

**A look at US equity valuations after the rally, and a fiscal cliff scorecard; South Carolina**

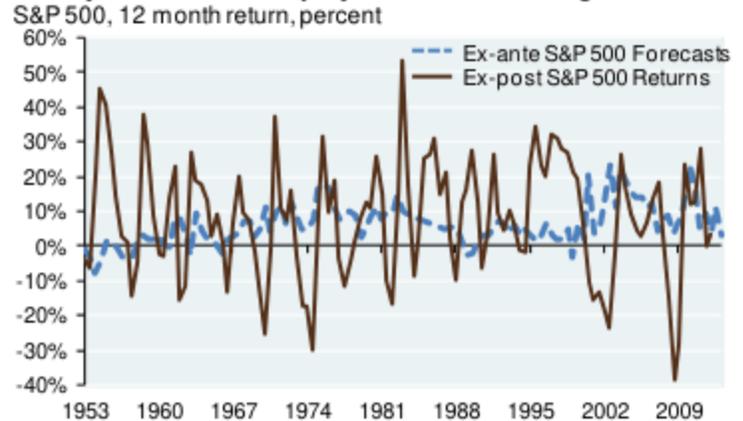
In 2012, rising equity markets have mostly been a function of rising multiples applied to modestly rising earnings. While we have had a normal weighting to US equities in model portfolios since mid-2009, I would've put no more than a 1 in 4 chance on a 17% advance in the S&P 500 this year. Forecasting annual equity returns is a treacherous exercise; the second chart shows how annual gains and losses in equities have completely swamped annual industry forecasts since 1950.

**S&P 500: earnings and P/E multiples**



Source: Bloomberg, Factset.

**Futility of short-term equity market forecasting**



Source: RBC Capital Markets, Federal Reserve Bank of Philadelphia.

In any case, we're getting questions about where US equity valuations stand after the rally. To be clear, valuations might not be the driving factor at this point. The debasement of money by the Fed has altered the calculus of investing for many participants, and not necessarily for the better. An analysis we are still working on shows that since the Greenspan/Bernanke era of negative real interest rates began, stock market volatility is even higher than before the creation of the Fed in 1913, an era of recessions, depressions and widespread bank failures. Nevertheless, here's a look at the US equity valuation question, and what the current 13x-14x P/E multiple on the S&P 500 is worth in historical context.

**The traditional version of the Graham-Dodd/Shiller model makes equities look a bit expensive, cheaper only than the 1990's valuation bubble.** In a May 2<sup>nd</sup> note, we walked through this model in detail. Our primary concern: using ten years of trailing reported earnings<sup>1</sup> effectively assumes that the mayhem of the prior decade is highly indicative of the future. As shown in the second chart, earnings are usually volatile, but the 2008 collapse was something that hadn't been seen in over 100 years. Given the massive compositional shift in the S&P 500 since 2000 (240 of the 500 companies in the S&P changed), I'm not sure this is a great assumption. The use of reported earnings instead of operating earnings also has a large impact, given the abnormally large decline in the ratio of reported to operating earnings during the financial crisis. If the valuation model (a) incorporated the earnings history of the companies *now* in the index and not the prior constituents; (b) assumed that reported earnings rise back to their historical average level relative to operating earnings (88%); and (c) assumed that earnings declines during recessions are 20%-30% and not 70%; then valuations are pretty close to average. **In short, anchoring expectations in the immediate past is a potential problem with the Graham-Dodd/Shiller approach.**

**Graham-Dodd/Shiller valuation approach: expensive**

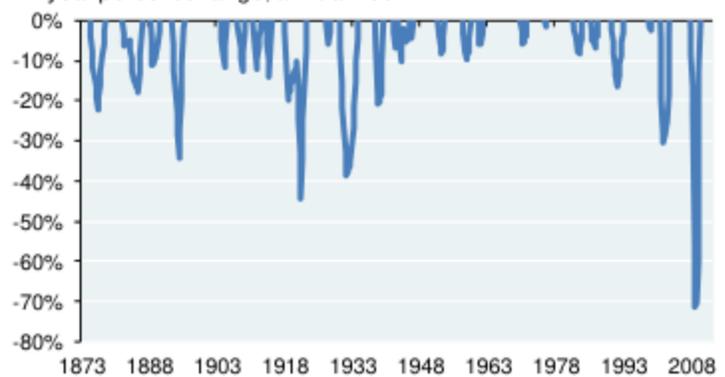
S&P Price to ten year trailing average reported earnings



Source: Robert J. Shiller dataset. Standard & Poor's.

**S&P 500 reported earnings drawdowns**

2-year percent change, annualized



Source: Robert J. Shiller, Standard & Poor's.

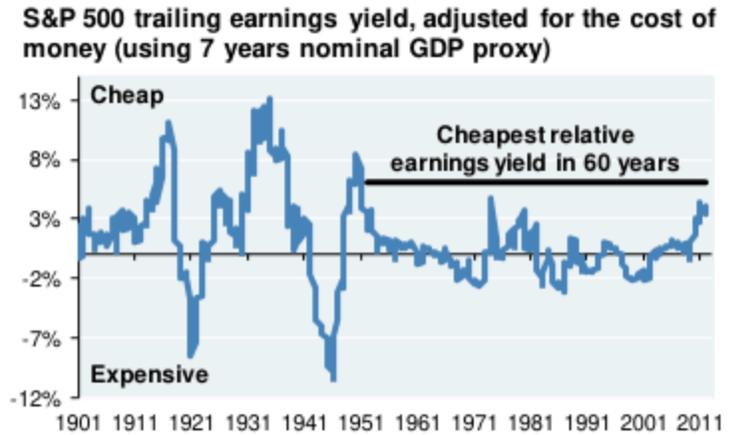
<sup>1</sup> The ten year assumption on trailing earnings is designed to smooth for business cycles.

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**On the other side of the spectrum: an approach that takes current earnings at face value, and also adjusts for the cost of money.** Assume that current earnings are not at a cyclical high, and represent ongoing earnings power (margins are high, but consistent with capacity utilization). The first chart inverts the P/E to derive an earnings yield. Nothing remarkable here; however, this is where the cost of money comes into play. Equities are one investment among many, and government bonds are a starting point for comparison. In the 2<sup>nd</sup> chart, we subtract a proxy<sup>2</sup> for long-term interest rates from the earnings yield to derive the “relative value” of equities. Using this approach, equities are cheaper than they have been in 60 years. [*Quite a different answer than Graham-Dodd, right? These models rely on perpetuity formulas, and are very sensitive to their inputs*].

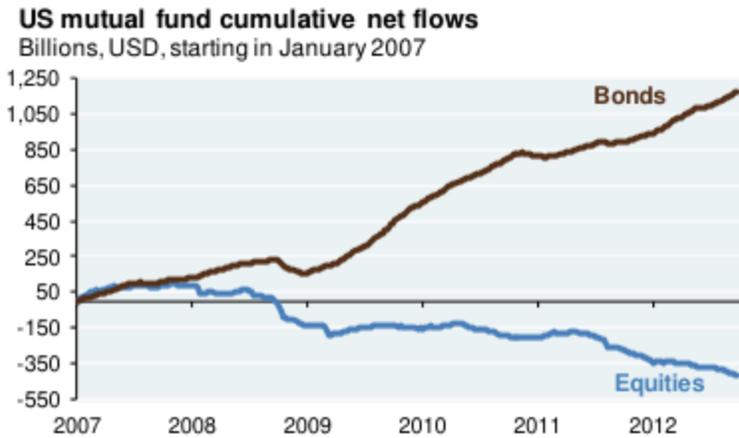


Source: Robert J. Shiller dataset, Standard & Poor's.

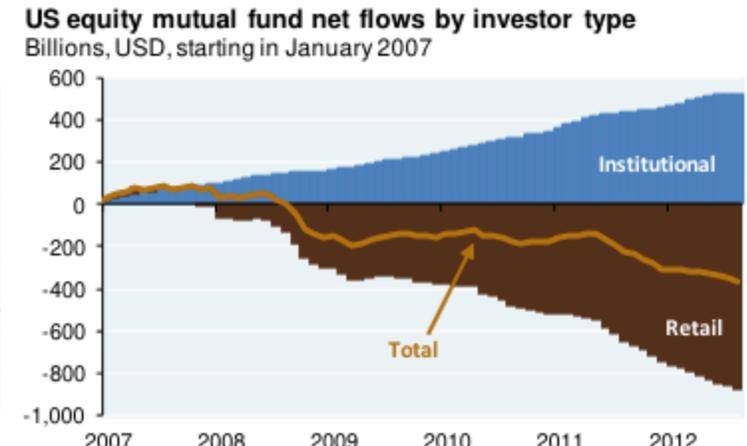


Source: Robert J. Shiller dataset, Standard & Poor's, BEA.

It is this latter dynamic that the Fed is seeking to build on. **By driving interest rates down and promising to keep them there, a 7% nominal equity earnings yield (i.e., a 14 P/E) is transformed into a more compelling investment.** To reiterate, we have reservations about all of this, but that's how the market has reacted to Fed policy so far. The divergent reaction from different classes of investors is striking. It has been widely reported that net equity mutual fund flows have been negative. However, as shown below, institutional investors continue to add exposure while retail investors have been fleeing en masse.



Source: Investment Company Institute.



Source: Investment Company Institute.

**We have concerns about the adjusted earnings yield model as well.** This cycle's profits have been boosted by weak labor compensation compared to prior ones (see next page). Given the unemployment situation we don't expect wages to rise anytime soon, but there are consequences that may affect equity markets at some point (outsized government transfers to households and large fiscal deficits). The other profit driver has been the increasing contribution from outside the US. This trend appears to be fading, given the slowdown this year in both Europe and China (from different starting points). The latter issue is putting downward pressure on 2013 earnings expectations, which have been falling steadily over the last year. As part of this ratcheting down of expectations, there has been a rise in negative earnings preannouncements. S&P earnings are expected to fall by 4%-5% in the third quarter compared to Q3 2011. **In short, the earnings boom is not worth quite as much if derived from extraordinarily weak labor compensation and potentially unsustainable demand from Europe/China.**

<sup>2</sup> We don't use actual long-term rates since the Fed has been manipulating them for the last three years. Trailing nominal GDP growth rates have been a good proxy for long-term rates over several decades.

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Current US recovery

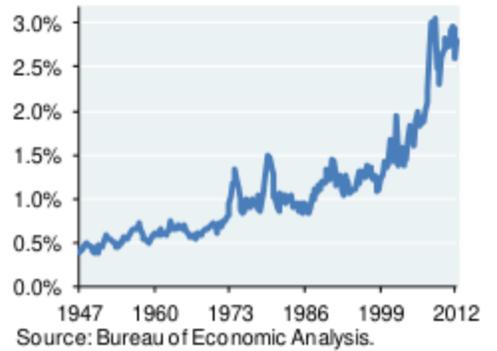


Source: Bureau of Economic Analysis, J.P. Morgan Asset Management.

Past 5 US recoveries



US foreign-sourced corporate profits  
Percent of GDP



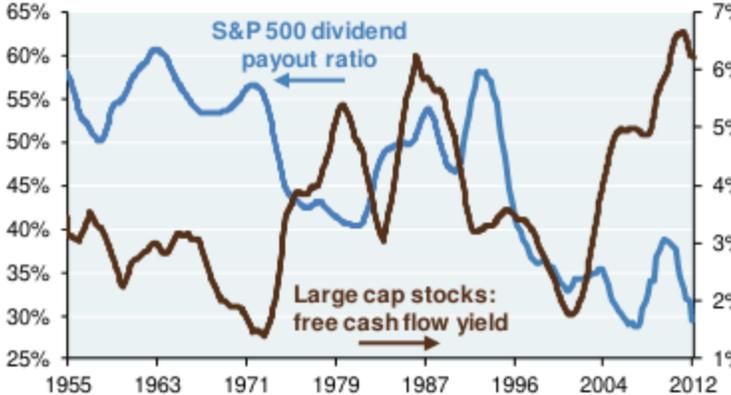
Source: Bureau of Economic Analysis.

A couple of other things that stand out as we think about US equities:

- Corporate free cash flow is high, while at the same time, dividend payout ratios are very low. As a result, the scope for additional dividends and stock buybacks is in place. This trend is already underway (2<sup>nd</sup> chart).
- Low interest rates have resulted in a flood into dividend-paying stocks, such that the relative valuation of cyclical stocks is close to the lowest level in 40 years (3<sup>rd</sup> chart)
- The growth of corporate profits has delinked from nominal GDP growth, a departure from past cycles (4<sup>th</sup> chart). This is unfamiliar territory for investors, since it suggests that you should just ignore weak domestic growth concerns and watch profits keep rising. The political and social risks of this trend are self-evident.

Dividend payout ratio and free cash flow yield

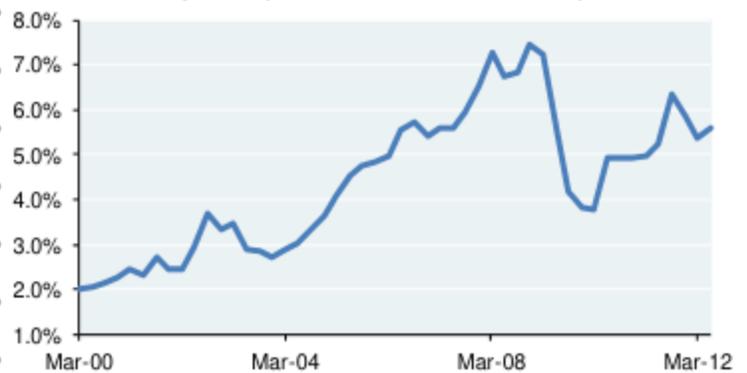
Percent, 3 year moving average (both axes)



Source: Robert J. Shiller data set, Standard & Poor's, Empirical Research.

Return of capital to shareholders rising

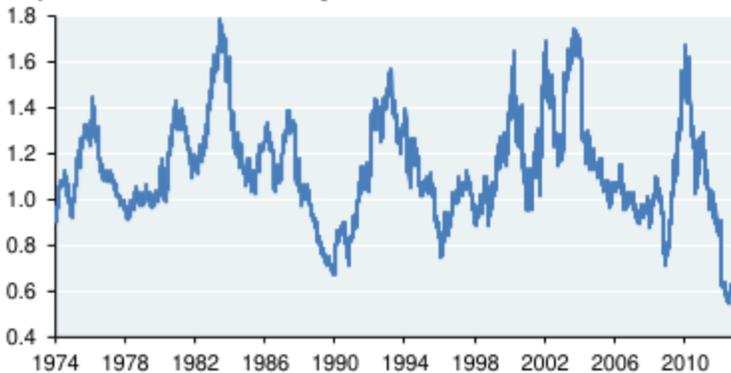
Dividends + buybacks, percent of S&P 500 market cap, ex-financials



Source: UBS.

Cyclicals trading very cheaply vs. Defensives

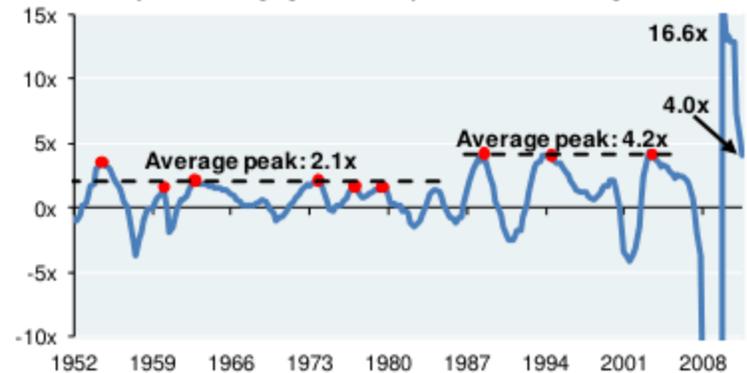
Cyclicals / Defensives trailing P/E



Source: J.P. Morgan Securities LLC.

Earnings outperforming the economy

Ratio of 2-year earnings growth to 2-year nominal GDP growth



Source: Standard & Poor's, BEA, J.P. Morgan Asset Management.

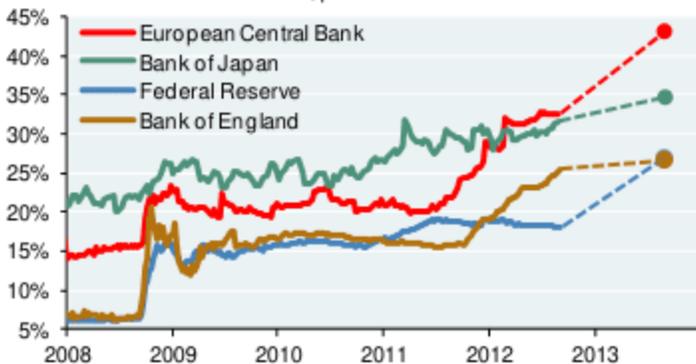
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**Conclusions**

Equity markets have taken off in anticipation that the monetary stimulus shown below will start working. This seems to be as much of a factor in the equity rally as the small recent improvement in leading indicators. Last week's employment report, after filtering through the noise and accusations around it, suggests that there will not be a recession in the US. However, the report is also consistent with a very slow rebound in payrolls, below-trend GDP growth of ~2%, and a continuation of the Fed's zero-rate policy. **With this backdrop, 13x-14x P/E valuations on US equities that are simply average become more compelling, but at the point of a bayonet: the Fed has simply lowered expected returns on a lot of the alternatives (cash, Treasuries, agencies, credit, convertible bonds, MLPs, REITs and other dividend-paying stocks).** For now, we remain close to normal US equity weightings in model portfolios, but recognize that this year's gains have already factored in an improvement in growth, profits and as described below, politics.

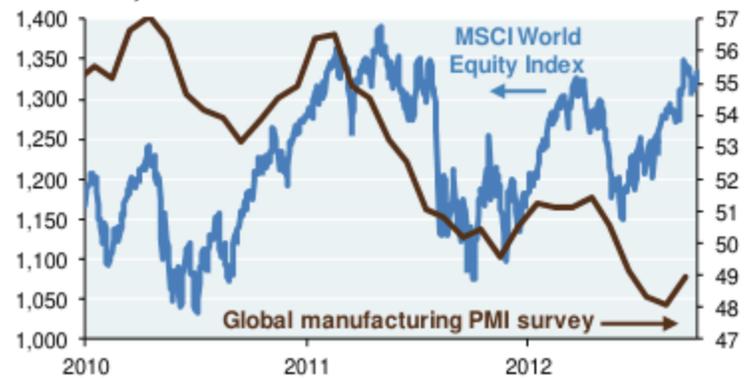
**To infinity....and beyond!!**

Central bank balance sheets, percent of GDP



Source: FRB, BEA, ECB, Eurostat, BoE, UK Office for National Statistics, BoJ, Japan Cabinet Office.

**Equity rallies usually coincide with high or rising leading indicators, but not in 2012**



Source: Bloomberg, J.P. Morgan Securities LLC.

**Fiscal Cliff Scorecard**

Normally this subject is about as interesting as watching paint dry, but this year, it plays a larger role in the market outlook. While S&P profits have delinked from growth trends, a 4%+ fiscal hit in 2013 would be a large hurdle for the economy that markets would probably notice. The table shows all the components of the fiscal austerity scheduled to kick in, along with a couple of scenarios that show what we believe are the compromises markets assume will get made. Anything more than 2% of GDP could be a shock to the system.

**The fiscal cliff**

Anticipated 2013 fiscal adjustments, USD billions

	Legislated	Scenario 1	Scenario 2
<b>Increased Revenues from:</b>			
Expiring payroll tax holiday	115	115	115
Expiring stimulus tax relief <sup>1</sup>	27		
Expiring/expired non-2001/2003 tax relief (Extenders) <sup>2</sup>	75		
New healthcare taxes	24	24	24
AMT no longer indexed for inflation <sup>3</sup>	40		
Expiring 2001/2003 Upper Income tax relief	83	83	
Capital gain and dividend tax	8	8	
Ordinary income and deductions	44	44	
Estate tax	31	31	
Expiring 2001/2003 remaining tax relief	171		
<b>Total increase in revenues</b>	<b>535</b>	<b>222</b>	<b>139</b>
<b>Reduced Expenditures from:</b>			
Lower Medicare physician reimbursement (ending "Doc" fix) <sup>4</sup>	14		
Ending extension of unemployment benefits	33	33	33
Mandatory Budget Control Act spending reductions (Sequester)	85		
<b>Total expenditure reductions</b>	<b>132</b>	<b>33</b>	<b>33</b>
<b>Total fiscal adjustment</b>	<b>667</b>	<b>255</b>	<b>172</b>
<b>Total fiscal adjustment (%GDP)</b>	<b>4.3%</b>	<b>1.6%</b>	<b>1.1%</b>

Source: Urban-Brookings Tax Policy Center, Congressional Budget Office, J.P. Morgan Asset Management.

<sup>1</sup> Consists primarily of credits such as the Earned Income Tax Credit, Child Tax Credit, American Opportunity Tax Credit.

<sup>2</sup> Miscellaneous provisions such as Research & Experimentation Tax Credit, Charitable IRA Rollover relief.

<sup>3</sup> AMT exemption amount no longer indexed for inflation.

<sup>4</sup> Ends deferral of Medicare Sustainable Growth Rate adjustment.

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J.P. Morgan Asset Management

**Wildlife advisory alert:** I took my 10-year old for what was marketed to us as "light tackle inshore fishing" in South Carolina. Not that far offshore from where people swim, we caught a 6-foot 145-pound blacktip shark that missed the state record by 19 pounds. There were signs that there are alligators in all the lagoons, and someone found a 7-foot diamondback rattlesnake under a porch. I recommend staying in the car if you are passing through the region.

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