Eye On The Market Outlook 2018 – Special Topics - Text Script – TIME: 9:32

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Text on screen:

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Note:

Upbeat introduction music plays.

Text on screen:

J.P. Morgan. INDUSTRIAL COMMODITY PRICES: More Room to Rise.

On screen:

Michael Cembalest, a man with short dark hair, glasses, and a blue jacket, sits in a spacious office. White text appears, briefly, on screen.

Text on screen:

Michael Cembalest. Chairman of Market and Investment Strategy, J.P. Morgan Asset & Wealth Management.

Mr. Cembalest:

A few years ago, Mary, who I work for, said to me that she had been to a conference, and at the conference one of the well-known commodity investor hedge funds was talking about that there were 20 or 30 years left in the unwinding of the commodity super cycle. And the person who made the statement said, well, I've looked at all of the commodity super cycles since the 1700s, and they take around 20 to 30 years to unwind when they happen. Then I asked Mary, well ask them what the percentage decline in commodity prices is during these super cycles, and the answer was, well, around 50 percent. Well, by the spring of 2016, commodity prices had already fallen by around 50 percent. I'm a lot more interested in price than time as an indicator of when something may have value.

On screen:

A line graph entitled, "Global copper, aluminum, nickel, zinc, and oil capex" appears, with all five in decline as of 2015. Five color coded dots project a continued decline in 2016 for copper, aluminum, nickel, and oil – but a rise for zinc. Small text, beneath the graph: Source – Wood Mackenzie, Barclays, December 2015. Dot is an estimate for 2015.

Mr. Cembalest:

We already felt by the spring of 2016 that the worst was over for commodity prices, and we also started to see massive declines in capital spending projections across the industrial metals complex and oil as well.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

That was basically the foundation then of the view that we were headed for better supply-demand conditions across the oil and industrial metals markets. As things stand now, we expect metals and oil prices to remain range bound, and where they are right now is perfectly fine as it relates to the export revenue potential of a lot of the countries and companies that we look at.

On screen:

A title appears on a gray and white screen.

Text on screen:

BRAZIL - Economics Trump Politics.

On screen:

A bar graph entitled, "Investment Signal Rankings" appears. The graph shows the monthly S&P return differential based on investment signals from 1985 to 2017, with:

- Leading Indicators at nearly 1.2%;
- CEO Confidence at 1.1%;
- Payroll Growth at 0.9%;
- GDP Growth at nearly 0.8%;
- Forward 12 Month Profits at 0.7%;
- Small Business Optimism at nearly 0.6%;
- ISM Manufacturing at 0.5%;
- Financial Conditions at 0.5%;
- Trailing 12 Month Profits at 0.3%;
- Policy Uncertainty at 0.2%;
- and Geopolitical Risk at 0.1%.

Small text, beneath the graph: Source - JPMAM, Confidence Board, BLS, BEA, NFIB, ISM, Chicago Fed, S&P, Boston College, Stanford University.

Mr. Cembalest:

We ran some analysis to show that the stuff that matters over time for investors is CEO confidence, forward-looking profits growth, job growth, and things related to the real economy. And that issues related to geopolitics and economic uncertainty indices weren't very reliable investment signals.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

I can't think of a better example of that than Brazil. Because over the last two years, there's probably no country that's gotten worse press: The calamity of the Olympic aftermath and this wide-ranging and never-ending political scandals. Yet, over that period of time, Brazil has gone through a fairly normal balance of payments adjustment.

On screen:

A line graph entitled, "Brazil equity markets" appears. The graph shows an increase from 2016 into 2017. Small text, beneath the graph reads, “Source – Bloomberg. November 9, 2017.”

Mr. Cembalest:

Brazilian equity markets are up substantially over that same timeframe. If you were paying attention to the usual suspects as it relates to equity markets, you would have seen opportunity in Brazil.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

Whereas if you were just focused on a lot of the headlines and the political risks, you would have definitely missed it.

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Text on screen:

U.S. MUNI MARKET: Debt burdens of U.S. Cities & Counties.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

Earlier in this taping, I mentioned that there was a very small list of countries in distress. Unfortunately, I think over the next few years there are a handful of states and cities and counties in the U.S. which may be added to that list alongside Puerto Rico. We took another deep dive into the muni market, this time looking at the counties and the cities in addition to the work that we've already done a couple of times on the states. And, again, what you find is a very heterogeneous picture. The bottom line is we come up with a scoring mechanism that indicates to us what are the places that have the highest both visible and less visible accumulation of debt relative to their revenue collections. Our overall exposure to those entities is generally somewhere around one percent of all of the municipal assets that we managed. So, safe rather than sorry, I think, is a good way to approach investing in fixed income. Because when everything works out, you get your coupon. When it doesn't work out, you lose $30 to $40 in principal. The rules of the road as it relates to adjudicating disputes between bondholders and pensioners isn't completely worked out in the courts yet. What we've seen so far in terms of precedent is, if the pensioners take a hit, the bondholders get it worse. It's for those reasons we're trying to be very proactive about how we manage our exposure to some of the entities that have higher levels of debt.

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HEDGE FUND PERFORMANCE: Valuation Compression Remains Challenging.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

Hedge fund performance in 2017 was a little better than in 2016, which was a low bar. We take a closer look at some of the factors related to that. What we now have is an industry that maybe 10, 20 years ago was thought of as an equity proxy. When you actually look at the volatility of a diversified hedge fund portfolio now, it looks more like a risky fixed income proxy. So, to me, the hedge funds are not quite as far away from delivering on that kind of mandate than some people think. The big headwind that’s left for the hedge funds is the impact of central bank intervention has completely collapsed all of the valuations across different sectors. For that reason, it seems premature to make permanent judgments about hedge fund potential until the central bank interventions starts to fade. Presumably, as that happens and the valuation compression starts to reverse, and you start to see broader market distinctions between winners and losers, the opportunity set for hedge funds should presumably improve. That's what we're looking to see over the next two to three years.

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Text on screen:

U.S. EQUITY MARKETS: Concentration of returns in 2017.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

One of the special topics that we talked about this year had to do with the return contribution of a handful of the big tech stocks. Some clients have mentioned to us that they were disturbed by just how much the market return was reliant on the contribution of a handful of stocks. We look back over the last 20 years or so, and for better or worse, the largest contributors are generally always delivering something on the order of, let's say, a three or four percent return just from the largest five stocks or so.

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U.S. LISTING GAP: Shrinking Number of Public Companies.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

We've been watching this for a while, the shrinking number of public companies. There's a couple of reasons for it.

On screen:

A line graph entitled, "Additions and subtractions to listed companies." appears. The graph shows the number of listed firms at about 4000 in 2016. Small text, beneath the graph reads, "Source – "The U.S. Listing Gap," *Journal of Financial Economics*, Doidge, Karolyi, and Stulz, Credit Suisse. 2017."

Mr. Cembalest:

One of it has to do with the fact that new listings have dropped, and the other part of the equation has to do with rising levels of M&A and industry consolidation.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

With both of those things happening at once, the number of public companies outstanding continues to shrink. For many of our clients, endowments, foundations and pension plans, and ultra-high-net-worth individuals, this isn't necessarily a problem because they have the ability to invest in pre-IPO markets and venture capital and private equity. So whether their value is created pre-IPO or post-IPO, many of our clients have the ability to access that value creation in their portfolio in a lot of different ways. The concern we have about it is for investors that don't have the ability or the risk appetite to invest in pre-IPO markets. There's a fairness issue.

On screen:

A line graph entitled, "Number of participants in pension plans" appears. It shows "Defined Benefit" with about 40 million participants in 2014 and "Defined Contribution" with about 100 million participants in 2014. Small text, beneath the graph: Source - Department of Labor. 2014.

Mr. Cembalest:

For example, if you look at the degree to which defined contribution is dominating the pension landscape compared to defined benefit these days, you've got this growing pool of defined contribution assets that really don't take advantage in any material way of value creation in pre-IPO markets.

On screen:

Close-up of Mr. Cembalest.

Mr. Cembalest:

I think there's in addition to the fairness for median income investors and funding their retirement, there's also a fairness issue related to the public companies that are providing all of the information that we as investors use to make judgments about the stock market and the economy. There are obviously very limited disclosures from private companies. And so the fewer public companies you have, the smaller the aggregate universe of great information for us to be making our investment decisions on. So that free riding benefit that accrues to private companies is a concern to us because in the long term we'd rather have more information rather than less when it comes to making investment decisions in client portfolios. What should be done about it, well, those are some complicated questions. Some people believe that the onerousness of the regulatory framework for public companies needs to be relaxed. To me, the bigger issue is the extent to which the private capital has been deregulated, which gives private companies the ability to spend a lot more time privately without having to go public. I think while you can relax some of the regulatory burdens on public companies, unless you reregulate some aspect of the private capital markets, it's going to be very difficult to put the genie back in the bottle.

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