Topics: Early report card on our 2016 Outlook; charts of the week (earnings, short covering, China, oil, high yield and momentum); the GOP primary, immigration, trade and Huey Long

It's early for this kind of thing, but given the market volatility, here's a self-assessment of some of the major views that appeared in our 2016 Outlook, *"Planet of the Aches"*. The assessments reflect whether or not the views are on track given what has happened since we wrote it in mid December. The big picture from the Outlook still stands: the pass-through from emerging economy and energy sector weakness has been limited, but the aches and pains of the global economy are continuing to constrain financial market returns, primarily through slower earnings growth.

View on track | View partially on track/mixed | View not on track

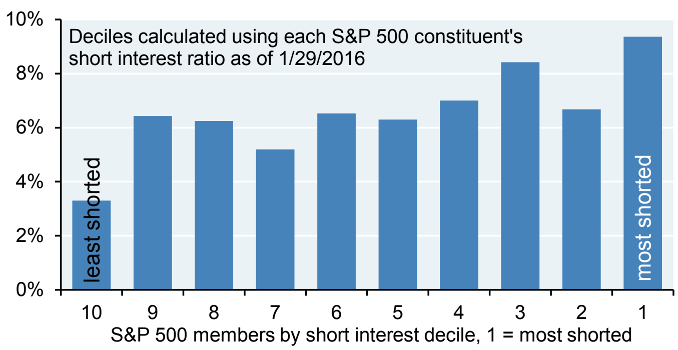
2016 Eye on the Market Outlook view	Assessment based on Q4 2015 and Q1 2016 data releases
US sales/profits growth weak since declines in energy and mining not sufficiently offset by gains in other sectors	Q4 S&P ex-energy sales & profits growth was 1.5%-2.5% y/y; Q1 2016 est. show 7 of 10 sectors with neg. earnings growth
Limited contagion in US from weakness in oil/manufacturing to service sectors	When excluding energy, payrolls and capex are stable, and GDP growth in non-energy states is over 3.5% Y/Y. However, warning signs from weaker Feb service sector surveys
Limited contagion from emerging to developed markets	DM credit creation, retail sales and business surveys remain much stronger than comparable EM measures
China continues to slow	February manufacturing and services surveys fell to lowest levels since 2011; very weak import data, exports tumbling; worst major market equity performance YTD
High yield spreads to widen further, be patient	HY spreads did widen almost 2% in Jan-Feb, but rallied and are now flat YTD. HY returns are +2.6% YTD
Majority of the US dollar's rise has already taken place	US$ has declined YTD vs. Euro, Yen, other trading partners
US GDP growth of 2.5%-3.0%	Consensus 2016 GDP forecasts falling, now 2.1%; consumer stable but growth restrained by weak manufacturing/exports
Cyclical improvement in Europe continues with 1.5%-2.0% GDP growth, but growth is insufficient to support further equity market appreciation vs. US	Consumption, retail & bank lending holding up; Eurozone/ German IP rebounding. However, exports weak, growth peaking at 2% and European equities still underperforming US
Abenomics isn't working, but rising corporate profits, central bank equity purchases, corporate governance reform & higher dividends should support Japanese equity markets	Pension/BoJ equity purchases & corporate buybacks continue, business capex positive. However, profits growth and capex expectations now slowing along with stronger Yen; consumer spending/wage gains very weak. Nikkei down 11% in Yen
Bottom in EM asset prices over next 12-18 months after large selloff and substantial FX depreciation. We may only be 50%-60% through EM economic adjustment, but markets tend to bottom well before adjustment process is complete	Ex-China, EM commodity exporter and EM manufacturing exporter equity markets are positive YTD and outperforming DM. Positive returns as well on EM $ and local currency debt
Brazil: local assets likely to remain weak, but spreads on external debt attractive given low prob. of external default	Brazil still a total mess but is best performing major EM equity market YTD; external sovereign debt tighter by ~1% YTD
Oil may fall from $37 below $30 temporarily, but should gradually rise given production and industry-wide capex cuts	Oil fell from $37 to $26, but has since rebounded to $37 despite high levels of surplus production and floating storage
Single digit returns on diversified portfolios in 2016	60/40 diversified portfolios of equities and fixed income cited in the Outlook have YTD returns of -1.0% to -1.5%
Improved resilience of global banking system	Financials: worst sector returns in the US and Europe YTD; flat yield curves, negative rates and increased energy provisions
Monetary policy to remain very easy	YTD decline in Fed and BoE tightening expectations; BoJ moves to negative rates; ECB expands bazooka, arguably rendering Maastricht constraints irrelevant by financing gov't deficits and mutualizing government debt
Limited geopolitical impact on markets	No clear impact on markets from intensification of Syrian/ Yemen wars, refugee crisis in Europe, collapse of Dublin Regulation on treatment of refugees, ongoing Ukraine War

Source: J.P. Morgan Asset Management. March 2016.

Here are a few charts that we're looking at right now, and why:

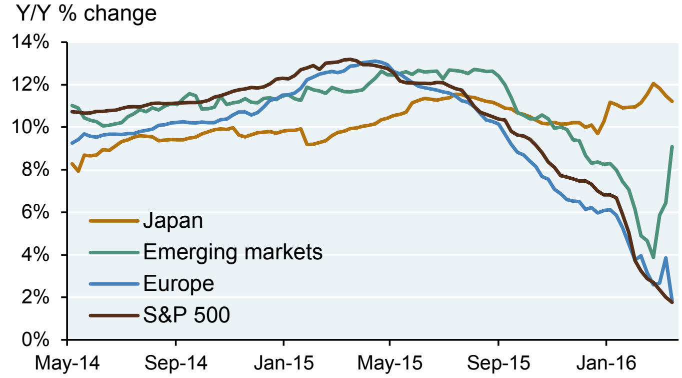
- *Short covering*. When looking at the best and worst performing stocks since the end of January, it looks like short covering played a large role. However, for the rest of the distribution, this is less clear.
- *US earnings growth slowing*. Consensus estimates for 2016 US earnings growth have fallen from 12% last summer to just 2%. Earnings growth is expected to be negative y/y in Q1 and Q2 as earnings weakness spreads beyond energy. In the past, when earnings rolled over, it was a sign that the cycle was ending. However, in 5 prior cycles dating back to the 1930's, **profits rebounded after rolling over**[1]. Usually, a heavy dose of monetary or fiscal stimulus was involved.
- *Non-US earnings expectations mixed*. Europe earnings expectations decline similar to US; EM expectations rising with oil price rebound. Japan 2016 expectations are holding up, but for the first time since 2011 the Yen has been rallying and trailing profits growth is slowing, so we'll see.
- *Labor incomes*. If profits are going to rebound, rising labor incomes and increased consumer spending will also have to play a role. Recent signs are positive in the US and Europe.
- *High grade downgrade wave.* The amount of high grade bonds estimated to tumble into the high yield market is much smaller than in 2000-2003. On the margin, a positive for the HY market.
- *Oil prices and high yield defaults.* Note how rapidly high yield default expectations decline should oil prices be sustained above $25/barrel. That's why lower oil prices are not linearly positive.

Since January, returns on best and worst S&P stocks correspond to short interest, total return by decile



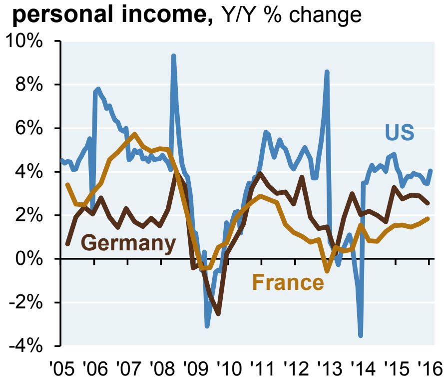
Source: Bloomberg, JPMAM. March 15, 2016.

Consensus earnings per share growth estimates for 2016
Y/Y % change



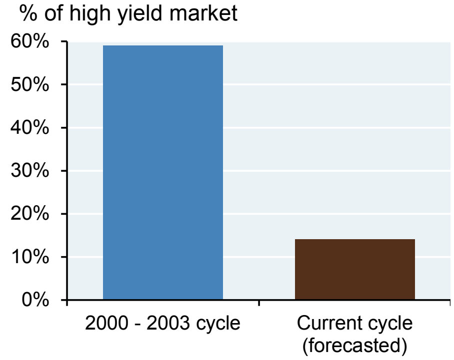
Source: Thomson Reuters IBES, Datastream. March 15, 2016.

Developed world disposable personal income, Y/Y % change



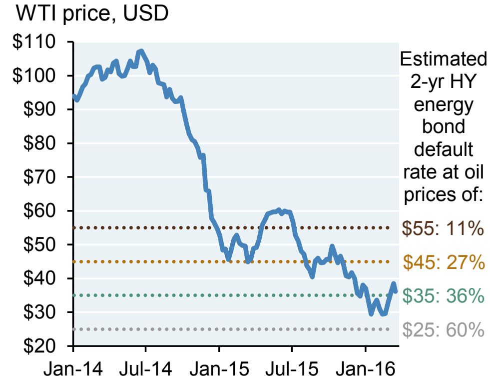
Source: BEA, StBa, INSEE. January 2016.

Current downgrade wave vs. tech cycle, Investment grade downgrades as % of high yield market



Source: Morgan Stanley. February 26, 2016.

Oil and high yield energy default rates
WTI price, USD

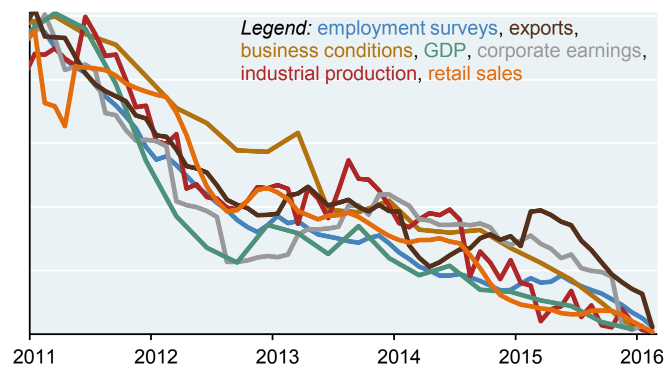


Source: Bloomberg, JPMS, Fundstrat. March 15, 2016.

[1] Drawn from a report by J.P. Morgan Securities: "*US Portfolio Strategy: Implications of a Contracting Profit Cycle*", February 25, 2016, Dubravko Lakos-Bujas, Equity Strategy and Quantitative Research.

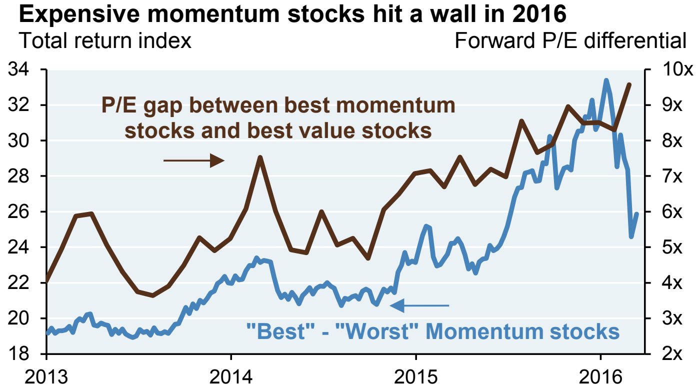
- *China slowdown.* No respite in China where just about everything we look at is slowing, other than data related to property markets. Latest gov't strategy: a multi-pronged effort to curtail capital outflows (scrutiny of FX transfers, freezing of outbound investment quotas, restrictions on corporate FX purchases and rumors of a new tax on FX transactions). Labor unrest is also spiking sharply.
- *A violent end to the momentum era.* From 2011 to January 2016, stocks with the best momentum (i.e., greatest trailing price appreciation) had been outperforming. As shown in the 2nd chart, this trend came to a violent end this year. Markets were overpaying for stocks with high earnings growth in an environment in which it is scarce, pushing their relative valuations to extreme levels (brown series shows valuation differential of the best momentum stocks vs. the best value stocks, with the latter based on P/E, P/Sales and P/Book Value).
- *Resilience in the US non-energy economy.* One reason we do not expect a recession in the US: the resilience of the non-oil economy. Two examples: business capital spending and payrolls. Their growth rates are not consistent with a huge growth rebound, but at least they are stable. Same story with respect to high yield defaults: energy default rates have spiked to 12% of outstanding issues, but non-energy default rates remain stable at 2%, roughly the same level they've been at since 2011.

China: The Year Of The Draggin'



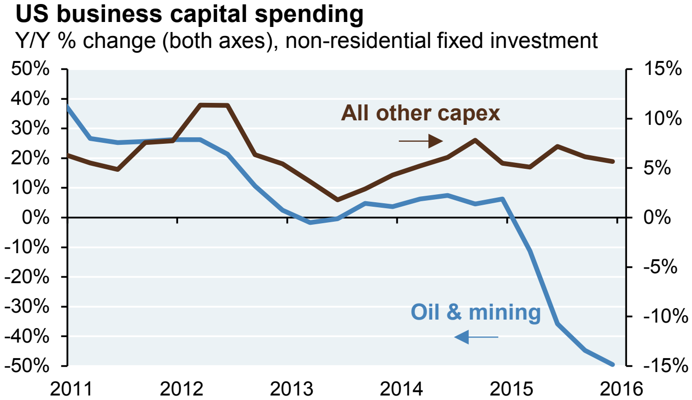
Source: CFLP, Markit, CC, PBoC, CNBS, MSCI, Haver, BBG. Feb 2016.

Expensive momentum stocks hit a wall in 2016



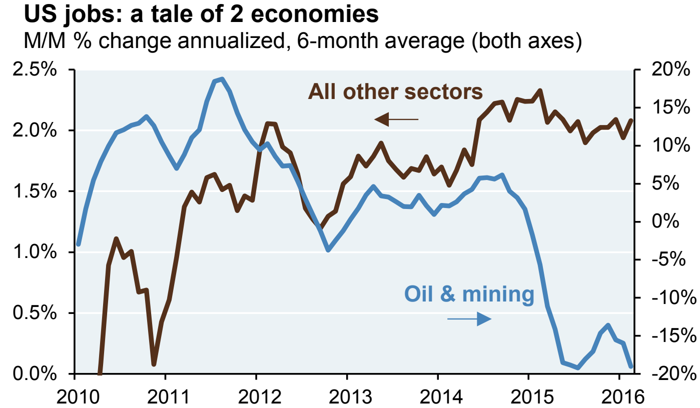
Source: J.P. Morgan Securities LLC, Bloomberg. March 15, 2016. L-S momentum basket based on Bloomberg ticker FTUSMTUT.

US business capital spending



Source: Bureau of Economic Analysis, Haver Analytics, JPMAM. Q4 2015.

US jobs: a tale of 2 economies

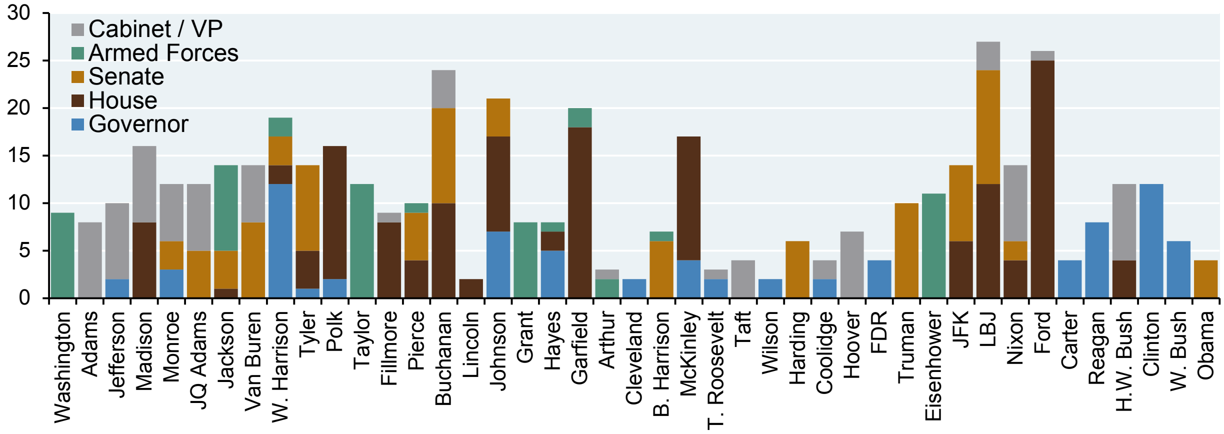


Source: Bureau of Labor Statistics, JPMAM. February 2016.

Are You Experienced? US presidential resumes and outcomes, the GOP primary, trade with China, immigration and Huey Long

While a contested convention is a very distinct possibility (see note[2]), in the end the GOP might nominate a candidate without prior political experience, this being the "year of the outsider" in both parties[3]. This is of course unusual; since 1787, all US presidents had some prior experience in government and/or the military that involved legislation, leadership and experience with machinations of the political process:

Government and military experience of past US presidents
Years as a governor, in Congress, as a General in the Armed Forces, as VP or in a Presidential Cabinet



Sources: J.P. Morgan Asset Management, White House Historical Association. March 2016. We excluded experience in local government, the judiciary, state legislatures, sub-cabinet federal positions and government positions held before 1789.

To be clear, the *degree* of prior experience does not always match up with the success of a president's administration. Grading presidents is subjective work, but we can start with surveys[4] compiled by historian Arthur Schlesinger, Siena College, the Wall Street Journal and the American Political Science Association. Some of the consistently best-ranked presidents had little prior experience: Lincoln, Wilson, both Roosevelts and Eisenhower (whose prior experience was entirely in the military). Furthermore, some of the worst-ranked presidents had *plenty* of prior political experience: Fillmore, Pierce, Buchanan, Andrew Johnson and Nixon [the low rankings of the first four mostly reflect their inability to resolve the issues of slavery and states' rights that led to and followed the Civil War]. **Nevertheless, a president without any prior political or military experience at all would represent a new era in American politics.**

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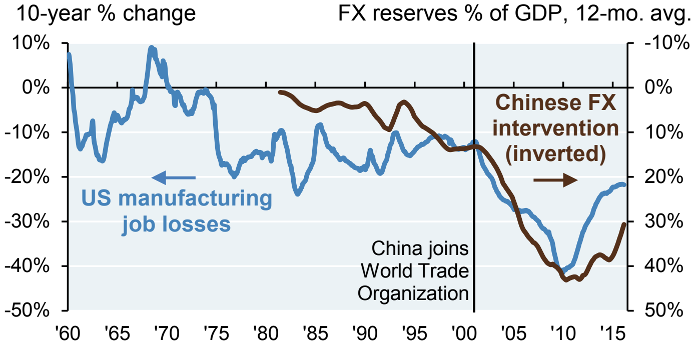
[2] ***The GOP convention***. While Trump is leading in the delegate count, many remaining Republican primaries are closed to independent voters, and others allocate delegates proportionally rather than winner-take-all. Even if one candidate has a majority of delegates by the end of the primary process, it's still technically possible (though unlikely) for the GOP to end up with a **contested convention**. Here's a link to a good piece on contested conventions, bound vs. unbound delegates, rules changes, Ted Kennedy's attempt to unbind delegates in the first round in 1980, etc. Since 1940, candidates who got their party's nomination after multiple ballots (Wilkie-1940, Dewey-1948 and Stevenson-1952), or after needing last-minute shifts in unbound delegates (Ford-1976, Carter-1980 and Mondale-1984) to win on the first ballot, **ended up losing the general presidential election**.

[3] **Sanders** is not an outsider in the traditional sense, having served in the House and Senate since 1991. However, Sanders is an outsider with respect to the Democratic Party. As we showed last December, Sanders' ideological uniformity is in a league of its own, substantially higher than even the most progressive Democratic Senators dating back to 1937, with the exception of the current senior senator from Massachusetts. Compared to all senators since 1937, Sanders ranks in the 100th percentile of liberal voting patterns, while Clinton ranks in the 88th percentile. On the other end of the political spectrum, Cruz ranks in the 100th percentile of conservative voting patterns.

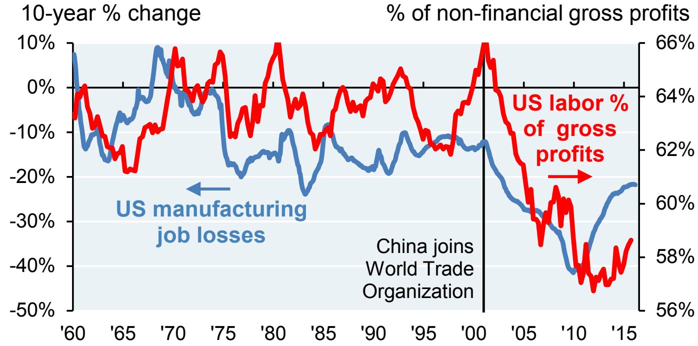
[4] The WSJ attempted to ensure equal participation by both liberal and conservative historians. **This was probably not that easy to do**: the ratio of Democratic to Republican history professors in US universities has been estimated at 10-1, 20-1 and 75-1 in different studies, something I wrote about in 2013 when my son was leaving for college.

What's driving the appeal of outsiders? My sense is that the charts below may be the best empirical explanation of the primary results so far. Other factors like automation play a role, **but China's 2001 entry into the World Trade Organization ended up having a large and very negative impact on US workers[5].** China's entry into the WTO ushered in a period of rising FX intervention by China, a collapse in US manufacturing jobs and a sharp decline in US labor's share of corporate profits relative to its 40-year trend. Hence, the appeal of candidates with a different approach to trade, whether it's renegotiation of existing trade deals or resistance to new ones.

After China joins the WTO, its FX intervention rises and US manufacturing job losses accelerate...



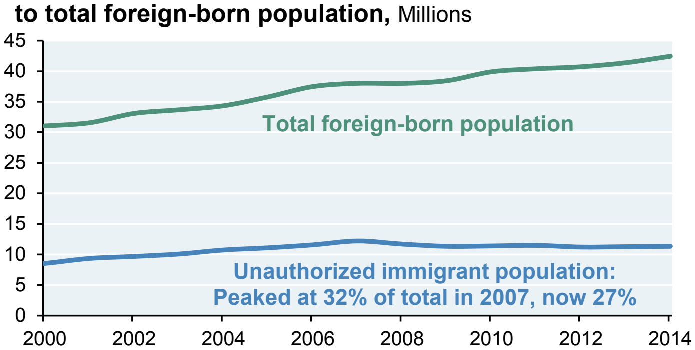
...coinciding with a sharp decline in US labor's share of corporate profits



Source: BLS, IMF, People's Bank of China, BEA, JPMAM. February 2016.

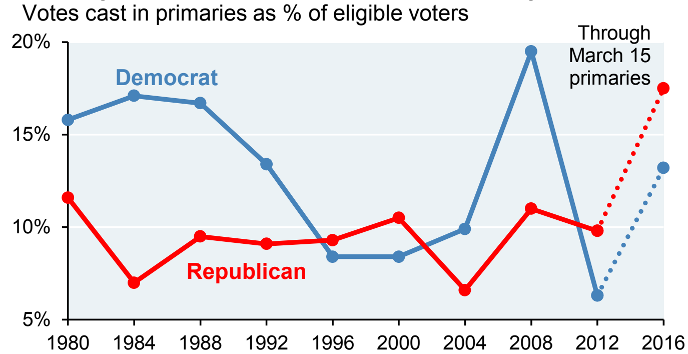
On the other hand, with respect to undocumented immigrants, available data do not show the same kind of sharp changes in recent years. Estimates of undocumented immigrants peaked in 2007 at 32% of the total foreign-born US population, and have declined modestly to 27% since. In any case, these issues have prompted GOP primary voters to turn out in large numbers, as shown in the last chart.

Estimates of unauthorized immigrant population relative to total foreign-born population, Millions



Source: Pew Research Center estimates from the Census Bureau and the American Community Survey. December 2014.

Primary turnout since 1980 (modern primary era)
Votes cast in primaries as % of eligible voters



Source: Pew Research Center, ElectProject.org, our calculations. Includes primary states only, excludes caucus states.

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[5] "**Recent papers on the subject include** "*The Surprisingly Swift Decline of U.S. Manufacturing Employment*", Pierce (Federal Reserve) and Schott (Yale), April 2015, and "*The China Syndrome: Local Labor Market Effects of Import Competition in the United States*", Autor (MIT), Dorn (CEMFI) and Hanson (UC San Diego).

On the US impact of China's entry into the WTO, authors of the 1st paper state: **"Something big happens".** "We find a link between this sharp decline [in US manufacturing] and the US granting of Permanent Normal Trade Relations to China, passed by Congress in October 2000". They discarded other explanations, such as a decline in the US competitiveness of labor-intensive goods, policy changes in China and macroeconomic events in the US. The lack of a job response in the EU (where tariffs didn't change) reinforces their perception of a linkage between US trade policy and US job declines. The 2nd paper came to a similar conclusion: "The 'aha' moment was when we traced through the industries in which China had surging exports to the local addresses of their US competitors and saw the powerful correspondence between where China had surged and where US manufacturing employment had collapsed." David Autor (MIT). "Rising imports from China cause higher unemployment, lower labor force participation, and reduced wages in local labor markets that house import-competing manufacturing industries."

What might the election of a political novice mean for investors, if it happened? There are not a lot of parallels to go by. Possibilities include pressure on healthcare given Trump's stated intention to negotiate Medicare drug prices, and related benefits for companies with large healthcare costs. The Tax Foundation projected a large rise in the budget deficit based on Trump's tax plan, something we covered in last year's holiday piece[6]. But I wonder as well about the broader **uncertainty principle** involved with such an outcome and how it might impact markets. One of the greatest periods of political uncertainty in US history took place 80 years ago in Louisiana, so I went in search of information on **the impact that Huey Long had on Louisiana-based stocks in the 1930s**.

By 1935, Huey Long controlled the legislative, judicial, and executive branches of the state of Louisiana in an unprecedented dominance of one state's government[7]. Biographies refer to Long's **physical assaults, firing and jailing of opponents, blackmail, bribery, voter fraud, use of un-uniformed state militias, extensive corruption and kidnapping**. Long planned to run against Roosevelt in 1936. Here's Huey in his own words: "No man has ever been President of the United States more than two terms. You know that; everyone knows that. But when I get in, I'm going to abolish the Electoral College, have universal suffrage, and I defy any sonofabitch to get me out under four terms"[8]. FDR considered him one of the two most dangerous men in America (Douglas MacArthur was the other).

Huey Long for Governor campaign flier, ca 1928, Ephemera Collection, Louisiana Research Collection, Tulane University

After some digging, I found a surprising answer: **Huey didn't have that much of a negative impact on Louisiana stocks or bonds[9].** Researchers from American University and the University of Iowa looked at Louisiana-domiciled stocks and bonds starting in 1924, when Long surprisingly finished 3rd for Governor. They continued through 1928 when Long was elected Governor, to his impeachment proceedings in 1929, to his Senate election in 1930 and ending in 1936, the year after his assassination. They compared returns and volatilities of these stocks and bonds to national averages, and could not find substantial evidence of Long's impact (negative or positive), even with regards to oil companies that Long targeted with lawsuits and higher taxes. A lot has changed since 1937, but this time capsule shows how markets can remain stable despite heightened uncertainty and a journey into the political unknown.

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[6] In the Tax Foundation analysis of Trump's plan, revenue benefits from higher growth are more than offset by the loss in gov't tax receipts, resulting in a $10 trillion deficit increase over 10 years, compared to $800 billion for Cruz.

[7] Thomas Harry Williams biography of Huey Long, 1981. While Long's misdeeds are documented in biographies such as these, **so are his public works**: free school textbooks (Louisiana's illiteracy rate was the highest in the US), free night courses for adult illiterates, reduced poll taxes, a debt moratorium, increased spending on hospitals and universities, and 13,000 miles of paved roads (vs. just 330 miles in 1928). **An illustrative editorial**:

> "He is not a fascist, with a philosophy of the state and its function in expressing the individual. He is plain dictator. He rules, and opponents had better stay out of his way. He punishes all who thwart him with grim, relentless, efficient vengeance. But to say this does not make him wholly intelligible. One does not understand the problem of Huey Long or measure the menace he represents to American democracy until one admits that he has done a vast amount of good for Louisiana. He has this to justify all that is corrupt and peremptory in his methods. Taken all in all, I do not know any man who has accomplished so much that I approve of in one state in four years, at the same time that he has done so much that I dislike. It is a thoroughly perplexing, paradoxical record." Raymond Gram Swing in *The Nation*, Jan 1935.

[8] Hugh Graham Davis biography of Huey Long, 1970. **Hodding Carter's** section on page 104 is the best part.

[9] "*How Much Does Political Uncertainty Matter? The Case of Louisiana under Huey Long*", Mathy (American University) and Ziebarth (University of Iowa and NBER), June 2015.

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