

Topics: On staying invested over time; Market update; and the magic elixir of the Clinton Recovery

The “**By Any Means**” necessary mantra of the world’s central banks remains in place, boosting global equity markets again last week, now up 16% for the year. This theme has trumped any other with regards to financial markets in 2012. With US and European core inflation below 2% and falling, it’s full steam ahead for the printing presses. Milton Friedman expressed concern about a system which “gives so much power and so much discretion to a few men”, and “without any effective check by the body politic”. Let’s hope the Fed and the ECB are doing the right thing in the long run; their track record is mixed. More details below in the *Market Update*.

On staying invested: the consequences of “Coast is Clear” investing

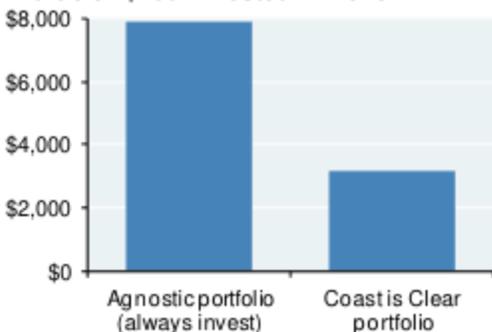
Most of the time, we focus here on issues affecting the global business cycle and their impact on portfolio investments, with the goal of emphasizing ones we think offer good value (e.g., large cap US growth stocks, public and private credit), and ones we don’t (European equities over the prior 3 years). While these portfolio emphases can be valuable if executed at the right time (i.e., S&P 500 outperformed Europe by 34% since 2010, and Japan by 380% during the 1990’s), the benefits of staying close to some kind of “normal” investment position over time has been just as important. Here’s an example of how investors sometimes vary from their normal risk objectives, and what the consequences can be. The most frequent example I can think of is “**Coast is Clear**” investing: waiting for a clear turn in the business cycle before adopting normal investment positions.

Start with a highly stylized example involving a portfolio of \$100 that can either invest in the S&P 500 or cash. Let’s assume the investor decides that in order to invest in the equity market, the following conditions have to hold:

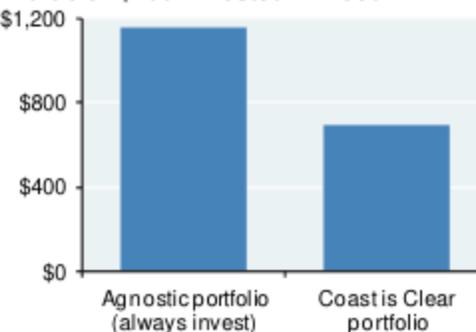
- **Avoid overvalued markets:** trailing S&P 500 P/E multiples have to be 17x or less. The median multiple since 1950 has been 14.5x and the mean has been 15.5x, so 17x allows for some modest over-valuation, but not too much.
- **Avoid recessions:** unemployment has to be below 6%, and if not, then falling vs the prior year; and the PMI survey has to be above 50 (a sign the economy is expanding), and if not, then rising vs the prior year. In other words, invest when data is weak if it’s clearly improving.
- **Avoid environments where my profits are inflated away.** Headline inflation has to be either less than 4%, or if above that level, then declining vs the prior year. In other words, capture periods of high but falling inflation.
- If these 3 conditions are not met, sell my S&P 500 position and stay in cash until the coast is clear, when I will reinvest.

Now let’s take a look at the outcomes. As shown in the first two charts below, since 1948 and 1980, “Coast is Clear” investing trailed an agnostic portfolio that stayed invested in equities irrespective of market conditions. The simple reason is that sometimes, markets generated positive returns even when conditions presumed necessary are not in place. “Coast is Clear” portfolios generated a lot less volatility, since they avoided periods in and around recessions. Given the alternatives, an investor would have to decide between total return objectives and tolerance for volatility.

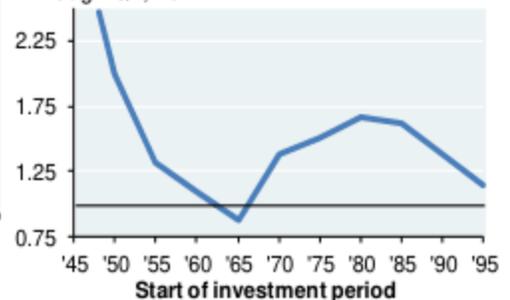
Value of \$100 invested in 1948



Value of \$100 invested in 1980



Multiple of "Agnostic" portfolio final value over "Coast is Clear" portfolio Through Q2, 2012



Source: Bloomberg, JPMAM.

The 3rd chart shows the ratio of the agnostic portfolio’s final value to the Coast is Clear portfolio over several multi-decade periods since 1948. Most of the time, the agnostic portfolio outperformed. This is not an argument for putting blinders on and ignoring the business cycle, or other concerns such as public sector debt ratios and deficits, current account deficits, etc. It is simply meant as a reminder US equity markets¹ have had a habit of advancing during conditions that might not seem conducive to them, albeit with plenty of volatility. This analysis focuses on the merits of having stayed close to strategic investment allocations over the last 60 years. It does not negate the importance of maintaining sufficient cash balances and other lower-risk investments to meet expenses, mandatory outlays and the need for precautionary savings.

¹ We do not have the history to perform this kind of analysis on European or emerging equity markets over multiple decades.

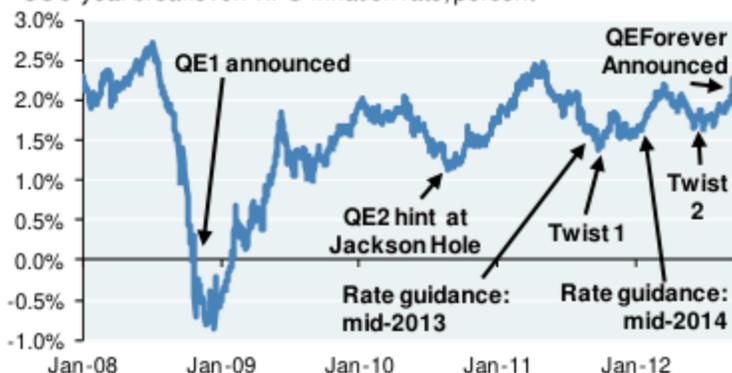
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Market update: Growth and profit fundamentals take a back seat, as the most important investment insight in 2012 has been the timing and magnitude of government support programs which have driven global equities to a 16% gain YTD

The US is stumbling along at a GDP growth rate between 1.5% and 2.0%, without major momentum shifts in either direction. Over the past couple of years, Fed easing programs (known as QE) have led to modest increases in manufacturing, economic surprises, risk sentiment and commodity prices. However, the Fed's greater concern, employment, has not improved much, and growth is faltering again. As a result, the Fed informed the markets that it will once again print money to purchase hundreds of billions in mortgage backed securities, and that it intends to hold the Fed Funds rate near zero for the rest of our natural lives. This is a bold move, particularly considering that at least one measure of inflation expectations has been *rising*, rather than *falling* (see chart). The Fed's approach is designed to avoid what happened to Japan in the 1990's after its bubble burst, and implies that the Fed will not act to combat inflation as quickly as it normally would. With the opportunity cost of holding cash being further punned, US equities have risen yet again, as was part of the plan (see box). Rising equity markets are generally a good thing; I just wish the destruction in the value of cash was not the price paid for getting them. This is going to be a wild ride; tonight, I am going to re-read Jeremy Grantham's essay, "*Night of the Living Fed: The Ruinous Cost of Fed Manipulation of Asset Prices*" (Halloween, 2010) as a reminder of what can go awry.

New Fed policy despite rising inflation expectations

US 5-year breakeven TIPS inflation rate, percent



Source: Bloomberg, GaveKal.

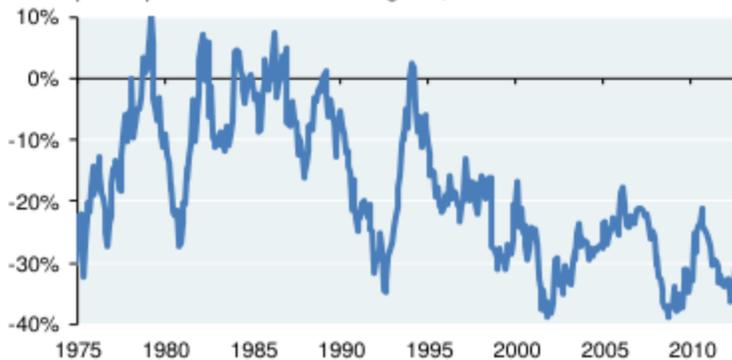
"The Circle Game": Fed Chairman Bernanke explains the link between QE, stock prices, spending, growth and employment

Post QE3: "The tools we have involve affecting financial asset prices"; "To the extent that consumers will feel wealthier, they'll feel more disposed to spend".....Post QE2: "This approach eased financial conditions in the past and, so far, looks to be effective again. **Stock prices rose and long-term interest rates fell** when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. Lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. **Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, further support economic expansion.**"

In **Europe**, the ECB's plan to expand its balance sheet calmed markets: Italian and Spanish credit spreads narrowed by ~2%; Italy placed short, medium and long-term debt; unsecured European bank debt issuance picked up (mostly core countries but a couple of peripheral issues such as Santander and Unicredito); and European equities are up over 10% since Draghi's July Bumblebee speech which laid out the ECB's intentions. The Euro is up 7% over the same time frame. All of this has happened, like the surrender of Czechoslovakia in 1938, **without the ECB firing a shot**. For now, it looks to us like the large valuation premium of US over European stocks is as wide as it will get (see chart). However, the data in Spain is still terrible, leaving the fundamental questions of its future in the Eurozone, and the health of the ECB balance sheet, for another day. **The other interesting data comes from China.** Announcements of infrastructure projects totaling 1 trillion RMB indicate that the government is willing to use fiscal policy to put a floor under growth. Infrastructure investment growth is already showing up and the recent improvement in bank credit suggests that more spending in this area is underway. Among the data that are now stabilizing rather than falling: residential home prices, home sales, cement and steel production, retail sales and auto sales.

European equity discount to US: as bad as it gets?

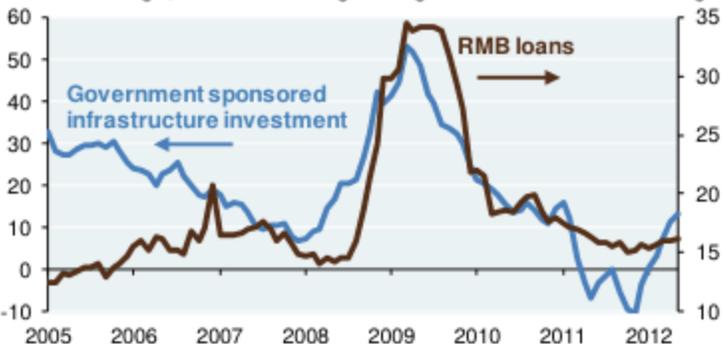
Composite premium/discount using P/E, P/B and P/Dividend



Source: MSCI, Morgan Stanley.

Fiscal stimulus and credit growth in China

YoY % change, 3-month moving average



Source: China National Bureau of Statistics, JPMAM, People's Bank of China. *Infrastructure is defined as power, gas, water, and transportation.

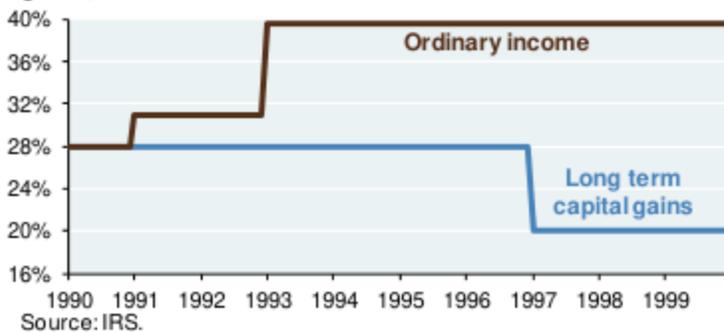
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Appendix: The “Clinton Recovery”

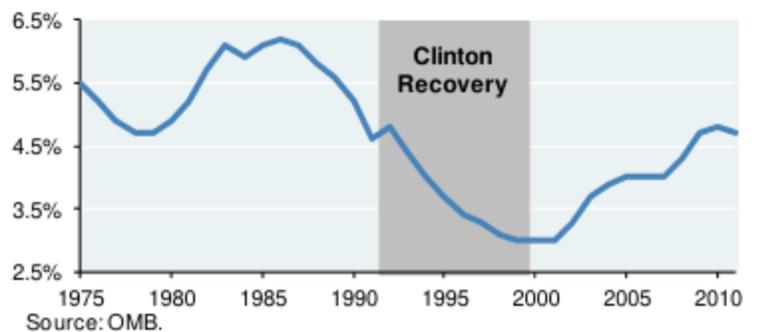
Amidst the debates on what the US should do to re-establish an era of prosperity, there are a lot of references in the media and at political conventions to the “Clinton Recovery”. This refers to the period from 1992 to 2000, the best in post-war history: 19% equity returns, 3.8% annualized real GDP growth, monthly payroll gains of 265,000 (adjusted for today’s population) and an average budget deficit of less than 2% of GDP. Applying a President’s name to a recovery or recession always seems to be a case of artistic license; you might as well call it “The Kardashian Recovery” in some cases, given how little Presidential policies had to do with it. Most of the time, domestic and global business cycles, monetary policy and other factors were the primary drivers. However, let us assume that there was a “Clinton Recovery”; what policies drove it?

To begin: 2 policies normally considered liberal/progressive: increase taxes on the wealthy and cut military spending to reduce the deficit. In 1993, Clinton raised the top marginal rate (also raising the top bracket, which mitigated part of its impact). However, later in the decade, he cut the long term capital gains rate to 20%. As for military spending, the US benefitted from that brief synapse in time in between the collapse of the Soviet Union/fall of the Berlin Wall in 1989, and the emergence of another combatant 10 years later whose conflict with the US is almost as costly, and much more diffuse. The origins of this clash are complex, but can in part be traced to Operation Cyclone, a policy enacted by Carter and expanded by Reagan. It was designed to stop Soviet expansion by channeling sophisticated weapons and billions of dollars to militant Islamic groups, mostly via Pakistan. This program arguably backfired², contributing to a series of events in 2001 that brought the decline in post-war US military spending to an end.

Top tax rate on ordinary income and long term capital gains, Percent



US military spending, in between combatants Percent of GDP

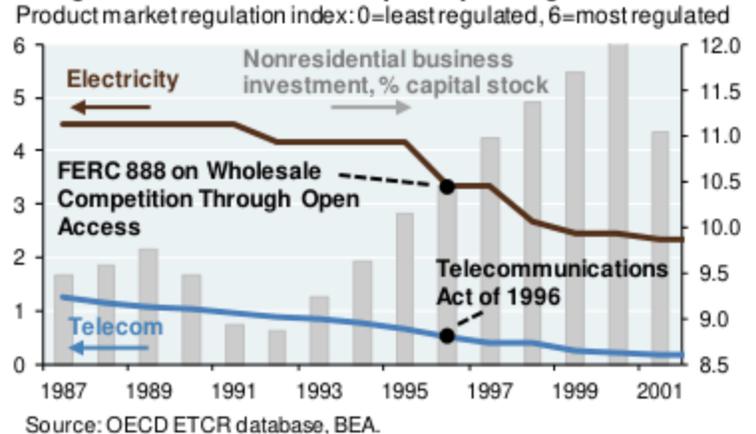


Here is where the story deviates from the progressive script: Clinton Administration support for free trade and deregulation. While NAFTA was not the only catalyst for the improvement in trade (the rise of India and China after the Rao and Deng reforms played a role as well), it was a clear sign of the Administration’s support for free trade. Two years later, the Clinton Administration presided over two major deregulation efforts, one involving electricity and the other telecom. An NBER paper from 2003³ analyzed data in both the US and Europe, and found that regulatory reforms that liberalize entry barriers spur investment, a trend which benefitted US capital spending during the latter part of the decade (see chart below).

US trade and trade policy



Deregulation and business capital spending



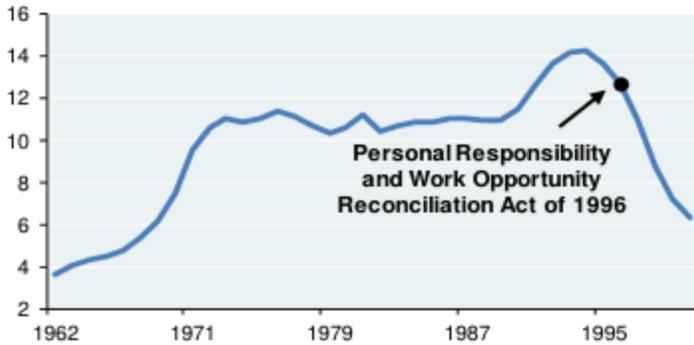
² Pakistani President Benazir Bhutto to President Bush in the late 1980’s: “You are creating a Frankenstein” (Newsweek).

³ “Regulation and Investment”, NBER Working Paper 9650, March 2003, Alesina (Harvard) and Nicoletti (OECD).

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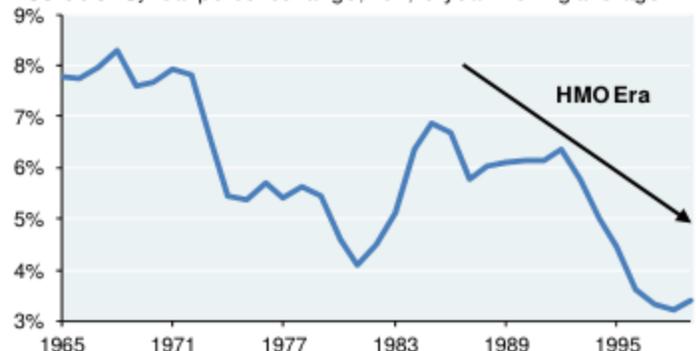
Other aspects of the Clinton Recovery are equally centrist: welfare reform, and private sector solutions to healthcare. The 1996 welfare reform act was a fundamental shift, in that it introduced work requirements for recipients. It also delegated more responsibility to states, and reduced the burden on Federal public finances. On healthcare, it was not the intention of the Administration to rely on private sector solutions. The First Lady's universal healthcare plan was the President's preferred approach, but it could not get past Congress. However, around the same time, growth in healthcare expenditures began to slow, a by-product of the HMO era. While HMOs emerged in the 1970's, private sector control of healthcare costs through managed care gained some traction in the 1990's, and the growth in healthcare expenditures fell. HMOs leveraged increased enrollment to negotiate discounts from providers, and controlled the amount/type of care that was provided to insured members. When the US Department of Health and Human Services looked back at the 1990's, they cited competition among HMOs as being one of the major factors leading to slower growth in healthcare expenditures. Healthcare expenditures are still growing at 3%-4% in real terms, which is a problem since the structural growth rate of the US may be declining.

Average monthly recipients of Federal assistance
Millions



Source: US Department of Health and Human Services.

National healthcare expenditures and private sector solutions, real percent change, YoY, 5-year moving average



Source: Centers for Medicare and Medicaid Services, BLS.

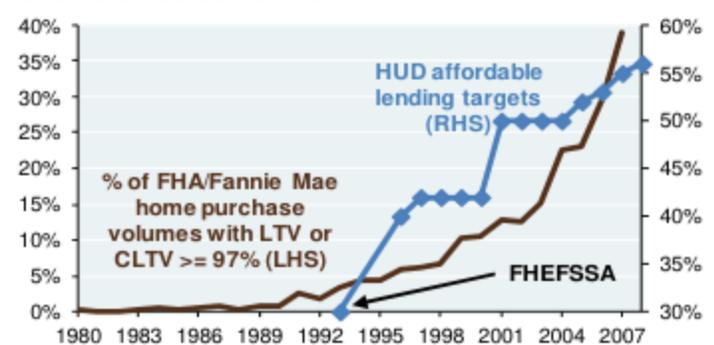
On housing, **the Clinton Recovery benefitted from conservative underwriting standards, although his administration's policies contributed to the eventual housing crisis a decade later.** I am not going to go into detail here, since I've written about this before⁴. Home prices and housing's contribution to growth were stable during the 1990's. However, seeds were sown when President Bush passed the Federal Housing Enterprises Financial Safety and Soundness Act in 1992 (a delightfully Orwellian name since it ended up destroying them). By allowing the Department of Housing and Urban Development to set mandatory affordable lending targets for the GSEs, the government unleashed an avalanche of 3% down-payment loans by the end of the decade (see below), a trend which the private sector then followed, and the rest is history. The Clinton Administration's contribution to the mess includes raising affordable lending targets from 30% to 50% of all GSE loans.

National average downpayment on home mortgages
Percent



Source: Federal Housing Finance Agency.

A look back at the origins of the housing crisis
Percent of annual loan volume



Source: FHA, HUD, American Enterprise Institute.

⁴ EoTM May 3, May 23, and November 1, 2011. By the time Clinton's term ended in 2000, HUD had a **roadmap** for GSEs to jumpstart subprime lending: "Because GSEs have a funding advantage over other market participants, they have the ability to under price competitors and increase market share... As GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by GSEs look more like an increase in the prime market. Since one could define a prime loan as one that GSEs will purchase, the difference between the prime and subprime markets will become less clear." [HUD report, October 2000].

Quote of the decade, from Nobel Laureate Stiglitz and future OMB Director Peter Orszag who sided with HUD and their wafer-thin 0.45% capital standards for GSEs: "The probability of a shock as severe as embodied in the risk-based capital standard is substantially less than one in 500,000 – and may be smaller than one in three million". They also estimated the cost to taxpayers of \$1 trillion in GSE guarantees at \$2 million [2002].

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So, where does that leave us? To recreate the policy conditions which prevailed during the Clinton Recovery (not necessarily the President's preferred policies), we would theoretically need to find a Presidential candidate who would:

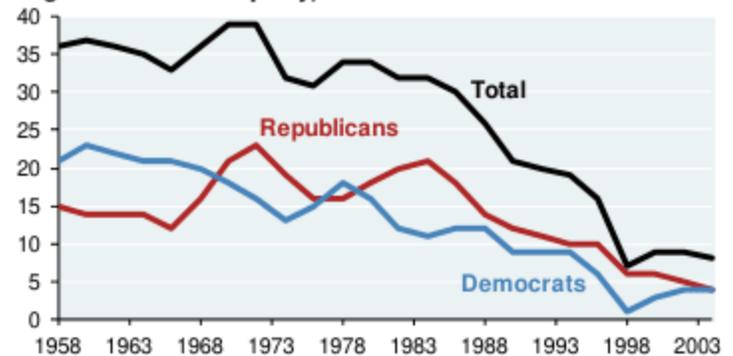
- Raise taxes on the wealthy to improve public finances, but also be willing to reduce taxes on capital gains
- Cut military spending whenever possible
- Agree to reduce the scope of government entitlements and take on entrenched constituencies, in spite of multiple decades of program expansion, and in spite of the political risks (there were multiple resignations at Health and Human Services after the Welfare Reform Act)
- Encourage free trade and deregulation
- Support private sector solutions to healthcare
- Maintain conservative housing underwriting standards, without coercing private sector entities to act as conduits for fiscal policy/affordable lending programs

Good luck finding this person, since he/she would be a centrist, and most likely excommunicated by their party for heresy. As shown in the accompanying chart, using the Senate as an example, the political middle normally occupied by party non-conformists is gone.

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Party non-conformists in the Senate (Senators who vote against their own party)



Source: *The Creation of an Endangered Species: Party Nonconformists of the U.S. Senate*, Richard Fleisher and Jon R. Bond, 2005.

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