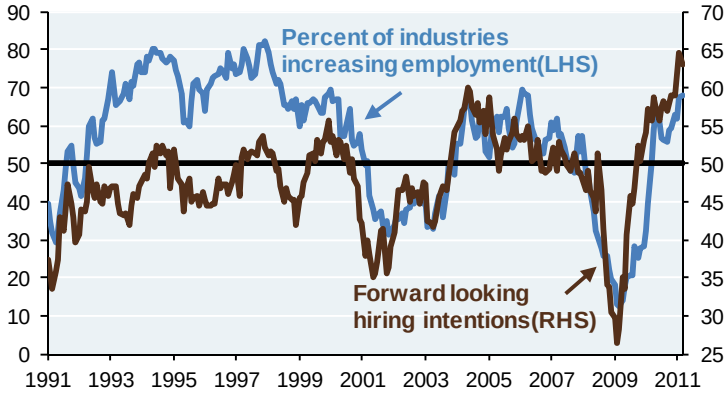
Topics: US labor markets, oil prices, China, Europe and more on Japan (reconstruction investing and the ocean)

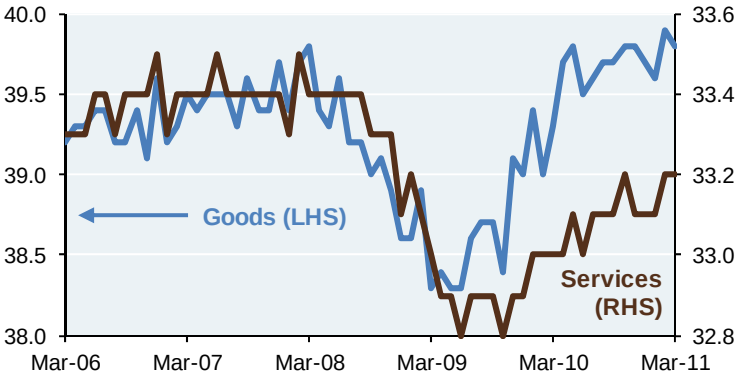
Wishful thinking. There's a long way to go, but US labor markets are finally improving. There have been 13 consecutive monthly gains in private sector payrolls, and what's just as important, the percentage of industries increasing their hiring is broadening. While payroll gains have been below what many economists were forecasting a few months ago, behind the scenes, the work week has been increasing (people who have jobs are working more hours)[1]. These trends need to be sustained, given the large number of workers that dropped out of the labor force over the last couple of years.

US hiring trends, actual and forecast



Source: Bureau of Labor Statistics, ISM.

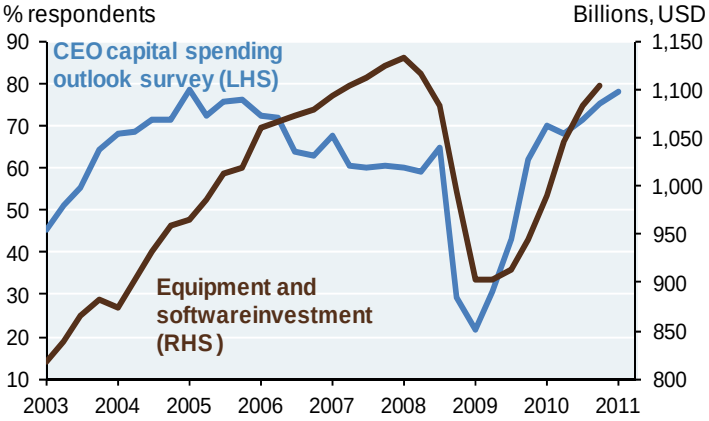
Extension of the US workweek



Source: Bureau of Labor Statistics.

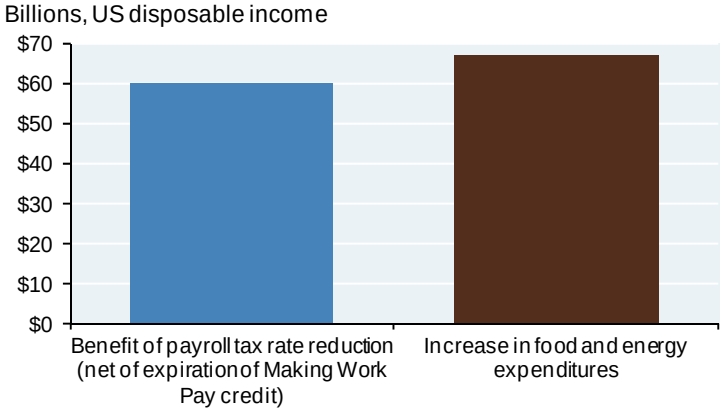
One reason for optimism on hiring is the recovery in capital spending, which has begun to turn and appears headed higher based on recent CEO surveys. Capital spending and employment gains are the normal components of a durable recovery. Financial markets, as they usually do[2], began to price in these outcomes in 2009 and 2010.

Capital spending, actual and intentions



Source: The Business Roundtable, BEA.

Rising food and energy prices offset payroll tax reduction



Source: Bureau of Economic Analysis, J.P. Morgan Securities LLC.

The next hurdle for the expansion: rising food and energy prices. As shown in the chart, **increased food and energy prices more or less offset the benefit of the payroll tax reduction.** Food and energy prices are assumed by the Fed to be cyclical, and in a prior note, we walked through an analysis of why we believe anomalous weather conditions in the Atlantic and Pacific will end (EoTM Jan 24, 2011). That being said, there are plenty of reasons why food and energy prices may remain high:

- After Saudi increases to offset declines in Libyan oil exports, the world may only have 2 million barrels per day of spare oil capacity; global demand for oil is expected to rise by 1.5-2.0 million barrels per day in 2011, putting a further squeeze on spare capacity (see chart on following page)
- Emerging economies are still behind the curve on raising interest rates to "normal" levels, given their levels of growth, employment and utilization. China's oil imports in February were above trend for the 8th time in the last 12 months
- The stocks-to-use ratio of corn and soybeans is close to all-time lows, in part a function of biofuel demand
- For austerity reasons, countries like Spain cut subsidies for solar power, increasing fossil fuel demand (on the margin)
- The US administration (so far) seems reluctant to release Strategic Petroleum Reserves to mitigate higher oil prices

[1] Had the work week not increased, private payroll gains would have averaged 173k since January 2010 instead of the actual average of 95k.
[2] In the October 21, 2009 EoTM, we reviewed the long history of financial markets anticipating eventual improvements in jobs and output.

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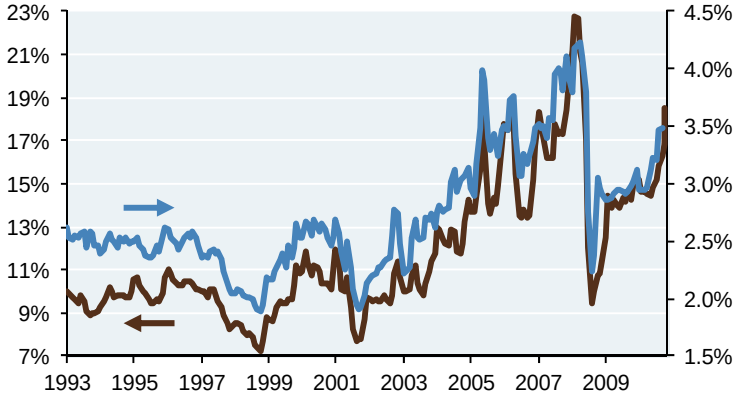
Payroll gains will need to stay above 200k per month to offset these headwinds, since the payroll tax reduction will expire at the end of the year. To get a sense for the pressure on US consumers, the chart below shows gas prices and expenditures relative to hourly earnings and personal income. We are not at the peak levels of summer 2008, but we're getting closer.

Rising energy prices and the consumer

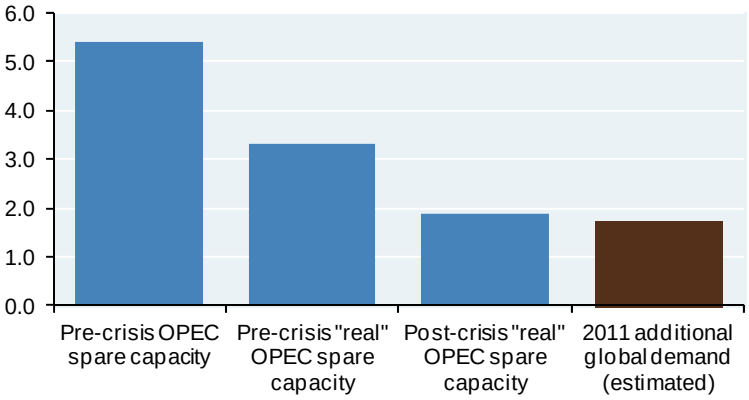
Gas prices to hourly earnings Gas spending to personal income



Source: U.S. Department of Energy, BLS, BEA.

Post-Libya OPEC spare capacity running out

Millions of barrels per day

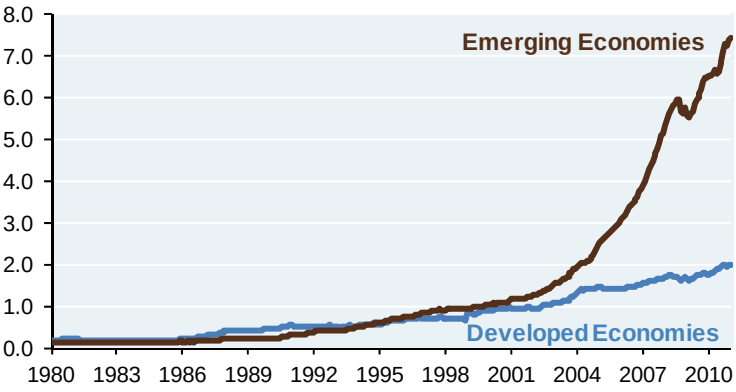


Source: J.P. Morgan Securities LLC.

The chart below (left) gets at the heart of the circular problem facing the world. Emerging economies are accumulating large amounts of foreign exchange reserves. To some, this is an unmitigated "good thing", since these reserves are often reinvested back into stocks, bonds and private companies in the developed world. **True enough; rising M&A volumes are in part a reflection of that trend (one of our primary investment themes this year).** But the downside is that in accumulating these reserves, many emerging economies are taking on a lot of inflation risk, since reserve accumulation results in undervalued currencies and an artificially low cost of money. This fuels construction and consumption at a pace that may not be sustainable, and which in the short term pushes up demand for scarce commodity inputs.

Global Foreign Exchange Reserves

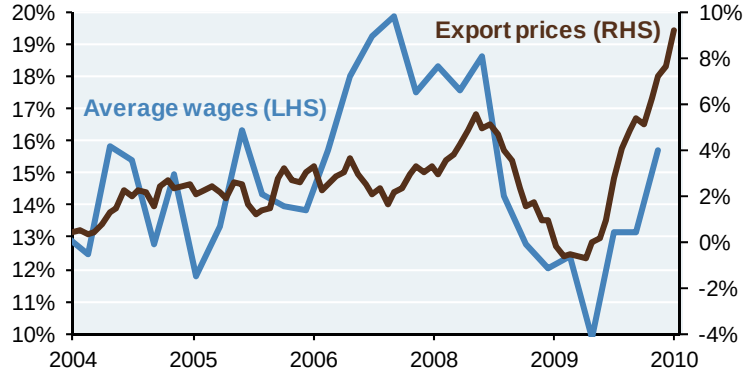
Trillion, USD



Source: International Monetary Fund, J.P.Morgan Securities LLC.

Chinese export prices and wages

Percent change, YoY



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

Increases in Chinese export prices may signal the exhaustion of excess resources taken for granted over the last 2 decades. Li & Fung (a Hong Kong-based consumer goods sourcing and logistics company) warned that "a new era in sourcing with higher prices" has begun, as manufacturers pass on rising raw materials and labor costs. William Fung (the group's managing director) said competition for Chinese labor resulted in wage increases of 20 per cent this year, marking the end of China-led deflation for the world economy.

What does all of this mean for portfolios? Around ¾ of the world's countries (weighted by GDP) are expected to grow by more than 4% this year, with the US, Germany, Brazil, Canada, Australia, Sweden[3] and Asia offsetting weakness in Europe and Japan. However, super-easy monetary policy and energy constraints make this recovery more uncertain that prior ones. For Central Banks to assume that there would not be a price to pay for artificially low policy rates was wishful thinking. Through a variety of means, we are positioning portfolios for upward but volatile markets in 2011 as policy rates normalize around the world**. Distressed asset investing has been a part of this approach, with 2 opportunities outlined in the following section.**

[3] "Sweden?" Yes, its economy is more than twice the size of Ireland's, and grew by 7.3% in 2010.

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Geological and financial crisis clean-up: investments related to Japan and Europe

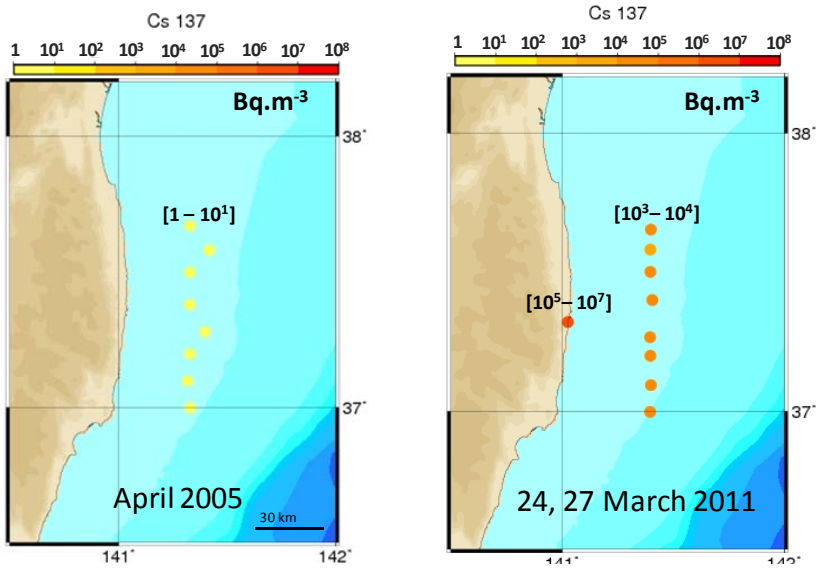
- As estimated damages from the earthquake and tsunami in Japan grow (see Appendix), we see opportunities for companies either **positioned to participate in the reconstruction**, **or companies positioned to benefit as non-nuclear energy providers**. As reconstruction estimates approach 5% of Japanese GDP, there are a variety of companies (mostly domiciled in Asia) that we expect to play a role in the rebuilding. These companies are involved in the production of iron ore, copper, steel and aluminum; the sale of construction machinery and equipment; and the construction of commercial and residential property. Other companies include liquefied natural gas producers and coal (unfortunately).
- As the melodrama over restructuring of European sovereign debt plays out (Portugal actually issued 12-month T-bills this week at 6%), we are focused on **investment opportunities associated with bank de-leveraging and the decline in the European shadow banking system**. These trends are driven by tighter Basel III regulations, reductions in wholesale funding availability, the decline in European bank proprietary trading capacity and a 96% decline in new CLO origination since 2006. Approximately 1 trillion Euros of bank sales have been pledged by banks in the wake of government-funded bailouts. The investment opportunities include distressed residential and commercial property loans, and senior-secured corporate loans. Some of these positions trade at steep discounts, part of which reflects the scarcity of capital available to refinance the 270 billion Euros of maturing high yield bonds and loans from 2011 to 2015.

Fishful Thinking, the latest from Japan *(warning: no investment content ahead)*

We have been following the situation in Japan closely, for a variety of investment, energy and socio-economic reasons. Our understanding of the status quo is that large amounts of freshwater and seawater are being dumped on spent fuel pools and reactors, in order to keep the nuclear materials submerged in water. This process is designed to function as a "heat transfer", so that the nuclear materials do not react with oxygen (which would release more fission fragments into the atmosphere). When in normal operation, heat exchangers allow plant operators to cool the reactors and spent fuel pools in a closed loop, so that water coming in contact with radioactive materials is not released. Unfortunately, heat exchangers, valves, pipes etc are not operable after the earthquake and hydrogen-fueled explosions, so that's why you see pictures of diesel-fueled pumps and cranes spraying water onto the facilities. This radioactive water accumulates in underground concrete trenches, but they are now filling up. In a remarkable statement yesterday, Tokyo Electric Power said the following:

- It began to release more than 10,000 tonnes of contaminated water into the sea to free up storage space for water with much higher levels of radioactivity (Cesium-137 and Iodine-131)
- Chief Cabinet Secretary Yukio Edano says that if the current situation continues for a long time, with accumulation of more radioactive substances, there will be "a huge impact on the ocean", as it could take months to stop radiation leakage

Given what's going on, I am surprised at how sanguine press reports[4] have been about risks to marine life and human consumption. Most rely on the notion that "dilution is the solution", and that the ocean is a great "radiation sink". Some reference a report from the International Atomic Energy Agency, showing the decline in Cesium-137 the farther they went away from Fukushima (see right). What the IAEA is saying here is that offshore concentrations of Cesium-137 are 3-4 times *higher* than usual (the bad news), but that offshore concentrations around 300 miles out are 3-4 orders of magnitude *lower* than on the coast itself (the good news), supporting what they describe as the "high dilution capacity of the marine environment"[5].



[4] **Examples of articles downplaying risks to the ocean and consumption of marine life** include Science Magazine, Science NewsLine quoting the Woods Hole Oceanographic Institute and 2 recent Bloomberg articles.
http://news.sciencemag.org/scienceinsider/2011/03/quake-question-8-what-impact.html
www.sciencenewsline.com/nature/2011032910240000.html
www.bloomberg.com/news/2011-03-31/sushi-safe-from-japan-radiation-as-ocean-dilution-makes-risk-negligible-.html
www.bloomberg.com/news/2011-04-03/tokyo-electric-s-plan-to-plug-leaking-radioactive-water-with-sawdust-fails.html

[5] "Marine Environment Monitoring: Assessment of IAEA Environment Laboratories on Data provided by Japan", April 1, 2011

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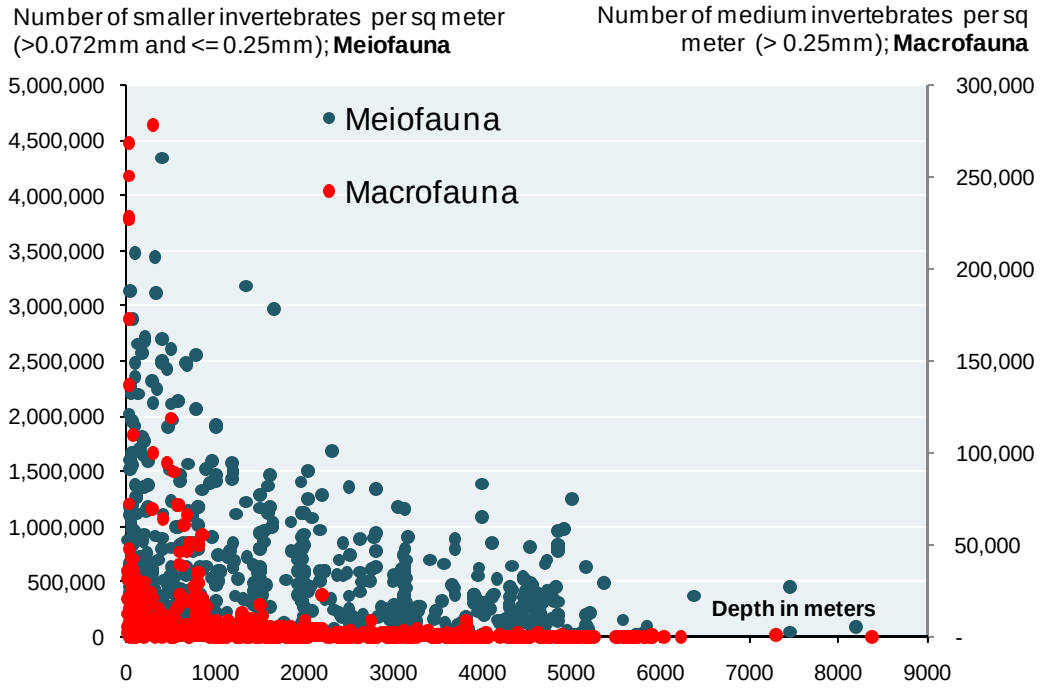
However, there may be 3 problems with this line of thinking:

1. **Some radioactive particles, before drifting out to the deeper ocean, will be absorbed by phytoplankton and zooplankton, the beginning of the oceanic food chain**. In coastal waters, these organisms and accumulated radioactivity will sink into the sediment, according to Ray Sambrotto of Columbia University's Lamont Doherty Earth Observatory. When animals that eat or absorb Cesium-137 die off, the radioactive isotopes live on after them in whatever biological material remains; recall that cesium has a half-life of 30 years. As a result, **sediment samples and animal tissue samples will be critical additions** to traditional water samples, the latter being the pre-occupation of most press reports.

2. **Declining radiation levels far offshore is great news…except most animals live closer to the shore**. This is perhaps the most important thing that is not addressed in many press reports. Check out the chart below, using data which biologists at the University of Massachusetts shared with us. *Macrofauna* are typically the dominant life forms in marine sediments, and include a variety of bristle worms, crustaceans and mollusks. *Meiofauna* refer to smaller animals (typically less than 0.25 mm in size) such as nematode worms. Both categories are heavily impacted by whatever organic material descends upon them, and live close to shore, rendering the IAEA's "radiation diffusion" argument perhaps less meaningful.

3. **As smaller animals consume radioactive materials, the isotopes can become concentrated in larger animals in a process called bio-accumulation**. It will take some time for the cesium to make its way through the food web. The risk is that as it does, it becomes more and more concentrated over months and years in the animals that are a part of this web. A 1994 study by the U.S. National Biological Service[6] examined various anthropogenic sources of radiation, and their impact on marine life. While accumulation factors were much worse for freshwater, they were still very evident in oceanic marine life. **The study cited cesium concentrations that were 8, 15 and 23 times higher in mollusks, fish and crustaceans when compared to cesium levels measured in the water in which these animals lived.**

The problem with the "radiation diffusion" theory: oceanic life tends to live very close to the shoreline



Source: University of Massachusetts, Department of Biology, Michael Rex and Ron Etter

Examples of macrofauna: an isopod, a polychaete and an Asian date mussel

Pictures courtesy of Peter J Bryant at the University of California/Irvine

Like the normalization of central bank policy rates, we have a long way to go before this is over.

Michael Cembalest
Chief Investment Officer

[6] "Radiation Hazards to Fish, Wildlife and Invertebrates", Ronald Eisler, Environmental Science Center, U.S. National Biological Service, December 1994. The radiation comparisons cited above compared becquerels per gram of animal sample to the becquerels per milliliter of water in which the animals lived. Additions comments/feedback on this section from the Texas A&M Maritime Academy at Galveston.

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