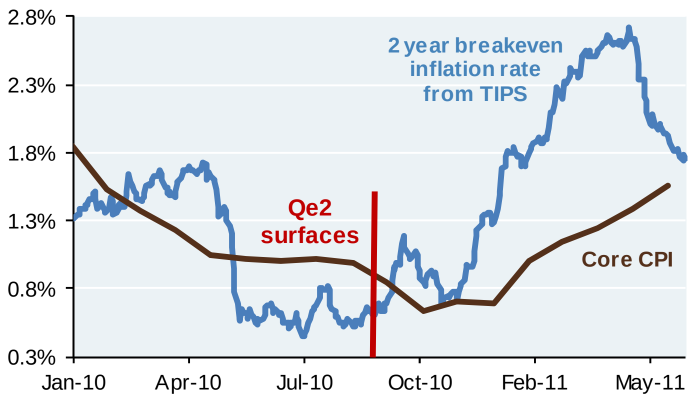
Topics: The global recovery has to grow up on its own

Helicopter Men, Grounded. Over the last 2 years, it has been hard to disentangle how much of the global recovery was organic, and how much was a byproduct of stimulus (monetary and fiscal). We are now going to find out how fast the world can grow on its own, relying on the private sector. **Political and economic factors are bringing the era of the Helicopter Men (and not just Helicopter Ben) to an end**. Markets are likely to be in for a bumpy ride as this takes place, with reduced return expectations for financial assets. How to adapt? As I said to my wife when we were discussing investments recently, my highest conviction portfolio idea may be this: *let's spend less money*. We still expect single digit returns for stocks, credit and hedge funds this year by the time it's over, but the current pace of private sector activity needs to improve for this to happen. In this week's note, we review constraints on the Helicopter Men in the United States, Europe and China.

On the US Helicopter Men: out of bullets in both barrels

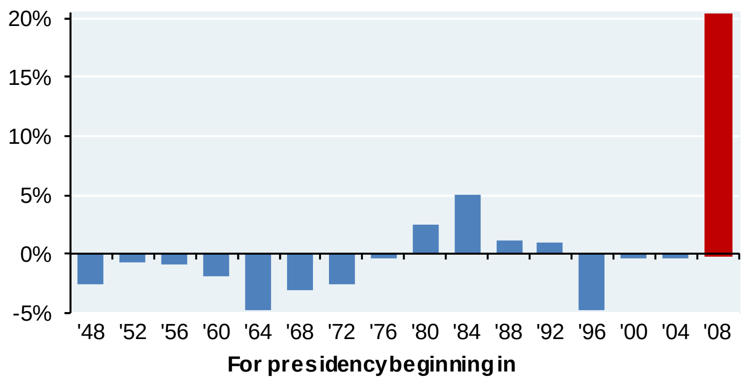
The Fed would have a lot of explaining to do if it engaged in more quantitative easing now. As shown below, US inflation and inflation expectations have risen since August 2010 when Qe2 was surfaced. **Qe3: off the table unless things get much worse**. As for more fiscal stimulus, that looks like a long shot as well. Some research reports earlier this year put forth the cocktail napkin aphorism that "US equity markets do well in the third year of the electoral cycle, since Presidents spend money to get re-elected". Let's assume that this effect does explain the historical phenomenon of better stock market performance in year 3. The problem: as we first wrote a year ago, in prior electoral cycles, Federal debt/GDP did not increase by 20% in years 1 and 2, so incumbent administrations had ammunition to spend. This time, it did, and they don't (see chart).

Inflation and inflation expectations: falling before Qe2
Breakeven: percent, CPI: percent change, YoY



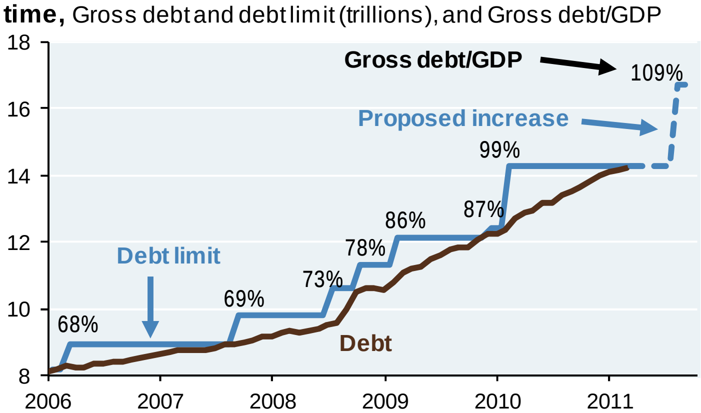
Source: Bloomberg.

This cycle is different: less ammunition to spend
Increase in federal debt/GDP from inception of presidency



Source: Bureau of Economic Analysis, OMB.

Debt ceiling to be raised above 100% of GDP for the first time, Gross debt and debt limit (trillions), and Gross debt/GDP



Source: US Department of the Treasury, J.P. Morgan Securities LLC, J.P. Morgan Private Bank.

The US will have to recover on its own
Institute for Supply Management surveys

Source: Institute for Supply Management.

It would also be odd to see more fiscal stimulus while the debt ceiling debate takes place. The latest discussions reportedly involve a $2 trillion increase in the debt ceiling, and $2-$4 trillion in long-term deficit reduction over the next ten years. The deficit reduction reportedly would be comprised of cuts to discretionary and non-discretionary spending, itemized budget caps, Medicare reform and revenue-raising efforts (e.g., higher tax collections). Entitlement reform has been the third rail of American politics, so we'll believe it when we see it.

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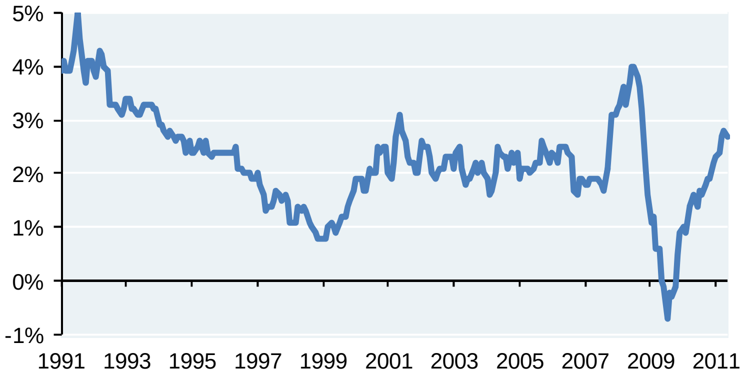
With the US Helicopter Men grounded, the US economy is going to have to recover on its own. We don't see much chance of a large payroll tax cut, or a repatriation holiday for accumulated offshore profits (since it didn't do anything to help hiring last time they tried it in 2004). We expect corporate profits and capital spending increases to eventually result in higher payrolls, and there should be some benefit from the end of Japanese supply-chain disruptions. It also looks like gasoline prices are rolling over. It will probably take until the end of the summer to see whether things turn around, which would be reflected in leading indicators such as surveys of manufacturing and services (see last chart on prior page).

On Europe's Helicopter Men: worried about inflation, and sticking to IMF austerity ideology

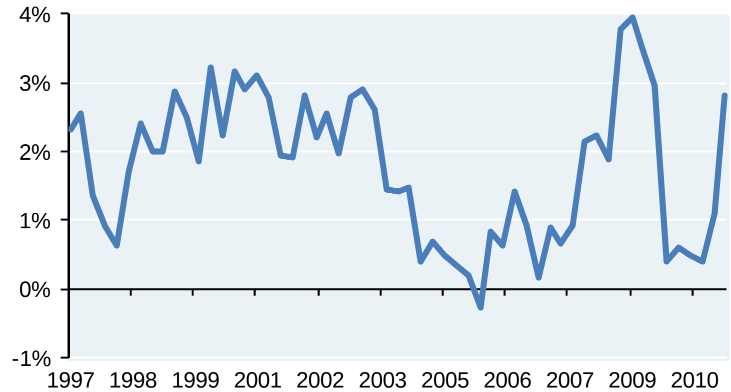
It's getting harder for the ECB to keep policy rates low when headline inflation and German wages are rising. ECB rate hike expectations have fallen by 1% in recent weeks as data weakened, but rates are still going to have to rise from current levels.

EU headline inflation on the rise
Annual percentage change in Eurostat HICP, nsa



Source: Bloomberg, Eurostat.

Germany labor costs on the rise
Percentage change, compensation per hour, YoY, sa

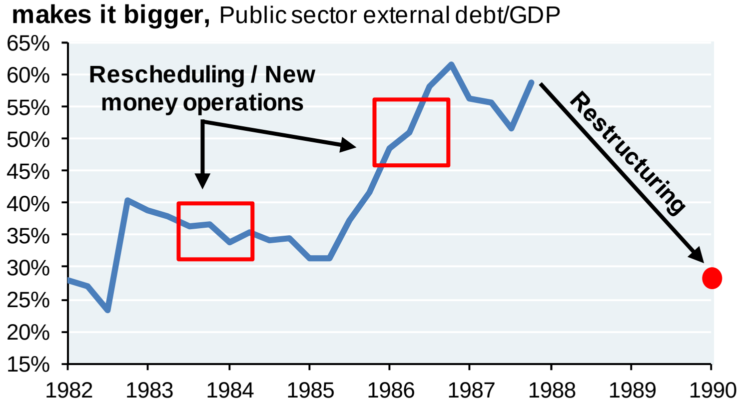


Source: German Federal Statistical Office.

As for fiscal transfers from the EU's Helicopter Men (and their partners at the IMF), there appears to be another "deal" for Greece. **Let's be clear**: so far, the EU and IMF have presided over a large transfer of exposures from European banks to the European Central Bank; an economic collapse in Greece; and the partial destruction of the civil society that has existed in Greece since the end of its Military Junta (1967-1974). The latest deal promises more of the same: some money from bilateral sources, rollover of maturing debt (primarily by Greek banks) and some Greek asset sales.

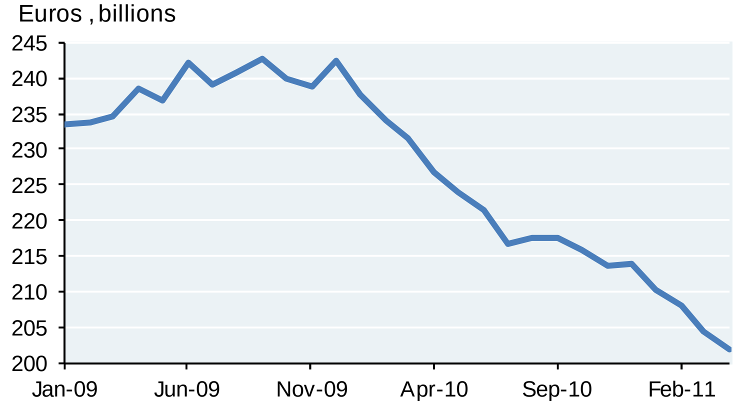
Let's take a step back from the monthly melodrama for a moment. In the context of the 1980's timeline involving Mexico and its external creditors, **the EU/IMF and Greece are somewhere in the middle, still reluctant to embrace a durable resolution to the crisis**. In Mexico, all the 1983/84 and 1986/87 Rescheduling and New Money Operations (also known as the Baker plan) did was to prolong and increase the size of the problem. By not resolving Greece's GDP and employment growth questions, the current approach will likely do nothing to reverse private sector capital flight, or restart private investment. As Greek deposit outflows continue, Greek banks do not have many liquid assets left to sell, and must primarily rely on borrowings from the ECB to fund them.

Mexico's lost decade: kicking the can down the road makes it bigger, Public sector external debt/GDP



Source: Mexico Ministry of Finance and Public Credit.

Greece retail bank deposits: slow-motion exodus
Euros , billions



Source: Bank of Greece. Data of April 2011.

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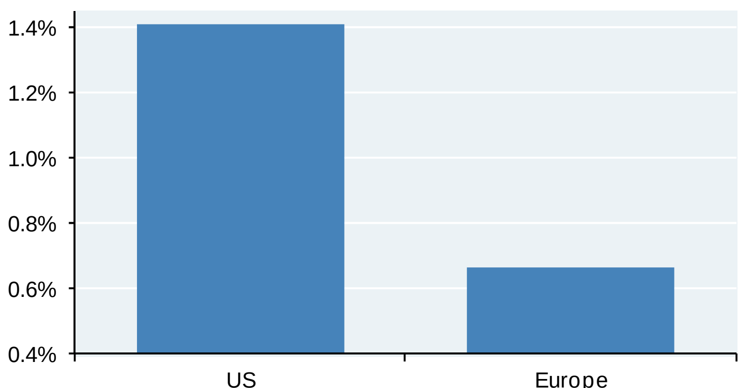
The IMF is swimming upstream in supporting the current plan, and surely they know it. Why?

- **In the past, countries in similar situations devalued by 35%-50%** (including Greece in 1989, and Spain in 1982)[1], and/or obtained debt forgiveness. I don't know of any countries that relied solely on austerity, privatization[2] and structural reform to solve the problem (maybe Latvia, but its debt is one third of Greece's and did not have a domestic banking crisis). Mexico did an enormous amount of structural reform in the 1980's[3] (way more than Greece now), but still needed 35% principal forgiveness (not just rolling over of debt). By the time it's over, Greece will probably need much more.

- **It is risky to impose austerity without clear burden sharing by creditors**. From the World Bank's own archives, in 1990: "*Mexicans have made such enormous adjustments, accepted such a large reduction in living standards, that* ***any package without an extensive and visible contribution by external creditors would not be acceptable domestically***"[4]. Why the official sector doesn't reflect on its own experience and judgment is an open question. More recently (2001), an IMF-sponsored "austerity without creditor participation" plan failed in Argentina, forcing President De La Rua to flee the Presidential Palace in a helicopter (Argentina defaulted the following spring).

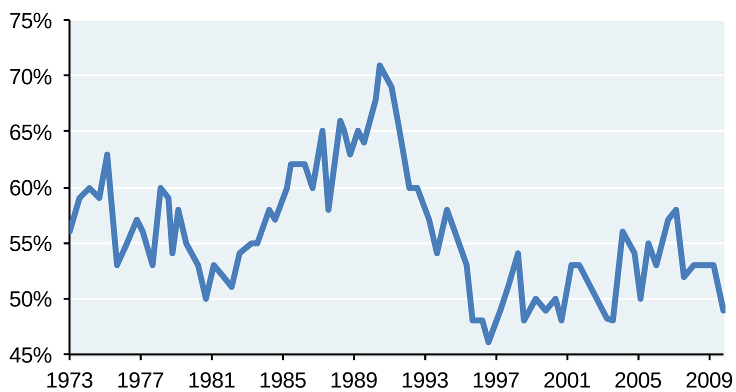
Instead, as we enter month 18 of the European sovereign debt crisis, the EU and IMF continue with an approach designed to help EU private sector banks. EU bank exposures to Greece are shrinking[5], but mostly through transfers of the exposure to EU governments and the ECB through purchases, loans and repos. A clear way to visualize the wealth transfer taking place: EU banks have raised half the equity as US banks since March 2009. After all, why raise equity when the public sector will be left bearing the losses? Meanwhile, as this saga progresses, support for EU membership continues to erode.

Capital raised by financial institutions since March 2009
Percent of total assets



Source: Goldman Sachs.

"Is EU Membership a good thing?"
Eurobarometer poll respondents, percent



Source: European Commission - As of June 2010.

We are underweight European equities, European high yield and sold peripheral European sovereign debt from portfolios long ago. Our preferred approach to the region is to hold mostly German equities, and participate in distressed loan sales by overleveraged European banks. One example: one of our managers recently purchased a deeply-discounted Spanish credit card portfolio and associated servicing operations in anticipation of more sales to come.

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1 From our 4-dimensional devaluation, growth, debt ratio and export chart from May 2010.

2 We are taking the *under* on Jurgen Stark's reference to 300 bn Euros in privatizable Greek assets. An excellent June 10 piece from J.P. Morgan Securities LLC walks through some history on nationalized asset sales. For example, **after the legalities and regional politics, only 7% of Italy's non-financial assets were disposed in 2003**. We reviewed Greek privatization prospects two weeks ago in the EoTM; it is one of the most aggressive in history, given its compressed timeline and reliance on illiquid real estate.

3 In the 1980's, Mexico's structural reforms were massive. Mexico cut government spending by 40%; froze minimum wages; reduced sectors covered by tariffs from 100% to 20%; reduced maximum tariff rates from 100% to 17%; removed prohibitions against foreign ownership in mining and petrochemicals; lowered marginal tax rates to OECD levels; and abolished forced allocation of commercial credit towards favored sectors. At the same time, over 750 state-owned enterprises were sold or liquidated.

4 "*Mexico's External Debt Restructuring in 1989-90*", June 1990, S. van Wijnbergen, World Bank Regional Working Paper 424.

5 **EU Solidarity Award of the Week**: French Secretary of State for European Affairs Laurent Wauquiez, as reported by Reuters: "French banks are exposed to Greece...(but) they are less exposed than the German banking sector, for instance."

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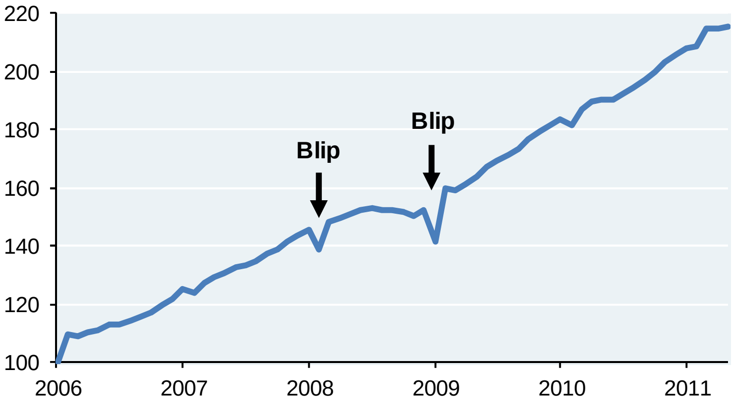
<u>On the Chinese Helicopter Men: almost done reining in prior stimulus? Probably not</u>

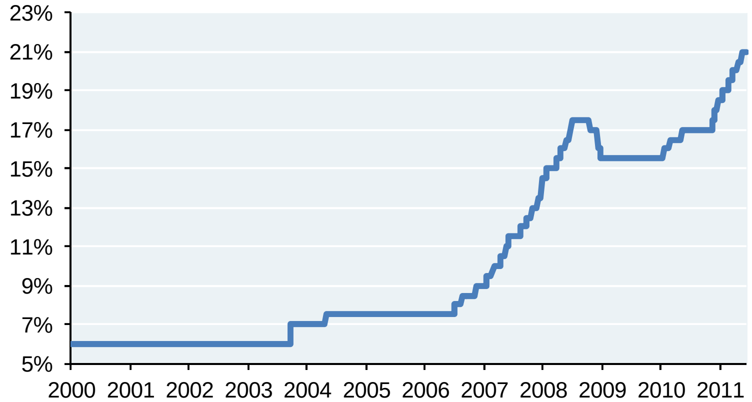
In China, one could argue that the Helicopter Men never should have boarded in the first place. The financial crisis and global recession show up as mere blips on Chinese industrial production (see first chart). Nevertheless, China engaged in substantial monetary and fiscal stimulus, which led to an overheated rebound in 2009-2010. Then, once inflation started rising, China raised reserve requirements above their 2008 peak to try and rein things in (see second chart).

China real industrial production
Index, 2006=100, sa



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

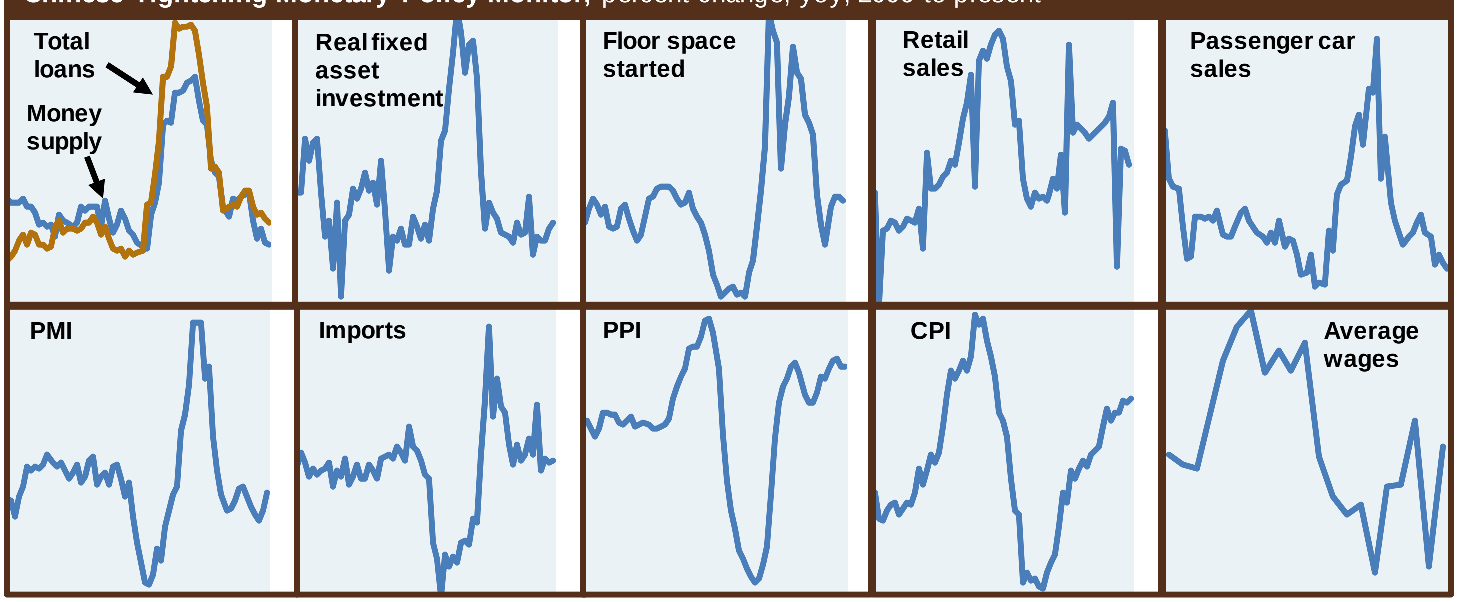
China reserve requirement ratio for large banks
Percent



Source: People's Bank of China.

Our monitor shows how the Chinese economy has reacted to tighter bank reserve requirements. Leading indicators, bank loans, money supply, imports and consumer categories have rolled over. This is what we look at to try and answer one of the most important questions of the day: **is China almost done tightening monetary policy?** Weaker data could help bring producer and consumer price inflation back down. However, Chinese bank deposit rates are still below the rate of inflation, which implies a low (or negative) real cost of money. As a result, China will probably have to raise interest rates and not just rely on administrative controls to do the job. The same holds true for other EM countries as well, where wage growth is often higher than consumer price inflation, and where credit creation is very high. An EM slowdown creates some risks for US and European corporate profits, which as we have pointed recently, rely more and more heavily on Asian demand (that's why high US profits growth has co-existed with only 2% real growth in the US).

Chinese Tightening Monetary Policy Monitor, percent change, yoy, 2006 to present



Source: National Bureau of Statistics, PBOC, China Automotive Information, China Economic Information Network, CLSA-Markit.

The good news: Asia is going through a traditional over-heating phase; once inflation is under control, there's a lot of positive momentum in the region. We see value in Asian (ex-Japan) equities at current levels, a bit less than 12 times forward earnings.

Michael Cembalest
Chief Investment Officer

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