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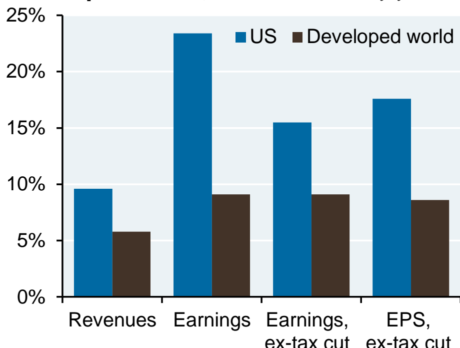
Topics: Another year of American exceptionalism in equity markets, tempered by the tech-dependence of equity returns, high valuations, fading stimulus and constitutional/tariff risks; Italy and "Europartenza"; golden era for US commercial property closing; *Hydrocynus vittatus*

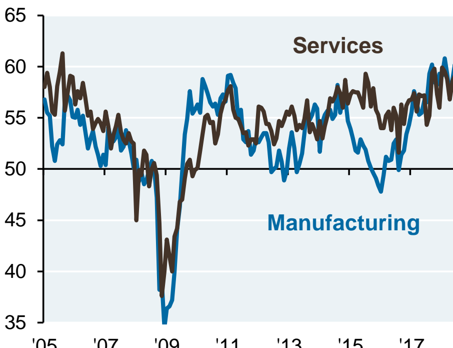
America, First. Most signs of the US expansion still look healthy: business surveys are strong and while rising Fed policy rates are starting to cool housing and autos, other household purchases and the business sector have more than offset the drag. Q2 2018 was another stellar quarter for US earnings compared to the rest of the developed world, even without the benefit of US corporate tax cuts. A sharp **upward revision** in the US personal savings rate also paints a picture of a healthy household sector.

US corporate sector outpaces developed world, 2Q18 results, % y/y



Source: Credit Suisse. August 21, 2018.

US business surveys signal expansion
PMI survey level, 50+ = expansion



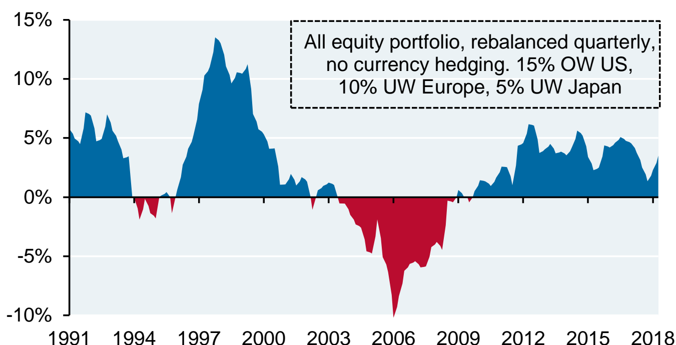
Source: ISM, Haver. July 2018.

	YTD equity return, US$
NASDAQ	18.3%
Russell 1000 growth	16.4%
Russell 2000	14.3%
S&P 500	9.9%
World ex-EM	5.5%
Russell 1000 value	3.7%
Eurozone	-1.1%
Europe	-1.5%
Japan	-1.5%
Emerging Mkts	-6.8%
China	-6.9%
Brazil	-19.4%
Turkey	-51.6%

Bloomberg. August 31, 2018

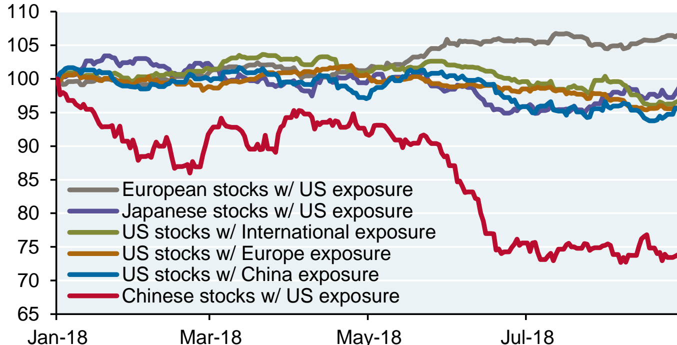
While Europe and Japan may offer better food, wine, beer, cinema, literature, clothing, luxury cars, gas mileage, gun safety and life expectancy than the US, **an overweight to non-US equities has been remarkably unrewarding**. As shown below, US equity markets keep chugging along, outpacing Europe and Japan consistently since 2008 (and with the exception of the pre-crisis period in red, since 1988). As for Trump's tariffs, so far **the big equity market loser is China.** The last chart shows each country's stocks with foreign exposures relative to their domestic markets. Trump may pay a political price for tariffs one day, but as of now, there's little evidence of substantial damage in US equity markets, or deceleration of earnings, hiring or capital spending by export-dependent US companies[1].

US outperforming for most of the last 30 years
3-year rolling out (under) performance vs MSCI All World Index



Source: Bloomberg, JPMAM. Q2 2018.

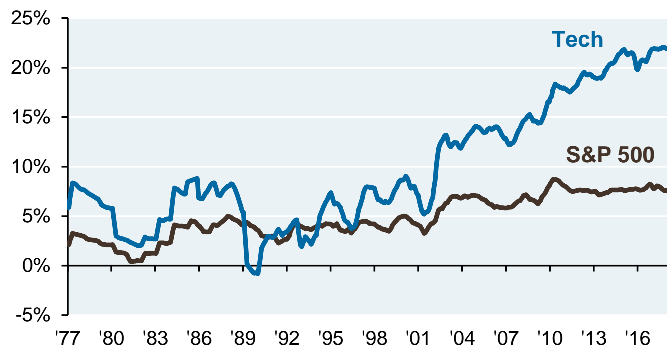
China is the big equity market loser from the tariff war
Performance vs respective local market, index, Jan 1, 2018 = 100



Source: Bloomberg, Goldman Sachs. August 31, 2018.

[1] There are signs that US apparel, auto and manufacturing companies are exploring the idea of migrating production out of China to other Asian countries. Tariffs are starting to show up in some analyst earnings projections for 2019, but very tentatively given the lack of specifics.

US equity market returns and tech sector concentrations. Q2 was a very good quarter for US earnings (the highest percentage of earnings beats vs misses in 20 years), but I can't help but wonder about the risks of a market that is so reliant on the technology sector. Tech has been enormously important for investors, accounting for almost the *entire* increase in US profit margins to a new all-time high, and accounting for an increasing portion of overall market returns as well. As shown on the right, other than during the tech bubble of the late 1990's, it is unusual for a handful of stocks to make such a large contribution to overall S&P 500 returns.



Source: Empirical Research Partners. August 2018. S&P 500 excludes financials, utilities, REITS, energy and industrial commodities.

Source: JPMAM. August 21, 2018.

While P/E multiples for the tech sector are higher than for the market (28x vs 21x, trailing), the gap isn't that large given superior tech earnings performance. To me, the risks are related to investor crowding[2], "earnings beats with poor guidance"[3], and high *absolute* valuations: while P/E's have come down since the start of the year, the S&P 500 index still trades at the 85th percentile of expensiveness vs. its history, and the *median* stock trades even more richly, at the 96th percentile.

The bottom line for investors in US equity markets in 2018: positive returns, but at a rate below the pace of earnings growth as P/E multiples decline. I think that's what we will see next year as well (our earnings expectations for 2019 are 10%-12%), for reasons outlined on the next few pages. I don't think the risk of contagion from emerging markets to developed markets is very high, given the substantial changes in the EM balance of payments landscape over the last 20 years[4].

[2] A prime brokerage report covering 830 hedge funds found that a record 28% owned Facebook in Q3 2018; that tech is the largest sector weight; and that the 5 most common positions are FB, AMZN, MSFT, GOOGL and NXPI.

[3] FB and NFLX beat EPS targets, but FB provided weak margin guidance and NFLX reported weak subscriber growth.

[4] As we wrote in back in May, Turkey is only 0.9% of the EM equity index and Argentina is not present at all, having been exiled to the MSCI Frontier Equity Index alongside Lebanon and Kenya; the **Turkey/Argentina headlines are not commensurate with the amount of investor capital at risk**. Furthermore, the large current account deficits of Argentina and Turkey are no longer representative of the EM universe, many of whom run a surplus, are much less reliant on foreign capital and hold higher levels of FX reserves relative to external debt. While EM returns are negative this year, I don't see the kind of contagion risks for developed market investors that were present in the 1980's, in 1998 or in 2001.

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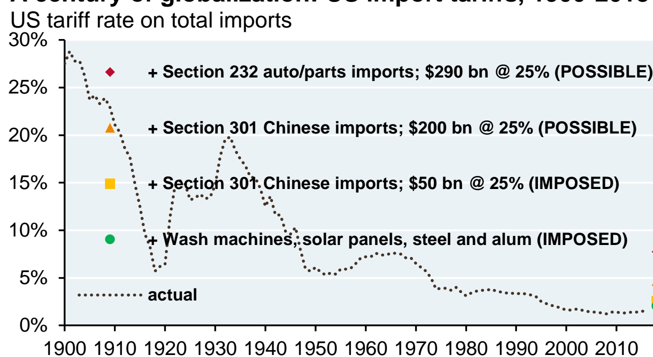
- ***US tariff conflict with China***. It looks like Trump is trying to resolve/postpone disputes with Europe and Mexico to unite the developed world against China's trade practices and geopolitical ambitions. So far, tariffs imposed are small (yellow dot in the chart), but there are unquantifiable risks that Trump escalates the tariff conflict to the orange or red dots (particularly after Trump scuttled Treasury Secretary Mnuchin's "trade deficit reduction" plan last May), and/or that China retaliates more aggressively with a large currency depreciation or via sanctions on US companies operating in China[5].

Trump is also moving forward with restrictions on Chinese investment in the US. A bipartisan bill signed in mid-August allows the US Committee on Foreign Investment (CFIUS) to block **non-controlling** foreign investments via venture capital funds in "critical, emerging and foundational technologies", such as robotics, artificial intelligence, self-driving cars, cybersecurity and big data. The risk of expensive and complex CFIUS reviews is already reportedly discouraging some US venture capital funds from accepting Chinese capital, creating downstream risks for a US equity market highly reliant on the tech sector.

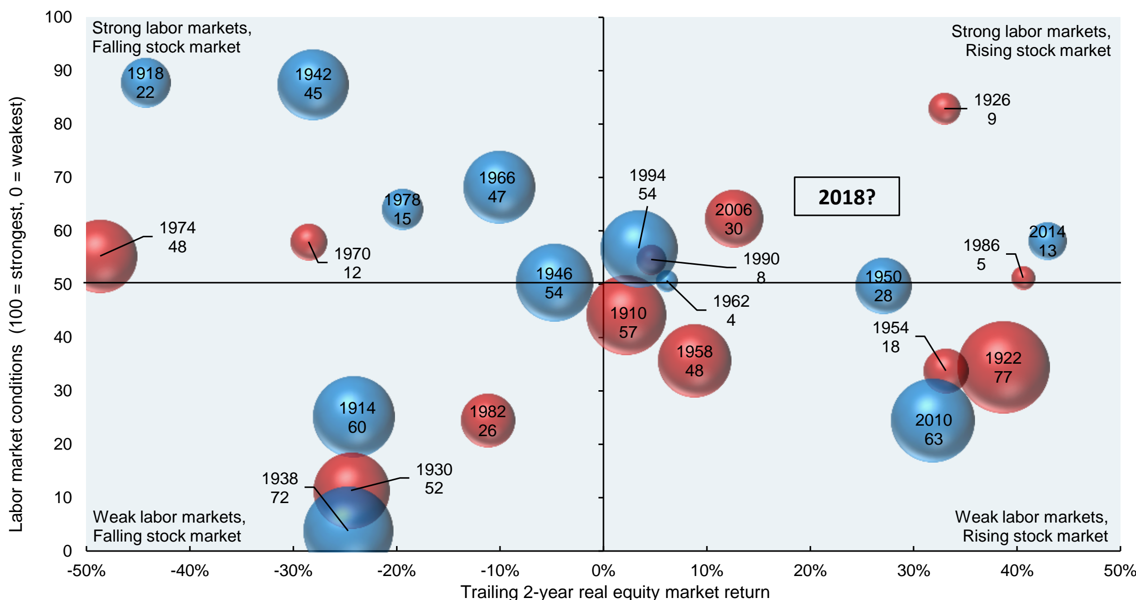
A century of globalization: US import tariffs, 1900-2018
US tariff rate on total imports



Source: Esteban Ortiz-Ospina and Max Roser "International Trade", US International Trade Commission, JPMAM. 2018.

- ***US midterm elections***. As we first illustrated in March 2018, the President's party generally loses seats in midterms elections. However, the major routs (large bubbles in the chart below) took place when either equity markets or job markets were doing poorly, with the exception of the 2006 voter rejection of the Iraq War which resulted in 30 lost GOP seats. Given recent strong US equity returns and a healthy job market, the GOP should only lose 10-15 seats and hang onto the House. A much larger Democratic gain would be unusual, and an inescapable referendum on the President. Markets will be watching to assess any change to the President's mostly pro-business agenda resulting from the midterm elections, and any risks of impeachment proceedings (see next page).

Is the GOP heading for a historic rejection at a time of rising stock markets and strong labor markets?
Bubble color/size indicates President's party and number of House seats lost in midterm election



Source: Robert Shiller (S&P history), C. Romer (pre-1952 unemployment data), JPMAM. 2018. Excludes midterm elections of 1934, 1998 and 2002 when President's party picked up House seats in midterm elections. Labor market conditions reflect the level of unemployment and the 2-year change.

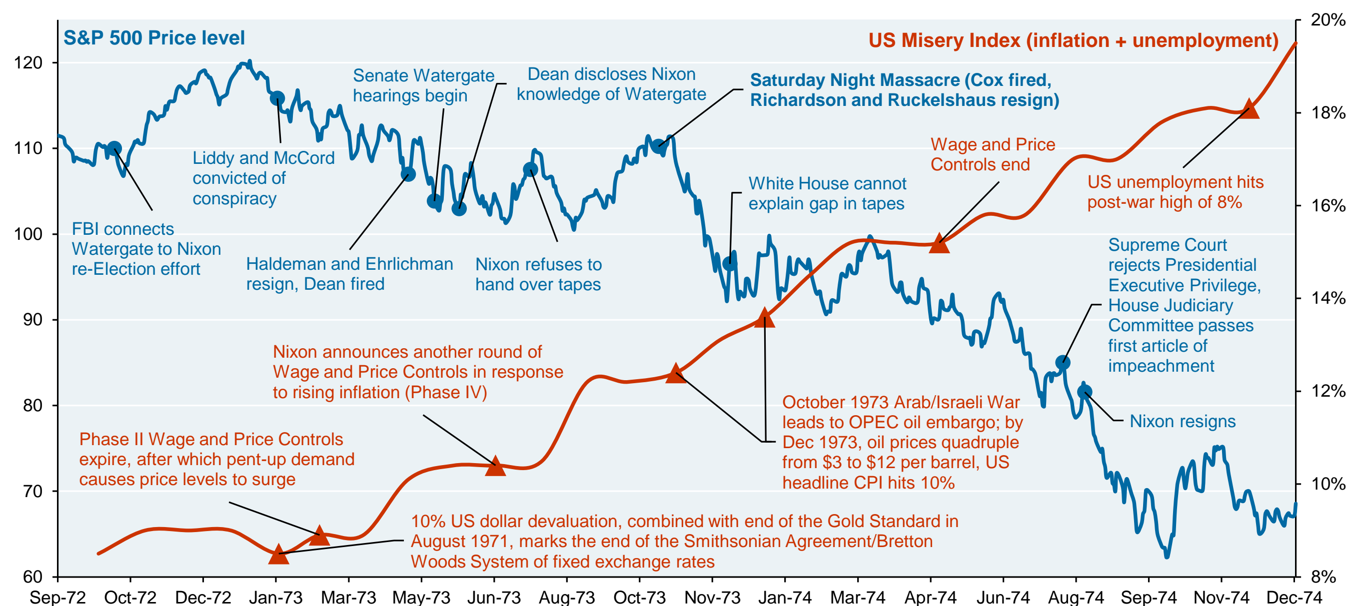
[5] The Yuan has already depreciated by 8% since May. On potential sanctions, the revenues of US companies operating in China are equal in size to the entire US trade deficit with China [EoTM May 30 2018].

- ***The risk of a constitutional crisis***. Political crises are hard to assess since they hinge on discrete, non-predictable events. In August 1974, the ten Republicans on the House Judiciary Committee that had opposed every single article of impeachment changed on a dime once the contents of Nixon's tapes were disclosed to them[6], causing two thirds of the GOP members of the Senate to abandon Nixon as well. In other words, things can change fast in politics.

  The challenge with analyzing market reactions to US political crises is (a) there aren't that many of them, and (b) Watergate (1973/74) and the Starr Report (Sept 1998) also coincided with major economic and market troubles. In 1973/74, markets faced Wage & Price controls, sharply rising inflation and unemployment, an OPEC oil embargo and a declining dollar following the end of Bretton Woods fixed exchange rate system. The accompanying chart from our 2018 *Outlook* walks through the details, and shows the collapsing stock market and the rise in the Misery Index. In 1998, markets had to absorb the Long Term Capital Management unwind and the Russian default.

  Those caveats notwithstanding, a Constitutional crisis in 2018 or 2019 could negatively impact markets that would prefer to focus on the expansion. The negative market reaction to the October **1973 Saturday Night Massacre** is one clue: the 10% decline in the US stock market that occurred appears unrelated to the recessionary conditions that were present at the time.

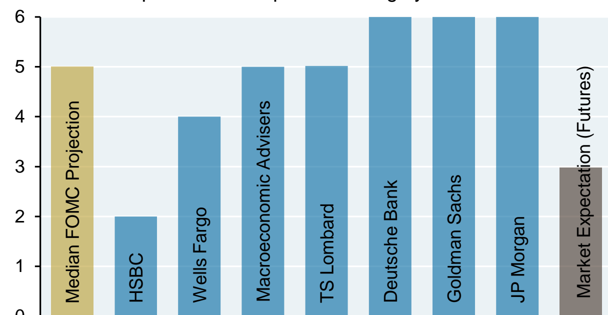
S&P 500 weakness in 1973-1974: it's not easy to determine whether stagflation or the Presidential crisis was the bigger driver

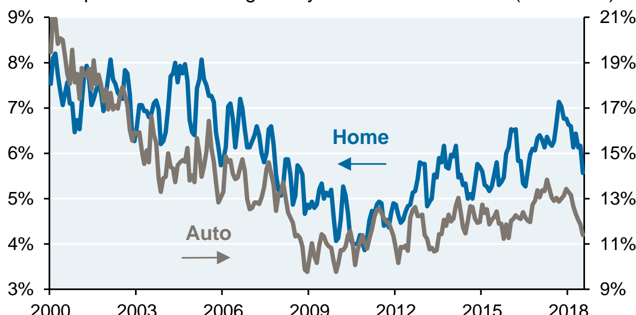


Source: JPMAM, Washington Post, US Federal Reserve, Bloomberg. 2017.

[6] When **Nixon** was reviewing the evidence against him during the investigation, the Secret Service disabled the "erase" button on his recorder, and as additional measure, provided tapes that were duplicates of the originals.

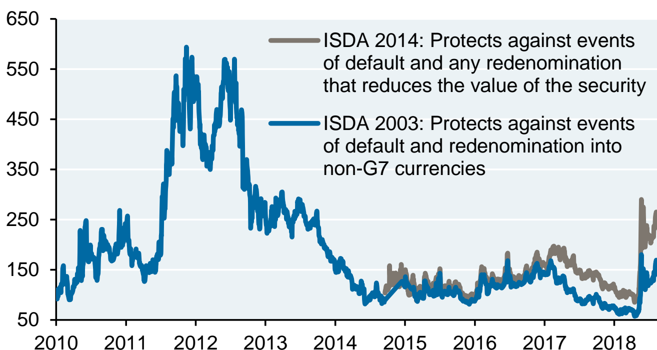
- ***Rate increases by the Fed***. J.P. Morgan expects 6 rate hikes by the end of 2019, which if implemented, would finally re-establish a positive cost of money in real terms. The small rise in interest rates so far has already impacted demand for housing and autos, (chart, right). If JP Morgan is right, there's potential for market disappointment given just 3 Fed hikes priced in by the futures market. Trump has been critical of the latest Fed moves, but has not (yet) resorted to the crude interventions that President Nixon visited upon poor Arthur Burns in the early 1970's[7].

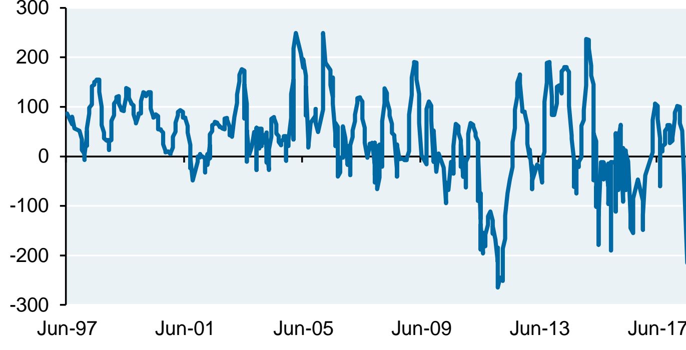




- ***Italy vs the Eurozone***. Italy's new government is looking for fiscal breathing room from Brussels, and denies any interest in "**Europartenza**" (a word I made up which refers to an Italian departure from the Eurozone). Italy is looking for 6% fiscal *expansion* while Eurozone rules call for fiscal *contraction* in Italy given the size of its debt. Even if the Eurozone allows expansion, there's a risk it doesn't work: Lombard Research estimates Italy's fiscal multiplier at just 0.5 and a best-case growth rate of 1.5% in 2019 ["*Italy Autumn Heatwave Warning*", TS Lombard, August 22, 2018].

  The risk of a market scare is always present in Italy, whose growth rate since 1988 is the lowest in the developed world (even worse than Japan), and whose citizens register the lowest support for the Eurozone (58%) of any member. As a result, we're tracking the rising cost of protecting against Europartenza and Italy's net debt outflows, which spiked again this year (see charts below). The most likely outcome is a compromise and limited risk for global investors; we will know more by October when Italy submits its budget to the European Commission.





[7] When Fed chairman Arthur Burns resisted pressure from **Nixon** to guarantee full employment during the 1972 Presidential campaign, the White House planted negative stories about Burns in the press. Nixon's people also floated stories about diluting the Fed Chairman's power by doubling its Board's members. Nixon wrote to Burns: "There is no doubt in my mind that if the Fed continues to keep the lid on with regard to increases in money supply and if the economy does not expand, the blame will be placed squarely on the Fed." In 1971, H.R. Haldeman spoke about the effectiveness of Nixon's strategy: **"We have Arthur Burns by the [expletive] on the money supply".**

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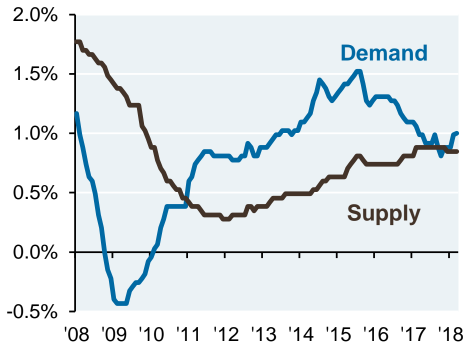
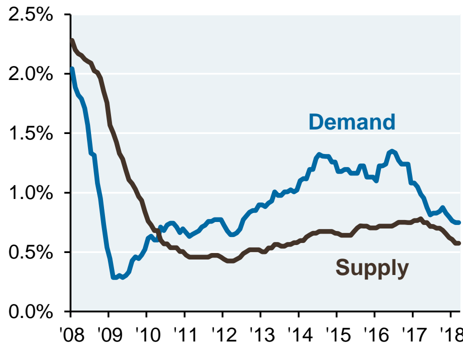
US commercial real estate golden era gradually ending

One last topic. The last decade has been stellar for US commercial real estate: low interest rates, tight credit spreads and demand for office, retail and industrial space that consistently outstripped new supply. Supply-demand dynamics have shifted in recent months, such that demand is now roughly equal to supply. When combining these trends with rising interest rates and the risk of rising spreads, I would not be surprised to see plenty of commercial property supply coming online over the next year.

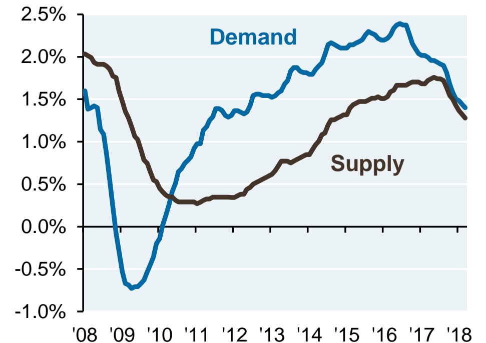
Office
Percent change



Retail
Percent change



Industrial
Percent change, %



Source: Bridgewater Associates. July 6, 2018.

Michael Cembalest
JP Morgan Asset Management

Hydrocynus vittatus

R. insisted on going to Northwest Zambia near the Angolan border to catch the aptly named African tigerfish for our 25th anniversary. It was a **fantastic** idea.

African tigerfish, Lukulu, Zambia August 2018

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