

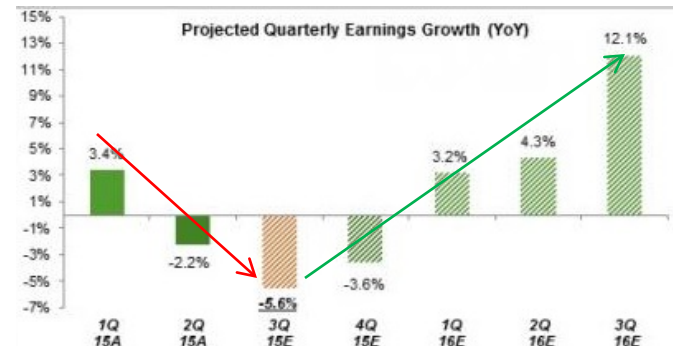
# **Q4 2015 LOOK AHEAD**

## Disclaimer

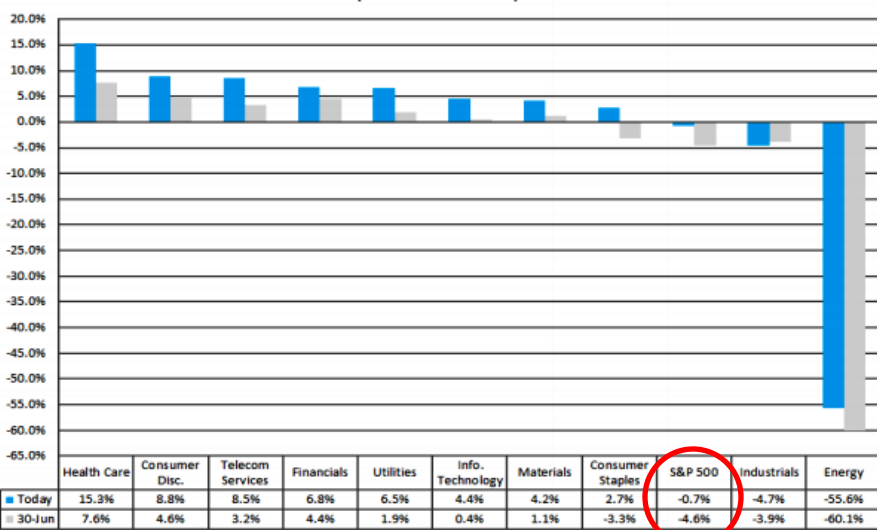
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# Earnings Recession–Economic Recession - Both?

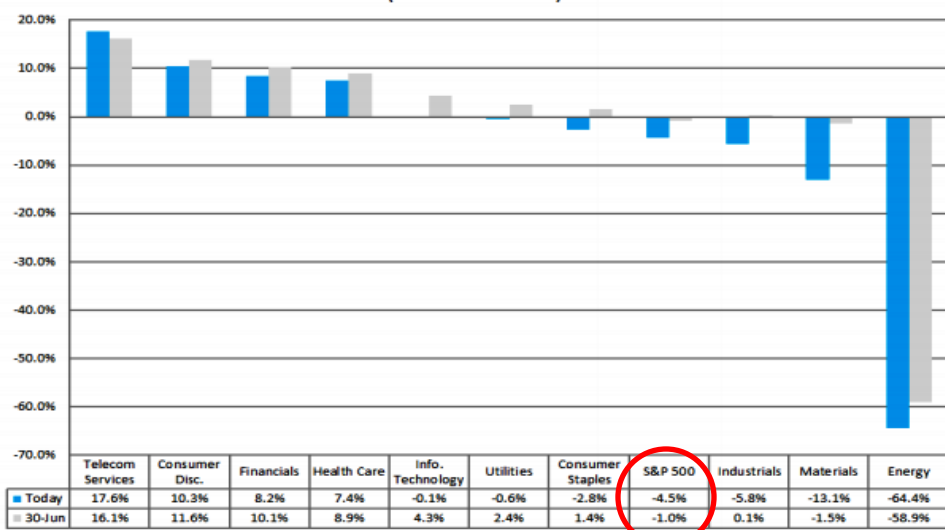
- We will see back-to-back earnings declines for the first time since Q2 and Q3 2012.
- Are we in an earnings recession without being in an economic recession?
- Calendar year earnings still projected to be positive.
- Turning the corner on earnings decline in Q4 2015 or Q1 2016?



Q2 2015 Earnings Growth  
(Source: FactSet)



Q3 2015: Earnings Growth  
(Source: FactSet)



Sources:  
[www.factset.com](http://www.factset.com), Oct 2, 2015 S&P 500: Change in EPS P. 20  
 S&P 500 Average Growth Rate JPM Guide P. 10

# Earnings or Economic, What's the Difference?



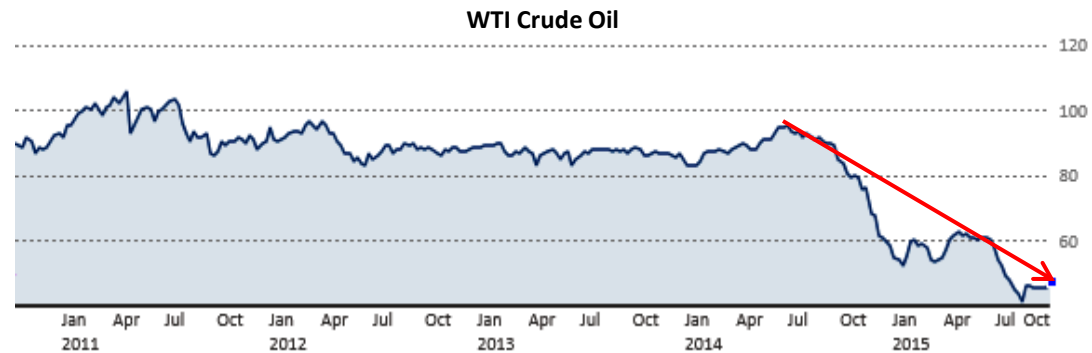
	Earnings Recession	Economic Recession
Time Period	1 Year	Up to 2 Years
Average EPS Contraction	13.24%	49.74%
Price Correction	8.60%	29.59%

Earnings Recessions*								
EPS Recession Range		EPS Recession Peak To Trough Dates		EPS Change From Peak to Trough			Duration	
From	To	Peak	Trough	EPS Peak	EPS Trough	Percent Change	Qtrs	Days
Jan-61	Jun-61	December-60	March-61	0.80	0.72	-10.00%	2	89
Jan-67	Sep-67	December-66	September-67	1.47	1.23	-16.33%	3	273
Oct-69	Dec-70	December-69	September-70	1.49	1.21	-18.79%	5	273
Oct-74	Sep-75	September-74	March-75	2.32	1.64	-29.31%	4	180
Apr-80	Sep-80	March-80	September-80	3.94	3.40	-13.71%	2	183
Jan-82	Mar-83	December-81	March-83	4.06	2.93	-27.83%	5	454
Jan-85	Mar-86	December-84	December-85	3.95	3.33	-15.70%	5	364
Jul-89	Dec-91	June-89	December-91	6.48	2.55	-60.65%	10	912
Oct-97	Dec-98	March-98	December-98	10.29	8.56	-16.81%	5	274
Oct-00	Dec-01	September-00	June-01	13.71	4.83	-64.77%	5	272
Jul-07	Mar-09	June-07	December-08	21.88	-23.25	-206.26%	7	548
Apr-12	Sep-12	March-12	September-12	23.03	21.21	-7.90%	2	183
Overall Median						-17.80%	5.00	273

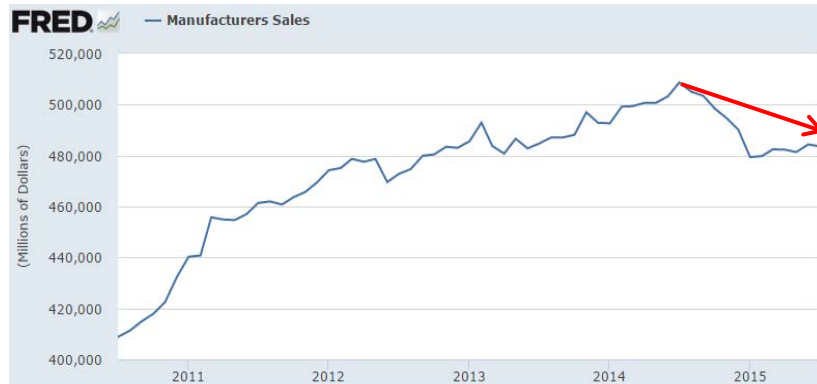
Maximum S&P 500 Index Declines That Coincide With EPS Recessions*						
S&P Index Decline: Peak To Trough Dates		S&P Index Decline: Peak to Trough Change			Duration	Classification
Peak	Trough	S&P 500 Peak	S&P 500 Trough	Percent Change	Days	Correction or Bear?
8/24/1960	10/25/1960	58.07	52.2	-10.11%	61	Correction
2/9/1966	10/7/1966	94.06	73.2	-22.18%	239	Bear
11/29/1968	5/26/1970	108.37	69.29	-36.06%	542	Bear
10/12/1973	10/3/1974	111.44	62.28	-44.11%	355	Bear
2/13/1980	3/27/1980	118.44	98.22	-17.07%	42	Correction
8/11/1981	8/12/1982	133.85	102.42	-23.48%	365	Bear
11/6/1984	12/13/1984	170.41	161.81	-5.05%	36	Bull Continued
7/16/1990	10/11/1990	368.95	295.46	-19.92%	86	Correction
10/7/1997	10/27/1997	983.12	876.99	-10.80%	19	Correction
9/1/2000	9/21/2001	1520.77	965.8	-36.49%	384	Bear
10/9/2007	3/9/2009	1565.15	676.53	-56.78%	516	Bear
4/2/2012	6/1/2012	1419.04	1278.04	-9.94%	59	Bull Continued
Overall Median				-21.05%	225	

# Threats to the Economy

- Are we walking back to recession?
- Two main drivers:
  1. Collapse in oil prices
  2. Strong U.S. dollar
- Impacts:
  1. Decline in earnings
  2. Increase in layoffs
  3. Drop in overall manufacturer's sales



Manufacturer's Sales



Employment Trends



# U.S. Consumers - Strong All Around

Most indicators suggest strength, but risk of recession is growing

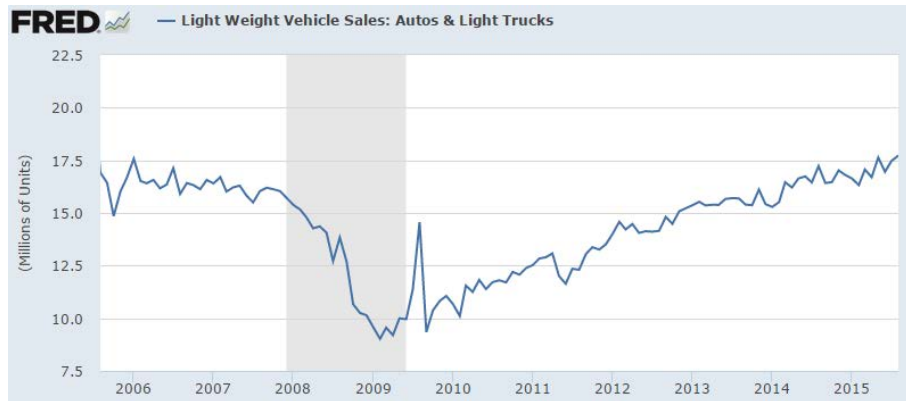
## Housing Starts



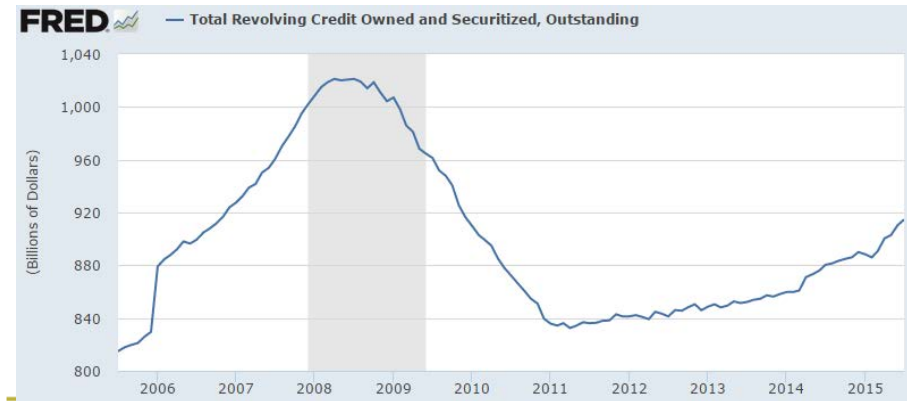
## Income



## Auto Sales



## Revolving Credit



# U.S. Dollar – Strong Dollar Impact

- When the U.S. dollar strengthens, it is more likely that earnings results will miss estimates
- The U.S. dollar is at its highest level since 2008
- American goods are becoming increasingly more expensive as other countries devalue their currencies
- Goldman Sachs says for each 10% gain in strength for the U.S. dollar, full year S&P 500 EPS will lower by \$3.00
- The sectors circled in green may help to mitigate the impacts of the strong U.S. dollar

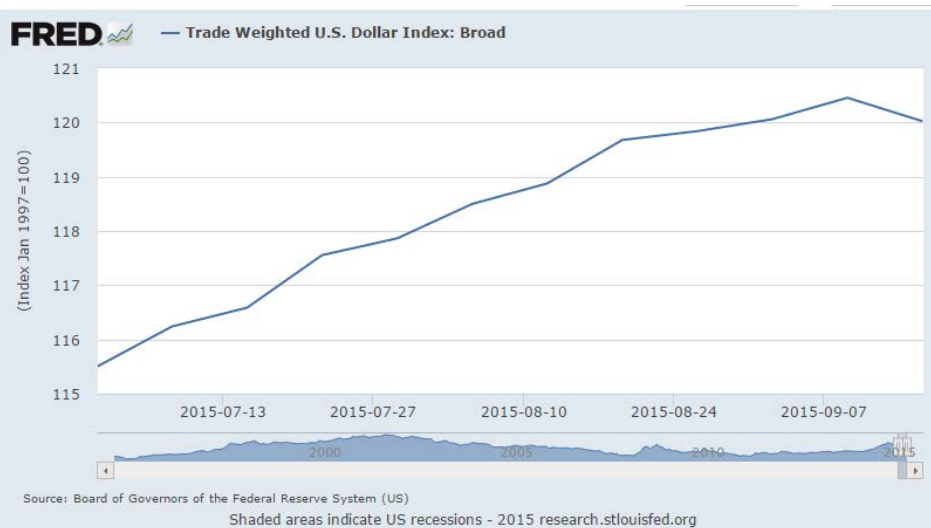
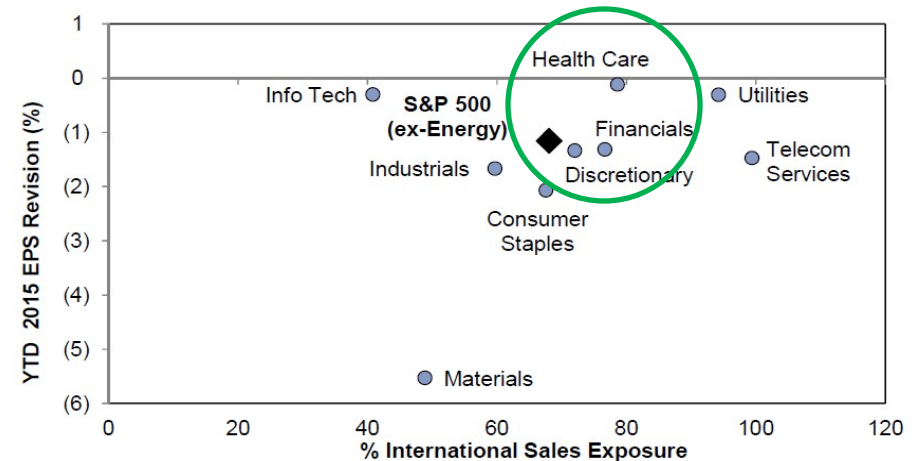


Exhibit 5: Bottom-up consensus 2015 earnings revisions versus international exposure



Source: Company filings, FirstCall, and Goldman Sachs Global Investment Research.

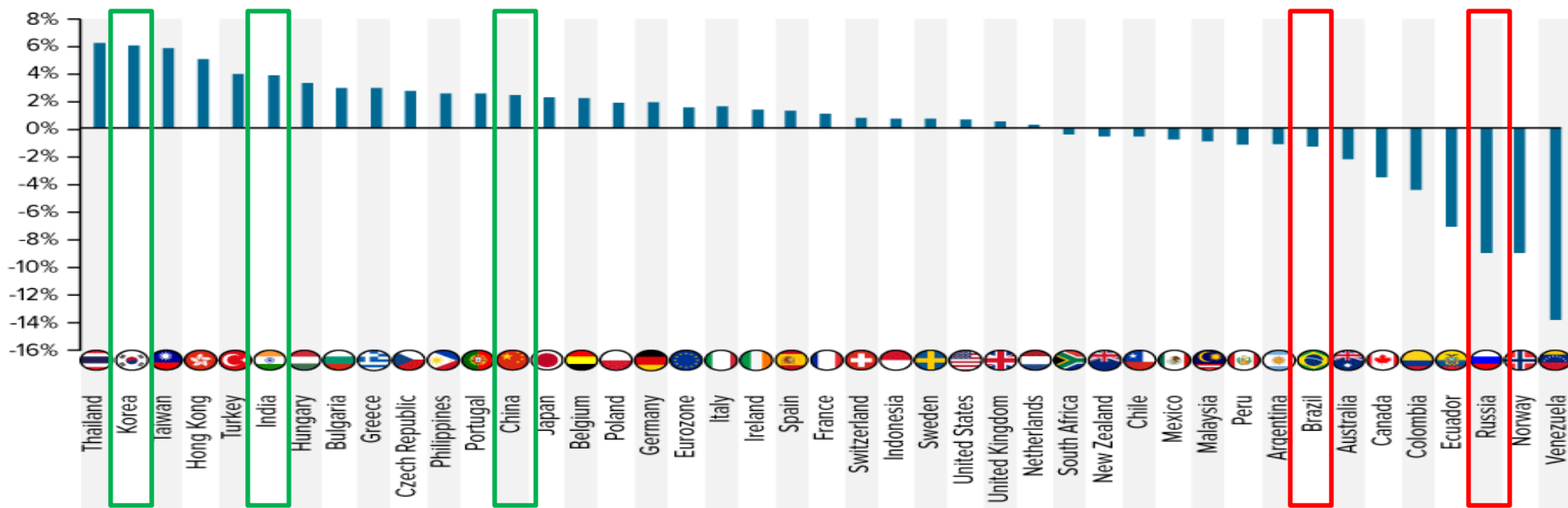
# Looking at Commodities

- Commodity price decline brought on by slowing global demand
- Export dependent economies suffer when commodities are worth less
- Import countries are strengthening on lower commodity prices

Importers Win

Exporters Lose

**Massive Money Flow Shift: Impact on Incomes from Commodity Price Drop Since June**  
As a Percentage of GDP



Source: Bridgewater Associates, ValueWalk, U.S. Global Investors

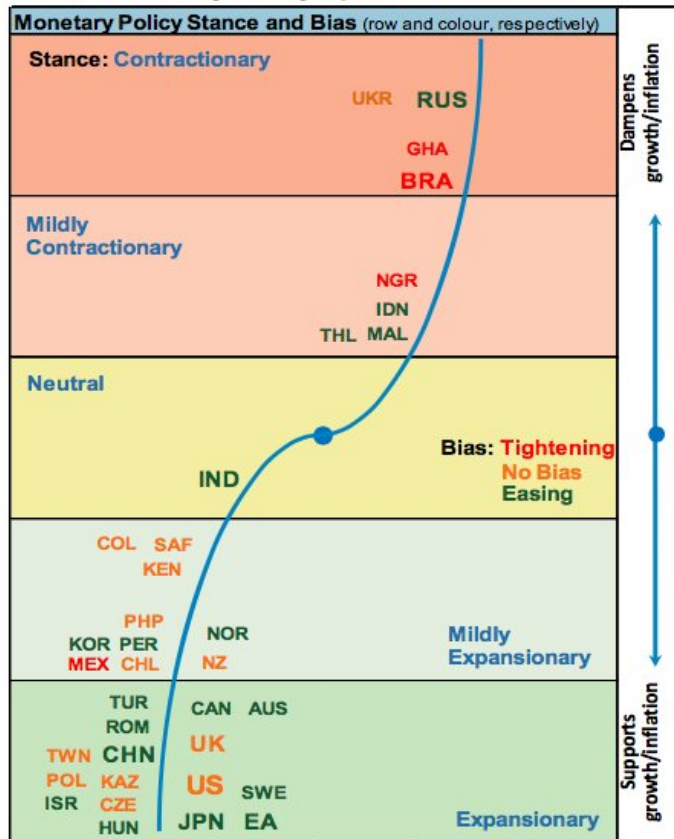
Sources:  
<https://www.scutify.com/article.aspx?q=552d1abcb6d37724d84ac540>



# The World Is Fighting Deflation & Hard

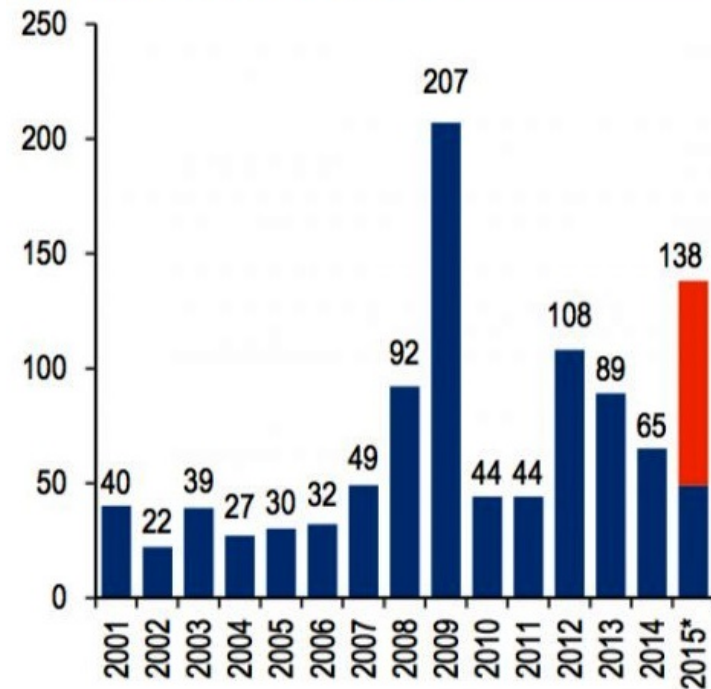
- There are far more central banks cutting rates than hiking rates
- Policymakers are attempting to stimulate global growth
- Central bank easing is now at the most aggressive pace since 2009

## The Global Monetary Policy Spectrum



Source: Morgan Stanley Research

**Chart 2: Global central bank rate cuts, per year.**  
49 cuts in 2015 thus far, which extrapolated suggests 138 rate cuts in 2015



Sources:  
<http://www.businessinsider.com/global-central-bank-rate-cuts-2015-2015-5>  
 BofAML Global Research. Red bar for 2015 is the YTD extrapolated number of rate cuts, global. Bloomberg Database.

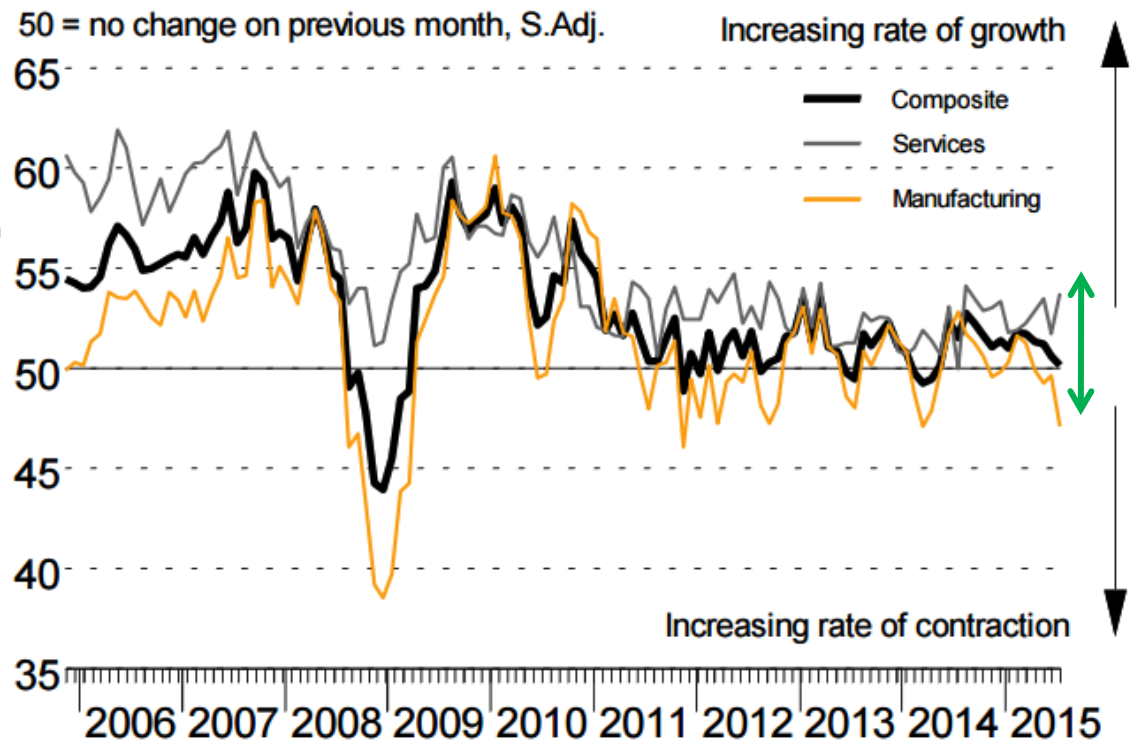
# China, The Two-Headed Dragon

- Chinese equity valuations are much more favorable vs. U.S.
- China represents the second largest economy in the world
- The recent market selloff was triggered by the surprise devaluation of the Renminbi on August 11<sup>th</sup>
- Industrial activity slowed sharply

## China: Doing Whatever it Takes

- China embarks on their most ambitious stimulus in decades
  - Buying ETFs
  - Cut stock transaction fees and increase margin
  - Suspended IPO's
  - Brokerage firms to buy \$19B in equity
  - Cut benchmark lending rate
  - Cut banking reserve requirements
  - Injected \$15.7B into the nation's stock market
  - Renminbi devalued
  - Selling of FX reserves to prop up Renminbi
  - Pension fund money injected into markets

## Caixin China Output PMI



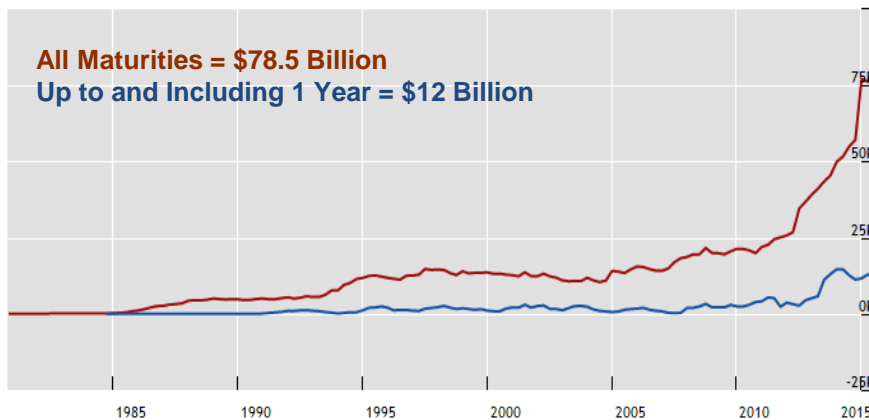
# Are We Facing an Emerging Market Crisis?

- Currency devaluations raise solvency concerns in Emerging Markets
- Strong dollar helps Emerging Markets
- Countries have excess capital reserves to defend their currency against the dollar
- Emerging Markets have longer debt maturities that defer any default
  - Example: China

Capital Reserves of the 5 Largest MSCI Index Countries

	Current	Previous	Change	% Change
China	\$ 3,557,381.00	\$ 3,651,309.89	\$ (93,928.89)	-2.57%
South Korea	\$ 368,110.00	\$ 367,938.00	\$ 172.00	0.05%
Taiwan	\$ 4,263.30	\$ 4,247.91	\$ 15.39	0.36%
India	\$ 349,980.00	\$ 352,020.00	\$ (2,040.00)	-0.58%
South Africa	\$ 614,761.00	\$ 579,877.00	\$ 34,884.00	6.02%

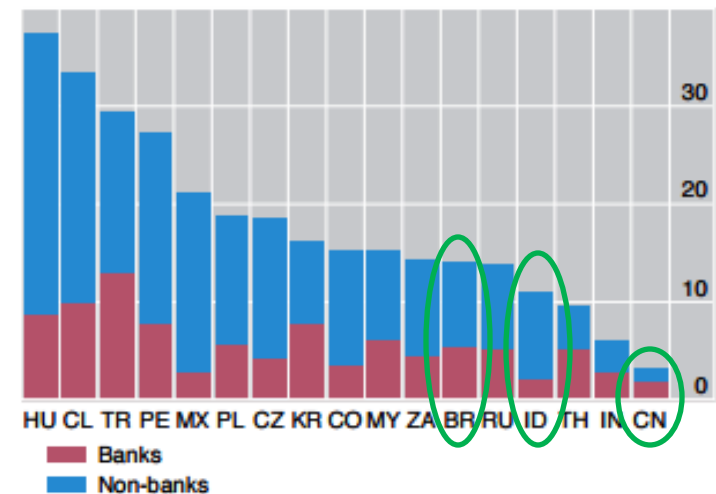
Chinese Outstanding Debt Maturities



Emerging Market Countries Foreign Currency Debts

Amounts outstanding, as a percentage of nominal GDP

Banks vs non-banks<sup>1</sup>

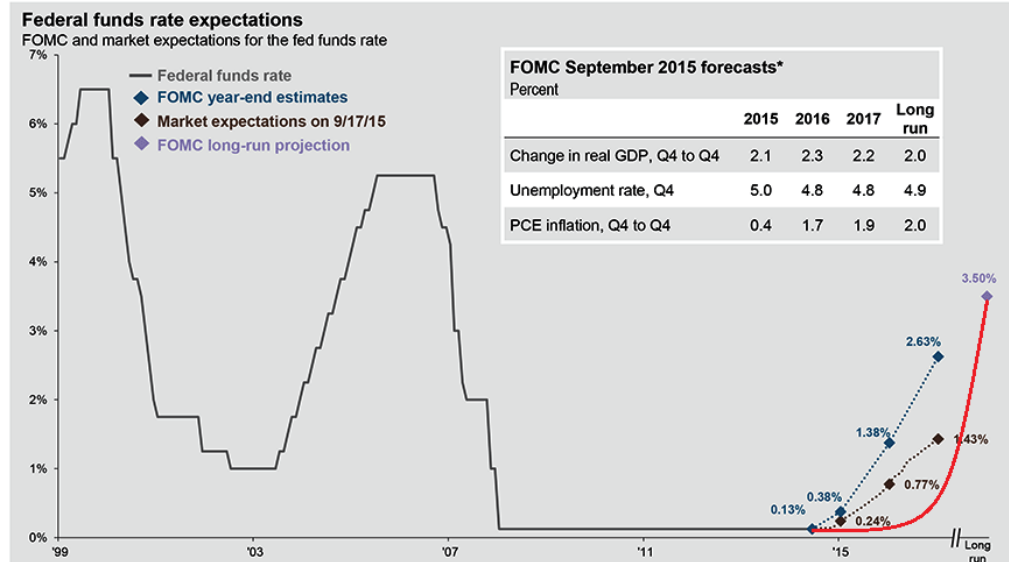
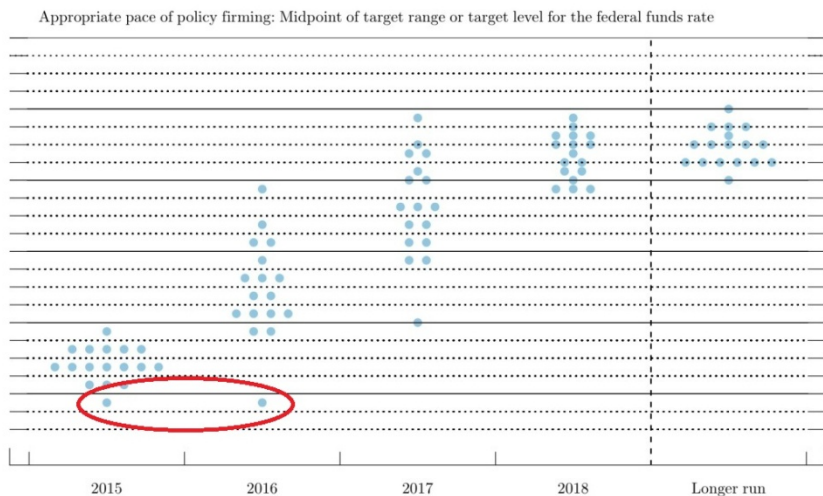


US outstanding debt held by foreign entities is 47% of GDP

# The Fed Is Still On Hold

- Deflationary concerns in the U.S. and Europe are causing the Fed to push out increases and lower their pace of increases
- The committee anticipates that it will be appropriate to raise rates when it has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its 2% objective over the medium term; and they recently added *global stability* to the mandate
- Fed Funds rates are projected at 3.50% by 2018, that's 0.25% lower than projected last qtr
- The wait will continue

## Fed is pushing out increases



Sources:

Central Key Bank Policy Rates, JP Morgan Guide to the Markets Q3  
Federal Open Markets Committee. (9/17/15).

# Mean Reversion Dashboard

Style Current P/E as a % of 20yr Avg. P/E

	Value	Blend	Growth
Large	97.9%	88.1%	81.3%
Mid	105.8%	100.0%	83.3%
Small	100.2%	92.5%	83.3%

Regional Fwd P/E as a % of 10yr Avg. Fwd P/E

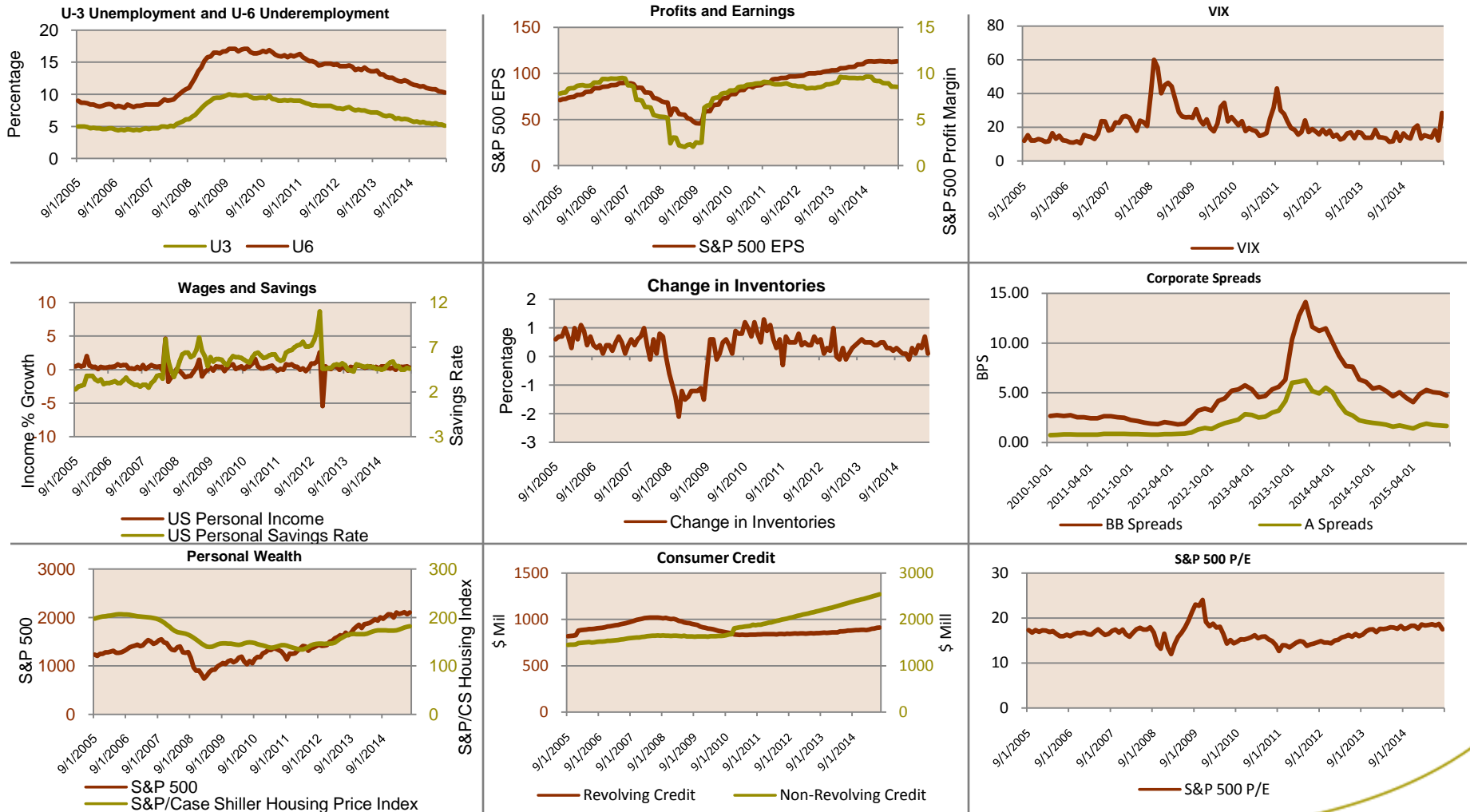
ACWI	EAFE Index	EM Index	United States	Germany	U.K.	China	Brazil	India	Russia
107.6%	107.0%	95.5%	110%	101.7%	122.4%	74.4%	101.9%	109.4%	67.1%

Sector Trailing P/E as a % of 20yr Avg. P/E

Financials	Technology	Health Care	Industrials	Energy	Cons. Discr.	Cons. Staples	Telecom	Utilities	Materials
85.2%	68.8%	86.3%	88.2%	88.0%	99.0%	101.9%	117.2%	109.9%	86.0%

Source: JP Morgan Asset Management. (September 30, 2015). "3Q 2015 Guide to the Markets", p. 9-10, 54-55. JP Morgan sources data from MSCI, FactSet, Standard & Poor's, Russell Investment Group, and J.P. Morgan Asset Management. Trailing P/E ratios are bottom-up values defined as month-end price divided by the last 12 months of available reported earnings. Historical data can change as new information becomes available. Past performance is not indicative of future returns.

# Economic Dashboard



Source: Bloomberg LP and Federal Reserve. Data is from sources deemed to be reliable. No representation or warranties either expressed or implied are made as to the accuracy of the information presented. Data retrieved on 7/02/2015.

# Recommendations

## Summary:

- We expect to be in an earnings recession
- Continue to monitor data to watch for economic recession
- **Earnings are the critical factor.** Expectations are low with a chance to surprise to the upside
- Dollar hedging may be an unspoken opportunity to exceed expectations
- Emerging markets continue to offer better valuations and long term growth

## Recommendations:

- Tilt to US Large Cap Growth for best valuations and protection
- Focus on Financials, Health Care, and Consumer Discretionary
- Hold Emerging Market and Developed Market exposures
- Buy actively managed fixed income with an eye on liquidity to withstand retail investor's fear of rising rates

# THANK YOU