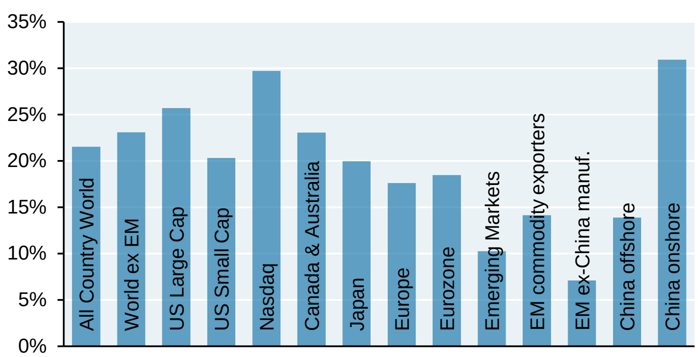
War of the Worlds: Life at home in 2019

The 2020 Eye on the Market Outlook will be released on January 1st. We will cover the usual suspects (the never-ending trade war), and include additional sections on IPO markets, the China slowdown, the extraordinary outperformance of US equities vs the developed world, the death of inflation, negative rates in Europe, market risks from a possible progressive overhaul of the US economy, why we don't think there will be a US recession in 2020 and what markets may suffer most when there eventually is. Despite a lot of recession obsession and other gloom, 2019 was a very good year for investors; although to be clear, the 2019 US equity rally was based *entirely* on multiple expansion, in contrast to the 2009-2018 rally which was primarily driven by earnings growth. That makes equities very sensitive to further imposition of tariffs, which markets have been assuming would not happen. In any case, we expect lower equity and fixed income[1] returns in 2020 even as the global economy recovers.

At this time each year, I write a piece that's different from our normal investment commentary. This year, I describe what happened on a random Tuesday evening at home. I look forward to seeing many of you in the New Year. Happy Holidays.

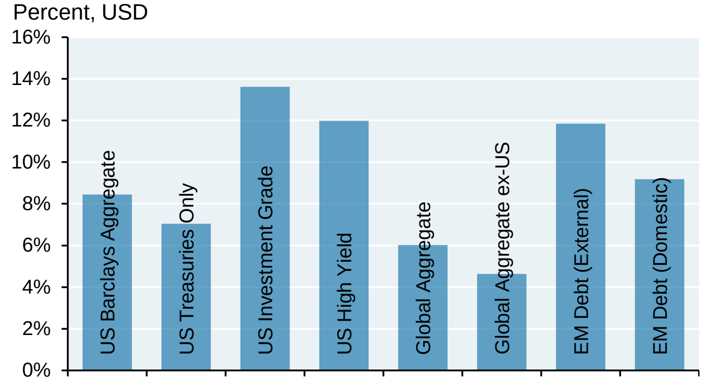
Michael Cembalest
J.P. Morgan Asset Management

YTD total returns for major equity markets/regions
Percent, USD



Source: Bloomberg. December 3, 2019.

YTD total returns for major fixed income markets
Percent, USD



Source: Bloomberg. December 3, 2019.

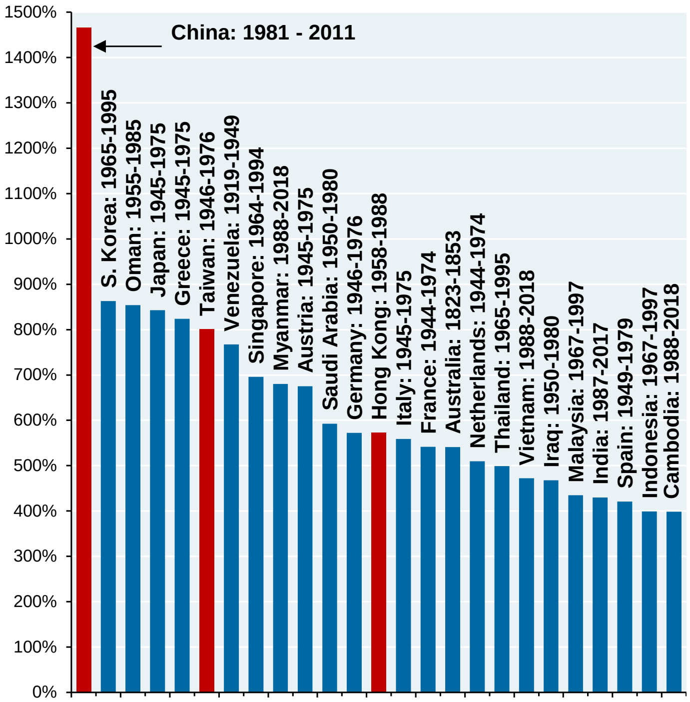
[1] The YTD 14% return on investment grade corporate bonds reflects the rally in 10 year Treasuries to 1.7% and spreads tightening below 200 basis points over Treasuries, gains which are not likely to repeat themselves in 2020.

War of the Worlds: Life at Home in 2019

It all started out innocently enough. After my spouse ("R") got tired of talking about fishing, I mentioned the two charts below that I had just created. From 1981 to 2011, China engineered the largest leap in living standards in modern history[2], and did so while prioritizing the needs of the State over the rights of the Individual in the most pervasive way you can imagine. This approach manifests itself in multiple ways, including China having the worst environmental conditions in the world when adjusting for GDP[3]. Taiwan and Hong Kong also engineered large wealth gains, but with a very different approach that prioritizes the rights of the Individual.

China's economic transformation in context

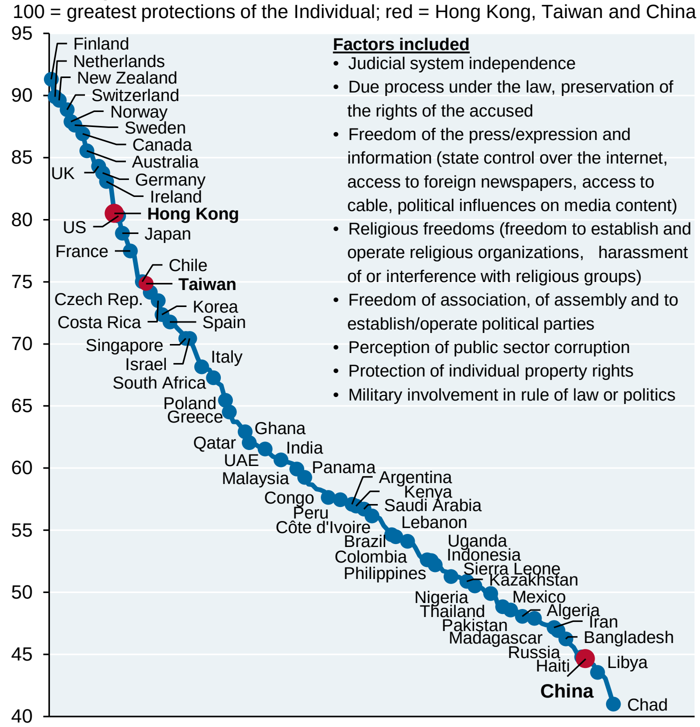
Largest 30 year increase in real per capita GDP by country



Source: J.P. Morgan Asset Management, University of Groningen, Conference Board. 2019.

The Rights of the Individual versus the State

100 = greatest protections of the Individual; red = Hong Kong, Taiwan and China



Source: J.P. Morgan Asset Management, World Economic Forum, CATO Institute, Fraser Institute. 2019.

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[2] On the **largest per capita GDP gains by country** shown in the first chart:

- In Europe and Japan, they resulted from rebuilding efforts after WWII
- In the Middle East, they usually occurred after the increase in oil prices at the end of the 1970's
- In China, they followed economic liberalization which began under Deng Xiaoping in 1981
- In the rest of Asia, some are underway right now (India, Myanmar, Cambodia, Vietnam), while in Indonesia and Malaysia, they occurred after debt-fueled growth which ultimately collapsed in 1998
- In Australia, they coincided with a period of rapid colonization in the 1800's, including convicts exported from Britain's overcrowded prisons
- In Venezuela, they were a consequence of oil sector development starting in 1926, a sector that its government is now destroying (production of 3 million barrels/day in 2000 declined to 830,000 by 2019)

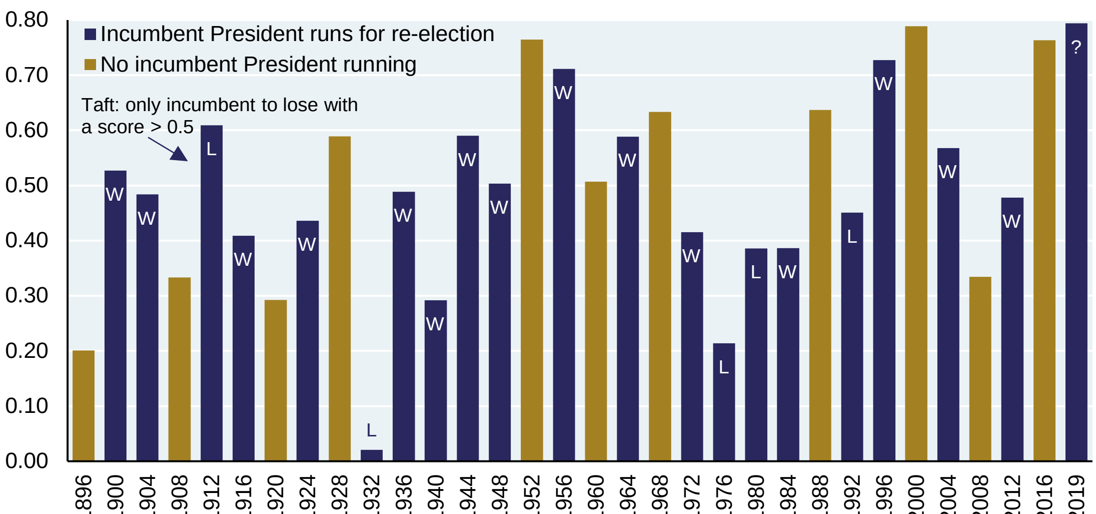
[3] **The wealthier a country is, the better its environmental conditions generally are**. According to Yale's Environmental Performance Index, there are only a few countries in the world with worse environmental conditions than China, and all of them have a much lower per capita GDP.

I thought these China charts were interesting in their own right, but R somehow made the discussion about Trump as well. I was confused, since I didn't see a connection between Trump and what's happening in Hong Kong. I then realized that this disconnect reflects the fact that R and I now live in two very different worlds of information, each of which I will illustrate with a chart.

Here's the chart from my world. We collected data on unemployment (both levels and changes), home prices, US per capita GDP vs other G10 countries, equity markets and inflation. Here's what we found:

- Going back to the Presidential election of 1896, Trump as an incumbent benefits from the **strongest tailwinds on record**, using our set of variables (which are constrained by availability of data that can be sourced back to the late 19th century)[4]
- With the exception of Taft in 1912, the only incumbent Presidents that lost did so at a time when this tailwind measure was **below 0.5**: GHW Bush, Carter, Ford and Hoover
- This is not a comment on Trump's re-election chances (he currently trails many possible candidates in early polls). It is simply to say that if Trump is not impeached by the House[5] and Senate, and if he were to lose the election in 2020, it could easily be described as the **greatest Presidential** "**fumble**" of economic and market tailwinds in modern history. And as a reminder, the GOP lost 40 House seats in the 2018 **midterm elections** when market and economic conditions were comparable; that number of lost House seats normally occurs when conditions are much weaker. This indicates that market and economic factors may not be the primary drivers of voter considerations right now

2020: the strongest Presidential election tailwinds since 1896
Average percentile score of consumer price inflation, producer price inflation, unemployment level, change in unemployment, US per capita GDP vs the G10, equity market returns/volatility and home price appreciation (higher percentile score = more favorable conditions)



Sources: J.P. Morgan Asset Management, R. Shiller (Yale), Bureau of Labor Statistics, Conference Board, Univesity of Groningen, C. Romer (Berkeley), S&P, CoreLogic, St Louis Fed. 2019. Inflation percentiles based on deviation from assumed optimal 2% level.

[4] It's hard to determine which tailwinds this administration is responsible for, and which are due instead to cyclical improvements that began under the Obama administration, easy Fed policy, unsustainable fiscal deficits, etc

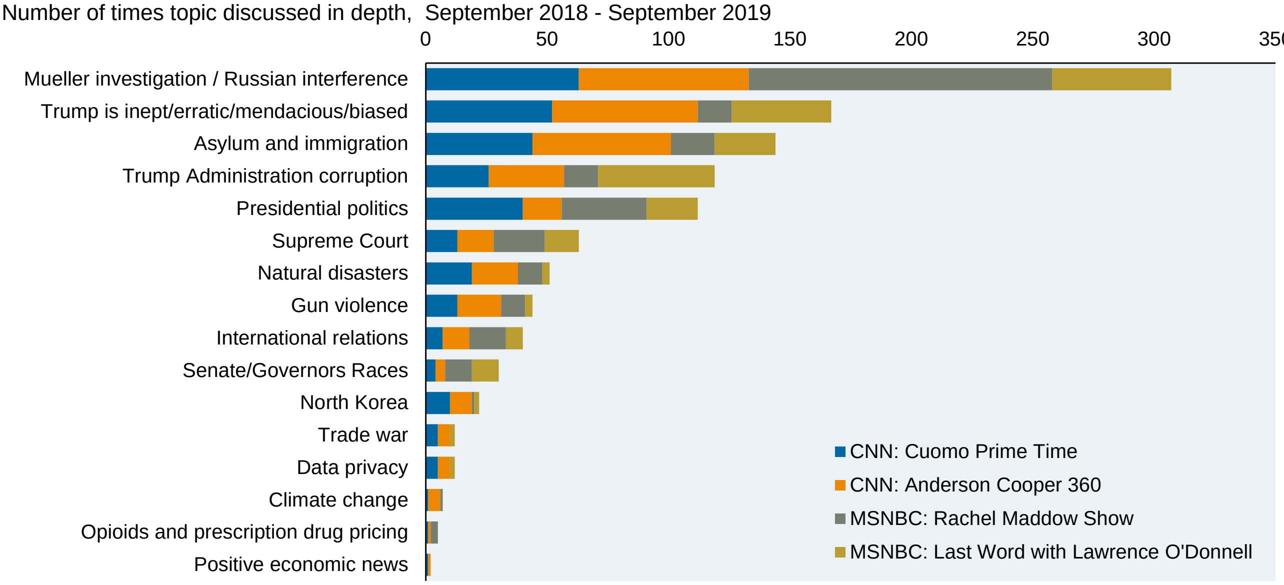
[5] Given the predisposition of Senate Republicans against impeachment, a House impeachment proceeding is more likely aimed at influencing swing voters in the general election. The hearings do not appear to have swayed public opinion very much; the NYT reports that support for impeachment is mostly unchanged vs where it was before.

For contrast, here's a chart from R's world, which is a very different place…

- Using transcripts of the two most popular shows on her favorite networks (CNN and MSNBC), my team and I kept a tally of topics covered each night. We started in September 2018 and ended in September 2019 before the onset of the Ukraine/political interference scandal
- From an investor's perspective, I agree that the President merits the coverage he's getting on a variety of topics shown in the chart. Of the 128 variables in our global growth and policy model, "**rule of law**" and an "**uncorrupt government**" have the highest correlation to a country's per capita GDP. It's worth re-reading select parts of Washington's Farewell Address[6], particularly with Trump reportedly considering an invitation to attend the May Day parade in Moscow[7] next year
- Even so, it's remarkable that in R's world, there's **so little attention paid to the positive economic news of the day**, some of which has occurred since 2016. Look at the tiny little bar showing how infrequently these shows report on it; no small wonder that R and I talk past each other sometimes

That's all for 2019. Enjoy the holidays and we will (digitally) see you again on January 1st.

The Medium is the Message: relative reporting of positive economic news on select cable programs
Number of times topic discussed in depth, September 2018 - September 2019



Examples of positive economic news (see Appendix for charts on items listed below)

- Wages rising across all levels of income, with wage growth of lowest-income workers growing the fastest
- Highest rate of job vacancies in 20 years, particularly in construction
- First sustained pickup in manufacturing dynamism since 2009 (rise in new hires and voluntary quits, decline in layoffs)
- Consumer confidence surveys exceed pre-crisis levels
- Lowest household debt service to income obligations in 40 years
- Lowest misery rate (inflation plus unemployment) since the 1960s (for all citizens, as well as by race and gender)
- Substantial rebound in labor force participation rate for prime age workers since 2016
- Small Business Optimism finally back to pre-crisis levels

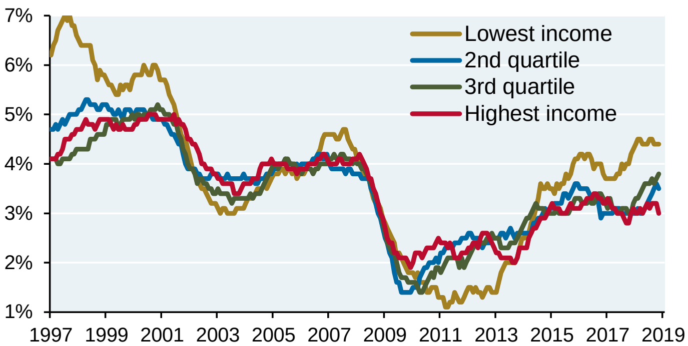
Source: J.P. Morgan Asset Management, CNN and MSNBC show transcripts. 2019.

[6] "Against the insidious wiles of foreign influence, the jealousy of a free people ought to be constantly awake, since history and experience prove that **foreign influence is one of the most baneful foes of republican government**. …Real patriots who may resist the intrigues of the favorite are liable to become suspected and odious, while its tools and dupes usurp the applause and confidence of the people, to surrender their interests". *G. Washington, 1796.*

[7] ***Glass Houses Dep't.*** After **Romney** said in 2012 that Russia was the greatest geopolitical threat to the US, he was mocked by **Obama** ("the 1980s are calling to ask for their foreign policy back"), and **Biden** ("Romney is one of a small group of Cold War holdovers…he acts like he thinks the Cold War is still on and Russia is still our major adversary. I don't know where he has been"). Maybe they changed their minds on Russia after the 2016 election?

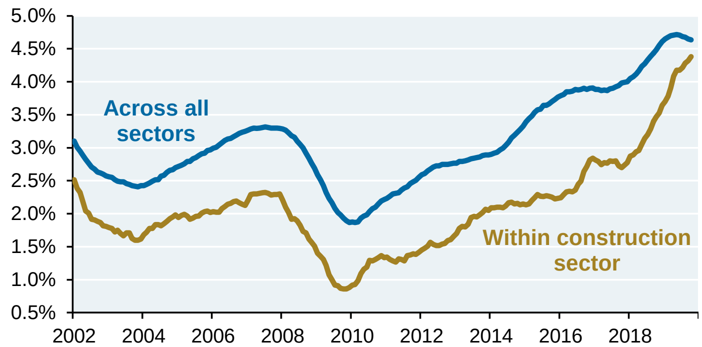
Appendix charts. These measures are pretty standard, and have been used to assess growth and prosperity for decades. This is not meant to be an exhaustive list, since there are important trends to analyze on inequality as well. However, scholarship on inequality is more art than science. As we have discussed before, researchers at the Joint Committee on Taxation, the US Treasury and Columbia (among others) have expressed significant concerns about the ubiquitous Saez/Zucman/Piketty (SZP) findings on inequality which have gone viral in recent years. "Distorted" and "improbable" are two adjectives used to describe SZP findings; alternative assessments show much smaller changes in wealth and income inequality over the last 40 years.

Wages rising across all levels of income
12 month moving average of monthly median wage growth, %



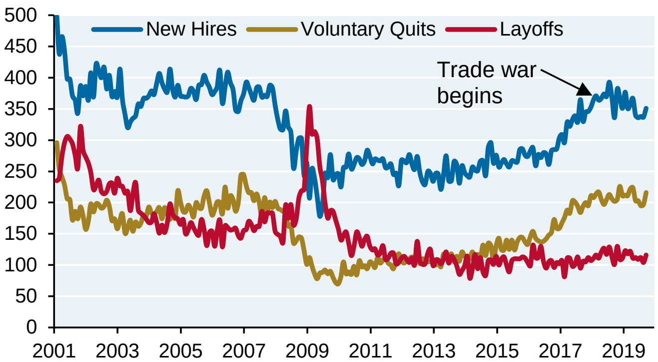
Source: Federal Reserve Bank of Atlanta. October 2019.

Highest rate of job vacancies in 20 years
Job vacancies as % of employment, 12 month average



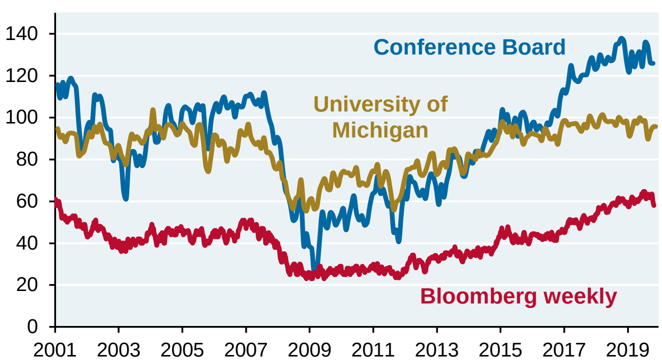
Source: Bureau of Labor Statistics. September 2019.

First sustained pickup in manufacturing job dynamism since 2009, Thousands



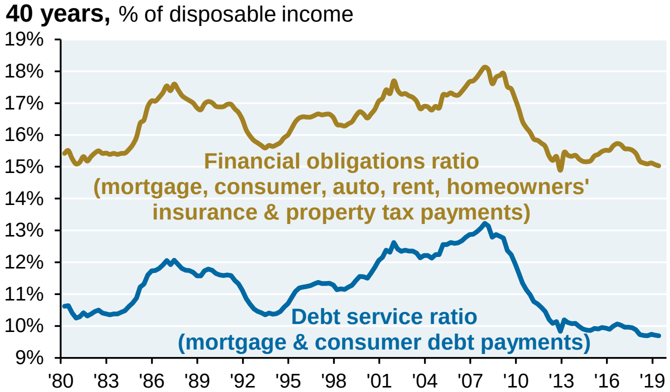
Source: Bureau of Labor Statistics. September 2019.

Strong pickup in consumer confidence
Index level



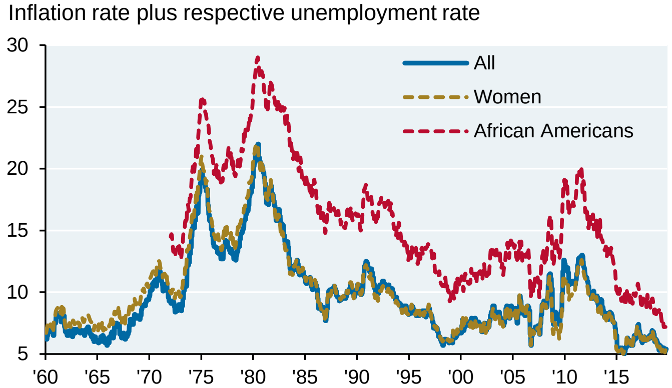
Source: Bloomberg, Conference Board, University of Michigan. Nov 2019.

Lowest household debt service to income obligations in 40 years, % of disposable income



Source: US Federal Reserve. Q2 2019.

Lowest misery rates since the 1960s
Inflation rate plus respective unemployment rate



Source: Bureau of Labor Statistics, Bloomberg. October 2019.

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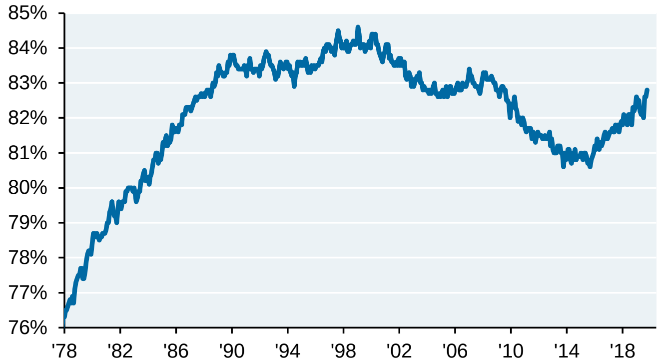
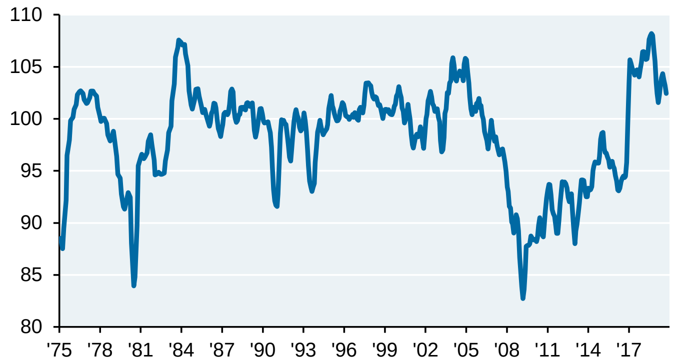
Substantial rebound in labor force participation
% of population aged 25 to 54



Source: Bureau of Labor Statistics. October 2019.

Small business optimism finally back to pre-crisis levels
Index, 1986=100, 3 month average



Source: National Federation of Independent Business. October 2019.