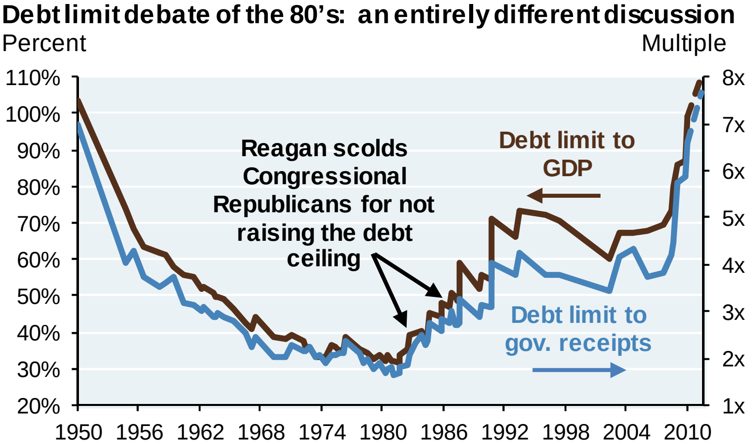
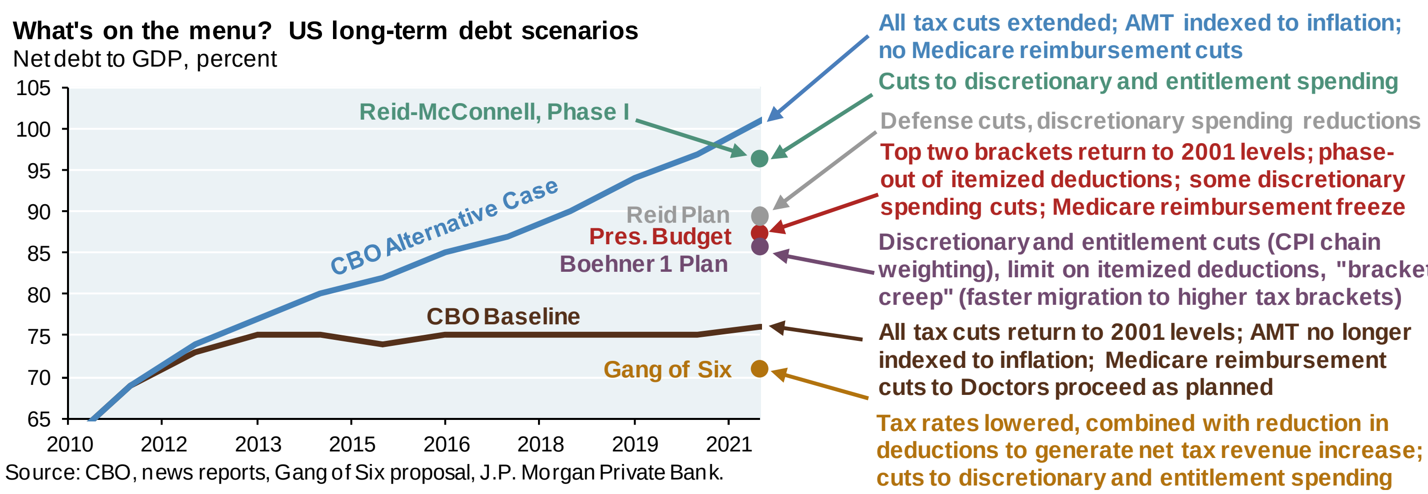
Topics: US debt ceiling negotiations, a more ambitious European bailout plan (finally), and how large cap growth stocks and rising corporate profits are patiently waiting for both of them to end

White Castle. Twenty five years ago, I had a friend with a peculiar way of responding to seeing things he didn't like on TV: he would throw White Castle hamburgers at the screen. I always thought this was a bad way to waste a good hamburger, but I had one of those moments the other night when watching news reports on debt ceiling discussions. Media outlets have referred to President Reagan's scolding of Congressional Republicans for delaying debt ceiling increases, and the 18 increases that took place during his Presidency. The implication: reservations about raising the debt ceiling are as irresponsible now as they were then. **This is a disingenuous argument; in the 1980's, the debt ceiling being debated was 50% of GDP, and had no bearing on the solvency of the United States**. Today, the proposed increase raises the debt limit twice as high, measured relative to GDP or government revenues. While a default is a *very* bad idea (deserving of a White Castle hurling of its own), unconstrained debt growth with no plan to slow it is bad as well. Some suggest we not worry about debt growth, since demand from foreign central banks and the Federal Reserve would keep yields in check. That logic is irresponsible at best. Debt limit legislation is a rocky but healthy way for a democracy to decide whether mega-deficits are in the long-term public interest.



Source: OMB, BEA, J.P. Morgan Private Bank.

Over the last few days, the Gang of Six plan, the Reid-McConnell plan and the Obama-Boehner plan have all been raised up the flagpole and then lowered. By the end of the process, we're still looking for deficit reduction of $3 trillion+ over 10 years (relative to the CBO Alternative case in which there is no deficit reduction at all). However, Congress is running short on time, and may have to do a smaller debt ceiling increase/deficit reduction first. For now, we wait to see the balance of spending cuts and revenue increases[1] will be agreed to. Last week's *Profiles in Courage* piece walked through the history and dynamics of this process, so we won't repeat that here. **Here's our take on what has been proposed so far**, with the caveat that many plans are not crystal clear what baseline they are using[2], or what steps they recommend to get to that baseline first.



Source: CBO, news reports, Gang of Six proposal, J.P. Morgan Private Bank.

[1] On the AMT: the Tax Policy Center estimates that if the AMT is not indexed to inflation, it would impact 31 million filers in 2012 (and raise $132 billion in revenue), compared to 4 million filers in 2011 (and $39 billion in revenue).
[2] For example: the Gang of Six state that they used the President's budget as a baseline (scored by CBO in March 2011), reduced deficits by $3.7 trillion, and ended up with a 71% debt/GDP ratio; but they do not explain how they get to the President's baseline in the first place.

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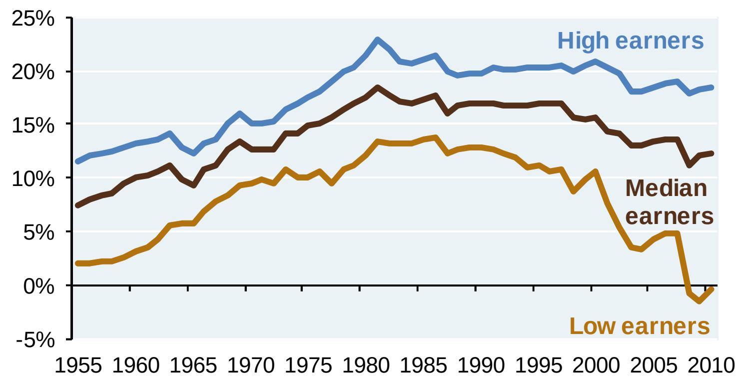
I have a feeling that revenue increases will be a material (e.g., 25% or more) part of the deal. The Peterson Foundation's sampling of 6 policy groups shown below indicate that 5 of 6 recommend revenue increases compared to where we are today; the Heritage Foundation's "*Woody Guthrie Memorial Budget Plan*" is the only exception. What kind of revenue increases? Raising the top two brackets, which would affect joint filers with adjusted gross incomes above $212,300, would raise $450-$700 billion over 10 years (depending on whether you use OMB or CBO numbers). If they cannot agree to raise *rates*, another option (as in the Gang of Six plan) would be reductions in the deductibility of state and local taxes, sales taxes, mortgage interest, etc. As this gets sorted out, let's hope everyone recognizes that the US tax system is already progressive. As shown in the chart below, effective Federal tax rates for low earners have dropped to zero over the last decade, even after including FICA taxes. News reports that the US tax system is regressive make me want to throw hamburgers at the screen.

Revenues and Spending	*as a % of GDP*	
	Revenues	Spending
Fiscal year 2011	15.3%	24.1%
Fiscal years 1950-1969	17.5%	18.1%
Fiscal years 1970-2010	18.0%	20.8%
Estimates for 2035:		
CBO alternative case	19.5%	33.9%
American Enterprise	19.9%	22.8%
Bipartisan Policy Center	23.1%	23.7%
Center for Am. Progress	23.8%	23.2%
Economic Policy Institute	24.1%	27.8%
Heritage Foundation	18.5%	17.7%
Roosevelt Institute	22.9%	24.8%

Source: OMB, CBO, Peterson Foundation 2011 Fiscal Summit.

What a progressive income tax system looks like
Combined effective federal income and FICA tax rates



Source: Tax Policy Center.

<u>Europe: Finally (!!), but now what?</u>

For the first time since 2009, it felt last week like European policymakers were trying to get out in front of things. In exchange for a modest amount of "private sector involvement", Germany agreed to more generous financing terms for Greece, Ireland and Portugal, and an expanded role for the EU-IMF lending facility (see following page). What would the plan accomplish if implemented? While Greek debt to GDP ratios would remain well over 125% of GDP (the IMF estimate for next year is a ridiculous 170%), Greece's near-term financing obligations would decline, due to debt buybacks, exchanges into long maturity bonds, and interest grace periods on new EU loans. More broadly, the plan also allows for money to be lent to countries *before* they enter into an IMF program, for recapitalization of banks. **All things considered, it's the broadest defense of the Monetary Union so far.** On paper, it even looks like a **free ride** for holders of Greek paper that don't participate in the debt exchanges (they would be paid at par). So, what's not to like? Well, there are still questions about Greece:

- There's a big difference between generous *financing* terms and generous *economic* terms. Greece must still meet an enormous 5%-6% primary budget surplus target (government revenues less spending, pre-interest) during a recession
- Greece must execute on its asset sale targets, despite having little success or experience doing this in the past
- Banks listed in the IIF document (the committee representing them) are under no binding legal obligation to participate in the debt exchanges, and may turn out to own less Greek debt than currently believed. [Note: bank participation in the Latin Brady bond era was high, since at the time, banks held almost all the paper, and in the form of illiquid loans].

The big question: **would Germany still live up to the deal** if Greece missed deficit targets or assets sales, if bank participation was too low, or if hedge funds (once referred to by the Chairman of the German Social Democratic Party as a "swarm of locusts") reaped large free rider windfalls? Ultimately, this is a political question. If "yes", Germany will underwrite Greece no matter what; if "no", then a broader, coercive Greek restructuring might follow in the not-so-distant future[3].

[3] This could get complicated. If there is a need for further debt forgiveness for Greece, will policymakers find a way to "ring-fence" the banks that participated in the first round, and impose losses just on the hold-outs? Will the EU tell banks that if they don't participate, their older bonds will not be eligible for financing at the ECB?

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What the EU gave: an easing of lending conditions, and an expanded role for the EU lending facility (EFSF)

* Another 109 bn for Greece, allowing the country to continue to pay off maturing debt (to those not participating in the exchanges)
* Rate on new EU loans to Greece, Portugal and Ireland cut to 3.5%, maturities on new & old loans extended from 7.5 to 15-30 years
* 10 year grace period on interest on new EU loans to Greece; the unpaid interest accumulates
* EU loan facility has the ability to buy sovereign debt in the secondary markets, including a plan to purchase 40 bn of Greek debt (most likely including much of the Greek debt purchased by the ECB)
* EU loan facility has the ability to lend to countries (even those not in an IMF program) to recapitalize their banks
* Language (with no specifics) regarding the use of EU structural funds to boost growth in Greece

What the EU gets: more austerity, Maastricht with teeth (?) and private sector involvement in Greek debt rollover

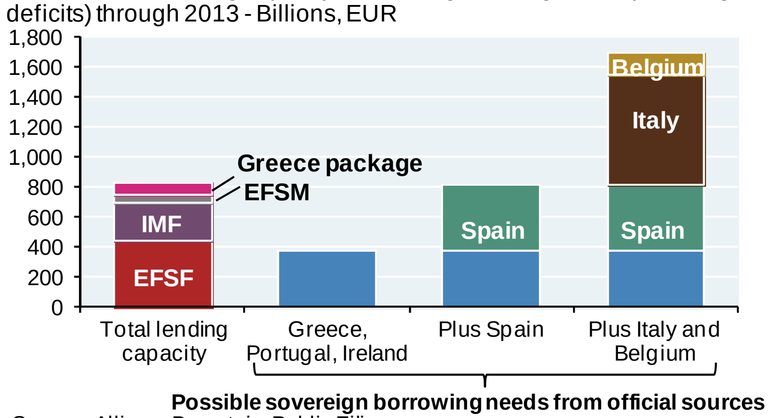
* Legally binding national fiscal framework to be developed by end of 2012; fiscal deficits brought to 3% by 2013 at the latest
* Private sector involvement in Greek debt rollover, committed in principle by 30 financial institutions listed in the document released by the Institute of International Finance; target participation rate of 90%; exchange appears to result in Selective Default credit rating
* Voluntary participation options include exchanging existing debt into 15 or 30 year bond with AAA-guarantees of principal. Bonds exchanged at par will carry low coupons (4.25% effective), while bonds with higher coupons will be exchanged at a 20% discount

Source: Eurozone draft proposal July 21, 2011, IIF press release July 21, 2011

In addition to execution risk in Greece, we are left with 3 other concerns. First, while there's enough in the EU-IMF lending facility[4] to deal with problems in Greece, Portugal and Ireland, if you include Spain, it gets tight (note: the chart excludes costs to recapitalize banks). If Italy or Belgium entered Europe's Liquidity Hospital, a lot more money might be needed from European parliaments (in one worst-case scenario, Alliance Bernstein estimates that the EU lending facility would have to increase from 440 bn to 1.7 trillion Euros, mostly from Germany). Italy faces a multi-notch downgrade from Moody's, which is not going to help. As we discussed two weeks ago, Italy has been a model citizen in terms of running low budget deficits for 20 years, but still cannot escape the confines of its very large existing debt stock (120% of GDP).

Limited capacity at the European Liquidity Hospital

Official sector lending capacity vs sovereign funding needs (including deficits) through 2013 - Billions, EUR

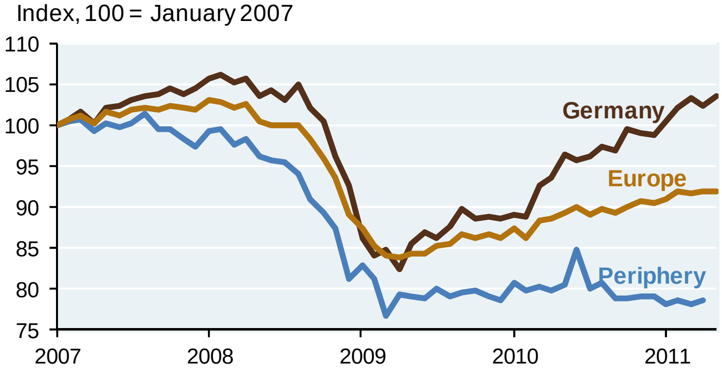


Source: AllianceBernstein, Public Filings.

Second, as shown below, Europe is now a two-speed economy, with the periphery stuck in neutral (industrial production is one proxy for this; there are others, such as unemployment, consumption, export shares, etc). If the idea behind the EU/IMF effort is that austerity will boost growth and lead these countries back to the public markets, there is very little momentum in this direction. **If the status quo in the periphery does not change, all the EU package does is allow the current approach more time to fail.**

Industrial production

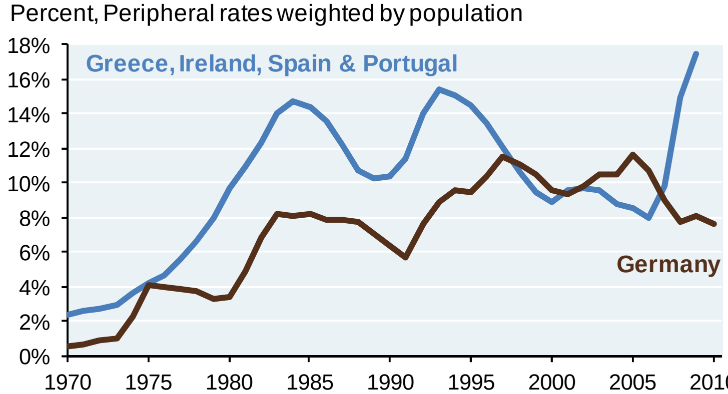
Index, 100 = January 2007



Source: INE, CSO, ISTAT, NSS, Eurostat, Bundesbank, J.P. Morgan Securities LLC, J.P. Morgan Private Bank. Periphery = Portugal, Ireland, Italy, Greece, Spain.

Unemployment rates - core vs. periphery

Percent, Peripheral rates weighted by population



Source: J.P. Morgan Private Bank, Bank of Spain, Bank of Portugal, OECD, CSO, NSS, Bundesbank.

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[4] The current EFSF lending capacity is Eur 255 bn, but we anticipate that as agreed, national parliaments will expand it to 440 bn.

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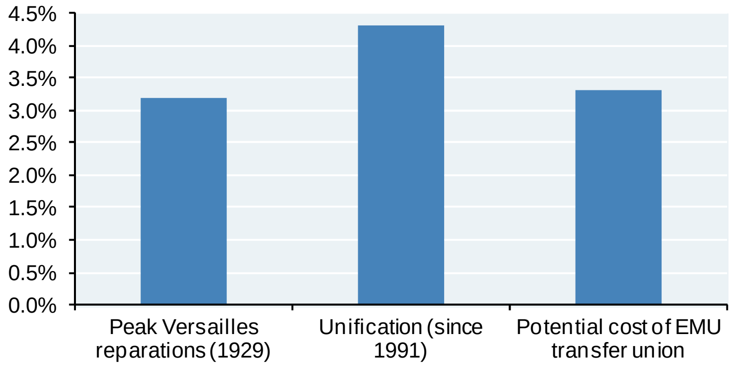
The third concern: Germany as paymaster. We are often told that Germans across both major parties are unflinching supporters of the European project, and will do whatever it takes to prevent a break-up. The objections from members of the Bundesbank are described as lonely voices of opposition that carry no weight[5]. **But how large are the costs going to be?** German politicians and voters may see current circumstances as exceptional, and that if they just agree to one more package, the problem will go away. However, we are starting to see analyses of how costly a permanent transfer union may be for Germany. Bernard Connolly at Hamiltonian Advisors sent me a recent paper from the *Centrum fur Europaische Politik*[6] in Freiburg, which provides some clues. They see three alternatives for the deficit countries:

- massive reduction in regulations and unit labor costs to regain competitiveness
- exit from the EMU, re-introduction of national currencies
- permanent transfer union from surplus countries to deficit ones

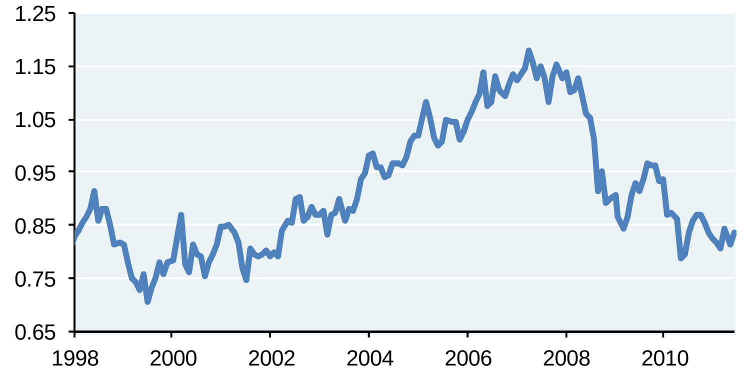
On the last option, they estimate a "creditworthiness gap" in European deficit countries of Eur 108 billion in 2010. The gap measures how much European deficit countries rely on capital inflows to fund consumption, rather than investment (which contributes to future GDP). Germany's share of the European surplus is around ¾, so let's assume a pro-rata burden on Germany to maintain the transfer union. As a result, the theoretical economic cost could be 3.3% of German GDP every year, which as shown, gets close to some expensive episodes in German history. If German citizens were faced with costs this high, it could be a White Castle hamburger-throwing moment of national proportions.

Cost to German taxpayers of major events
Percent of GDP, annual



Source: Carl-Ludwig Holtfrerich, Halle Institute for Economic Research, Zentrum fur Europaische Politik (Freiburg), J.P. Morgan Private Bank.

Europe equities, priced for the risks
Europe 10-yr trailing PE divided by US 10-yr trailing PE



Source: Factset, MSCI.

Bottom line. At a time when European equities are trading close to 2009 lows relative to earnings and book value, this package could result in a relief rally for European equities, particularly banks. The chance of a disorderly default in 2011 has decreased markedly, and a process has been put in place to create more seamless transfers to areas (and banks) in need. But the size of the transfer union fund is not big enough to allay all concerns, particularly with Spain and Italy growing at anemic levels, and there is execution risk in Greece.

Recent bank stress tests conducted by the EU concluded that only Eur 2.5 billion of capital needs to be raised (70 to 80 billion sounds more reasonable to us). And in the package announced last week, the **following Orwellian clause** indicates how European policymakers feel about rating agencies these days:

> *Point 15. We agree that reliance on external credit ratings in the EU regulatory framework should be reduced, taking into account the Commission's recent proposals in that direction, and we look forward to the Commission proposals on credit ratings agencies*

In Europe, denial appears to be an essential ingredient to the process (See "*Five Stages of Greece*", June 30, 2011). **Last week's package is a bold step towards Federalization and the worst-case outcomes have been avoided (money market failures, bank runs, etc), but markets will remain nervous about Europe**.

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[5] Bundesbank President Weidmann, in response to last week's package: "By transferring significant risks to the support-giving countries and their taxpayers, the Euro area has taken a large step to **socialising risks created by unsound government finances** and macroeconomic problems. **This weakens the foundations of the fiscal self-responsibility that EMU is built on**".
[6] Centrum fur Europaische Politik, "*Creditworthiness trends in European countries*", Lüder Gerken & Matthias Kullas, 2011

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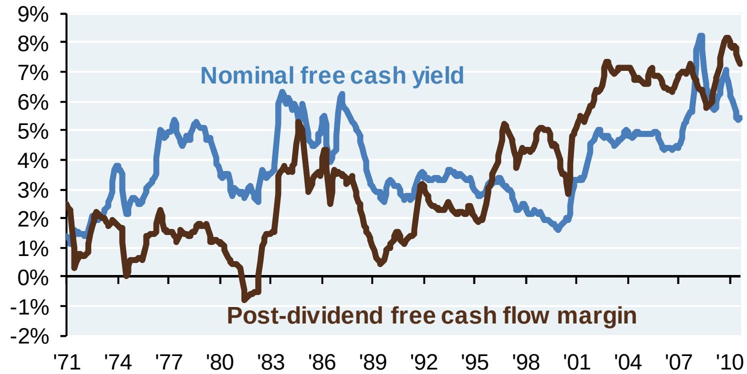
While we're waiting: large cap growth stocks

One day, the melodramas around US and European sovereign debt will end. While we're waiting, one of the asset classes that looks attractive is large cap growth stocks. As shown below (for a universe of 300 U.S. large cap growth stocks that meet certain earnings quality and stability factors), **free cash flow relative to both revenues and stock prices looks good compared to the last four decades**. This is where we believe investors should be adding exposure if they are underweight versus their desired equity allocations. This is also an asset class where active management can still provide a lot of value; the dispersion of large cap growth managers is higher than large cap core, large cap value and international equity manager dispersion.

Q2 earnings season in the US is off to a good start. Nearly 30% of the S&P has reported, and results have generally been positive. Earnings are beating consensus estimates by almost 4% (7.4% ex-financials), all ten sectors are beating on revenue targets, and only 7% of companies are reporting below-consensus earnings. Given earnings expectations for 2011 at $98.50, the S&P 500 is trading at a reasonable 13.5x forward multiple. However, y/y earnings growth expectations appear to be flattening out for both 2011 and 2012 at around 11%-12%. While Q2 earnings are doing well so far, some company guidance for the remainder of the year has been below consensus, which would be consistent with the recent batch of reports indicating a slowdown in manufacturing and service sector surveys.

Attractive valuations for US large cap growth stocks
Percent



Source: Empirical Research Partners.

Michael Cembalest
Chief Investment Officer

CBO	Congressional Budget Office
OMB	Office of Management and Budget
EFSF	European Financial Stability Facility
FICA	Federal Insurance Contributions Act
EU	European Union
IMF	International Monetary Fund
IIF	Institute of International Finance
ECB	European Central Bank
EMU	European Monetary Union
AMT	Alternative Minimum Tax

A White Castle hamburger is smaller than its competitors' offerings, measuring 2.5 inches square.