Topics: US rating outlook; high dividend stocks; Spain, Greece; race between inflation vs jobs; hedge funds <> equities

In the wake of S&P changing its U.S. credit outlook from stable to negative, I would like to remind clients of the piece we published last week with our thoughts on this issue ("*Logan's Run: the Averted Government Shutdown, the Debt Ceiling and the Long-Term Fiscal Situation of the United States*"). Here are three quick bullet points to add to what we wrote last week:

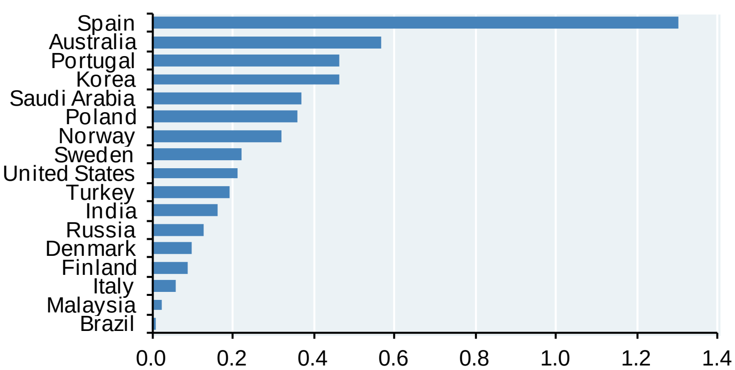
- Raising tax rates on America's aristocracy (> $250k in adjusted gross income) may seem like a good way to close the budget gap. But as we discussed before (EoTM Sept 2009), removing the Bush era tax cuts on the wealthy only closes 5%-8% of the CRFB's expected projected budget gap over the next decade. As a result, a lot of other hard choices will have to be made.
- One of those choices could be cuts to defense spending. If the defense budget were cut 20%, that could allow for tax cuts to be maintained, to prevent indexation of the AMT from affecting the middle class, and prevent physician reimbursement cuts
- There is an irony seeing Democrats on the hot seat for today's deficit. While healthcare entitlements closely associated with Democrats are considered the principal cause of *future* deficits, they play a smaller role in the deficit *right now*. Policies like Iraq/Afghanistan, the 2001-2003 tax reductions, and aspects of financial sector deregulation (e.g. 2004 change to Broker-Dealer Net Capital rule) bear more responsibility for today's deficits. These policies, like Medicare D, were created by Republican Administration/Congresses. But this is ancient history, and has little to do with the options chosen from here.

Spain: who's holding the bag? Spain's economic aristocracy, probably

As Greece, Portugal and Ireland enter Europe's "*Liquidity Hospital*", all eyes are on Spain. As for financial markets, it looks like Spain is de-coupling from the other three. Spain's credit spreads have tightened, its borrowings from the European Central Bank have declined, China has been buying its government bonds and is in very preliminary discussions to invest in Spain's troubled regional banks. All of these are positive signs. But Spain's economy is still quite weak (little improvement in retail sales or employment), and is only growing at around 1%. A rise in exports is more or less the lone bright spot.

Who's left holding the bag in Spain?

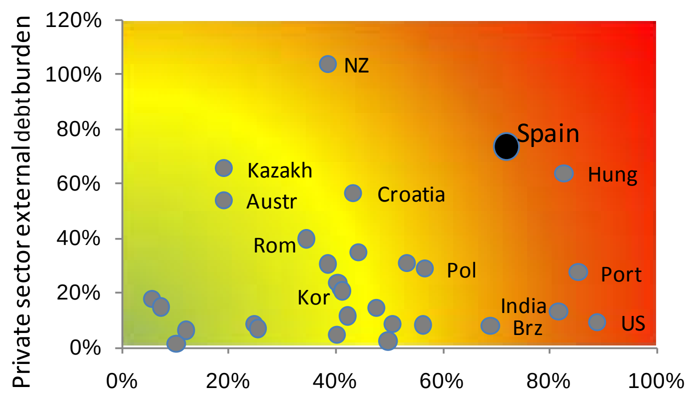
Net private sector external debt per unit of GDP growth, 2002-2009



Source: Fitch Ratings, J.P. Morgan Private Bank.

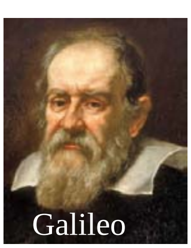
An inquisition into public and private sector debt burdens

Percent of GDP



Source: Fitch Ratings, J.P. Morgan Private Bank.

Over the last decade, **no country relied more on external debt[1] to finance growth than Spain**. It's net private sector external debt rose from $63 billion to $1.1 trillion from 2002 to 2009, allowing an increasing number of Spanish citizens to join its economic aristocracy. Now that Spain is settling into a low rate of growth, what happens to the lenders? One alternative to large-scale losses by lenders to Spain: a long period of debt paydown by Spanish borrowers. We think this is part of the reason why Spain's savings rate is so high (15%-18%), and why Spain is recovering so slowly. Capital spending, hiring and consumption are sacrificed in favor of paying down loans to foreign (and domestic) lenders. If that's the case, we expect to see continued increases in Spain's debt ratios, as its debt burden rises relative to the size of its slowing growing economy. Spain's debt no longer prices in much risk of a problem, which is why it looks expensive to us. Consider the inquisition in the second chart. While other countries saw their private sector borrow a lot from abroad, there are **few countries in the same league as Spain**, with a high combined level of both sovereign debt (shown on a gross basis), and net private sector external debt.



As for Greece, German Finance Minister Schauble continues to cast doubt on its solvency, and Reuters reported that an EU working group assumes the need for 40%-50% Greek debt forgiveness. This is unsurprising, given Greece's massive public debt (well over 120% of GDP), huge deficit and shrinking economy (at last count, by 6% per year). It is also worth noting that a 40% haircut on Greek bonds, which is what is priced into bond markets, would wipe out the Tier 1 capital of the Greek banking system. However, also this week, EU President Van Rompuy said a Greek restructuring was "out of the question" and French Finance Minster Christine LaGarde said Greek debt does not need to be restructured. Economic Affairs

[1] Our calculations are "NET", and include loans, deposits and bonds held by Spanish firms abroad as part of the computations.

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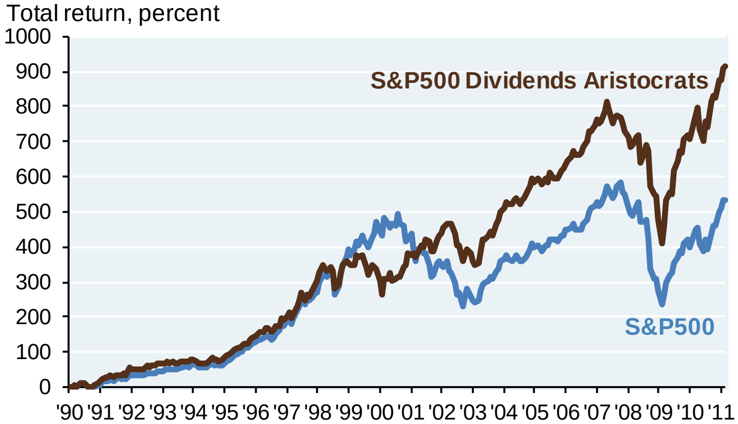
Commissioner Olli Rehn more or less said both: restructuring is not an option since there is too much contagion risk. It is at times like this that I am reminded that for centuries, Europe persecuted scientists like Galileo for saying that the Sun does not revolve around the Earth. **Denial is a powerful belief system**. Growth in Germany, the fact that European equities are priced cheaply relative to US equities, and Europe's high incremental profit margins are the best reasons to still own some of them.

<u>The Aristocrats</u>[2]

In a year like this, stock selection is increasingly important, as it does not appear to be a year characterized by broad-based strength or weakness across global equity markets. One of the strategies we find interesting: a focus on select dividend-paying stocks. Some companies raised dividends during each of the prior four years, demonstrating balance sheet flexibility and a commitment to shareholders. Many of these companies have the ability to maintain dividend growth rates of 7%-10%. Some are part of what S&P defines as the *Dividend Aristocrats*, which have outperformed the broad market since the end of the 1990's preoccupation with growth. We consider S&P's definition as an investment approach too constraining, since S&P requires 25 years of consecutive dividend hikes to be eligible for inclusion. There have been changes to business models (in technology, for example) that now place a much greater importance on returning cash to shareholders.

Outperformance of dividend-paying stocks since '99

Total return, percent



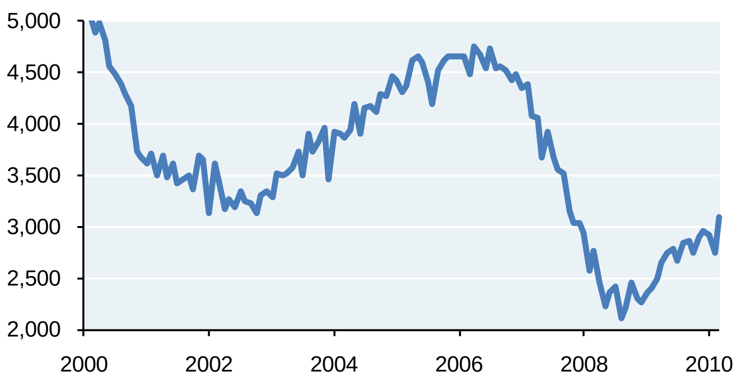
Source: Bloomberg.

<u>In the US, a race between inflation and jobs, and the implication for equity multiples</u>

Many economists were blind-sided by the rise in headline inflation which resulted in Q1 GDP forecasts being revised down to ~1.5%. The short term growth battle looks like this: **can the recovery in the labor markets offset inflationary pressures?** As shown below (left), the Bureau of Labor Statistics reports an increase in job openings, which is a sign that labor markets may improve from their currently dismal conditions. But job gains/wages need to rise consistently to offset rising inflation in terms of overall consumer purchasing power. As shown last week, rising food and energy prices offset the benefit of payroll tax cuts. In the chart (right), decent nominal spending growth in Q1 is lower in real terms once inflation is factored out.

A pick-up in job openings

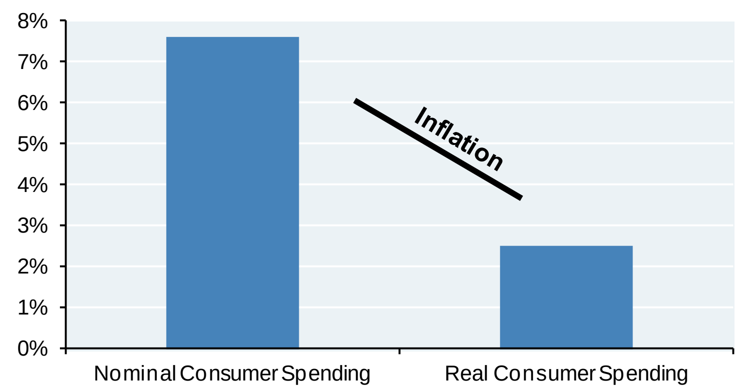
Thousands



Source: Bureau of Labor Statistics.

Inflation takes a bite out of consumer spending in Q1 '11

Percent



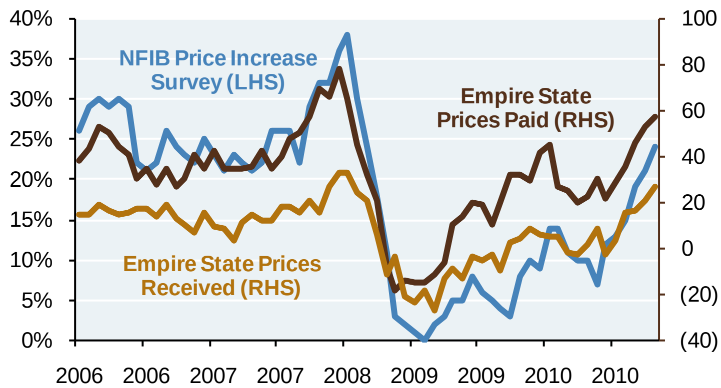
Source: Bureau of Economic Analysis.

[2] Be careful on Netflix. The Aristo*cats* is a G-rated animated Disney movie with Eva Gabor. The Aristo*crats* is an unrated movie about an extremely vulgar joke told by comedians that is for very mature audiences only.

Cost and price increases are also showing up in profits and corporate pricing intentions. Small business price increase intentions are rising, confirmed by rising prices paid and received in the Empire State Manufacturing Survey. Lastly, the Bureau of Economic Analysis tracks rising inventory costs. The more negative the "IVA adjustment", the lower the quality of corporate profits, since they include the benefit of selling lower-cost inventories that cannot be replaced the same price.

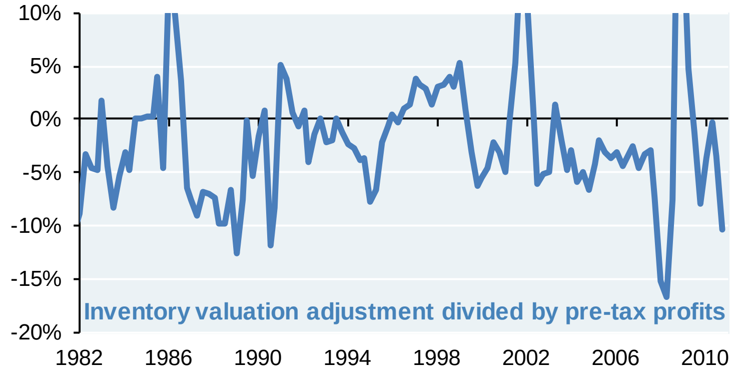
Business price increases

Businesses planning to raise prices (net)



Source: National Federation of Independent Business, NY FRB.

Adjusting for cost of inventory replacement, Q4 profits not quite as good as they looked

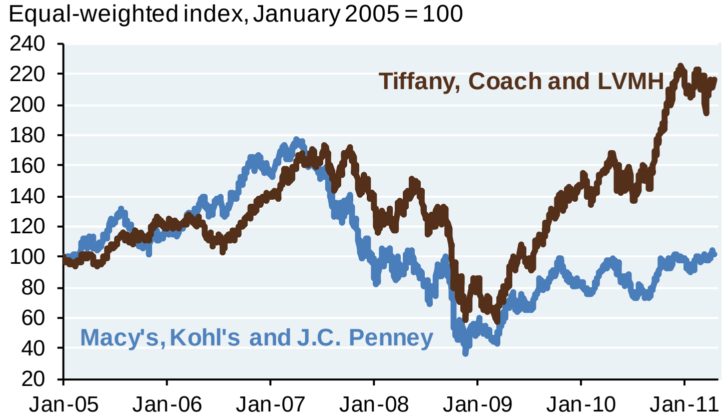


Source: Bureau of Economic Analysis.

Rising commodity prices are not a problem for **America's aristocracy** (see chart below, left), but may take a bite out of overall consumer spending if sustained. We're optimistic that a **capital spending and labor recovery will take place in 2011**, and are forecasting another year of profits growth for US large-cap companies. **We're expecting 10% S&P 500 profits growth in 2011 to roughly $94 per share.** Where we remain nervous is on valuation multiples (currently around 14x), given all the expected and unexpected headwinds that the global economy is facing this year. We are not expecting increases in P/E multiples until the world gets through monetary and fiscal policy withdrawal, and the current oil price surge[3].

US monetary policy "report card"

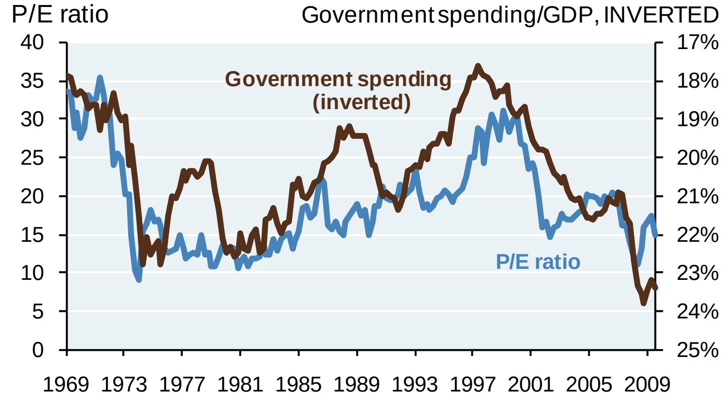
Equal-weighted index, January 2005 = 100



Source: Bloomberg.

Inverse relationship between spending & multiples (UK)

P/E ratio Government spending/GDP, INVERTED



Source: MSCI, Gavekal, UK Office of National Statistics.

We have included as a final chart something we first showed in September 2010. We picked the UK since 1969, but the chart looks similar for other countries as well. **High levels of public debt tend to correspond to periods of lower equity valuation multiples**. There's always the chance that the latest focus on the deficit will end up being the defining moment in a generation for the US, reversing a doubling of its debt/GDP ratio since 2007 (when it was 36%, a number we will probably never live to see again). But as S&P notes in today's credit outlook change, it might still "take a number of years before the government reaches a fiscal position that stabilizes its debt burden."

[3] On oil, there's a lot of commentary about large speculative positions driving prices. But to us, it looks like physical demand is behind today's prices, given spare capacity less than 3 mm barrels per day, declines in Libyan exports and 1.5 – 2.0 million barrels per day of incremental demand growth in 2011. A rough calculation shows that the value of oil cash markets are well over $3 trillion per year; the magnitude of ICE and NYMEX Brent and WTI futures contracts are less than ten percent of this amount.

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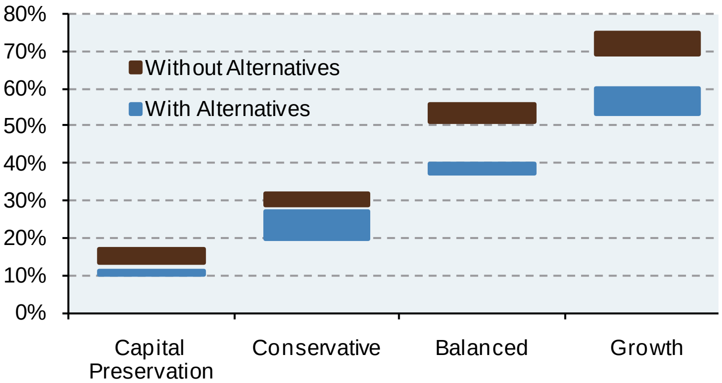
A quick comment on hedge fund and equity allocations

The chart below shows our equity allocations by portfolio across a range of regions and investment styles. Equities in this case include both publicly traded equity, and private equity. Where do hedge funds fit into this? While hedge funds take risk (and plenty of it), we do not simply add them to equity allocations when thinking about portfolio risks and returns. The 5 primary categories we use are long-short managers, event-driven managers, relative value credit, distressed and macro. Our long-short managers have the highest market exposure over time; currently, their aggregate net long position is around 25%, reflecting our bias towards using hedge funds for security selection purposes rather than directional market exposure. As for other categories, our managers' correlations and Betas to the S&P 500 are low enough that they are not simply a substitute for equities.

Range of our public equity plus private equity allocations
Percent of portfolio



Source: J.P. Morgan Private Bank, across all regions.

Hedge Funds not a direct proxy for equity markets
5-year Correlation and Beta of our managers to the S&P500

	Event Driven	Relative Value Credit	Macro	Distressed	Long/ Short
Correlation	0.46	0.61	0.15	0.71	0.74
Beta	0.28	0.50	0.06	0.40	0.38

Source: J.P. Morgan Private Bank.

Michael Cembalest
Chief Investment Officer

CRFB = Committee For A Responsible Federal Budget; AMT = Alternative Minimum Tax