

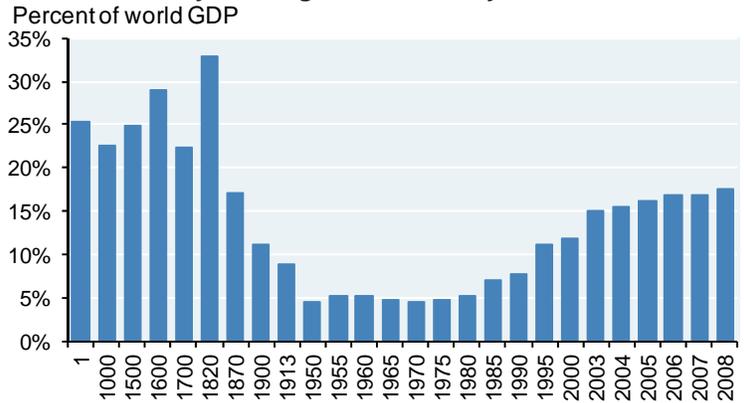
Market update. Recent US economic data continue to soften, as consumer spending, income, housing and manufacturing surveys have come in below expectations. It's too soon to tell if this is a temporary swoon like last year. The disconnect between subpar economic data and resilient equity markets is growing. Our views haven't changed since January: a recovery reliant on monetary and fiscal policy bazookas runs the risk of unexpected potholes, and negative feedback loops (higher commodity prices¹). Corporate profits are a clear bright spot, but require measures to address the negative personal income implications of all-time lows in relative wages. Our portfolios are positioned for a muddle-through kind of year.

On China. Last week, I had the opportunity to interview Dr. Henry Kissinger at our Institutional Research Summit on the occasion of his new book entitled "On China", and his 88th birthday. Opinionated, controversial, an unflinching believer in *Realpolitik*, unparalleled access to politicians around the globe, still an adviser to US Presidents; not much has changed for Dr. Kissinger in 50 years. This week's note summarizes the interview, which focused on China's past, present and future.

The Past

In Dr. Kissinger's opinion, there is no country whose view of the future is more influenced by its past than China. While the West sees China's meteoric rise, China sees a natural return to prominence after the interruption brought on by the Industrial Revolution. This disconnect has wide-ranging implications for investors, as it affects Chinese attitudes towards issues such as currency intervention, non-Chinese firms operating in China, Sovereign Wealth Funds, etc. Understanding China is an exercise in contradictions; in the latest American Chamber of Commerce in China Business Climate Survey, US CEOs cited inconsistent enforcement of laws (particularly intellectual property rights), difficulty in obtaining licenses, regulations limiting market access to sectors that used to be open, and China's Indigenous Innovation Policy (which favors local firms). Nevertheless, 75% of the respondents have higher Chinese margins compared to worldwide operations, and 91% are optimistic about the 5-year outlook.

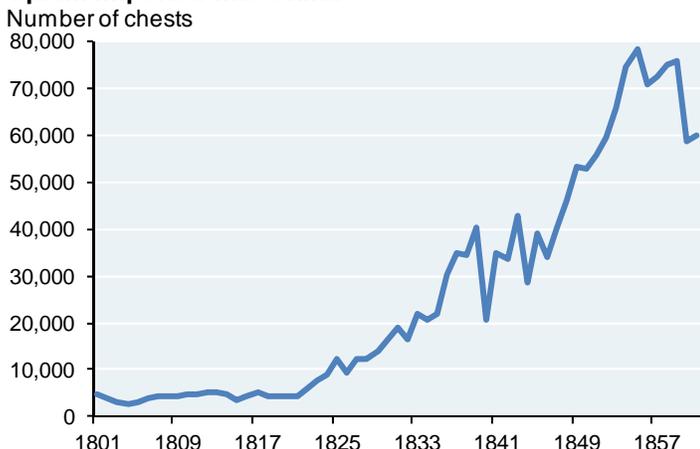
The 20th century was a growth anomaly for China



Source: Angus Maddison, Historical Statistics of the World Economy: 1-2008 AD. December 31, 2008.

We began our discussion of China's past by focusing on the 1800's, during the Opium Wars. In the 1800's, the United Kingdom exported a lot of opium into China, via India. Consequences were disastrous: a proliferation of drug addicts (27% of adult males), a surge in corruption and other criminal behavior, a breakdown in public morality, and an exodus of silver shipped abroad by addicts (see charts). The Chinese Imperial Commissioner sent a letter to Queen Victoria begging her to cease the opium trade, which was banned in China in 1729 (and again in 1836). For mercantilist reasons, the British ignored the request. After a Chinese blockade of opium ships, the British invaded in 1840, and easily defeated the Chinese. China was forced to sign the Treaty of Nanking, one of the more one-sided treaties in history. The opium trade then doubled, leading to another war (and Chinese defeat) 20 years later. This is not "ancient history" in China; the Opium Wars played a large part in the collapse of the Qing Dynasty and subsequent defeats and occupations by foreign powers (Japan, 1895).

Opium imported into China



Chinese silver outflows to England and India

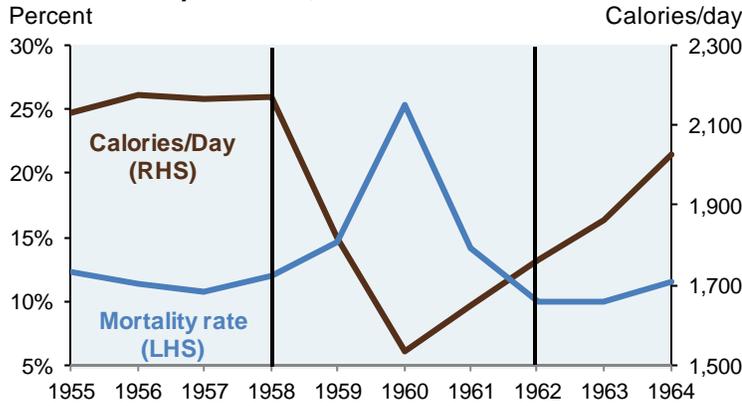


Source: "China Upside Down: Currency, Society, and Ideologies, 1808-1856", Man-houng Lin, Harvard University Asia Center, 2007.

¹ The Fed sees itself as driving equities higher, but not commodities. Faith is the illogical belief in the occurrence of the improbable.

China's post-war policies were designed to re-establish Chinese prominence, but left China in economic disarray, and at odds with the USSR. Both developments led to China's decision to open to the West. The *Great Leap Forward* was one of the 20th century's greatest self-inflicted disasters. Instead of conceding that China could not meet steel output targets, Chairman Mao required that industrial equipment be melted down into steel. This and other collectivist approaches resulted in a terrible famine and the deaths of tens of millions (the chart below shows the spike in China's mortality rate and collapse in caloric intake). This episode was followed by the *Cultural Revolution*, which decimated China's economic and political leadership. At the same time, China sought to reassert its regional prominence through a series of border skirmishes, including conflicts with South Korea (1950-53), Taiwan (1958), India (1962), Russia (1969), and Vietnam (1978). The Russian conflict in particular almost led to a broader war. According to Dr. Kissinger, this combination of economic and military challenges convinced Mao to open to the West, leading to the Nixon/Kissinger trip to China in 1972.

The Great Leap Forward, in Socioeconomic terms



Source: "Visualizing the Effects of the Great Leap Forward", Basil Ashton, '84.



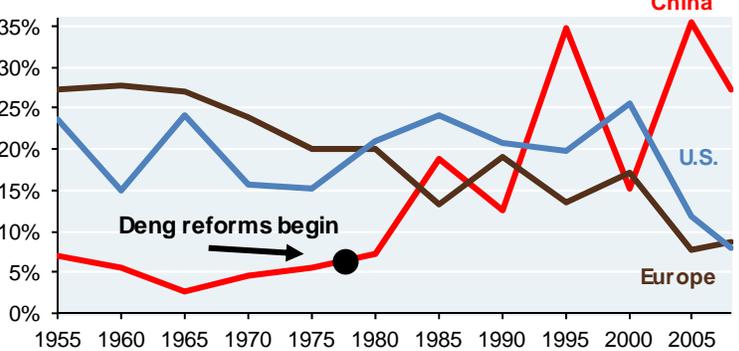
While Mao's decision to establish relations with the United States was done for political reasons, it eventually led to economic changes as well. In 1978, Premier Deng (twice jailed and exiled by Mao) began a series of reforms which integrated China's economy with the rest of the world, primarily through trade. With a Confucian mix of capitalism, communism and socialism, China's economy expanded rapidly, culminating in the chart at the lower right: China's contribution to world growth has eclipsed the US and Europe for most of the last two decades.

China's opening to the world best visualized through trade, Trade as a percent of Chinese GDP



Source: Penn World Tables. December 31, 2007.

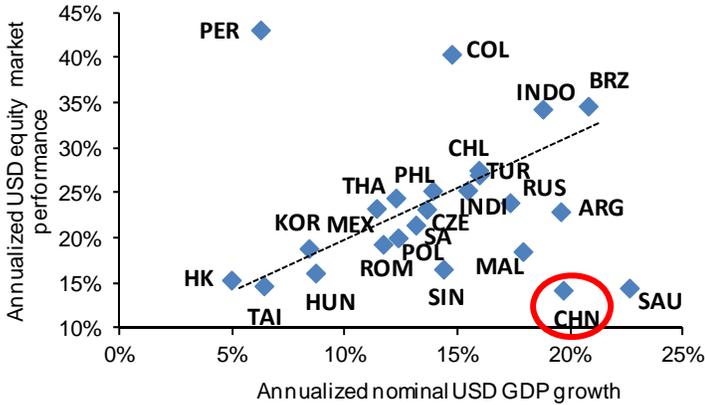
China's contribution to global GDP growth



Source: Angus Maddison, Historical Statistics of the World Economy: 1-2008 AD. December 31, 2008.

The chart on China's contribution to world growth is why we spend so much time evaluating its economic and political development; Chinese equities in their own right are a less important issue. China has become the dominant player in most commodity markets; it has become the centerpiece of an Asian growth engine which is lifting the entire region; and its trade and labor markets play a large role in the recovery of US and European corporate profits at a time of low growth in the West. As for Chinese equity markets, we spend less time on them. As shown on the following page, China is a notable exception to the rule that positive GDP growth generally translates into better equity market returns. China has the second worst equity market to GDP ratio in the developing world (the worst is Saudi Arabia), as its equity markets appear to be something of a liquidity casino reflecting the ups and downs of monetary policy, and the prevalence of current and former state-owned enterprises on the listed exchanges.

Equity markets vs. GDP growth - 2003 to the present



Source: International Monetary Fund, Bloomberg, J.P. Morgan Private Bank.

Liquidity drives Chinese equity markets



Source: Bloomberg, PBOC.

The Present

China's economy powered through the global recession, yet China still maintains a very low real cost of money, whether using headline or non-food CPI inflation to measure it. The consequence of this policy has resulted in rising inflation, continued expansion of China's investment share of GDP, and a decline in the *relative contribution* of consumption (although to be sure, Chinese consumption is rising rapidly on a standalone basis). Dr. Kissinger believes that this policy reflects China's aversion to chaos and desire for uninterrupted employment growth, particularly in the wake of uprisings in the Arab world fueled in large part by poor employment prospects.

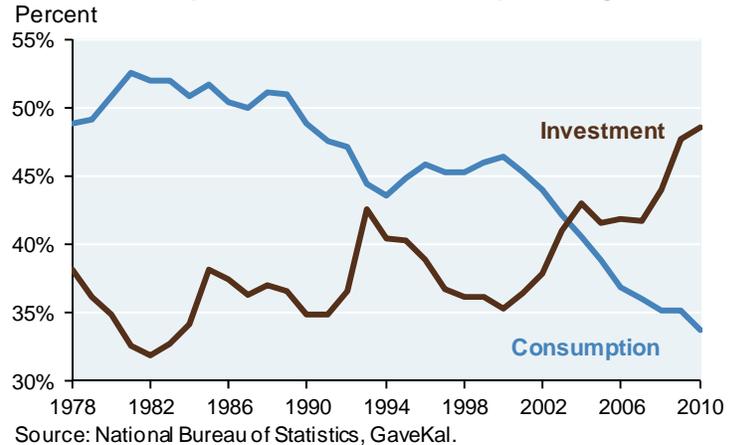
The real cost of money in China

One year deposit rate, less headline and non-food CPI, percent



Source: National Bureau of Statistics, PBOC, J.P. Morgan Securities LLC.

China consumption and investment as percentage of GDP

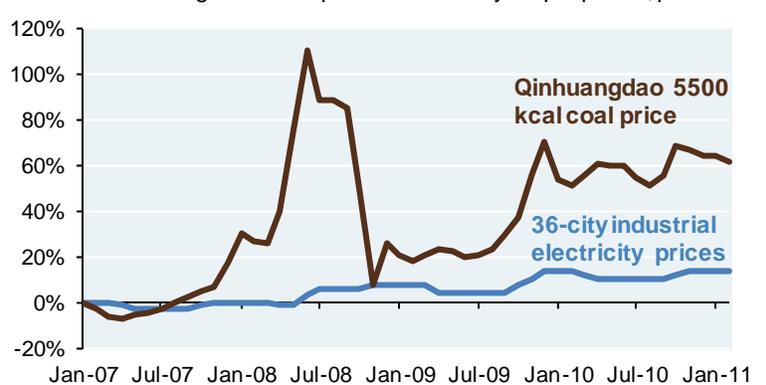


Source: National Bureau of Statistics, GaveKal.

Increasingly, the costs of an investment-led and price-controlled economy are becoming more apparent. One example: China does not want electricity prices to rise, so it caps the amount Chinese utilities can charge, despite rising coal input which makes up 70%+ of total input costs. As a result, Chinese utilities restrict the amount of electricity they produce at a negative margin. The power deficit in China could exceed 30-40 gigawatts this summer, more than all the power plants in Argentina. It reminds me of the decline in Pacific Gas & Electric and SoCal Edison in 2000, when California utilities suffered the same kind of margin squeeze (rising input costs and capped electricity pricing). The big picture is that on many occasions in China, **corporate profits take a back seat to price stability and social stability.** On Sunday, China raised non-residential electricity prices, but only by 3.5%, which is probably not enough to alter the negative margin dynamic.

China utilities cut output due to margin squeeze

Cumulative change in coal input and electricity output prices, percent



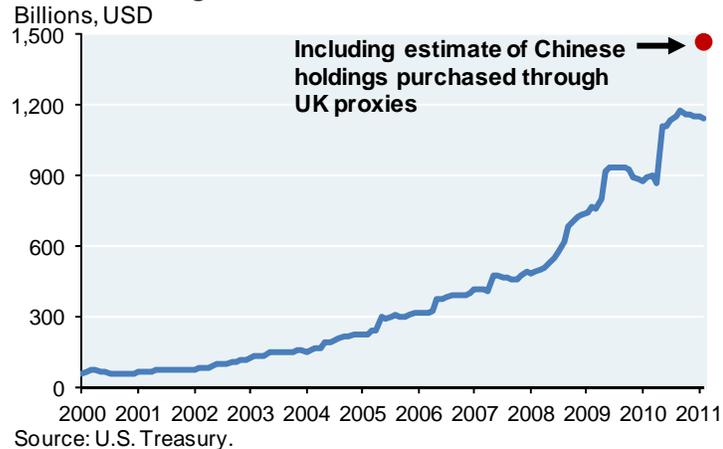
Source: CEIC.

The Future

Dr. Kissinger was clear about three beliefs: China is unlikely to use Treasury holdings as a weapon; North Korea is the largest potential trouble spot for US-Chinese relations; and China is intent on establishing the RMB as a reserve currency.

On the Treasury question, Dr. Kissinger could not recall another example of two competing super-powers that became so willingly intertwined with each other's debt. Usually, it takes war reparations debts to create bilateral obligations this large. He sees the situation as something of a Chinese Finger Trap; both sides are woven together in a predicament that requires cooperation to navigate. He does not believe China will use its Treasury holdings as a tool of diplomacy, despite recommendations by senior Chinese army officers to do so after US arms sales to Taiwan. China's State Administration of Foreign Exchange rejected the notion that China would do this, but there is precedent for military matters governing economic affairs. Berkeley's Barry Eichengreen reminded me of the **Eisenhower threat to dump its large holdings of British bonds in 1956 if the UK did not withdraw from the Suez Peninsula (which it then did).** Eichengreen believes that such a move would be counterproductive for China, since its massive Treasury holdings amount to \$1,000 per citizen, and it relies on the US as a major export market. He sees the greater risk as an economic one: if the US does not get its fiscal house in order, China would have a more rational basis to reduce its Treasury holdings.

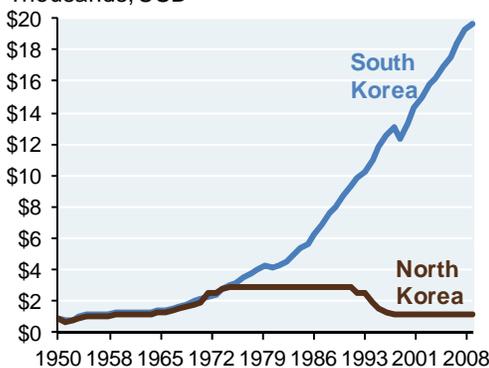
China's holdings of US Treasuries



North Korea is a topic we covered last November after the sinking of a South Korean submarine. As shown below, North Korea's economic disaster is like an unending *Great Leap Forward*. Consider this: the only country to experience a worse decline in the World Hunger Index from 1990-2010 than North Korea was the Democratic Republic of the Congo. Dr. Kissinger believes that China will be keen to protect its interests on the Korea peninsula when/if North Korea crumbles. A unified, West-aligned Korea is not necessarily something China would like to see on its border. According to a 2008 report by the Center for Strategic and International Studies, China has contingency plans to dispatch troops to North Korea in case of instability or regime collapse. According to something called OPLAN 5029, so do South Korea and the United States. This could get complicated.

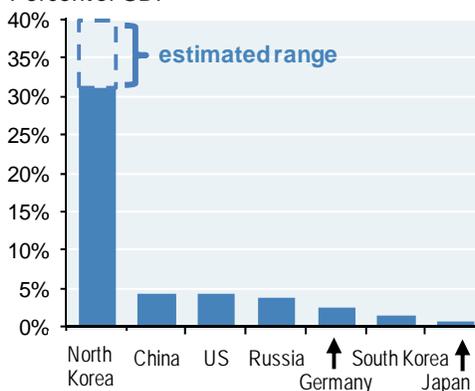
North Korea by the numbers:

Per capita GDP
Thousands, USD



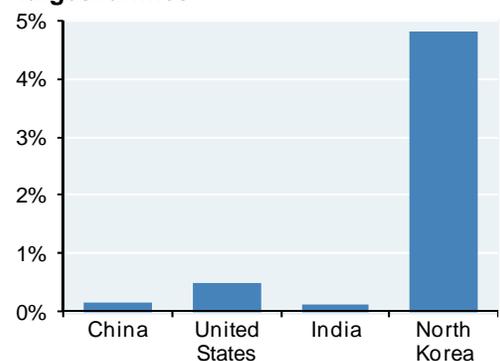
Source: "Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD", Angus Maddison, University of Groningen.

Military expenditures
Percent of GDP



Source: Korean Economic Institute of America.

Troop-to-population ratio of the four largest armies

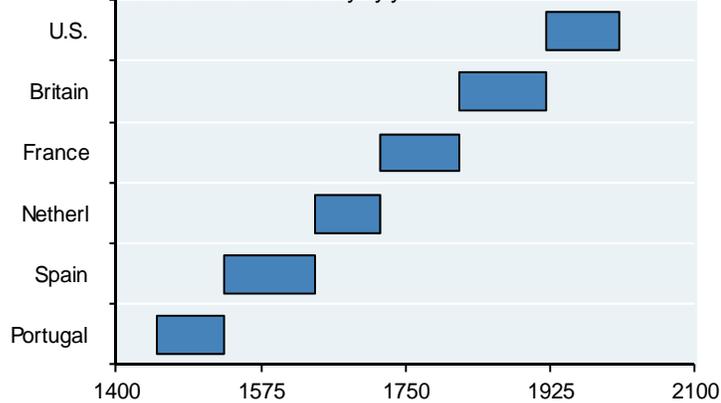


Source: "The Military Balance", International Institute for Strategic Studies (2005), CIA World Factbook.

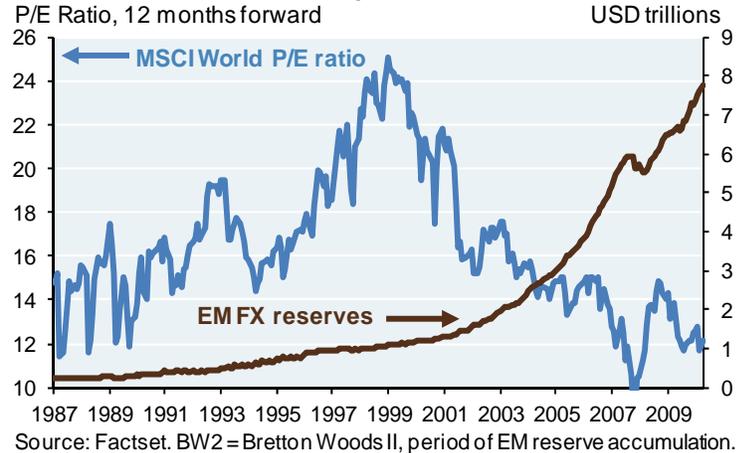
Dr. Kissinger believes that China is **serious about its intentions to establish the RMB as a reserve currency** (not necessarily the reserve currency). He conceded that his friends in academia see the prospect as remote in the near term, but believes that China is moving in this direction. The latest data from the Bank of International Settlements shows how far China has to go: only 0.3% of FX transactions took place in RMB in 2010. Recent issuance of RMB-denominated bonds by the World Bank, an RMB-denominated IPO by a Hong Kong REIT and the meteoric rise of RMB deposits held in Hong Kong mark the beginning of a process that should gather speed in the years ahead. Of course, internationalization of the RMB is broadly inconsistent with government intervention in currency markets, so at some point, China will have to choose. We have shown the chart on the following page before. It plots the roughly 100-year life span of reserve currencies since the Portuguese Escudo; usually an over-extended military and declines in relative productivity mark the end of an era.

The world's reserve currency: is China next?

Dominant world reserve currency by year



Source: Hong Kong Monetary Authority.

Is BW2 the reason P/E multiples have never recovered?

Source: Factset. BW2 = Bretton Woods II, period of EM reserve accumulation.

Conclusions

There are a lot of angles to China not presented here; this note summarizes a discussion with Dr. Kissinger, who focuses on geopolitics rather than markets. **Nevertheless, it captures four aspects of China that influence our investment views:**

- China is unlikely to be swayed by US or European calls for much more rapid currency revaluation. We are bullish on the Asian currency bloc, but expect appreciation to be gradual rather than sudden.
- China's dual market/command economy generates rapid GDP growth, which is great for the Asian region, but operates in a manner that is not as positive for Chinese equities themselves.
- Using massive reserve accumulation to foster development is untried and untested, at least in the magnitudes involved (emerging economies accumulated \$3.7 trillion in FX reserves over the last 4 years). This is arguably the largest monetary policy experiment in history. The uncertainty may partially explain why P/E multiples have not expanded in the last decade, restricting equity market gains (roughly) to profits growth and buybacks. On the plus side, P/E multiples are not expensive; forward earnings yields for the S&P 500 are now higher than junk bond yields for the first time on record.
- China's growth is commodity-intensive, even during periods of monetary tightening. Two examples: social housing and public sector infrastructure. While China attempts to slow the private sector real estate frenzy, its 5-year plan entails the government constructing (or financing) 36 million of units of low-cost housing on its own, as well as over 30,000 hospitals. And while private sector projects may slow with rising interest rates, the government still has ambitious plans regarding power generation, the electrical grid, rail connections, urban subway systems and water-resource facilities. Commodity prices are prone to booms and busts, as both sentiment and leverage can overwhelm fundamentals (e.g., silver in 2011). But with 1.3 billion people in China (and 1.1 billion in India) joining the global economy, commodity markets (copper and oil in particular) may never be the same. We are on the lookout for oversold commodity conditions, with an inclination to add.

Dr. Kissinger closed by noting that he was worried about the ability of US and Chinese policymakers to navigate their way to a lasting peaceful co-existence. Wouldn't it be ironic if China's bloated holdings of US Treasuries ended up forcing both countries to find a way?

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