

Too Long at the Fair

Ubiquis
61 Broadway – Suite 1400 – New York, NY 10006
Phone: 212-346-6666 ♦ Fax: 888-412-3655

Too Long at the Fair

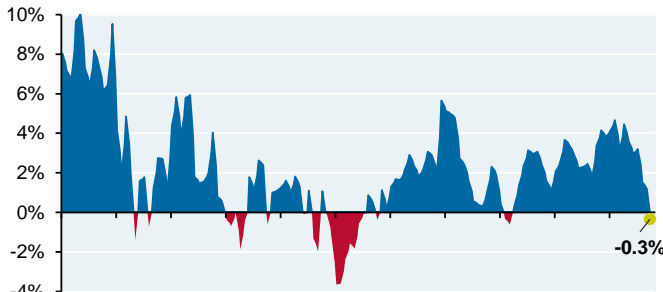
[START RECORDING]

FEMALE VOICE: This podcast has been prepared exclusively for institutional wholesale professional clients and qualified investors only, as defined by local laws and regulations. Please read other important information, which can be found on the link at the end of the podcast episode.

MR. MICHAEL CEMBALEST: Good morning, everybody, and welcome to the May 2023 Eye on the Market podcast. This one's called Too Long at the Fair. I have recommended to clients for well over a decade, actually since 2009, that they should overweight the United States and emerging markets and underweight Europe and Japan in their regional equity allocations. The excess returns from that kind of strategy, if implemented, have been enormous. But the time has come to retire this barbell for a while. I stayed too long at the fair, and I should've made this recommendation to put the barbell aside a few months when Europe was trading at a massive 35% P/E discount to the US. And a slightly brighter picture in Japan relative to China is another reason why it's time to put this barbell aside.

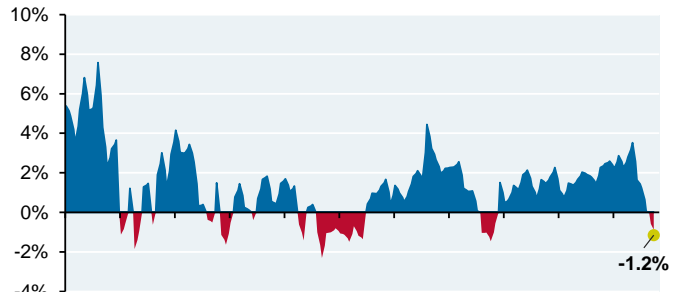
So this month's Eye on the Market goes into the detail; we have some charts. The barbell has actually done extremely well since 1988. It's been 30 years that investors have benefitted from overrating the United States and emerging markets versus Europe and Japan. Most of that benefit has come from overweighting the US over Europe. The EM versus Japan thing has been profitable, but smaller and kind of hit-or-miss over the last decade or so. And we have some charts in here that kind of illustrate that.

Overweight US & EM, underweight Europe & Japan
3-year rolling out (under) performance vs MSCI All World Index



Source: Bloomberg, JPMAM. May 2023. All equity portfolio, rebalanced quarterly. O/W US by 10%; U/W EUR by -10%; U/W JPN by -5%; O/W EM by 5%. Assumes no currency hedging.

Overweight US & EM, underweight Europe & Japan
2-year rolling out (under) performance vs MSCI All World Index

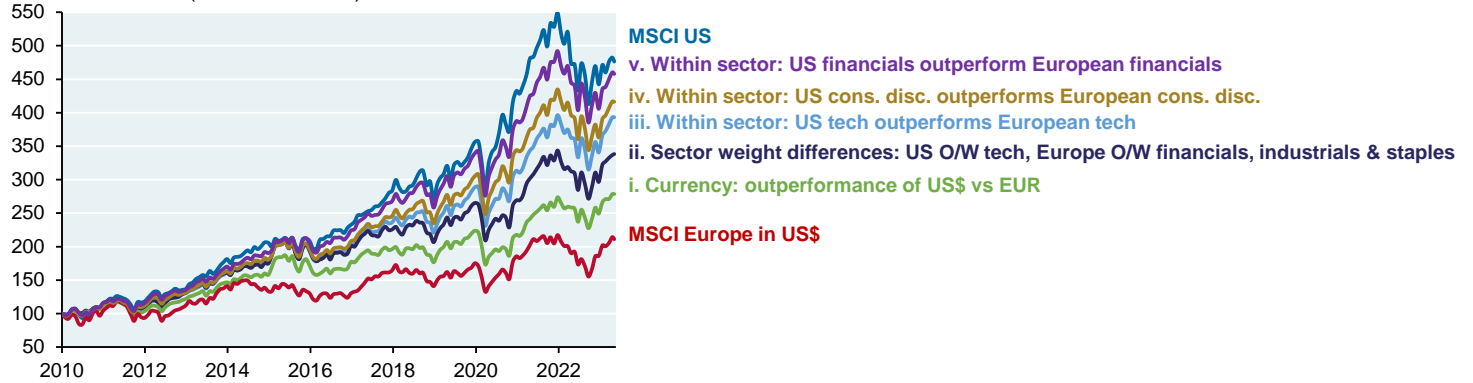


Source: Bloomberg, JPMAM. May 2023. All equity portfolio, rebalanced quarterly. O/W US by 10%; U/W EUR by -10%; U/W JPN by -5%; O/W EM by 5%. Assumes no currency hedging.

So first, why did this barbell perform so well since 2009 when we started to recommend it? We have a chart here that decomposes the reasons. And there's five major factors. One is the outperformance of the dollar versus the euro. Another one is that US sector weights are higher in tech and healthcare and lower in financials, energy, industrials, and staples. And so there's a sector benefit in the modern world to being overweight tech and healthcare. And then within sectors, US technology, consumer discretionary, and financial stocks have substantially outperformed their European counterparts. These five factors explain over 90% of the US outperformance since 2009.

Decomposition of US equity outperformance vs Europe since 2009

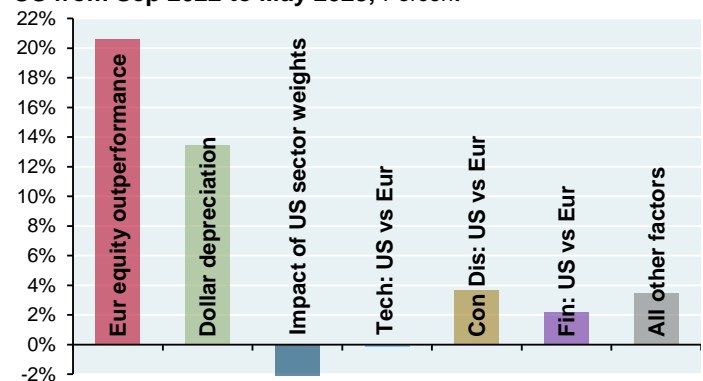
Total return index (100 = Dec 2009)



Source: Bloomberg. May 2023.

Now what has changed over the last few months, since September of last year, Europe has outperformed the US by around 20%. Around two-thirds of that is simply due to the decline in the dollar. Now as we wrote last time, while we don't think that the dollar's reserve currency status is under serious threat, there is room on a cyclical basis for the dollar to decline, given its sharp rise versus other currencies. And there's other bits and pieces in there, outperformance of European consumer discretionary stocks, a tiny bit of outperformance of European financials. But the vast majority of what's happened over the last few months has been the change in the dollar.

Decomposition of European equity outperformance vs US from Sep 2022 to May 2023, Percent

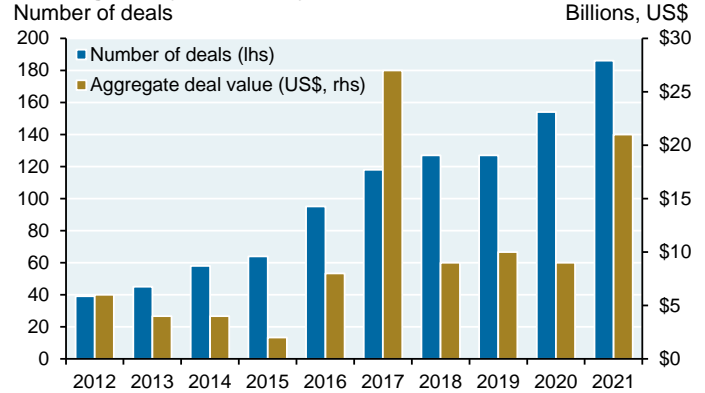


Source: Bloomberg. May 2023.

And the other interesting thing is that since last fall, Japan

has outperformed emerging markets by about 10%. And to me, what's notable is that one of the factors there is a resurgence in M&A activity in Japan, which is unusual, and some of which is coming from foreign investors, which is even more unusual. And you have seen some of these deals, but Bain acquired Hitachi Metals, Evident, and Gelato Pique. KKR acquired Hitachi Transport; Fortress acquired Seven & I. All of these were multi-billion-dollar deals. A little bit more on Japan later, but the increase in leveraged buyout activity is kind of a big deal in Japan.

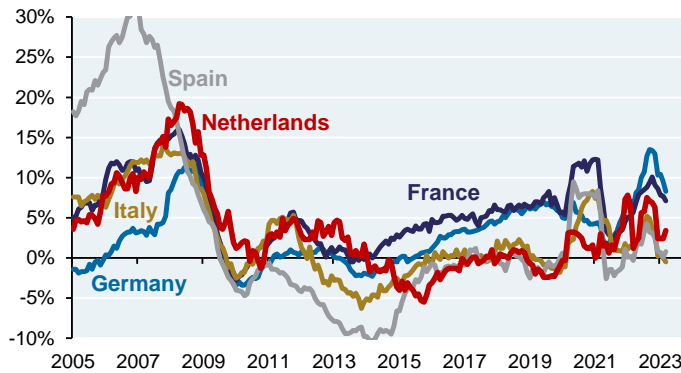
Leveraged buyout activity in Japan



Source: Bloomberg, Prequin. October 2022.

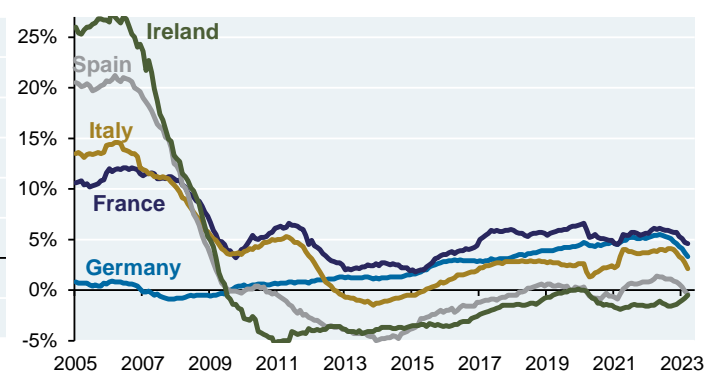
Now we've seen some arguments that suggest that while we're in for another period like 2005 to 2007, where Europe crushed the US, that was kind of a weird period in Europe. There was an explosion of bank lending everywhere from Germany to Spain, Netherlands, Italy, France, and I don't think that's going to be repeating itself, so I think that's kind of a silly argument. We have some charts in here that explain why.

Eurozone bank lending to non-financial corporations
y/y % change, adjusted for loan sales and securitizations



Source: ECB, JPMAM. May 2023.

Eurozone bank lending to households
Y/Y % change, adjusted for loan sales and securitizations



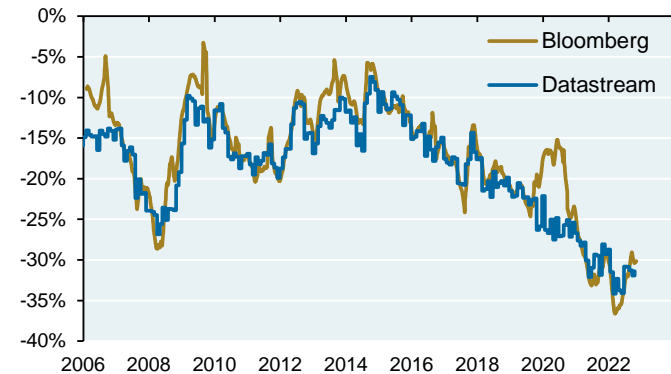
Source: ECB, JPMAM. May 2023.

The mistake that I made is that by not recommending this a few months ago, Europe is essentially a value play, when you look at the context of its heavy sector weightings to staples, financials, energy, and utilities. And everything has a price in the value market, right. And eventually price to earnings, price to book could get cheap enough that everything has a price. And I should have been paying more attention to how

cheap Europe got. By September of last year, Europe's P/E multiple hit the lowest level on record versus the US of around 35% P/E discount. And while there were valid concerns that all of us had about Europe's energy situation, rising inflation, exposure to China, which was still in lockdown, investors were receiving an enormous discount for taking European equity exposure, and I should've been more focused on that.

Largest Europe P/E discount vs US in Q3 2022

Relative P/E discount based on forward earnings



Source: Bloomberg, Datastream, JPMAM. May 16, 2023.

Now how much can it rally? I think Europe's outperformance is capped when you look at return on assets and return on equity. In almost every major sector, the US companies are more profitable than the European counterparts. But you're getting paid a lot of money at a 30 to 35% P/E discount to take exposure to Europe.

And let me just spend a couple minutes on Japan. There's been discussions about improved corporate governance in Japan for probably 20 years. But just over the last few years, it seems like the government is a little bit more serious in doing something about it. There's been a record increase in stock buybacks. Sony's spinoff and buyback is one example of that. And now the government is really going after the 50% of companies that trade below book value. They have to outline a plan to maximize shareholder value and comply with these new shareholder liquidity and director reforms. And the 10 to 20% of companies that don't comply with the cross-holding and free-float rules may face delisting. So there's a little bit more teeth now.

And around half of Japanese companies have a lot of cash compared to less than 20% in the US and Europe. So there's a lot of potential benefits from a corporate governance move into Japan that has real momentum behind it. And of course, positioning is low in Japan. I don't think I've ever talked about Japan on this podcast, or several years since I've talked about Japan in the Eye on the Market.

So to wrap up, the valuation discount for Europe and Japan

Japan P/E discount vs US

Relative P/E discount based on forward earnings



Source: Datastream, JPMAM. Apr 28, 2023. Note: 30-day smooth.

remains pretty high. There might be a little bit more legs left in this anti-barbell trade. I wouldn't argue for a reverse barbell, which would be overweight Europe and Japan. And I don't have that much conviction in Europe to do that. Europe has a long history of grasping defeat from the jaws of victory, and the ECB still has tightening to do. But I also think the US debt

ceiling is going to be raised one way or another.

FEMALE VOICE: Michael Cembalest's Eye on the Market offers a unique perspective on the economy, current events, markets, and investment portfolios, and is a production of J.P. Morgan Asset and Wealth Management. Michael Cembalest is the Chairman of Market and Investment Strategy for J.P. Morgan Asset Management and is one of our most renowned and provocative speakers. For more information, please subscribe to the Eye on the Market by contacting your J.P. Morgan representative. If you'd like to hear more, please explore episodes on iTunes or on our website.

This podcast is intended for informational purposes only and is a communication on behalf of J.P. Morgan Institutional Investments Incorporated. Views may not be suitable for all investors and are not intended as personal investment advice or a solicitation or recommendation. Outlooks and past performance are never guarantees of future results. This is not investment research. Please read other important information, which can be found at www.JPMorgan.com/disclaimer-EOTM.

[END RECORDING]