

From: US GIO <[REDACTED]>

To: Undisclosed recipients;

Subject: JPM Eye on the Market, July 17, 2012

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Attachments: 07-17-2012_-_EOTM_-_The_Big_Screen.pdf

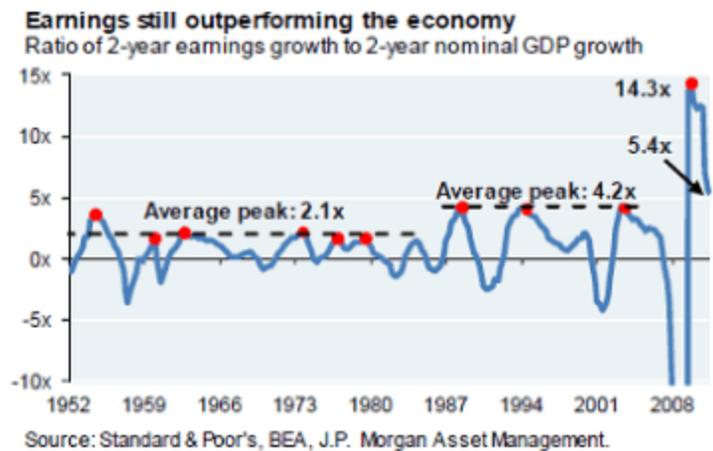
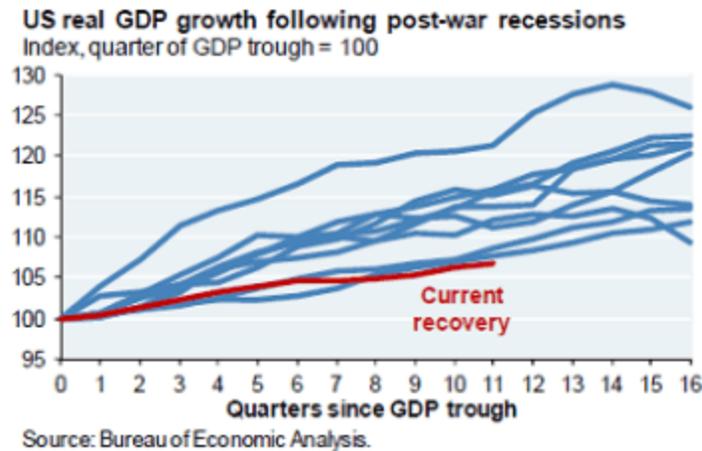
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Eye on the Market, July 17, 2012 (attached PDF file is much easier to read this week, particularly the last 2 charts)
Topics: US equity markets holding in despite poor economic data; which fiscal cliff is worse; European Credit Divorce; will China respond to economic CPR; After 50

The Big Screen. Given all the monetary and fiscal stimulus thrown around, recent data has been weak in the US (low readings on retail sales, payrolls, small business surveys and GDP), China (declining manufacturing surveys and imports) and Europe (recessionary conditions in all places between the Po River, the Aegean Sea and the Strait of Gibraltar). Nevertheless, equity markets have held up better than they otherwise might have. US equities are up 7%, Asia ex-Japan is up 5% and Europe is flat (heroic given the circumstances). It's difficult to know for sure, but in addition to low valuations, this might reflect the fact that institutional and individual investors, now well-versed in the macroeconomic train wrecks of the day, have reduced equity positions to those they are comfortable holding from here. It's like staying in the theater watching a bad movie since there's nothing better playing anywhere else. **In that context, here's what we're watching this summer to see if we should shift portfolio risk more towards elation or despair; right now, we are in the middle.**

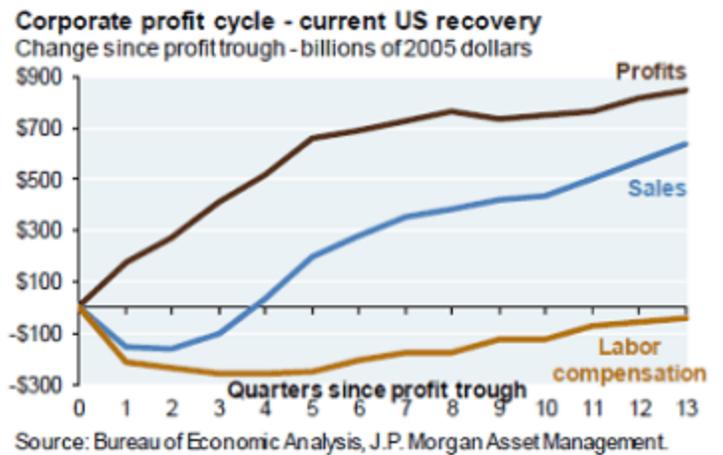
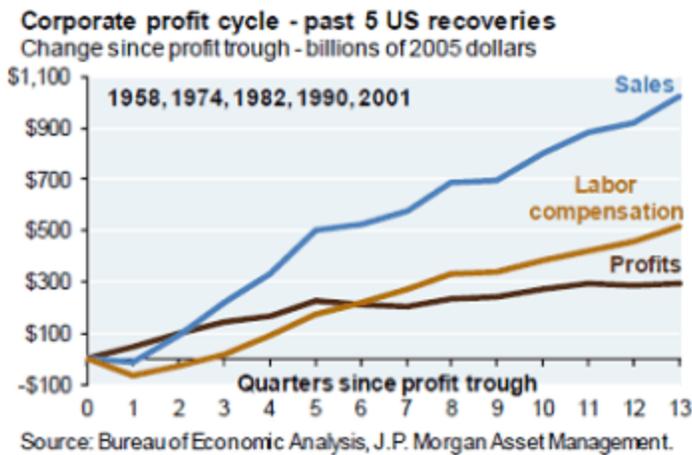
The Lion in Winter (1968), and the sluggish response of the US economy to monetary and fiscal stimulus

Despite all the stimulus, this is the weakest US post-war recovery on record. A couple of years ago, some argued that the deeper the recession, the more the economy would roar back. Not this time: the US economy is a lion in winter, struggling to maintain a 2% growth rate. Saving grace: profits have outpaced GDP, a function of demand from faster-growing emerging economies, and a shift in compensation from labor to capital (see next section). To be more optimistic, we need to see growth > 2.5%.

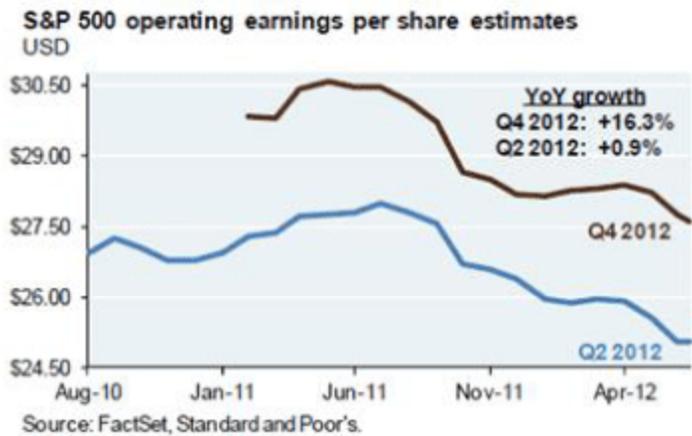
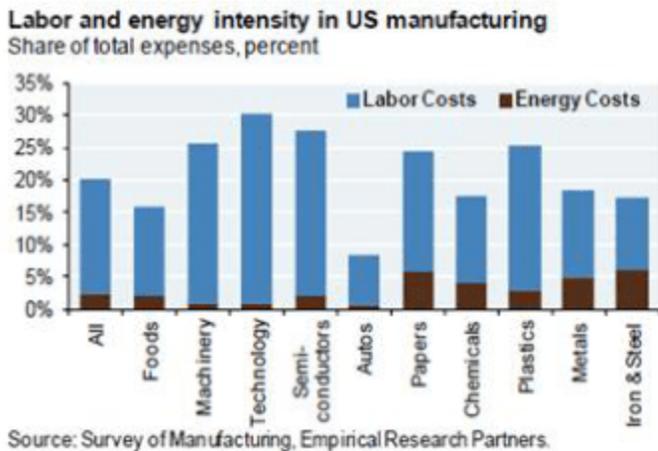


Grapes of Wrath (1940): low labor compensation as the primary driver behind fat profit margins

The last time I showed these charts, they were picked up by a journalist at the Washington Post who is the vice-chair of the National Political Committee of the Democratic Socialists of America. In other words, they mean different things to different people. While the implications are debatable, the picture is clear: extremely weak labor compensation has been a large driver of the profits boom this time. High profit margins are likely to be sustained for a while longer, but the consequences of what drives them (weak consumer spending, large government transfers to households and political acrimony) may keep P/E multiples low. I can only imagine what Steinbeck would have said about this. Any signs of a pickup in labor compensation would be good news, but we haven't seen much yet. The employment cost index and average hourly earnings are growing at 2% y/y (nominal).



One other point: the chart (below, left) shows how labor costs in most US manufacturing sectors dwarf energy costs. With high unemployment, this means little pressure on margins from labor. But it also means that you might want to temper enthusiasm regarding the benefit of cheap natural gas, since energy makes up less than 5% of total expenses. There are some multiplier benefits not accounted for here, but I think it's worth waiting to see what they really are.



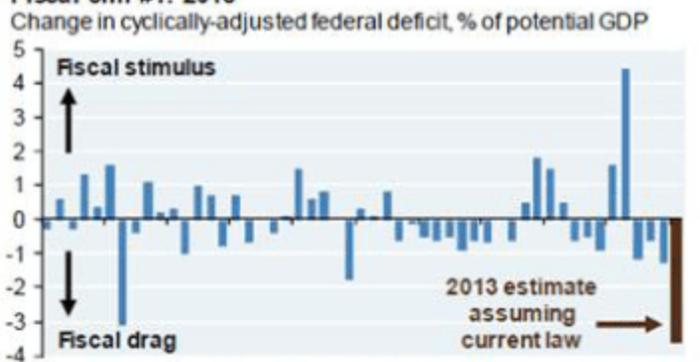
The Man Who Fell to Earth (1976): realism sets in on US corporate profits, at least for Q2 2012

With the onset of Q2 earnings season, US equities should hold up over the next few weeks if the pattern since January 2010 is any guide. Since that time, the S&P 500 is up a cumulative 28%: 13% during profits reporting seasons, 13.5% immediately after quantitative easing announcements by the Fed and ECB, and 1.5% during the rest of the time. Furthermore, Q2 profits do not have to do much to hit expectations. As shown above (right), Q2 earnings estimates have come crashing to earth since their highs last summer. Analysts now expect 0% y/y profits growth in Q2 2012, which as hurdles go, is a low one. A higher hurdle is the 16% y/y earnings growth analysts expect in Q4 2012 (*Great Expectations, 1946*).

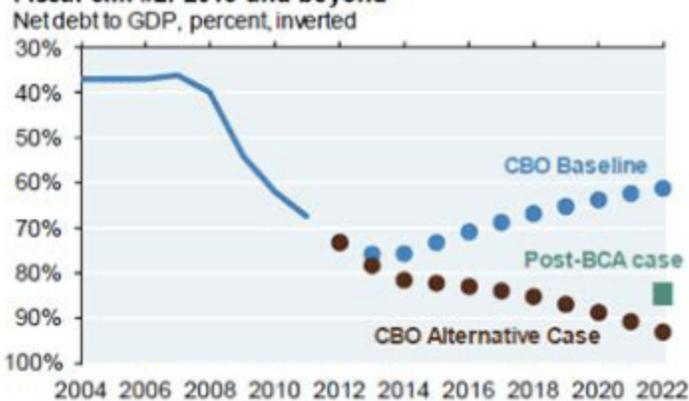
Thelma and Louise (1991): which fiscal cliff is worse?

A lot of people hope that the US does not, like Susan Sarandon and Geena Davis, drive off the 2013 (fiscal) cliff to a grisly end. While I understand the reasoning, take a look at the 2 charts below. The first shows the 2013 fiscal cliff (the austerity impact if all legislated tax increases were to take place). The second looks at the other cliff, which is the increase in US federal debt over the next decade, shown on an inverted scale to capture its cliff-ness. Just as scary, right? These dueling cliffs are essentially a generational battle. By completely avoiding the first cliff, the US would be passing the buck to the next generation, violating Washington's farewell address which warned against "ungenerously throwing upon posterity the burden which we ourselves ought to bear". So far, the US has not paid much of a price for its escalating debt burden, other than the shock of last year's S&P downgrade. Will its luck continue? A lot may depend on the game plan for bringing the debt down over time. Given current gridlock, almost any signs of progress would be taken positively by financial markets.

Fiscal cliff #1: 2013



Fiscal cliff #2: 2013 and beyond



Sometimes a Great Notion (1971): how did the US dig itself out of wartime debt levels after WWII?

I find that there is a lot of misreporting about how US debt levels were halved during the 1950's. As shown in the table below, government spending was *not* cut sharply; there was *no* radical increase in tax collections, either from businesses or from households; and the Fed did *not* engineer negative long-term real interest rates to jumpstart growth. In addition to the competitive advantage the US had over recovering Axis Powers, the US of the 1950's benefited from pro-business policies that resulted in over 4% annualized GDP growth throughout the decade. This approach is not in play now, raising questions about how the US will deal with 80% net debt to GDP for only the second time in its 200+ year history.

	Net debt (% of GDP)	Net debt (bn)	Nominal GDP (bn)	Real GDP (bn 1950 USD)	Outlays (% of GDP)	Receipts (% of GDP)	Average real 10-year rate
1950	80%	\$219	\$273	\$273	16%	14%	1.3%
1951	67%	\$214	\$320	\$302	14%	16%	-5.3%
1952	62%	\$215	\$349	\$322	19%	19%	0.5%
1953	59%	\$218	\$373	\$341	21%	19%	2.0%
1954	60%	\$224	\$377	\$343	19%	19%	2.1%
1955	57%	\$227	\$396	\$354	17%	17%	3.1%
1956	52%	\$222	\$427	\$368	17%	18%	1.7%
1957	49%	\$219	\$451	\$377	17%	18%	0.3%
1958	49%	\$226	\$460	\$377	18%	17%	0.6%
1959	48%	\$235	\$490	\$398	19%	16%	3.3%
1960	46%	\$237	\$519	\$415	18%	18%	2.7%
Comp. ann'l gr:		0.8%	6.6%	4.3%			

Source: OMB, BEA, Robert Shiller data set, Bureau of Labor Statistics.

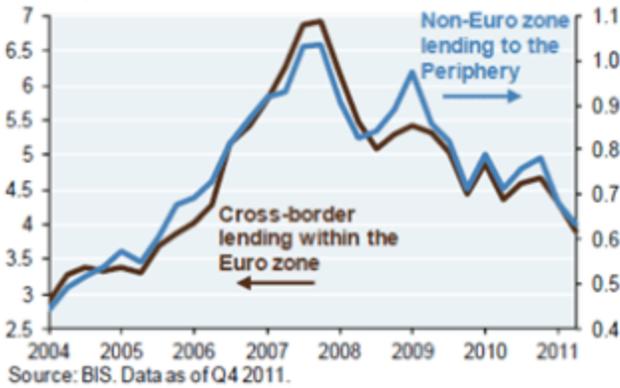
1950's time capsule: taxes were regarded as a greater cause for small business failures than tight money. Eisenhower championed legislation which eased tax burdens on small business and which culminated in a bill eliminating double-taxation (Subchapter S); he also eliminated wage and price controls. In the 1950's, the private sector accounted for a post-war peak of 86% of all employment, a level not seen since.

A brief detour: The 1971 film chosen above is about rugged individualism, the power of small business and the lack of reliance on government or organized labor to solve problems. It's actually hard to find a pro-business or pro-capitalist film. According to Larry Ribstein at the University of Illinois College of Law (see page 6 for details), US filmmakers have a long history of disliking profit-maximization, and have generated a huge volume of work depicting evil, soulless corporations and heartless capitalists. He quotes Joseph Schumpeter and theorizes that filmmakers are an intelligentsia over-produced by the bounties of capitalism which directs its resentment at a society that refuses to value what they do. Ouch!

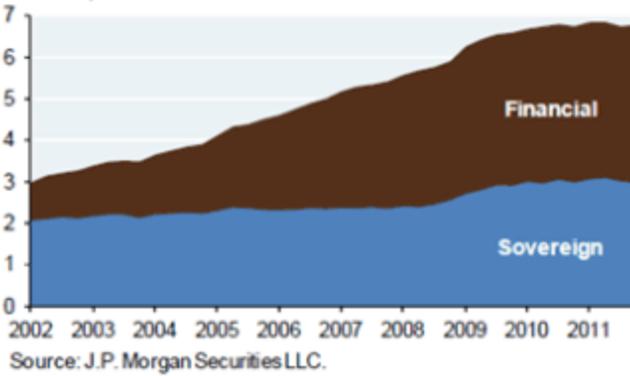
Scenes from a Marriage (1973): the European Credit Divorce keeps getting more worse

A decade of European monetary integration continues to unravel. As shown below, Eurozone banks are cutting their cross-border credit exposure as fast as they can. Unsurprisingly, the rest of the world is not any more anxious to lend to the European Periphery, and is cutting its exposures as well. The ECB is providing the stop-gap to finance all of this capital flight, which helps prevent an outright Depression. But to be more optimistic on Europe, we need to see *some* improved economic conditions in the Periphery, and evidence that structural reforms are paying off. As things stand now, there are still serious questions about how the ECB and the EU will come up with the money to finance all the maturing Peripheral sovereign and bank debt that investors no longer want to hold. Total Periphery sovereign and bank debt: almost 7 trillion Euros.

Flight of the Bumblebee
Trillions, USD



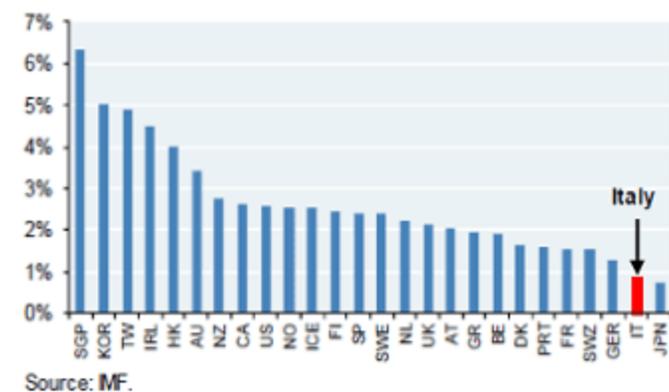
Peripheral sovereign and financial debt
Trillions, Euros



Death in Venice (1971): will the Italian economy ever grow again?

Spain is the fulcrum of the crisis now, given the dreadful condition of its economy and banks. But Italy is a lingering concern, given its low growth and massive debt burden, the third largest in the world. Italy runs a very tight primary (pre-interest) budget surplus, among the best in Europe. But the size of its debt burden (120% gross, 99% net) means that there is little room for error. The second chart is as stark an example as you will ever see on how a seemingly benign political idea can negatively affect economic reality. In terms of its private sector economy, Italy is even less like Germany than Spain (third chart), raising questions about whether southern European economies can be Germanified. Keeping the Euro together at any cost probably means the cost will be very high. It's unlikely that markets will get a sustained respite from this melodrama in 2012 or 2013.

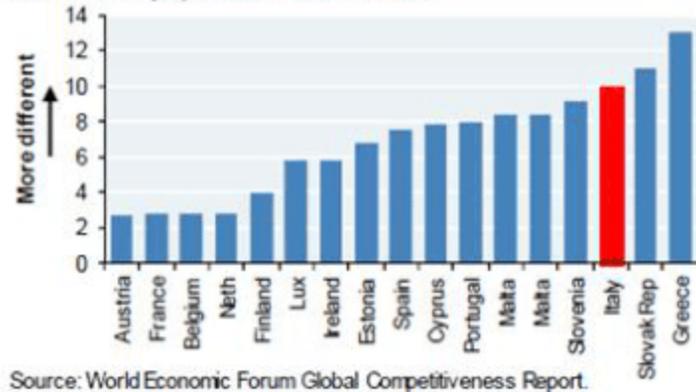
20-year growth rates, 1991-2011
Percent



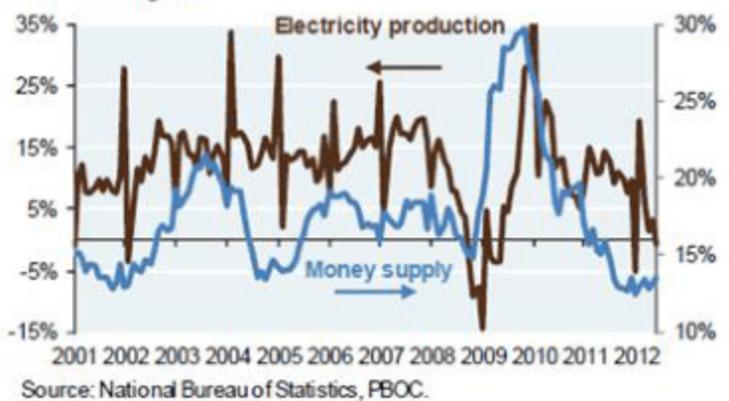
Death in Venice
Industrial Production Index, 1998 = 100, sa



How different are Eurozone countries from Germany?
Sum of country specific factor differentials



Can stimulus turn the tide in China
Percent change, YoY



Let the Bullets Fly (讓子彈飛, 2010): will China's economy respond to stimulus?

In the last chart above, we show everyone's new favorite China indicator: electricity production, which presumably cannot be easily fudged or massaged. The sharp drop confirms what we are seeing elsewhere, which is a slowdown in China to around

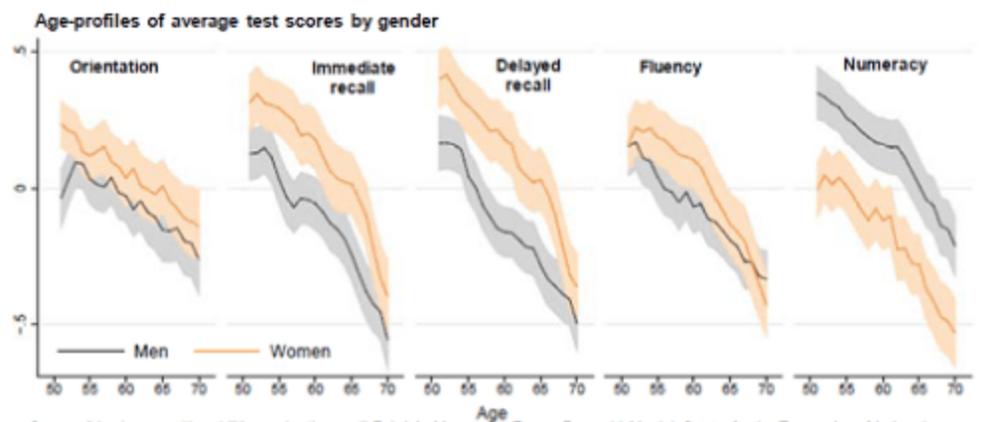
a 6%-7% growth rate. The government is responding with an impressive array of bullets:

- ** Reduction in bank lending and deposit rates; reduction in bank reserve requirements; PBOC injection of liquidity through reverse repo
- ** Increasing bond issuance limit for the Ministry of Railways, and infrastructure projects pulled forward
- ** Incentives to acquire energy-efficient appliances and automobiles
- ** First-time homebuyer restrictions eased, tax relief for small and medium sized companies
- ** Easing rules for domestic and foreign investment in Chinese equities

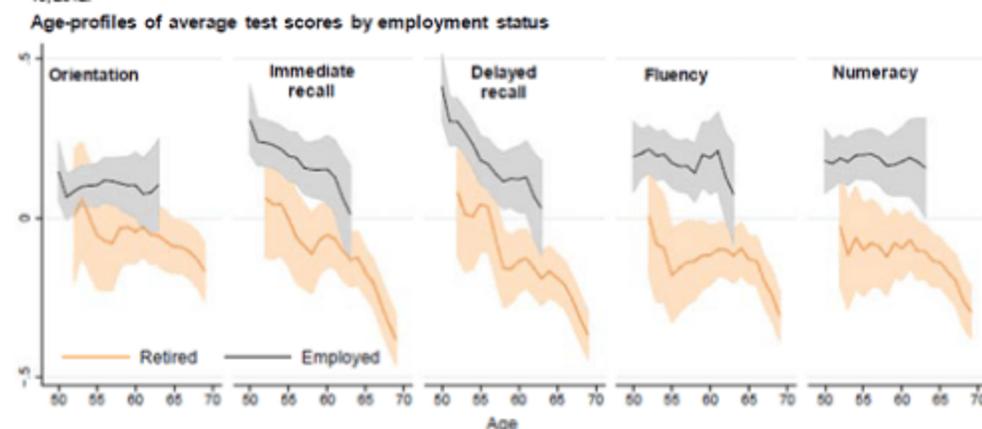
As shown in the chart, there has been a recent pickup in the money supply, which is a good start. We are watching intently to see if this momentum builds, which would be critical for a growth rebound in the second half of 2012. We are guardedly optimistic on the chances for success here; we will know more by the fall.

No Country for Old Men (2007): what happens after you turn 50?

Having crossed this threshold recently, I have been asked what it feels like. I don't sense anything concrete just yet, other than more and more young people not understanding references to HR Haldeman or Ursula Andress. However, based on some research I have seen, I intend to (a) keep working, and (b) acknowledge that my spouse is right if we disagree on remembering something. Why? A 2010 study on cognitive abilities and aging shows some pretty striking results. **As shown in the top set of charts, mental faculties fade rapidly with age once you hit 50, with women maintaining a steady lead over men in all categories except numeracy. And in the second set of charts, all things being equal, cognitive abilities remain in much better shape the longer you work and do not retire.** That, and zero interest rates, makes working the better option.



Source: "Ageing, cognitive abilities and retirement", Fabrizio Mazzonna, Franco Peracchi, Munich Center for the Economics of Aging, January 10, 2012.



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Sources

"Wall Street and Vine: Hollywood's View of Business", March 2009, Larry Ribstein, University of Illinois College of Law. Examples of anti-business sentiment examined in the paper: Erin Brockovich, Silkwood, The Insider, The Constant Gardener, Michael Clayton, Mission Impossible II, The Hudsucker Proxy, Executive Suite, Network, Wall-E, The Graduate and Star Trek: First Contact, in which Captain Picard tells a citizen of the 21st century that "the economics of the 24th century are

different – people are no longer motivated by money, but rather by the good of mankind.” I’d like to see how that economy would work.

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