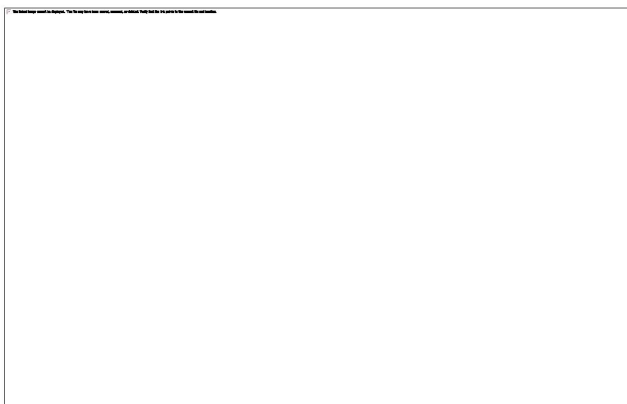

From: US GIO [us.gio@jpmorgan.com]
Sent: 7/25/2011 4:33:45 PM
To: Undisclosed recipients;;
Subject: Eye on the Market, July 25, 2011
Attachments: image002.png; image004.png; image006.png; image008.png; image021.png; image022.png; image023.png; image024.png; 07-25-11 - EOTM - White Castle.pdf

Eye on the Market, July 25, 2011 (the attached PDF document is much easier to read)

Topics: US debt ceiling negotiations, a more ambitious European bailout plan (finally), and how large cap growth stocks and rising corporate profits are patiently waiting for both of them to end

White Castle. Twenty five years ago, I had a friend with a peculiar way of responding to seeing things he didn't like on TV: he would throw White Castle hamburgers at the screen. I always thought this was a bad way to waste a good hamburger, but I had one of those moments the other night when watching news reports on debt ceiling discussions. Media outlets have referred to President Reagan's scolding of Congressional Republicans for delaying debt ceiling increases, and the 18 increases that took place during his Presidency. The implication: reservations about raising the debt ceiling are as irresponsible now as they were then. **This is a disingenuous argument; in the 1980's, the debt ceiling being debated was 50% of GDP, and had no bearing on the solvency of the United States.** Today, the proposed increase raises the debt limit twice as high, measured relative to GDP or government revenues. While a default is a *very* bad idea (deserving of a White Castle hurling of its own), unconstrained debt growth with no plan to slow it is bad as well. Some suggest we not worry about debt growth, since demand from foreign central banks and the Federal Reserve would keep yields in check. That logic is irresponsible at best. Debt limit legislation is a rocky but healthy way for a democracy to decide whether mega-deficits are in the long-term public interest.



Over the last few days, the Gang of Six plan, the Reid-McConnell plan and the Obama-Boehner plan have all been raised up the flagpole and then lowered. By the end of the process, we're still looking for deficit reduction of \$3 trillion+ over 10 years (relative to the CBO Alternative case in which there is no deficit reduction at all). However, Congress is running short on time, and may have to do a smaller debt ceiling increase/deficit reduction first. For now, we wait to see the balance of spending cuts and revenue increases will be agreed to. Last week's *Profiles in Courage* piece walked through the history and dynamics of this process, so we won't repeat that here. **Here's our take on what has been proposed so far**, with the caveat that many plans are not crystal clear what baseline they are using, or what steps they recommend to get to that baseline first. For example: the Gang of Six state that they used the President's budget as a baseline (scored by CBO in March 2011), reduced deficits by \$3.7 trillion, and ended up with a 71% debt/GDP ratio; but they do not explain how they get to the President's baseline in the first place.

I have a feeling that revenue increases will be a material (e.g., 25% or more) part of the deal. The Peterson Foundation's sampling of 6 policy groups shown below indicate that 5 of 6 recommend revenue increases compared to where we are today; the Heritage Foundation's "*Woody Guthrie Memorial Budget Plan*" is the only exception. What kind of revenue increases? Raising the top two brackets, which would affect joint filers with adjusted gross incomes above \$212,300, would raise \$450-\$700 billion over 10 years (depending on whether you use OMB or CBO numbers). If they cannot agree to raise *rates*, another option (as in the Gang of Six plan) would be reductions in the deductibility of state and local taxes, sales taxes, mortgage interest, etc. As this gets sorted out, let's hope everyone recognizes that the US tax system is already progressive. As shown in the chart below, effective Federal tax rates for low earners have dropped to zero over the last decade, even after including FICA taxes. News reports that the US tax system is regressive make me want to throw hamburgers at the screen.

Europe: Finally (!!), but now what?

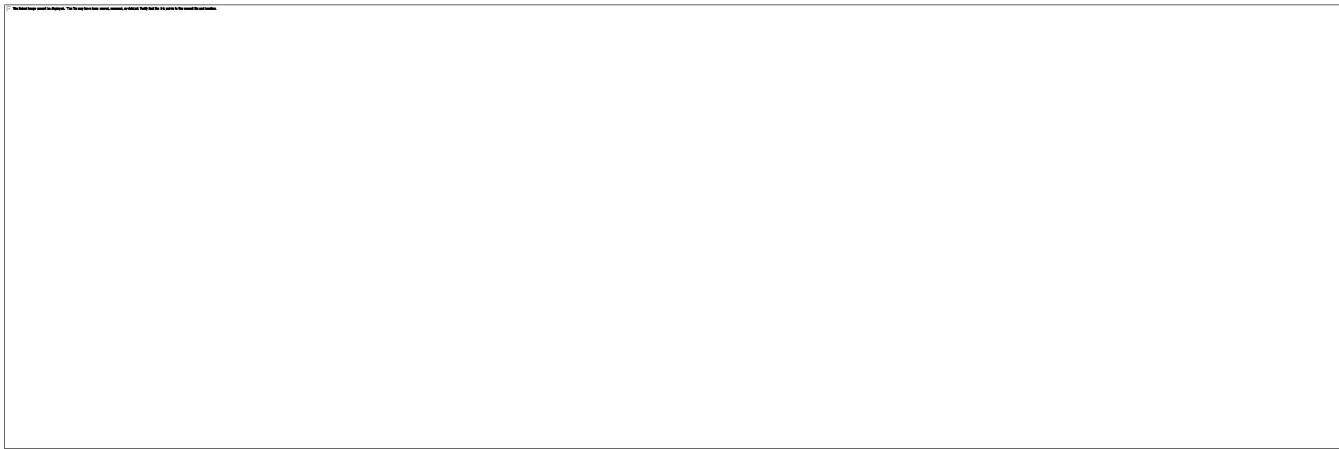
For the first time since 2009, it felt last week like European policymakers were trying to get out in front of things. In exchange for a modest amount of "private sector involvement", Germany agreed to more generous financing terms for Greece, Ireland and Portugal, and an expanded role for the EU-IMF lending facility (see following page). What would the plan accomplish if implemented? While Greek debt to GDP ratios would remain well over 125% of GDP (the IMF estimate for next year is a ridiculous 170%), Greece's near-term financing obligations would decline, due to debt buybacks, exchanges into long maturity bonds, and interest grace periods on new EU loans. More broadly, the plan also allows for money to be lent to countries *before* they enter into an IMF program, for recapitalization of banks. **All things considered, it's the broadest defense of the Monetary Union so far.** On paper, it even looks like a **free ride** for holders of Greek paper that don't participate in the debt exchanges (they would be paid at par). So, what's not to like? Well, there are still questions about Greece:

** There's a big difference between generous *financing* terms and generous *economic* terms. Greece must still meet an enormous 5%-6% primary budget surplus target (government revenues less spending, pre-interest) during a recession

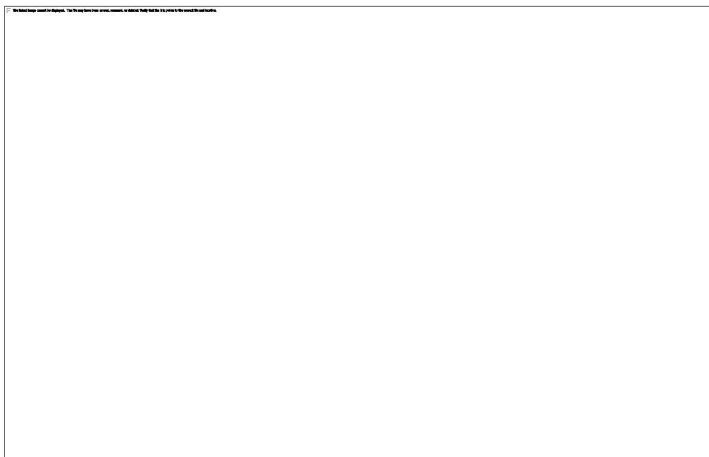
** Greece must execute on its asset sale targets, despite having little success or experience doing this in the past

**** Banks listed in the IIF document (the committee representing them) are under no binding legal obligation to participate in the debt exchanges, and may turn out to own less Greek debt than currently believed. [Note: bank participation in the Latin Brady bond era was high, since at the time, banks held almost all the paper, and in the form of illiquid loans].**

The big question: **would Germany still live up to the deal** if Greece missed deficit targets or assets sales, if bank participation was too low, or if hedge funds (once referred to by the Chairman of the German Social Democratic Party as a “swarm of locusts”) reaped large free rider windfalls? Ultimately, this is a political question. If “yes”, Germany will underwrite Greece no matter what; if “no”, then a broader, coercive Greek restructuring might follow in the not-so-distant future.



In addition to execution risk in Greece, we are left with 3 other concerns. The current EU-IMF lending facility capacity is Eur 255 bn, but we anticipate that as agreed, national parliaments will expand it to 440 bn. First concern: while that’s to deal with problems in Greece, Portugal and Ireland, if you include Spain, it gets tight (note: the chart excludes costs to recapitalize banks). If Italy or Belgium entered Europe’s Liquidity Hospital, a lot more money might be needed from European parliaments (in one worst-case scenario, Alliance Bernstein estimates that the EU lending facility would have to increase from 440 bn to 1.7 trillion Euros, mostly from Germany). Italy faces a multi-notch downgrade from Moody’s, which is not going to help. As we discussed two weeks ago, Italy has been a model citizen in terms of running low budget deficits for 20 years, but still cannot escape the confines of its very large existing debt stock (120% of GDP).



Second, as shown below, Europe is now a two-speed economy, with the periphery stuck in neutral (industrial production is one proxy for this; there are others, such as unemployment, consumption, export shares, etc). If the idea behind the EU/IMF effort is that austerity will boost growth and lead these countries back to the public markets, there is very little momentum in this direction. **If the status quo in the periphery does not change, all the EU package does is allow the current approach more time to fail.**

Blackboard Learning System - The following information is provided for your information only.

The third concern: Germany as paymaster. We are often told that Germans across both major parties are unflinching supporters of the European project, and will do whatever it takes to prevent a break-up. The objections from members of the Bundesbank are described as lonely voices of opposition that carry no weight [a]. **But how large are the costs going to be?** German politicians and voters may see current circumstances as exceptional, and that if they just agree to one more package, the problem will go away. However, we are starting to see analyses of how costly a permanent transfer union may be for Germany. Bernard Connolly at Hamiltonian Advisors sent me a recent paper from the *Centrum für Europäische Politik* in Freiburg, which provides some clues. They see three alternatives for the deficit countries:

- ** massive reduction in regulations and unit labor costs to regain competitiveness
- ** exit from the EMU, re-introduction of national currencies
- ** permanent transfer union from surplus countries to deficit ones

On the last option, they estimate a “creditworthiness gap” in European deficit countries of Eur 108 billion in 2010. The gap measures how much European deficit countries rely on capital inflows to fund consumption, rather than investment (which contributes to future GDP). Germany’s share of the European surplus is around $\frac{3}{4}$, so let’s assume a pro-rata burden on Germany to maintain the transfer union. As a result, the theoretical economic cost could be 3.3% of German GDP every year, which as shown, gets close to some expensive episodes in German history. If German citizens were faced with costs this high, it could be a White Castle hamburger-throwing moment of national proportions.

Blackboard Learning System - The following information is provided for your information only.

Bottom line. At a time when European equities are trading close to 2009 lows relative to earnings and book value, this package could result in a relief rally for European equities, particularly banks. The chance of a disorderly default in 2011 has decreased markedly, and a process has been put in place to create more seamless transfers to areas (and banks) in need. But the size of the transfer union fund is not big enough to allay all concerns, particularly with Spain and Italy growing at anemic levels, and there is execution risk in Greece.

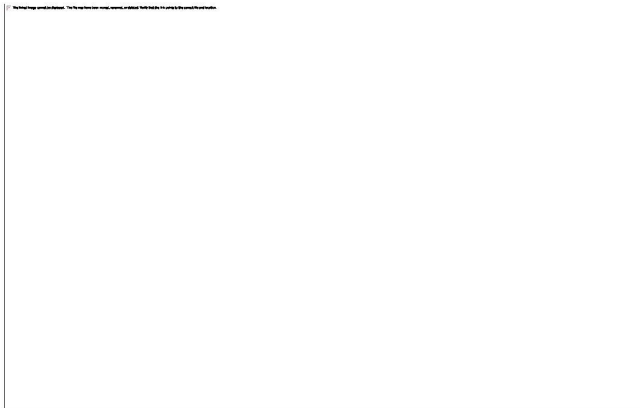
Recent bank stress tests conducted by the EU concluded that only Eur 2.5 billion of capital needs to be raised (70 to 80 billion sounds more reasonable to us). And in the package announced last week, the **following Orwellian clause** indicates how European policymakers feel about rating agencies these days:

Point 15. We agree that reliance on external credit ratings in the EU regulatory framework should be reduced, taking into account the Commission's recent proposals in that direction, and we look forward to the Commission proposals on credit ratings agencies

In Europe, denial appears to be an essential ingredient to the process (See “*Five Stages of Greece*”, June 30, 2011). **Last week’s package is a bold step towards Federalization and the worst-case outcomes have been avoided (money market failures, bank runs, etc), but markets will remain nervous about Europe.**

While we’re waiting: large cap growth stocks

One day, the melodramas around US and European sovereign debt will end. While we’re waiting, one of the asset classes that looks attractive is large cap growth stocks. As shown below (for a universe of 300 U.S. large cap growth stocks that meet certain earnings quality and stability factors), **free cash flow relative to both revenues and stock prices looks good compared to the last four decades.** This is where we believe investors should be adding exposure if they are underweight versus their desired equity allocations. This is also an asset class where active management can still provide a lot of value; the dispersion of large cap growth managers is higher than large cap core, large cap value and international equity manager dispersion.



Q2 earnings season in the US is off to a good start. Nearly 30% of the S&P has reported, and results have generally been positive. Earnings are beating consensus estimates by almost 4% (7.4% ex-financials), all ten sectors are beating on revenue targets, and only 7% of companies are reporting below-consensus earnings. Given earnings expectations for 2011 at \$98.50, the S&P 500 is trading at a reasonable 13.5x forward multiple. However, y/y earnings growth expectations appear to be flattening out for both 2011 and 2012 at around 11%-12%. While Q2 earnings are doing well so far, some company guidance for the remainder of the year has been below consensus, which would be consistent with the recent batch of reports indicating a slowdown in manufacturing and service sector surveys.

Michael Cembalest
Chief Investment Officer

Notes

[a] Bundesbank President Weidmann, in response to last week’s package: “By transferring significant risks to the support-giving countries and their taxpayers, the Euro area has taken a large step to socialising risks created by unsound government finances and macroeconomic problems. This weakens the foundations of the fiscal self-responsibility that EMU is built on”.

CBO Congressional Budget Office
OMB Office of Management and Budget
EFSF European Financial Stability Facility
FICA Federal Insurance Contributions Act
EU European Union
IMF International Monetary Fund

IIF Institute of International Finance
ECB European Central Bank
EMU European Monetary Union
AMT Alternative Minimum Tax

A White Castle hamburger is smaller than its competitors' offerings, measuring 2.5 inches square.

The material contained herein is intended as a general market commentary. Opinions expressed herein are those of Michael Cembalest and may differ from those of other J.P. Morgan employees and affiliates. This information in no way constitutes J.P. Morgan research and should not be treated as such. Further, the views expressed herein may differ from that contained in J.P. Morgan research reports. The above summary/prices/quotes/statistics have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness, any yield referenced is indicative and subject to change. Past performance is not a guarantee of future results. References to the performance or character of our portfolios generally refer to our Balanced Model Portfolios constructed by J.P. Morgan. It is a proxy for client performance and may not represent actual transactions or investments in client accounts. The model portfolio can be implemented across brokerage or managed accounts depending on the unique objectives of each client and is serviced through distinct legal entities licensed for specific activities. Bank, trust and investment management services are provided by J.P. Morgan Chase Bank, N.A. and its affiliates. Securities are offered through J.P. Morgan Securities LLC (JPMS), Member NYSE, FINRA and SIPC. Securities products purchased or sold through JPMS are not insured by the Federal Deposit Insurance Corporation ("FDIC"); are not deposits or other obligations of its bank or thrift affiliates and are not guaranteed by its bank or thrift affiliates; and are subject to investment risks, including possible loss of the principal invested. Not all investment ideas referenced are suitable for all investors. Speak with your J.P. Morgan Representative concerning your personal situation. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Private Investments may engage in leveraging and other speculative practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuations to investors and may involve complex tax structures and delays in distributing important tax information. Typically such investment ideas can only be offered to suitable investors through a confidential offering memorandum which fully describes all terms, conditions, and risks.

IRS Circular 230 Disclosure: JPMorgan Chase & Co. and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with JPMorgan Chase & Co. of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties. Note that J.P. Morgan is not a licensed insurance provider.

© 2011 JPMorgan Chase & Co; All rights reserved

This email is confidential and subject to important disclaimers and conditions including on offers for the purchase or sale of securities, accuracy and completeness of information, viruses, confidentiality, legal privilege, and legal entity disclaimers, available at <http://www.jpmorgan.com/pages/disclosures/email>.