Topics: Delta variant; the Fed as firefighter and arsonist; US-China economic divorce picks up steam; a unified theory of the US, China, wages, inflation, the WTO, opioids and investment portfolios for 2022 and beyond

COVID and Thy Brother's Keeper

"*If you've ever desired a vacation on a ventilator in the ICU, then not getting vaccinated is probably for you*"
Craig McCoy, former paramedic and president of Mercy Springfield Communities Hospital, Springfield Missouri

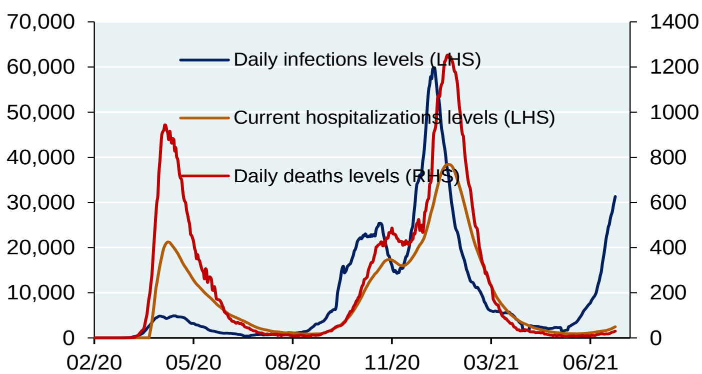
I led an internal discussion recently on the Delta variant for our asset management business. The details can be found in Section 1 on our virus portal **here**. Main messages: while the Delta variant has caused a small number of breakthrough hospitalizations and deaths for vaccinated people, the main risks overwhelmingly affect unvaccinated and immunocompromised people with no or insufficient antibody responses. From an investor's perspective, developed world equities should be able to withstand the Delta variant; a chart we added on economic throw-weight (trade, FDI and portfolio flows), vaccination and mortality by country explains why.

One important chart to watch is the first one from the UK: so far, a large spike in Delta infections has not led to a surge in overall hospitalization or mortality. **However, this masks what's happening to unvaccinated people over 50 in the UK: 14% of such Delta infections ended up in the hospital and almost 4% died**[1], figures which are 4x higher than for vaccinated people over 50. The good news: in the UK, 96% of people over 50 are vaccinated, reducing the size of its at-risk unvaccinated population. However, in the US age 50+ vaccinations are ~75% nationwide (lower in many rural counties), resulting in larger populations of at-risk people; and in hotspot states (AR, FL, LA, MO, NV, WY), hospitalizations are rising more rapidly than in the UK.

Even so, my primary message to the group was that the US reopening train has left the station and that the Delta variant is unlikely to have a durable impact on US equity markets. Federal and local governments are unlikely to reimpose mobility restrictions to protect a cohort that is mostly unprotected by its own volition. The policy borrows from Genesis 4:9: "**you are not thy brother's keeper if he chooses to expose himself to COVID**", irrespective of whatever his reasoning may be. A February NYT article[2] described how younger generations are bearing unacceptable sacrifices to protect older ones. I doubt the NYT would have published this while Trump was President, for fear of being seen as aligning itself with his Administration's views. But with a new administration in DC, I suppose it's safer to make one's intergenerational prosperity preferences clearer.

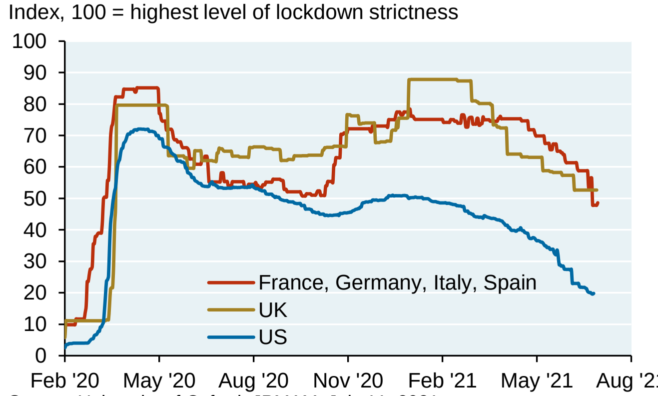
Charts: 96% vaccination rate of people over 50 explains the gap between UK infections and deaths; in the US, the reopening train has left the station irrespective of Delta variant outbreaks

United Kingdom



Source: JHU, IMF, OWID, JPMAM. Jul 11, 2021. 7 day smoothing.

Lockdown stringency index: US, UK and Europe
Index, 100 = highest level of lockdown strictness



Source: University of Oxford, JPMAM. July 11, 2021.

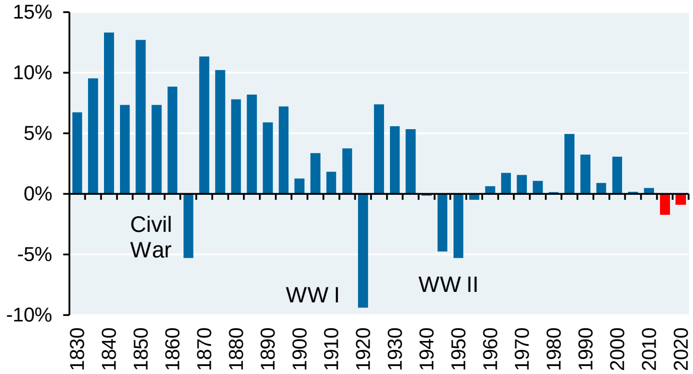
[1] *"The Delta variant in the UK: how is it going?"*, David Mackie, J.P. Morgan Economic Research, July 6, 2021. See Table 3 for all the Delta impact data by vaccination status and age.

[2] https://www.nytimes.com/2021/02/14/world/europe/youth-mental-health-covid.html

The Fed as firefighter and arsonist at the same time

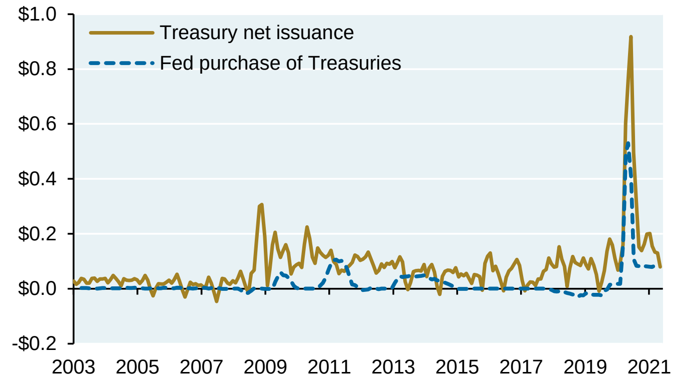
I read something recently which referred to the Fed as both firefighter and arsonist. That's a good description: resuscitating private sector demand while simultaneously destroying decades of underwriting and investment discipline in the process. The firefighting resources the Fed is using: the easiest monetary policy in US history other than during wartime; and a symbiotic relationship with the US Treasury which now entails the Fed buying the entire stock of net Treasury issuance. You have to see it to believe it.

Lowest real yields on cash since 1830, other than during wartime, T-bill/Funds rate less inflation, 5-year average



Source: FRB, Robert Shiller, GFD, BLS, JPMAM. December 2020.

Fed Treasury purchases covering net issuance
US$, trillions, 3 month average



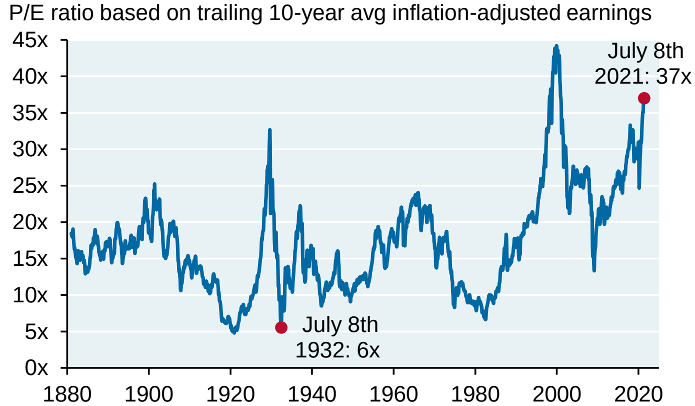
Source: Bloomberg, SIFMA. May 31, 2021.

During the March 2009, 2012 and 2020 selloffs, the right question to ask was "what could go right". When markets reach all-time highs and are close to the highest valuations on record (as they are now), the right discipline is to focus on risks as well. The US and global economy are set for a powerful recovery as pent-up corporate and household demand is unleashed. In the US, for example, household debt service ratios are close to *the lowest levels in 40 years*, suggesting a sustainable expansion in consumption. Even so, markets are pricing a lot of that in. As the world resets closer to trend growth in 2022, I envision modestly higher inflation in which industrials, energy, financials and other reflation plays outperform; and a market in which earnings growth drives equity returns, rather than rising valuations.

S&P 500 price / earnings ratio
Price / forward 2 year earnings per share

Source: Bloomberg, J.P. Morgan. July 8, 2021.

S&P 500 cyclically adjusted P/E ratio,
P/E ratio based on trailing 10-year avg inflation-adjusted earnings



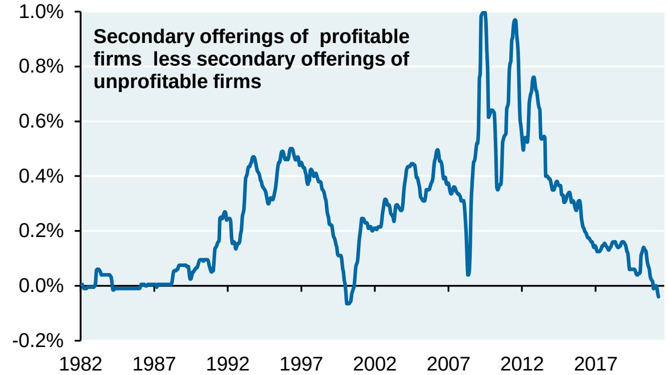
Source: Robert Shiller. July 2021.

In any case, here are some ashes that can be laid in part at the doorstep of the Fed and its policies: a collapse in the spread on high yield bonds, a locust-like scourge of secondary equity offerings from unprofitable companies, a rise in the market cap share of unprofitable companies, a surge in home prices and perhaps most concerning, **a collapse in loan underwriting standards**. **Even when compared to the free-wheeling credit environment of 2007, lenders have discarded any discipline they used to have** regarding covenants, restricted payments clauses, protections against layering and subordination, mandatory payments from asset sales, etc. This kind of thing is never a problem until you hit the bumpier part of the business cycle.

US corporate high yield bond index
Spread over 10-year treasury

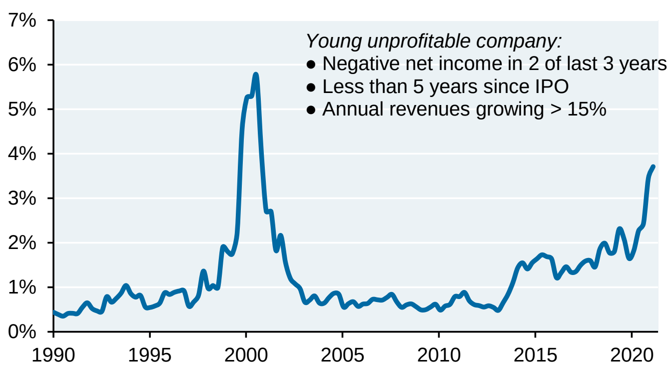
Source: Bloomberg. June 2021.

Unprofitable companies have flooded the market
Net secondary offerings as % of US stock market



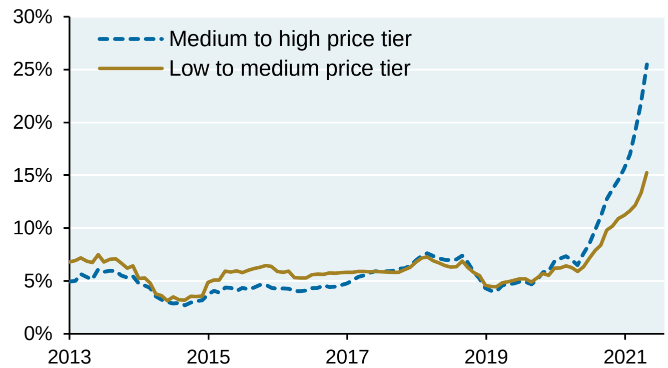
Source: Sundial Capital Research, Bloomberg. June 26, 2021.

Market cap of young unprofitable companies
% of total market cap



Source: Factset, J.P. Morgan Asset Management. Q1 2021.

US home price appreciation index
y/y change

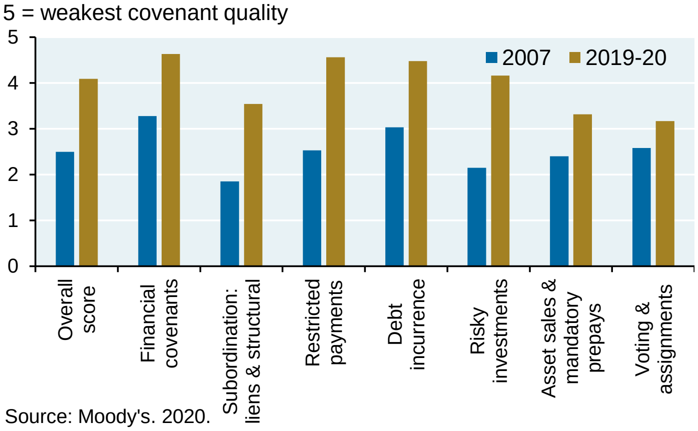


Source: American Enterprise Institute. May 2021.

Loan investors waving the white flag: Moody's loan covenant quality score, 5 = weakest covenant quality

Source: Moody's. 2020.

Loan covenant quality scores: 2007 vs 2019-2020
5 = weakest covenant quality

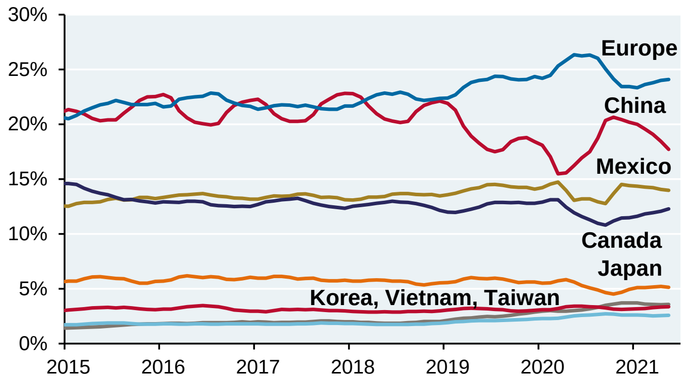


Source: Moody's. 2020.

US-China economic divorce picks up steam, but is that what's negatively affecting Chinese tech stocks?

The 25% decline in Didi's stock has refocused investors on the US-China economic divorce. However, it's important to understand that there's still plenty of normalcy in the US-China economic relationship. China's share of US imports is only modestly below 2018 levels, US stocks exposed to the trade war are doing fine vs the market, US semiconductor exports to China are still rising despite Huawei, US investors continue to accumulate more Chinese stocks and bonds, and unlike Russia, China has not engaged in economic warfare via its US Treasury holdings. Only bilateral FDI flows appear to be suffering from changes in national security policy.

Trade war impact on US import counterparties
Share of US imports, 6 month average

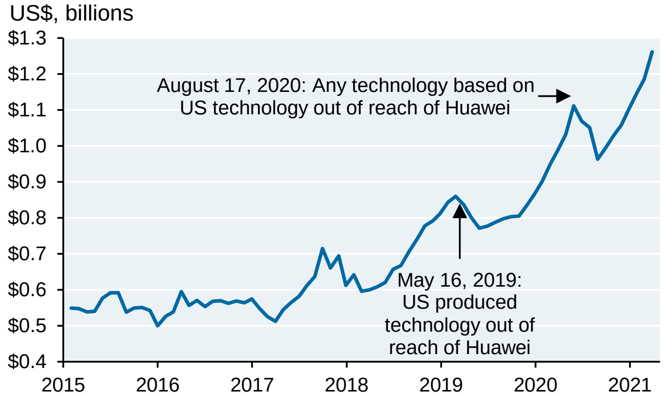


Source: US Census Bureau. May 2021.

Relative performance of US companies with high exposure to US-China trade war vs S&P 500, Jan 2018 = 100

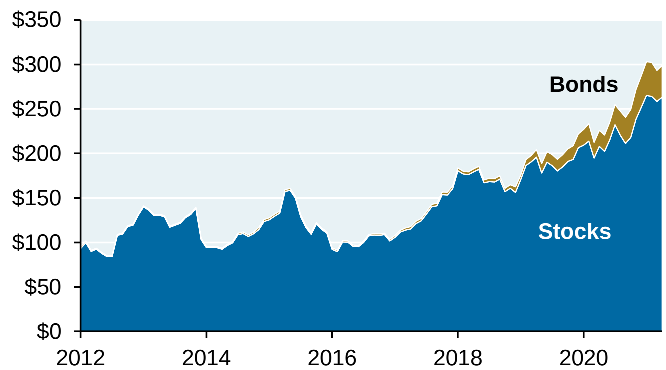
Source: Barclays Research, Bloomberg, JPMAM. July 9, 2021.

US semiconductor exports to China
US$, billions



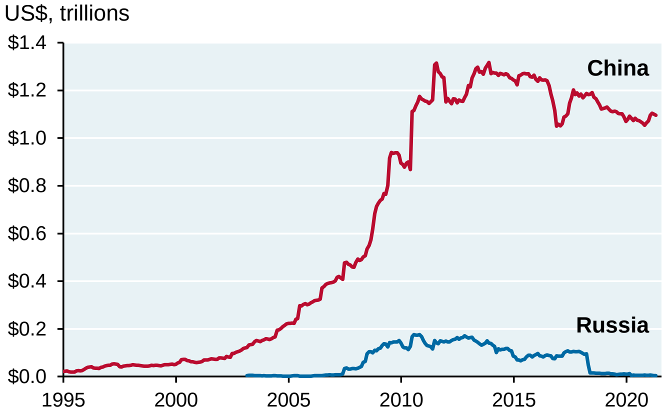
Source: US Census Bureau. May 2021.

US holdings of Chinese stocks and bonds
US$, billions



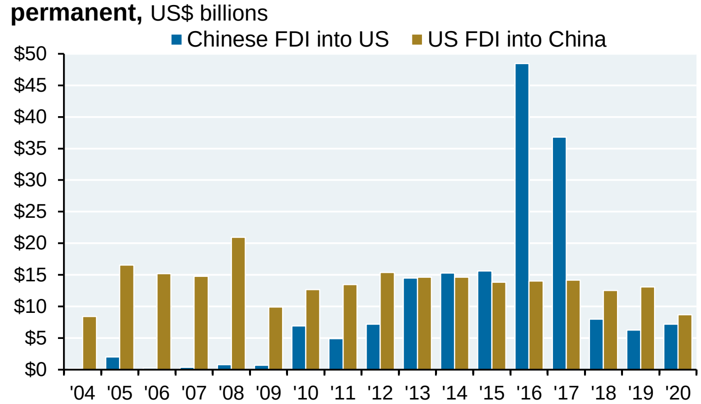
Source: US Treasury. April 2021.

Ownership of US Treasuries
US$, trillions



Source: US Treasury. April 2021.

Decline in bilateral foreign direct investment may be permanent, US$ billions



Source: Rhodium Group. 2020.

That said, the Biden administration has unleashed an alphabet soup of China-targeted policies:

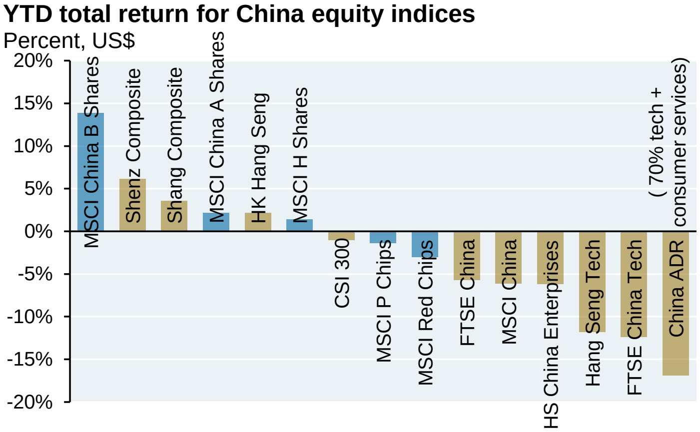
> **Executive Orders** restricting China's access to US sensitive data via consumer apps and restricting US investment in Chinese companies affiliated with its military; **Holding Foreign Companies Accountable Act** (de-listing of Chinese companies non-compliant with SEC data requirements); **CHIPS Act and 5G Emergency Appropriations** ($ for US semiconductor companies); **Endless Frontier Act** ($ for STEM R&D); **Strategic Competition Act** (CFIUS oversight of mergers and gifts by Chinese entities to US institutions); **Homeland Security and Governmental Affairs Committee Provisions** ("Buy America" requirements for iron and steel in US infrastructure projects); **Meeting the China Challenge Act** (sanctions for cyberattacks, IP theft and economic espionage); **Uyghur Forced Labor Prevention Act** (sanctions on US and Chinese companies knowingly using forced labor or conducting surveillance)

China's possible partnership with the Taliban in Afghanistan won't play well in DC either. Even so, many US initiatives are meant to boost US competitiveness and only a couple target Chinese companies in the MSCI China index, and usually impact smaller ones. **In fact, the largest risks facing Chinese tech stocks and ADRs come from China rather than the US.** Chinese regulators have implemented guidelines aimed at curbing monopolistic practices, limiting lax underwriting activities, policing data privacy, censoring content, addressing worker mistreatment and reforming entire industries like fintech and education. While the *timing* of enforcement actions on Didi suggest that there's a message to US politicians in there as well, domestic policy concerns were the driving factor behind China's decision to order mobile stores to remove Didi's ride-hailing app.

On top of all that, **China just proposed new rules to require companies with more than 1 million users seeking to list in foreign countries to undergo a cybersecurity review** due to the risk that data and personal information could be "affected, controlled, and maliciously exploited by foreign governments". This review will look into possible national security risks as well.

Whether new risks facing Chinese tech stocks are due to the US-China policy war or to Chinese domestic policy actions, large Chinese tech stocks now face hurdles that suggest the need for lower valuations than their US counterparts (they now trade at roughly the same level, as illustrated below).

YTD total return for China equity indices
Percent, US$



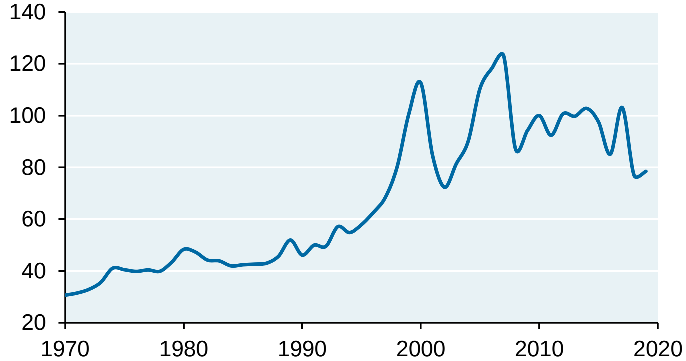
Source: Bloomberg. 7/8/2021. Blue: MSCI subcomponent. Gold: index.

US and China tech valuations
Price / forward 2 year earnings per share

Source: Bloomberg. July 9, 2021.

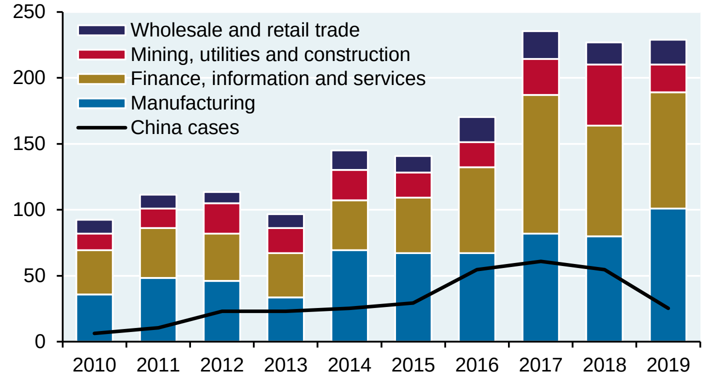
I don't think Biden's China agenda has the capacity to derail China's economy from whatever trajectory it's on. That said, a decline in globalization and a rise in US national security enforcement argue for slightly higher inflation in the years ahead, which we discuss next.

Globalization index, Index of global trade, portfolio flows and foreign direct investment as % of global GDP, 2010 = 100



Source: World Bank, IMF. 2019.

US Committee on Foreign Investment actions
Number of CFIUS notices and investigations

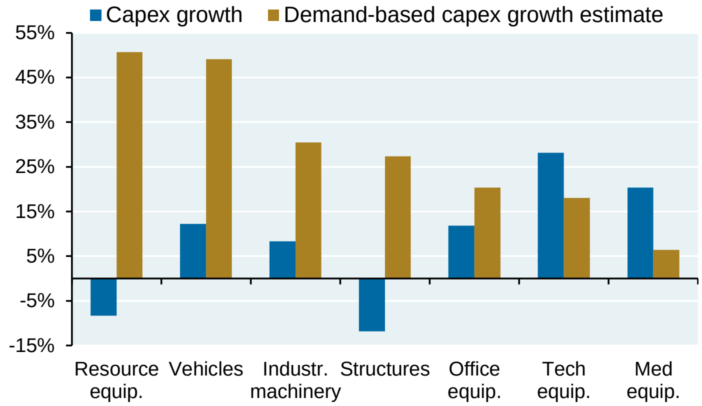


Source: J.P. Morgan Economic Research. July 2021.

The Pig and the Snake: a unified theory of the US, China, wages, jobs, inflation, opioid use, the WTO and investment portfolios for 2022 and beyond

The US economy is booming: capital spending and hiring tailwinds should last a few more months at least. There are some wacky inflation readings on the high side, but most professional economic forecasters and market-based inflation expectations are looking past them (the spike in used car prices is one example).

US leading indicators point to a lot more capital spending

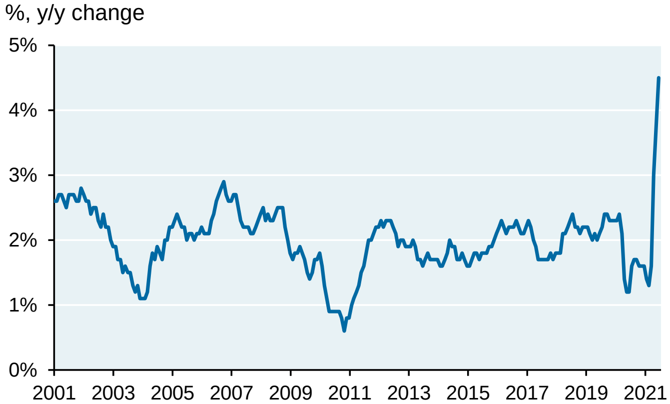


Source: Bridgewater. May 26, 2021.

US CEO hiring plans
Index, 50+ = increased hiring expectations

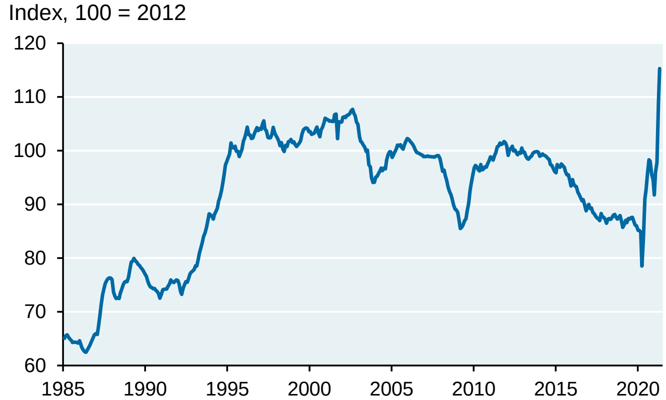
Source: Bloomberg. June 2021.

Core consumer price index
%, y/y change



Source: Bloomberg. June 2021.

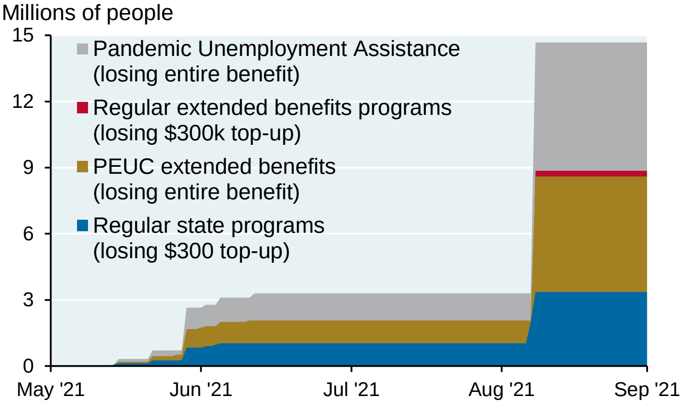
Used car prices
Index, 100 = 2012



Source: BEA. May 2021.

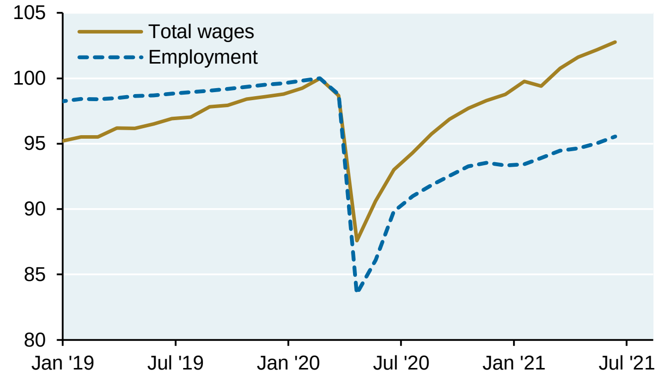
On goods, services and commodity prices, I think benign inflation expectations for 2022 are right. In a few months, the pig will move through the snake and these price measures should be within the Fed's comfort zone. **However, I'm less convinced about wage inflation.** There's a lot riding on the assumption that expiration of COVID unemployment benefits this fall will loosen tight labor markets. Perhaps it will. **But the exhibits below show a lot of momentum beyond COVID unemployment payments**: price hike intentions outstripping wage hikes, wages rising faster than employment, the highest number of "hard to fill" job openings and wage increases on record, more people who don't want a job vs people who do, and a high "reservation wage" reflecting the cost of luring employed and unemployed persons to new jobs.

Workers losing federal unemployment benefits
Millions of people



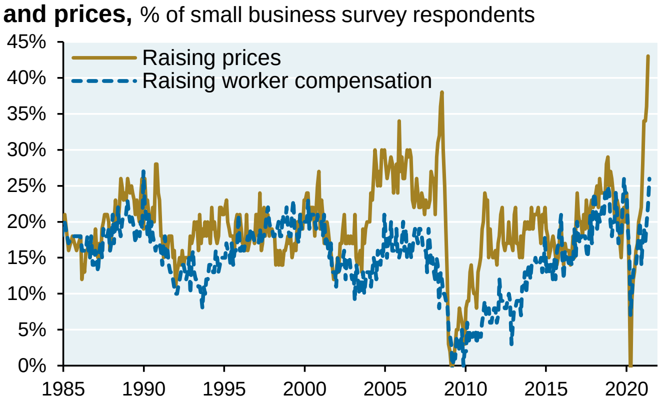
Source: GS. June 2021.

Total private employment vs wages
Index (100 = Feb 2020)



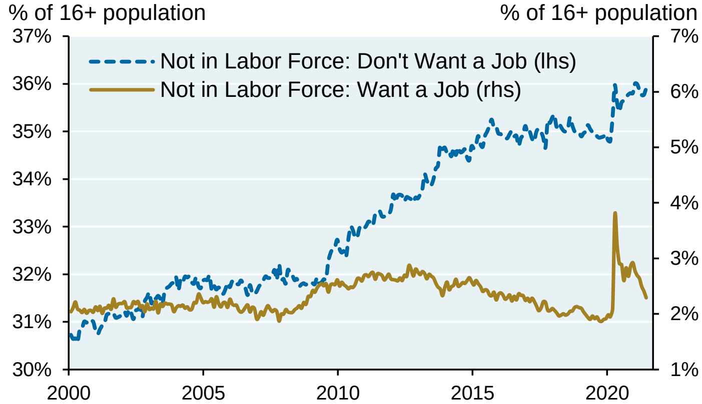
Source: BLS, JPMAM. June 2021.

Small businesses planning to raise worker compensation and prices, % of small business survey respondents



Source: Bloomberg, NFIB. June 2021.

Not in labor force: want a job vs don't want a job
% of 16+ population
% of 16+ population

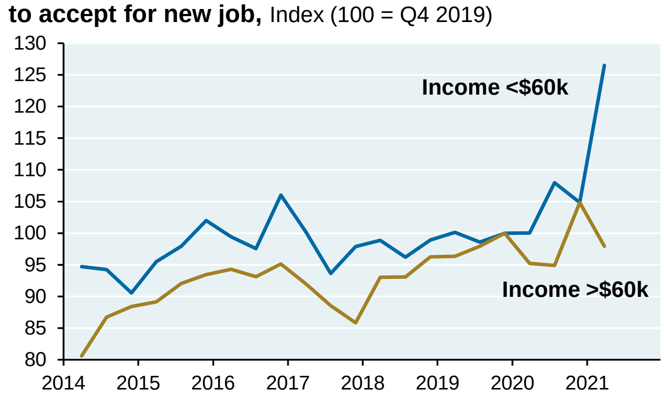


Source: BLS, JPMAM. June 2021.

Small businesses with "hard to fill" job openings
% of small business survey respondents

Source: Bloomberg, NFIB. June 2021.

"Reservation wage": lowest wage respondents are willing to accept for new job, Index (100 = Q4 2019)



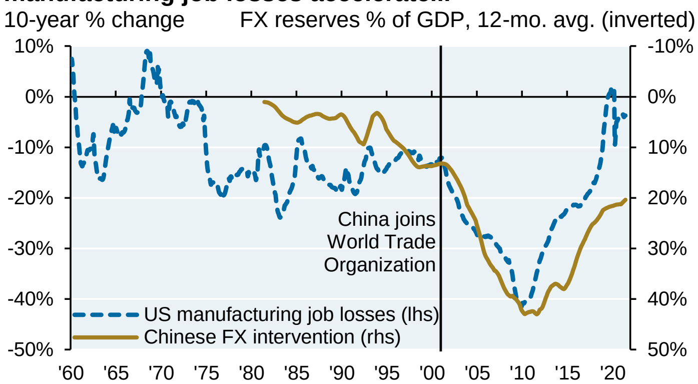
Source: Federal Reserve Bank, JPMAM. March 2021.

To be clear, rising wages are a positive development for the US economy but there are levels at which the Fed's zero rate policy becomes inconsistent with them. **To bring the whole US-China-wage-inflation discussion full circle consider the following, illustrated below**:

- In 2001, the West allowed China into the World Trade Organization…
- After which China immediately launched a massive and unprecedented intervention in its currency markets to prevent appreciation and boost its manufacturing and export shares….
- Which allowed China to mount the greatest economic boom in post-war history…
- Flooding the US with cheap goods (the US import price index from China is at the same level as in 2004)…
- But which contributed significantly to an acceleration of US manufacturing job losses…
- And a collapse in the US of the share of gross profits accruing to labor vs capital…
- Whose aftershocks include the opioid epidemic, rising polarization and growing wealth inequality

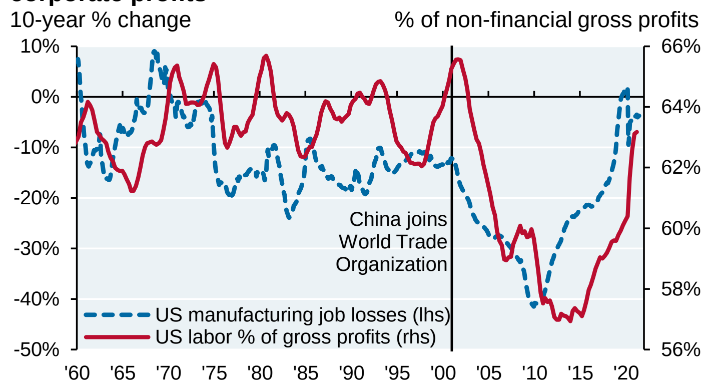
With wages now rising, the US labor share of profits is finally getting closer to its post-war average, something the Fed will be VERY reluctant to interfere with. As a result, if wage pressures remain my guess is that the Fed will not do much at first, creating more reasons to favor reflation strategies in portfolios in 2022 and beyond.

After China joins the WTO, its FX intervention rises and US manufacturing job losses accelerate...



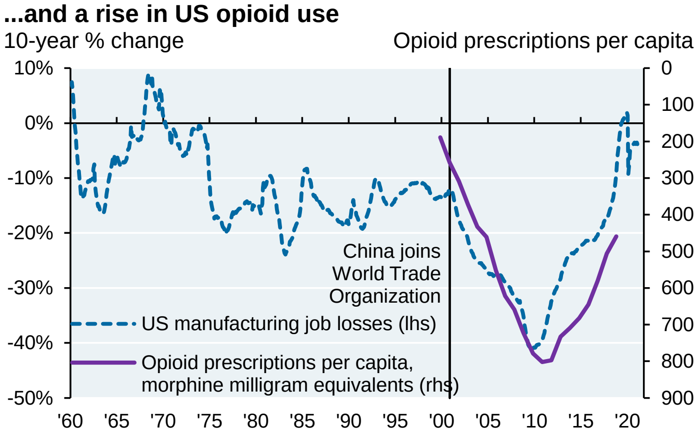
Source: BLS, IMF, People's Bank of China, JPMAM. June 2021.

...coinciding with a sharp decline in US labor's share of corporate profits



Source: BLS, BEA, JPMAM. June 2021.

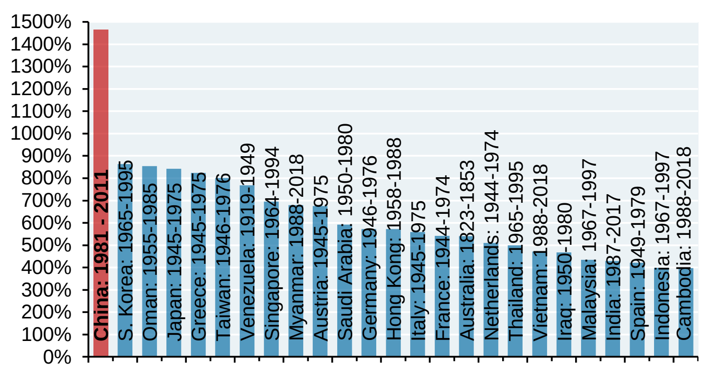
...and a rise in US opioid use



Source: BLS, Stanford SIEPR, CDC, JPMAM. March 2021.

China's economic transformation in context

Largest 30 year increase in real per capita GDP by country



Source: JPMAM, University of Groningen, Conference Board. 2021.

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