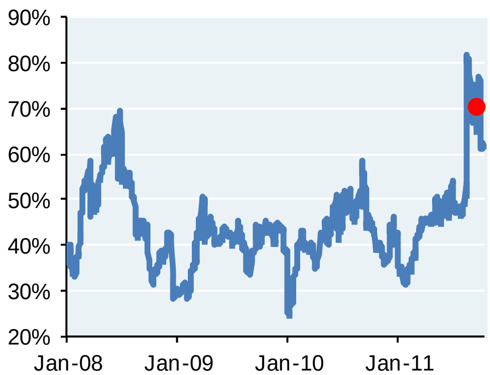
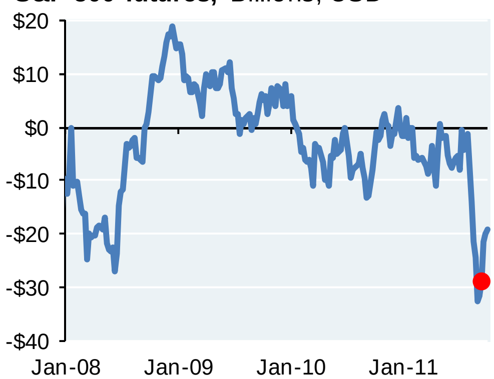
Topics: Is the recent rally anything more than short-covering, given ongoing risks in the US and Europe?

The S&P 500 is up 9% and European equities are up 16% since their lowest levels of the last month. There has been some mildly better than expected economic data in the US, and more talk of a plan in Europe to recapitalize banks. However, it appears that "short covering" has played a large role in this recent rally. Markets often bottom with short-covering preceding real money buying, so there's nothing wrong with that. But it's worth considering the technical factors in play before trying to interpret what the recent rally might mean. The charts below highlight some of the technical factors we look at: short interest on the S&P 500 ETF, short interest on S&P futures contracts by speculative investors on futures exchanges, and a proprietary measure of hedge fund risk appetite compiled by ISI. [See Appendix for sources and definitions].

[1] Short interest on S&P 500 ETF
Percent of shares outstanding

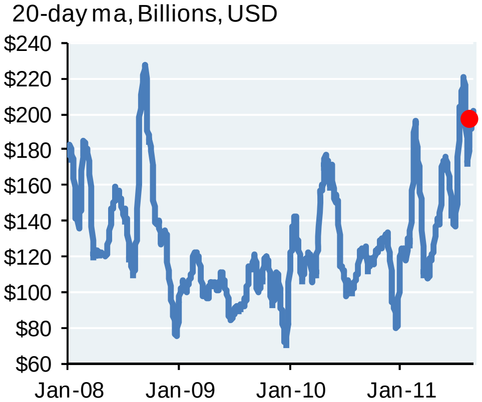


[2] Net long speculative positions on S&P 500 futures, Billions, USD

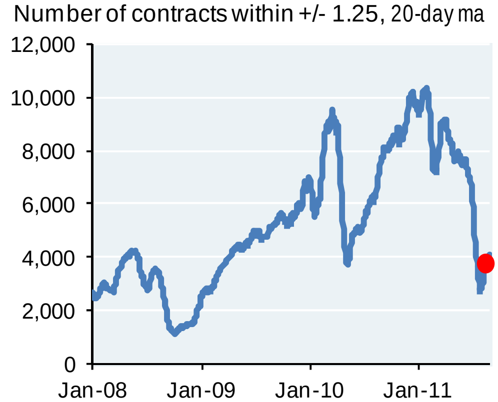


[3] Bullish sentiment of S&P 500 futures positions, Net long / short, %

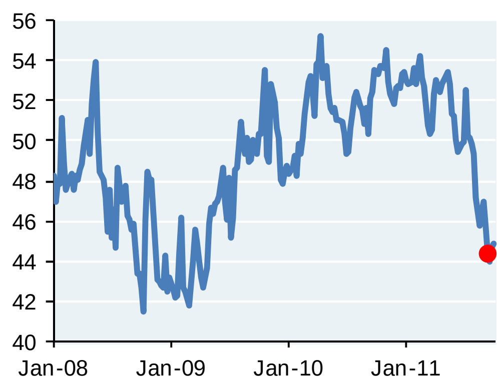
[4] S&P 500 futures market volume
20-day ma, Billions, USD



[5] S&P 500 futures market depth
Number of contracts within +/- 1.25, 20-day ma



[6] Hedge fund net exposure survey
Index, 50 = "normal"



In aggregate, these charts suggest that short interest was quite high in September when the recent rallies began (red dot is mid September). Computing short interest is complicated, since you have to look at both cash and futures markets, and even these measures do not capture all the effective shorting activity taking place. The first chart, a traditional measure of short interest in the S&P in the cash markets, was even higher than its prior 2008 peak. Bearish positions executed through futures exchanges (charts 2 and 3) were also high in September, exceeding 2008 levels. Some short interest measures are measured against average daily trading volume, which makes short interest look lower given high recent S&P futures volumes (chart 4). But when thinking about a short squeeze, you have to consider market depth, and not just volume. One measure of depth is the number of futures contracts trading within a given bid-offer range (chart 5). As shown, there was not a lot of depth when the recent squeeze began, creating the risk of an exaggerated move. Lastly, a measure of hedge fund risk confirms this trend; they generally carry much less risk than usual, close to Spring 2009 levels.

Not all technical indicators are this positive. A measure of investor margin account debt balances (chart 7) shows that investor leverage is still high. It is declining, but the prior two market bottoms did not take place until these debt balances crashed and gradually starts to rebuild.

[7] NYSE margin debt balances
Billions, USD

Source: NYSE, Bloomberg. Data as of Aug. 31.

Topics: Is the recent rally anything more than short-covering, given ongoing risks in the US and Europe?

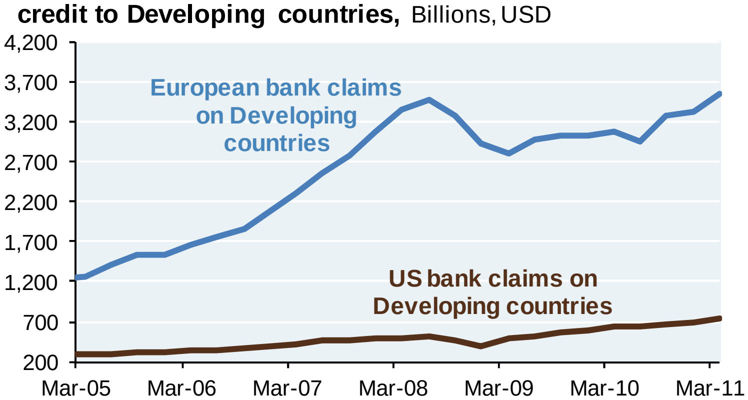
Given these trends, September and early October was a dangerous time to reduce risk, given the elevated level of short interest, and the potential for policy discussions in Europe to force investors to cover short positions and drive markets higher. Mega-short investors were positioning for unavoidable US and European recessions and a continuation of the seemingly unending problems in European banks. Is there any hope on either front from the two things frightening markets?

***Bankenstein's Monster*: the world eagerly awaits a solution to European bank under-capitalization**

We don't need to go through of all of this again; our "*Ransom Note*" from September 25th walked through the details on European banks and their possible need for 200 billion Euros of capital, almost 100 times what European regulators said is needed. From an investor's perspective, the European Banking Authority Stress Tests may be the worst received regulatory pronouncement of good health in the history of such exercises[1]. Investors are waiting for whatever steps the EU might take to address *Bankenstein's Monster*: the size, scope, leverage and funding of the European banks. In prior notes, we have shown how the size of European banks relative to GDP is 2 to 4 times US levels, and how their loan to deposit ratios are much higher.

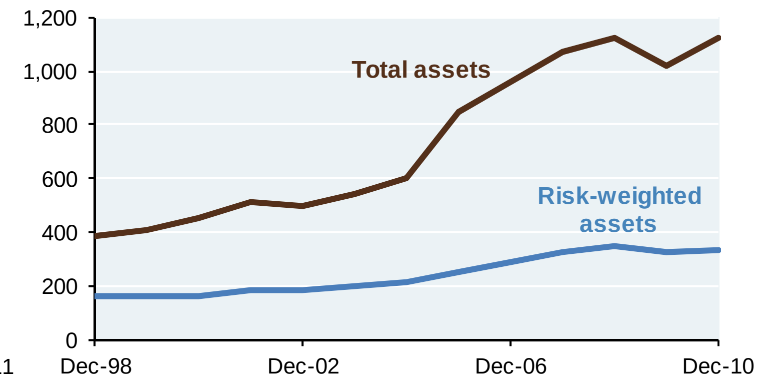
In the first chart, you can see why under-capitalization is a problem: it threatens to choke off the credit that EU banks have been supplying to the Developing World. In the second chart, an illustrative French bank, and one reason markets lost confidence: the increasing divergence between the total assets of European banks, and what they report as their risky assets (which is used to compute capital requirements). Last week, we hoped that Dexia's failure would accelerate the end-game here, which appears to be delayed by negotiations between Germany ("large countries should recapitalize their own banks if necessary") and France ("an enlarged EFSF should recapitalize them") on last-resort capital infusions. In Mary Shelley's *Frankenstein*, the doctor sets out to destroy the monster and ends up being killed by it. It November, we will find out if Europe can control its own unwieldy creation. While it feels like something is coming, it's not clear what it is. It will take an uncharacteristically bold move to change the pattern of "short first and ask questions later", which has worked well in Europe over the last 2 years.

***Bankenstein's Monster*: a monstrous rise in EU bank credit to Developing countries,** Billions, USD



Source: BIS.

Illustrative French bank: lack of trust in RWA assessment
Billions, EUR



Source: Worldscope, Factset.

All of the uncertainty and confusion is weighing heavily on European equity valuations. Even after the recent rally, companies listed in Europe but which have global business are trading at very depressed levels compared to their history. There are ten stocks in particular which look interesting to us, which in aggregate trade at 9 times next year's earnings, and which earn 50% of their revenues outside Europe. They span capital goods, energy, technology, pharmaceutical, telecommunications and chemical sectors, and offer the characteristics shown in the table below. These companies, select bank senior and subdebt, and the purchase of loans sold by deleveraging European banks seem to us to be the best investments in Europe right now.

Oversold European Multinationals - average characteristics	Market Cap ($bn)	Forward P/E	Projected Dividend Yield	Dividend Coverage	Return on Equity	Net Debt to EBITDA	% of Revenue Exposure outside Europe
	89.0	9.2x	5.0%	2.3	27.0	0.8	51%

Source: J.P. Morgan Private Bank, Bloomberg, Company filings. Data as of October 11, 2011.

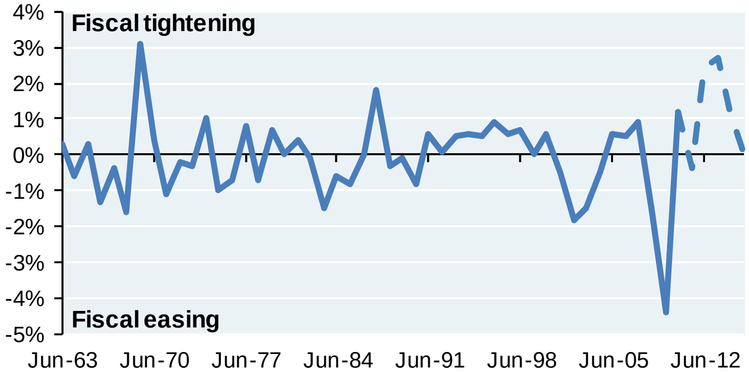
[1] On top of the objections noted in our September 25th note, Hamiltonian Advisors refers to another problem: liberal use of IAS 39, an accounting procedure by which European banks transferred risky assets from trading books to hold-to-maturity accounts, so as to reduce the need for greater capital charges and boost RoE. The Corporate Reporting Users Forum and CFA Institute warned at the time that it could undermine investor confidence. Financial market analysts at Mannheim and Zurich Universities estimate that 1/3 of banks took advantage of these procedures, which involved 4% of assets and 130% of book value. They estimate that such banks recognized a 2.5%-3.0% return on equity benefit, which in some cases overstated capital ratios by 1%. IAS 39 rules appear to be more liberal than their GAAP counterparts.

Topics: Is the recent rally anything more than short-covering, given ongoing risks in the US and Europe?

The US: facing the King Kong of fiscal adjustments in 2012

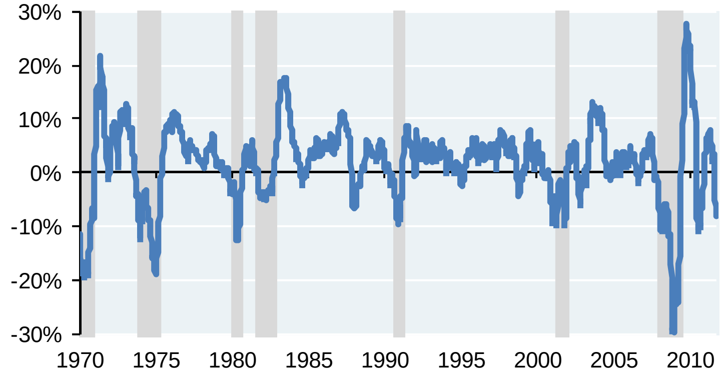
The threat of recession in the US is the other substantial risk for financial markets to sort through. As shown in the first chart, the US faces the King Kong of fiscal adjustments in 2012[2], the largest one since the late 1960's. There are leading indicators that point to recession already, such as the ECRI index. This index is quite controversial in economic circles: ECRI does not completely disclose their methodology, and there is some suspicion, as with the LEI index, that its infallible track record in predicting recessions is due to retroactive revisions to their models. Even with these misgivings, the current reading of the ECRI of around -10 is rarely seen outside recessions (as shown in the second chart); last summer was a notable exception.

US faces King Kong-sized fiscal adjustment in 2012
Change in cyclically-adjusted federal fiscal deficit, Percent of GDP



Source: J.P. Morgan Securities LLC.

ECRI weekly leading index growth rate
Percent



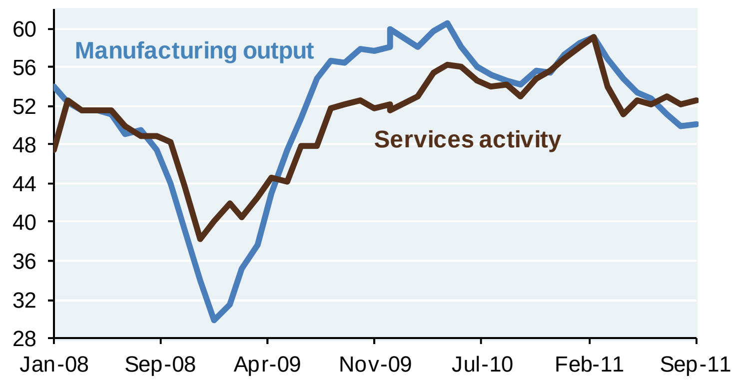
Source: ECRI, Bloomberg. Shaded bars denote recessions.

Even without drawing firm conclusions on the ECRI index, surveys of contemporaneous output (see chart below) shows that the world is slowing to a pace as tepid as anything we have seen since the recovery began, with services holding up only a little better than manufacturing. **The recent trend of better than expected manufacturing surveys, auto purchases and payroll gains in the US will need to be sustained to fully allay such concerns.** A US recession looks like a close call to us; we believe one will be narrowly avoided. Either way, this is not the kind of recovery that merits normal valuations, even if corporate profits deliver yet another quarter of double digit year-on-year gains in Q3.

There have been some comparisons drawn with 1937 in the US. In other words, a recovery in the economy which was sharply derailed by overly tight monetary and fiscal policy. The fiscal tightening in the late 1930's was roughly the same size as what is projected for 2012. On monetary policy, all the Fed did in 1937 was stop growing its balance sheet (it didn't shrink it), raised rates by less than 1%, and the economy relapsed into recession. Industrial production fell by one third, and retail sales fell by 15%. Equities and commodities collapsed, and investment grade spreads widened sharply. [The counter-argument is that 1937 was a separate cycle, with durable goods and capital spending levels having risen enough to fall again, unlike now].

What do these comparisons imply? While the Fed's recent Operation Twist was a modest move, Bernanke's familiarity with the 1930's playbook suggests he has not yet run through his entire toolkit. It would probably take more confirmation of a recession before it is revealed. And on fiscal policy, here is where we agree with Bernanke more unreservedly. Bernanke does not see a conflict between fiscal stability over the long term and helping a fragile recovery now. The two goals, Bernanke said, "are certainly not incompatible, as putting in place a credible plan for reducing future deficits over the longer term does not preclude attending to the implications of fiscal choices for the recovery in the near term."[3]

Global manufacturing and services output surveys
Index, sa



Source: J.P. Morgan Securities LLC.

[2] The chart above represents CBO current law for 2012, which assumes that the payroll tax cuts and unemployment benefits expire. If both of these programs are extended (even though the President's jobs bill was not approved), 2012 fiscal tightening would fall roughly in half.
[3] As reported in the Washington Post, Sunday, October 9, 2011. There's also a reference to our deficit reduction piece in the same Op-Ed.

Topics: Is the recent rally anything more than short-covering, given ongoing risks in the US and Europe?

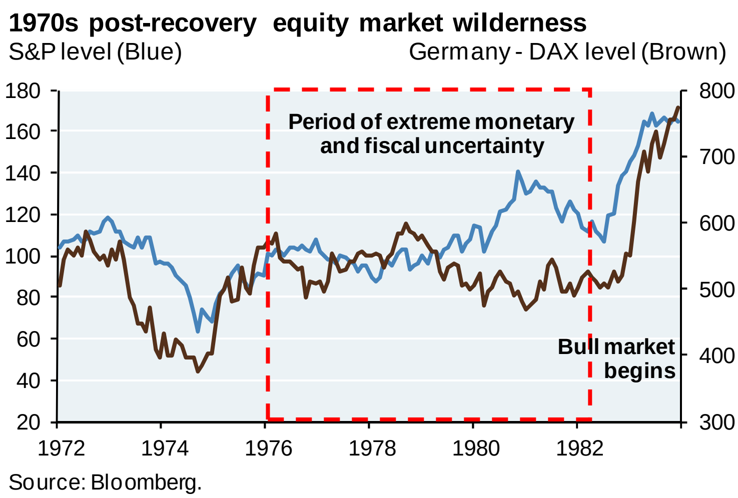
The bottom line: absent a Godzilla outcome in 2012, a modest underweight to risky assets makes the most sense

September and October appeared to us to be the wrong times to reduce portfolio risk, given the risk of short squeeze and given the impending announcement of something out of Europe. However, we are watching to see how far markets will run, since the world still faces some combination of the following risks:

- that fiscal and monetary authorities the West and East have run out of ammunition
- that 2012 will usher in recessions in the US and/or Europe
- that China will have a hard landing (sub-6% growth)
- that it will be impossible to bring Italy back to debt markets, given its high debt, low growth and intractable politics. Like a marriage that has experienced infidelity, it's not clear if markets will ever look at Italian debt quite the same way again[4].
- that Europe is still in the "denial" and "bargaining" phase of the Five Stages of Greece (EoTM, May 21), and has no ability to resolve questions about bank capital adequacy on a timely basis
- that when global IP is finally reported for the fall, it will collapse hard, as it did in 2008
- that there will be a collapse in corporate profits of 15%-25%
- that the U.S. Joint Select Committee on Deficit Reduction will accomplish nothing

My sense is that while one or two of these will happen, the chances that all of them occur is much lower. In other words, we are not expecting a repeat of the fall of 2008; maybe a repeat of the late 1970's and early 1980's when markets went sideways for a long while until there was clarity on the eventual direction of monetary and fiscal policy (see charts below). If that's the case, a portfolio that is underweight normal levels but still positioned with some equity and credit exposure may benefit. That's how we are positioned. If all of the risks above were to happen at once (the equivalent of Godzilla appearing), even our somewhat dour view of the future will be proven to be too optimistic.

Michael Cembalest
Chief Investment Officer



[4] I know, this is a particularly stark analogy. Look at the Italy charts in the Sep 21 and Oct 5 Eye on the Markets to see why it fits.

Topics: Is the recent rally anything more than short-covering, given ongoing risks in the US and Europe?

Acronyms
IFRS=International Financial Reporting Standards
IAS=International Accounting Standard
GAAP=Generally Accepted Accounting Principles
EFSF=European Financial Stability Facility
EU=European Union
ECRI=Economic Cycle Research Institute
CFTC=Commodity Futures Trading Commission

Appendix
[1] Short interest on the S&P 500 ETF. Number of shares of SPDR S&P 500 that are short divided by total number of SPDR S&P 500 shares outstanding. Reported by the New York Stock Exchange. Data as of September 15, 2011.
[2] Net long speculative positions on S&P 500 futures. The net speculative positions (long – short) in US equities of firms that are not commercial or end users in billions of US dollars. Reported by CFTC. Data as of October 4, 2011.
[3] Bullish sentiment on S&P futures positions. Billions of dollars of net speculative positions as defined in Chart 2, divided by billions of dollars of short open interest. Reported by J.P. Morgan Equity Derivatives & Delta One Strategy, Bloomberg, CFTC. Data as of October 4, 2011.
[4] S&P 500 futures market volume. The notional amount of S&P futures traded in billions of US dollars. Reported by J.P. Morgan Equity Derivatives & Delta One Strategy, Bloomberg. Data as of September 28, 2011.
[5] S&P 500 futures market depth. The number of S&P 500 futures contracts with a bid/offer within 1.25 index points. Reported by J.P. Morgan Equity Derivatives & Delta One Strategy, Chicago Mercantile Exchange. Data as of September 28, 2011.
[6] Hedge fund net exposure survey. Current net exposure of hedge funds relative to their “normal” net exposure. Net exposure defined as long positions – short positions, as a percentage of portfolio value. A survey value of 50 indicates that a manager holds their normal level of net exposure. A survey value lower than 50 means the fund is shorter than normal and a survey value higher than 50 means the fund is longer than normal. Reported by ISI Group. Data as of October 5, 2011.