

The madness of crowds, and its impact on the following investments: European bank NPLs, commercial property, bank consolidations, junk bonds, US municipals and of course, the internet; Egypt

European bank NPLs: the benefits of bargain-hunting

The herd phenomenon of European banks is an extensive reliance on wholesale funding to fund expansion, rather than more stable retail customer deposits. This is best conveyed by looking at loan-to-customer deposit ratios. In our view, the size of European bank balance sheets has only one place to go: lower, particularly in light of Basel III guidelines and tighter ECB collateral rules. We expect European banks to continue to shed non-core assets, and are pursuing strategies involving the **purchase of non-performing loans** at deep discounts. One of our managers recently purchased a pool of non-performing commercial real estate loans in Germany, the UK and the rest of the continent at 36 cents on the dollar. We consider Europe the epicenter for distressed investing in 2011.

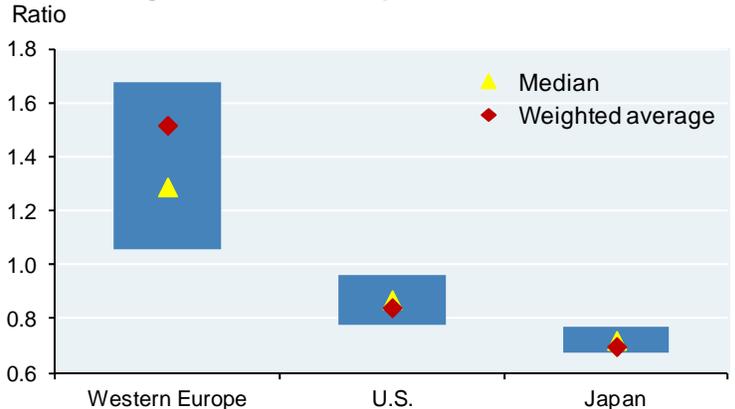
US bank consolidation: Hope Springs Eternal

Bank mergers proceeded at a steady pace during 1980s, 1990s and the early part of this decade, as the number of US banks shrank in half. As shown, the credit crisis and recession interrupted this process, but we believe it is re-emerging. The best signs: **banks looking to make acquisitions that ended up selling out instead**, given how large the premiums are (1.5x to 2.5x tangible book value). Recent examples of this include NewAlliance Bancshares and Danvers Bancorp. Another bank (Legacy) sold out after having installed a new CEO for only 6 months. As a result, we are focused on investment strategies that **position for high premiums paid for publicly traded target banks**. What's the herd instinct here? Historically, most bank mergers do not add much value to acquiring shareholders¹, yet larger banks continue to acquire smaller ones anyway, a trend we assume will accelerate in 2011. Mergers in the last 4 months already equal those executed in the prior year.

US commercial property: direct investing vs REITs

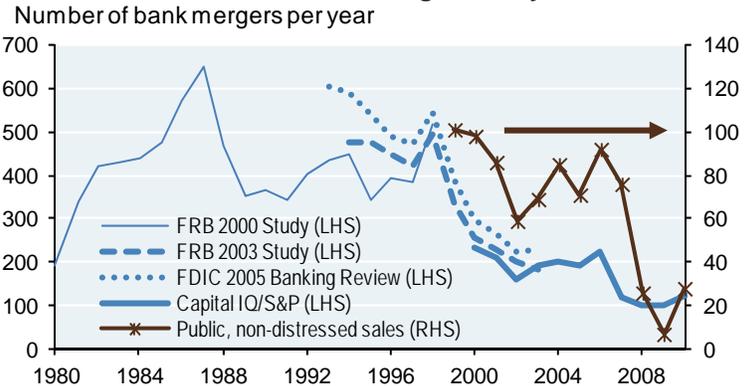
Most investors only have access to commercial property using publicly traded vehicles like Real Estate Investment Trusts. At times, the crowding can result in REITs becoming expensive. That's why we follow the price of REITs relative to direct investments. There are several ways to measure this; most show that REITs are more expensive right now (see chart). This reflects to some extent the yield mania which we discuss on the following page. As another sign that REITs are trading on the expensive side, REIT dividends are below their historical averages relative to corporate bond yields, Treasury yields and TIPS yields. We have discussed in prior notes our revived interest in commercial property (see 2011 EoTM Outlook); direct investing appears to offer modestly better value as a means of acquiring it.

G-3 banking sector loan to deposit ratios



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

Consolidation in the U.S. banking industry



Source: Federal Reserve, FDIC, Capital IQ/S&P, Sandler O'Neil Asset Management.

U.S. commercial real estate public market premium
REIT premium to private market valuation



Source: Green Street Advisors, J.P. Morgan Investment Management.

¹ With a couple of exceptions, **the vast majority of research on US bank mergers over the last 30 years does not show enhanced shareholder returns to acquiring firms** (either upon the initial announcement or following the merger). Furthermore, cost and profit efficiency on average does not improve following mergers. Positive abnormal returns, to the extent they occur, tend to accrue to the acquired firm. Abnormal returns to shareholders of the acquiring firm tend to be either significantly negative or zero. **See research citations on page 4.** There are of course very accretive transactions in some circumstances; these are industry-wide analyses.

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Junk bonds, The Fed and Zerophobia

Zerophobia is how we describe the quest for yield that results from current monetary policy. In the past, negative real interest rates resulted in indiscriminate risk-taking. As a result, we're closely evaluating the rally in CCC-rated junk bond spreads to 9.0% over Treasuries. The tightest CCC spread was around 5% in June 2007, but this is a meaningless number unless one assumes a return to the largest credit bubble ever. CCC bonds have a high propensity to default (according to S&P data, from 1970 to 2009, 50% of bonds originally rated CCC defaulted within 6 years of issuance); getting the timing right is important.

- The good news is that default rates are down sharply (see below), and more importantly, tend to be clustered in the business cycle during recessions when credit is tightening. This is not our expectation for 2011.
- The lagged nature of rating agency actions is a well-observed phenomenon, as shown below. What this means is that some companies and industries now rated CCC may be upgraded as the business cycle advances, just as they were slow to be downgraded during the recession.
- Part of the improvement in the CCC market is circular: yield-hungry investors pile into bond funds, improving the ability of CCC-rated companies to refinance maturing debt. For now, inflows into high yield bonds funds continue to be positive, with recent monthly flows as high as they have been in all of 2010.
- Some bonds have poor interest coverage at trough earnings, but as earnings improve, coverage and solvency improve. In addition, sometimes managers value certain kinds of collateral more than rating agencies do (e.g., coal plants).

Nevertheless, as the cycle matures, the riskiest bonds tend to become the most mispriced. We were early in exiting high yield in 2006, which is fine with us. We are holding our high yield positions for now, for the reasons above, and since many of our managers are now reducing their exposure to CCC-rated and unrated credits. To us, 2012 and 2013 look more challenging, given the end of CLO investment periods², and the elevated maturity of all outstanding high yield bonds and loans.

J.P. Morgan Domestic HY CCC Index

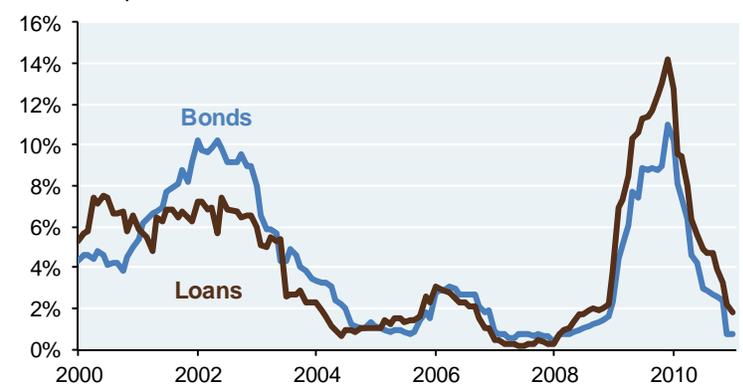
Spread to worst, %



Source: Bloomberg.

U.S. High Yield default rates

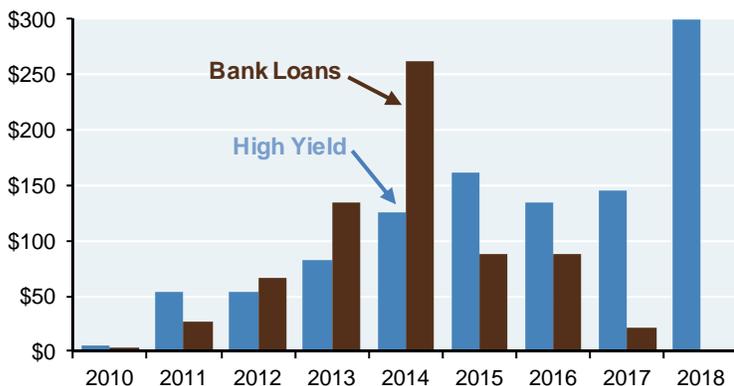
Percent of par value



Source: J.P. Morgan Securities LLC.

High yield bond and bank loan maturity schedule

Billion, USD



Source: J.P. Morgan Securities LLC.

High yield ratings momentum

Ratio, upgrade to downgrade dollar amount



Source: J.P. Morgan Securities LLC.

² CLO (collateralized loan obligation pools) accounted for as much as 60% of demand during the prior cycle.

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Municipal Bonds: Mayhem and Misinformation

The exodus of municipal bonds has been striking: a record \$3.6 billion outflow in a single week, and the worst quarterly returns since 1994 when the Fed was raising rates. It's hard to say how much of this is related to investors migrating out of lower-risk investments into higher ones, and how much is related to concerns about solvency issues at the state and local level. We consider the wholesale exodus out of municipal bonds to be misplaced anxiety; we continue to fear the economic impact of state/local budget tightening more than municipal defaults per se:

- **The municipal market does not lend itself to the homogenous descriptions applied in the financial press.** I understand investor skepticism, however. In 2007, the balance sheets of US and European broker-dealers were all very similar (reliance on wholesale financing, large exposures to structured credit, etc), so that generalizations were accurate. The same applied to peripheral sovereign credit risks in Europe in 2009-2010. But last week's chart on Illinois showed how its reliance on vendor financing deficits, low personal tax rates³ and term financing of pension shortfalls is unique among the 50 states. The goal of actively-managed, nationally diversified municipal funds is to avoid exposure to reprobate credits.
- **We have opted for a conservative portfolio approach that at times has cost us in terms of potential performance.** As described last year, our managed portfolios are concentrated in pre-refunded bonds (backed by Treasuries), state general obligation bonds, essential service revenue bonds (*see next bullet point*) and AAA/AA-rated local issuers. There *have* been defaults on unrated California and Florida "dirt bonds" (special assessment bonds not guaranteed by state and local entities). These bonds make up 50% of what the Distressed Debt Securities Newsletter publishes as municipal defaults. Another 20% of DDSN defaults are Industrial Development and Multifamily Housing bonds. However, this default wave hasn't been an issue for the \$40 bn of municipals we manage, as these three categories make up less than 0.2% of our municipal assets. Furthermore, DDSN defaults declined from \$7 billion in 2009 to \$2.8 billion in 2010 on a \$2.6 trillion municipal market.
- **Vallejo, California** has been closely watched for a city of 116,000 people since its 2008 bankruptcy (it's the Punxsutawney Phil of municipal issuers). The aftermath: a lot of press was given to unsecured creditors getting 5 to 20 cents on the dollar. But these were general unsecured *individuals* (e.g., employees, vendors), not general unsecured *bondholders* (Vallejo did not have any). What should have been highlighted: the sacrosanct nature of its special revenue bonds, which are being paid at 100 cents on the dollar. The reorganization plan acknowledged that such bonds are protected under California law, and any violation of that law would be an infringement upon its sovereignty as per the Tenth Amendment⁴. Separately, the judge allowed for union collective bargaining agreements to be torn up and renegotiated, while underfunded pensions were made whole. **As a municipal bankruptcy Petri dish, Vallejo reaffirms our prior assumptions.**
- There is going to be plenty of supply coming to market. The Build America Bond program was terminated, pushing issuers back into tax-exempt bond markets. Some bank letters of credit that were taken on during the Auction Rate Preferred mess are maturing, another potential source of supply. On top of that, the last installment of Federal Aid is ending this year. **However, states have done a good job tightening their belts. As shown below, over the last 3 fiscal years, states closed ~\$300 bn in budget gaps; it looks like they have another \$130 bn to go.** We see the municipal exodus, to the extent that it results in widespread weakness, as an opportunity to add exposure to selective names and strategies.

U.S. municipal bond fund flows

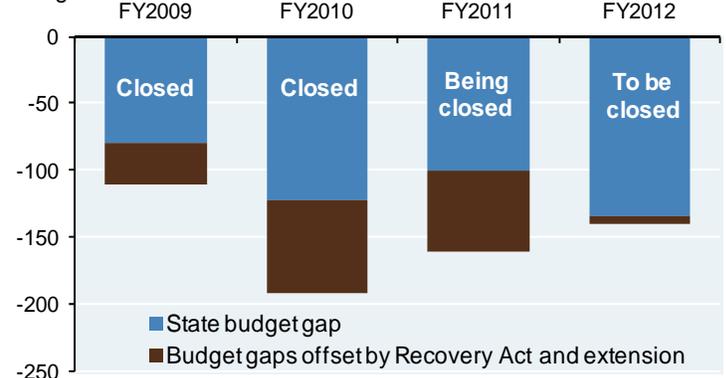
Billion, USD - weekly reporting funds only



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

State budget shortfalls: \$300bn closed so far, \$130bn to go

Budget shortfall in billions



Source: Center for Budget Policy and Priorities, September 2010, January

³ Illinois raised corporate and personal taxes to close most of its structural deficit; details are not clear yet. They continue to fund pension shortfalls through debt rather than through current year tax collections, and are seeking approval to issue debt to pay unpaid vendors.

⁴ "Vallejo writes a new chapter on Chapter 9", JP Morgan Securities US Fixed Income Strategy, January 21, 2011.

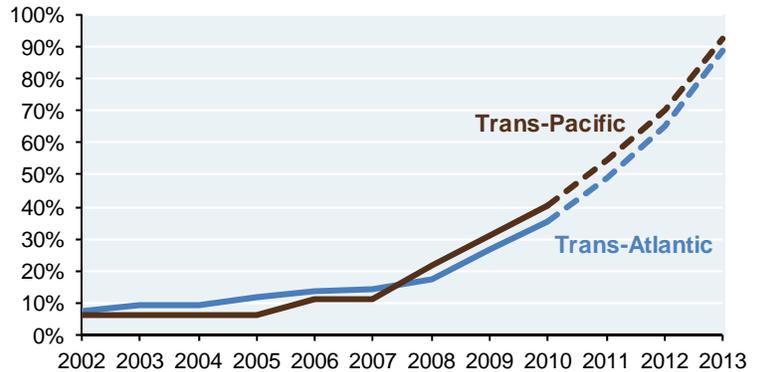
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The internet mania, version 2.0

A decade ago, markets were halfway through the process of dismantling the prior internet mania. The problem at the time: technology, applications, accessibility and user behavior were not in sync with expectations, and did not develop quickly enough to get there. One proxy for this: **the massive amount of unlit (spare) subsea fiber across the Atlantic and Pacific.** Over the next 3-4 years, we finally expect a convergence of factors to absorb much of this spare capacity. In addition to the cheapness of large cap technology stocks highlighted in the 2011 Outlook, we are exploring other ways to invest in companies that may benefit from the infrastructure and application demands this evolution will finally create.

Existing cable capacity continues to diminish

Percent of potential capacity in use



Source: TeleGeography Research.

Egypt: a year of living dangerously

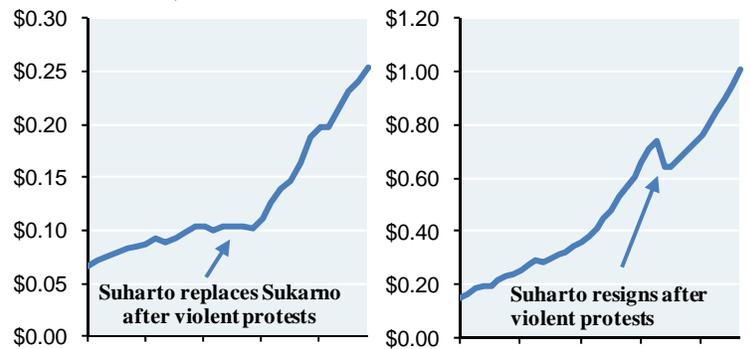
On why the situation is combustible: despite IMF-reported unemployment of 9%, youth unemployment is closer to 28%, Egypt's labor rigidity is very high, its Human Poverty Index is eclipsed only by Yemen (44% of Egypt survives on less than \$2 per day), literacy is very low, and its sensitivity to food prices is the highest in the region at just the wrong time. [Weather patterns discussed last week are relevant here: Egypt's tomato crop fell from 40 tons per acre in 2009 to 15 tons in 2010]. These are very troubling numbers for a country whose population is headed for 123 million by 2019.

	Youth Unempl.	Labor Rigidity	Food % of CPI	Poverty Index	Corruption Rank	Adult Literacy
Egypt	28	0.40	45	23.4	111	66.4
Tunisia	31	0.40	32	15.6	65	78.0
Algeria	55	0.45	43	17.5	111	72.6
Syria	26	0.40	41	12.6	126	69.3
Yemen	19	0.28	NA	35.7	154	58.9
S. Arabia	28	NA	26	12.1	63	85.5
Qatar	11	NA	12	5.0	22	93.0
UAE	6	NA	13	7.7	30	90.0
Kuwait	13	0.30	18	-	66	94.5

Sources: United Nations, World Bank MENA Situational Assessment Report, Transparency International

Amazingly, the Economist Intelligence Unit ranked Egypt less vulnerable than Brazil, Spain and Slovakia in its 2009-2010 Political Instability Index. Any assessment of its stability needs to incorporate the reality that Egypt has been in a declared state of emergency since 1981, and for all but 3 of the last 50 years.

The Years of Living Dangerously (Indonesia), Real GDP in constant dollars, trillions



Source: "Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD", Angus Maddison, University of Groningen.

Like Indonesia in 1965 and 1998, pent-up frustration with economic and political inequities can erupt without warning, interrupting a deceptive period of calm. It should be noted that both of these years turned out to be very positive inflection points for Indonesian growth; whether the same will be true in Egypt seems like a much more complicated story.

Michael Cembalest
Chief Investment Officer

Sources for citations regarding the general lack of shareholder value created through US bank mergers

"Impact of Community Bank Mergers on Acquiring Shareholder Returns", Journal of Performance Management, Jan 2006; "Megamergers in Banking and the Use of Cost Efficiency as an Antitrust Defense" Antitrust Bulletin, Fall 1992, Berger and Humphrey; "Determinants of Cost Efficiencies in Bank Mergers", Journal of Economic Perspectives, August 1993, Robert DeYoung; "The overall gains from large bank mergers", Journal of Banking and Finance, Houston and Ryngaert, 1994, Volume 18; "Performance Changes and Shareholder Wealth Creation Associated with Mergers of Publicly Traded Banking Institutions", Journal of Money, Credit and Banking, August 1996, Steven J Pilloff; "A multiple metric study of the returns to shareholders: the case of bank holding company mergers", Journal Of Financial And Strategic Decisions, Fall 1995; "New evidence on shareholder wealth effects in bank mergers during 1980-2000", December 2008, Journal of Economics and Finance; "Post-Merger Strategy and Performance: Evidence from the US and European Banking Industries", Leeds University Business School, Hagendorff and Keasey, Accounting and Finance Journal, May 2009.

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