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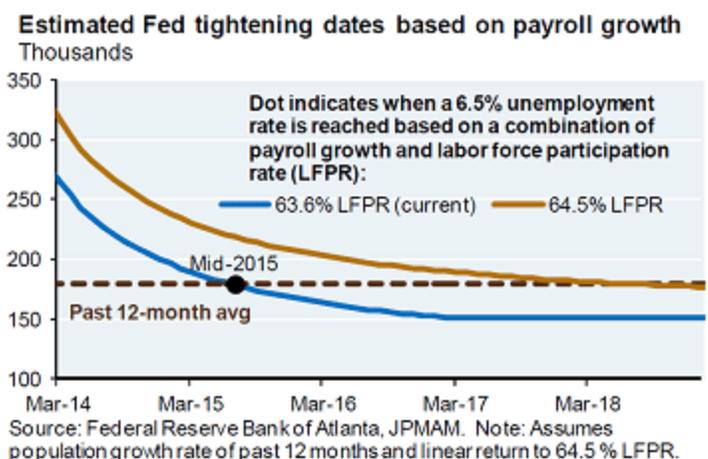
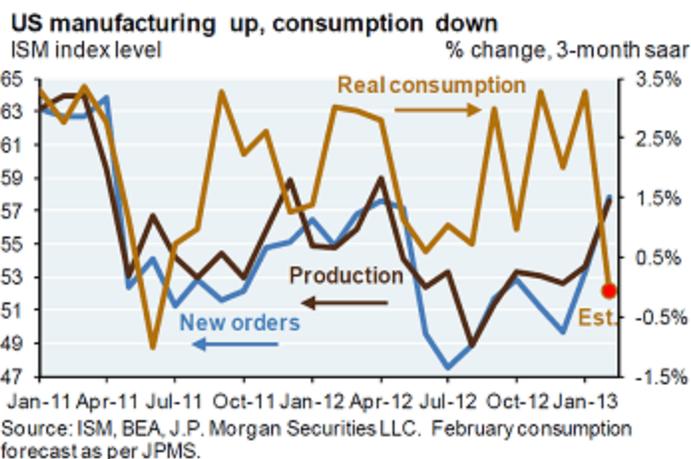
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## Eye on the Market, March 6, 2013

**Something for everyone: US growth trends; when the Fed will raise interest rates; value in US bank and healthcare stocks; why I believe the Spanish economic adjustment is destined to fail; springtime for stockpickers; and some Keystone XL math**

**US economic/Fed update.** US business activity is picking up (Q4 capital spending, January core durable goods, February production, capital spending and new order surveys), while real consumer spending is set to decline for a while as higher payroll and income taxes bite, and as the sequester kicks in. The drag from the sequester (as planned) is around half of the impact from the tax hikes already in place. All things considered, US growth looks like it will rebound to 2.5% or so by the end of the year. On the policy front, the Fed has been trotting out multiple defenses of its asset purchases (a topic covered in the *Fifty Trades of Grey* note from two weeks ago), and is not expected to raise interest rates for a very long time. To get a sense for how long, consider one of the Fed's reported thresholds: a 6.5% unemployment rate. If payroll gains average 177k per month (the trailing 12-month average), and if the labor force participation rate remains constant at today's 63%, the Fed would hit its threshold in the summer of 2015. If the labor force participation rate rose (as discouraged job-seekers re-enter the job market), the threshold would be delayed even further. Of course, much faster payroll growth or signs of inflation could accelerate a Fed hike, but so far, Bernanke and his presumed successor (Yellen) have an easy money story to tell and they are sticking to it.



**As the equity market keeps rallying, what sectors are still priced at large discounts to history?** While banks and healthcare are subject to a mountain of regulatory issues, valuations appear to fairly compensate investors for many of the risks.

On **healthcare**, the Affordable Care Act will take time to sort out. Here are some concepts to keep in mind by sub-sector:

- \*\* Private hospitals have already suffered ACA Medicare provider cuts, and now stand to benefit from increased utilization rates and a reduction in uncompensated care. It's not clear how many states will participate in the Medicaid expansion plan, but our sources indicate that 10-15 million individuals may eventually be covered for the first time, a benefit to hospitals.
- \*\* Lab testing companies may see reimbursements fall, first from Medicare and then commercial customers who follow suit.
- \*\*\* There are Senators advocating on behalf of medical device companies to lessen the impact of a 2.3% tax on revenues mandated by the ACA, but so far, they have not been successful. The high US margins of device companies (~70% median

gross margin) make the politics of repeal difficult; the administration believes they will make it up on volume.

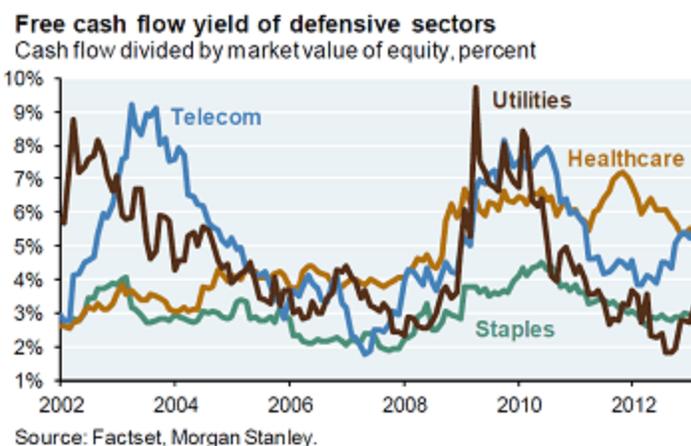
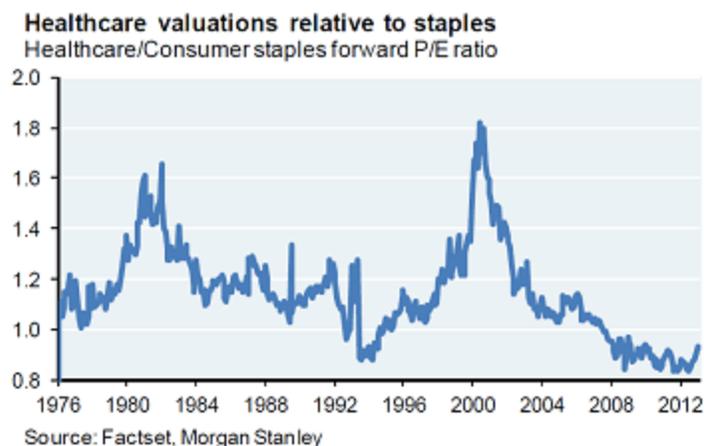
\*\* Drug distribution generally lays outside the scope of the government price-setting, and should benefit from increased drug utilization. Life Sciences companies have already seen valuations decline due to fears about the impact of sequestration.

\*\* Good news for biotech and large cap pharmaceutical companies: in 2012, the FDA approved new drug compounds at a fast pace last seen in the mid 1990's, alleviating the patent cliff many had been facing. However, even though the Affordable Care Act focused primarily on healthcare coverage expansion and how to pay for it [a] and less on reducing costs, the US government may eventually get around to asserting control over drug prices as its pricing power grows (as Europe has).

\*\* On insurers, the 85% medical loss ratio (MLR) has been in place for 2 years for commercial healthcare policies covering ~160 mm people, and only resulted in small premium rebates (since most insurers have MLRs above 85% once all allowable expenses are loaded in). MLRs will now be applied to Medicare Advantage product lines, a very profitable segment of ~14 mm people. Experience with commercial healthcare MLRs suggests the impact should be minor, but time will tell. What about the net cost/benefit for insurers of having to accept patients with pre-existing conditions (adverse selection) vs the promise of new young, healthy customers that don't opt out of the individual mandate? That remains to be seen as well.

[Note a] Our best estimate of the cost of Obamacare is \$1.7 trillion, IF one asks the following question: what is the total amount of taxes and penalties raised (from businesses and individuals) that would otherwise not have been levied, and spending cuts which would otherwise not have taken place? According to the Congressional Budget Office, for the period 2013-2022, this answer to this question is \$1.7 trillion.

The charts below show valuation measures for healthcare. In the first, we show how healthcare P/E multiples are at multi-decade lows relative to consumer staples, and in the second, we show the free cash flow yield of the four major defensive sectors. The uncertainties and complexities of government reform will not go away anytime soon, but in many cases, investors are being paid to wait and see what happens to the healthcare sector.



On **US commercial banks**, there are plenty of headwinds as well:

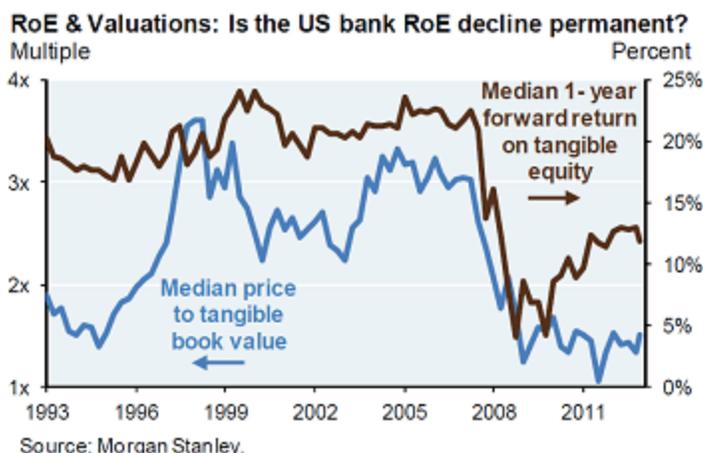
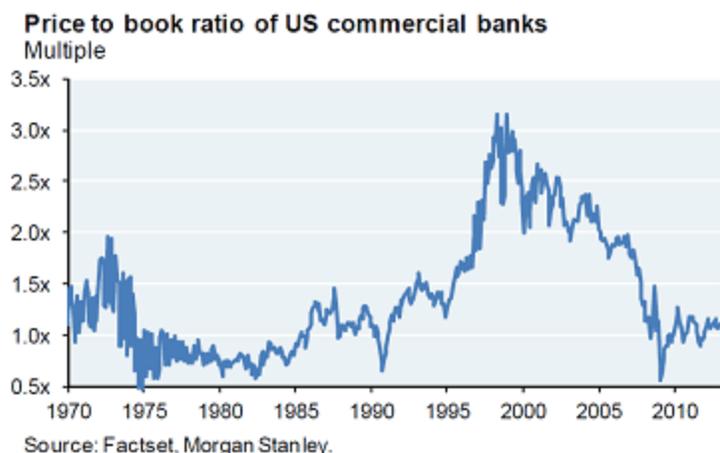
\*\* over 10,000 pages of rules & regulations from Dodd-Frank so far (and they are only 35% complete according to Davis Polk)

\*\* a decline in net interest margins associated with the collapse in the steepness of the yield curve

\*\* a decline in returns on tangible equity compared to 1993-2007 (see chart)

\*\* further release of loan loss reserves may slow. While reserves to total loans shot up in 2008/2009, banks have since released 50-65% of the increase. From 2010 to 2012, released provisions are roughly equal to the improvement in bank earnings

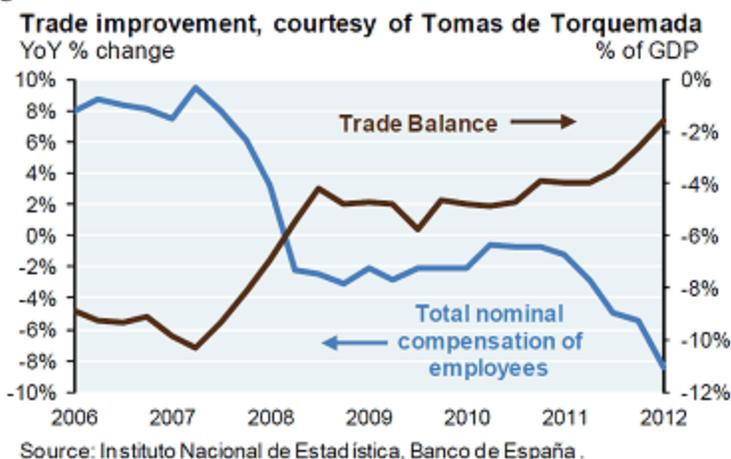
On the plus side, capital ratios are in good shape, loan demand is improving (autos, commercial real estate, commercial/industrial and residential), and the ongoing housing recovery should begin to show up in earnings. If/when the yield curve steepens and nominal GDP growth is running at 5% again, will the leverage embedded in commercial bank balance sheets boost RoEs back to 15%? If so, multiples may follow.



Remaining questions deal with Dodd-Frank and Volcker Rule implementation. An August 2012 research note from S&P estimates that such regulations (excluding those already in place, such as the Durbin Amendment) could represent an additional RoE drag of 0.9% to 2.0%. Impacts are related to over-the-counter derivative rules, limits on proprietary investments and trading, and higher compliance costs. Meanwhile, affordable lending policies which played a large role in the financial crisis continue to chug along. Government-sponsored enterprises now guarantee ~90% of all 1-4 family mortgage origination, and the FHA continues to make 2%-3% downpayment loans to families with very high debt-to-income ratios, resulting in elevated foreclosure rates in those communities. Recently announced underwriting changes by FHA are a distraction; they only apply to loans above \$625k or to loans with FICO scores below 620, which combined represent less than 5% of current FHA volume.

**The Spanish Prisoner: why the adjustment in Spain looks like it will eventually fail**

The people of Spain are prisoners of an economic adjustment that looks like something dreamed up by Torquemada. Let me explain. I was discussing Spain with a colleague, and I mentioned the ongoing collapse in Spanish labor compensation (see chart). He cheerfully connected the compensation decline with an improvement in Spain's competitiveness, and offered the improvement in Spain's trade balance as proof. A lot of the recent compensation decline had to do with *public* sector workers (who export nothing) and not *private* sector ones, but let's assume he's right that private sector wages are impacted as well. Is this a sustainable way to regain competitiveness? Historically, balance of payments crises brought on by competitiveness gaps were almost always addressed in part through currency devaluation, as shown in the table. Let's go to the archives.



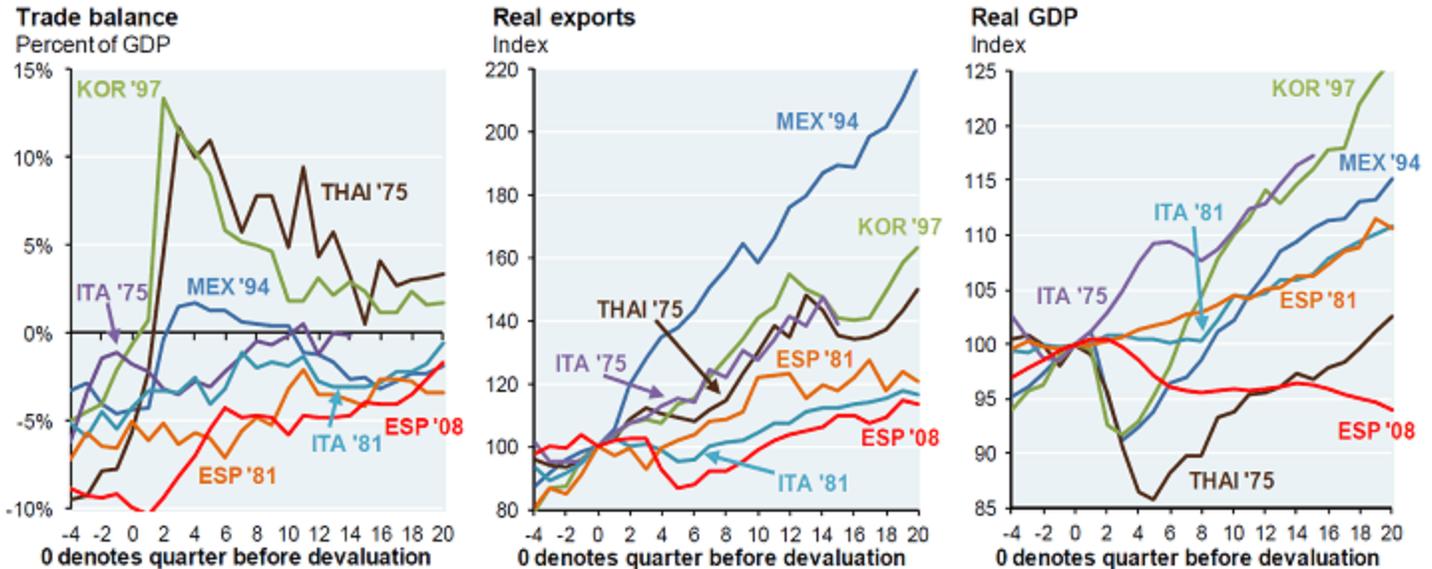
**The road less travelled**

Episode	How external adjustments were accomplished
Mexico 1994	56% decline in the trade-weighted Peso
Thailand 1997	22% decline in the trade-weighted Baht
Korea 1997	20% decline in the trade-weighted Won
Italy 1975	26% decline in the trade-weighted Lira
Italy 1981	10% decline in the trade-weighted Lira
Spain 1981	20% decline in the trade-weighted Peseta
Spain 2008	11% decline in total compensation and a 26% unemployment rate

Source: JPMAM, Haver Analytics. FX declines represent 24-month changes

The 2008-2012 recovery in Spain's trade balance didn't happen as quickly as the other episodes, but at least the gap closed, right? Not so fast. Spain's exports have been growing, but its recovery is the worst of the bunch, indicating that trade improvement relies heavily on an import collapse and 25%+ unemployment. **The last chart is the smoking gun: the growth dynamics of the current Spanish adjustment are nothing short of terrible in an historical context.** One could also look the collapse in capital spending in Spain, down at a 28% annual rate in Q4 2012 even when excluding construction. Did inflation spike in prior episodes after devaluation? Yes, but real GDP measures improvement after taking inflation into account, which is why the last chart tells you most of what you need to know. Torquemada the Inquisitor would be impressed with the pain that Spain is inflicting on itself. The bad news for Spanish labor markets isn't over: most measures of Spanish competitiveness show that only half the gap has been closed vs Germany. **I don't see how**

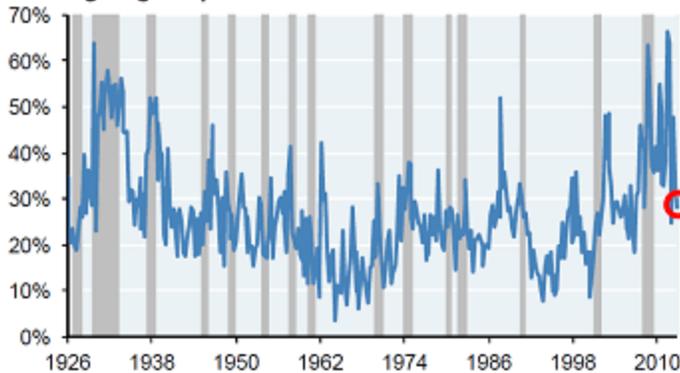
**this can be sustained indefinitely, even with the rally in Spanish sovereign and bank spreads, and with looser fiscal policy sanctioned by the EU.** Without a true fiscal transfer union in Europe, caveat emptor in its Periphery, unless prices for stocks, bank loans and real estate are sufficiently cheap.



Source: IMF, Bank for International Settlements, OECD, Respective Central Banks

**Good news for active equity managers:** the last few years were characterized by an extraordinarily high degree of correlation across individual large-cap stocks, as all the geese flew together regardless of wingspan. As many of the world's macro risks have subsided, these correlations have fallen again. In many subsets of the equity market, this has increased the opportunity set for active equity managers to add value through stock-picking. In the second chart, we show how the percentage of large cap core managers outperforming the S&P 500 jumped towards the end of 2012. To me, these developments are connected, and suggest that manager outperformance of equity benchmarks may face an easier road that it has in recent years.

**A decline in average cap-weighted return correlation among large-cap stocks...**



Source: Empirical Research Partners.

**...may be contributing to an increase in the number of managers outperforming, % of large cap core managers outperforming the S&P 500, 6-month basis**

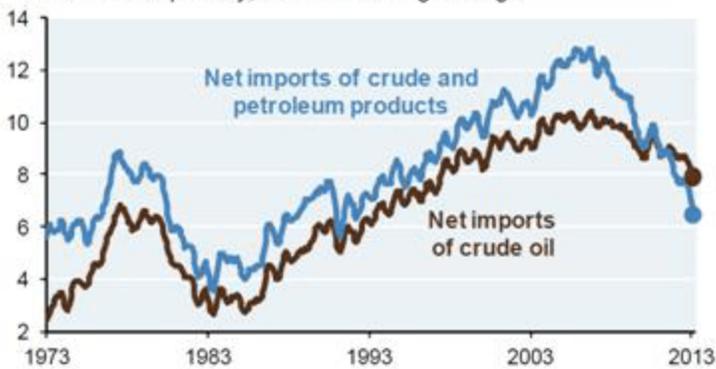


Source: Lipper. Data as of January 2013.

**Last comment, on some Keystone XL pipeline math.** The US State Department released a 2,000 page report indicating that the net CO<sub>2</sub> impact is effectively zero, since the oil in Alberta's tar sands will be produced and consumed anyway even if the pipeline to the US isn't built. But let's assume for a moment that if the US didn't build this pipeline, there would be no demand for related Canadian tar sands oil from other buyers, and that the US obtains an equivalent amount of oil from some other conventional source with a lower CO<sub>2</sub> footprint (one of the primary objections to Keystone). The net amount of CO<sub>2</sub> emissions saved over the course of an entire year in this scenario would be offset every 8 hours by emissions from China alone, based on our calculations. It will be interesting to see how the Administration makes its decision. While net crude and petroleum imports are declining at a rapid pace (due to a surge in unconventional oil production and increased use of more fuel-efficient cars), the US will still need to import oil. Are the economic and geopolitical consequences for the US better if this oil comes from Venezuela, Africa or the Middle East?

## US net imports of petroleum

Million barrels per day, 6-month moving average



Source: US Energy Information Administration.

Michael Cembalest

■ Morgan Asset Management

**Biographies.** Tomas de Torquemada, 1420 – 1498, grand inquisitor and most infamous figure of the Spanish Inquisition, under whose guidance the Inquisition used various forms of gruesome torture to extract heresy confessions from its victims. Torquemada traveled with 300 bodyguards, well aware of how despised he was in 15<sup>th</sup> century Spain. Anyone could bring anonymous accusations or testimony to Inquisition tribunals, leading to false accusations as a means of settling scores and seizing property. Public executions (of those burned at the stake) were festive events, sometimes lasting all day. “*The Inquisition, A History*”, Michael Thomsett, McFarland, 2010.

ACA = Affordable Care Act (Obamacare); BEA = Bureau of Economic Analysis; FDA = Food and Drug Administration; FHA = Federal Housing Administration; FICO = a consumer credit scoring system; ISM = Institute for Supply Management; MLR = Maximum Loss Ratio

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