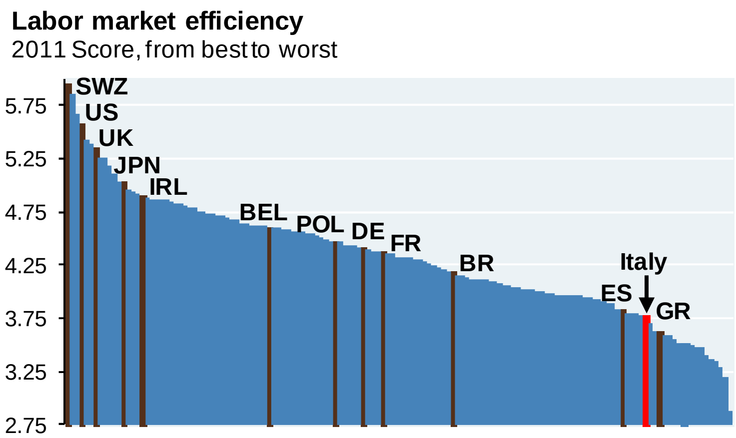
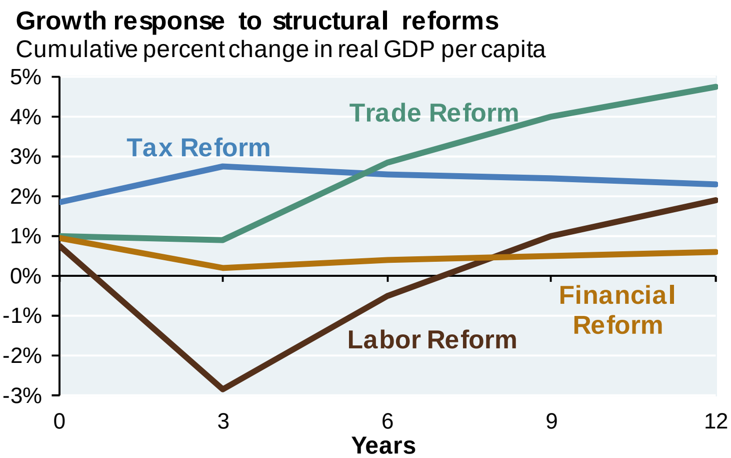
Topic: Challenges facing a new Italian government; the IMF effect; and good news of the week (since there was *some*)

The morning after. There's some enthusiasm about a new Italian government, but now the hard work begins. The tricky thing about structural reforms is that they are more easily accomplished when times are good, so you can spread the adjustment more slowly, and with counter-cyclical support from the private sector. The problem is, few countries do that. Italy is facing this challenge in spades: it ranks 123rd out of 142 countries in terms of labor market efficiency (142=worst), and unfortunately, the labor market reforms Italy is considering are among the most growth-depressing reforms of all, in the *short* term. I found agreement on this point in meetings last week with some of Italy's largest industrialists.

Italy needs to fix its labor markets… …..but that tends to come at a price in terms of near-term growth



Source: World Economic Forum Competitiveness Report (142 country universe).



Source: International Monetary Fund.

The multi-dimensional uncertainties are enormous. Will markets reward Italy for austerity decisions (if they are taken), and sit tight with their 1.9 trillion in Italian bonds, even as Italy's debt ratios rise further as a recession hits? Will Europe be able to leverage private sector capital and increase the size of its bailout facility, which as things stand now is inadequate if needed to fund Italy and Spain for 2012 and 2013? What will happen if European banks needing higher capital ratios opt to shrink their balance sheets instead of issue equity? Will the ECB buy a lot more Italian debt now that Italy is enacting austerity budgets? Will the IMF come to Italy's rescue? It's hard to say, particularly on this latter point; as shown on the next page, in the cases of Mexico, Russia, Indonesia and Argentina, events became unglued *after* IMF and other bilateral loans were announced. Bottom line: **it is difficult to be very optimistic on prospects for in-flight refueling and repairs of a monetary union in distress**.

As we wrote last week, economics and finance trump politics almost all the time[1], which means that Europe's structural problems may be a lot more important to investors than the names of the politicians in charge. Even as we consider the possibility of politics as a positive catalyst, we are all still looking for more evidence of how it will actually work on a regional level[2]. A comment that stuck with me since I first saw it was this remark from the author of the 1992 German Constitutional Court opinion on Maastricht[3]. In the words of the author, the Maastricht treaty…

> "*…is not able to support its own premise: the common ground of a European Staatsvolk which belongs together: a minimum of homogeneity in basic constitutional attitudes, a legal language accessible to all, economic and cultural similarities or at least some forces of approximation, the possibility of political exchange through media, which reach the whole of Europe, a leadership known in Europe and parties active across Europe. A European-isation without a prior European consciousness and therefore without a European people with a concrete capability and readiness for common statehood would be, in terms of the history of thought, un-European*."

The assertion that as a *region*, Europe's debt and deficit levels are lower than the US, the UK and Japan may not matter until there is Federalization of European revenues, or until its sovereign issuers are subject to the same market and budget discipline that applies to US states. This is the kind of "statehood readiness" that the author may have been referring to.

[1] Another example of premature extrapolation is the May 2011 capture of Osama Bin Laden, heralded at the time in some research reports as a very positive catalyst for equity markets. That weekend turned out to be the peak for the year on the S&P 500, as the US fiscal deficit, of which elevated military spending is a part, became a catalyst for the S&P downgrade of the US just 3 months later.

[2] In October, Trichet noted how European integration has been around for a while, and cited the "Revocation of the Edict of Nantes". This refers to Louis XIV's revocation of a law protecting Protestant Huguenots, which resulted in their expulsion to other countries. It's hard to escape the EMU's contradictions: even when trying to provide evidence of regional integration, its long-standing cultural differences remain.

[3] Written by Paul Kirchhof, as per Bernard Connolly of Hamiltonian Global in his 2003 essay on the European Monetary Union.

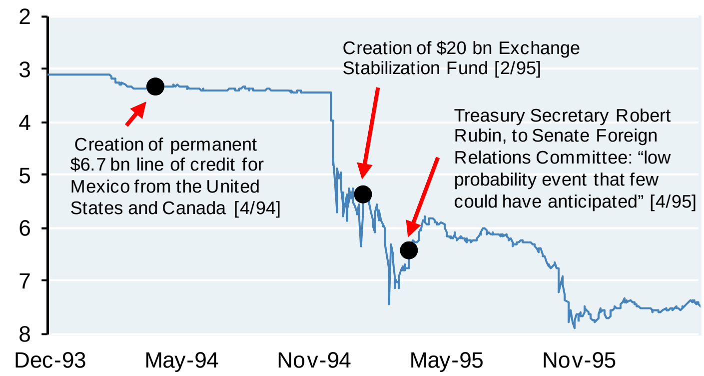
Topic: Challenges facing a new Italian government; the IMF effect; and good news of the week (since there was *some*)

The IMF as White Knight? The charts below are from our Sovereign Default Time Capsule, published in May 2010. Note how IMF and other bilateral loans did not mark the end of the problem. The quotes on Russia are a useful reminder that the IMF is often not a great judge of investment merit, and that single-country investment funds may have too much money at stake in one place to think about worst-case outcomes.

Argentina
Sovereign debt price: 11 3/8 2017

Source: Bloomberg.

Mexico
Peso/USD



Source: Bloomberg.

Russia
Sovereign debt price: GKO (T-Bill) 3/10/1999

Source: Bloomberg, International Monetary Fund.

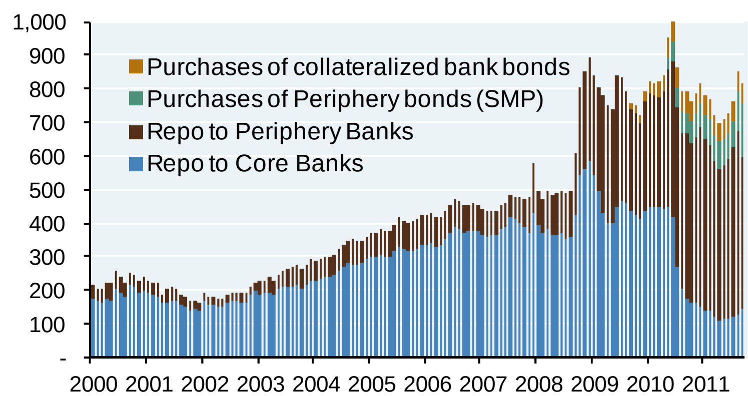
Indonesia
Sovereign debt price: 7 3/4 2006

Source: Bloomberg.

The difference this time is that these countries didn't have the ECB as a potential lender (and buyer) of last resort. Will the ECB continue to expand its balance sheet (shown below)? It is possible that the increasing *risk* of the ECB balance sheet, rather than its increasing *size*, is what is bothering the Bundesbank and German members of the ECB.

There have been articles on Italy's extensive household wealth, as well as 1.8 trillion Euros of state-owned assets that could be sold to pay down debt. On the former, there's no question household wealth exists, but getting at it is another issue. The Società Italiana di Economia Pubblica and the University of Linz estimate that Italy's **tax evasion** is the highest in the OECD, and has been rising since the late 1980's. On the sale of state-owned assets, it's a possibility, but **Italy only sold non-financial assets worth 2% of GDP in the entire period from 1997 to 2006**. Italy owns 17 billion in publicly tradable shares, but the rest looks more complicated. What's even more disturbing: an analysis showing that from 1997 to 2006, the improvement in Italy's debt ratio was almost entirely due to temporary measures, with little improvement in its structural deficit. Understanding Europe is like a visit to the psychiatrist: every answer simply leads to another question.

Total public support to European banks and sovereigns
Billions, EUR



Source: NCBs, ECB, Bloomberg. November 2011.

Topic: Challenges facing a new Italian government; the IMF effect; and good news of the week (since there was *some*)

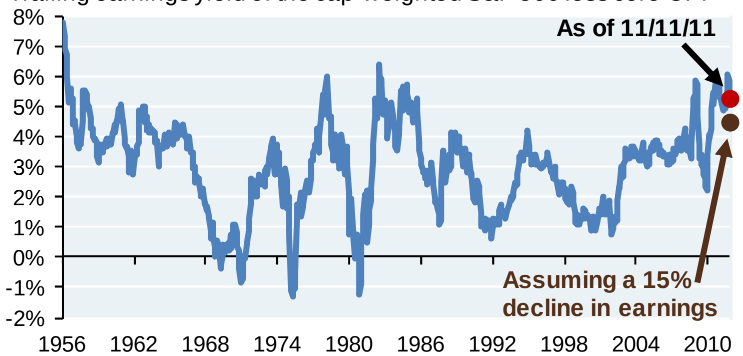
Unrelated good news of the week, and what equity market pricing looks like

- Continued improvement in US state and local tax collections
- Signs that global inflation has peaked, including in China; we expect inflation to fall by around 1% or more in the next few months, allowing for some easing in China next year
- S&P 500 profits and top-line sales grew by 18% and 10%, respectively, in Q3 vs 2010. However, the magnitude of earnings outperformance and CEO capital spending intentions are beginning to show signs of weakness
- Modest improvements in high-frequency data in the US, including chain store sales, jobless claims, small business sentiment, job openings and consumer credit

The simple observation is that there is a lot of worrying news about sovereign risk in the U.S. and Europe, and that equity markets appear to be incorporating that. As shown below, the trailing earnings yield of the S&P 500, adjusted for inflation, is close to the highest level seen in roughly 50 years. Even assuming a 15% decline in earnings next year, which would be a par-for-the-course earnings recession, these yields would still be on the cheaper end of their historical range.

Real S&P 500 trailing earnings yield

Trailing earnings yield of the cap-weighted S&P 500 less core CPI



Source: Robert Shiller, S&P, corporate reports, Empirical Research Partners.

Michael Cembalest
Chief Investment Officer

Components of labor market efficiency, as defined by the World Economic Forum in its Global Competitiveness Report
Cooperation in labor-employer relations; Flexibility of wage determination; Rigidity of employment; Hiring and firing practices; Redundancy costs; Pay and productivity; Reliance on professional management; Brain drain; Female participation in labor force

"*Should Italy Sell Its Nonfinancial Assets to Reduce the Debt*?", Stefania Fabrizio, IMF Policy Discussion Paper, April 2008
"*The value added of underground activities: size and measurement of the shadow economies of 110 countries*", Friedrich Schneider, Johannes Kepler University of Linz, June 2002

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 and Chase Investment Services Corp., (CISC) member FINRA and SIPC. Securities products purchased or sold through JPMS or CISC 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