

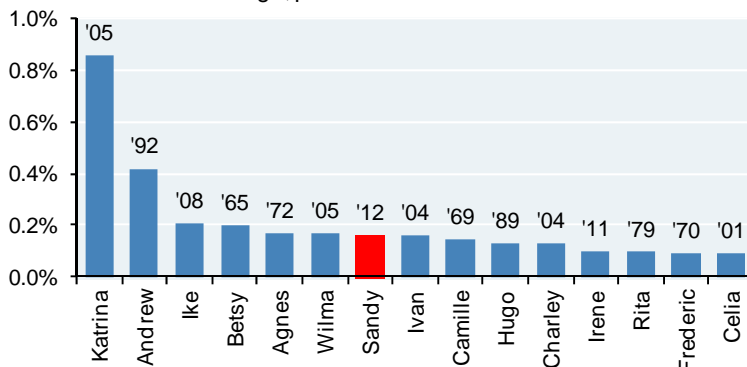
## The Storm; and my list of demands regarding global growth, US profits, the US Federal debt and China

Some of our clients have suffered temporary or permanent damage from the storm. Please let your J.P. Morgan team know if there are ways they can help. It's a bit early to draw too many conclusions, but here are some thoughts on the economic and civil engineering aspects of the storm:

- Comments on CNBC about positive multiplier effects from the storm defy the laws of economics. Natural disasters can change the contours of spending and investment (lower than trend today, higher than trend for a few months afterwards), but in general, **natural disasters which destroy the capital stock are bad, not good**<sup>1</sup>. Only in cases where a country responds to a disaster by radically improving productivity through innovation and more advanced technology could the balance be positive (along the lines of Joseph Schumpeter's theory of "creative destruction"). **The best that most developed countries can shoot for is to re-attain pre-disaster growth levels as soon as possible, which the US has had a habit of doing.**
- Japan is a good example: industrial production collapsed and then rose sharply after the tsunami, but has since resumed its downward trend. As per last week's energy piece, Japan's transition from nuclear to offshore wind is not likely to yield creative destruction benefits.
- Early estimates of the cost of Hurricane Sandy are ~\$20-\$25 billion. Measuring natural disaster costs relative to GDP makes more sense than simply adjusting over time for inflation. As shown below, Sandy ranks with more severe hurricanes, but well below Katrina and Andrew even if cost estimates rise from current levels. The long-run economic impacts should not be very large if history is any guide.
- However, there are some things for New York to think about: it has the worst "wealth to flood protection" ratio in the world.** Studies by the OECD<sup>2</sup> analyzed 136 coastal cities around the world with at least 1 million inhabitants. As shown in the table, Greater New York was #2 in terms of assets exposed to coastal flooding, only behind Miami. And more ominously, Amsterdam and Rotterdam are protected to a flood standard of the most severe storm every 10,000 years; Tokyo, Shanghai and London are protected to a 1,000 year standard; Osaka to a 300 year standard; and New York only to a standard of 100 years. If the UK is any example, it takes time to change: the Thames Barrier was 30 years in the making.
- While electricity outages in metropolitan areas are mostly a function of coastal flooding, **millions of suburban and rural customers are without power due to downed electrical wires.** This has always struck me as a 19th-century kind of problem. These instances would be dramatically reduced if power lines and transformers were buried underground. However, the costs of underground electricity distribution systems can be 4-6 times higher than overhead wires. Can these costs be justified by the associated benefits: reduced repair costs after storms, fewer car accidents involving utility poles, reduced tree trimming costs and lower electricity line losses? Not really; in 2005, Virginia estimated the benefits of burying power lines and transformers as being only 40% of the \$10 billion cost. Only if you are willing to assume large increases in property values can the numbers be made to work. Most US states that looked at this have come to similar conclusions.

### The 15 costliest mainland US tropical cyclones

Total estimated damage, percent of GDP



Source: National Weather Service, Bureau of Economic Analysis.

### Flood protection standard worst storm per # of years

Amsterdam	1:10,000
Rotterdam	1:10,000
Shanghai	1:1,000
London	1:1,000
Tokyo	1:1,000
Osaka	1:300
New York	1:100

### Cities ranked by assets exposed to coastal flooding (bn, 2007\$)

Miami	416
New York	320
New Orleans	234
Osaka-Kobe	216
Tokyo	174
Amsterdam	128
Rotterdam	115
Nagoya	109
Guangzhou	84
Shanghai	73

University of Southampton (UK) and OECD; see footnote 2

<sup>1</sup> The Summer 2011 issue of International Economy Magazine had an article on the impact of natural disasters on growth, and the majority of contributors shared this point of view.

<sup>2</sup> "Ranking of the world's cities most exposed to coastal flooding", 2007, and "A global ranking of port cities with high exposure to climate extremes", 2009, both from the OECD and the School of Civil Engineering and the Environment, University of Southampton (UK).

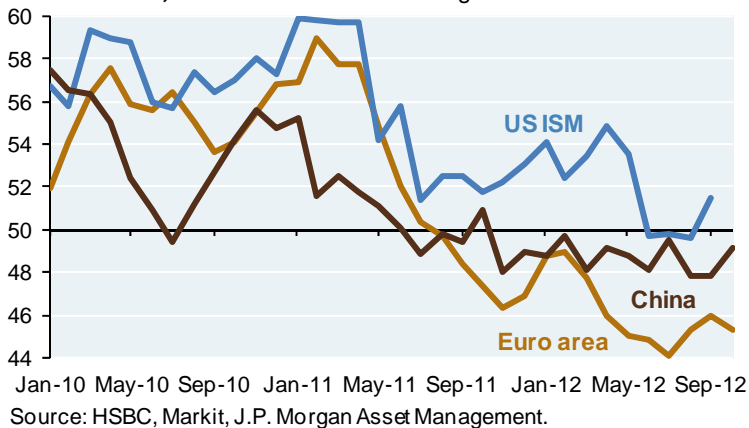
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OK, now for my list of demands. Each is related to the investment outlook for 2013 and beyond.

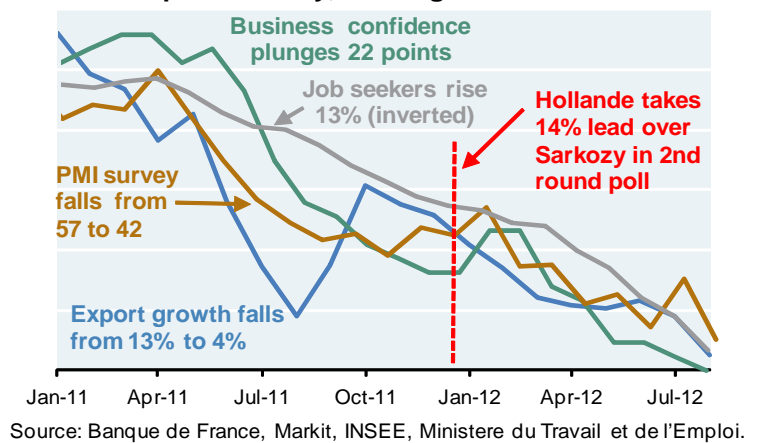
### Demand #1: More disclosure by US firms on non-US operations as global growth cools off

The current mix of leading indicators is a mixed bag. The US is growing at 2% with the help of very easy monetary policy (10-yr interest rates below the rate of inflation) and easy fiscal policy (9% budget deficit). Elsewhere, China, Korea and Taiwan are getting a bit better, but Europe is still weak (German IFO survey, Euro/German PMI survey, etc.) As for France, its economy is reacting to its new President the way a French family I once lived with reacted when I put barbecue sauce on salad (2<sup>nd</sup> chart). More on this next time, but France is the closest thing in the world to a worker's utopia<sup>3</sup>, which is expensive to maintain.

#### Manufacturing: stable in US; improving in China; sluggish in Euro area, Flash Markit Manufacturing PMI

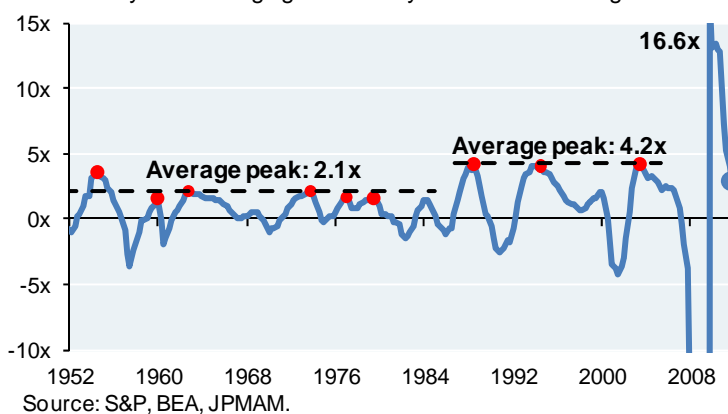


#### France: Après Sarkozy, le Déluge?

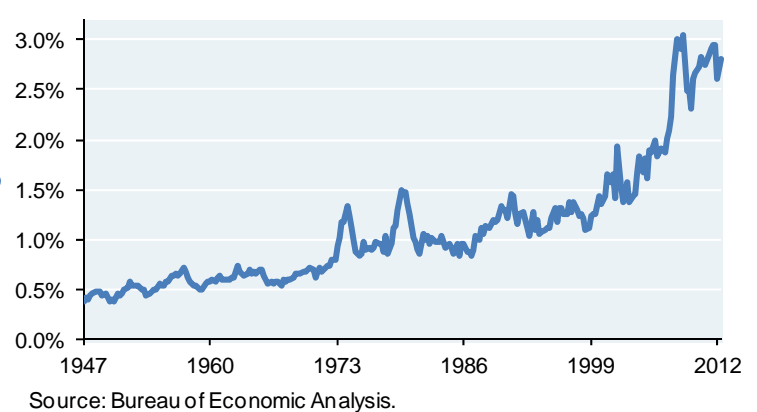


We introduced the next chart 2 years ago when corporate profits started outperforming GDP by a margin we hadn't seen before. The primary contributors to earnings outperformance: weak labor compensation, and rising profit contributions from outside the US. **However, with the summer slowdowns in Europe, China and Japan, this factor has been working in reverse, leading to negative US earnings guidance for Q4 2012.** 56 companies provided Q4 guidance, and 47 were negative (mostly tech and consumer discretionary). Street estimates for these companies were ~9% higher than guidance provided. While most companies provide regional revenue breakdowns, they are often bucketed into "Americas", "Europe" and "Asia". That doesn't help much when there are huge differences between Mexico and the US, Spain and Germany, and China and Taiwan. A more detailed breakdown would help analysts so that some earnings surprises wouldn't be such a surprise. While earnings growth is slowing, Q3 was not a disaster; S&P earnings are down ~1% vs 2011. There were larger disappointments on sales, offset by companies managing expenses and increasing share repurchases (the S&P share count divisor shrunk for the 5<sup>th</sup> quarter in a row).

#### Unusual period of earnings outperformance ending Ratio of 2-year earnings growth to 2-year nominal GDP growth



#### US foreign-sourced corporate profits Percent of GDP



We need to see a more decisive upturn in non-US leading indicators to anticipate higher US profits momentum next year. The good news: companies have reduced inventories in response to lower growth, setting the stage for a possible rebound in the spring. As the year comes to a close, the S&P 500 at 1,400 is 13 times 2013 earnings. If earnings are re-converging to nominal US GDP growth, that's about as high as I would expect them to get until a stronger recovery is more evident.

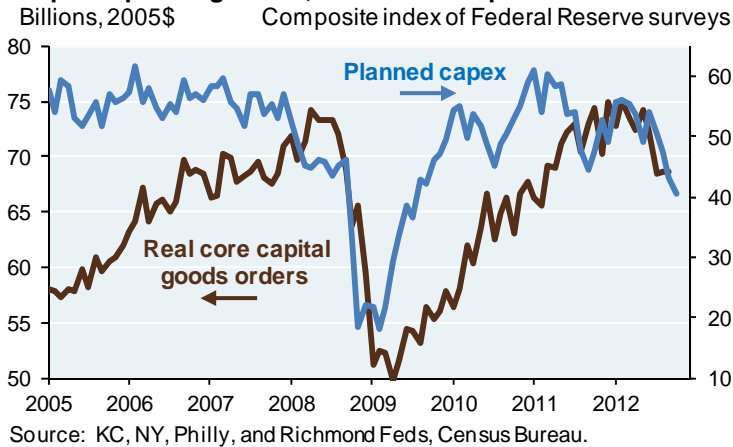
<sup>3</sup> Scanning the world, France ranks at or near the top in government transfers to households, vacation times and labor market rigidity, and at or near the bottom in hours worked per week, labor force participation rates and retirement age as a % of life expectancy.

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### Demand #2: The CBO should stop publishing its Baseline Case for US Federal Debt since it is increasingly preposterous

The US business sector would be relieved if the fiscal cliff were dispensed with after the election, based on all the letters to Washington pleading for this to happen. Some believe that this could jump-start business capital spending, which has fallen sharply (although part of the decline was related to a massive, still-unexplained decline in orders for HVAC equipment).

#### Capital spending slows; fiscal cliff responsible?



#### The fiscal cliff, in billions and percentage of GDP

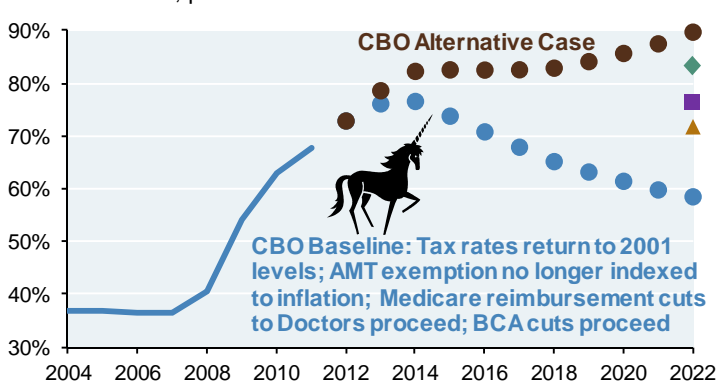
Increased Revenues from:	Legislated	#1	#2
Expiring payroll tax holiday	115	115	115
Expiring personal tax provisions	27		
Expiring business tax provisions	75		
New healthcare taxes	24	24	24
Alternative Minimum Tax	40		
Expiring 2001/2003 Upper Income tax relief	83	83	
Expiring 2001/2003 remaining tax relief	171		
<b>Total increase in revenues</b>	<b>535</b>	<b>222</b>	<b>139</b>
Reduced Expenditures from:			
Lower Medicare physician reimbursement	14		
Ending extension of unemployment benefits	33	33	33
BCA spending reductions (Sequester)	85		
<b>Total expenditure reductions</b>	<b>132</b>	<b>33</b>	<b>33</b>
<b>Total fiscal adjustment</b>	<b>667</b>	<b>255</b>	<b>172</b>
<b>Total fiscal adjustment (%GDP)</b>	<b>4.3%</b>	<b>1.6%</b>	<b>1.1%</b>

Source: Tax Policy Center, CBO, J.P. Morgan Asset Management.

Defusing the fiscal cliff (possibly through iterations #1 and #2 in the grid) would help growth in 2013. However, it would contribute to rising Federal debt unless the growth payoff was huge<sup>4</sup>. As a result, the business sector is also requesting that something be done about the long-term fiscal outlook. Eighty US CEOs published a letter last week calling for Washington to strike a long-term fiscal “grand bargain” that includes higher tax revenues (but not in 2013). In that context, here’s our updated Federal debt chart. The outer contours of the wedge represent the Congressional Budget Office Baseline Case and Alternative Case. The problem with the Baseline Case is that while it represents “current law”, it has become increasingly preposterous, as it includes items that Congress passed but has been deferring for a decade (changes to the Alternative Minimum Tax and Medicare reimbursements), and a wholesale resumption of 2001 tax rates that Congress has no intention of implementing. The CBO should just stop publishing it, or put a unicorn next to it as an indication of how likely it is to happen.

#### US long-term debt scenarios

Net debt to GDP, percent



- All tax cuts and subsidies extended, AMT and medicare patches continue, no BCA sequester
- ◆ For AGI > \$250k, tax rates return to 2001 levels
- President's budget as written; for AGI > \$250k:
  - \* Tax rates return to 2001 levels, tax dividends as ordinary income, tax LTCG at 20%, other deduction and exemption limits (PEP/Pease)
  - \* Limit the tax value of itemized deductions to 28%
  - \* New tax on municipal bond income, contributions to 401k plans, and all health insurance premiums paid by employees and employers (taxed at difference between taxpayer's top statutory rate and 28%)
  - \* Bring estate tax exemption and rates back to 2009 levels
- ▲ President's budget as written + BCA Sequester

**What might a second Obama administration do about this?** The President’s proposal shown by the purple square stabilizes the Federal debt over a ten-year horizon according to CBO forecasts, and does so almost entirely through higher taxation of families with more than \$250,000 in adjusted gross income. The plan does not appear to be politically feasible, even if there is a Democratic sweep. If the President is re-elected and only manages to pass increases in tax rates on the top two brackets, then as shown by the green diamond, the impact on the long-term debt is more modest. As we briefly mentioned last week, the President’s tax plan (if enacted) would raise effective tax rates on high net worth families by 4% to 12%, based on some demographic examples we examined.

<sup>4</sup> There are those who believe that the Fed could just write off the Treasuries that it owns. This view has been advanced by Ron Paul in H.R. 2768, and seconded by his ideological opposite Dean Baker, ultra-progressive founder of the Center for Economic and Policy Research. The economists that I trust the most describe the idea as “ludicrous”.

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**As for Romney, there is no dot to plot given a lack of specifics.** The candidate has proposed cutting tax rates and broadening the base by reducing itemized deductions. However, the Tax Policy Center concluded that reducing tax rates by 20% would result in lost revenue that is 3x higher than revenue gained by limiting itemized deductions at \$25k. Romney also mentioned cutting discretionary spending by 5%, which would most likely fall on non-defense spending as a 10% cut. However, the first phase of the Budget Control Act *already* brings non-defense discretionary spending well below the lowest level in 40 years. As a result, like Obama's tax-the-mass-affluent plan, Romney's idea of further non-defense cuts may not be politically feasible.

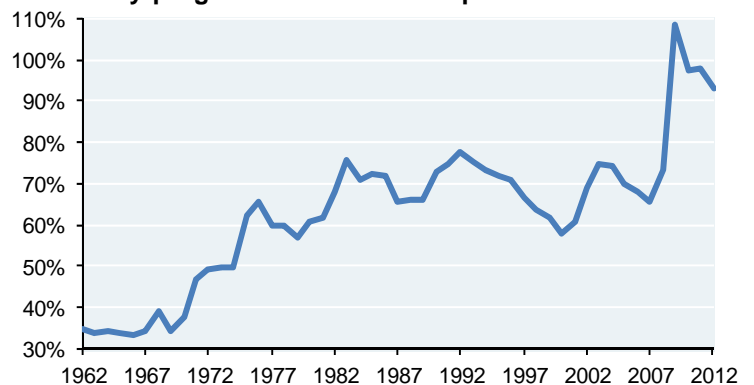
As a result, we don't have much insight on a Romney long-term debt outlook, other than the notion that pro-growth policies will reduce the debt. **Before you dismiss this, it is exactly what happened during the 1950's, when US debt/GDP fell from 80% to 40%. The popular myths as to how this happened are wrong:** as shown below, government expenditures were *not* gutted; tax receipts did *not* rise sharply; the government did *not* inflate the debt away (inflation was ~2%); and the Fed did *not* rely on Greenspan-Bernanke market manipulation (ten year Treasuries were above the rate of inflation). The economy *grew* its way out, as 4.3% real growth solved the debt problem through rising growth instead of falling debt. **Whether pro-business policies like those enacted by Eisenhower can accomplish the same result again is part of what the current election is about.** It's also about the chart next to the table, showing that close to 100% of government revenues are already committed to entitlement programs, other mandatory programs and interest. The President's signature health care bill expanded the entitlement system, whereas his opponents have mentioned (in very abstract terms) efforts to reduce it.

### 1950's Federal debt reduction relied on growth, not austerity, inflation, taxation or artificially low interest rates

	Net debt/ GDP	Net debt (bn)	Nominal GDP bn	Real GDP bn	Outlays % of GDP	Receipts % of GDP	Real 10 year Treas rate
1950	80%	\$219	\$273	\$273	16%	14%	1.3%
1951	67%	\$214	\$320	\$302	14%	16%	-5.3%
1952	62%	\$215	\$349	\$322	19%	19%	0.5%
1953	59%	\$218	\$373	\$341	21%	19%	2.0%
1954	60%	\$224	\$377	\$343	19%	19%	2.1%
1955	57%	\$227	\$396	\$354	17%	17%	3.1%
1956	52%	\$222	\$427	\$368	17%	18%	1.7%
1957	49%	\$219	\$451	\$377	17%	18%	0.3%
1958	49%	\$226	\$460	\$377	18%	17%	0.6%
1959	48%	\$235	\$490	\$398	19%	16%	3.3%
1960	46%	\$237	\$519	\$415	18%	18%	2.7%
Comp. ann'l gr:	0.8%	6.6%	4.3%				

Source: OMB, BEA, Robert Shiller data set, Bureau of Labor Statistics.

### Percent of US government revenue already committed to mandatory programs and interest expense



Source: CBO, J.P. Morgan Asset Management.

### Demand #3: China should clean up contradictions in its reported data particularly as growth is slowing

There have been press articles on the accuracy of Chinese data<sup>5</sup>, an important discussion given the debate about Chinese growth. China is partly to blame; measures of GDP, retail sales, electricity consumption, industrial profits and fixed asset investment from China's National Bureau of Statistics are at times internally inconsistent (i.e., extrapolations of monthly results from YTD data do not match those from year-on-year data). China also just reported the 9<sup>th</sup> quarter in a row of a magically unchanged unemployment rate (4.1%), and still does not report quarterly components of GDP (consumption, investment, etc) which are only provided annually. There are lots of factors involved, but these issues might be contributing to the apparently structural decline in Chinese P/E. These issues did not matter much to investors in 2007, but as Chinese growth has slowed down, many people are taking a closer look at the numbers.

### Chinese equity valuations a shadow of their former selves, Price to trailing earnings



Source: Bloomberg.

<sup>5</sup> US data is considered much more reliable, but last month, Jack Welch described a report from the Bureau of Labor Statistics as "downright implausible" due to the spike in the number of people working part-time, and the increase in the number of government workers.



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Given these concerns, a cottage industry has arisen which looks at contemporaneous, high-frequency Chinese data to see if it matches up with GDP. The grid below is part of what we look at (it doesn't make sense to just pick one of these and obsess on it, which some people do with electricity production). In aggregate, these data points tell a story of an economy that slowed this year but is now stabilizing, albeit at a reduced level of growth (around 7%), and with the help of government infrastructure spending (China ran a 600 bn RMB budget *surplus* through September, and intends on having an 800 bn RMB *deficit* through December). This may explain why some of our EM hedge fund managers have just turned positive on China equities. While Chinese growth is stable, there's a big difference between 7% and 10% for the rest of the world.

### High-frequency complements to Chinese GDP data

Data	Latest read
Cement production	Improvement in Aug/Sep to normal pace
Container throughput	Small improvement in Sep
Electricity consumption	No growth
Exports	Small improvement in Aug/Sep
Floor space started	Very volatile, weak after summer rebound
Highway freight	Improvement in Aug/Sep
Hong Kong Luxury sales	Flat vs large gains in 2009-2011
HSBC Manuf. survey	Flat, no improvement all year
Macau gaming revenue	Flat vs large gains in 2009-2011
Passenger car sales	Still weak after large gain in '09 and smaller gain in 2010 and 2011
Rail freight	Improvement in Sep after summer collapse
Steel production	Flat vs large gains in 2009 and 2010
Waterway freight	Small improvement in Aug/Sep

Source: ISI, JP Morgan Asset Management

### EM domestic demand has held up well

Real retail sales growth, 3m/3m annualized % change



Source: J.P. Morgan Securities LLC.

### Demand management

My demands are pretty simple, at least compared to some riders I have seen from performing artists as part of their concert venue contracts<sup>6</sup>. However, I have few expectations they will be granted, and surfaced them to walk through the issues we are looking at as 2012 comes to a close. **All things considered, financial markets digested these issues pretty well this year.** **Here's an optimistic read for 2013:** easy monetary policy increases global growth from its current 2% pace to 3.0%-3.5% next Spring, with contributions from emerging economies where retail sales are still growing by 10%+; the US avoids the 2013 fiscal cliff and simultaneously strikes a grand bargain on long-term debt, making headway on both entitlements and tax reform; US companies respond by increasing capital spending and hiring in a virtuous circle; and with the ECB buying bonds and providing an incentive for others to join them, Spain and Italy start to grow again, France avoids another recession, and the EU crisis gradually fades away. I can't figure out which part of this outlook is more remote: a grand compromise in Washington, or the notion that all Spain and Italy ever needed was a more interventionist Central Bank.

Michael Cembalest

J.P. Morgan Asset Management

*[if you missed our annual energy issue last week, please ask your J.P. Morgan contacts for a copy]*

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<sup>6</sup> My favorites are the ones that request Gundelsheim pickles, a barber's chair, an XBOX, white and purple hydrangeas and "absolutely no American beer".

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