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J.P.Morgan

**Headline:** [US Equity Strategy FLASH : Sell-Off Post Election Shows More Hoped for a Romney Win; Reasons for Selling Improves Equity Risk/Reward; 30 Ideas](#)

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**Abstract:**

- Equity markets sold off sharply today (S&P 500 down 34 pts), more than reversing the 11-pt gain yesterday. We spent a lot of time on the phone with PMs and found most investors trying to understand the catalyst behind such a large sell-off and it seems there is disappointment, owing to a combination of: (i) an election outcome without a mandate (poor voter turnout, Obama and Romney garnered fewer votes than in 2008); (ii) shift to focus on the fiscal cliff; (iii) concerns about higher taxes, particularly capital gains taxes, with an Obama regime; (iv) some hoped for a Romney surprise.
- We see the sell-off more due to disappointment with outcome (more Romney hopefuls than we realized) vs. fiscal cliff. Why? Investment Grade and High Yield markets should be selling off if this is a "fiscal cliff" issue, similar to 2011's weakness. The fiscal cliff (fiscal drag) is large enough to potentially push the US into a recession, which would have negative consequences for both IG and HY bonds. But notice the contrast in those markets. In 2011, HY and HG spreads widened sharply as investors worried about the fiscal cliff. In 2012, HY and HG spreads have rallied since October. And liquidity (issuance) remains strong. These markets do not seem as concerned with the fiscal cliff as the US equity markets.
- Where do we go from here? So let's say this weakness is indeed due to a knee-jerk reaction to an Obama win (Romney disappointment). One might argue there are some reasons the market can recover from here.
- #1) Since September, US gasoline prices have fallen \$0.38 from \$3.84 to \$3.46, resulting in \$50 billion in annualized savings for households, or 0.40% lift to GDP. The US consumes 134 billion gallons annually, so the \$0.38 drop in price per gallon is worth \$51 billion, or 0.4% annualized lift to GDP. As shown in Figure 2 and Figure 3, the S&P 500 has historically rallied following a drop in gasoline prices. In other words, this is a potential upside driver in the next few months.
- #2) Potential that, with the election over, compromise on the fiscal cliff could be less political. One element of uncertainty around the fiscal cliff has been reduced, as we now know three of the key players in negotiating the fiscal cliff: (a) President Obama; (b) Senate Majority Leader (Reid); and (c) Speaker of the House (Boehner). And unlike 2011, when 2012 election political calculus interfered with negotiations, there is a possibility of reaching an agreement, or at least deferring the difficult decisions (punting). Our economists' base case remains a portion of the fiscal cliff is avoided in 2013 (1.6% fiscal drag is the result).
- #3) US housing continues its recovery regardless of the White House. One of the upside stories in 2012 has been the better-than-expected improvement in US home prices and housing demand (absorption and starts). The latest data point is 3Q12 US household formation (Census Vacancy Report) exceeded 1.1mm for the first time since 2Q06 as the recovery in labor markets and pent-up demand drive a surge in household formation. And, as we noted in the past, the recovery in home prices has delivered already in 2012 wealth effect of \$1.7T (see "S&P 500 3Q EPS..." dated 10/11/12). And, as we noted in the past, each 250k increase in starts is worth 1mm jobs and an estimated \$4 in S&P 500 EPS.
- #4) US corporates still have record cash balances. As we noted a few weeks ago, US corporates which have enjoyed unusual liquidity in this expansion now boast the largest cash balances in history with \$1.5T in cash (up 7% y/y vs. 0.8% EPS growth), in part due to inventory liquidation in the quarter. Shareholders will eventually pressure corporates to deploy this cash either via buybacks, dividends or M&A (the latter more likely if there had been a Romney victory). But this remains a positive for US equities.

- #5) Equity markets traded cheap relative to credit prior to this weakness, and discount is wider today—HY remains the “harbinger” to equity valuations and it remains strong. The lag of equities to corporate credit has been discussed by our fixed income team for some time and in past episodes this has led to equities outperforming. Take HY markets, for instance. HY YTW is now 6.59%, down 38bp from 6.97% on 9/1, lifting the implied P/E (inverse of yield) to 15.2X from 14.3X. The S&P 500 has fallen 30 points since to 1390-ish and now trades at 12.7X. Since 1980, the S&P 500 P/E has EXCEEDED the HY P/E by at least 3 turns (i.e., should be 18X now), meaning the risk/reward in equities is substantially greater. And corporate credit is NOT IMMUNE to a fiscal cliff. Thus, those markets should be converging.
- #6) Investors are still underperforming, thus unlikely to write off the beta chase. Investors are still badly lagging their benchmarks. Thus, the weakness, in our view, is coming at a time when active managers (mutual funds) are underperforming. Thus, we see pressure for funds to improve returns during what is seasonally a strong quarter for stocks. Thus, the beta chase should continue, while tempered by concerns of the US fiscal cliff.
- What could go wrong? We have a fiscal cliff. The biggest risk to our view in the short term is the US fiscal cliff becomes unavoidable. That could justify further downside from here pushing the S&P 500 into the 1350-ish level from the 1400s today. However, as we noted above, there are some reasons to expect the US to avoid this (see reason #2 and also reason #1).
- MARKET STRATEGY: Focus on Global Cyclical and High-Dividend stocks, among others. We believe once the initial selling exhausts itself, investors will reconsider the positive risk/reward in equities. One notion is that the current White House policies are less pro-growth (than Republican ones), and thus growth outside the US becomes more attractive. As a consequence, investors are likely to favor global cyclical (see Figure 4) which include Technology (semis, hardware, software) and Industrials (multinationals, machinery, etc.). We also maintain our 2012 YE target of 1430. We have identified 30 Global Cyclical using the following criteria: (a) % revenue from outside the US > 50%; (b) positive FCF yield; (c) belongs to a Cyclical sector; and (d) rated OW by J.P. Morgan. The tickers are: DELL, PAY, KBR, FLR, AA, AAPL, NLSN, TRW, ORCL, BWA, MA, GOOG, SNPS, CCK, MCD, PCLN, QCOM, EBAY, MOS, DHR, XLNX, TXN, IBM, ETN, ALB, CREE, PPG, TRMB, YUM, and ADI.

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