The Great Race. Markets have zoomed ahead since 2009, anticipating that eventually the world’s economies would catch up. Thanks to extra fuel from the Fed, the U.S. is running at a steady pace and should accelerate modestly in 2014. China has hit some potholes but is still moving, just more slowly. Japan’s experimental model is designed to overtake EM surplus countries; still a work in progress. The Eurozone is moving again, but its design is economically and aerodynamically flawed. The EM debtors are temporarily off-road. See inside for more details.
The countries and regions depicted on the cover make up 75%-80% of the world on both a GDP and equity market capitalization basis. The remainder is primarily made up of developed countries of two kinds: commodity exporters like Canada and Australia, and countries in Europe that do not use the Euro (UK, Denmark, Sweden, Norway, Switzerland, etc.). With the exception of Australia (which has been affected by the China slowdown), all these countries are in growth mode as 2013 comes to a close. From an artistic license perspective, they would have been depicted on the cover near the front of the pack. These countries are all different, but similar in one important way: they set their own monetary policy and do not suffer from the albatross of a common currency.

Countries referred to as “Emerging Markets” do not rely on the same economic model. Some still rely on substantial foreign capital for growth (India, Brazil, Indonesia and Turkey), while others run a trade surplus (exporters of Southeast Asia), or run small trade deficits and no longer require large inflows (Mexico, Poland and the Czech Republic). The eventual return to a higher interest rate world is a bigger risk for the first group than the second or third.

Returns shown on the front cover represent the period from January 1, 2010 to November 30, 2013. **Note:** Past performance is not indicative of future returns. See sources and definitions at the end of this publication.

Cover illustration by Matthieu Forichon
Happy New Year. As we enter 2014, we remind ourselves of how much has changed in the past two years, from 2012’s uncertain landscape to 2013’s increased stability and markets moving quickly as a result. But even as markets surged, corporate profits, employment and economic growth have struggled to keep pace.

So where do we go from here? What needs to happen in the coming year to close these gaps? That’s exactly what Michael Cembalest, our Chairman of Market and Investment Strategy, sets out to answer in his Outlook 2014, “The Great Race.” Michael and team take a closer look at the factors that will determine the markets’ continued progress, and most importantly the investment opportunities we can expect as a result.

The 2014 Outlook reflects our view of the global investment landscape and focuses on the opportunities in the year ahead. It is our thought leadership and sound investment guidance that have enabled us to provide our clients with the most effective solutions for the last 175 years.

Thank you, as always, for your continued trust and confidence in J.P. Morgan.

Most sincerely,

[Signature]
The Great Race: Growth and profit improvements needed to propel financial assets further

Markets zoomed ahead of the facts on the ground over the last year and were taking a pit stop as the year came to a close. After a recession, markets often rally first, profits follow and economic growth brings up the rear; there’s nothing unique about that. But as shown in a note we sent last year\(^1\), the current gap between markets and economic/profit conditions is larger than in the past. For equity market gains to be sustained and built upon, profits and economic growth will have to catch up to what markets are anticipating. The outcome of this Great Race is what we believe will drive market returns in 2014.

Let’s take a closer look. In 2013, GDP growth and earnings growth were both in low single digits, and the pace of positive economic surprises slowed. Equities rallied anyway, and price-to-earnings multiples rose back to long-term historic averages. A variety of other indicators also moved back to pre-crisis levels (see box).

\(^{1}\) Eye on the Market, September 3, 2013
A major factor contributing to the equity rally has been easy monetary policy almost everywhere. One purpose of low Central Bank policy rates was to accelerate the post-recessionary rise in financial asset prices; that part worked. Central Bank policy rates will probably not change much in 2014, apart from a few places like China. But at this stage, it will probably take more than another year of cheap money to drive markets higher. We will have to see concrete improvements in economic and profit conditions.

Central Bank policy rates expected to remain low...

![Chart showing Central Bank policy rates expected to remain low](source: Various central banks, J.P. Morgan Asset Management. Sept 2013.)

...while longer term rates rise modestly higher

![Chart showing 10-year govt bond yields less core inflation](source: Various central banks and statistical offices. November 2013.)

That’s why manufacturing surveys are the most important indicator we’re looking at. These surveys are useful in forecasting economic and profits growth. In the U.S., the recent uptick drives our expectation of a 2014 profits rebound of 8%-10%. In Europe, leading indicators have also risen but the gains are smaller. We are not expecting a sharp European profits rebound; the profits spike of 2003-2007 was a temporary by-product of the doomed Southern European consumption boom. Nevertheless, the Eurozone is emerging from a recession, and its corporate sector is seeing sequential profits growth again.

Rising U.S. business surveys point to rebound in earnings

![Chart showing PMI business activity survey and U.S. earnings growth](source: ISM, J.P. Morgan Securities LLC. November 2013.)

Similar but more muted outcome in the Eurozone

![Chart showing PMI business activity survey and Eurozone earnings growth](source: Markit, J.P. Morgan Securities LLC. December 2013.)
Global business surveys also show a world gradually getting back to normal. The two-fisted combination of a global recession in 2008-2009 and the European debt crisis two years later took its toll. As 2013 came to a close, leading indicators suggested a return to 3.5% global growth in 2014, and a rising number of countries in expansion mode. A decline in fiscal austerity should help; in the developed world, the 2014 fiscal drag should be around half of what it was in 2012 and 2013.

The potholes: the Eurozone (still) and Emerging Markets debtor nations. The latter are undergoing a traditional balance of payments problem, defined by falling growth, the exodus of foreign capital, rising interest rates and a period of retrenchment. Less liquidity from the U.S. Federal Reserve is a challenge for capital importers like the EM debtor nations. As for the Eurozone, recent improvements are notable, but the region is still suffering from deleveraging, sub-trend growth, and sharply diverging fortunes between Germany and the Periphery (and France). Net private sector credit creation is a clear indicator of whether a region is getting back to normal, and in the Eurozone, it’s still zero. 2014 looks like a better year for Europe, but there are reasons to be concerned about its long-term growth.

U.S. leads in the private sector credit recovery
Net private sector credit creation as % of public plus private

A growing gap between EM debtor nations and the rest
6-month annualized % change in industrial production
On regional equity markets, last year was a break in the trend of U.S./Emerging Markets portfolios outperforming Europe/Japan. This was mostly a by-product of Emerging Markets underperformance at a time when investors re-embraced Europe and an unorthodox policy experiment in Japan. Keep in mind that Japan’s experiment is not just monetary: As outlined on page 16, Japan is attempting to steer hundreds of billions (in USD) of Japanese household and pension assets into equities. With more Japanese stimulus coming and the problems of the EM debtor nations, 2014 looks like another year of developed market equity outperformance vs. EM equities.

The era of Central Bank-driven equity rallies
Equity markets total return index, 12/31/2008 = 100

We expect 2014 to mark a return to more traditional risk/return relationships

To summarize, we expect the markets car to slow down from its break-neck pace as the economic vehicles catch up, and for 2014 to be a year of more modest appreciation in equity, credit and real estate markets. After the surge since the spring of 2009, we anticipate a gradual return to high single-digit equity market gains and double-digit market volatility. As for fixed income, we are emerging from a period when Central Banks drove government bond yields to or below the rate of inflation; long-term interest rates are now starting to rise modestly. Consequently, 2014 also looks like another year in which cash and lower-risk fixed income don’t add much to portfolios. If so, investors would benefit in 2014 from maintaining many of the portfolio allocations that have been working since the global recession ended in 2009.

This year’s Eye on the Market Outlook walks through our views on markets by region, followed by an in-depth analysis of a few portfolio and market topics (public equity, private equity, municipal bonds, hedge funds and credit markets).

Michael Cembalest
J.P. Morgan Asset Management

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2 Let’s take the U.S. Barclays Aggregate Index of government, agency and corporate bonds as an example, and incorporate its current yield of 2.4% and sensitivity to rising interest rates (including the reaction function of mortgage prepayments). Assuming a 0.50% parallel shift higher in the Treasury curve in 2014, we estimate that the Index would return 0.5%-1.0% for the year. If interest rates were unchanged, that estimate would rise to 2.5%-3.0%. In 2013, through December 16, the Index returned -1.9%.
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United States: Post-austerity growth improvements to show up by mid-year

It would be great to be able to say that the U.S. economy is doing well enough for monetary policy to get back to normal, but this is not the case. As shown by the motorcycle on the cover, the Fed’s support for growth is still substantial. While the pace of Fed asset purchases will slow in 2014, there are two important things to remember:

- **The Fed will be around for a long time.** The size of the Fed’s balance sheet will not probably peak until late 2014, and we expect it to remain above 2011 levels until 2020. Remember, the Fed has stated that it has some tolerance for a period of inflation in excess of its long-term targets.

- **Fed tapering was mitigated by a recommitment to low policy rates for a long period.** The output gap (a proxy for spare capacity in the economy) is substantially larger than in comparable post-recession periods. In more concrete terms, zero percent real wage growth and a large cohort of involuntarily unemployed people are still problems for the Fed. Bottom line: We expect policy rates at or close to zero until 2016.

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**Fed’s stock of securities holdings should remain high**

Fed securities holdings, USD trillions

- U.S. Treasuries (< 1yr)
- U.S. Treasuries (1-5 yrs)
- U.S. Treasuries (5-10yrs)
- U.S. Treasuries (> 10yr)
- Agency debt
- Agency MBS


**A proxy for excess capacity explains the Fed’s go-slow approach so far,** output gap, percent of potential GDP

Another reason we think the Fed will go slow: in addition to a large output gap, the recovery has been driven so far by interest-rate-sensitive sectors. This is typical for a recovery, but highlights the risk of interest rates rising prematurely. As things stand now, real hourly earnings have experienced no material rise since 2008; weak wage growth is the largest single factor behind the corporate profits boom. GDP growth is still in the 1.5%-2.0% range.

With that backdrop, why is the U.S. car in the lead in the Great Race? Because we believe 2014 will show signs of improvement after last year’s austerity. When taking into account increased taxes (payroll, income and Obamacare) and spending cuts, 2013 was the third-largest fiscal drag in the past 50 years. Furthermore, there was the distraction of a government shutdown. Without these roadblocks in 2014, we expect growth to improve. The long-term fiscal situation is still a problem, but after the 2011 Budget Control Act and the 2013 tax act, the 10-year deficit outlook has stabilized since the August 2011 rating agency downgrade (see page 25).

Other reasons for optimism: U.S. household and corporate balance sheets have undergone substantial healing. There are two ways to look at this: on a debt/GDP basis (the Eurozone is shown for comparison purposes), and based on debt service to household income. The latter has fallen to early-1990’s levels, courtesy of low interest rates. To be clear, there are few signs of households or small businesses adding much credit right now; credit growth is primarily confined to student loans and borrowing by large businesses. But the deleveraging trend has slowed.
More ammunition for a U.S. recovery:
- A lot of cash held by households and companies\(^3\), and low corporate debt levels
- Signs of continual easing in bank lending standards
- State and local payroll growth increasing for the first time since the financial crisis; state and local consumption and investment are now the strongest in four years
- Cheaper electricity costs in the U.S., a topic discussed in detail in last year’s annual energy piece\(^4\) and on page 20
- Even after accounting for shadow inventory, new and existing homes for sale as a percentage of households is very low (a by-product of several years of limited new construction). The number of 25-34 year olds living with their parents is at a 35-year high

Some believe that elevated cash balances and low business capital spending are structurally permanent by-products of an aging population, zero interest rates and/or the long-term Federal debt outlook. I see a mix of structural and cyclical forces at work, with structural issues being more of a problem for businesses than households. **All things considered, by mid-2014, a 3% growth rate in the U.S. is within reach.**

\(^3\) While global M&A activity has been weak, the stock buyback story has generally been positive. In September 2013, FactSet noted that the number of S&P companies engaging in both a dividend and a buyback over the trailing twelve-month period reached its highest level since 2005 (71% of the S&P 500 index). Q2 buybacks in dollars were up 24.2% from Q1, and up 12.3% vs. 2012. However, y/y growth when measured in dollars would have been roughly flat without Apple.

\(^4\) *Reality Check: Annual Energy Eye on the Market, October 28, 2013*
Europe: Enjoy the intermission

Signs of improvement appeared on a number of fronts in the Eurozone last summer.
Manufacturing surveys started rising again and we began to see foreign capital returning, even in Spain and Greece. Examples include foreign capital seeking non-performing loan sales by European banks, and distressed real estate and bank acquisitions in Spain. In the U.S., these kinds of transactions have historically signaled that the worst is over.

Other positive news:

- European countries that don’t use the Euro (Denmark, Norway, Poland, Sweden, Switzerland, UK, etc.) are doing better, in large part a result of having their own independent monetary policies
- Consumer confidence is rising, and leading indicators on hiring are picking up
- Current account deficits in Spain, Greece and Portugal are in balance after having registered massive gaps of 10%-14% of GDP in 2008. These indicators suggest on paper that Southern Europe has finally shed its reliance on foreign capital
- **Unit labor cost gaps versus Germany, a primary feature of the Eurozone for over a decade, have declined by half in Ireland, Portugal, Spain and Greece** (not Italy or France)
- Fiscal austerity in Europe will be considerably smaller next year: In 2012, the fiscal drag on growth was 1.7% of GDP; in 2013 0.9%; and in 2014, is estimated at 0.7%
- Low-cost ECB lending reduced near-term default risk: Spanish and Italian banks borrowed from the ECB and bought the lion’s share (50%-60%) of government debt issuance since 2008
- Germany is setting a pro-growth agenda (higher minimum wage, more government spending, tax incentives for housing and R&D). The German IFO business survey surged into year-end
The problem: these improvements may only result in a growth rebound of ~1.5%, which may not improve conditions much. Even where surveys are rising, actual consumption and production have not picked up as much. If GDP growth peaks at 1.5%, Eurozone employment may remain weak with little improvement to unemployment rates, which are at all-time highs. On improved current accounts, a collapse in consumption and imports has a lot to do with how these deficits closed; this was not just an export-led result. Finally, European corporate deleveraging has further to fall (see page 7), and the Euro’s rise vs. the Yen is not going to help European exports.

Let’s put the cyclical issues aside for a moment. The fundamental challenge for the Eurozone remains: how to reconcile macroeconomic and microeconomic differences between member countries. We have published dozens of charts about this, and the one that resonates most is the one on industrial production in Germany and Italy. After moving in tandem for decades, they were driven apart by the Euro. On page 23, we include some work we have done on regional divergence, including a chart showing how cross-country differences in the Eurozone are as high as for a hypothetical monetary union comprised of all countries in the world beginning with the letter “M”. Where this issue becomes more tangible: if these differences prevent more aggressive, proactive ECB action regarding Southern European deflation risks. ECB monetary policy even as it now stands is causing concerns about inflation risk and stealth expropriation of savers in Germany. These challenges explain why the Euro is depicted on the cover as an albatross following the region.

\(^5\) Despite very high levels of unemployment, an explicitly anti-Euro party has not succeeded at the polls. However, as cited by Germany’s Friedrich Ebert Foundation, there has been a noticeable rise in “right-wing” and “extremist” parties in parts of Europe. This is a different issue, but one that bears risks of its own.

\(^6\) In real terms, import contraction explains 19% of the current account improvement in Portugal, 23% in Spain, 15% in Italy and 30% in Greece, with rising exports accounting for the rest. However, in Asia (1990’s) and Latin America (1980’s), import contractions accounted for 0%-10% of current account improvements. In other words, it is rare that an import collapse plays such a big role.
On investments in Europe. In 2011, when financial markets were pricing in a high certainty of negative outcomes, European equities were much cheaper than U.S. counterparts. The Draghi “whatever it takes” speech in July 2012 immediately lowered perceptions of disintegration risk and the equity valuation gap versus the U.S. began to close. This revaluation process is mostly complete with perhaps a bit more to go in 2014, particularly if the ECB engages in the kind of large-scale securities purchases undertaken by the Federal Reserve. So far, the ECB is saying these measures will only be taken if there’s another shock. As a reminder, long-term growth rates in France, Spain and Italy are at their lowest levels since the 1820's (ex-wartime).

To conclude, our view on 2014 is that investors should enjoy the intermission during which Eurozone economic growth and financial asset prices improve. As shown on page 2, rising business surveys do point to better earnings growth. However, if a 1.0%-1.5% GDP growth rebound proves insufficient, many of the structural issues will return to the forefront. As shown on the cover, the Eurozone as currently configured is not built for speed.

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Sources and Methods:

European equity discount to U.S. continues to fall

- **European P/E ratio divided by U.S. P/E ratio:**
  - Premium to U.S.
  - Discount to U.S.


European earnings growth crawling back to positive territory, Y/Y percent change, 12-month forward earnings per share

- **MSCI Europe**
- **EuroStoxx 50**
- **S&P 500**


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Two indices are most often referred to as “European equities”: the EuroStoxx 50 and the MSCI Europe Index. They are quite different: There is only a 26% overlap in companies due to the higher concentration and larger market capitalization sizes in the EuroStoxx. The other big difference: The MSCI Europe Index has large exposures to the UK (34%) and Switzerland (14%), while the EuroStoxx has none.

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7 According to an analysis by J.P. Morgan Securities LLC, a European bond-buying program would need to be around 550 billion Euros, derived in order to maximize employment without jeopardizing price stability.

8 See *Eye on the Market, April 1, 2013*, for a chart on 7-year real growth since 1826 in France, Spain and Italy.
Emerging Markets: Debtor nation balance of payments crises not as severe as prior episodes, but still painful

For once, the main story in emerging markets is not about China. There’s an old-fashioned balance of payments crisis going on in the “debtor nations” (Brazil, India, Indonesia and Turkey). A combination of factors makes this episode less problematic than prior ones in Latin America in the 1980’s and Asia in the 1990’s, but we don’t think the adjustments are over yet.

What’s a balance of payments crisis? The next three charts tell the abbreviated story. First, capital floods into a country, allowing interest rates to fall and consumption to rise. The country typically experiences a large current account deficit due to rising imports and falling exports. Then, if capital inflows do not result in sufficient growth and productivity improvements, eventually growth declines and investors want their money back.

Capital outflows generally cause a decline in growth and asset prices, and a decline in the currency. It would be tempting for a Central Bank to lower interest rates to reinvigorate growth, but if the country is running close to full capacity, lower interest rates could cause inflation. Instead, affected countries often have to raise interest rates to defend their currencies and prevent inflation from rising too much. That is what has happened so far.
Fortunately, there are two major differences compared to prior crises. First, countries involved have a lot of foreign exchange reserves, allowing them to defend their currencies as capital flees. This prevents a collapse in their exchange rates, and reduces risks of inflation and domestic bankruptcy. The second difference is that these countries do not have fixed exchange rates, making the “rush for the exit” problem less acute. 2014 should be another difficult year of adjustment, but we expect the process to play out with less damage to their economies and to the rest of the world than in the past.

As for China, recent data have been positive, with GDP growth at 8%-9%. Manufacturing surveys show signs of modest improvement and key indicators like electricity production have picked up. Production growth is at the strongest level since 2010 and fixed investment growth is stable.

The risk in China relates to the credit expansion that took place after the global recession. China’s real growth is lower than reported after adjusting for credit expansion and loose fiscal policy. While inflation is low, there are signs of rapid growth in real estate prices, rising wages and tight labor markets. Short and medium-term interest rates have risen sharply and will probably remain high, which will likely reduce growth to ~7%. Tighter monetary policy appears to be part of the plan announced by China’s Central Bank, which has referred to “periods of deleveraging and capacity reduction”. China’s plan re-emphasizes market mechanisms and a reduced presence for inefficiently run state-owned enterprises. Sounds good on paper, but the immediate future entails tighter monetary policy to address asset inflation and credit risks.
Are EM debtor countries worth buying? The debtor nations underperformed the rest of EM in 2013 by ~15%, but their P/E multiples are still higher. This is partially explained by sector differences, since debtor markets are more heavily weighted to consumer and technology stocks that trade at higher multiples. Nevertheless, markets might be too sanguine about 2014, particularly as the Fed reduces its asset purchases, which in turn reduces global liquidity. We prefer countries that run a current account surplus, or at most a small deficit (Mexico, Korea, the Czech Republic, Taiwan, the Philippines) for the reasons discussed above. We also see 2014 as another year in which emerging market equities trail developed markets. Even in some EM surplus nations, exports have slowed down and the general commodity price decline is taking a toll. As discussed in the next section, Japan’s stimulus plan is designed in part to recapture export market share from other emerging Asian countries through a weak Yen.

One last observation on investing in emerging markets. Investors are often focused on rising household wealth and consumption in emerging countries. In many countries, however, there aren’t enough publicly tradable consumer discretionary and consumer cyclical companies, leaving equity markets to be dominated by industrials, exporters, banks, utilities, etc. As a result, investors often look to private equity markets as well. Private equity has outperformed public equity in Asia and Latin America over the past five years. In our experience, one of the primary reasons is a greater focus on consumer-related investments by EM private equity managers.
Japan: The experiment continues, but so far, only weakening the Yen seems to work

At the end of 2012, Japan was still mired in its 25-year malaise. A radical approach was launched that involves monetary stimulus that dwarfs what the Fed and ECB have done. **Goals: 3% nominal GDP growth and 2% real GDP growth, levels that haven’t been seen in Japan in 20 years.** Japan’s leaders point to similar efforts during the 1930’s by Finance Minister Takahashi that ended deflation. Takahashi’s policies included a 40% decline in the Yen, lower tax revenue and a rise in public works spending (note: the only spending Takahashi cut was military spending, which led to his assassination by Japanese military officers in 1936).

Is it working? The Japanese stock market liked the idea and took off. It sure looked like the program was working during the spring and summer of 2013 when exports, machinery orders, consumer spending and consumer confidence jumped. **Unfortunately, this bump appears to simply coincide (as it has over the last 25 years) with a period of Yen depreciation.** As soon as the Yen’s slide ended, most economic data rolled over as well, and (as in the U.S.) cheap money had a more durable impact on the Nikkei than on Japan’s economy:

- Its monetary base grew by 50%, but money supply (reflecting private sector activity) is up < 5%
- Most signs of rising inflation are more related to energy costs than wages
- Rising corporate profits have led to an increase in capital spending by Japanese companies, but almost all the increase has been outside Japan rather than domestic
- Most of the increase in hiring has been related to part-time rather than full-time workers

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9On March 18, 2013, we reviewed the dismal state of Japanese nominal and real GDP growth, corporate profits, cash earnings per employee and net exports. In level terms, Japan is a rich nation but the growth in these variables has been negligible, which is what deflation is all about.
Japan’s government is using more than monetary policy to try and boost its financial markets:

The Nippon Investment Savings Account allows notoriously equity-averse Japanese households to buy ~US$10K per year of risky assets and exempts them from taxation for five years as long as the account is invested in equities or mutual funds. This plan could prompt hundreds of billions of dollars to shift from bank deposits to equities over the next five years (Japanese households have ~US$8 trillion of deposits). Nomura estimated last May that NISA accounts could reach ~US$260 billion by 2018. If Toshin investment funds are any guide, Japanese households would invest around half of their NISA balances in Japanese securities.

A November 2013 report from a government-appointed panel proposed new guidelines for Japan’s US$3 trillion Government Pension Investment Fund that would raise weights in domestic and non-Japanese equities from 24% to 40%. The proposal is still under consideration, and would represent another source of demand for Japanese equities if adopted.

To be clear, Japan’s demographic and debt outlook is still terrifying. In the next few years, Japan’s net debt will reach 150% of GDP\(^\text{10}\) and its demographics are awful. The government assumes it will be able to generate what I would describe as a productivity miracle: substantial benefits from increased business capital spending and a free trade deal that involves major changes to Japan’s service and manufacturing sectors. Furthermore, the plan assumes a large increase in female labor force participation, presumably achieved by introducing more maternity leave, child care programs, etc. None of this will be as easy in reality as it is on paper, particularly in Japan.

<table>
<thead>
<tr>
<th>Japan’s plan: a productivity and labor force miracle</th>
<th></th>
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<tbody>
<tr>
<td>Productivity (output per hour) + Labor force growth = Real GDP (output growth)</td>
<td></td>
</tr>
<tr>
<td>2000-2010 Actual</td>
<td>0.80%</td>
</tr>
<tr>
<td>2010-2020 Baseline</td>
<td>0.80%</td>
</tr>
<tr>
<td>2010-2020 Abenomics</td>
<td>2.00%</td>
</tr>
</tbody>
</table>

Source: Japan Cabinet Office, Gavekal Research.

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\(^{10}\)The debt bubble is why Japan is seeking to increase inflation. If Japan had been able to run just 3% nominal GDP growth instead of 0% since 1990, its gross debt to GDP would be 100%-130% instead of 230%.
Nevertheless, it seems risky to be underweight Japanese equities. Japanese equity valuations are not low compared to other countries, and poor return on equity has been a problem (see table). However, earnings growth estimates are rising for 2014, and the cyclical aspect of the government’s plan has the potential to override Japan’s structural problems for another year. That’s what we think will happen in 2014. If global exports are a zero-sum game, it’s also risky to be underweight Japan if its short-term success comes at the expense of other industrialized export nations in Asia and Europe.

### Global equity market valuations

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>UK</th>
<th>Europe</th>
<th>EMU</th>
<th>Japan</th>
<th>EM</th>
<th>EM</th>
<th>EMEA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price-to-Book</td>
<td>2.7x</td>
<td>1.9x</td>
<td>1.8x</td>
<td>1.5x</td>
<td>1.3x</td>
<td>1.6x</td>
<td>1.6x</td>
<td>1.7x</td>
</tr>
<tr>
<td>Return on Equity (2013E)</td>
<td>14.6%</td>
<td>13.8%</td>
<td>10.9%</td>
<td>8.5%</td>
<td>8.0%</td>
<td>12.4%</td>
<td>13.4%</td>
<td>11.7%</td>
</tr>
<tr>
<td>Price-to-Earnings (12m Fwd)</td>
<td>15.4x</td>
<td>12.4x</td>
<td>13.2x</td>
<td>12.9x</td>
<td>14.4x</td>
<td>13.5x</td>
<td>11.0x</td>
<td>12.6x</td>
</tr>
</tbody>
</table>


### Japanese TOPIX forward price-to-earnings ratio

Beyond the Great Race

The remainder of this year’s Outlook provides further analysis of some market and investment themes that are part of our portfolio thinking for 2014.

I: Risk and opportunity in credit markets
II: A revised look at private equity performance, and some themes for 2014
III: On the recent underperformance of hedge funds relative to equities, and outperformance vs. bonds
IV: Tracking performance trends in active equity management
V: How different are the countries of the European Monetary Union?
VI: Indicators cited in the preface that have returned to pre-crisis levels
VII: U.S. fiscal outlook: Quieter in 2014, with long-term battles ahead
VIII: U.S. municipal bond outlook and the question of Detroit
I: Risk and opportunity in credit markets

Five years into the Fed’s zero interest rate policy, the search for yield continues. In addition to the decline in credit yields (see page 24), covenant-lite loan issuance has risen above 2007 levels, the riskier CCC-rated component of the high yield market is rising, and the number of loans and bonds trading below a price of 80 is shrinking. On the plus side, credit fundamentals are positive: cash flow coverage of debt service is high, default rates are low and as shown on page 8, the S&P 500 debt-to-market cap is low as well. The concern is not one of recession or debt service coverage, but whether credit market enthusiasm has gone too far. 2014 might be a good year to make sure portfolios do not own too much credit that is priced for perfection.

Tracking underwriting standards in high yield, leveraged loan and leveraged buyout markets

The flood of money into public credit markets has resulted in tighter spreads and modestly weaker underwriting standards. The same dynamics are less prevalent in private credit markets. Many small and mid-size companies (and real estate entities) that used to have access to public credit markets find that access is harder now, and borrow from private credit and mezzanine debt markets instead. Private credit portfolios generally entail less diversification and less liquidity in exchange for higher lending rates and at times, call protection, debt service coverage, escrow requirements and change of control provisions sometimes absent in public credit markets.

As outlined in a November Eye on the Market, bank loan sales in Europe are finally picking up across countries. This process has accelerated as rising earnings allow banks to absorb more losses. As an example, Lloyd’s, Unicredit, BBVA, Commerzbank and Société Générale took asset charges equal to 90% of gross operating profit in 2012. PricewaterhouseCoopers cites bank loan sales at 10 to 40 cents on the Euro in Ireland, and UK/German real estate loan sales at 40 to 50 cents. Loan-to-deposit ratios of European banks are still high, so we expect bank loan sales to continue for an extended period.
II: A revised look at private equity performance, and some themes for 2014

In July of 2013, we wrote a detailed paper on private equity, part of which focused on recent findings by an Oxford lecturer regarding problems with a commonly used private equity performance database. Due to stale records, missing cash distributions and incomplete fund records, widely read prior studies factored in a downward performance bias for private equity. After the exclusion of incomplete fund records, the previously estimated private equity underperformance of 3%-6% against the S&P 500 turns into outperformance of 4% per year.

A separate 2013 paper from academics in Virginia, Oxford and Chicago confirms these findings. The authors found that buyout funds outperformed the S&P 500 in each of the last three decades. Venture capital funds, on the other hand, had a great run in the 1990's, after which industry performance has been below equity markets. The authors also found that performance of buyout funds did not differ substantially by fund size, and that there is no identifiable relationship between manager fees or GP ownership levels and buyout fund performance.

Subsequent to our paper's release, the most frequent questions we received were:

How do buyout funds perform relative to public equity when using benchmarks other than the S&P 500 (to reflect the small/mid-cap nature of companies often acquired by private equity firms)?

The authors of the paper cited above also computed buyout fund performance using the Russell 2000, the Russell 2000 Value Index and the NASDAQ. Buyout fund outperformance using an S&P 500 benchmark was 1.22x; using the Russell 2000, Russell 2000 Value Index and NASDAQ, the ratios were 1.22x, 1.16x and 1.20x, respectively. In other words, basically the same.

How does buyout fund outperformance look when applying leverage to the S&P 500 benchmark (to reflect the high level of leverage often used by buyout funds)?

The authors reran their analyses using a leveraged S&P 500 benchmark. Buyout outperformance fell to 1.08x; still positive, but less than the original results. Interestingly, this measure was 1.28x for the 2000’s, 1.09x for the 1990’s and 0.76x for the 1980’s. Applying leverage to the S&P during a decade with two 40%+ declines in the market created a lot of distress in the benchmark.

Private equity in 2014

If our views on leading indicators are correct, global GDP growth will pick up in 2014 close to pre-crisis averages. If so, one theme that we expect to continue is the increase in energy-related investments in private equity portfolios. The phrase “energy-related” is broad, and refers to projects designed to increase proven and producing oil/gas reserves that are subsequently sold to integrated and independent energy companies; infrastructure and logistics companies; and recapitalization of manufacturing and associated service companies. The chart shows electricity costs for industrial users and domestic/import prices for natural gas across countries.

Another trend to watch: there’s increasing pressure on companies with slowing earnings growth and elevated cash balances to sell non-core businesses, often at the urging of shareholder activists. Private equity firms aim to restructure these underperforming units as stand-alone entities with revitalized growth prospects and greater management focus.

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12 In 2012, the U.S. completed 45,000 oil and gas wells compared to 4,000 in the rest of the world, excluding Canada. “The Shale Oil Boom: A U.S. Phenomenon”, Leonardo Magueri, Harvard Belfer Center, June 2013.
III: On the recent underperformance of hedge funds relative to equities, and outperformance vs. bonds

For the first time since the late 1990’s, the hedge fund industry has lagged equities. This assessment is based on two methods commonly used to evaluate performance. The first compares hedge funds to a stock-bond portfolio, and the second compares hedge funds to equities on a risk-adjusted basis. In the charts, when the lines are positive, hedge funds are outperforming and vice versa. For the bulk of the 2000’s, hedge funds (measured by the HFRI Composite) held their own. Over the last two years, relative performance moved into negative territory, indicating hedge fund underperformance.

Individual hedge fund portfolios will of course differ from the HFRI Composite, which measures performance across the entire industry. Even so, the charts demonstrate the extent to which many hedge funds trailed investor performance objectives during the double-digit, low-volatility equity rally. The unwinding of Central Bank liquidity should help level the playing field for hedge funds, which are typically less “long” than equity managers. In any case, before monetary policy normalizes, it seems premature to assume that there has been a permanent and structural shift in the performance of hedge funds relative to equities.

Investors who bought diversified hedge funds of funds as replacements for overpriced government bonds, on the other hand, have seen better results. When thinking about a portfolio proxy for bonds, we need to switch from the HFRI Composite to the HFRI Fund of Funds Diversified Index, since the latter has a lower volatility that is more consistent with bonds and credit. Over the last two years, the HFRI Fund of Funds Index has outperformed the Barclays Aggregate Index both on a nominal and risk-adjusted basis.

In the next section, we review how the pair-wise correlation of stocks is finally coming down after spiking to the highest levels in several decades. We expect a decline in correlations to benefit long-only active equity managers, and long-short hedge fund managers as well. As shown in the chart, there is a clear pattern in which rising correlations correspond to lower returns on the HFRI Equity Hedge Index since the early 1990’s.
IV: Tracking performance trends in active equity management

As part of our institutional Investment Insights series, we took a look at manager performance trends in active equity management. As shown below (and as we explain in great detail in the paper), manager outperformance trends have been positive in most investment styles with the exception of U.S. Large Cap Growth and Mid Cap Growth.

Generally positive manager outperformance trends over the last 5 and 7 years, with the exception of U.S. LC Growth

These outperformance trends coincided with a difficult period for some active managers given the sharp rise in pair-wise stock correlations. We are finally seeing a decline in correlations, in both U.S. and international markets. If history is any guide, this decline may be a positive signal for Large Cap Growth and other strategies. Before the global recession, outperformance for U.S. Large Cap and Mid Cap growth categories was well above 50%.

Pair-wise stock correlations falling...


...which in the past coincided with higher outperformance


Other findings:

- Outperformance trends in U.S. markets were markedly higher before the global recession
- Risk-adjusted outperformance measures were similar to nominal ones
- Managers that outperform over 5 years usually underperform in 2 or 3 individual years
- We did not find a consistent relationship between outperformance and manager size
- We computed outperformance based on stated benchmarks and based on investible benchmarks (exchange-traded funds). In U.S. markets, differences were minor. Outside U.S. markets, ETF fees and tracking error are higher. As a result, outperformance trends were higher using ETFs. We believe ETF comparisons come closer to the “real investible experience”, since using stated benchmarks effectively assumes index replication with no fees and no tracking error.

13 A search for intelligent life in the active equity management universe, November 2013
V: How different are the countries of the European Monetary Union?

The Death in Venice chart on page 10 is an example of what can happen when two countries with different levels of productivity are joined in the same monetary union. **How pervasive is this problem in Northern and Southern Europe?** While some of the important gaps are closing (e.g., unit labor costs versus Germany), there are material differences that remain. The table below shows country rankings for select categories from the World Economic Forum, with a rank of 1 = best and 144 = worst. Southern Europe has some stark differences with Northern Europe in terms of the day-to-day life of a citizen, a consumer or a business owner.

**World Economic Forum Report, 2012-2013: 1=Best, 144=Worst**

<table>
<thead>
<tr>
<th>Category</th>
<th>Northern Europe</th>
<th>Southern Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property rights</td>
<td>Germany 14</td>
<td>Spain 48</td>
</tr>
<tr>
<td>Diversion of public funds</td>
<td>France 18</td>
<td>Italy 69</td>
</tr>
<tr>
<td>Public trust in politicians</td>
<td>Netherlands 9</td>
<td>Greece 73</td>
</tr>
<tr>
<td>Irregular payments / bribes</td>
<td>Belgium 31</td>
<td>Portugal 49</td>
</tr>
<tr>
<td>Judicial independence</td>
<td>Finland 1</td>
<td></td>
</tr>
<tr>
<td>Gov’t officials favoritism</td>
<td>16</td>
<td>53</td>
</tr>
<tr>
<td>Gov’t regulations</td>
<td>33</td>
<td>79</td>
</tr>
<tr>
<td>Burden of gov’t regulations</td>
<td>18</td>
<td>40</td>
</tr>
<tr>
<td>Legal framework to settle disputes</td>
<td>7</td>
<td>60</td>
</tr>
<tr>
<td>Gov’t policy transparency</td>
<td>71</td>
<td>54</td>
</tr>
<tr>
<td>Bus. costs of crime / violence</td>
<td>20</td>
<td>68</td>
</tr>
<tr>
<td>Organized crime</td>
<td>27</td>
<td>68</td>
</tr>
</tbody>
</table>

Using all the factors analyzed by the World Economic Forum, we took this one step further: **How does the European Monetary Union compare to other monetary unions, either real or imagined?** As shown below, the European Monetary Union has around the same cross-country factor dispersion as a hypothetical monetary union composed of all countries beginning with the letter “M”. The rest, including monetary unions composed of countries that were members of the Ottoman Empire or the Soviet Union, exhibit more cross-country similarities than Europe. The European Monetary Union, for all its successes and pitfalls, is a road less traveled.
VI: Indicators cited in the preface that have returned to pre-crisis levels

In the charts below, we show the items cited in the preface whose valuations or levels have returned to where they were in 2007. On corporate bonds, usually we look at credit spreads over Treasuries. Given the intervention by Central Banks (directly and indirectly) in government bonds, credit yields are probably a better measure of value right now.

**Global and U.S. trailing price-to-earnings ratios**

![Graph showing Global and U.S. trailing price-to-earnings ratios](source: Bloomberg, Empirical Research. JPM Securities. November 2013.)

**Speculative stock-bond position**

![Graph showing Speculative stock-bond position](source: CFTC, J.P. Morgan Securities LLC. November 2013.)

**U.S. and European volatility indices**

![Graph showing U.S. and European volatility indices](source: Chicago Board Options Exchange, Bloomberg. November 2013.)

**Homes resold within 6 months of purchase in California**

![Graph showing Homes resold within 6 months of purchase in California](source: Empirical Research Partners, PropertyRadar.com. October 2013.)

**U.S. corporate investment grade and high yield bonds**

![Graph showing U.S. corporate investment grade and high yield bonds](source: Bloomberg. November 2013.)

**Discount rates for newly underwritten core real estate transactions**

![Graph showing Discount rates for newly underwritten core real estate transactions](source: J.P. Morgan Asset Management. November 2013.)
VII: U.S. fiscal outlook: quieter in 2014, with long-term battles ahead

After a tumultuous couple of years in Washington, it looks like 2014 will be quieter on the fiscal policy front. In 2011, the budget outlook was pretty dire: the Alternative Fiscal Scenario from the Congressional Budget Office projected the federal debt at 109% of GDP by 2023. Since then, the 2011 Budget Control Act and 2013 tax act significantly contributed to deficit reduction and the 2023 debt outlook has fallen to 70%-80% of GDP. The trajectory of the federal debt has stabilized for now, and the budget deficit should improve for cyclical reasons to 3.3% of GDP in 2014.

In 2014, we do not foresee any major tax policy legislation, any material changes to the Sequester’s net impact over a 10-year period, or any significant change in entitlements. We expect a budget deal to push debates about the debt ceiling and other fiscal issues into 2015.

The long-term battle in Washington is now about the mix of government spending as well as the level. The Budget Control Act cuts non-defense discretionary spending as a % of GDP to the lowest level in 40 years. This category of spending includes the items in the table below, which in aggregate impact the productivity and future of the U.S. economy (infrastructure, worker retraining, renewable energy R&D, general science research). The prioritization of entitlements over non-defense discretionary spending has taken over. As shown, the ratio of entitlement to discretionary spending began at 1:1 in the 1970’s; has risen to 2.5:1 today; and is headed to 4:1 by the end of the decade. The concept of “generational theft” has entered the American policy lexicon, and the battles should heat up as the line in the chart below keeps rising.

### Federal debt held by the public

**Percent of GDP**

<table>
<thead>
<tr>
<th>Year</th>
<th>Baseline (current law)</th>
<th>2013 Alternative Fiscal Scenario</th>
<th>2011 Alternative Fiscal Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>106%</td>
<td>110%</td>
<td>115%</td>
</tr>
<tr>
<td>2012</td>
<td>105%</td>
<td>110%</td>
<td>115%</td>
</tr>
<tr>
<td>2013</td>
<td>104%</td>
<td>110%</td>
<td>115%</td>
</tr>
</tbody>
</table>

Source: CBO. September 2013.

### Ratio of entitlement spending to non-defense discretionary spending

- Job training and worker dislocation programs
- All elementary, secondary and higher education
- Health research and training
- Consumer and occupational health and safety
- Federal law enforcement and federal judicial system
- Pollution control and abatement
- Air, ground and water transportation
- U.S. Army Corps of Engineers
- General science research, NASA
- Energy R&D and demonstration projects
- NIH/CDC spending on disease control and bioterrorism
- International drug control and law enforcement

Source: CBO. September 2013.
VIII: U.S. municipal bond outlook and the question of Detroit

Over the past few years, there has been a proliferation of dire warnings on the U.S. municipal bond market. While there have been a few high-profile defaults, properly diversified municipal portfolios should not be experiencing too much stress. Over the long haul, municipal default rates have been low. Looking at all investment grade municipal bonds rated by Moody’s that were issued from 1970-2012, 5-year and 10-year cumulative default rates were 0.03% and 0.07%, respectively. These levels compare to 1.07% and 2.78% for investment grade corporate bonds over the same period. Municipal Chapter 9 filings have risen in the last three years from 7 cities per year to a little over 10, but these levels are still very low for a market with tens of thousands of issuers.

State and local taxes have begun to rebound at a national level. Some of the increase may be a consequence of accelerated income recognition by investors anticipating higher capital gains taxes on the top two brackets last year. However, withheld taxes on ordinary income have been increasing at a 7%-8% rate, indicating that the trends are real. We look at both state and local property taxes when thinking about municipal risk. When evaluating city issuers, the property tax base is more useful. According to the U.S. Census Survey of State and Local Governments, property taxes make up ~75% of total city tax receipts. At the state level, property taxes are less important: 83% of state tax revenues come from sales and income taxes. What about bond insurance? A decade ago, municipal bond insurers such as AMBAC and MBIA wrapped around 50% of the entire market. Today, virtually no new issues are insured, and the insured component of the outstanding stock has fallen to 30%. This argues for more rigorous credit analysis applied to municipal portfolios.

The difficult questions for some municipalities lie in the long-term rather than the short-term. Some challenges relate to underfunding of certain pension plans. While financial assets have rallied since their 2009 lows, public plan liabilities grew uninterrupted throughout the prior decade. There’s around a $1 trillion negative gap between plan assets and liabilities, assuming a 7.5% discount rate on liabilities. To close this gap over time starting today, annual pension plan returns of 9% would be needed14. Bridgewater estimates that if the contribution-outlay relationship of public plans remains unchanged, in 10 years, this annual required return would rise to 13%. If so, and if such returns were not achieved, there may be a need for (a) higher taxes, (b) revised pension formulas and/or (c) reductions in non-pension spending.

14 Bridgewater Daily Reports, November 21, 2013.
Investor focus is now understandably on Detroit where an emergency manager has been appointed by the state to sort things out. The emergency manager proposed write-downs of 80%-90% on holders of Detroit unsecured general obligation bonds, as well as reductions in unfunded pension fund and healthcare obligations to retirees. The latter are 2-3 times larger than the former.

The more relevant issue for municipal investors: how similar is Detroit to the rest of the city-level municipal market? That is an issue we addressed in depth last year in “How Different is Detroit?”, Eye on the Market, August 6, 2013. We examined where Detroit stands relative to other cities in terms of growth (gross metropolitan product), income per capita, labor force growth, population growth, property tax base per capita, etc. As shown by the black lines in each chart, Detroit is considerably worse. In the view of our municipal bond managers, portfolios with much better economic fundamentals can be constructed. The blue lines depict a mapping of our largest general obligation holdings based on balances held as of August 2013.

Our August Eye on the Market goes into more detail, but to summarize, our view is that Detroit is more an outlier than a paradigm. While Cleveland, Youngstown, Dayton and Toledo share some of Detroit’s problems, Detroit in aggregate stands alone. There may be more city bankruptcies in the years ahead, but the visibility around Detroit’s problems and those of similarly positioned cities should allow defensive-minded municipal portfolio managers to avoid large exposures to the country’s biggest problems.
Cover art data sources

Acronyms

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