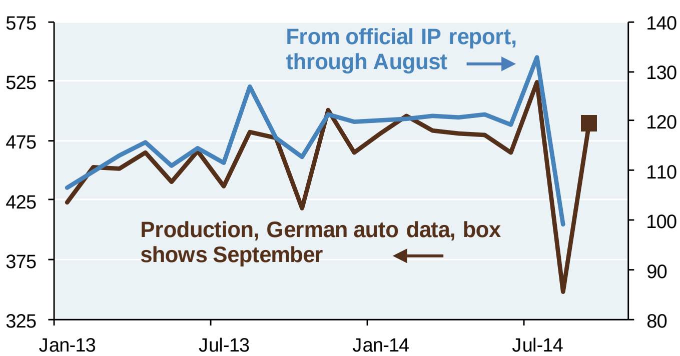
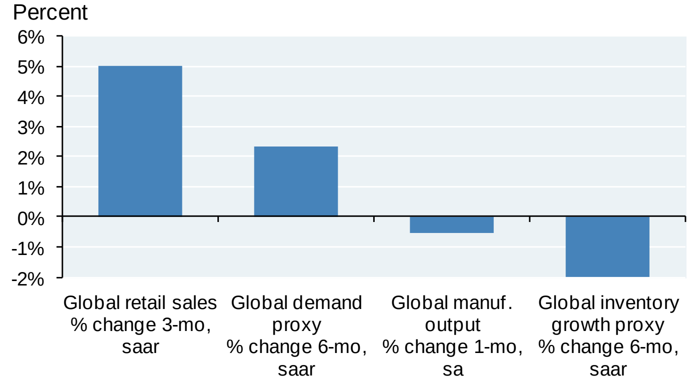


Source: Destatis, VDA, J.P. Morgan Securities. September 2014.

Global indicators: strong demand exceeds production
Percent



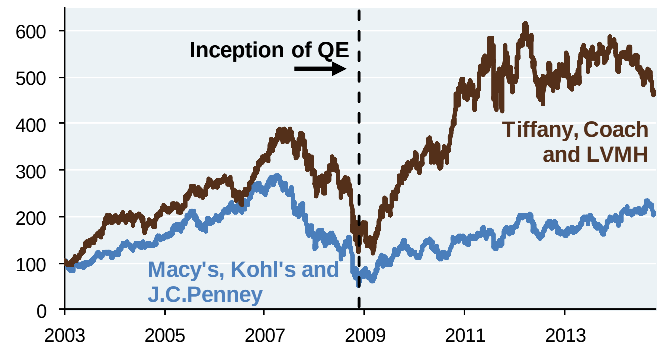
Source: J.P. Morgan Securities LLC. August 2014.

[1] Czech Republic, HK, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Phil, Poland, Taiwan, Thailand

A few closing comments:

- Corrections like this are common. Since 1950, the S&P 500 has experienced 73 of them, and there have been 62 in global equities. Another way to think about it: since 1950, there has been at least a 7% intra-year correction in all but 14 calendar years. Furthermore, such intra-year corrections are not good predictors of what happens next.
- There are limits to what monetary policy can accomplish; the chart shows some of the redistributive aspects of zero interest rates that reflect underlying imbalances in the economy.
- There are also limits to the financial engineering benefits of debt issuance to fuel stock repurchases if revenues don't grow (see IBM Q3 earnings report, Q3 revenues were down 5.6% y/y)
- Some see the oil price collapse as a reflection of a positive supply side response, related to a small rise in Libyan output, falling marginal costs of production for US shale oil and the reluctance of Saudi Arabia to cut production. That may be part of it, but to me, the oil price decline is mostly a demand story, related to falling Chinese oil demand growth (from 800k barrels per day to 200-250k bpd), and a world which is still only growing at 3% 5 years after the global recession.
- Some argue that the current state of affairs in volatile markets or in weak global economic growth can be laid at the doorstep of some of the world's Central Banks, and/or country parliaments and legislatures that should be spending more money. I find this hard to accept. **The last few years have seen the greatest explosion of monetary stimulus of the last century, and fiscal deficits in many countries have breached their highest levels in decades. If we are facing periods of stagnation in some countries, it is occurring *despite* monetary and fiscal easing, and not because there is not enough of it.**

A stock market reflection of the distributional effects of Quantitative Easing, Equal-weighted index, Jan. 2003 = 100



Source: Bloomberg. October 17, 2014.

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ECB purchases of European government bonds: it might not accomplish much

I agree with the concerns cited below about ECB purchases of government bonds (plan B). We have already written about the limitations of ECB purchases of certain corporate and asset-backed securities (plan A), since such securities only represent 9% of Eurozone GDP, compared to 120% in the US for the securities eligible for Fed purchasing.

From "***The ECB's Faulty Weapon***", Daniel Gros, Center for European Policy Studies. "**QE can be effective only in economies in which changes in long-term interest rates play an important role in the private sector.** But this is not the case in Europe, where most investment is financed via bank loans that typically do not have long-term maturities – often less than five years – because banks themselves have little secure long-term financing. Moreover, interest rates charged on these loans are not linked to market rates, but rather to the bank's refinancing cost, which is already close to zero. In the eurozone, lower long-term rates for government bonds are thus unlikely to improve the corporate sector's financing conditions and boost investment demand. By contrast, in the US, a much larger proportion of investment is financed by issuing bonds, which can have a longer maturity than bank loans. Moreover, these bonds are priced as spreads on the government-bond yield curve, implying that QE will have an immediate impact on enterprises' financing costs. For households, the main impact of lower interest rates is felt through mortgages. But most of southern Europe relies mainly on floating rates. This implies that QE would not reach, say, Spanish households, whose mortgages are indexed to short-term rates, which are already close to zero."

Acronyms:

CFTC: Commodity Futures Trading Commission; ECB: European Central Bank; EIB: European Investment Bank; INSEE: National Institute of Statistics and Economic Studies – France; IPO: initial public offering; METI: Ministry of Economy, Trade and Industry – Japan; MSCI: Morgan Stanley Capital International; NBS: National Bureau of Statistics – China; P/E: price-to-earnings ratio; PMI: Purchasing Managers Index; QE: Quantitative Easing; ROE: Return on Equity; VAT: Value-added tax; VDA: German Association of the Automotive Industry