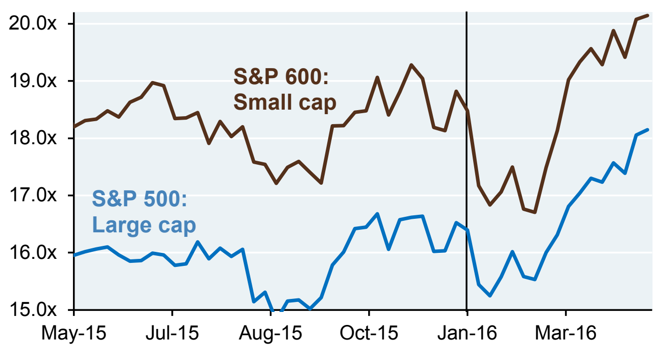
Topics: US equities, China, structured credit, Germany 😡 ECB, US Democratic Primary and 1972

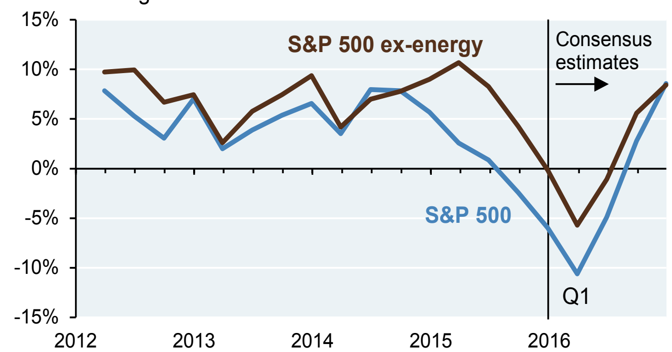
Letters of the week. US equities are on track to deliver the single digit gains we were expecting this year, but not for the reasons we expected them. Small positive returns YTD are due to rising valuations rather than an earnings rebound. After using some very complex technical models and consulting with a red, furry talking children's plush toy, I determined that the first chart below on valuations looks like the letter **W,** as in **W**ait before chasing this rally much further. In our 2016 Outlook, we did expect a weaker US dollar and an oil rebound this year, both of which should eventually help S&P earnings[1]. But productivity growth remains low, and we're not seeing signs of re-acceleration in the business cycle (manufacturing surveys softened a bit in April). Even with a modest recovery in earnings growth by year-end (in the 2nd chart, our models and plush toy identify the letter **V,** as in **V**olatile), it looks like another "no recession, no rebound" kind of year in which single digit portfolio returns are to be expected.

Valuations of large and small cap stocks
P/E ratio based on consensus 2016 EPS



Source: Thomson Reuters IBES, Bloomberg, JPMAM. April 22, 2016.

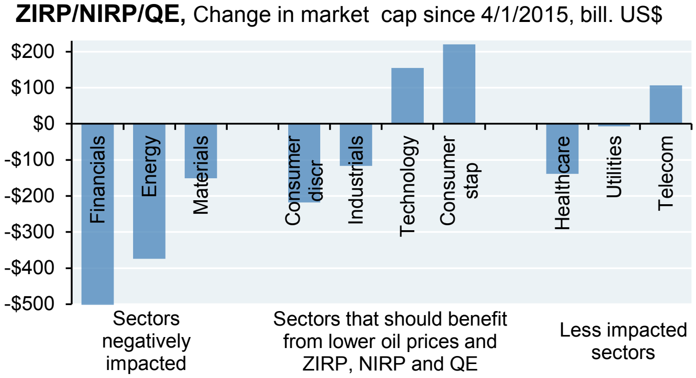
S&P 500 quarterly earnings growth
Y/Y % change



Source: J.P. Morgan Securities LLC. April 20, 2016.

What's not working for investors? While the oil decline hurts energy and mining, it was also supposed to unleash a strong positive consumer response. And while low policy rates and central bank yield curve suppression hurts banks[2], they were also supposed to generate positive outcomes for tech and industrial companies via a growth rebound. **However, as shown in the chart on developed world equity returns by sector, negative responses on the left side have not been adequately offset by positive responses in the middle**. In effect, some important economic linkages have short-circuited. That's one reason why a proxy for risky assets has been moving sideways since the fall of 2014.

Global sector returns and the impact of low oil prices and ZIRP/NIRP/QE, Change in market cap since 4/1/2015, bill. US$



Source: MSCI World global equity returns from Bloomberg. April 22, 2016.

A simplified portfolio of risky assets
Cumulative total return in USD since 1/1/2005, rebalanced quarterly

Note: 50% of European equity and high yield exposure is currency hedged.
Source: Bloomberg, Barclays Research, JPMAM. April 22, 2016.

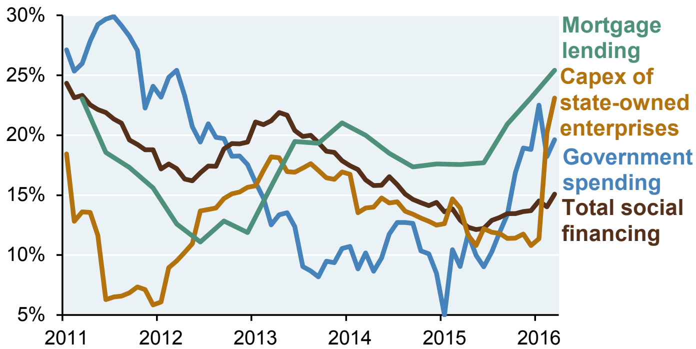
[1] For an explanation as to why the dollar and oil are more important for S&P earnings than for the US economy, see **this table** from the February 8, 2016 Eye on the Market.

[2] **How do low rates affect banks?** Take Europe, where 80% of banks surveyed reported declining net interest income, suggesting that higher loan volumes are not offsetting the ECB rate impact. The IMF estimates that annual net loan growth in Spain and Italy would have to be 6% to offset compression of net interest margins. Current annual net loan growth: -1% in Spain and 0.3% in Italy [Source: Gavekal Research, April 22, 2016].

China: lots of stimulus for a very modest growth response

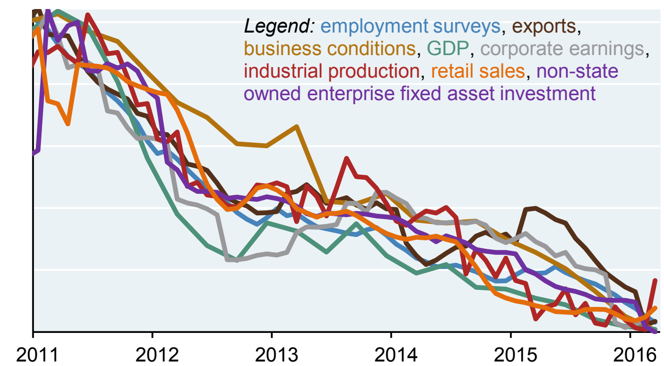
China is once again proof that if you channel 4,000 volts of monetary and fiscal stimulus into a languid economic patient, it will twitch and respond. However, this doesn't tell us much about long-run health. Most private sector data still look consistent with sub-6% growth, although there has been a pickup in industrial production from low levels, and capital outflows have slowed. Our technical model/plush toy verdict on the first chart: the letter **U**, as in **U**nconventional, **U**nusual and **U**nsustainable.

Pump Up the Volume
Y/Y % change



Source: JPMS, PBoC, CNBS, Haver Analytics. March 2016.

China: The Year Of The Draggin'

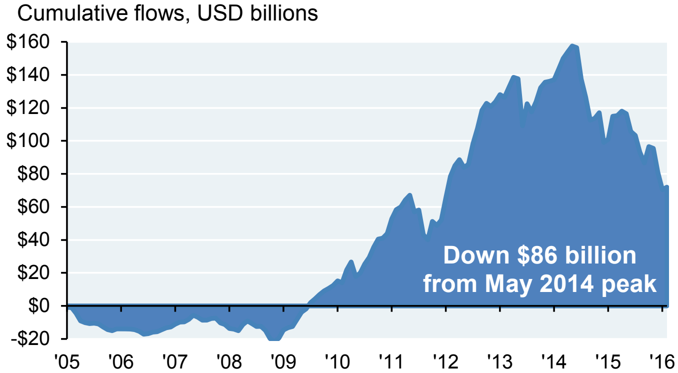


Source: CFLP, Markit, CC, PBoC, CNBS, MSCI, Haver, BBG. Mar 2016.

Credit markets: surviving mutual fund outflows, and some opportunities in structured credit

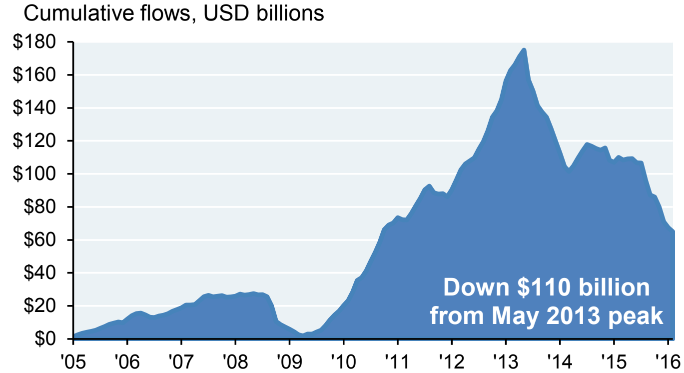
Credit markets have survived a big test: substantial withdrawals from high yield and emerging market debt funds. Fund managers report difficult liquidity conditions, but all things considered, credit spreads have held up well in the face of these outflows. The 3rd chart shows the rally in high yield and emerging market spreads since February 2016, and the last shows the recovery in local currency EM debt.

Global high yield bond funds
Cumulative flows, USD billions



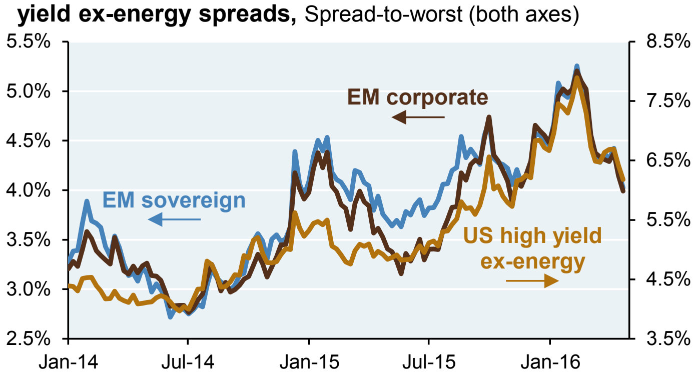
Source: EPFR. February 2016.

Global emerging market debt funds
Cumulative flows, USD billions



Source: EPFR. February 2016.

Emerging market dollar-denominated debt and US high yield ex-energy spreads, Spread-to-worst (both axes)



Source: J.P. Morgan Securities LLC, Bloomberg. April 22, 2016.

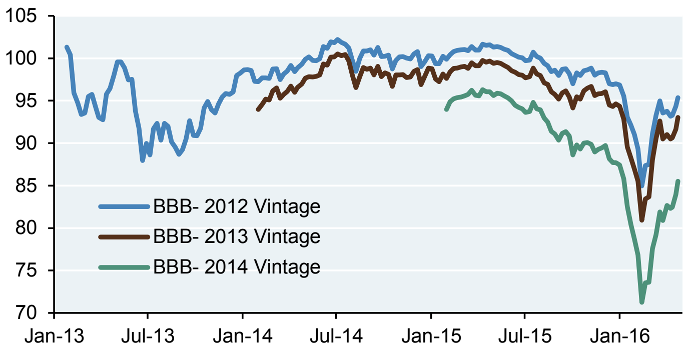
Emerging market local currency government debt
Total return index level

Source: J.P. Morgan Securities LLC, Bloomberg. April 22, 2016.

Structured credit can refer to pools of commercial real estate and corporate loans whose repayments are segregated into different tranches according to the seniority of repayment. Compared to pre-crisis transactions, structured credit underwriting is now generally more conservative and favorable for investors. Some examples: credit enhancement for BBB- rated investments backed by commercial real estate was 3.5%-4.5% pre-crisis, and is now 8%-13%; loan to values are lower, resulting in higher debt service coverage; and the use of interest-only loans has fallen from 75% of each pool to 25%. I would also categorize certain regulatory changes as positive for investors: starting in December 2016, sponsors of structured credit transactions are required to retain 5% of the pool for several years.

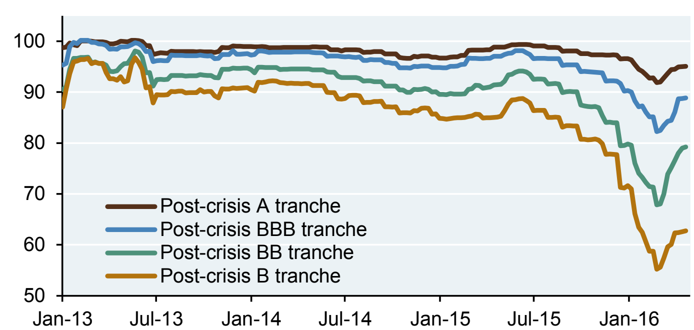
As shown below, some real estate and corporate loan structured credit investments have sold off this year, an opportunity which is worth considering relative to expected underlying default rates.

Structured credit backed by commercial real estate
CMBS price index



Source: Markit, J.P. Morgan Securities LLC. April 22, 2016.

Structured credit backed by corporate loans
CLO price index

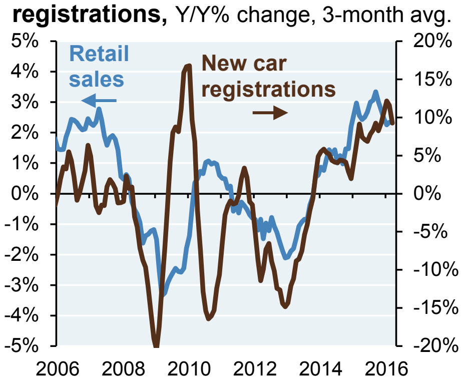


Source: Bloomberg. April 22, 2016. Post-crisis CLOs constitute CLOs issued after 2009.

Europe: no pressure on the ECB from German inflation, more from savings expropriation

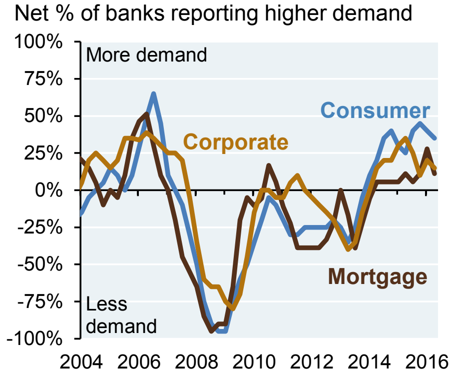
European equity markets are now flat for the year, having survived concerns about European banks and contingent coupon preferred stock. Expectations for Q1 European earnings (ex-energy) show a -12% decline followed by a rebound of 20%+ later in the year; same V-shape as in the US, but even more pronounced. There are a few positive signs in Europe, such as the rebound in Spanish/Italian credit, and increases in retail sales, durable goods and car registrations. Even so, Eurozone GDP growth is running at a tepid 1.5% - 2.0% pace.

Eurozone retail sales and car registrations, Y/Y% change, 3-month avg.



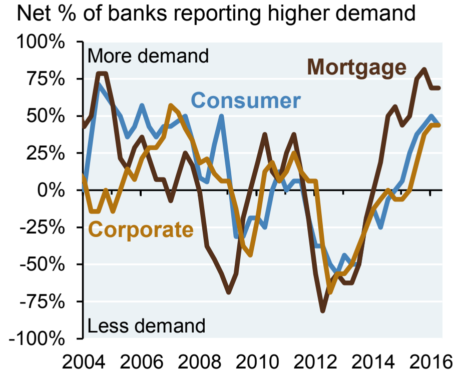
Source: ECB, Eurostat. March 2016.

Spain credit demand
Net % of banks reporting higher demand



Source: Banco de España. Q2 2016. 2-quarter avg.

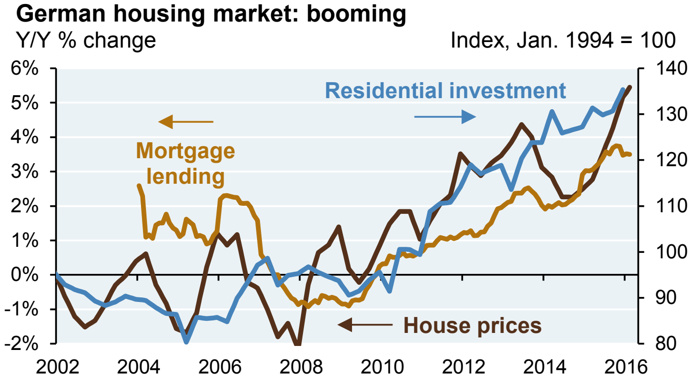
Italy credit demand
Net % of banks reporting higher demand



Source: Banca d'Italia. Q2 2016. 2-quarter avg.

What bears watching is the strength in German housing, retail sales and household income, and whether it leads to inflation. To be clear, German core CPI is just 1% and German wage inflation is just 2%-3%. In other words, no pressure on the ECB to change course from an *inflation* perspective. But if German inflation does pick up, the ECB could face more pressure to rein in what it's doing. To us, this looks like an issue for 2017 at the earliest. Our technical model/plush toy verdict on the next two charts: the letter **J**, as in **J**ahreswachstumssteigerung (year on year growth).

German housing market: booming



Source: ECB, Federal Statistical Office of Germany. February 2016. 12-month average used for home prices.

German retail sales and household income: surging

Source: Federal Statistical Office of Germany. Feburary 2016. 6-month average for household income, 3-month for retail sales.

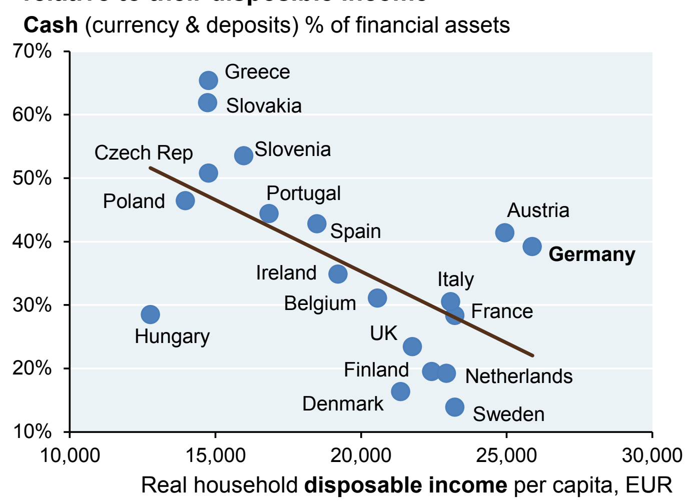
What the European Central Bank intends to do is remarkable, and why some Germans object:

- The ECB will finance European businesses directly as the anchor investor in European corporate bonds
- The ECB will buy up to 70% of any individual corporate bond issue rated BBB- or better, compared to 50% for supra-national bonds and 33% for sovereign bonds
- No minimum issuance volume, so small companies will be included
- Companies incorporated in the Eurozone will be eligible even if their parent company is not

This plan was devised either by a genius or by a lunatic; I can't tell yet. What I do know is that it will probably intensify debates in Germany about expropriation of savers through low interest rates. German Finance Minister Schäuble reportedly attributed part of the reason for the rise of a rightist, Euroskeptic party (the AfD) to ECB monetary policy[3].

As a reminder, ~40% of European gov't bonds now trade with *negative* yields. Why are Germans so focused on savings expropriation due to low rates? As shown in the chart, **for their level of disposable income, German households have a very strong preference for cash,** compared to other high-income countries like France, Netherlands and Sweden. As a result, we're not surprised to see opposition to ECB monetary policy coming from Germany.

German households have a strong preference for cash relative to their disposible income



Source: ING, Eurostat. 2014.

[3] Financial Times, *Germany blames Mario Draghi for rise of rightwing AfD party,* April 10, 2016. As for the success of **Austria's** right-wing Freedom Party in the 1st round of Presidential elections, the ECB didn't play a large role; it was all about immigration. The anti-asylum Freedom Party will be pitted against a pro-asylum former head of the Green Party in Round 2. **This is just the beginning of Europe's existential election cycle.**

Acronyms of the week – AfD: Alternative for Deutschland; CLO: collateralized loan obligation; CMBS: commercial mortgage backed securities; ECB: European Central Bank; EM: Emerging Markets; IMF: International Monetary Fund; NIRP: negative interest rate policy; QE: quantitative easing; ZIRP: zero interest rate policy

The Democratic Primary: exploring the strategic implications of super-delegates

This election season has been notable for rancor[4] within the parties on topics related to procedural rules, debates, eligibility and party affiliation. One issue I'm not sure I understand is the objection by supporters of Senator Sanders to the super-delegate system. Suppose that super-delegates did not exist. That would mean that bound delegates are the only ones candidates would be competing for. If so, the hurdle for winning the nomination would be 2,026 delegates (half of the total of 4,051). Secretary Clinton has 1,446 and Sanders has 1,205. So, in the absence of super-delegates, Clinton could win the nomination by securing just 580 of the remaining 1,400 delegates, implying that she would only need between 40% and 42% of the vote in upcoming primaries. The math is essentially the same if we assume that super-delegates are eliminated, re-designated as bound delegates in each state, and allocated according to existing voting results in each state so far.

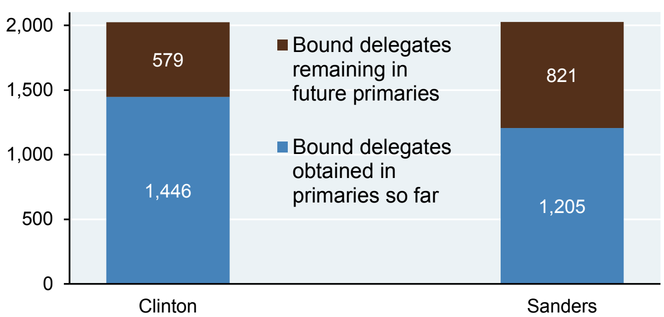
As a result, let us imagine two paths to a Sanders nomination:

A: In a system **WITHOUT** super-delegates, Sanders wins 60% of the vote in remaining primaries and edges Clinton in the bound delegate count

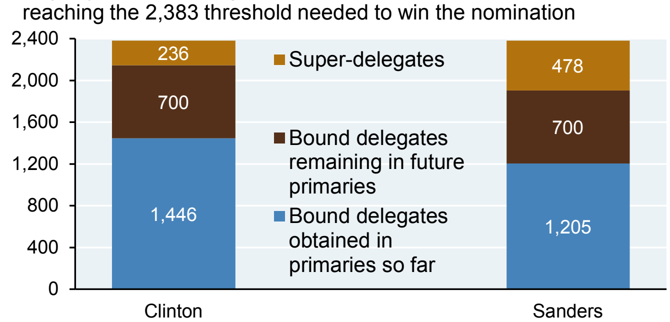
B: In the existing system **WITH** super-delegates, Sanders does not win 60% of the vote in remaining primaries, but does win enough bound delegates to prevent Clinton from winning 2,383 delegates, the threshold needed to win on the first ballot. Then, at the convention, Sanders convinces a large majority of super-delegates to support him on the first ballot, allowing him to reach the 2,383 threshold

If you are a Sanders supporter, and if you consider B to be more plausible than A, the existence of super-delegates would be a *positive* rather than a *negative*, at least based on this logic.

Scenario A: in a system ***without*** super-delegates, Sanders wins 821 (60%) of all remaining bound delegates to reach the 2,026 necessary to obtain the nomination



Scenario B: in a system ***with*** super-delegates, Sanders splits remaining bound delegates 50/50, and convinces a very large majority of super-delegates to support him at the convention, reaching the 2,383 threshold needed to win the nomination



Source: The Green Papers (delegate estimate), JPMAM. April 22, 2016.

Our technical model/plush toy perceived the letter **I** in these charts, as in **I**ndependent voter. On the question of independent voters and open vs. closed primaries, Sanders was quoted as follows in *The Hill*: "Today, 3 million people in the state of New York who are independents have lost their right to vote in the Democratic and Republican primaries". While preferring open primaries is a reasonable position to take, it seems odd to use the words "**today**" and "**lost**" when closed primaries have been a fixture of New York state politics since the 1970s. In fact, New York State Election Law §5-210, 5 (f) specifically states that election registration forms must include "notice that political party enrollment is optional but that, in order to vote in a primary election of a political party, a voter must enroll in that political party, unless state party rules allow otherwise". How can you lose rights that you never had?

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[4] If you're looking for the ultimate in political rancor, **Nixon and his aides in 1971-72 are your first and last stop**. Even before Watergate, President Nixon and an aide discussed planting McGovern campaign literature in the apartment of the man who shot George Wallace [NYT, Dec. 14 1992]; Nixon operatives produced counterfeit mailings on Muskie letterhead that were critical of Ted Kennedy, and that accused Humphrey and Henry Jackson of sexual misconduct [William Manchester, Wesleyan, and J. Anthony Lucas in *Nightmare: The Underside of the Nixon Years*]; Nixon aides hired phony Muskie volunteers to call people at home in the middle of the night, ringing back multiple times with the same questions [Lucas]; Nixon aides hired a woman to strip outside Muskie's hotel room yelling "I Love Ed Muskie!" [Lucas]; and invitations to non-existent events claiming free food and alcohol were distributed on behalf of other candidates, angering people when there was none [Lucas].

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