Topic: A biological look at the latest attempt to resolve the European Monetary Union debt crisis; US Q3 earnings

The EMU (technical name: *Economic and Monetary Union*, common name: *European Monetary Union*) is beginning to bear more and more resemblance to its aviary twin: the flightless, awkward, and bumbling[1] emu (*dromaius novaehollandiae*). Europe's long-awaited sovereign and bank bailout package will soon attempt liftoff; we will know more after yet another summit on Wednesday. There are flaws that may weigh this emu down, as annotated in the picture below. **Why is this so important?** Bank recaps in Sweden ('92), the US ('92, '08), Japan ('99) and Asia ('98) were close to marking the bottom of the equity market cycle….but were not designed using the equivalent of the "Goal Seek" function in Microsoft Excel.

Will the EMU bailout fly? The annotated version

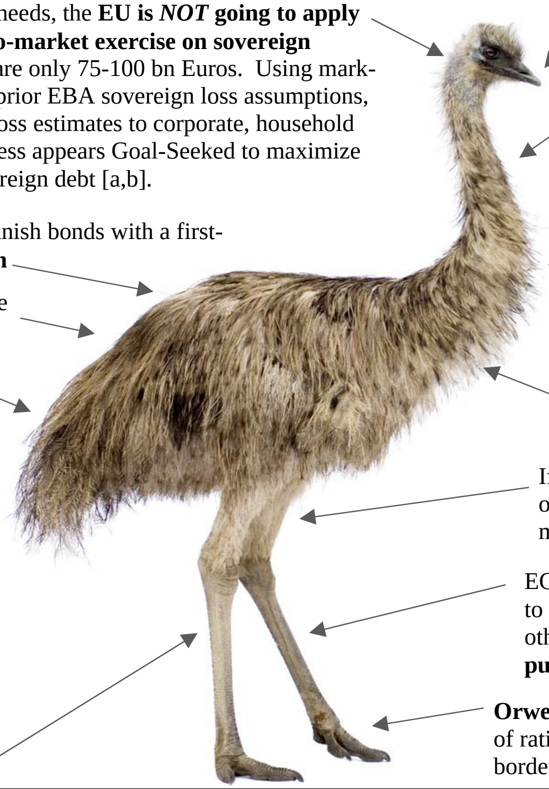
For purposes of determining bank capital needs, the **EU is *NOT* going to apply a stress test per se, but a simple mark-to-market exercise on sovereign bonds**. That's why reported recap needs are only 75-100 bn Euros. Using mark-to-market levels is *less* conservative than prior EBA sovereign loss assumptions, and the planned exercise does not assign loss estimates to corporate, household and commercial property loans. The process appears Goal-Seeked to maximize EFSF proceeds available to backstop sovereign debt [a,b].

Demand (depth, pricing) for Italian or Spanish bonds with a first-loss guarantee from the EFSF is **unproven**

EFSF direct guarantees could be a possible violation of EMU bailout restrictions [c]

Risks to France's AAA rating from the extension of too many guarantees to either the EFSF or its own banks [d]

No stress test this time, but **we still have reservations about the prior one**, as it only assumed 1.3% for household, corporate and commercial property loan losses over 2 years. This compares to the current market-implied loss rates of 3.4%, and the US May 2009 Stress Test assumption of 9%. German bank exposure to GIPSI *sovereign* debt is 1/5th of their exposure to *non-sovereign* GIPSI debt, so these assumptions matter, particularly with a recession looming.



Markets might require a **higher degree of bailout package "coverage"** of Italian and Spanish financing needs in 2012 and 2013 (see page 3)

A **recession, perhaps confirmed by today's weak PMI survey (Germany was the only bright spot),** could result in higher than expected deficits, increasing government financing needs beyond current expectations [e]

Deutsche Bank CEO Ackermann warned that if asked to substantially raise capital ratios, EU banks might **shrink their loan books by 1 trillion** instead of raising equity, possibly exacerbating a recession

20% might be insufficient for a first-loss guarantee, given historical Moody's recovery rates of 53% for defaulting sovereigns

If less than 50% debt forgiveness is used for Greece in order to avoid triggering CDS contracts, the exercise may lose credibility [f]

ECB might be asked to print hundreds of billions of Euros to purchase debt in secondary markets, or finance some other entity that does, **exceeding ECB, Bundesbank or public tolerance for monetary expansion**

Orwellian proposals by EU regulators to limit the ability of rating agencies to act during "inappropriate moments" borders on the bizarre, could further concern investors [g]

<u>*Emu notes*</u>

[a] Using the prior EBA stress test and a 9% Tier 1 ratio would result in a capital shortfall of 150 billion, even after *including* the conversion benefit of convertible bonds and the use of existing loan loss reserves, and *without* applying sovereign losses to the hold to maturity book.
[b] In prior stress tests, the European Banking Authority only applied loss assumptions to bonds in the trading book. The EBA now appears ready to assume losses on hold-to-maturity and available-for-sale bonds as well, but with a kinder, gentler loss percentage assumption.
[c] Direct first-loss guarantees from the EFSF may run afoul of Article 125 of the Lisbon Treaty which prohibits member states from being liable for commitments of other states. There are viable alternatives that get to the same place: a country could borrow from the EFSF and place borrowed funds into escrow (collateralizing the guarantee), or purchase zero coupon bonds.
[d] With 84% debt to GDP (gross government debt), a large current account deficit, rigid labor markets, lost export competitiveness to Germany and low growth, France is flirting with a downgrade. France is already highly taxed (government revenues and expenditures are already at Nordic levels), making deficit reduction a difficult exercise. EFSF commitments from France are another 8.4% of GDP. S&P wrote last week that a recession in Europe could usher in a round of downgrades for European sovereigns, including France.
[e] Recent example: Spain, where flow of funds data suggest that the budget deficit could be 8.6% in 2011, higher than the targeted 6%.
[f] Less debt forgiveness raise the chances of a voluntary restructuring, which would avoid triggering credit default swap contracts. Larger losses are likely to mean that the restructuring is involuntary.
[g] "*In order to prevent that credit rating agencies issue sovereign ratings which do no accurately reflect the situation of the country concerned and would cause negative spillover effects to other countries, ESMA should be granted the power to temporarily restrict the issuance of credit ratings in exceptional, precisely defined situations*" [EU regulatory draft as reported by the Financial Times]. I remember reading articles like this in Pravda in 1982.

[1] Professor Louis Lefebvre at McGill University in Montreal has compiled a **Bird IQ Index**. The emu (and its cousin the ostrich) rank at the bottom of the list. At the top: crows, ravens, falcons, hawks, woodpeckers and herons.

Topic: A biological look at the latest attempt to resolve the European Monetary Union debt crisis; US Q3 earnings

We consider the universe of oversold European stocks mentioned 2 weeks ago, and portfolios of loans sold by deleveraging European banks at deep discounts, as the best value in Europe. We are not positioning for a broader recovery in European financial assets, and retain our overweight to the US. Q3 S&P 500 earnings look to be around 14%[2] vs 2010, continuing the run of US corporate profits growth to a new all-time high. **As a reminder, profits are holding up since manufacturing is 60% of the S&P 500 (compared to 15% of the US economy), and labor costs are at their lowest levels in 50 years relative to revenues.** There are some negative trends in play: both margins and earnings surprises are beginning to flatten out. In addition, estimates for Q1 2012 profits have fallen from 10.2% y/y on October 3 to 7.6%, consistent with declines in manufacturing and service sector surveys. **Silver lining: there's room for disappointment when the S&P is priced at 11 times earnings.** Left to its own devices, we expect the S&P to close up on the year, but the situation in Europe and the outcome of the US Joint Select Committee on Deficit Reduction are two substantial wild cards.

The other animal of the week: the Sloth

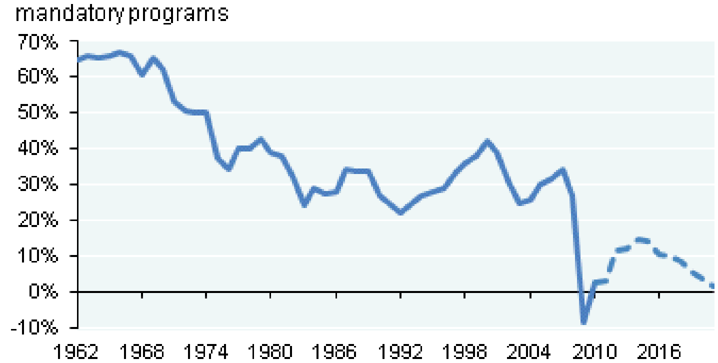
We had a client conference in Istanbul two weeks ago. I had the opportunity to interview Jin Liqun, the Chairman of the Board of Supervisors of China Investment Corporation. Most of the discussion focused on the challenges that CIC faces in investing its accumulated reserves at a time of fiscal and economic weakness in the West. Normally I would not disclose comments made in a closed session, but as reported below by the London Telegraph, Mr. Jin made the following comments, which were similar to what he said at our conference in Istanbul:

> Oct. 20 (Telegraph) -- Britain's "sloth-inducing" work ethic and dependence on benefits are to blame for the current economic downturn, a senior Chinese official has claimed. Jin Liqun, chairman of China Investment Corporation (CIC), the nation's sovereign wealth fund, warned that Europeans should "work a bit harder" if they want to pull the Eurozone out of recession. He said people in the West are too reliant on welfare payments and the benefits system, looking for external solutions to the debt crisis rather than tackling the problem from within. Mr Jin also said the long-term economic slide could only be solved by amending the restrictive labour laws that mean Western workers are unable to compete in global markets….."**The root cause of the trouble is the over-burdened welfare system, built up since the Second World War in Europe – the sloth-inducing, indolence-inducing labour laws. People need to work a bit harder, they need to work a bit longer, and they should be more innovative**. We (the Chinese) work like crazy. European countries have a lot of advantages. They just need to tap these advantages and they will be back on their feet."

Ouch. For the benefit of our urban clients, a sloth (*megalonychidae*) is a slow-moving, tree-dwelling animal that sleeps 15 hours a day and is covered in beetles. There are many ways to react to this**:** a wake-up call for the West; an unfair diatribe, given China's currency intervention which arguably contributes to the economic challenges facing the US and Europe; or a reflection of inevitable wage convergence, driven by 2.6 billion people in China and India entering the global workforce after decades of self-imposed isolation. Whatever the truth is, Jin's comments seem in sync with other Chinese assessments of Western fiscal policies (see August 6th article in Xinhua: "*China, the largest creditor of the world's sole superpower, has every right now to demand the United States address its structural debt problems and ensure the safety of China's dollar assets.*").

To stress-test Jin's assertion, we recreated a chart from Eugene Steuerle, former Deputy Assistant Treasury Secretary for Tax Analysis, now with the Urban Institute. He calls the chart a measure of "fiscal democracy": the degree to which Congress can spend revenues not already committed to mandatory programs. **In 2009, for the first time, all US government revenue was pre-committed to mandatory spending** (social security, healthcare entitlements, farm subsidies, unemployment insurance) and interest. After a brief rise over the next couple of years (due to projected declines in unemployment insurance), it is estimated by the CBO to fall back to zero again. The chart confirms the post-war shift to a more entitlement-heavy economy, a shift former U.S. Comptroller David Walker describes as crowding out the kind of productive discretionary spending needed for the US to compete against China and India.

A measure of Fiscal Democracy shows there isn't much left, % of U.S. government revenue not already committed to mandatory programs



Source: CBO, J.P. Morgan Private Bank.

Michael Cembalest
Chief Investment Officer

[2] S&P 500 earnings for the third quarter look to be overstated by 3%-4% due to "debt valuation adjustments" by banks. These adjustments require banks to mark some of their own debt issuance to market. As a result, when their spreads widened in Q3, it resulted in a gain on their income statements (when spreads rally, banks record a loss); Bank of America and Morgan Stanley had the largest ones. Looking forward, **C&I loan volumes and credit quality** are now improving, providing some support for better organic bank profitability in 2012.

Topic: A biological look at the latest attempt to resolve the European Monetary Union debt crisis; US Q3 earnings

Appendix. Here is an abbreviated version of the model we use to assess the adequacy of the European Financial Stability Facility. There are multiple scenarios; we show a few of them below. The bottom line is that the proposed package appears to just about cover contingent funding needs for Spain and Italy through 2013, assuming that Germany and France recap their own banks and don't draw on the EFSF to do so; and assuming that T-bills do not need any backstop. IMF participation would further increase the EFSF's potential capacity. Throwing 2014 into the mix, adding Belgium, or requiring a larger (more realistic) bank recap makes the math more difficult, and results in coverage ratios close to 1.0x. The best scenario is the one where all countries are assuming to return to debt markets in 2013, the 20% first loss guarantee works and the IMF helps out.

EFSF vivisection table				
Line	Item	Eur bn		Comment
1	Bilateral funds available	500		EFSF plus original EFSM
2	Disbursed so far to Ireland and Portgual	37		Greece disbursements have not impacted the EFSF; Greece was funded through other bilateral and IMFprograms whose unspent balances are assumed to expire
3	To be disbursed to Ireland and Portgual	55		Through the end of 2013
4	To be disbursed to Greece post-default	50		The July 2011 109 billion package won't be needed if Greece defaults, but monies will still be needed to recapitalize banks, insurance companies, pensions, etc. Also includes next 8 billion disbursement
5	Funds remaining	358		After incorporating prior and future disbursements
6	Funds required for bank recap	44		As of right now, we are assuming a total new recap effort of 75 bn, after some massive window-dressing by the EBA (see EMU on page 1). The 100 bn number mentioned in the press might include monies already pledged to Ireland, Greece and Portugal, so we reduced the figure to 75 bn. In our model, France and Germany assumed to recap their own banks, further reducing the drawdown needed from the EFSF to 44 bn.
7	Funds remaining	314		After incorporating prior and future disbursements and bank recap
8	First loss guarantee from EFSF	30%		We do not think a 20% guarantee would be sufficient
9	Implied sovereign issuance capacity	1,047		Total debt that periphery countries could issue with EFSF guarantees
			Cov.	
10	Funding needs for Spain and Italy	988	1.1	Through 2013, including T-bills
11	Funding needs for Spain and Italy	750	1.4	Through 2013, excluding T-bills
	Other scenarios			
12	What if Belgium is included as well?		1.2	Relative to line 11
13	What if total bank recap needs were 150 bn instead?		1.2	Relative to line 11
14	What if the IMF covered the bank recap for the periphery?		1.6	Relative to line 11
15	What if a 20% guarantee worked?		1.9	Relative to line 11
16	What if 2014 had to be covered as well?		0.9	Relative to line 11
17	Larger bank recap, 2014 coverage needed for Sp/Bel/It		0.8	
18	20% EFSF guarantee, IMF help, thru 2013 only		2.4	Relative to line 11

EFSF = European financial stability facility; EFSM = European financial stabilization mechanism; EBA = European Banking Authority
EMU = European monetary union (the common name); ECB = European central bank; CBO = Congressional budget office;
CDS = Credit default swaps; ESMA = European Securities and Markets Authority
London Telegraph article: http://www.telegraph.co.uk/news/uknews/8837768/Britons-are-lazy-and-addicted-to-benefits-China-claims.html
Xinhua article: http://news.xinhuanet.com/english2010/indepth/2011-08/06/c_131032986.htm