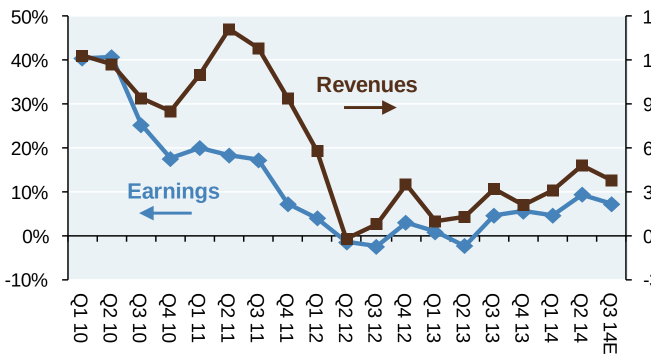
Topics: oil, the Bundesbank, Brazil, Japan and voters in Massachusetts/Maryland/Illinois

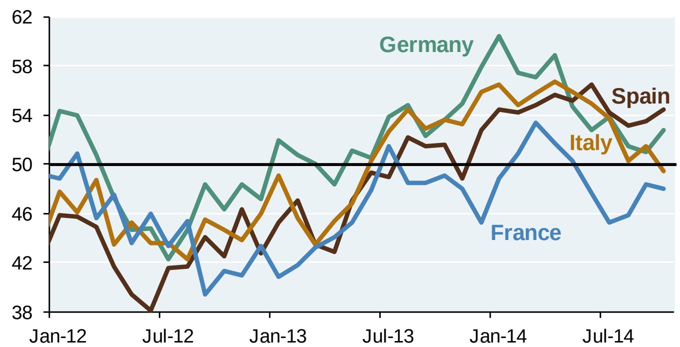
The economic and profit news has improved recently: the number of US job openings is now higher than during the prior cycle from 2002-2007, Q3 US earnings growth picked up to 7% y/y, US real disposable income is growing at ~3.0% (a by-product of more hours worked and rising employment), oil and gasoline prices are down 30%/20% in many parts of the world since July, the ECB promised to expand its balance sheet by EUR 1 trillion (despite the problems being more structural than monetary at this point), and business surveys improved in Germany and Spain (but not in France or Italy). These developments helped equity markets recover from a modest mid-October decline. So far, 2014 is turning out to be the mid-cycle year I had expected back in January, with returns on a stylized portfolio[1] that are lower than in 2010, 2012 and 2013, but still positive. See 3rd chart below for details.

S&P 500 earnings and revenue growth (ex-financials)
Y/Y % change



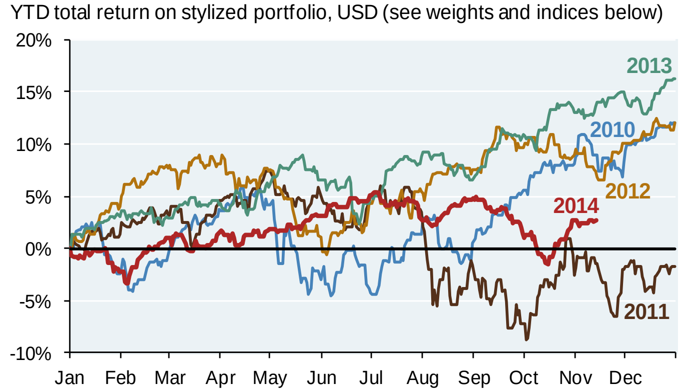
Source: UBS. November 2014.

Mixed results from European business surveys
Markit Manufacturing PMI output Index, sa



Source: Markit. October 2014.

Subpar growth outside US drags down 2014 portfolio returns
YTD total return on stylized portfolio, USD (see weights and indices below)



Source: Bloomberg. November 14, 2014.

***Flipping out*[2].** Despite these improvements, there are a few instances where people are still flipping out. It's worth reviewing them, as they're indicative of risks and opportunities in financial markets heading into 2015, and of the continued presence of central banks affecting asset prices. They also explain why I believe 2015 will be more like 2014 (modestly positive returns with the US in front) than 2013, when most global equity markets rose in tandem.

[1] Indices and portfolio weights used in stylized portfolio: S&P 500: 21%, S&P 600 Small Cap: 9%, MSCI Europe: 16%, MSCI Japan: 5%, MSCI Emerging Markets: 8%, Barclays US Aggregate: 20%, J.P. Morgan Domestic High Yield: 5%, Barclays US Treasury Bills: 5%, S&P GSCI Commodities: 5%, HFRX Global Hedge Funds: 5%.

[2] This *Eye on the Market* was written from the Palace Hotel in San Francisco. The long, vacant hallways, wooden doors and early 20th century design reminded me a lot of the hotel in *The Shining*, and not in a good way. That may account for the flipping out reference of this note.

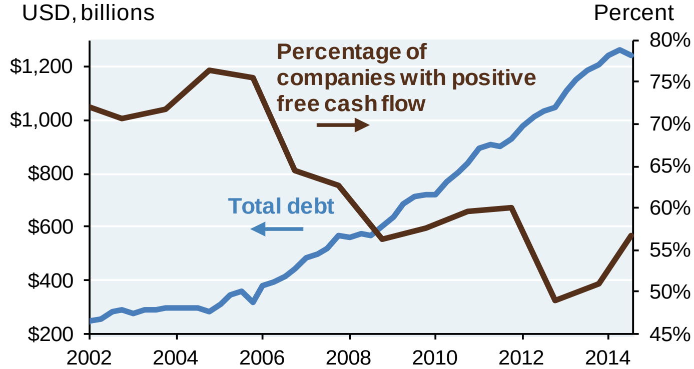
Flipping out: Oil company investors. Oil prices have fallen by 30% since June 2014. What's not to like about an effective tax cut for consumers? Well, there's the issue of the world's largest oil companies which took on a trillion dollars of debt in recent years to find and develop new fields, usually with the expectation that oil prices would be higher than they are now. Biggest borrowers: Petrobras (by far), PetroChina, Total, Shell and BP. Even before this year's oil price decline, only a little more than half of the top 100 had positive free cash flow (see 1st chart below). If WTI prices remain at ~$80, which oil futures markets are pricing in until 2018, the positive free cash flow universe will probably fall further.

Energy stocks: percentile of current Price to Free Cash Flow valuations, 1952 to 2014	
Large cap energy companies	15th
Large cap oil service companies	9th

Source: Empirical Research Partners
(99th = most expensive, 1st= cheapest)

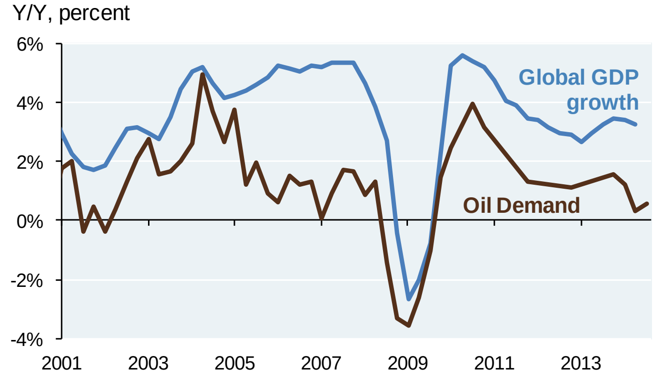
Investors have flipped out about this turn of events, driving valuations of energy and oil service stocks lower (see box), and driving credit spreads wider on HY energy issues, 50% of which are rated B or CCC. Lower oil prices reflect weaker global GDP growth, a supply shock from the US shale boom and decreased energy intensity in places like China, whose oil demand per unit of GDP has fallen by **35%** since 2005. Given this backdrop, S&P 500 profit forecasts for 2015 have come down ~3%, with energy-related reductions outweighing increases in consumer discretionary forecasts so far. The bottom line: **lower oil prices help consumers (see box below), but cut into US energy-related investment and production[3], and may also result in disruptions and distressed stock/bond opportunities in a highly leveraged global energy sector.**

Fundamentals of the top 100 global energy companies
USD, billions | Percent



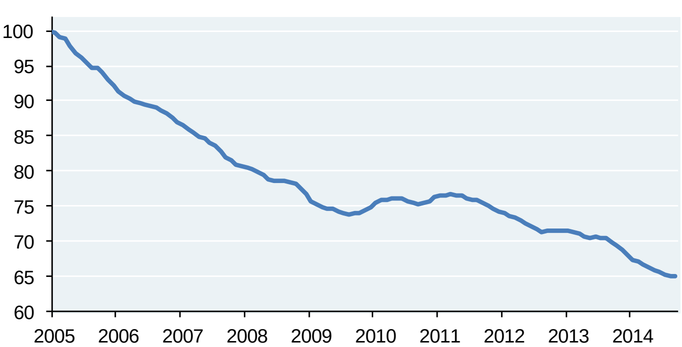
Source: Bloomberg. Q3 2014.

Lower GDP growth only explains part of the demand decline
Y/Y, percent



Source: BP, DOE, IEA, IMF, JPMAM. Q2 2014.

Decline in Chinese energy intensity
Index, 2005=100, barrels of crude oil demand per unit of real GDP



Source: Chinese National Bureau of Statistics. September 2014.

Oil price declines and GDP growth

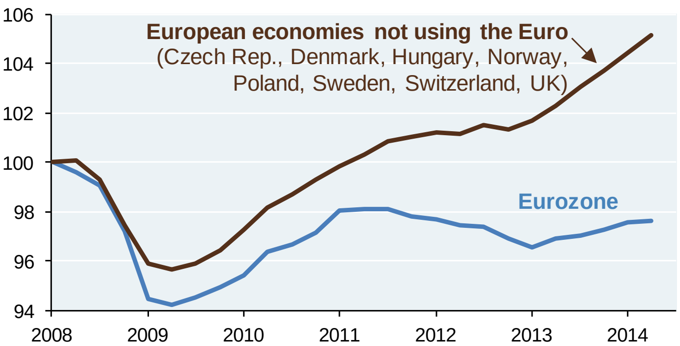
Benefits from lower oil prices are greatest in countries whose energy spending as a % of consumption is high; where energy taxes are lower, passing on more of the oil price decline to consumers; where savings rates are lower, so more of the increase in disposable income gets spent; and where energy intensity (barrels of energy equivalent per unit of GDP) is high. Many of these conditions are true for the US, at least relative to other countries. However, these growth benefits are partially offset when the dollar is rising, which encourages more imports and less exports. As per a recent note from Goldman Sachs, a **10%-15% decline in oil prices when combined with a stronger dollar would boost US GDP growth by just 0.10%-0.15%.**

[3] I have seen contradictory economic analyses on the hit to US growth from a slowdown in shale-related activity. One analysis estimates the ongoing boost to GDP from the shale boom at 0.5%, and which could fall to a -0.75% drag; another analysis puts the negative impact at only -0.10%. Nothing to do here but wait and see.

Flipping out: the Bundesbank. While the Eurozone is not falling back into recession, growth and inflation are stuck at ~1% and unemployment is still high outside Germany. There are signs of rising voter discontent, particularly given better outcomes in European countries *not* using the Euro. There's pressure on the ECB to purchase government bonds, since its loans and purchases of private sector securities may only result in 1/3 of its EUR 1 trillion balance sheet expansion target. The prospect of ECB government bond purchases is reportedly causing current and former Bundesbank leaders to flip out; the Bundesbank prefers productivity-enhancing measures by member states instead. However, my sense is that Draghi and his allies will continue to squelch Bundesbank opposition, and that we will see ECB purchases of Eurozone government bonds next year. The bottom line: **if the ECB buys gov't bonds, markets will probably take it positively, but ECB balance sheet expansion is not having nearly the same multiplier effect on growth or profits that it had in the US/UK.**

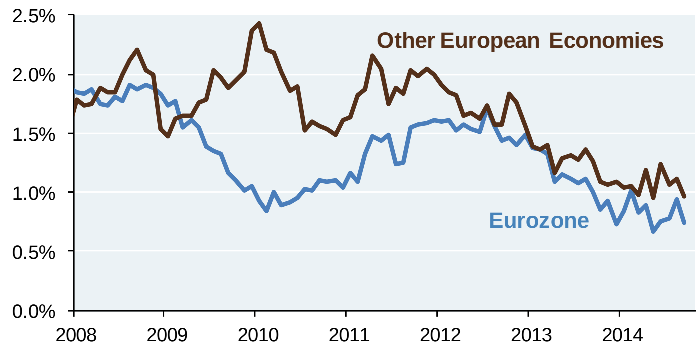
Draghi: Hast Du nicht mehr alle Tassen im Schrank?
Former ECB chief economist Jurgen Stark called existing ECB unconventional policy measures "an act of desperation" and described its purchases of asset-backed securities as adding "incalculable risks". Current Bundesbank President Weidmann cautions that ECB government bond purchases "would raise legal questions, set wrong incentives and may not produce desired results."

Is the Euro an albatross?
Real GDP growth, Q1 2008=100



Source: Eurostat, JPMAM. Q2 2014. GDP weighted average.

Inflation
Y/Y % change, core CPI



Source: Eurostat, IMF, JPMAM. September 2014.

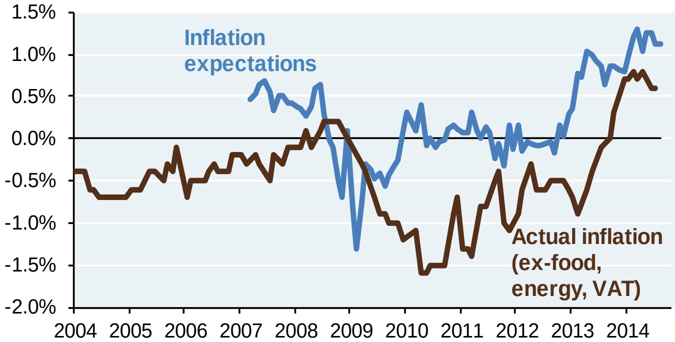
Flipping out: Brazilian manufacturers. The combination of rising interest rates, rising inflation and falling demand/prices for Brazilian commodity exports has caused Brazilian manufacturers to flip out: their confidence levels are close to the lows of the global recession. Even with all the bad news, the Bovespa was up 20% for the year in September since markets were pricing in the possibility of a new government. After the recent election, however, the Bovespa is down for the year as markets price in a continuation of the status quo. Too much optimism was probably priced in even if there *were* a change in governance, since the choices are all difficult at this point. The bottom line: **Brazil (and Turkey) remain EM question marks given rising inflation, weak growth and large reliance on foreign capital. We prefer EM manufacturers like Mexico, Poland and South East Asia instead.**

Brazil manufacturing confidence plunges
Index level

Source: FGV. October 2014.

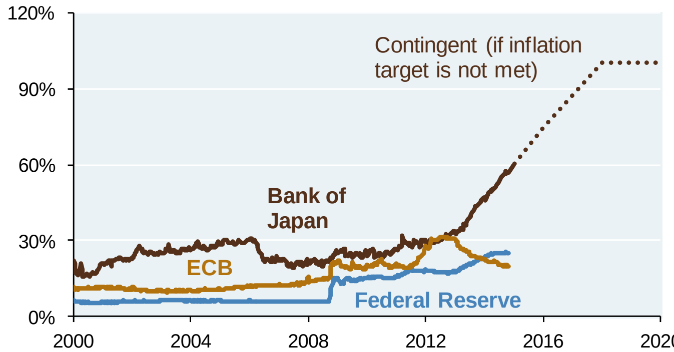
Flipping out: Some Japanese economists. In Japan, inflation and inflation expectations are now above zero, and employee compensation and full-time employment are growing at +2%, their highest levels in years. So despite the bad Q3 GDP result, there are *some* signs that "Abenomics" is having its desired impact, although it has taken a 30% Yen decline vs the US$ since mid-2012 to get here.

Some success against deflation, but is it the good kind?
Percent



Source: Ministry of Internal Affairs and Communications, Bloomberg. Oct. 2014. Note: inflation expectations derived from Yen inflation swap market.

Japan's massive money experiment
Central Banks' balance sheets, percent of GDP



Source: Federal Reserve, ECB, Bank of Japan, JPMS LLC. October 2014.

However, not everyone is a fan of the Bank of Japan's almost total monetization of government debt issuance and its purchases of Japanese equities and real estate investment trusts. In fact, some Japanese economists are flipping out:

- In the Nikkei Asian Review, Izuru **Kato** from Totan Research highlights that little is being done to address Japan's structural problems (i.e., Japan used to rank in the top ten in the World Bank's Ease of Doing Business Index; Japan is now 27th, and 120th in "starting a business"). Negotiations have stalled on the Trans-Pacific Partnership[4], a centerpiece of government plans to increase productivity and GDP growth. Kato is nervous about the BoJ's massive balance sheet growth (2nd chart above) and criticizes the BoJ's "monetary shamanism" resulting from its private sector asset purchases.
- Former BoJ chief economist **Hayakawa** believes the government should "quit while it's ahead", and start *shrinking* the balance sheet. The risk of current policies: cost-push inflation in which prices go up mostly due to a weak Yen, but without boosting growth, exports or employment enough.
- As per economist Richard **Koo** at Nomura, that's exactly what's happening: "Most of the price increases reported in Japan recently have been imported inflation fueled by the weak Yen. The resulting decline in the nation's terms of trade implies an outflow of income, which naturally depresses domestic final demand." Koo's latest report shows almost no growth (yet) in bank lending or in the money supply despite growth in base money. Furthermore, the rise in corporate profits in Japan is almost entirely a result of translation effects of a weaker Yen on foreign sourced revenues.

On Halloween, the Bank of Japan announced even *more* purchases of Japanese government bonds, and a tripling of its purchases of Japanese stocks. To augment the forced march to higher asset prices, government-controlled Japanese pension funds are being brought along for the ride: mandated equity allocations have been doubled. The Bank of Japan vote was 5-4, with 5 bureaucrats and academics voting in favor, and 4 board members with private sector experience voting against. I imagine that at some point soon, holding cash in Japan without the intention of investing it will qualify as some kind of misdemeanor. The bottom line: **there are some signs that Japan is reflating and BoJ purchases are good news for investors in Japanese equities (if you hedge the Yen exposure), but what if a perpetually weakening Yen is needed to keep Abenomics moving? This is without question the world's greatest Central Bank High Wire Act.**

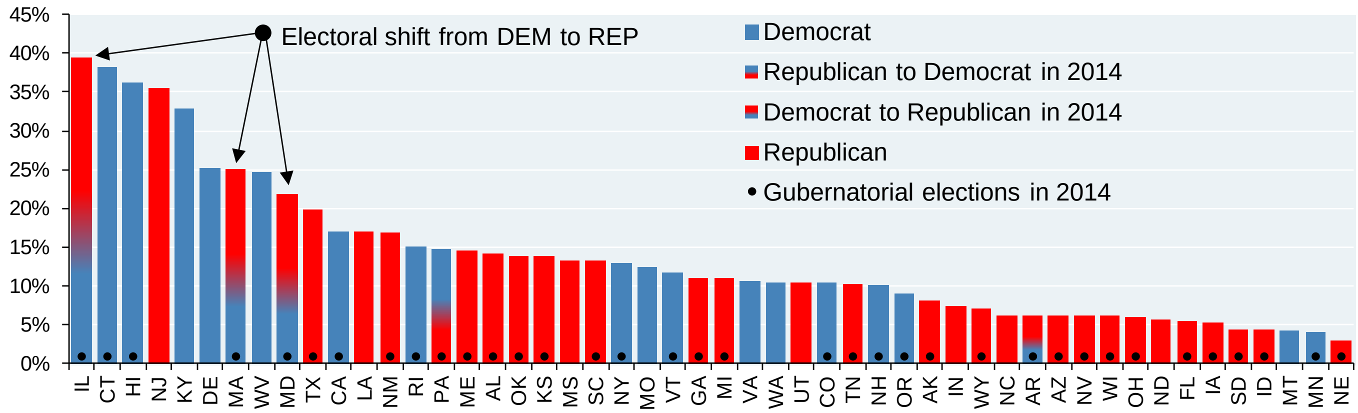
[4] The Trans-Pacific Partnership is a 12-country pact which began in 2005, and which was supposed to be completed by 2012. Disagreements related to tariffs on agriculture, intellectual property and other topics are still ongoing. At issue: closed Japanese beef markets and a 775% tax on imported rice, US tariffs on Japanese auto parts, etc. In September, the Japanese trade negotiator reportedly walked out of meetings after one hour of negotiation.

Flipping out: Voters in highly indebted US states. A surprise from the mid-term elections: the blue states of **Massachusetts**, **Maryland** and **Illinois** flipped governors from blue to red (how blue are they? See table below). There are a lot of factors involved in elections, and it's difficult to pinpoint why things turned out the way they did. But in looking at the shift in these states, it brings to mind an analysis we did earlier this year on the fully loaded funded and unfunded debt of US states:

What percentage of state tax collections is needed to pay interest on funded debt and amortize the state's unfunded pension and retiree health care obligations, assuming a 30 year amortization period and a 6% return in the pension plan?

Our estimates are shown in the chart[5]. The higher the percentage, the greater the pressure on the governor and the state legislature to increase state tax collections and/or reduce discretionary spending. **There's a big difference between the states, making national generalizations misleading.**

Percentage of state tax collections required to pay bondholders and retirees, assuming accrual based payments of unfunded amounts, and a 6% return on plan assets



Sources: J.P. Morgan Asset Management; state/pension plan Comprehensive Annual Financial Reports; BEA; Pew Research; Moody's; Census; Merritt; Loop Capital Markets. All data as of 2012. See "The Arc and the Covenants", Special Eye on the Market edition published June 5, 2014 for more details.

What's notable is that three states that flipped from blue to red this year (Massachusetts, Maryland and Illinois) ranked in the top ten according to our computations. It's hard to say for sure, but it is possible that the difficult choices on mandatory spending, discretionary spending and state taxes are starting to play a role in US gubernatorial elections.

You can find our research note from which this chart was drawn **here;** we will have a client conference call on this analysis in early December.

Michael Cembalest
J.P. Morgan Asset Management

Large Democratic majorities in 3 states whose governors flipped from blue to red in 2014

	State senate #		State house #		House of Repr #		Voter registration / Gallup %		
Illinois	40	19	71	47	12	6	51	34	G
Maryland	34	12	96	43	7	1	55	26	VR
Massachusetts	36	4	124	29	9	0	52	31	G

Respective state electoral and voter registration statistics; Gallup

[5] **As a reminder, this is not what the states are *currently* paying, it's what they *would* be paying under a full accrual basis using a 6% portfolio return, and as per other assumptions outlined in our report.** As of today's date, gubernatorial results in Alaska and Vermont were not determined; we left both states coded with the colors of their respective incumbent governors.

Acronyms:

BEA: Bureau of Economic Analysis; BoJ: Bank of Japan; DOE: Department of Energy; ECB: European Central Bank; FGV: Getúlio Vargas Foundation; IEA: International Energy Agency; IMF: International Monetary Fund; VAT: Value-added tax; WTI: West Texas Intermediate

Sources:

"Abenomics: Where's the deregulatory reform?", Izuru Kato, Nikkei – Asian Review, January 2, 2014.
"Bank of Japan should quit while it's ahead, says Hayakawa", Chikako Mogi, Bloomberg, October 15, 2014
"BOJ's surprise announcement: monetary easing by a currency interventionist", Richard Koo, Nomura Securities, November 11, 2014
"ECB's plans to buy rebundled debt draw criticism from Germany", Michelle Martin, Reuters, October 5, 2014.
"ECB's Weidmann Affirms QE Worries", Deutsche Borse Group, November 12, 2014
"Quiet critic of Kuroda's 'monetary shamanism' turns up the volume", Leika Kihara, Reuters, October 21, 2014.