



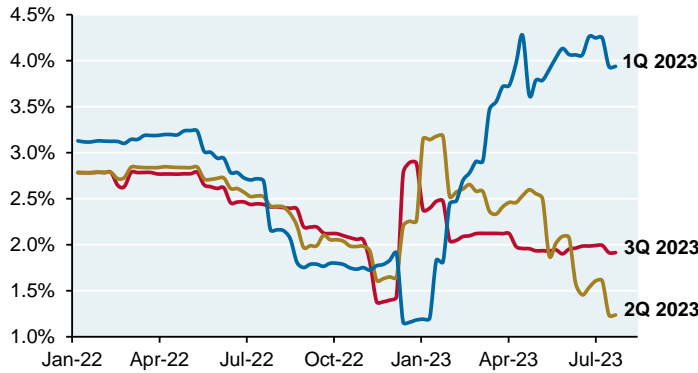
The Rasputin Effect: Explaining global economic and equity market resilience in the face of the fastest central bank hiking cycle on record; China reopening flops due to housing overhang

Legend has it that Rasputin was poisoned, shot twice, beaten and then drowned before finally succumbing to Russian nobles trying to end his sway over the Czar. I’m reminded of this (probably false) account when looking at global resilience. Despite 400-500 basis points of rapid policy tightening in the US and Europe (since 2021 ~95% of the world’s central banks have raised rates, even more than during the 1970’s inflation shock), and despite a very tepid Chinese recovery, global Q3 GDP growth is still projected to be ~2% and the MSCI World Equity Index is up 18% this year.

How can we explain this? The obvious place to start: the decline in inflation surprises and in related measures (core, trimmed, sticky and median measures of consumer price inflation; NY Fed underlying inflation gauge; “truflation”; the Global Supply Chain Pressure Index, the jobs-workers gap, etc). But there are 6 other factors worth reviewing as well, which is the subject of this month’s note.

Resilient global Q3 growth still pegged at 2%

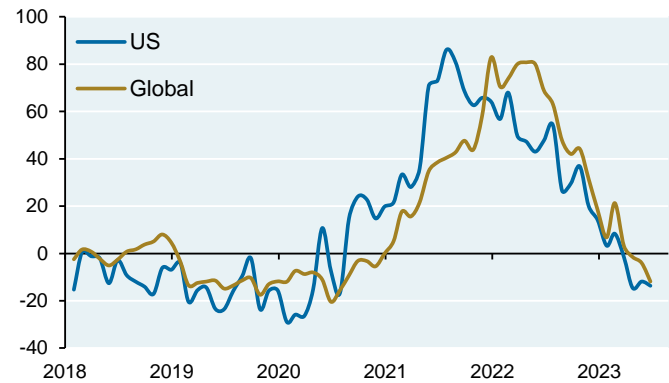
Global GDP forecasts by quarter and date made



Source: J.P. Morgan Global Economics. July 28, 2023.

Inflation surprises collapse

Inflation surprise index



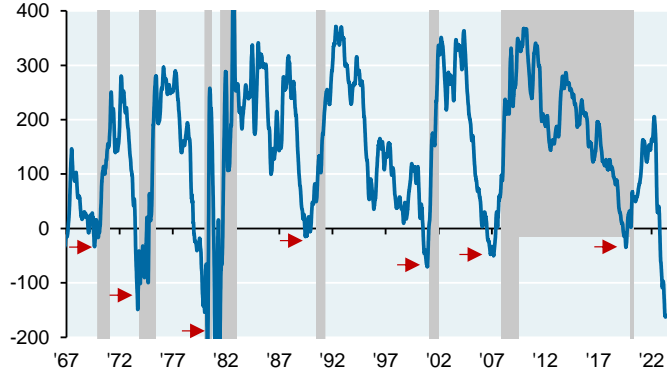
Source: Bloomberg, JPMAM. June 2023.



[1] The “inverted yield curve -> recession” argument is premature. Yes, inverted yield curves tend to precede recessions as shown on the left. But *why* was it such a consistent signal? Before prior recessions (other than COVID), yield curve inversion reflected policy rates that were restrictive in real terms (i.e., relative to inflation). This time, policy tightening in the US is barely restrictive at all, as shown on the right. And while a simple read of the yield curve points to recession, the health of the US corporate sector does not: the corporate sector financial balance is still in surplus, a condition which has never preceded a recession (see chart below).

Yield curve inversion preceded all recessions...

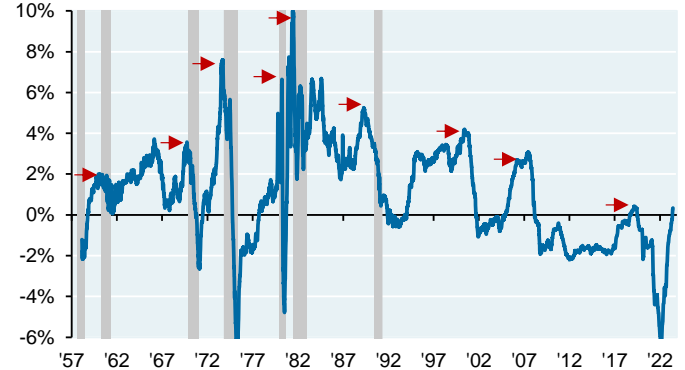
Basis points, 10Y - 3M yield spread, 30 day smoothing



Source: Bloomberg, JPMAM. July 31, 2023.

...but were caused by a higher real cost of money

Real interest rates (FED Funds - Core CPI), 21 day smoothing

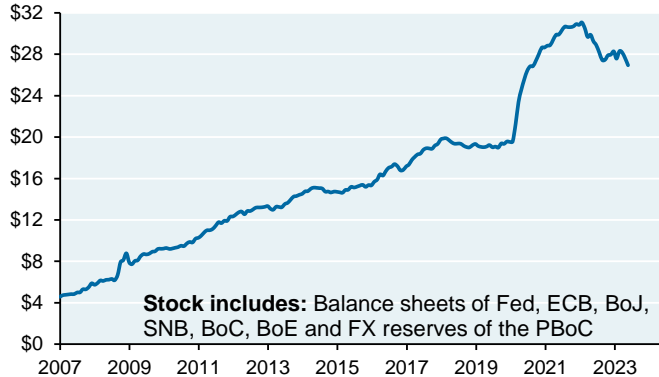


Source: Bloomberg, JPMAM. July 31, 2023.

[2] Central banks have only removed around one third of the \$11 trillion in global liquidity they created in 2020/2021. In other words when considering points #1 and #2, there’s still plenty of liquidity in the system and the cost of money is not prohibitive.

Central banks have reversed ~35% of emergency stimulus

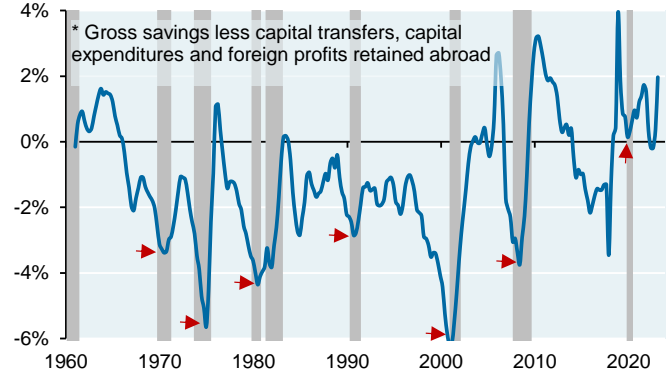
Total assets, US\$ trillions



Source: Bloomberg, JPMAM. June 2023.

US corporate sector financial balance

% of corporate gross value added, 4-quarter average



Source: Federal Reserve, BEA, JPMAM. Q2 2023.

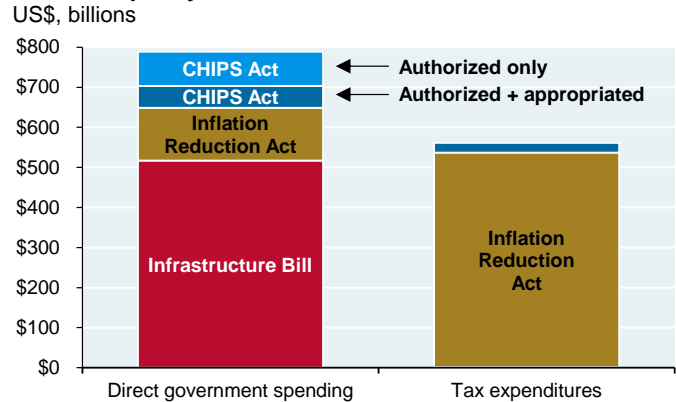


[3] Biden’s industrial and fiscal policies offset part of the drag from higher policy rates. The charts below show the construction bounce in the manufacturing sector, and the direct government spending and tax incentives associated with semiconductor, infrastructure and energy bills. And don’t look now, but **US fiscal policy has become very loose again:** the latest fiscal deficit is not far off the peak deficit during the financial crisis of 2009. A recent note from our economist colleagues goes into the details¹.

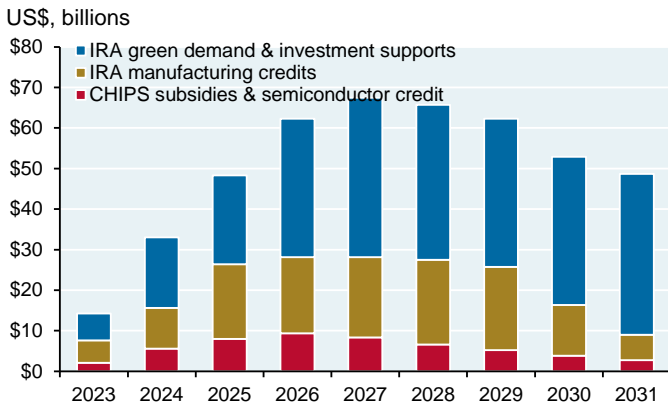
Real total manufacturing construction spending



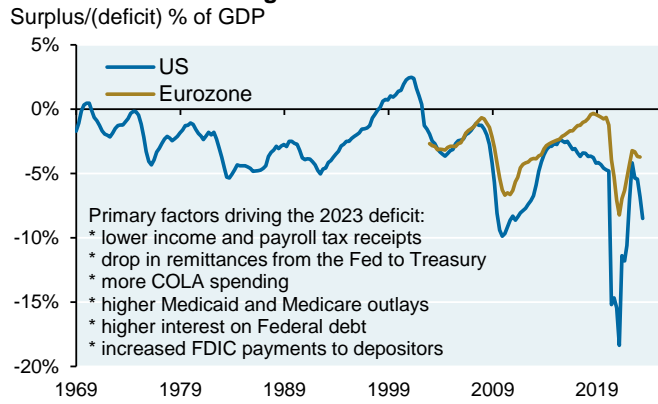
Industrial policy



Direct & indirect subsidies for semiconductors & batteries



US and Eurozone budget balance



Bidenomics, opioids and the Third Man. I’ve got questions on the long-term inflationary impact of Bidenomics. Two examples: the ultimate cost of US semiconductor production compared to Taiwan, and the cost of energy systems with large amounts of renewable power that also require substantial backup thermal power and/or energy storage. Also, the notion that hiring IRS agents will raise enough money to finance the energy bill and reduce the deficit is to me totally implausible. But there’s one thing to be optimistic about: **the potential for industrial policy to partially revitalize US manufacturing communities that were left in the dust by China’s entry into the World Trade Organization.** I’ve written before on the connection between post-WTO Chinese FX intervention, US manufacturing job losses and US opioid addiction rates (see Eye on the Market 7/13/2021). The “battery belt” that will stretch from Michigan to Georgia through Ohio, Kentucky and Tennessee will be welcome news in many communities.

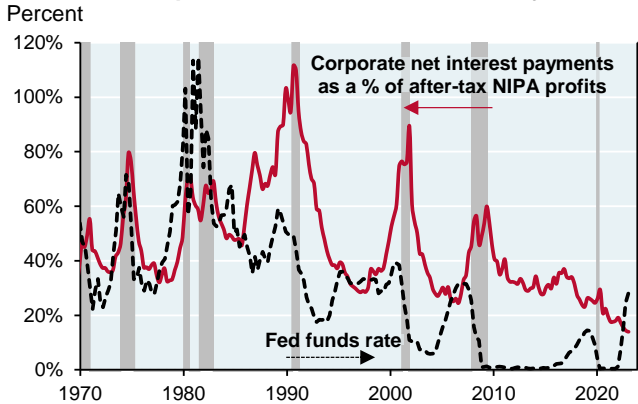
I never do media appearances but I did accept an invitation in July to speak on a video podcast called *The Compound* which is moderated by money manager Josh Brown. The reason I accepted: it’s a long form 90-minute show that allows for in-depth discussion and debate that does not occur in any other media I’ve seen. Anyway, they end the show by asking for a book and movie recommendation. I mentioned “*Empire of Pain*” by Patrick Keefe on the family behind the opioid crisis, and the 1949 film *The Third Man*. **The connection:** the ferris wheel scene in which Orson Welles describes to Joseph Cotton how he rationalizes his tainted penicillin scheme.

¹ “The Curious Case of the 2023 Fiscal Expansion”, JP Morgan North America Economic Research, M. Feroli, July 26 2023



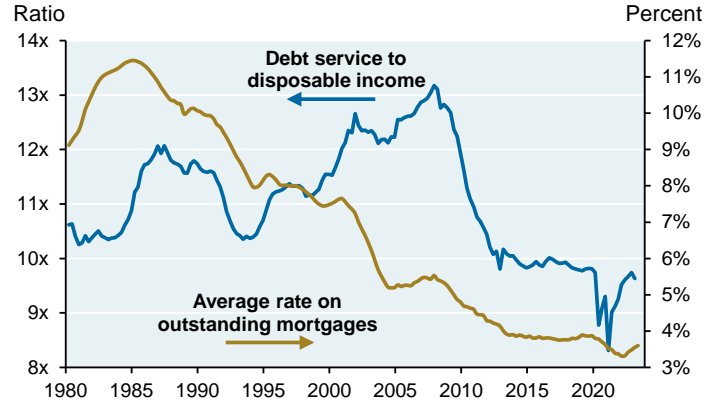
[4] Rising interest rates will take time to flow through to profit margins and household balance sheets. In contrast to some US banks that made extremely poor decisions to extend asset duration at the lows in rates², many US and European companies extended liability duration and enjoy the lowest levels of interest expense to cash flow in decades. As shown below, for the first time on record, **corporate interest expense is falling as the Fed is hiking rates**. US household debt service costs are also low. One reason: the average coupon on outstanding residential mortgages is ~3.5%, immunizing many homeowners from the spike in mortgage rates to ~7%. Credit card and auto delinquencies are rising, but from low levels and are now back at 2010-2020 averages.

US nonfin. corporate net interest costs at 60 year low



Source: Bloomberg, JPMAM. Q1 2023.

US household debt



Source: Bloomberg, BEA, JPMAM. June 2023.

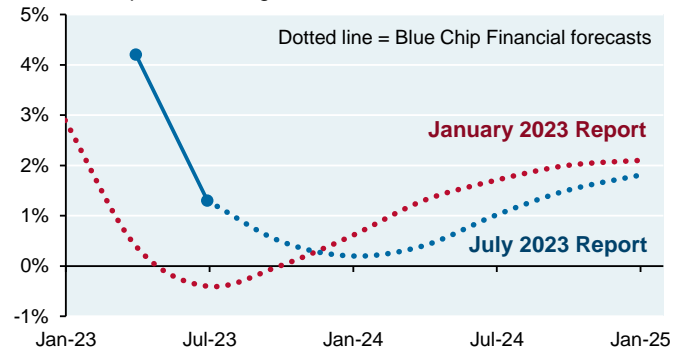
While higher interest rates hit US housing pretty hard, the lowest housing inventory in decades³ offsets what might have been an even sharper decline in home prices, permits and starts. Also: tight US labor markets have sustained personal income and spending. While goods spending is weakening, services spending and auto spending are holding up. Note how the timing and magnitude of the expected consumer slowdown has changed since January. Tech layoffs have declined by 50%-75% from peak levels according to Challenger data; the AI frenzy came just in time for some.

Months supply of existing single family homes



Source: National Association of Realtors, JPMAM. June 2023.

Timing and magnitude of expected consumer slowdown changed since January, Real personal consumption expenditures, Q/Q annual percent change



Source: Haver Analytics, JPMAM. Q2 2023.

² **What happened to the US banking crisis?** The perception of a blanket FDIC guarantee of uninsured deposits after SIVB and new Fed borrowing facilities has led to a sharp slowdown in bank deposit outflows, despite the ongoing gap between money market rates at ~5.0%, 1-year CDs at 1.8%-2.6% and deposit rates at ~0.5%. **Next issue to watch:** proposed Basel III regs that would increase capital requirements at large banks by 1.5%-2.0%, increasing protections for taxpayers and depositors but pushing more lending into private markets/fintechs.

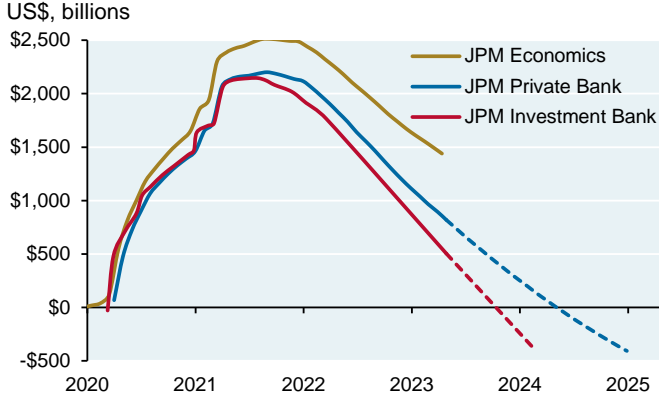
³ New homes are selling at roughly the same price as existing homes for the first time since the late 1960's. Most likely reason: very low levels of existing supply.



Note that the US government is not nearly as immune from rising interest rates as households or companies. Net interest payments to GDP have already risen from a post-war low of 1.2% in 2015 to 1.9%, and are heading to 3.2% by 2029 which would match the post-1960 high last seen in 1991. See our [American Gothic](#) piece from January for more on the long-term unsustainability of US Federal debt, entitlement spending and interest.

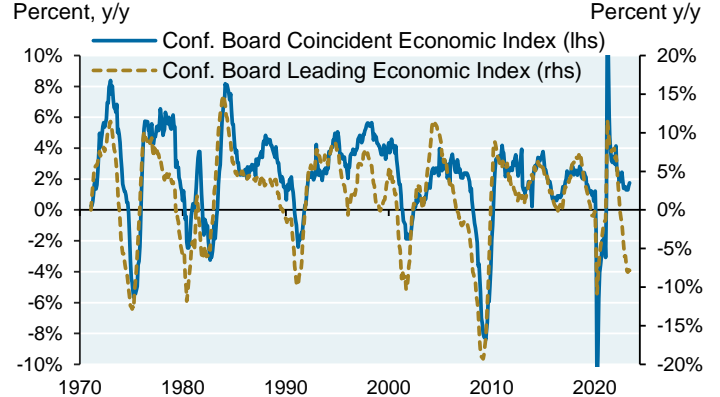
[5] Just wait, economic weakness is coming later this year or in early 2024. Monetary policy tightening works with a lag and is occurring after a period of unprecedented stimulus. Excess US household savings are projected to run out sometime in 2024, and while *current* economic indicators are robust, there's weakness in Conference Board *leading* indicators.

Estimates of US household excess savings



Source: J.P. Morgan. April 2023.

Coincident and leading economic indicators



Source: Conference Board, JPMAM. June 2023.

We also monitor the longer-dated indicators shown in the table. **The overall pulse does not point to a significant contraction, just to modestly weaker US conditions in 6-9 months.** Furthermore, new orders less inventories (#5) has improved three months in a row. We watch this metric closely given its leading signal on the PMI index, a useful predictor of economic growth and stock market returns over the long run.

#	Category	Leading indicator...	Advanced by...	Predicts a deterioration in...	Pulse
1	Bankruptcy	Banks tightening C&I loans	6 months	Corporate bankruptcy filings	Red
2	Capex	Banks tightening C&I loans	9 months	Non-residential capex	Orange
3	Capex	Earnings	3 months	Non-residential capex	Yellow
4	Construction	Leading economic indicators	18 months	Construction activity	Orange
5	Economy	New orders less inventories in ISM survey	3 months	ISM manufacturing index	Yellow
6	Economy	chg in 2 yr & 10 yr UST, chg in 1 yr global short rate, chg in 1 yr EM bond yield, ISM prices paid	12 months	ISM manufacturing index	Red
7	Employment	Single family home sales	16 months	Initial jobless claims	Yellow
8	Lending	Respondents reporting tighter credit standards	9 months	Bank lending	Orange
9	Profits	Fed Funds Rate, effective corporate tax rate, unemployment and productivity growth	8 months	Economy-wide profits	Red
10	Profits	Economic activity, business confidence, supplier deliveries, wages, inflation, cyclical GDP	12 months	S&P profits	Orange
11	Profits	US\$ dollar, PMI survey, consumer confidence, housing, credit spreads	12 months	S&P profits	Orange
12	Revenue	Active truck utilization	6 months	S&P revenue growth	Yellow
13	Sales	NFIB pricing survey	4 months	S&P sales growth	Yellow
14	Sales	Producer prices finished goods	4 months	S&P sales growth	Orange
15	Wages	Avg. growth in wages advertised in job postings	4 months	Corporate wage expense	Yellow
16	Wages	Rehiring rate proxy	12 months	Corporate wage expense	Yellow
17	Equities	China credit impulse	9 months	US high beta vs low beta stocks	Orange

Source: Bloomberg, Morgan Stanley, Piper Sandler, Steno Research, JPMAM. July 2023. Weakness projection colors: red = substantial, orange = modest, yellow = slight

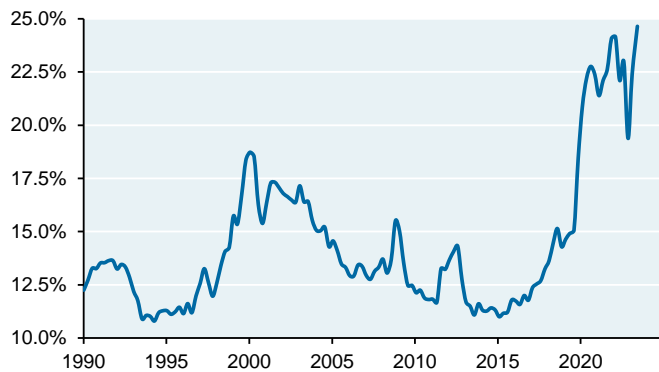


[6] YTD US equity returns have been substantially boosted by rising valuations of a few mega-cap stocks, most of which have not seen their earnings projections grow at all this year. We covered this issue in June, and J.P. Morgan’s Global Markets Strategy team wrote on the topic as well⁴.

- While NVDA and META earnings projections are rising for 2023 and 2024, they are flat for MSFT, GOOGL, AMZN and AAPL. Even so, the latter 4 stocks are up 40%-60% this year. TSLA, whose earnings are projected to decline by ~30% from 2022, has risen by over 100% this year
- Market cap concentration in a handful of stocks is at its highest level since the early 1970’s, even narrower leadership than during the 2000 TMT Bubble. Also: the increase in market cap concentration just reached its highest level in 60 years
- Six mega-cap stocks (MSFT, GOOGL, AMZN, META, NVDA, CRM) explain 51% of S&P 500 performance and 54% of the Nasdaq 100
- Crowding in growth factor investing has reached the 97th percentile, eclipsed only in early 2000
- A steep rise in concentration and narrow market leadership has historically reversed with the S&P 500 equal-weighted index outperforming the market-cap weighted index

Market cap of largest 7 companies

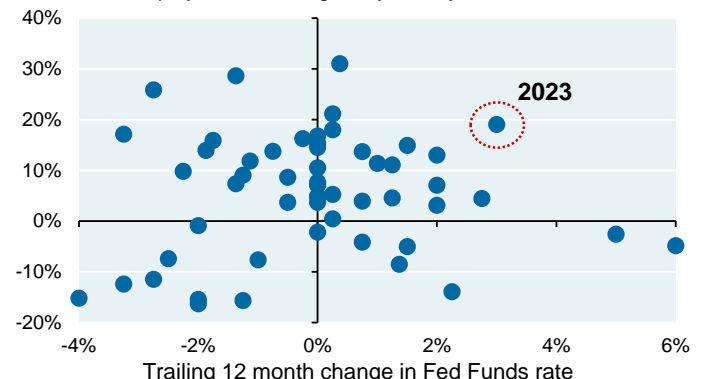
% of total large-cap market cap



Source: Factset, JPMAM. Q2 2023.

World equity returns vs US Fed Funds rate, 1970-2023

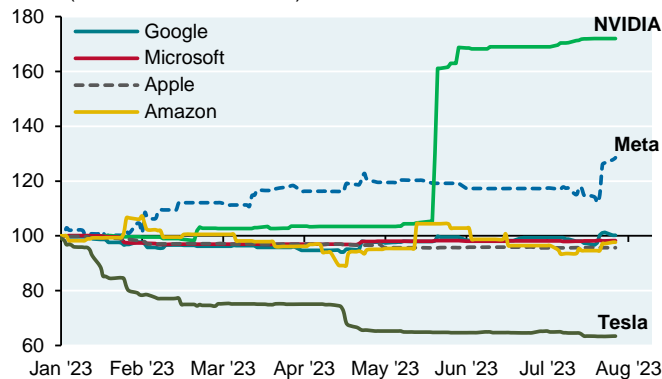
MSCI World equity return through July each year



Source: Bloomberg, JPMAM. July 2023.

Mega-cap stock earnings expectations for 2023

Index (100 = December 2022)



Source: Bloomberg, JPMAM. August 1, 2023.

⁴ “Steepest Rise in Concentration, Narrowest Leadership, ML Application of Crowding to Predict Market Returns”, J.P. Morgan Global Market Strategy, July 21, 2023, Dubravko Lakos-Bujas and Marko Kolanovic



The bottom line: risk appetite is back, courtesy of immaculate disinflation and plenty of liquidity

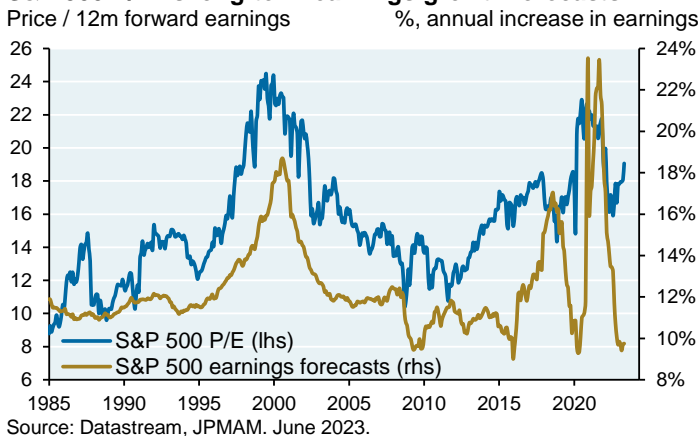
The equity rally can be justified on the grounds that the Fed’s “immaculate disinflation” was not expected by many investors, some of whom added risk this year after conservative positioning in 2022. **But: rising valuations account for 90%+ of the gain in the S&P 500 this year, with earnings growth accounting for the rest.** Multiple expansion has occurred despite the lack of a rebound in long term earnings growth expectations. As shown in the chart on the left, this is unusual. There’s a lot of good news priced in at current levels and little room for any negative developments in the Russia-Ukraine war or global energy/food prices next winter.

More signs of investor optimism:

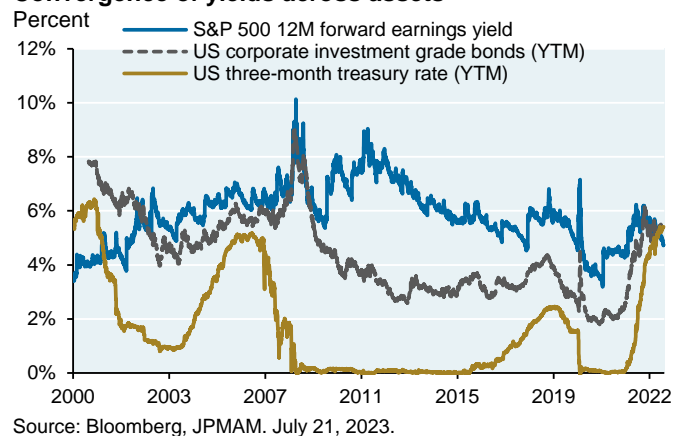
- market sentiment is in the 95th percentile of bullishness
- the cost of a one-year 95 strike put on the S&P 500 is in the 85th percentile of cheapness since 2008⁵
- the Dow Jones Index rallied for 13 consecutive days through July 26, the longest streak since 1987
- don’t look now, but the YUCs (young unprofitable companies) are rising again. The rally in electric aviation company JOBY is a prime example...see our energy paper on the dubious prospects for electrified aviation

The equity rally is also taking place when fixed income is competitive with equities from a yield perspective for the first time since 2002, as shown on the right. For risk-averse investors, some fixed income opportunities offer compelling risk-reward compared to equity counterparts⁶.

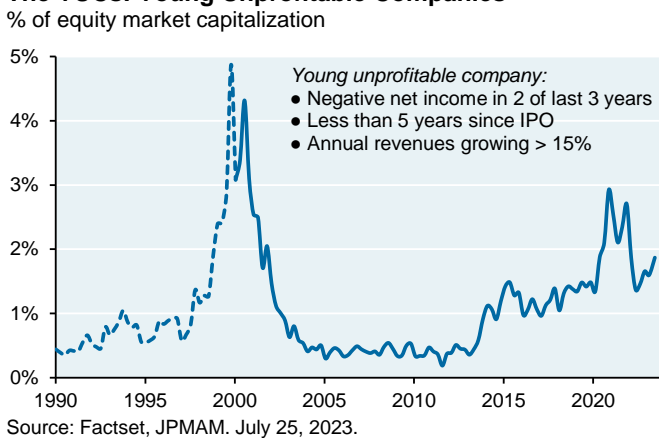
S&P 500 P/E vs long-term earnings growth forecasts



Convergence of yields across assets



The YUCs: Young Unprofitable Companies



⁵ Some press reports cite put options as being cheaper than at any time since 2008, but this is a little misleading. Option premiums incorporate short term interest rates and when rates rise, premiums get cheaper. When analyzing put option premiums struck based on S&P 500 *forward* prices (which effectively incorporates rate changes), they’re still cheap but not quite as much as when looking at premiums based on S&P 500 *spot* prices.

⁶ Another example: the yield on investment grade REIT debt is roughly the same as REIT cap rates (5.8%)

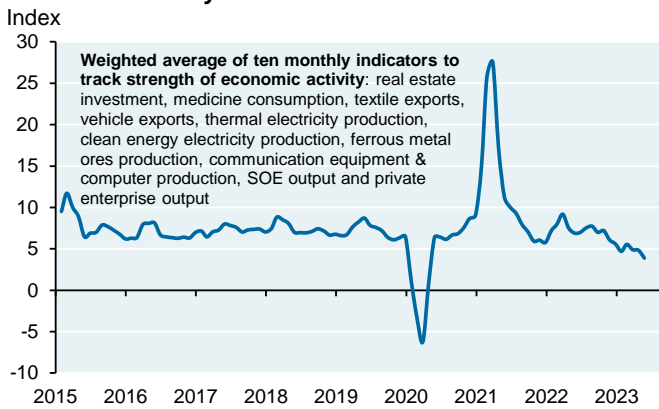


After the Flop, waiting for the Turn: China’s reopening fizzles due to real estate overhang

After *Strange World*, *Lightyear*, *Amsterdam* and *Babylon* flopped in 2022, China’s grand reopening did the same in 2023. The latest problem with China’s economy stems more from misallocated investment in residential real estate than from excess industrial capacity. China’s home ownership rate is ~90% (a figure unheard of in the US even during the most feverish attempts by the FHFA to unsustainably inflate it), and 20% of Chinese households own more than one home. Vacant properties amount to 2+ years of sales, and consumer confidence remains low despite low mortgage rates designed to boost leverage and homebuying.

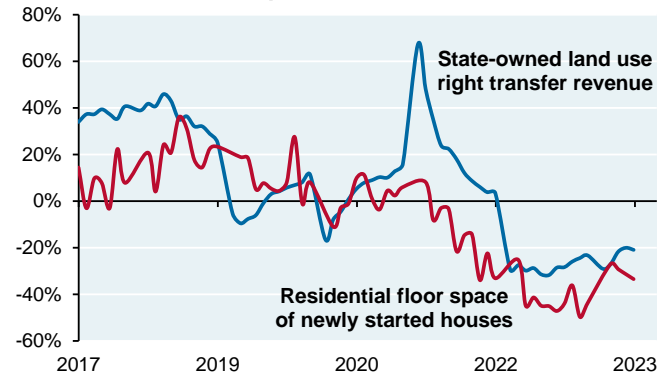
As discussed in [our April piece on the dollar as the world’s reserve currency](#), China relies on large amounts of trapped domestic savings to finance itself. Rather than a balance of payments or banking crisis, the housing situation in China has resulted in a period of slower growth and an equity market that trades at 10-12x earnings, a steep discount to the developed world. The Chinese Politburo appears to have announced intentions to provide more stimulus, but the timing and amounts are unclear.

China real activity remains weak



Source: Bloomberg, JPMAM. May 2023.

China housing drag: weak state-owned land transfer fees and residential floor space starts, Percent, y/y



Source: Bloomberg, JPMAM. June 2023.

China consumer confidence



Source: Bloomberg, JPMAM. March 2023.

China / US housing comparison

	China	US
Value of housing stock relative to personal consumption expenditures	6.0x	2.2x
Direct real estate related activities as a share of GDP	18%	6%
Home price to income ratios, mid-2023*	~40x	~10x
Home ownership rate	90%	66%

Source: Empirical Research, CEIC, NIH, Numbeo, Fed, Rogoff & Yang, 2022.

* China: Shanghai, Shenzhen, Beijing, Guangzhou. US: NY, San Fran.

**Eye on the Market Archives, 2023****[American Gothic](#)****January 24, 2023**

The Federal debt and how the Visigoths may try to break the system if no one fixes it.

[Winter Heating](#)**February 21, 2023**

Large language model battles begin: the future of web search, conventional wisdom machines, hallucinating bears in space, early successes and how far they still are from humans in the realm of real intelligence.

[Silicon Valley Bank failure](#)**March 10, 2023**

One of these things is not like the other, and that thing is Silicon Valley Bank.

[13th annual energy paper](#)**March 28, 2023**

Renewables are growing but don't always behave the way you want them to. This year's topics include the impact of rising clean energy investment and new energy bills, how grid decarbonization is outpacing electrification, the long-term oil demand outlook, the flawed concept of levelized cost when applied to wind and solar power, the scramble for critical minerals, the improving economics of energy storage and heat pumps, the transmission quagmire, energy from municipal waste, carbon sequestration, the Russia-China energy partnership, methane tracking and some futuristic energy ideas that you can just ignore, for now.

[Frankenstein's Monster](#)**April 10, 2023**

Banking system deposits and the unintended fallout from the Fed's monetary experiment; commercial real estate, regional banks and the COVID occupancy shock; the wipeout of Credit Suisse contingent capital securities; a market and economic update; and an update on San Francisco, which has experienced the weakest post-COVID recovery of any major city in North America.

[Oh, the Places We Could Go!](#)**April 26, 2023**

The dollar as the world's reserve currency: we look at trade, foreign exchange, reserve investment, gold, sanctions, money supply, the seeds of de-dollarization and the chart that everyone hates

[Too Long at the Fair](#)**May 23, 2023**

I have recommended since 2009 that investors overweight the US and Emerging Markets, and underweight Europe and Japan. Excess returns from such a strategy have been enormous over that time frame. However, the time has come to retire the barbell for a while. I stayed too long at the fair, and should have made this recommendation a few months ago when Europe traded at a record 35% P/E discount to the US. A modestly brighter picture in Japan relative to China is another reason why it's time to put the barbell aside for now.

[Letters to the Editor](#)**June 14, 2023**

A discussion on mega-cap stocks, artificial intelligence and the narrowest market leadership on record. Then, some unsolicited letters to Barron's, MSNBC, the "No Labels" US political movement, the Federal Housing Finance Agency, the Urban Institute, the National Housing Conference and Jeep. Topics include cell/gene therapy investing, gas stoves, unity tickets, the Electoral Count Act, and housing subsidies/shortages.

[Mr. Toad's Wild Ride](#)**July 18, 2023**

For IPO investors, some of the substantial gains from the prior decade were wiped out by a flurry of poorly performing IPOs that were issued in 2020 and 2021. There are several bright spots, including the strong performance of software and internet IPOs even when including 2020/2021 vintages. In this special issue Eye on the Market, we look at the wild ride of IPO performance, the SPAC disaster, IPO flipping, insider lock-up expirations, striking findings on IPO performance erosion in healthcare and some data on financial sponsors with the best performing IPOs.

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