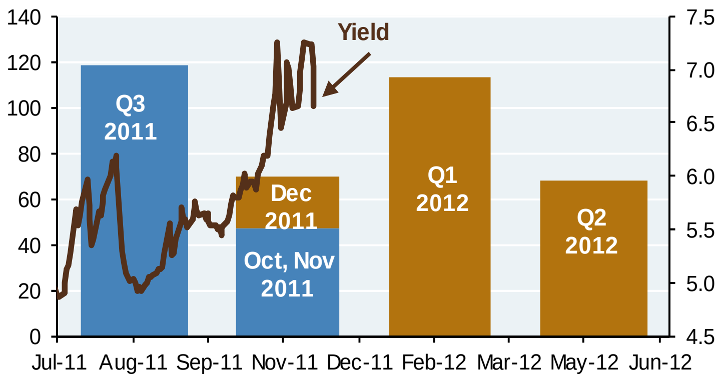
**Topic: Fig leaves preceding the ECB bonanza, better US data, and the US residential housing outlook (still flat/down)**

This will be brief, since there's only so much we will know before the EU summit on December 9th. As shown in the first chart, Europe needs an alternative to traditional debt markets before Q1 2012, when Italy's sovereign borrowing needs jump from 70 billion to 120 billion. Even with lower issuance in Q4 and ECB purchases, Italian yields rose anyway. **Let's not waste time wondering about multiple outcomes, and cut to the chase.** In all probability, the EU summit will result in ambiguous, unenforceable commitments to lower deficits and debt levels, which countries involved may or may not adhere to, making Maastricht 2.0 not that different from Maastricht 1.0. However, the ECB (headed by Italian Mario Draghi) is likely to greet summit pronouncements as if they were a combination of the Magna Carta and the Declaration of the Rights of Man, and proclaim that the era of European fiscal integration and soundness is upon us. After doing so, one can easily envision the ECB increasing purchases of Peripheral sovereign debt, and/or lending a few hundred billion to the IMF[1] (still run by Europe/France despite claims of neo-colonialism by China) so the IMF can support Italy and Spain. Financial markets would probably like debt monetization by the ECB, as it avoids for now all the unpleasantness of having sovereign debt markets clear at levels based only on private sector demand. **Takeaway #1: don't sell your gold here.**

**Italian sovereign debt maturities and 10-year yields**

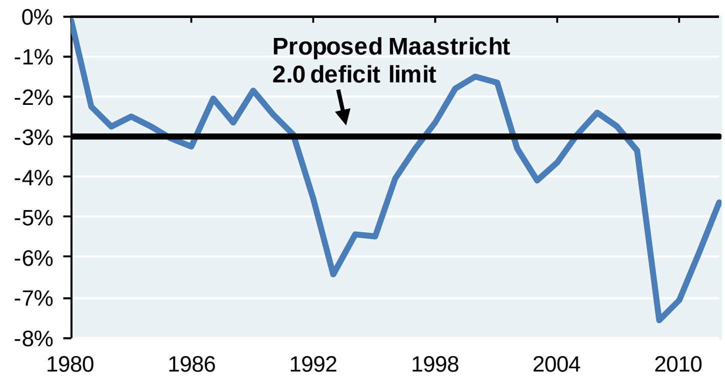
EUR, Billions — Percent




Source: Bloomberg.

**How would France cope with a 3% deficit constraint?**

French budget deficit, percent of GDP

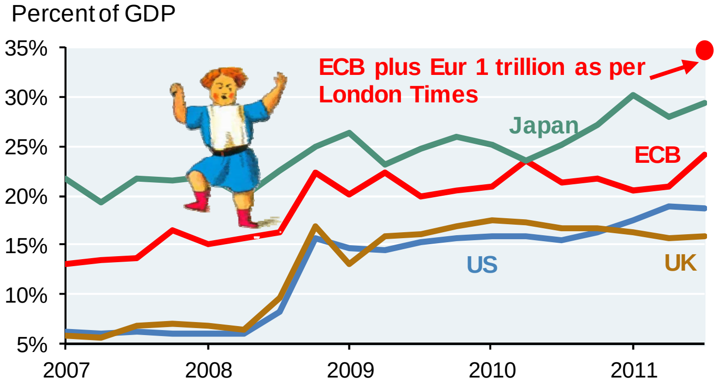



Source: IMF.

It's hard to believe France would really commit to 3% deficit limits (such as those proposed by former ECB chief economist Jurgen Stark). As shown above, France (like many countries) often relies on counter-cyclical fiscal policy, and would have found it hard to stick to 3% deficits in the past. **But again, the ECB is probably just looking for a fig leaf to allow member countries to raid the temple granaries.** German ECB members would stamp their feet like the boy in Die Geschichte vom Suppen-Kaspar (see below) and complain about debt monetization and moral hazard, but probably not do much to stop it.

**Central bank balance sheet size**

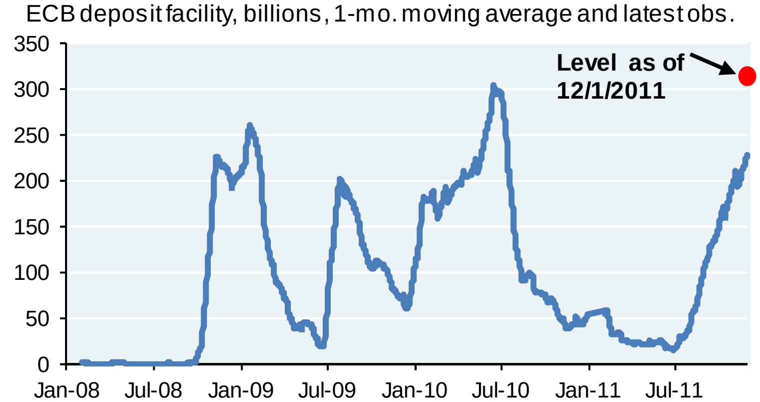
Percent of GDP




Source: FRB, BEA, ECB, Eurostat, BoE, UK Office for National Statistics, BoJ, Japan Cabinet Office, Heinrich Hoffmann.

**More signs of inter-bank distress in Europe**

ECB deposit facility, billions, 1-mo. moving average and latest obs.




Source: ECB.

As a reminder, sovereign debt is only part of the problem; there are also banking sector funding challenges. As shown in the 4th chart, there has been a sharp rise in the ECB deposit facility used by EU banks to park extra cash when they are reluctant to lend to each other. The latest data show a modest rise in retail bank deposit outflows in Spain, continued reductions to EU bank

[1] As my always well-informed Investment Banking colleague Joyce Chang notes, it will be interesting to see **who takes the risk on ECB loans to the IMF**, on-lent to Italy. An ECB loan via the IMF General Resources Account would mean the IMF takes the risk, as a preferred creditor. Or, the IMF could simply act as agent and overseer for ECB loans to the region, in which case the ECB takes the full risk of loss.

exposure by US money market funds, falling economic activity in Spain and Italy, and most EU banks intending to de-lever instead of raising more capital. To reiterate, markets would probably react favorably to debt monetization (if it happened) to counter these negative trends. Furthermore, there are signs that investors are very short; last week there was a 4% rally when the Fed reduced the cost of a dollar swap facility for EU banks that no one is even using. But I am reluctant to commit capital now to European debt and equity markets simply based on rumors of debt monetization, out of concern of not knowing what would happen after the fact, and the concern that it may happen too late.

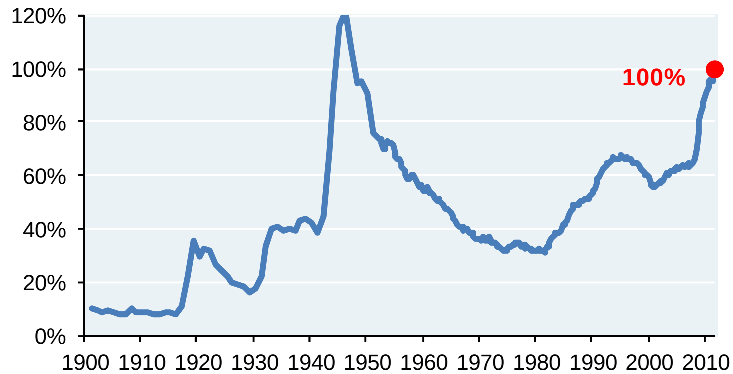
**Some better data out of the United States recently…**

The list of better news includes the ISM manufacturing survey (and in particular, a rise in new orders), auto sales, retail sales, industrial production and credit card delinquencies. There was even good news on employment in the JOLTS report from the Bureau of Labor Statistics, which measures private sector job openings, hirings, voluntary job separations and layoffs/ discharges. While this survey may foreshadow better news ahead, last week's payroll report was not it. Employment picked up, but more than half the decline in the unemployment rate was based on declining labor participation; incomes were weak (again); and there was an increase in the duration of unemployment. **The more encouraging trend: the modest growth in payrolls masks an ongoing decline in construction, finance and government jobs, and a steady rise in everything else.** Eventually, the latter trend should overtake the former. We disagree with ECRI's projection of an unavoidable recession, and believe we will see 2.0%-2.5% growth, depending on the outcome of the payroll tax debate. That's one reason why the US is our largest regional equity allocation. Despite the good news, a disappointing marker: last week, US gross debt to GDP passed 100% for only the second time in its history. The last time this happened, the US was fighting a two-front war and preparing a land invasion of Japan ("Operation Downfall"). As Walt Kelly (Pogo) once said, "**We have met the enemy, and he is us**".

**Some better news from US manufacturing surveys**
Index, sa


Source: Institute for Supply Management.

**The US reaches its Pogo moment**
Gross debt to GDP, Percent




Source: US Treasury, Bureau of Economic Analysis.

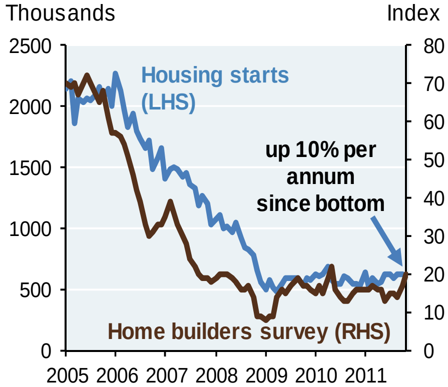
**…even on housing, although our medium term outlook is dominated by the supply overhang**

We have seen reports that are bullish on housing for 2012. One recent headline referred to UBS' chief economist predicting that housing would actually drive the US recovery in 2012. Here is the data that housing bulls may be looking at. If you look VERY closely, you will find stabilization in existing homes sales, and slight upticks in the homebuilder survey, housing starts and mortgage applications. These are taking place at a seasonally weak time of the year for housing, so that's good news.

**Existing home sales**
Millions


Source: US Census Bureau.

**Housing starts & home builders survey**
Thousands | Index



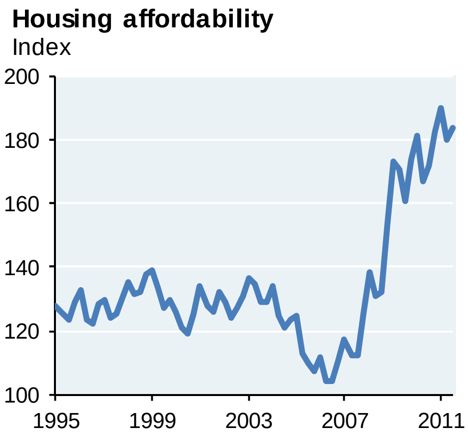

Source: US Census Bureau, National Association of Home Builders.

**Mortgage applications**
Volume index, sa, March 1990 = 100

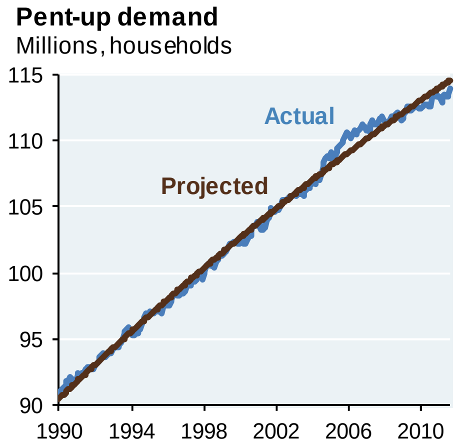

Source: Mortgage Bankers Association.

**Topic: Fig leaves preceding the ECB bonanza, better US data, and the US residential housing outlook (still flat/down)**

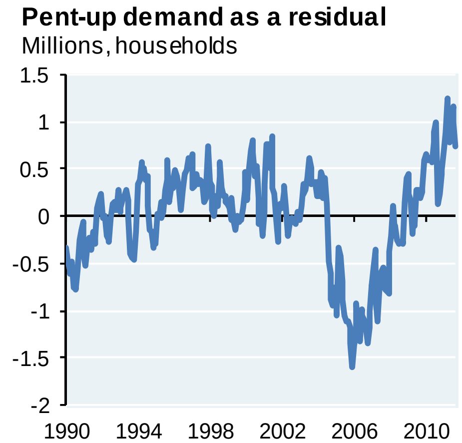
On a more fundamental level, perhaps housing bulls are looking at "Housing Affordability", an index computed by the National Association of Realtors measuring the ability of a typical family to buy a median priced home, using prevailing mortgage rates. In an environment of tightening underwriting standards, and the fact that the prior cycle exhausted a lot of demand for home ownership, this might be a **very misleading chart**. A measure of pent-up demand tells a similar story, by looking at the pace of household formation vs long term trends. It looks like there is a lot of pent-up demand to tap when conditions normalize.




Source: National Association of Realtors.

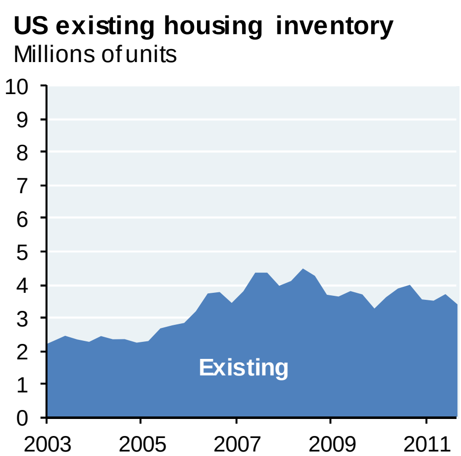


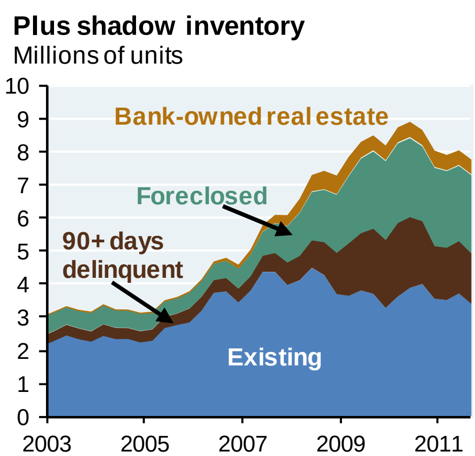

Source: Census Bureau, J.P. Morgan Private Bank.

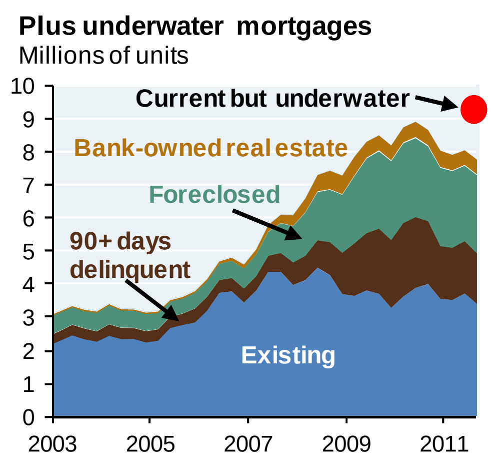



Source: Census Bureau, J.P. Morgan Private Bank.

Unfortunately, one can't look at housing without considering **potential shadow inventory**. Our research suggests a tough road ahead for parts of the US housing market. Let's start with the concept of inventory. The first chart shows 3.5 million units of homes for sale. The second chart adds homes that are 90+ days delinquent, in the process of foreclosure, or already owned by banks on their balance sheets. Not every 90+ DQ loan will default and be sold, but it's important to include this category as a potential source of future supply. The last chart makes another adjustment: let's add a lower-bound estimate for mortgages that **are and have always been current**, but which are underwater (current loan to value above 100%). We're getting close to 10 million homes, and have not yet added in mortgages that were modified and are now current (they have been re-defaulting at a 40%-50% pace). You get the picture; **existing homes for sale understate the potential selling pressure.**




Source: National Association of Realtors, J.P. Morgan Securities, LLC, Amherst Securities, Mortgage Bankers Association.

It is important to note that the bad news is somewhat concentrated. Underwater homes are concentrated in 6 states: Nevada, Arizona, Florida, Michigan, Georgia and California (according to CoreLogic, New York ranks the best out of 50 states in terms of underwater homes). Furthermore, many "current and underwater" households may be helped by both private sector banks and US agencies relaxing underwriting criteria for refinancing[2]. The concept of shadow inventory is a very inexact one; selling pressure will be regional rather than national; and a lot will depend on government policy, particularly from the US Agencies.

[2] HARP 2.0 was launched last week. The idea: make it easier for underwater homeowners whose mortgages have been guaranteed by GSEs to refinance. New features: no more loan-to-value caps; lower refinancing fees; limited liability for refinancing banks, reducing exposure to original loan docs; and a relaxation in credit score, appraisal, income and payment history requirements. The FHFA is hoping that by the end of 2013, HARP refinancings will double from their current level of 900,000, which was around 20% of their original target. Expected consumption gains of ~$20 billion (from Macroeconomic Advisers LLC) do not move the needle much in terms of a boost to growth.

**Topic: Fig leaves preceding the ECB bonanza, better US data, and the US residential housing outlook (still flat/down)**

Remember **Sir Thomas More**, who was under tremendous pressure by Henry VIII to recognize him as Supreme Head of the Church of England? His 21st century counterparts: Edward DeMarco (acting Director of the FHFA), and Draghi at the ECB. The former is under tremendous pressure by some in Congress to forgive principal on millions of underwater mortgages guaranteed by Fannie Mae and Freddie Mac, and the latter is under tremendous pressure by some EU governments to print money. Both options sound simple enough, but have consequences worth thinking about first, since taxpayers will bear them.

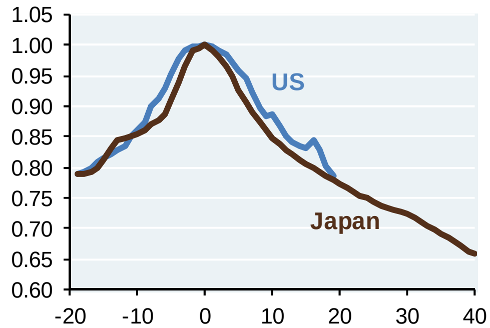
As the US deals with the housing boom-bust aftermath, it's worth noting that the US may be the only country that effectively delegated *part* of the criteria for the safety and soundness of mortgage underwriting to a social services agency (Department of Housing and Urban Development). This began in 1994, with the passage of the Federal Housing Enterprises Financial Safety and Soundness Act, which empowered HUD to set affordable lending targets for Fannie Mae and Freddie Mac, **targets which eventually peaked at 56% of all loans**. For more context, read the quote below[3], and refer to notes we wrote on May 3 and May 23. As things stand now, housing is reverting back to what it was for decades before 1994: a middle class entitlement available primarily to those who can afford the 15%-20% down-payment.

**One last point.** Some people overdo US vs Japan comparisons. However, no matter what your opinion on the topic, the evolution of the US housing market seems eerily similar to the Japanese experience, which means more pain may be in store for home prices, despite their cheapness versus renting.

Michael Cembalest
Chief Investment Officer

**Sources**
9/20/2011 Testimony of Laurie S. Goodman, Amherst Securities Group, to the Subcommittee on Housing, Transportation and Community Development of the Senate Committee on Banking, Housing and Urban Affairs

**Price-to-Rent Ratio**
Index, peak = 1*




Source: OECD, J.P. Morgan Private Bank.
*US peak 2006:Q3, Japan peak 1991:Q1. x-axis denotes quarters from peak.

ECB = European Central Bank; GSE = Government Sponsored Enterprise; HARP = Home Affordable Refinance Program; JOLTS = Job Openings and Labor Turnover Survey; ISM = Institute for Supply Management; ECRI = Economic Cycle Research Institute; FHFA = Federal Housing Finance Agency; HUD = Housing and Urban Development; DQ = Delinquent



[3] "Because the GSEs have a funding advantage over other market participants, they have the ability to under price their competitors and increase their market share. This advantage, as has been the case in the prime market, could allow the GSEs to eventually play a significant role in the subprime market. **As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market.** Since, as explained earlier in this chapter, one could define a prime loan as one that the GSEs will purchase, the difference between the prime and subprime markets will become less clear. This melding of markets could occur even if many of the underlying characteristics of subprime borrowers and the market's (i.e., non-GSE participants) evaluation of the risks posed by these borrowers remain unchanged." (Housing and Urban Development Affordable Lending goals for Freddie Mac and Fannie Mae, October 2000)