

Holiday Eye on the Market: The Year of Living Dangerously

On January 1 we will release our 2025 Outlook entitled “*The Alchemists*”. Topics will include the core tenets of Trumpism and their impact on markets and the Fed, AI capital spending, the high hopes of next-gen nuclear power investors, China, Europe, DOGE, crypto and a Top Ten list for 2025.

The Year of Living Dangerously: I was visited by six ghosts

It was a strange year. It began with speculation that Neil Gorsuch would lead the charge on the Supreme Court to overturn the Chevron Deference standard, a topic we covered in the Eye on the Market on July 9. It ended with Neil Gorsuch talking about the death of Peanut the Squirrel, a Tik-Tok star seized and euthanized by the New York Department of Environmental Conservation¹. The year also ended with the US on track for two consecutive years of 20%+ equity returns, something which has only happened four times since 1871; only during the 1990’s bull market did the good fortune continue.

I was visited by six ghosts recently², each one warning me of certain dangers. That’s the topic of this note.

Ghost #1: Predictions

The first ghost warned me about making predictions. From the Fed’s dot plot which has a terrible track record since its inception in 2012, to the 23% accuracy rate of the Survey of Professional Forecasts since 1968³, to the 25%-35% systematic overestimation of stock price returns by sell side analysts, forecasting is hard. But it’s too late; I made a Top Ten list of possible surprises last January. The table below shows a scorecard of these predictions. I will go into detail on each score in the 2025 Outlook, along with a new list.

Scorecard on 2024 predictions

Ranking	January 1 2024 prediction
1	Despite all the hand-wringing over risks to reserve currency status and BRIC efforts to develop a competitive reserve currency, the US dollar remains stable, within a +/- 1 std deviation band of 7%
2	The DoJ/FTC win a big antitrust case
3	President Biden withdraws between Super Tuesday and the election, citing health reasons
4	Little to no progress on self driving cars, no recovery in Lidar stock basket
5	Broadly syndicated leveraged loan losses rise above private credit losses for the first time
6	Argentine dollarization will fail if implemented
7	Russian invasion of Ukraine drags on with no ceasefire in 2024
8	US regional bank stocks will do well in 2024 with stable or rising price to book values
9	Major US cities will face electricity outages and/or natural gas outages due to outdated grid infrastructure
10	Researchers will complete work on an inhaled COVID vaccine that will reduce transmission

Source: JPMAM, 2024

¹ **Addressing the Federalist Society in November, Justice Gorsuch cited Peanut’s death as an example of government overreach.** Peanut the squirrel was rescued as an orphan after its mother was hit by a car. Its owner cared for Peanut for seven years and trained him to do tricks and eat waffles on social media, where Peanut had 1 million followers. A convoy of ten armed officers from the State of New York reportedly raided and ransacked the owner’s house, detained him for five hours, seized Peanut and Fred the abandoned baby raccoon and had them both euthanized and tested for rabies. Test results came back negative.

² According to a 2021 YouGov poll: 40% of Americans surveyed believe in ghosts, and 20% said that they had encountered one. Encouragingly, only 9% said they believed in vampires and werewolves

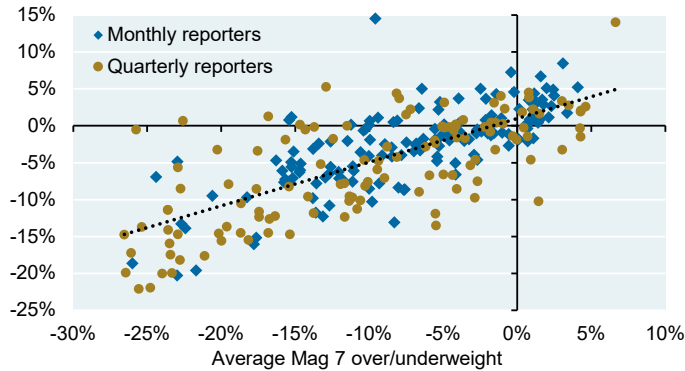
³ “*Overprecision in the Survey of Professional Forecasters*”, Collabra Psychology, 2024

Ghost #2: Allocations

The second ghost warned me about managers being underweight Mag 7 stocks. No disagreement there, based on some work we did on US large cap core equity managers. The first chart shows each manager’s average aggregate Mag 7 stock overweight or underweight since January 2023 on the X axis, and the manager’s excess return vs the S&P 500 on the Y axis. **The outperformers are highly clustered around managers that were overweight Mag 7 stocks.** We then computed the share of total months that each manager was overweight Mag 7 stocks on an individual basis⁴; results were similar with outperformers clustered around managers that were consistently overweight each one of the Mag 7 stocks.

Active manager Mag 7 weightings vs performance

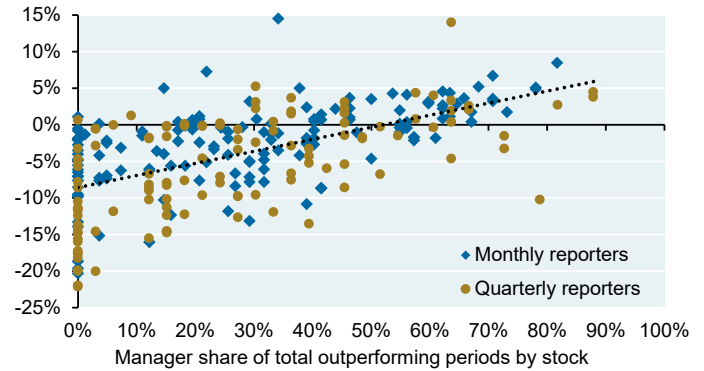
Excess return vs S&P 500, Jan 2023 - Jun 2024



Source: Morningstar, JPMAM, 2024

Active manager Mag 7 weightings vs performance

Excess return vs S&P 500, Jan 2023 - Jun 2024

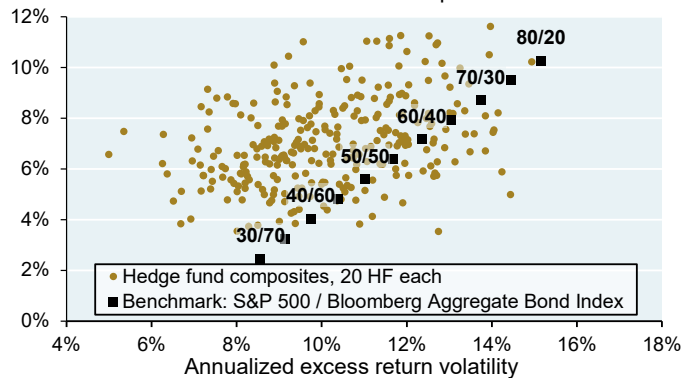


Source: Morningstar, JPMAM, 2024

The same ghost warned me about hedge fund investing, but I wasn’t as spooked on this one given the benefits of diversification. The chart on the left shows randomly constructed hedge fund composites, each of which contains 20 hedge funds sourced from the HFR dataset. Compared to stock-bond combinations of similar volatility, 88% of random hedge fund composites outperformed over the latest five-year period⁵. If you don’t diversify, risks went up. As shown on the right, the share of outperforming hedge fund composites fell from 88% to 65% if you had only invested in 5 funds instead of 20.

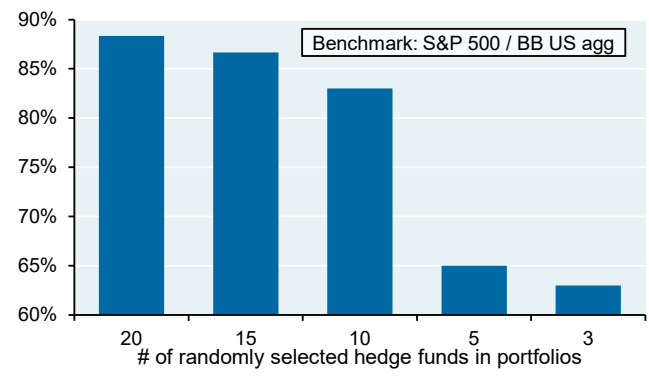
20-fund composites vs benchmarks [HFR]

Annualized excess return vs T-bills since Sep 2019



Source: JPMAM, HFR, August 2024

Outperformance of hedge fund portfolios declines with the number of funds included [HFR]



Source: JPMAM, HFR, August 2024

⁴ In other words: across 18 months and seven Mag 7 stocks, there’s a maximum of 126 stock-month overweightings a manager could register. If a manager were overweight each of the 7 stocks in 13 of the 18 months, the X axis value would be 72% (7 * 13 / 126)

⁵ We also performed this analysis using Pivotal Path hedge fund data and results were similar. For each analysis, we started with the entire hedge fund database and then eliminated hedge funds that are not US domiciled; that are not limited partnerships or limited liability companies; that are not one of our four core types (relative value, equity hedge, event driven and macro); and those with insufficient data or quarterly/annual reporting. See our December 2023 Biennial Alternative Investments Review for more details

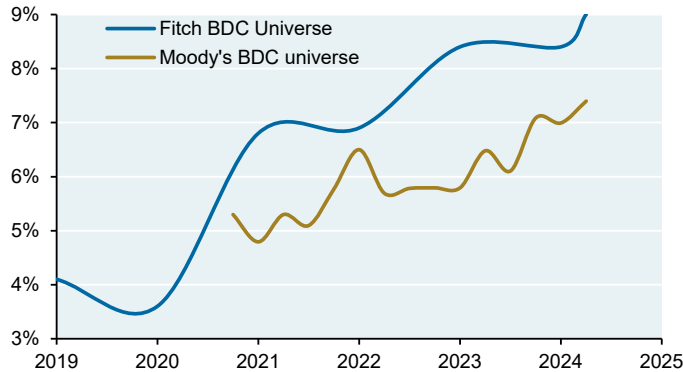
Ghost #3: Apparitions

The third ghost warned me about other ghosts inhabiting the world of private credit in the form of paid-in-kind income that, like a ghost, isn't really there. Business Development Corporations (BDCs) are the most common form of private credit investing. Paid-in-kind simply means that the borrower adds principal to the outstanding balance rather than paying anything in cash. As shown below, the PIK share of BDC income has been rising despite benign economic conditions and very tight high yield credit spreads. The second chart shows data from a recent JP Morgan Credit Research report⁶ on the PIK share of *net* investment income (net of cash expenses) for the major BDCs. The PIK share of net investment income gets closer to measuring actual coverage of dividends paid, and is generally a much higher ratio than the traditional one. The backdrop to these trends: a private credit market which has tripled in size in the last five years.

Other research that I found to be interesting⁷: the return on equity proposition for banks is vastly better when lending to BDCs rather than lending to the companies that BDCs lend to. The reasons that lending to BDCs is a better option: lower risk weights, lower operating expenses, lower expected default rates and higher expected recovery rates, all of which offset the impact of lower lending spreads. The table shows the results.

PIK income of BDCs

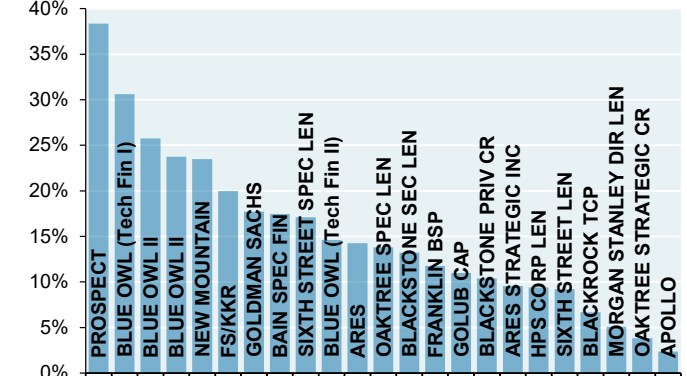
PIK income as a % of total investment income



Source: Fitch, Moody's, JPMAM, Q1 2024

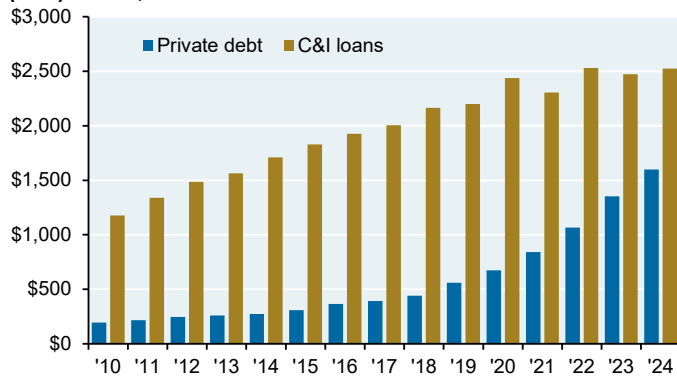
PIK income of major BDCs, Q2 2024

PIK income as a % of net investment income (net of cash expenses)



Source: JP Morgan Global Credit Research, JPMAM, October 2024

Outstanding US private debt vs commercial & industrial (C&I) loans, US\$ billions



Source: Cai et al, Federal Reserve Board, FDIC, Empirical Research, 2024

The economics of bank lending

	Loan to middle market company	BDC loan
SOFR overnight rate	5.30%	5.30%
Spread	6.25%	2.00%
Default rate	4.00%	0.25%
Recovery rate	60%	95%
Expected loss	1.60%	0.01%
Spread on debt funding	0.55%	0.55%
Tax rate	25%	25%
Operating expenses	2.00%	0.10%
Risk weight	100%	20%
Capital (% of assets)	12.00%	2.40%
Return on equity	18%	46%

Source: Chernenko et al, JPMAM, 2024

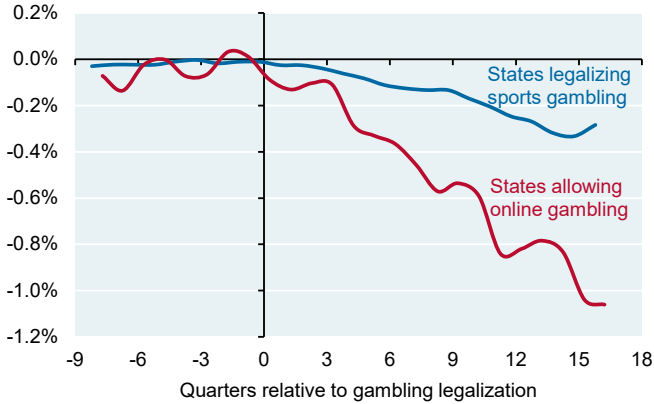
⁶ "Private Credit Uncovered", JP Morgan Global Credit Research, Dulake/Jantzen/Caprihan, October 2024

⁷ "Bank capital and the growth of private credit", Chernenko (Purdue) et al, July 2024

Ghost #4: Legalizations

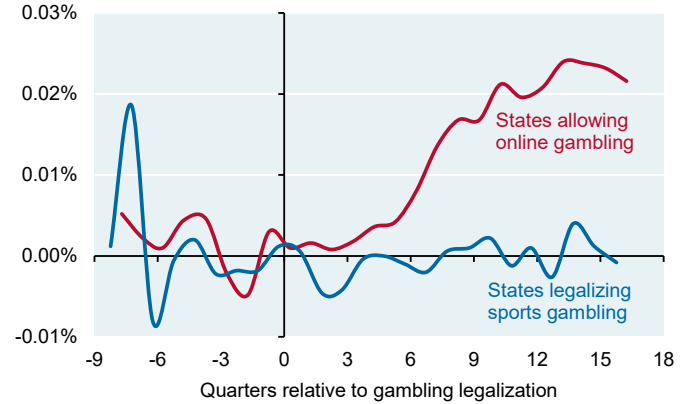
The fourth ghost warned me that legalizing sports betting would end up having a noticeably negative impact on US households. He was right, particularly in states that allow online sports gambling⁸. The authors of the study from which this data is drawn note that credit card delinquency probability is declining for the online cohort. While this might appear to be counterintuitive, they believe it reflects credit agencies reducing credit card limits to higher-risk consumers.

Change in consumer credit score



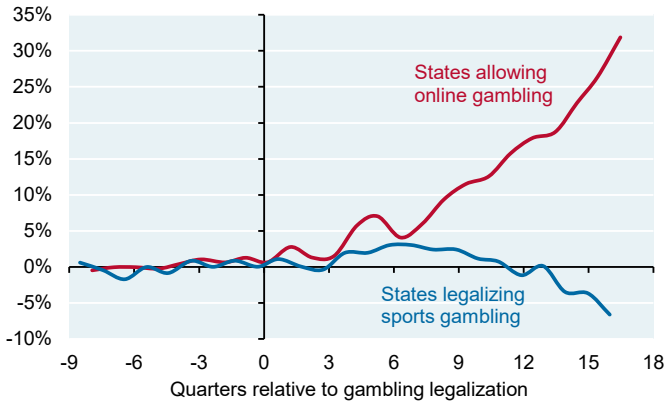
Source: Hollenbeck et al, October 2024

Change in likelihood of bankruptcy filing



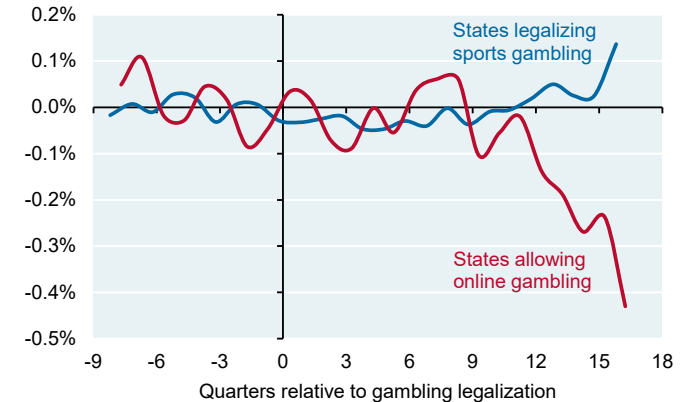
Source: Hollenbeck et al, October 2024

Change in debt collections on account



Source: Hollenbeck et al, October 2024

Change in likelihood of credit card delinquency



Source: Hollenbeck et al, October 2024

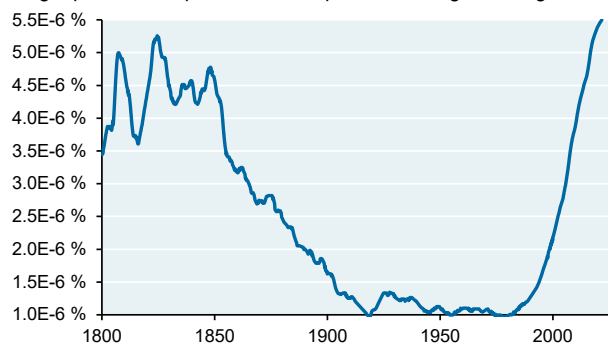
⁸ The charts above are sourced from “*The Financial Consequences of Legalized Sports Gambling*”, Hollenbeck, Proserpio and Larsen, October 2024. Thirty states currently allow online sports betting, and another eight states allow sports betting only in certain retail locations but not online.

Ghost #5: Expurgations

The fifth ghost warned me not to write about certain things since people are more easily offended now. Are they really? Perhaps: Google Ngrams analyze how often words or phrases appear in books and other historical materials over time. As shown, an Ngram of “easily offended” is at the highest level since the early 1800’s. Below, some possibly offensive topics that I have not written about yet with links to research if you’re interested.

Google Ngram: easily offended

Target phrase as a percent of total phrases in English Google Books



Source: Google, 2024

Why Europe is incapable of defending itself

[Europe is incapable of defending itself \[Spectator\]](#)

[Why Europe is unprepared to defend itself \[Bloomberg\]](#)

The Chicago Doom Loop

[How Debt Ate Chicago \[City Journal\]](#)

On the dismal rankings of US commercial ports and union opposition to any port automation

[How Bad Are US Ports? The Best Is 53rd \[WSJ\]](#)

[S&P Global/World Bank US Container Port Index, 2023](#)

Mexico is a Failed State

[The Failing State Next Door \[Atlantic\]](#)

[Mexico’s Slide From Democracy Toward Tyranny \[NOEMA/Former President Ernesto Zedillo\]](#)

Wealth destruction, Cathie Wood and ARK Investments

[Morningstar Calls Cathie Wood The Worst Wealth Destroyer \[Investor’s Business Daily\]](#)

Should the US defend Taiwan?

[Should the US change its policies toward Taiwan \[Brookings\]](#)

[Beijing’s Calculus for Invading Taiwan by 2030 \[Journal of Indo-Pacific Affairs\]](#)

[How China Could Blockade Taiwan \[CSIS\]](#)

Corruption and money laundering in European football

[Money Laundering in Football: The Not So Beautiful Game \[Royal United Services Institute/RUSI\]](#)

Unregulated AI algorithms, health insurers, financial incentives of prior authorization and the denials/appeals process

[Regulating Healthcare Coverage Algorithms \[Indiana Law Journal\]](#)

I don’t understand Sneex and apparently neither does anyone else

[Are the Spanx of Shoes As Comfortable As They Are Ugly? \[The Cut\]](#)

[Spanx Made Her a Billionaire. Will Sneex Be Her Undoing? \[WSJ\]](#)

Israel and Gaza

[Satellite maps of the destruction of buildings, roads and agriculture in Gaza through October 2024 \[NPR\]](#)

[Haaretz interview with historian Rashid Khalidi of Columbia University \[Haaretz\]](#)

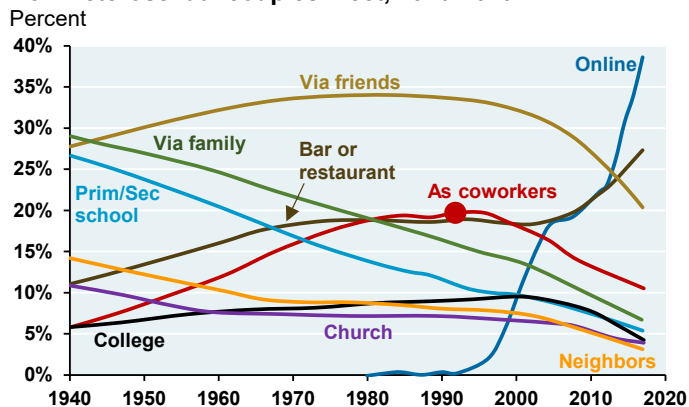
Kash Patel, Trump nominee to run the FBI

[Kash Patel, the FBI and Retribution \[WSJ Op-Ed\]](#)

Ghost #6: Ablations

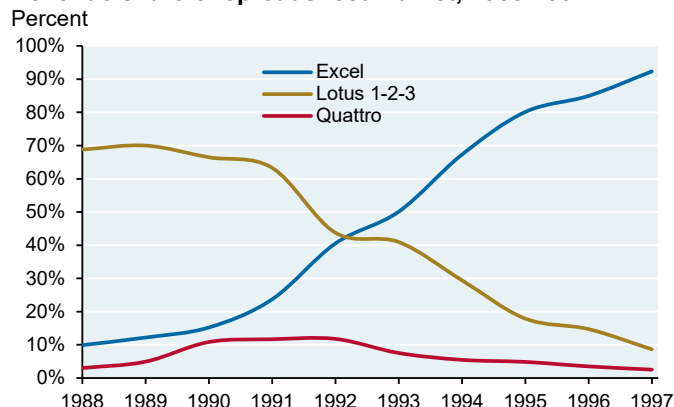
The sixth ghost warned me to take better care of myself, and I should have listened. First, some background. Like many people in the early 1990's, I met my spouse at work (red dot in chart). As the head of Latin American debt origination at JP Morgan, Rachel was more senior, well-traveled and sophisticated so I needed a way to gain her attention as an Associate. My entree in getting to know her was a three-dimensional surface plot that I created with Lotus 1-2-3 keystroke macros using basic trigonometry. A lot has changed since then: new rules on dating co-workers, socialization shifting online and the end of Lotus 1-2-3.

How heterosexual couples meet, 1940-2019



Source: Rosenfeld, Hausen and Thomas, PNAS, 2019

Revenue share of spreadsheet market, 1988-1997



Source: Stan Liebowitz (UT Dallas), 1999

Rachel comes from a long line of hard-core Chicago Democrats. Since the year 2000, 70%-75% of Cook County Illinois residents have voted for Democrats in Presidential elections. Even at the allegedly “non-partisan” University of Chicago, 97% (!!) of all faculty donations went to Democratic candidates and political action committees compared to just 3% for Republicans from 2015 to 2023. Chicago is a very blue place.

So, every time I heard a strange sound coming from the next room in November, I knew that another Trump cabinet nominee had been announced. It reminded me of the scene at the end of “*It’s A Wonderful Life*”: every time a bell rings, an angel gets its wings. Except this time it wasn’t a bell ringing, it was Rachel gasping in shock. Anyway, I admire Rachel’s commitment to her political beliefs so when I had to undergo a cardiac ablation the week before the election, I knew that I would be on my own since Rachel was going to Pennsylvania to ring doorbells for Kamala Harris. I had been having trouble with stairs and altitude last year for the first time, and my doctor felt that it was getting increasingly dangerous for me to leave this condition unattended.

On cardiac ablations Cardiologists use heat, cold or short bursts of energy to create scars in the tissue that is causing arrhythmia. Medical research papers estimate ablation success rates at 60%-90%, with higher success rates for paroxysmal AFib and lower success rates for persistent AFib. Some patients end up needing a second ablation, or eventually a pacemaker. The ablation procedure itself is not riskless: according to the British Heart Foundation, the risk of a disabling stroke is one in 500, the chance of a bleed around the heart needing to be drained is one in 200 and the risk of death is 1 in 1,000.

Following the ablation procedure (thank you Dr William Whang at Mount Sinai), I was put in a shared room with another post-op individual. Starting at 1 AM, this person began screaming and yelling unconsciously in another language, apparently in his sleep. By 3 AM I was exhausted from this, so I rang the night nurse. She spoke his language and explained that he was yelling about angry feelings he had towards his spouse and not me, so it was nothing for me to worry about. Needless to say I did not get much sleep that night and at 5 AM, I began to think about how anxious I was to leave the hospital, go on my December roosterfish trip and begin my 37th year at JP Morgan where unconscious screaming and yelling is generally kept to a minimum.

Happy Holidays, and I look forward to seeing many of you sometime in the new year.

Michael Cembalest, JP Morgan Asset Management

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