Eye on the Market | April 11, 2011 J.P.Morgan

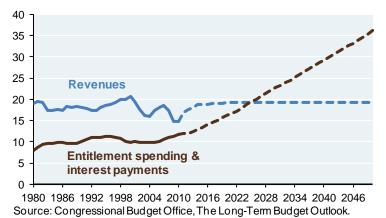
Logan's Run: the averted government shutdown, the debt ceiling and the long-term fiscal situation of the United States

If you are predisposed to reading about the terrifying condition of the US budget deficit, this has been your year. In the past few months, the following reports have been released which go through the grisly details:

- From Jim Grant's *Interest Rate Observer*, a mock prospectus on the United States as if it were a corporation offering its trillions in debt for sale to the public
- A January 2011 paper from the Committee for a Responsible Federal Budget, a group made up of former directors of the CBO, the OMB, the House and Senate Budget Committees and the Federal Reserve Board of Governors
- "The Financial Condition and Fiscal Outlook of the U.S. Government", a slide deck from David Walker, President of the Peter G Peterson Foundation and Former Comptroller General of the United States
- An IMF paper from April 2011, "An Analysis of U.S. Fiscal and Generational Imbalances: Who Will Pay and How?"
- An April 2011 piece from PIMCO's Bill Gross piece entitled "Skunked"
- And demonstrating that there is in fact a second act in American lives, former internet research analyst Mary Meeker's 460-slide behemoth entitled "USA Inc", distributed by venture capital firm Kleiner Perkins Caufield & Byers

At the risk of over-simplifying, here's a chart and a quote that capture the spirit of these pieces. Meeker highlights the CBO's Alternative Case which asserts that in the year 2025, when my youngest son will be entering the workforce, that US government spending on entitlements and interest payments will consume 100% of government revenues, leaving nothing left for anything else. This particular case assumes that the Bush tax cuts are extended through 2020, except for high income taxpayers whose tax rates rise in 2012; that AMT relief is extended through 2020; and that modest tax increases bring government revenues back up to their historical average of 19%-20% of GDP. Hence the comment from Bill Gross which follows.

CBO alternative case: No air traffic control in 2025 Percent of GDP



"Unless entitlements are substantially reformed, I am confident that this country will default on its debt; not in conventional ways, but by picking the pockets of savers via a combination of less-observable, yet historically verifiable policies – inflation, currency devaluation and low to negative real interest rates...It is incumbent, therefore, in order to preserve the integrity of the US Treasury Market along with its favorable global interest rates, and to promote a stable US economy, that entitlement spending be reduced, and that future liabilities be addressed in terms of healthcare and Social Security cost containment."

Bill Gross, "Skunked", April 2011

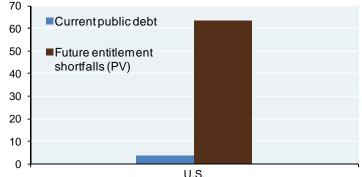
This is not new news. What got the ball rolling in some circles was a speech by Dallas Fed President Richard Fisher in May 2008 entitled "Storms on the Horizon", which cited \$99 trillion of long-term unfunded entitlement payments. Over the past year, our Eye on the Market reports included "The Office of Misinformation and Budget" (Jan 2010), "Long Day's Budget Journey into Night" (Feb 2010), "Irreconcilable Differences" (Mar 2010) and "Future Shock" (Jul 2010), the latter being so depressing that a few people told me to stop writing about it during the summertime. Among our citations and figures:

- On the President's budget: "even after a freeze on discretionary non-defense spending, higher taxes on wealthy Americans, reduced itemized deductions, a financial crisis responsibility fee paid by banks, higher taxes on companies doing business outside the U.S., higher taxes on private equity, and higher taxes on oil & gas firms, the US still faces a large budget gap"
- The scary part is what is *not* captured by OMB measures of public debt: unfunded entitlements, which dwarf the size of today's public debt by something like 8 or 9 to 1 (see charts on next page). Similar problems exist in Europe.
- The U.S. could fund the entitlement shortfall by doubling the 15.3 percent payroll tax on employers and employees (forever), or reducing discretionary spending by 80% on things like education, defense and environmental protection
- By 2020, the average EU country would need to raise its tax rate to 55 percent of national income to pay promised benefits

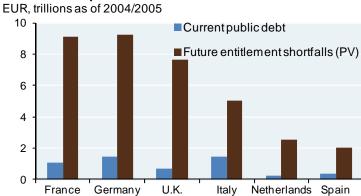
I could go on, but there's little point in it. The United States (its politicians and its citizens) have jointly created a leviathan of entitlement obligations which are 10 times the real cost of all its wars since the American Revolution.

Logan's Run: the averted government shutdown, the debt ceiling and the long-term fiscal situation of the United States





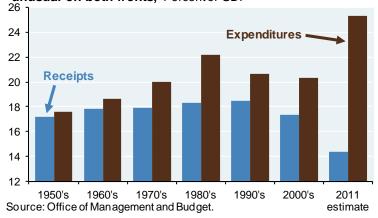
... and in Europe



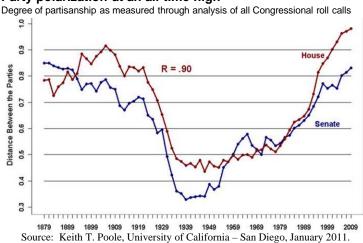
Source: "Measuring the Unfunded Obligations of European Countries", Jagadeesh Gokhale, European Commission, European Economy Economic Papers, No. 297, December 2007; National Center For Policy Analysis, Policy Report No. 319, January 2009.

Supporters of fiscal austerity point to the chart below. Compared to prior decades, current levels of spending relative to GDP are definitely elevated. However, revenues to GDP are much lower than normal; supporting the argument that taxes need to be raised as well. Why wouldn't both sides see this chart and agree to compromise? Two reasons. First, as we first showed in December 2009, partisanship has reached levels not seen since the Reconstruction period following the US Civil War. And second, because austerity advocates will point to the chart on the first page: even after raising taxes to historically "average" levels, interest payments on rising debt and the entitlement monster eventually consume Federal revenues anyway.

Government revenues and expenditures: 2011 is unusual on both fronts, Percent of GDP



Party polarization at an all-time high



As for the shutdown, Washington reached a compromise, as everyone expected they would (Republicans and Democrats were reportedly arguing over \$9 billion dollars of spending cuts on a \$1.3 trillion deficit). Most commentary I read suggests that a shutdown would not have been a big deal. That's probably true. But past government shutdowns took place when US debt burdens were much lower, as were foreign holdings of Treasuries (see table on following page). The legislature might be playing with fire by publicizing its budget woes to the world now. Foreign holders are increasingly "official sector", meaning central banks that don't buy Treasuries because they want them, but because they are running a policy of currency intervention, and buy them because they *have* to. Still, rattling their nerves with bi-partisan feuds is hardly a selling point for US Treasuries.

Now that the shutdown risk appears to be resolved, Washington has to figure out what to do about the debt ceiling, which looks like it will be breached sometime in May¹. Historically, Congress always raised the debt ceiling, but this time around, it is not clear what quid pro quos will be agreed upon by the hyper-partisan legislature. In the end, Congress has no choice but to raise the debt ceiling. Consider the other option: with 2011 revenues estimated at 1.6 trillion and spending at 3.3 trillion², the government could always cut 1.7 trillion in spending immediately, if it did not have legislature authority to borrow more money. Obviously not.

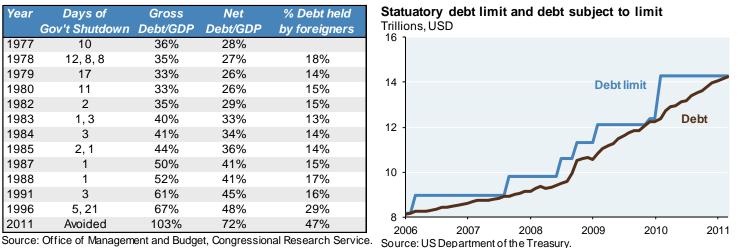
¹ For an excellent report on the shutdown and debt ceiling, see "Showdown at the not-OK Corral: battle over the US debt ceiling", J.P. Morgan Securities LLC, Feb. 25, 2011. The debt ceiling breach might be deferred until July, depending on some juggling the Treasury can do.

² These are the so-called "on-budget" numbers which excludes the inflows into and out of the Social Security Trust Fund.

J.P.Morgan Eye on the Market April 11, 2011

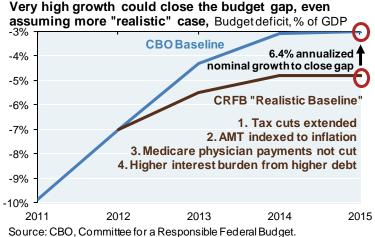
Logan's Run: the averted government shutdown, the debt ceiling and the long-term fiscal situation of the United States

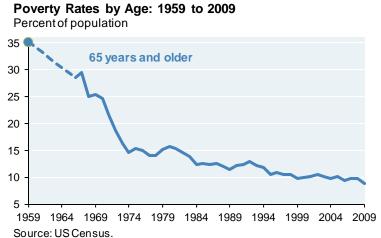
Year	Days of Gov't Shutdown	Gross Debt/GDP	Net Debt/GDP	% Debt held by foreigners
1977	10	36%	28%	
1978	12, 8, 8	35%	27%	18%
1979	17	33%	26%	14%
1980	11	33%	26%	15%
1982	2	35%	29%	15%
1983	1, 3	40%	33%	13%
1984	3	41%	34%	14%
1985	2, 1	44%	36%	14%
1987	1	50%	41%	15%
1988	1	52%	41%	17%
1991	3	61%	45%	16%
1996	5, 21	67%	48%	29%
2011	Avoided	103%	72%	47%



Some believe that current trends in New Jersey, Washington and Wisconsin are a sign that the mood of the country is changing. Perhaps; and there is a strong likelihood that some kind of discretionary non-defense spending cap will be imposed. But at only 12%-14% of government expenditures, there's only so much that kind of cap can accomplish. Growth can help as well; based on our calculations, fiscal deficits could be 3% in 2015 if annualized nominal GDP growth averages 6.4% over the next 4 years, even assuming an extension of all tax cuts, indexation of AMT and other deficit-unfriendly measures (see chart below). We don't think 6.4% will be consistently reached³, but the US might grow more than the 4.7% (nominal) assumed by the CBO.

In the long run, it's mostly about entitlements, which are at the heart of the \$6 trillion spending difference between the President's FY2012 budget and that proposed by Congressman Paul Ryan (R-Wis). As shown in the second chart, more than a third of the elderly lived in poverty⁴ when the second wave of entitlement programs were created in the late 1960's, a situation that no country would ever want to return to. The problem is that since that time, entitlements have grown by 11x while GDP has grown by 3x. The observation of CNBC anchors, "Medicare and Medicaid are popular with Americans so we shouldn't change them" adds little to a discussion of what the US can afford as a percent of its national income. US healthcare costs are the highest in the world, 2x the OECD average as a % of GDP, and 3x the OECD average on a per capita basis. What also sets the US apart: of the 33 most developed nations, 32 have been using some kind of universal health care for years.





Progressives like Paul Krugman take a different tack: raise taxes, and address healthcare. How so? By giving independent commissions the power to ensure that Medicare only pays for procedures with "real medical value"; rewarding health care providers for "delivering quality care rather than fixed sums"; and limiting the tax deductibility of private insurance plans. The quotation marks are meant to indicate his exact phrasing, but also the difficulty in defining these abstract terms in practice. The common feature among them is that **health care must be rationed**, either by individuals, or by the society which pays for them.

³ CBO Director Elmendorf said before the House Budget Committee that "the size of the current imbalance between spending and revenue is not something that can be closed through any feasible growth rate."

⁴ The poverty rate is defined by income threshold, and is designed to measure income inadequacy. For context, in 2009, the threshold for a household with two people aged 65 or older is \$12,968.

Eye on the Market | April 11, 2011 | J.P.Morgan

Logan's Run: the averted government shutdown, the debt ceiling and the long-term fiscal situation of the United States

It's not clear how the entitlement battle will play out. The United States has a deep-seated fear of government rationing, as if American exceptionalism would somehow eliminate the need for it. What does rationing look like to Americans, with some politicians talking about "death panels"? Like the 1976 film *Logan's Run*, with Michael York, Jenny Agutter and Farrah Fawcett. In the film, a world with insufficient resources maintains its equilibrium by killing everyone over the age of 30 (in the original book, the age was 21). The narrative revolves around how people are tracked through imprints in their hands, and how the protagonist tries to escape. It's just a movie, but it taps into American fears about who makes these choices, and how they make them. With 30% of Medicare expenses taking place in the last year of life, and with government healthcare spending outstripping education spending by 10x over the last 50 years, this issue will be very hard to sort out.



What about markets and portfolios? There's a time and place to factor long-term risks into portfolios, and the last two years have not been the right time to do it. A stimulus-fueled recovery in economic activity and risk-taking has been the dominant factor driving financial markets, overriding the doubling in US net debt/GDP ratios from 2007 to 2011. As of Q1, the US manufacturing and service sector recovery was among the strongest of the last 25 years, with prospects for a continued rise in capital spending. The US is also on the cusp of a long-awaited recovery in US labor markets, although rising energy prices may take some steam out of consumer spending (see last week's note for more details).

The United States is fortunate: unlike Greece, Spain and other countries that ran out of time, public and private sector investors are giving the US the benefit of the doubt. Treasury yields are stable, even with Fed support for Treasury markets expiring in the summer. The last 100 years of solvency, entrepreneurship, growth and military power led to the acceptance of the US dollar as the world's reserve currency, and of its debt markets as "riskless". The ballooning amount of government debt outstanding, the costs of servicing it and future entitlements could change that. Absent some of the changes discussed on prior pages, it may become difficult for markets to avoid factoring this in. In our view, the long-term US fiscal situation argues in favor of shorter-duration G7 government bond holdings, non-dollar assets and portfolios positioned for volatile markets (hedge funds, distressed assets and credit as a complement to equities). It also argues against applying 1990's valuation multiples to today's corporate profits. We are optimistic on profits growth this year, but do not believe the markets will be paying more for them.

Michael Cembalest Chief Investment Officer

OMB Office of Management and Budget CBO Congressional Budget Office

OECD Organization of Economic Cooperation and Development

AMT Alternative Minimum Tax

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. Securities products purchased or sold through JPMS are not insured by the Federal Deposit Insurance Corporation ("FDIC"); are not deposits or other obligations of 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 prov

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