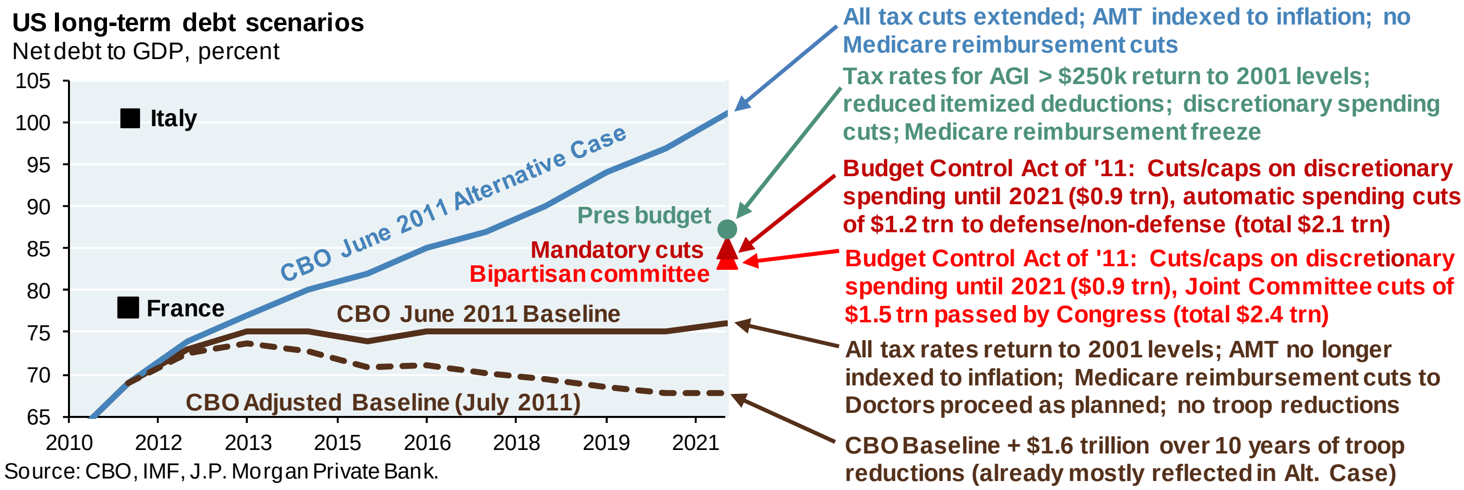
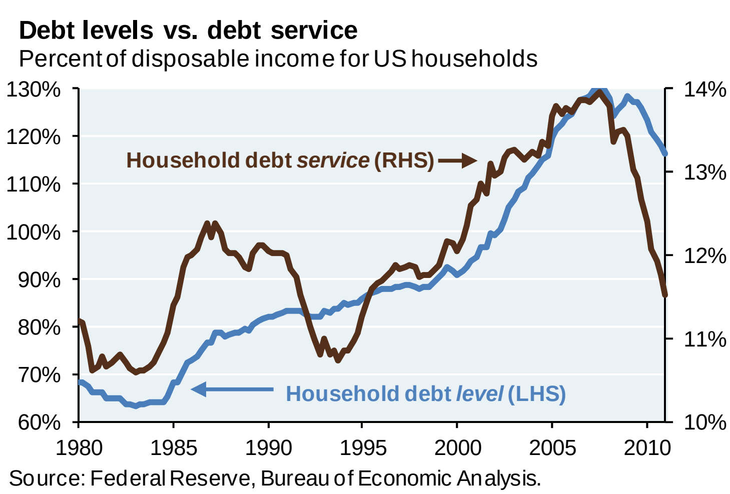
Topics: How will economies and markets respond to Cold Turkey austerity programs in the US and Europe?

Cold Turkey. The Budget Control Act has passed, so scenarios involving default or unorthodox measures by the Treasury to avoid it are off the table. How much wood did they chop? As shown in the chart below, the 2011 Budget Control Act splits the difference, reducing roughly half the gap between the case where deficits are closed through substantial tax increases across the board (CBO Baseline), and the case where there are no spending cuts or tax increases at all (CBO Alternative Case). Will S&P respond to this act by maintaining the US AAA rating? Unclear, but our hunch is that there is no downgrade for now, pending the outcome of the to-be-formed Joint Select Committee on Deficit Reduction which is charged with crafting legislation on an additional $1.5 trillion in deficit reduction by Thanksgiving. If this bipartisan committee cannot come to an agreement, or if Congress does not pass it, automatic spending cuts of $1.2 trillion to defense and non-defense spending (including Medicare reimbursements) come next; that's why the Mandatory Cuts outcome is a bit worse in the chart.



So now, the **Cold Turkey** phase of the budget adjustment begins, including for the Defense Department, which CBO assumes will have to cut $1.6 trillion in costs over the next decade if the US continues to fund "*Overseas Contingent Operations*" (this may be news to Army generals). Think about this: for the first time since 1970, there will be a sustained multi-year cap on nominal discretionary spending, and the plan **still** does not completely stabilize the debt ratios. This is an indication of just how large the entitlement burden is, and highlights the unanswered question about revenue increases. **The plan, which represents the largest fiscal adjustment in 40 years, coincides with a substantial recent weakening of US economic data**:

- The lowest ISM manufacturing survey since the beginning of the expansion, including a poor reading on the new orders component (often relied upon as a leading indicator), employment and supplier deliveries (no pent-up demand in sight)
- Downward GDP restatements for the recession which in retrospect, make the weak labor market recovery less of a surprise. The GDP growth rate in the first half of the year was around 0.8% (terrible)
- In Q2, one of the slowest advances in personal spending outside of a recession in the last 50 years, with a negative reading on consumer spending for June, indicating a slow trajectory into the third quarter
- Net exports helped in Q2, but trade is not big enough to move the growth needle in the US on its own



If one is looking for silver linings, IMF studies show that spending-based fiscal adjustments are much less disruptive than adjustments based on tax increases, and that spending cuts on transfer programs and government wages (compared to cuts in government investment) are the least disruptive of all[1]. However, as our Chief Economist Michael Vaknin points out, spending cuts are typically less painful and disruptive because they tend to be cushioned by further monetary easing. Whether the Fed will engage in another round of securities purchases is anyone's guess; they might, but it may not matter, since it's hard to argue that a high cost of capital is

[1] "*Will it hurt? Macroeconomic effects of fiscal consolidation*", International Monetary Fund, October 2010; see figures 3.7 and 3.8.

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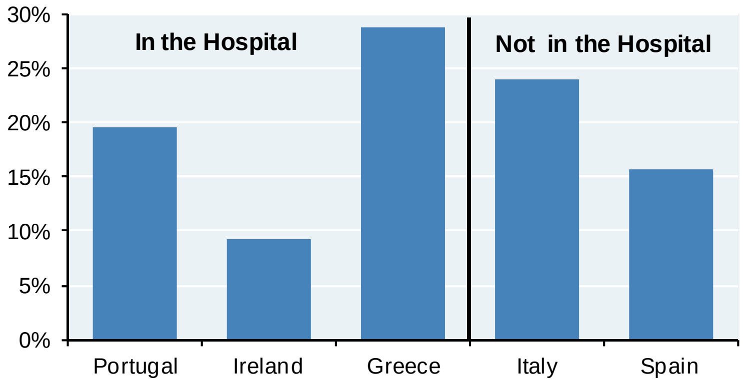
holding back the recovery. US economic weakness may result instead from continued de-leveraging by US households, which were facing headwinds from subdued income growth and the spike in gasoline prices earlier this year. **Household balance sheet de-leveraging from the heights attained by 2007 takes time, and there may not be a magic elixir of policies to completely negate it.** Some analysts are optimistic about the reduction in household debt *service* (see chart on prior page); but this is mostly a function of low interest rates. Household debt *balances* have not fallen nearly as far. The yoke of debt, regardless of its cost, can bear a heavy burden on sentiment and consumption. More recent data suggest that slowing commodity price advances have helped stabilize retail sales in Japan and Europe, as well as in the emerging world, so we expect modestly higher growth in the second half of the year, as long as Europe does not implode...but…

Europe: preparing beds for Spain and Italy at the liquidity hospital?

One of our most consistent themes since November 2009: be very skeptical of the bailout process in Europe. We will not go over the Greece bailout package again; we went into detail a couple of weeks ago (EoTM July 25, 2011), and the only thing we have to add is that it looks to be 50 to 100 billion Euros short of what they will eventually need for Greece[2]. The European package, across its various aspects, does represent the broadest attempt so far at creating a more seamless fiscal transfer union. Nevertheless, Spanish and Italian credit spreads have been rising again, to their highest level since 2008. This is a problem, particularly for Italy, which must finance a lot of debt in the next 12 months (see first chart below). As shown in the second chart, there is not enough room in the European liquidity hospital for Italy, and even if Spain checks in, it starts to look pretty tight. At this point, it feels like Europe faces three broad last-resort policy options:

- Enlarge the EFSF (bilateral EU lending facility) to 1.5 – 2.0 trillion Euros to create a credible backstop (once and for all). While it might not be sponsored by EU governments, the ECB could lend this amount to the EFSF (painful as it would be)
- Become the United States of Europe, and move to a true transfer union between Germany and the rest
- Unwind the European Monetary Union, just as the European Exchange Rate Mechanism was unwound in the early 1990s

Maturing debt and interest due in the next 12 months
Percent of GDP



Source: Bloomberg, INE Portugal, INE Spain, CSO, NSS, ISTAT.

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.

In our 2011 Outlook, we concluded our section on Europe with a quote from former EU President Jacques Delors, who said that in response to the crisis, Europe needs to "find its soul". As of now, Europe is still looking for it. For the last 30 years, professors from the University of Bremen and the University of Michigan have used their World Values Surveys to assess belief systems and their impact on social and political change using surveys from 90 countries[3]. According to their statistics, on several fronts, cultural differences between Germany and Southern Europe are greater than differences between countries in Latin America, Eastern Europe or Asia. Their work is consistent with Geert Hofstede's pioneering analysis on the cultural differences in Europe as well. **This is very abstract stuff, but as we watch Europe struggle to find its way, these factors may impede the imposition of a Federalist approach as fast as the markets would like to see it.**

In both the US and Europe, fiscal austerity mixed with easy monetary policy is a green light for gold to keep rising.

[2] The recent package appears to lack sufficient funds to lend to Greece to purchase the zero coupon bonds to back the securities offered in the debt exchange, and the funds to recapitalize Greek banks.

[3] "*Changing Mass Priorities: The Link between Modernization and Democracy*", Ronald Inglehart and Christian Welzel, Perspectives on Politics, June 2010, Volume 8, Number 2.

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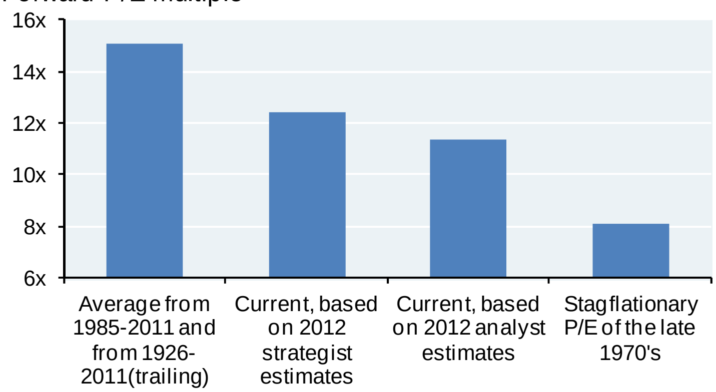
Valuations: preparing for the worst

As US and European public sector debt problems play out and GDP growth languishes, US corporate profits continue to rise. With 75% of S&P market cap reporting, Q2 revenues are up 14% y/y (8.8% excluding energy). We have discussed the possible reasons for this in prior notes (see EoTM April 26 on the 50-year low in relative labor compensation and the rising contribution from offshore revenues). In addition **to labor compensation and globalization trends, there are constituency reasons as well**: US GDP is weighted towards household consumption, housing and other consumer sectors which suffer from a weak US$; the S&P 500 is weighted towards manufacturing, energy, business spending and exports, and benefits from a weak US$.

In terms of regional weights, we still have larger exposures to the US (warts and all) compared to Europe and Asia. One reason: modestly better US earnings revisions in the face of slowing growth in the West and rising policy rate tensions in the East. In Q2, 75% of US companies beat estimates so far, compared to 40% for European counterparts. But even in the US, management guidance for the rest of the year has been on the weaker side, which is consistent with recent declines in business surveys around the globe. Since the bottom of the recession in 2009, analyst estimates climbed during earnings season by 8.4%; over the last year, they rose by 5%. We expect analyst estimates to be closer to the mark in Q3 and Q4 of this year, marking an end to the earnings surprise cycle.

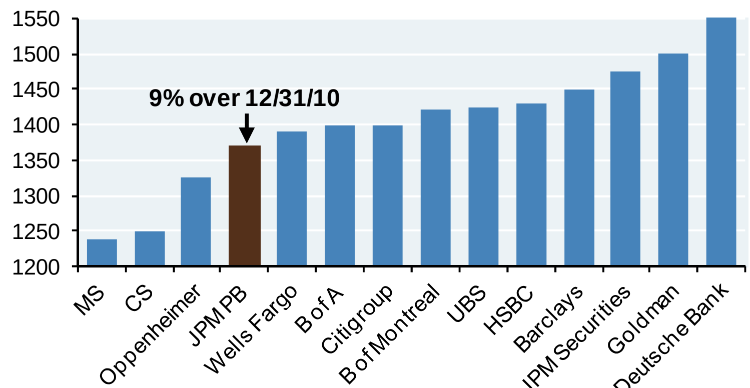
The litany of woes facing developed world governments (the adjective “developed” seems less apt as time goes by) is not lost on equity markets, which apply low multiples to the profits companies are generating. As shown below, based on estimates of forward earnings estimates for 2012, the S&P 500 is trading at a multiple of 11x-12x. As things stand now, equities are more or less flat on the year. While we still expect a single digit return year to emerge from the mess, we remain mystified at the more constructive opinions on equity markets shown in the second chart below.

P/E ratios on the S&P 500
Forward P/E multiple



Source: Standard & Poor's, I/B/E/S, Empirical Research Partners.

2011 S&P 500 targets by firm: hope springs eternal
Index level



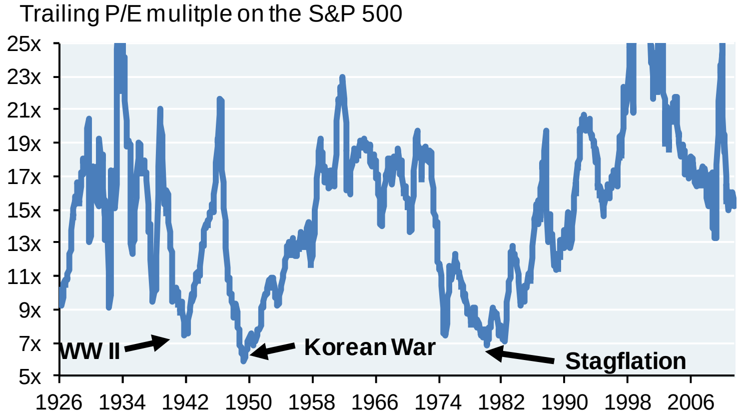
Source: Bloomberg. Targets as of May 3, 2011.

There is some comfort to be had that US, Japanese, European and Asian P/E multiples are, unlike the credit markets, pricing in a pretty lackluster future (see table). P/E multiples are on the low end of history, when history is defined as the last 20 years or so. Looking back further in time, there were 2 periods when US P/E multiples persisted at 10x or less, other than the stagflation period of the 1970’s: WWII and the Korean War are the two longest examples. As the U.S. and Europe struggle to bring down quasi-wartime levels of public debt, we are left feeling that low P/E multiples will remain until the trajectory of Western economy debt is stabilized, and both regions demonstrate they can handle the Cold Turkey period they have just embraced. Silver lining: at current levels, we don’t think P/E multiples will fall much further.

Forward multiples	2011e P/E	2012e P/E
US	13.7x	11.9x
Europe	10.6x	9.4x
Japan	17.2x	14.3x
Asia ex-Japan	12.5x	11.0x
Global Emerging Markets	11.2x	9.8x

Source: MSCI, I/B/E/S, J.P. Morgan Securities LLC.

Super low P/E ratios: Wars and stagflation
Trailing P/E mulitple on the S&P 500



Source: Empirical Research Partners.

Topics: How will economies and markets respond to Cold Turkey austerity programs in the US and Europe?

Please join us for a webcast/conference call on our global market and investment outlook on August 15th. Details to follow from your coverage team here at JP Morgan.

Michael Cembalest
Chief Investment Officer

Notes on our CBO scoring chart on the first page

The Congressional Budget Office is a federal agency charged with providing data to Congress on an objective, non-partisan and timely basis. We show the Baseline and Alternative case debt trajectories as per the June 2011 CBO reports, as well as the CBO July Adjusted Baseline which assumes $1.6 trillion in Iraq/Afghan operational cost reductions over the next decade versus the prior Baseline case. Specifically, what has been eliminated from the CBO's debt projection is the category of all "*Overseas Contingent Operations*". This might turn out to be too aggressive an assumption; by eliminating that category, CBO essentially assumes that such operations are terminated, or (more likely) that they are absorbed by the existing defense spending budget, requiring cuts of a similar amount to other defense programs. This is a very large budget cut for the Department of Defense to absorb; $1.6 trillion is more than the $1.2 trillion cost of the Iraq and Afghanistan wars (as per the Congressional Research Service). Since the CBO has not yet scored the debt/gdp trajectory of the 2011 Budget Control Act, we estimated it by using the Alternative Case as a baseline, and factored in either $2.1 or $2.4 trillion in deficit reduction, as well as the benefits of additional spending cap and troop reductions assumed in the CBO Adjusted Baseline. Recent tax receipts have come in a little better than expected, so the next CBO Baseline case due in August may incorporate this outcome, and extrapolate it into the future, modestly lowering projected deficit and debt ratios.

If this all seems confusing, it is. A former CBO director and a staff director on the House Budget Committee both mentioned to us that all the proposals have used multiple baselines, and that until the CBO scores the entire plan, the meaning of "deficit reduction" can be unclear.