

Subject: Eye on Inflation, February 14, 2011

Date:

Attachments: 02-14-11_-_EOTM_-_Eye_on_Inflation.pdf (251K)

Eye on the Market, February 14, 2011 *[the PDF this week is much easier to read]*

Topics: US inflation over deflation; France > Germany; new credit standards > old ones; Math > Meredith; ☺Day

It wasn't so long ago that we were wondering when the US economy would get its legs back. It was never a question of "if" but "when", since after trillions in monetary and fiscal stimulus, the patient was bound to respond at some point. Since this policy began in 2008, there have been concerns about when it would be unwound, and how the private sector would adjust. Some stimulus unwind periods are not so bad. Starting in 1994, the Fed raised rates by 3% in 7 steps; equity markets did not have a good year in 1994 (+1.3%), but they weren't terrible either. Once the adjustment took place, the economy and equity markets recovered. We believe that in the next 12 months, the US economy faces a similar test. The stakes are higher this time, given the amount of stimulus in place.

First, the good news. The list below US economic indicators that are improving, many of them quite visibly. Add to this considerable strength in China (industrial production, retail sales, new loan growth, housing), and for good measure, the best German manufacturing and service sector recovery since reunification. **A global victory over deflation** seems pretty much in the bag at this point, which was the primary goal of Central Bankers back in 2008-2009. Mission accomplished. [Strongly improving US economic data: manufacturing and service sector surveys, particularly new orders; employment surveys, jobless claims; consumer spending, auto sales; consumer credit growth and demand; small business hiring plans and sales; state tax receipts on personal income; announced US M&A volumes; capital spending plans; mortgage and credit card delinquencies; existing home sales; corporate profits and cash flow; exports].

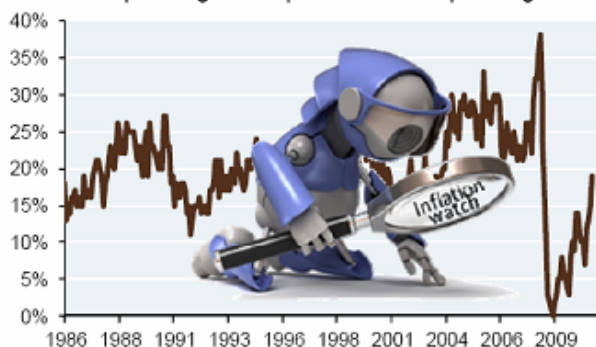
But with the global economy getting back to normal and real policy rates close to zero around the world, the focus shifts back to an inflation watch. Core inflation is low in the US, the European Union, and even in China (all below 2.0% y/y). **Nevertheless, we are keeping a close eye on the following inflationary pressures that are now on the rise:**

Chinese export prices and wages
Percent change, YoY



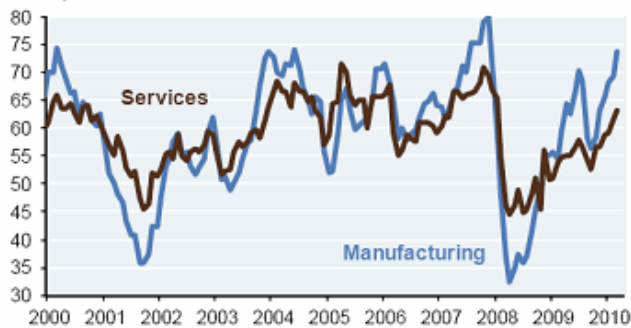
Source: China Economic Information Network, J. P. Morgan Securities LLC.

Small business price increase expectations
Businesses planning to raise prices less those planning to lower, %



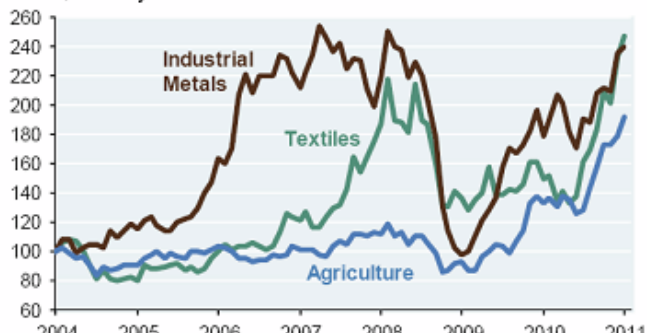
Source: NFIB.

Global survey of commercial input prices
Index, sa



Source: J.P. Morgan Securities LLC.

Food, industrial metal and textile prices
Index, January 2004=100



Source: Bloomberg - S&P GSCI, Economic Cycle Research Institute.

We doubt that a persistent inflationary dynamic will take root in the developed world. **On the contrary, what we are watching for are early signs that Central Bankers start withdrawing monetary stimulus, which could have a negative effect on equity markets.** Like in 1994, such a withdrawal might be temporary and somewhat painless, but it also might not be. This era's monetary stimulus, particularly in the US and China, is without precedent.

When the time comes, how much might interest rates have to rise?

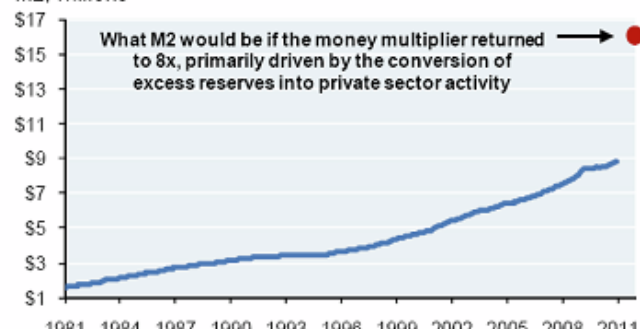
Around \$1 trillion in excess bank reserves still remain on deposit with the Fed, earning 0.25% in interest. What if money center banks decided to deploy these reserves and earn a market return on them? We are already seeing signs that Fed asset purchases are increasingly being recycled into new loans and other activity. As an exercise in the extreme, we looked at the US money multiplier, which over the past 60 years ranged from 8x to 12x. This concept measures the degree to which the private sector converts base money into loans, deposits, etc. If current excess reserves in the financial system were fully deployed by the private sector and the money multiplier returned to the low end of its historical average, there could be explosive growth in M2. Whether you're a Friedman-style monetarist or not, such an expansion could be quite worrisome.

Money multiplier
M2 divided by the monetary base



Source: Federal Reserve.

What could go wrong with high-powered money
M2, Trillions



Source: Federal Reserve.

Many economists would take issue with this chart, some quite strongly. First, the Fed would never allow M2 to get this high, and would raise interest rates well before then. Second, there are some banks that don't have the capital to fully utilize their excess reserves. **Still, its**

weaknesses aside, it's the best way I can think of to highlight the level of idle reserves, how much inflation they could theoretically result in, and the degree to which the Fed may have to tighten monetary policy to restrain them. The Fed claims to have a variety of tools (a) to accomplish this; the question is how high interest rates have to rise for them to work. The victory over deflation is likely to result in asset markets that are highly sensitive to signs of inflation appearing just about anywhere. We're expecting a roughly 10% year for equities this year, but the inflation and/or bond market risks to this view are considerably higher than in 1994.

France: coachman still in charge

As we highlighted a week ago, Germany appears to be moving closer to a bailout of the Periphery, which is still flat on its back. The ECB has reportedly been buying Portuguese government bonds (which now yield 7%), a practice which cannot continue indefinitely. Socialization of the Periphery problem looks more probable, in spite of all the political wrangling. A switch from Bundesbank chief Axel Weber to the likes of Klaus Regling (EFSF), Yves Mersch (Central Bank of Luxembourg) or Erkki Liikanen (Central Bank of Finland) as next ECB President would be another sign of continued accommodation by the ECB.

Maneuvering Germany into bailout mode is a huge victory for France. France's competitiveness gap vs Germany would be quite exposed by having to choose between joining a German-dominated Northern European Union (and a much stronger currency), or joining the Periphery and accepting higher inflation (b). A recent 230-page paper commissioned by the French Ministry of Industry highlights the issues in stark relief (c). Over the past 3 decades, French exports relative to Germany have plummeted, in part due to lost competitiveness, as well as a laundry list of other areas where the French economy is falling further behind.

Keeping the EMU in place prevents these fissures from being further exposed. [Marked deterioration in France compared to Germany in: exports, both industrial and agricultural; labor competitiveness, unit labor costs, job creation; hours worked; operating profits of manufacturers; R&D spending and patent filings; quality of industrial and consumer goods produced; labor and social security taxes; business creation (companies with > 9 employees); industrial sector value-added].

Widening French/German export gap
Real exports of goods and services - France divided by Germany



Manufacturing unit labor costs: Vive la difference!
Index - Dec 1998 = 100



Cutting through the politics and the economics, beginning last Spring, **the European Monetary Union faced 4 choices:** Germany accepts a large sustained period of financial transfers to the South; Germany accepts much higher inflation; the Periphery accepts a brutal period of wage and price deflation; or membership in the EMU would have to change. Germany

(to the presumed delight and good fortune of France) has apparently selected Option Number One. Absent an unexpected 11th hour rejection by Germany, we should get a better sense of the expanded bailout by early April. There are some oversold European healthcare, consumer discretionary and financial names that we are taking a close look at. We remain interested in European bank sales of non-performing loans, as de-leveraging makes its way through the European banking system.

Charles De Gaulle famously remarked that Europe is an affair of the French and the Germans, and that Germany is the horse, while France is the coachman. As things look right now, the coachman is still in place.

Structured credit: good riddance to 2005-2007 underwriting standards

During the credit bubble (2005 - 2007), we avoided investments in structured credit. Such assets are securitized pools of loans to residential and commercial property borrowers, and corporations. We did not have a problem with the structures per se in terms of their legal or servicer framework, but with the level of investor protection against loss. The extreme case was the securitized market for commercial property loans. As shown below (left), at the peak of the credit bubble, only a 5% property decline would have exposed AAA investors to losses, which is why we avoided it.

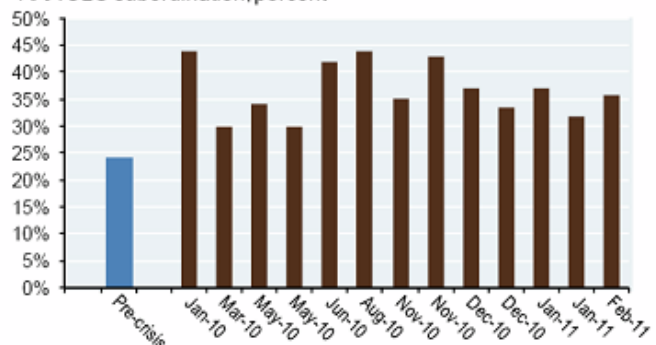
Now, investor protections for investors in these securities have risen back to where they were at the beginning of the prior decade. Improved credit enhancement levels do not just apply to the AAA tranches, but the lower ones as well. The chart on the right shows the level of protection for AAA investors in newly structured pools of collateralized corporate loans, which has also risen considerably. For this reason, we have been investing in structured credit in both new issue markets, and in secondary markets for older deals.

Property decline cushions return to sanity
AAA CMBS subordination adjusted for LTVs



Source: J.P. Morgan Securities LLC, Trepp, rating agencies, Bloomberg.

Pre-crisis vs. post-crisis CLO subordination levels
AAA CLO subordination, percent



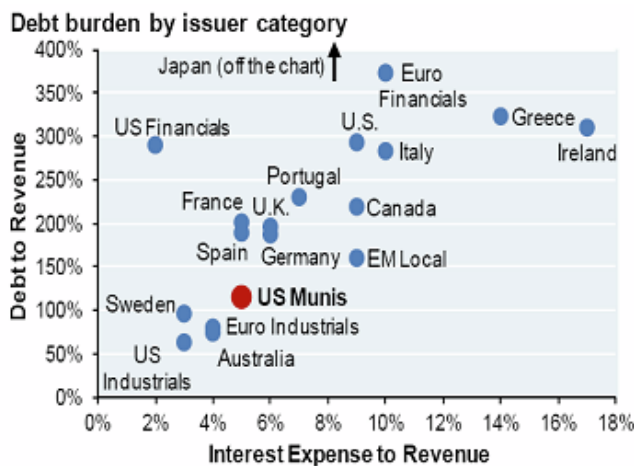
Source: J.P. Morgan Securities LLC.

US municipals: the slings and arrows of outrageous fortune

Meredith Whitney made a splash with a December 2010 "60 Minutes" appearance that forecast 50 to 100 sizable defaults which would amount to hundreds of billions of dollars. While everyone is entitled to their opinion, we don't believe that municipal issuers are as homogenously and uniformly weak as US and European broker-dealers in 2007, or European Periphery issuers in 2010. We held a conference call on municipal bond markets last week, and focused on much of the information included in the January 31 EoTM (*please ask your JP Morgan team for a copy if you have not seen it, and are invested in municipal bonds*). States

have already closed \$300 billion in budget gaps since the beginning of the recession, and have another \$130 billion to go. More than half of all states have raised taxes, almost all states have cut social services spending, instituted layoffs and hiring freezes, etc. Regarding unfunded pensions, half of all states have raised retirement ages, increased required employee contributions and/or required new hires to contribute to pension funding. In addition, we are seeing evidence of rising state and local tax receipts, with the largest gains in the New England and Mid-Atlantic regions. **The bottom line is that we continue to fear the economic impact of state/local budget tightening more than widespread municipal defaults per se.**

Last week, JP Morgan Securities published some interesting data on US municipals compared to other government and corporate debt (d). The chart below highlights the two important variables: interest expense and debt levels relative to revenues collected by each issuer category. Even after including underfunded pension plans, US states are considerably less leveraged than other issuers. There are other important aspects to solvency (namely economic growth, labor productivity and mobility, etc), but it's a pretty good starting point for evaluating credit risk.



Source: J.P. Morgan Securities LLC.

There will no doubt be distress in parts of the municipal market with the withdrawal of Federal funds, and as we have reviewed in prior notes, there are wide discrepancies between the US states, which are far from a uniform group in terms of budget discipline. All things considered, we expect defaults in the kind of municipals we own in our discretionary accounts to be a fraction of Meredith's projections. Municipal issuance is expected to rise sharply in 2011, particularly given the expiration of the Build America Bonds program and expiration of letters of credit backing shorter term municipal debt. Rising long term Treasury rates will put pressure on the market as well. This may set the stage for a substantial buying opportunity for select municipal names and strategies later in the year.

In the wake of the tech bubble, the housing collapse, the credit crisis and ongoing problems in Europe, there is a well-earned presumption of guilt these days that accompanies most markets. However, we are equally wary of the slings and arrows of broad generalizations that do not fit the facts on the ground.

Michael Cembalest
Chief Investment Officer



Highly recommended romantic location almost certain to smooth over any transgressions or misunderstandings: the waterfall hike at El Remanso Wildlife Lodge, Osa Peninsula, Costa Rica. There are occasional pit vipers, but if you remain in the water at all times, you should be fine.

Notes

(a) Reverse repos, in which the Fed borrows against securities they hold; Term Bank Deposits, in which banks deposit excess reserves for a 28-day period with the Federal Reserve; and allowing Fed-owned assets to run off as they mature.

(b) Bernard Connolly at CGMA believes that in addition to other drawbacks, such an outcome could bring back unwelcome memories of prior Latin monetary unions which were periods of French military/economic decline.

(c) *"Mettre un terme à la divergence de compétitivité entre la France et l'Allemagne"*, Coe-Rexecode, Janvier 2011.

(d) *"Evaluating bond markets in a world of rising debt"*, J.P. Morgan Securities Ltd, February 9, 2011.

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