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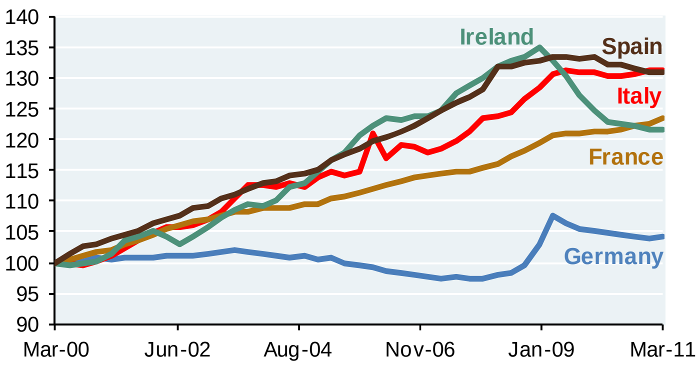
<u>Italy and the lesson of the last decade: Finance and Economics Trump Politics every time</u>

Markets were favorably anticipating resignations of Italian and Greek prime ministers, although it is not clear to me that it matters that much. The premise: resignations would lead to faster structural reforms, implemented by coalition governments led by technocrats. The logic: both Papandreou and Berlusconi are either too associated with austerity measures, or had too many domestic political opponents, to get things done. In Greece, there is chaos after Papandreou's resignation, since there is no new government, and it is unlikely that a hastily formed new one will have any legitimacy as it seeks to ply one last disbursement from the EU. In Italy, passage of austerity laws and a new government *could* prompt the ECB to increase bond purchases to stabilize Italy's crumbling debt markets, and/or allow the IMF to play a larger role by offering Italy a credit line. However, if Italy ends up having general elections instead of an interim coalition government run by technocrats like former EU Commissioner Monti or former PM Amato, the market's premise of accelerated Italian reforms may be disappointed.

Even if a new Italian government enacted structural reforms, they take a long time to "work", and usually entail less growth (rather than more) right after they are passed. This is particularly true for the labor market reforms Italy is being asked to implement. The bet Italy and the EU are making: by passing structural reforms (at the cusp of a recession), the growth penalty will be offset by markets having more confidence in long term growth prospects, and therefore regain appetite to buy sovereign debt. Europe is pursuing this route since it plans to rely on private capital (not just it's own) to create a leveraged backstop for sovereign debt issuance. In other words, Italy cannot be as agnostic as Japan, which is self-funded, as to how markets view its solvency. To be clear, Italy's austerity package is mild; one clause increases the retirement age from 65 to 67 by 2025 (I kid you not). Other clauses include privatization of government-owned real estate, and easier job hiring/firing rules.

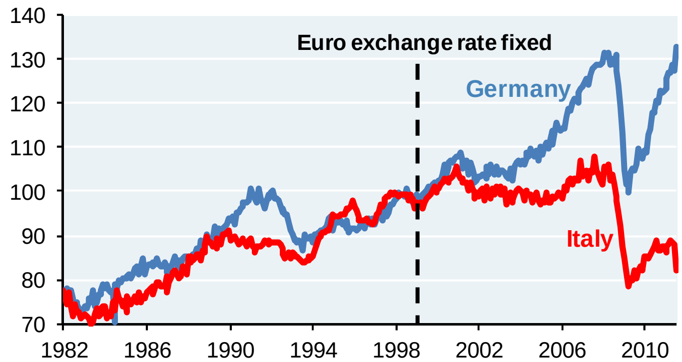
Structural issues in the EU are a decade in the making; as shown below, Italy has a long way to go to resolve them. Merkel conceded that it will take years to undo some of these imbalances. With a *credible* backstop in place for sovereign debt, and *well-capitalized* banks, markets might give Europe the benefit of time. But neither of these two conditions has been met yet, so it is premature to make any conclusions about the benefit of Prime Ministerial changes.

Internal devaluation? So far, only in Ireland, not Italy
Unit labor cost, index, 3/31/2000 = 100, sa



Source: OECD.

Industrial production gap began with the Euro
Index, 12/31/1998 = 100, sa

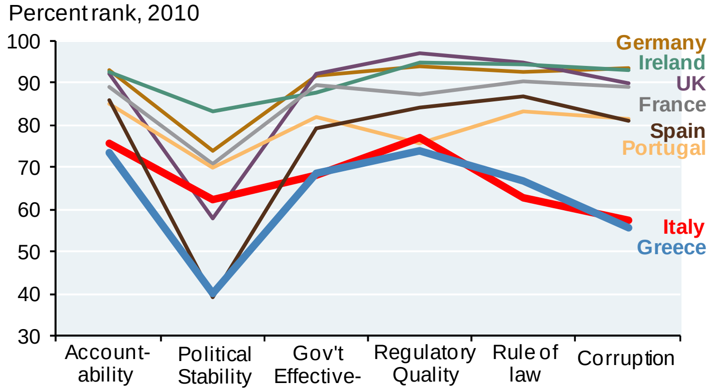


Source: OECD.

Here's another chart on how far Italy has to go on structural reforms (100 = best, 0 = worst). It's from an *Eye on the Market* we published last year, based on data compiled annually by the World Bank. Italy and Greece are neighbors in more than just geographic ways. Apart from political stability (ranking Spain below Italy is something we could debate), Italy and Greece rank at the bottom in all categories.

To be balanced, Italy has advantages vs other EU countries, such as a lower level of household debt to GDP, much higher household wealth relative to disposable income, the largest primary budget surplus in Europe, and lower home price to rent ratios. Many of these positives were outlined by the Banca d'Italia in its November 2011 report on Financial Stability.

On governance indicators, Italy and Greece are neighbors
Percent rank, 2010



Source: World Bank.

Unfortunately, these positives are overwhelmed by concerns about Italy's 1.9 trillion in government debt, which is at its highest level since 1861 unification (other than wartime). Some of Italy's debt is held by institutional investors and Italian

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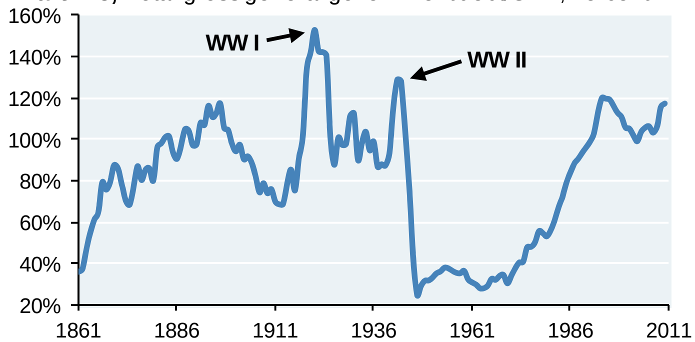
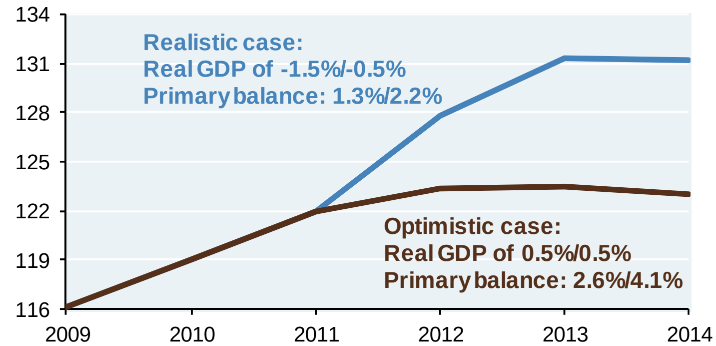
banks that do not pay for them 100% with cash; they use leverage via repo markets. A "repo haircut" indicates the amount of cash investors must put down to buy 100 Euros of Italian government bonds. Until recently, the haircuts only required ~6% upfront. The reason the haircut is so low is that these are full recourse loans, settled on a high frequency basis. **Today, LCH Clearnet, which determines repo haircuts, followed through on its long-standing warning that increased price volatility and widening credit spreads would result in higher haircuts**. Haircuts were doubled to around 12%, which prompts some holders to increase collateral, but prompts others to sell. This is a microcosm of the more extreme repo haircut increases that appear to have sunk commodity futures firm MF Global a couple of weeks ago. **Higher repo haircuts are the last thing Italy needed right now, but is perhaps an unavoidable and telling event for a region beset by large levels of government debt, *and* reliance on volatile wholesale funding to finance both its governments and its banks.** If debt markets do not stabilize, they could double again, like a backgammon cube. As I write this, 10 year bonds in Italy yield over 7%, and so do their T-bills.

Italy's debt/GDP: highest since unification other than wartime, Total gross general government debt/GDP, Percent



Source: Reinhart, Carmen M. and Kenneth S. Rogoff, "From Financial Crash to Debt Crisis," NBER Working Paper 15795, March 2010.

Italy- gross general government debt projections*
Percent of GDP

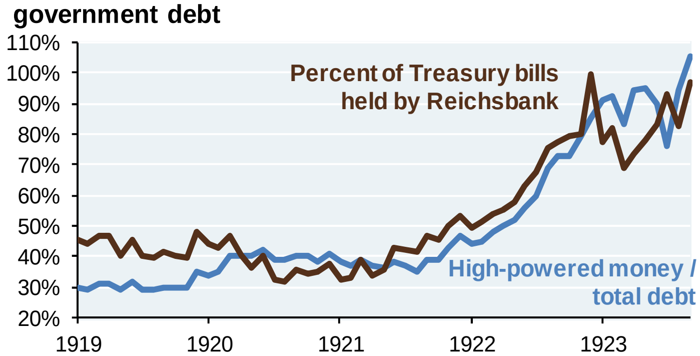


Source: IMF, Eurostat, National Inst. of Statistics, J.P. Morgan Private Bank.
*In both cases bond yields stabilize at 5-6%, GDP deflator of roughly 0.6%.

The bottom line is that the only entity in the world with the firepower to save Italy in the short term is the European Central Bank. If you remember the little plastic men exhibit from Labor Day's *Eye on the Market*, most of the arrows pointed to the ECB, indicating that just about everyone, other than the Bundesbank and perhaps conservative parties ruling Germany, thinks the ECB should solve the problem by printing money. **To-date, that's what the ECB has done**: of the 1.1 trillion Euros extended to European banks and governments (through sovereign/covered bond purchases and repo), 970 billion has been given by the ECB. The modest remainder has come from the IMF and EU countries themselves (e.g. fiscal transfers).

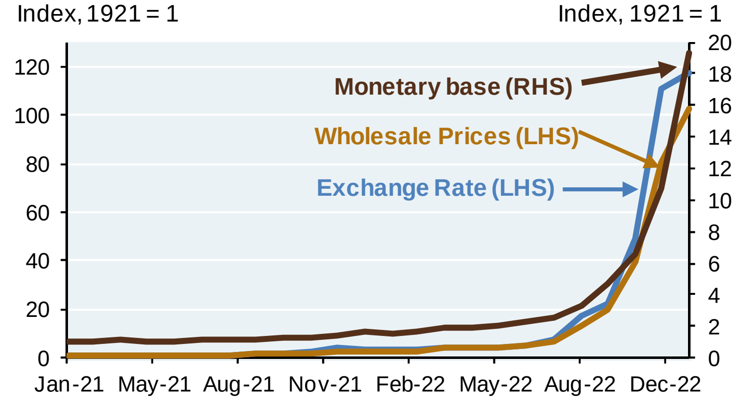
German members of the ECB appear to have resigned out of frustration with money-printing (Weber, Stark) and remaining ones like Wiedmann mentioned this week the reluctance of Germany to accept more of it, referring to the institutional memory of the Weimar Republic hyper-inflation. I have included 2 charts below on Weimar that show what he is referring to. There is no space here to assess whether such concerns make sense at a time of household and corporate de-leveraging in Europe; what matters is that HE thinks they do. **We do not know the most critical answer: are German members of the ECB fighting a battle that has already been lost? In other words, will the destiny of the ECB be to print a couple of trillion Euros to buy or lend against sovereign debt for the next several years? Until European policymakers answer this question, investors cannot be expected to have a lot of confidence in its markets or in its institutions.**

Remembrance of things past: Monetization of Weimar era government debt



Source: "*The Supply of Money and Reichsbank Financing of Government and Corporate Debt in Germany", 1919-1923*, Steven B. Webb, 1984; *The German Inflation 1914-1923,* Carl-Ludwig Holtfrerich, 1986.

The onset of German Hyper-inflation
Index, 1921 = 1 Index, 1921 = 1



Source: Statistisches Reichsamt: Zahlen zur Geldentwertung in Deutschland 1914 bis 1923, Berlin.

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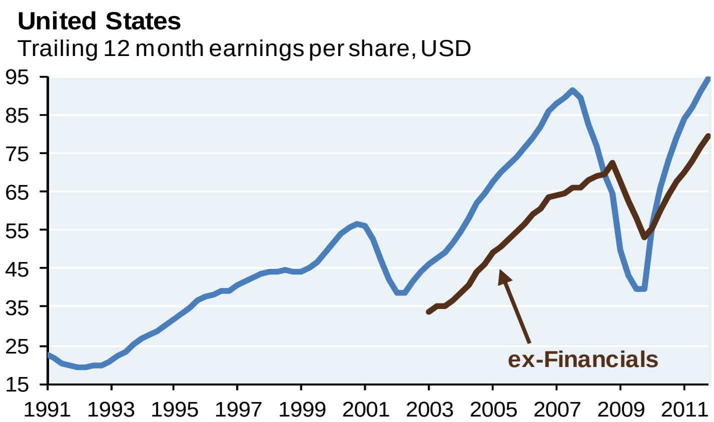
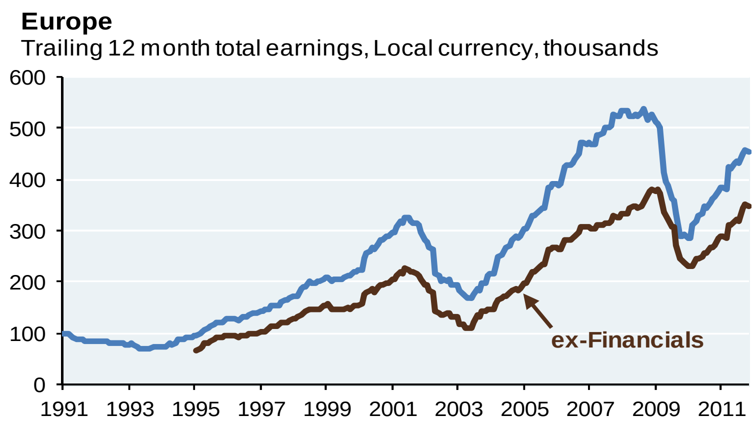
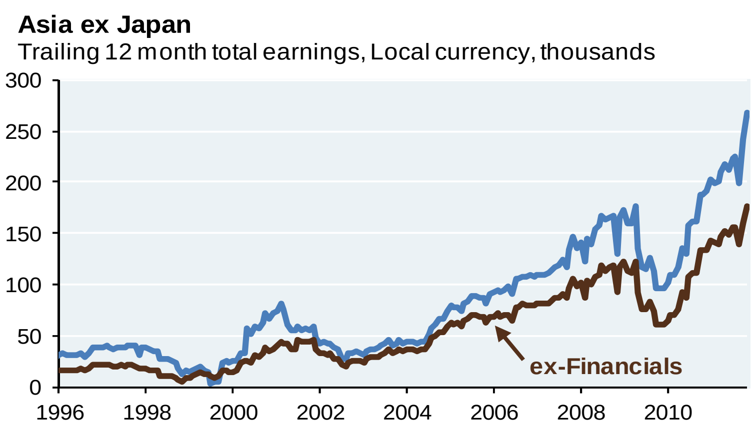
In Q3, earnings reached new highs in the US and Asia (particularly ex-financials), and even in Europe. The dichotomy between private sector profits and public sector problems looks like it will remain the primary issue for 2012. We expect earnings growth to slow in 2012 (and decline in Europe, given a pending recession), but not collapse. As explained last week, the closest proxy we can think of for the current period is the aftermath of the 1970's recession, when US and German equity markets collapsed, rallied back sharply, and then went sideways for quite a while until monetary and fiscal policy uncertainties dissipated (see below, right). As we prepare for this kind of market in 2012, we are investing portfolios with some equity exposure (less than normal but greater than zero), a regional equity preference for the US, macro hedge funds, high grade credit, Asian currencies, distressed European bank loan purchases, mezzanine lending to corporations and property owners, and enough liquidity to take advantage of whatever opportunities present themselves as the largest macroeconomic imbalances in decades continue to sort themselves out.



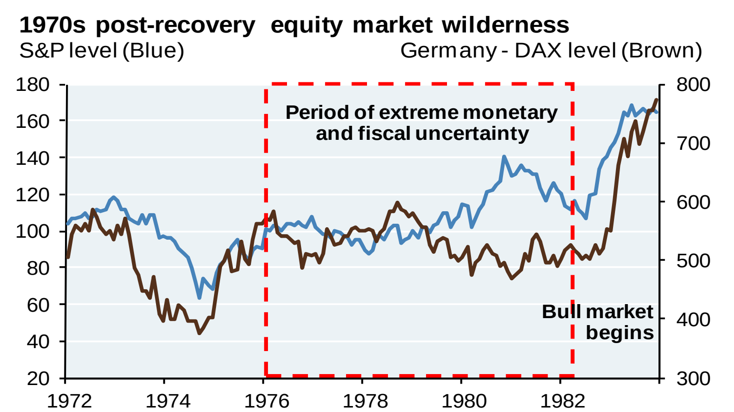
Source: Standard & Poor's. Q3 earnings are estimated.



Source: MSCI, J.P. Morgan Securities LLC.



Source: MSCI, J.P. Morgan Securities LLC.



Source: Bloomberg.

To be clear, any portfolio investment strategy that is not 100% cash is predicated on the notion that the European Monetary Union will not collapse in disorderly fashion, with Southern Europe defaulting/devaluing, or Northern Europe departing. We have been among the most despondent observers of the EMU since the crisis began exactly 2 years ago, with Greece's disclosure about its hidden budget deficits. But even we have trouble assuming that this kind of disastrous, poorly managed outcome should be the base case assumption for 2011-2012. If we are wrong and such an outcome does happen, the lonely strength of corporate profits will likely be insufficient to prevent another substantial decline in global equity markets. Our portfolios are ultimately positioned for a severe, lingering drag from the European mess, but not its implosion.

Even if US profits do continue to rise, it will be difficult for markets to pay much for them, given their reliance on the lowest labor compensation relative to revenues we have seen in a long time (see charts below). This dynamic results in the need for outsized government transfers to households to sustain consumption, which in turn raises the following question: **why are markets so calm about the US running a 6%-8% (e.g. Ecuador-style) budget deficit in 2012? See next section.**

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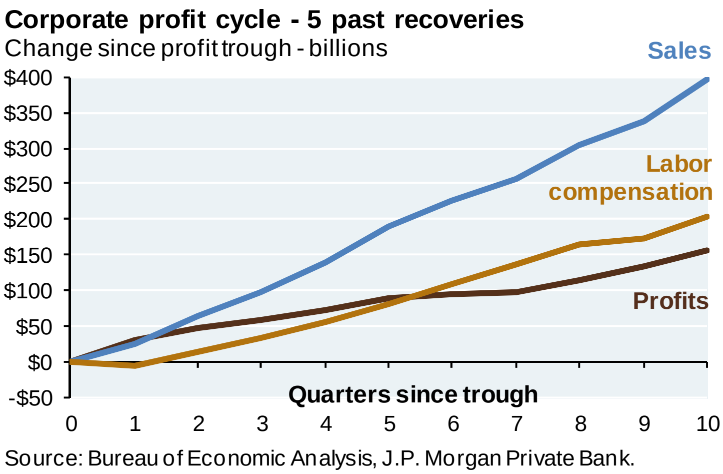
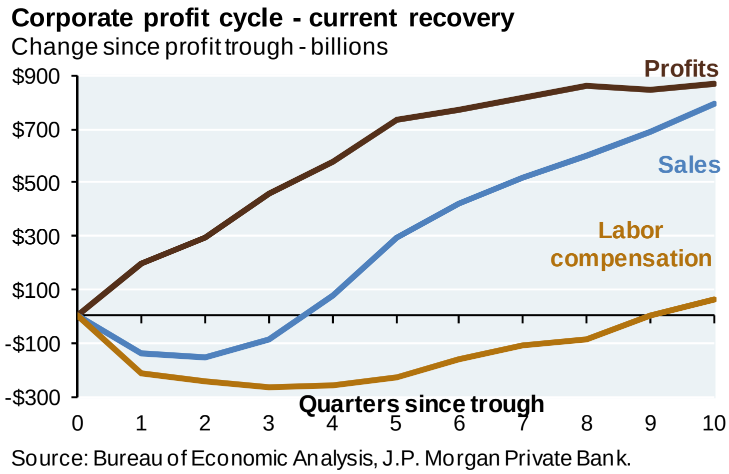
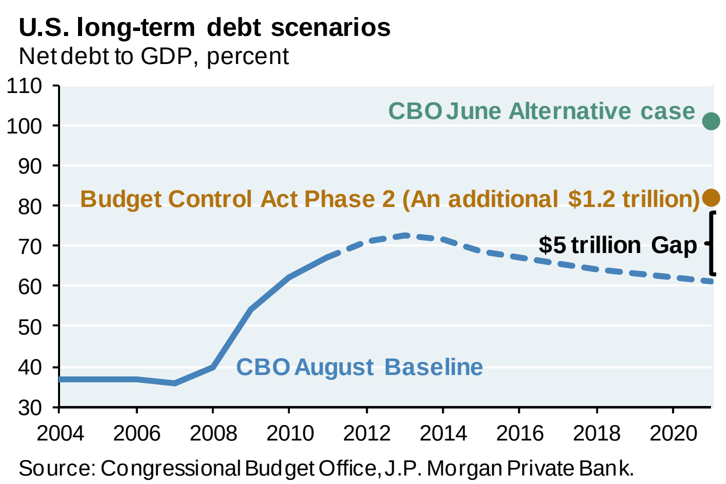


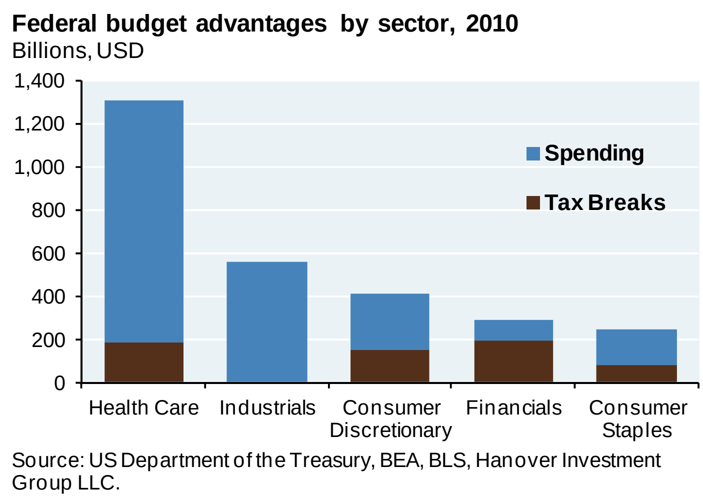


<u>**Super-Committee prospects: dissension on the team persists**</u>

Demand from banks, households and the Federal Reserve are part of the picture, but the central factor behind the stability of the US Treasury market is the ongoing purchases by Asian and other emerging economy Central Banks. The phenomenon of Central Bank reserve accumulation began around 10 years ago. Despite well-researched and well-documented explanations as to why it was doomed to failure as a model for developing countries, it has allowed countries like China to keep exchange rates cheap and foster export-led growth without paying too heavy a price in terms of their own inflation. So far so good, except the U.S. no longer controls its own fiscal and economic destiny.

The so-called Super Committee is tasked with regaining control of this destiny. You have seen the chart below from us before. As per Phase 2 of the Budget Control Act, the Super Committee is trying to find $1.2 trillion in deficit reduction over ten years, which moves the projected debt-to-GDP ratio from the Italianesque green dot to the Gaullist brown one (around 80% of GDP). I will not burden you with the procedures involved, other than to say that if the Super Committee does not come up with a recommendation by Thanksgiving, it looks like mandatory expenditure cuts will kick in starting in 2013, unless of course recent proposals by Republicans and Democrats defuse the sequestration robot, like at the end of Michael Crichton's *Andromeda Strain*. The most bullish outcome I can think of is a bit more stimulus for 2012, and $2-$3 trillion in long term deficit reduction (not subsequently unwound by Congress). To do it, they will need to overcome the vested interests of large constituency and advocacy groups. Hanover Investment Group in D.C. recently estimated the budget advantages by sector, as a way of thinking about whose oxen will one day have to be gored; healthcare and industrials lead the pack.





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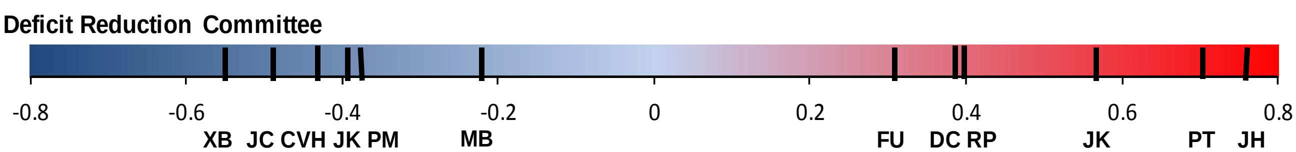
To get a sense for who is on the committee, we hereby introduce Super Committee trading cards. On each card, the color scheme is a proxy for each member's ideological voting record as compiled by the University of Georgia in their extensive database dating back to the first Congress in March 1789. A Political Ideology Indicator (PII) score of -1 indicates the most liberal voting pattern, while +1 is the most conservative[1]. As you can see, Max Baucus (D-Mon) is the closest thing to a "moderate" on the committee, with moderate defined by +/- 0.2. The rest are closer to the ideological wings of their respective parties, lessening the chance of a "rogue move to the middle", against the wishes of their respective congressional sponsors (e.g., the party leaders in the House and Senate). While the Super Committee only needs a simple majority to make a recommendation to Congress, it is unlikely that any member would cross party lines alone. This ideological make-up is admittedly representative of the Congress and electorate at large, but still, if the purpose of the Committee was compromise, couldn't they have opted for members that were closer to the middle? So far, the only thing Super about this committee is the level of its polarization and lack of progress.

Michael Cembalest
Chief Investment Officer



Source: Royce Carroll, Jeff Lewis, James Lo, Nolan McCarty, Keith Poole, and Howard Rosenthal. *"Common Space" DW-NOMINATE Scores With Bootstrapped Standard Errors.* University of Georgia.

[1] While the ideological spectrum ranges from -1 to +1, it has been quite some time since US Senators, for example, were as extreme as plus or minus 0.85 or more. The last Senator that liberal was Wayne Morse (D-Oregon), who served from 1945-1969. The last Senator that conservative was Charles Waterman (R-Colorado), who served from 1927-1932. While partisanship and polarization *between* parties is higher than ever, ideological extremes of individual politicians have generally moved away from +/- 1. Ron Paul is +0.95.