Market Bulletin

July 29, 2016

Cyclicals vs. defensives: The valuation imbalance

In brief

- Investors are worried that lower trend growth means it is easier for a shock to tip the U.S. economy into recession. This, coupled with historically low interest rates, has led valuations of defensive, income-producing assets to rise.
- However, the combination of improving U.S. growth prospects, expectations that central banks will ease further, and a view that earnings are positioned to improve has provided a boost to cyclical sectors in recent weeks.
- Earnings are still under pressure, but we expect earnings growth to turn positive in the second half of this year, providing fundamental support for continued cyclical outperformance.
- What we have on our hands is a valuation imbalance – cyclical sectors look cheap relative to defensive ones, which has created an opportunity for long-term investors.

A preference for stability

Many investors characterize U.S. equities as falling under the header of either growth or value. Another way of categorizing equities is to think about whether they are cyclical or defensive – in other words, do they exhibit a high or low sensitivity to the business cycle? Cyclical stocks tend to exhibit a strong, positive correlation to the business cycle, generally outperforming defensives when economic growth is accelerating and underperforming during periods when the economy is slowing or contracting. Additionally, the cyclical sectors all have a beta to the S&P 500 greater than one over the past 10 years, as well as a positive correlation to changes in interest rates. The pair of charts in **Exhibit 1** highlight performance of the cyclical and defensive sectors since the 2009

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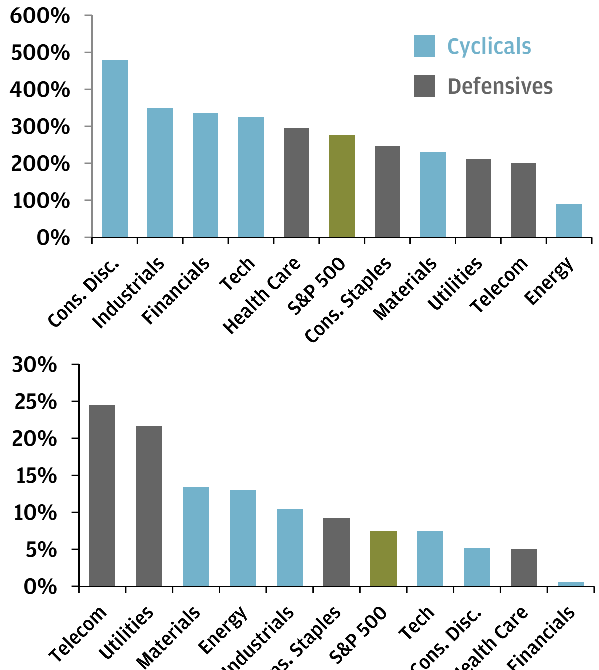
market low (top) as well as since the beginning of this year (bottom) [1].

Cyclicals have generally done well in this bull market, but 2016 performance has been mixed

EXHIBIT 1: S&P 500 GICS SECTORS, CUMULATIVE TOTAL RETURN

TOP CHART IS SINCE 3/9/09, BOTTOM CHART IS 2016 YTD



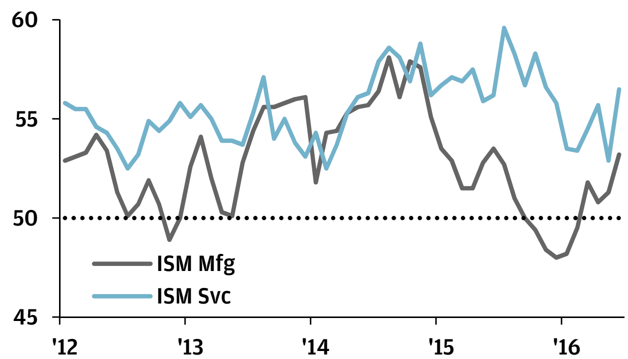
Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management; data are as of July 29, 2016. For illustrative purposes only.

The post-crisis economic recovery and bull market have been characterized by skepticism over the past few years, with investors constantly concerned about the next threat to the economy and markets. This has manifested itself in their behavior, specifically a preference for "safe" assets that generate a healthy stream of income, as evidenced by the year-to-date outperformance of the defensive sectors highlighted in the chart above.

Lackluster long-term growth prospects, political uncertainty, and easy monetary policy have led interest rates to the zero bound, creating demand for income as the preferred source of return. The reason for this is simple – the probability of receiving a recurring coupon or dividend is far greater than the probability of capital appreciation. In other words, investors prefer picking apples off of the tree right now, rather than betting on whether the tree will grow in the future. As a result, investors have bid up the price of defensive, income-producing assets while shunning the more cyclical parts of the market. This has created a valuation imbalance.

Manufacturing and services have shown signs of improvement

EXHIBIT 2: ISM MANUFACTURING AND SERVICES INDICES



Source: ISM, FactSet, J.P. Morgan Asset Management; data are as of July 29, 2016. For illustrative purposes only.

The cyclical rally: Fundamentals or fiction?

Better U.S. growth, expectations for additional central bank easing, declining risks in EM and better-than-expected earnings results have helped boost U.S. equities broadly, and the cyclical sectors in particular, over the past few weeks. While it can be debated whether this rally has been based off better data or the prospect of more easing, U.S. economic growth has undoubtedly reaccelerated following a weak first quarter.

Improvement in both services and manufacturing, coupled with the rebound in employment, an uptick in consumption, further firming in inflation and continued strength in housing, makes it difficult to deny that the U.S. economy has strengthened. However, better economic data only seems to be part of the story. As we have seen many times throughout this recovery, the view that central banks are going to provide more stimulus can, and has, pushed equity

[1] While some investors characterize the energy sector as being defensive, as people will pay for gas regardless of the economic environment, given the high beta of this sector, as well as its idiosyncratic nature, we will characterize it as a cyclical sector for the purposes of this paper.

markets higher. In the most recent instance, the expectation that monetary policy will stay loose and in some cases be eased further, along with a better outlook for U.S. growth, has provided support for cyclical parts of the equity market.

Emerging markets and commodities – two areas of stress in 2015 – have also been well behaved. As shown in **Exhibit 3**, emerging market spreads and yields have declined despite a mixed growth picture in China and a pullback in the price of oil and other commodities. This suggests that investors view these tail risks as better contained than they were last year, which, coupled with stronger growth and easier financial conditions, should be supportive of continued cyclical outperformance. In the long run, cyclicals tend to do well when economic growth is accelerating and the yield curve is steepening. Thus, the biggest risk to the current rally is that the probability of a Fed rate hike later this year begins to rise, leading to an uptick in demand for U.S. Treasuries, dollar strength and a flatter yield curve.

Emerging market bonds are signaling diminished tail risk

EXHIBIT 3: EMBIG DIVERSIFIED, SPREAD TO WORST

Source: J.P. Morgan, J.P. Morgan Asset Management; data are as of July 29, 2016. For illustrative purposes only.

Almost out of the woods

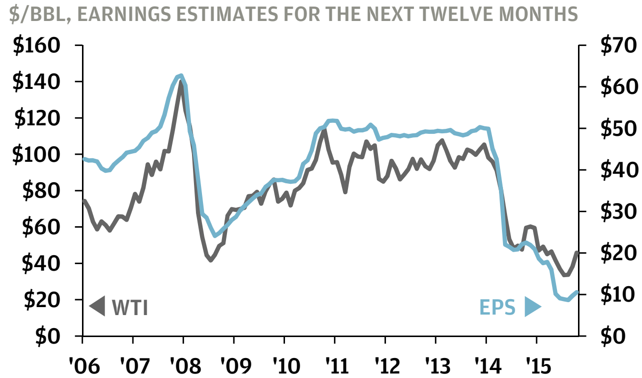
Abundant liquidity and easy financial conditions can only support markets for so long; eventually, the fundamentals need to improve. While we have seen an acceleration in economic growth, the recent rally also seems to be based on the view that earnings expectations bottomed in the first quarter. While this can provide a temporary lift to stock prices, in the long run, earnings need to grow. Our view is that lower energy prices and a stronger U.S. dollar dragged on earnings in 2Q, but these forces should gradually fade during the second half of this year. On the other hand, financial sector profits struggled under the weight of low interest rates and elevated loan loss provisions, and do not look set to recover until early 2017.

While Standard & Poor's expects energy sector earnings to be positive in 2Q, this outlook seems overly reliant on the recovery in oil prices since February of this year. Oil prices tend to lead earnings estimates for the energy sector by about two months, which, coupled with the fact that crude recovered to nearly $60/bbl in 2Q15, makes comparisons to last year particularly difficult. On top of this, the decline in production over the past year from efforts to align supply and demand will prevent volume growth from offsetting this weakness in pricing. All things considered, it doesn't appear that oil is out of the woods quite yet.

Oil prices are still down on a year-over-year basis

EXHIBIT 4: WTI OIL PRICES AND ENERGY SECTOR EPS ESTIMATES

$/BBL, EARNINGS ESTIMATES FOR THE NEXT TWELVE MONTHS



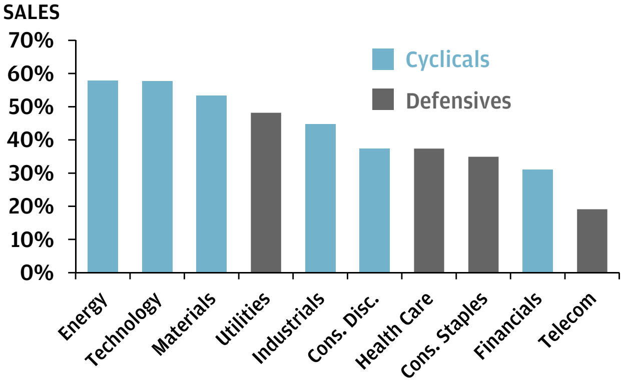
Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management; data are as of July 29, 2016. For illustrative purposes only.

Another common refrain has been that the weakening of the U.S. dollar from its January highs should be a tailwind for global multi-nationals, particularly in the wake of last year's dollar run. However, using the average value of the dollar index in 2Q15 versus 2Q16, the dollar was up approximately 5% on a year-over-year basis. Although this is less of a headwind than in 2015, currency strength continues to weigh on revenues and earnings of the more globally exposed sectors, a group that is dominated by cyclicals.

Dollar strength has specific implications for the energy and technology sectors, where approximately 58% of revenues come from outside of the U.S. Historically, the technology sector has had the most international exposure, but a decline in sector revenues has led energy to become the most internationally exposed GICS sector in percentage terms. Within technology, revenue and earnings beats have generally been in line with the broad index, but this likely stems from the ability of these firms to retain pricing power, even during periods of low inflation. Furthermore, very mild earnings growth and negative revenue growth on a year-over-year basis suggest the dollar headwind is still at play.

The cyclical sectors tend to do more of their business abroad

EXHIBIT 5: 2015 FOREIGN SALES AS A PERCENTAGE OF TOTAL SECTOR SALES

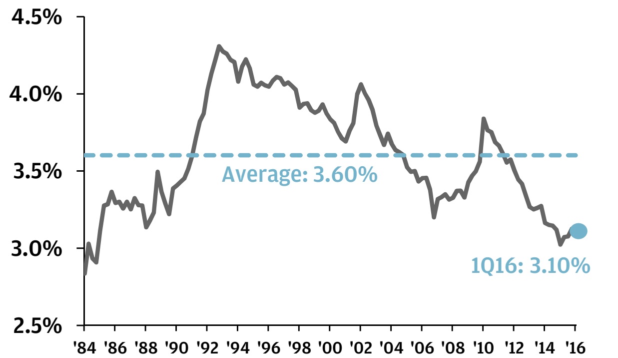


Source: Standard & Poor's, J.P. Morgan Asset Management; data are as of July 29, 2016. For illustrative purposes only.

Looking at financials, there is a tug of war going on between the various drivers of earnings growth. Loan loss provisions continue to rise due to stress in the energy sector, but it is important to note that these provisions are rising from a very low base and remain well below levels seen during the financial crisis. Additionally, interest rates look set to remain low for the foreseeable future, which will continue to weigh on net interest margins that are hovering near 30-year lows.

Lower rates are a structural headwind to bank profits

EXHIBIT 6: NET INTEREST MARGINS OF FDIC-INSURED INSTITUTIONS



Source: FDIC, J.P. Morgan Asset Management; data are as of July 29, 2016. For illustrative purposes only.

Stronger trading activity and solid loan growth contributed to financial sector earnings in the second quarter, but failed to offset the drag from low rates and rising loan loss provisions. Additionally, 2015 results were particularly strong, which may keep year-over-year comparisons in the financial sector under pressure through the end of 2016.

Despite continued headwinds for energy, multi-nationals and financials, the current earnings season does have some bright spots. Profits in the health care sector continue to rise on the back of broader reform, with medical device firms in particular benefiting from a 2-year suspension of the medical device tax. In addition, tighter labor markets and robust consumption growth seem supportive of consumer discretionary, but industry selection will be important, as changing consumer preferences should support home improvement, internet retailers and firms that provide experiences rather than more traditional consumer goods.

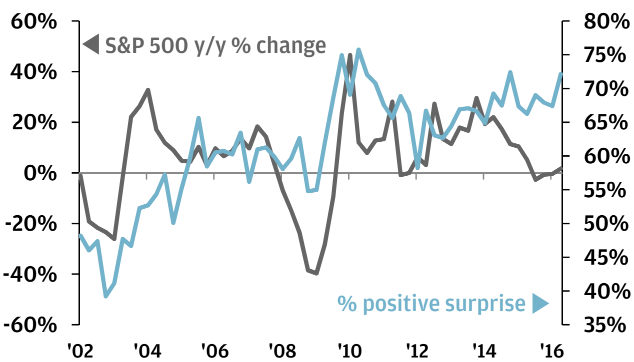
[2] Calculation is based on the Federal Reserve's nominal broad effective exchange rate.

Against what is clearly a mixed, but improving, earnings picture, we have seen stock prices rise to all-time highs. This rally seems to have been driven by the combination of an improving economic backdrop, expectations that central banks will ease further, declining tail risks from EM and better-than-expected earnings. The continued presence of this backdrop should support cyclical sector outperformance and serve as a reminder that in the short to medium term, changes in stock prices are as much about expectations as they are about fundamentals. However, in the long run, stock prices tend to follow earnings, and further improvement in both economic and corporate fundamentals will be required for this cyclical outperformance to continue.

When it comes to stock returns, expectations are what matter

EXHIBIT 7: S&P 500 PERFORMANCE AND EARNINGS BEATS

YEAR-OVER-YEAR % CHANGE, % OF COMPANIES BEATING ESTIMATES



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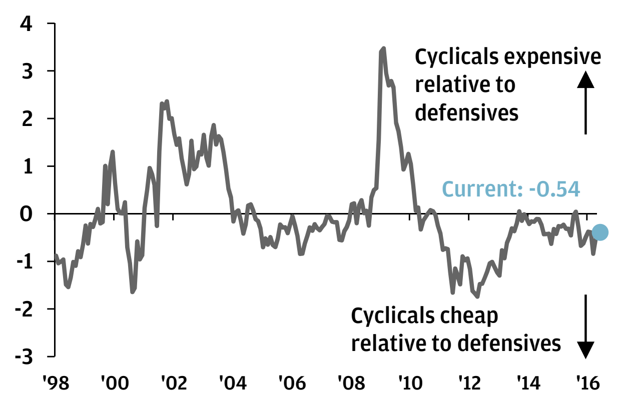
Investment implications: The valuation imbalance

There are a number of things that need to go right in order for cyclical outperformance to be maintained in the short run: central banks will need to ease in line with investor expectations, economic growth will need to remain solid and earnings growth will need to recover. This may be easier said than done, as it is impossible to know what central bankers will do, potential growth in the U.S. is lower than it has been historically and 2017 earnings estimates seem a bit aggressive. For example, the market is currently pricing in about +10% earnings growth over the next 12 months; while we think earnings growth will be positive over the next year, our expectation is that it will be more to the tune of 5%-7%.

In a world of abundant liquidity and very low interest rates, the more defensive parts of the market will continue attracting investor interest despite elevated valuations, particularly if uncertainty begins to rise toward the end of this year. In the long run, valuation is the single best predictor of returns. Excluding energy, the cyclical sectors look cheap relative to the defensive ones, pointing to greater opportunity in the cyclical part of the U.S. equity market.

Excluding energy, cyclicals look cheap relative to defensives

EXHIBIT 8: RATIO OF CYCLICAL FORWARD P/E EX-ENERGY TO DEFENSIVE FORWARD P/E, Z-SCORE



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Emotion can make investors lose perspective, chase performance and make exactly the wrong decision at precisely the right time. Recently, emotion has led investors to put their money to work in expensive parts of the market that are highly sensitive to changes in interest rates, simply because these sectors seem "safe." The reality, however, is that these defensive parts of the market are actually far more dangerous than most investors realize, particularly given our view that economic growth should remain solid and rates should gradually rise over time. Seven years of easy monetary policy and an investor base that remains risk averse has created a valuation imbalance – this is an opportunity for long-term investors to focus on what is cheap, rather than chase what looks expensive.

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