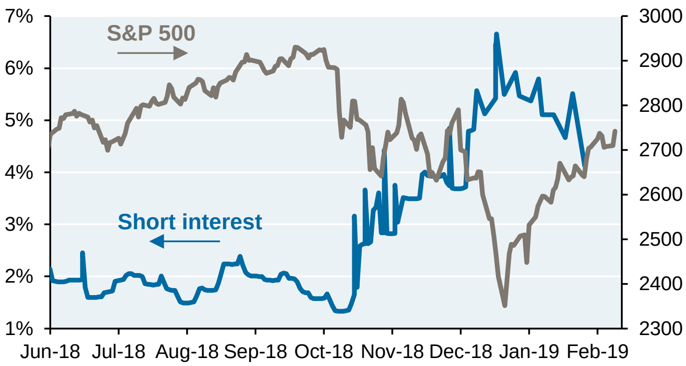
Topics: the market rebound from December lows, next steps in the China-US rivalry, a question for Marco Rubio, and some charts for New Yorkers

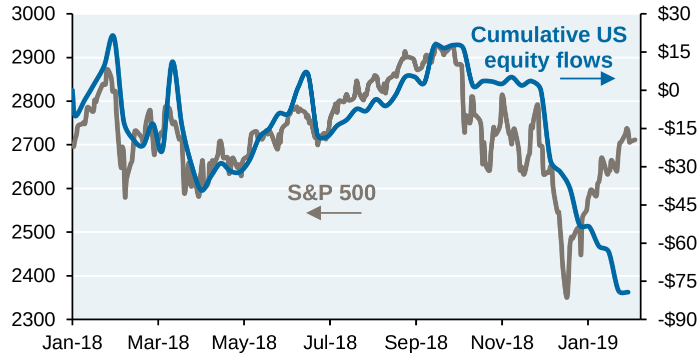
Short people. At 8 am on December 26th, we sent out a "Bear Market Barometer" that highlighted how stock and bond valuations had fallen well below median vs history, and that in the past, markets typically rallied after such sudden declines. We wrote that investor pessimism was priced in, and that late December prices offered good value for long-term investors, particularly given the surge in "fast money" accounts shorting equities in the days before Christmas in very thin markets. As you can see in the first chart (based on data from our Prime Brokerage business), **as the shorts have been covering, equities rebounded quickly**; more quickly, in fact, than after any prior post-war bear market. The second chart reinforces the lack of any "real money" participation in the rally so far, which is remarkable. The third chart illustrates how stock and corporate bond valuations are now around median, following the highs and lows of 2018.

Mirror images: as the shorts cover, equity market rallies



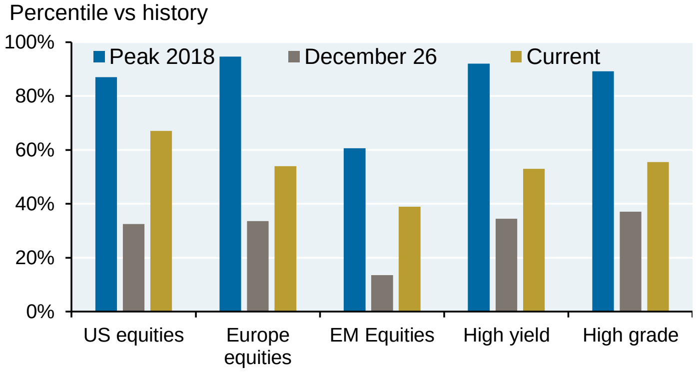
Source: J.P. Morgan Global Market Strategy, Bloomberg. February 2019.

S&P 500 rebound not accompanied by real money flows
Index Level US$ bn, since Jan 2018



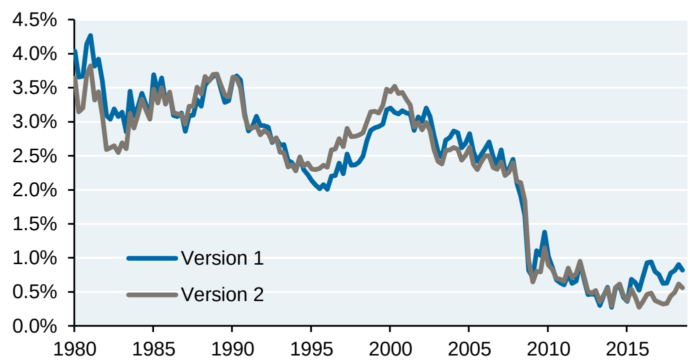
Source: EPFR, Bloomberg. February 2019.

Valuations for stocks and corporate bonds
Percentile vs history



Source: Bloomberg, JPM Global Index Research, Datastream, JPMAM. February 11, 2019.

Fed models suggest that equilibrium policy rates might only need to be 50-100 bps over inflation



Source: Holston-Laubach-Williams, Federal Reserve Bank of NY. Q3 2018.

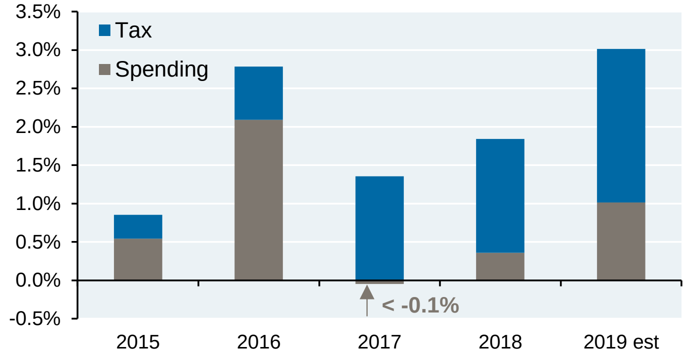
A lot of additional market support now comes from the Fed, which brought its hikes to an end and is apparently prepared to wait and see what happens. I ascribe this newfound Fed patience to a combination of (a) wonky Fed research shown above which suggests a decline in the required real rate of interest to something like 50-80 bps, and (b) excessive Fed fear of market gyrations/harassment by the President. Real Fed policy rates are still slightly below its modeled equilibrium levels, and if labor markets continue to firm (US job openings hit an all time high in December), the Fed will face some tougher choices later in 2019. We think one more hike is coming.

We also cited a technical reason for a market rebound: the shrinking universe of publicly traded equities. This kind of technical backdrop doesn't prevent the market from declining, but does contribute to favourable conditions after a selloff when large institutional investors rebalance.

A proxy for US equity supply
S&P 500 Index Divisor

Source: J.P. Morgan US Equity Strategy. October 18, 2018. Reflects primary and secondary issuance, buybacks, M&A activity, de-listings, etc.

More China fiscal stimulus on the way
% of GDP



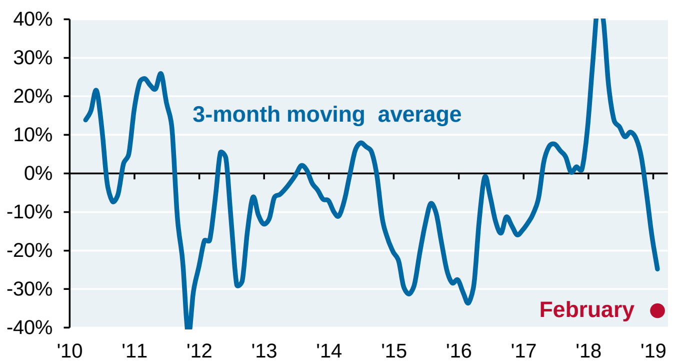
Source: Cornerstone Macro, February 11, 2019.

We also expect a positive market bump from more China fiscal stimulus, and any agreement that postpones or cancels the imposition of 25% tariffs on $200-$460 bn of Chinese imports, even as the US pursues its strategic rivalry with China in a different manner (see page 3). After that, the equity rally may pause, given uncertainties around possible tariffs on European and Japanese auto/parts exports, and slowing corporate profit momentum. As shown below, leading indicators for US earnings and earnings breadth are weakening. It's possible that the S&P will experience slightly negative earnings growth in 2019 vs 2018, with the low quarter in Q2.

Earnings rising through 2018, but earnings leading indicators forecast little to no earnings growth in 2019

Source: Morgan Stanley Research. 2019.

S&P 500 earnings revisions
# of positive revisions less negative revisions as % of total companies



Source: IBES, JPMAM. February 2019.

Bottom line: we're not making any major changes to our recommended investment strategy for 2019, which entails normal allocations to risk. The December selloff was a very good time to put money to work, and markets have rallied substantially since then, bringing valuations back to roughly median. We do not see significant risks of US recession this year, but expect earnings growth to slow sharply from its 2018 pace as US GDP growth slows to 2% by the end of the year. However, a dovish Fed and China stimulus may end up pushing valuations back up towards 2018 highs, despite whatever destabilizing implications such policies may have in the long run, in which case equity investors would continue to earn positive returns through the end of 2019. As stated in the Outlook, we prefer Emerging Markets to Europe as a deep value opportunity; our frequently discussed US-EM equity overweight vs Europe-Japan is outperforming *again* this year. If the trend holds, it would be the 10th out of the last 13 years to do so.

Next steps in the China-US rivalry: more aggressive use of export controls

The US is preparing much more aggressive use of export controls to deny Chinese firms access to US technology. These controls restrict sales across borders, including by companies in other countries whose products include US components. Even transfer of information to foreign nationals can be considered "**deemed exports**"; in other words, Chinese nationals working in the US for US tech companies may have to be segregated from projects related to "emerging" and "foundational" technologies as defined by the Department of Commerce. Proposed examples: biotech, neurotech, advanced computing, machine learning, robotics, hypersonics, advanced materials and surveillance, etc.

Based on Export Control Reform Act (HR 5040), Gavekal Dragonomics Research

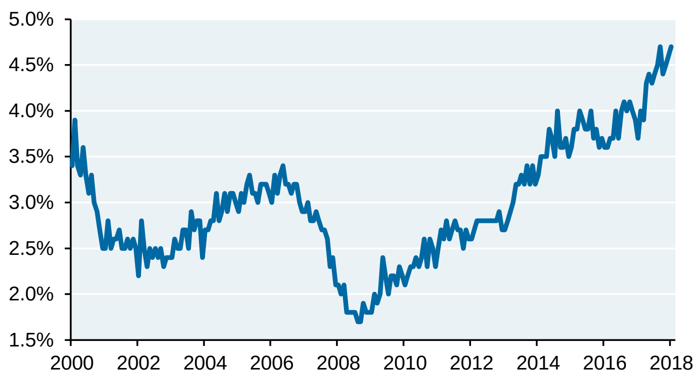
A question for Marco Rubio

"*When a corporation uses profits for stock buybacks, it's deciding that returning capital to shareholders is better for business than investing in their products or workers*"

Marco Rubio, December 2018

The question is rhetorical, but here goes. Marco Rubio has proposed changing US tax laws so that every time a company buys back stock, an imputed dividend would be received by all shareholders, which would be taxed at whatever rate their dividends happen to be taxed at[1]. The underlying presumption is that companies buy back stock instead of hiring people and investing in plant/equipment, so the government should discourage buybacks to promote employment and investment. Let's leave the corporate finance arguments aside for a moment (although most economists I know say that companies have every incentive to grow, particularly given the cut in corporate tax rates). More practically, **just what data is Senator Rubio looking at which indicates weakness in hiring or in capital spending?** The US just recorded the largest number of US job openings on record in December, and as shown on the right, all major categories of US non-residential investment are growing, many at a faster pace than before 2016 given the post-election change in the regulatory environment, and DESPITE a trade war which the GOP in the Senate has done little to effectively deter. Just asking.

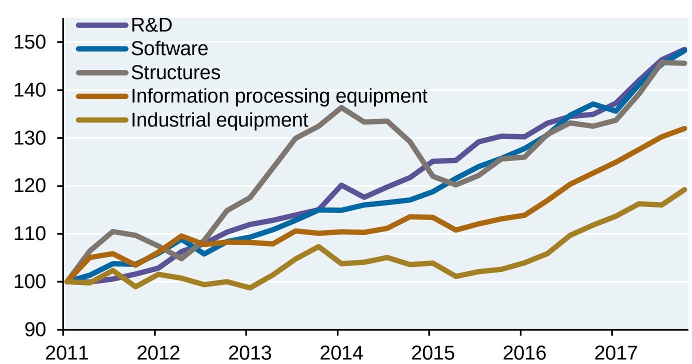
Job openings rate



Source: Bureau of Labor Statistics. December 2018.

US fixed investment

Index, Dec 2011 = 100, with data through Q3 2018



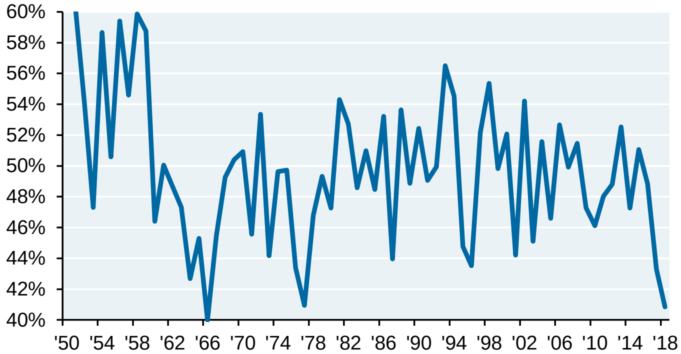
Source: Bureau of Economic Analysis. Q3 2018.

[1] Most dividends are taxed at 20% plus the 3.8% ACA tax. Dividends can be taxed as ordinary income if the position is hedged, or if the holding period is too short. On the broader issue of taxation and income/wealth redistribution, we wrote an *Eye on the Market* on the subject in late January in case you missed it.

New York: not such a wonderful town, for sports fans

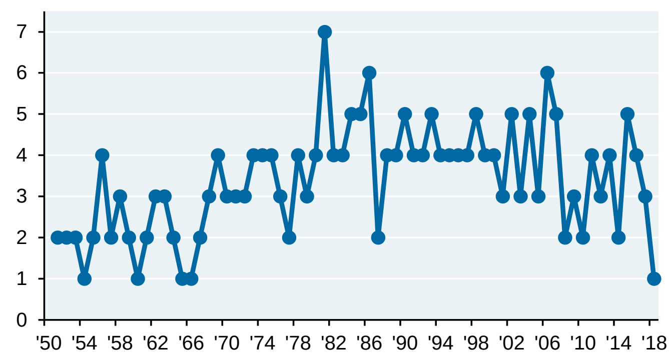
I presented our market outlook with Mary at our Investor Summit in Miami last week, and saw some successful sports team owners and athletes in attendance. It then dawned on me that it has been a very tough stretch for NY sports fans, even for the ones like myself who are not picky and root for all of the state's major professional teams. I pulled some data together to see if the performance drought in 2017-2018 was as bad as I had suspected, and it was. Since 1950, the NY sports team winning percentage has only been lower one time (in 1966-67[2]), and the recent collapse in the number of NY teams appearing in the playoffs is the worst since the 1950's and 1960's, before the Nets and Islanders even existed, and when the Mets and Jets were still expansion teams.

Average winning percentage of NY sports teams



Source: Sports Reference LLC. 2018. Teams included are: Mets, Yankees, Knicks, Nets, Jets, Giants, Bills, Rangers, Islanders.

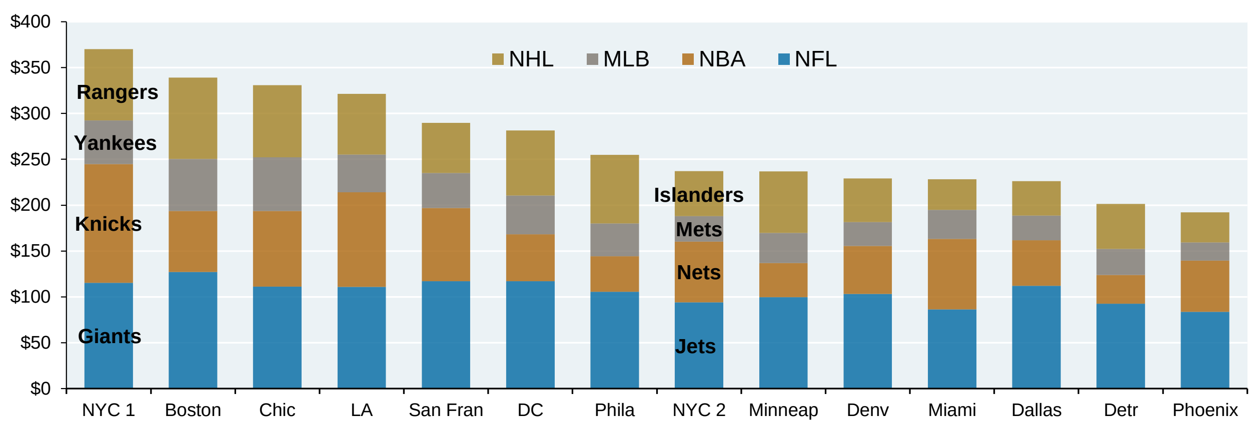
Number of playoff appearances, NY sports teams



Source: Sports Reference LLC. 2018. Teams included are: Mets, Yankees, Knicks, Nets, Jets, Giants, Bills, Rangers, Islanders.

How much are New Yorkers paying to see this kind of performance? A lot or around average, depending on which permutation of NY teams you're talking about.

Daily ticket price package for 4-sport cities



Source: Statista/Team Marketing Report, JPMAM. 2018. Seat pricing refers to general seating purchased from team distributors directly.

Michael Cembalest
JP Morgan Asset Management

[2] **1966**. New York Giants quarterback Earl Morrall led the Giants to a 1-12 season in which they set a league record for points surrendered. The Yankees finished in last place for the first time since 1912. On Sept 22nd, paid attendance at Yankee Stadium was 413 people. WPIX announcer Red Barber said "I don't know what the paid attendance is today, but whatever it is, it is the smallest crowd in the history of Yankee Stadium, and this crowd is the story, not the game". A week later, his contract was not renewed.