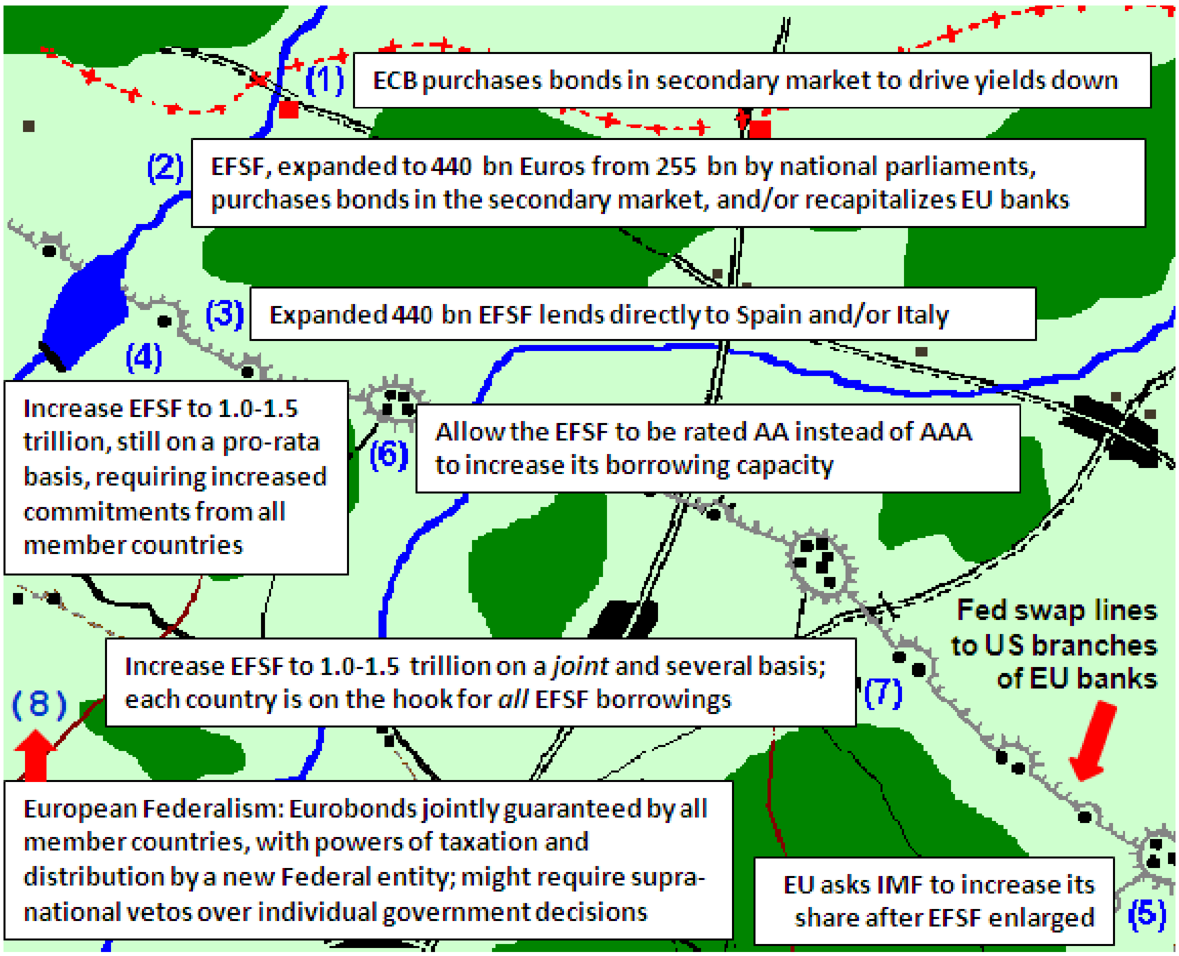
Topics: European lines of defense; the earnings decline priced into the S&P 500 at 1,150; examining the policy proposals of the self-proclaimed community of the under-taxed

The Maginot Lines. Rather than focus on what EU politicians said at yet another summit this week, let's look at the lines of defense they may eventually have to rely on to defend the European Monetary Union. For illustration's sake, we have super-imposed these defenses on a map of the Maginot Line constructed by France in the early 1930's to defend against an attack from the East. Right now, the weak link in the European chain is Italy. It looks like Italy will run out of cash some time in September. The good news is that 10-year Italian bond yields have declined by 1% since early August, most likely due to ECB purchases in the secondary market. But if new issue sovereign debt markets are not available to Italy at acceptable yields[1], the defenses shown below would presumably begin to kick in, one after the other, and only should the prior one fail.

The Maginot Line, 2011



ECB = European Central Bank

EFSF = the European Financial Stability Facility, currently severally (but not jointly) guaranteed by EMU nations. Actual lending capacity of 255 bn, scheduled to be increased to 440 bn Euros when national parliaments vote on it this fall.

IMF = International Monetary Fund, which contributed 250 bn to the original 750 bn Financial Stability Package

EMU = European Monetary Union

Source: J.P. Morgan Private Bank; map from Association des Amis de la Ligne Maginot d'Alsace

<u>There are quite a few gaps in some of these defense lines:</u>

- *Insufficient firepower*. Increasing the EFSF to 440 bn does not create enough capacity if Italy does not access debt markets, since most of it is already promised to Greece, Ireland and Portugal
- *Unproven weaponry*. I cannot remember a situation where an exogenous buyer (central bank, the IMF, an alien from outer space) through its own non-economic purchases, drives up a credit-impaired secondary market price and thereby resets the new issue price at that level. In other words, if the ECB pays champagne prices for spumante, will anyone else?
- *Self-inflicted losses*. Some lines of defense entail ever-growing contingent obligations taken on by AAA-rated Germany and France. Their gross debt to GDP ratios *already* range from 80%-87%. Could EFSF expansion trigger a downgrade?
- *Tepid allies*. The IMF does not appear to be in the mood to increase its contribution.
- *Vulnerability to attack from within the ranks*: some lines of defense might be hard for national parliaments to accept. The basis of Germany's entry into Maastricht was that it would *not* be a fiscal transfer union of commingled national obligations. Even Sarkozy conceded that Eurobonds would lack necessary the democratic legitimacy right now.

[1] Italy last issued 10 year debt at 5.7% on July 28th, and Spain issued at roughly the same level the prior week. German bunds are at 2.10%.

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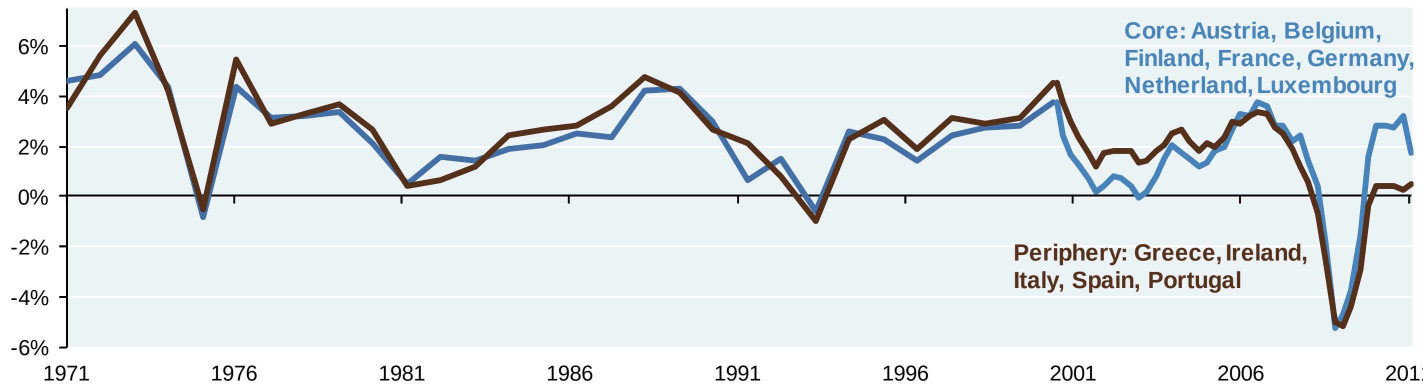
It’s hard to handicap the backdoor politics, given conflicting views across the EU. What we do know is that these steps are unlikely until there is some kind of market riot, which means asset prices may be much lower by the time they happen. I agree that there’s a wide array of defenses to prevent a disorderly default or unwind of the EMU. However, back to history: despite perceived impregnability, the Maginot Line[2] was an exercise in futility, as the German army simply went around it, crossing into France through Belgium and the Ardennes Forest. **Similarly, if the European Periphery is stuck in a structural growth rut from which it cannot emerge without weaker exchange rates, financial engineering can only delay the inevitable.** I have not seen a country be able to indefinitely endure low growth, high unemployment, austerity imposed from abroad, large debt burdens and limited prospects for a way out. As shown below, that’s where the European Periphery is right now, in sharp contrast to the prior 40 years of close connection to the Core. Optimists believe that Peripheral growth will rise once the multi-year fiscal adjustments are complete; I’m not so sure. European equities are priced cheaply, but are likely to stay that way.

European Periphery: stuck in neutral
Real GDP growth, percent, yoy, as of Q2 2011



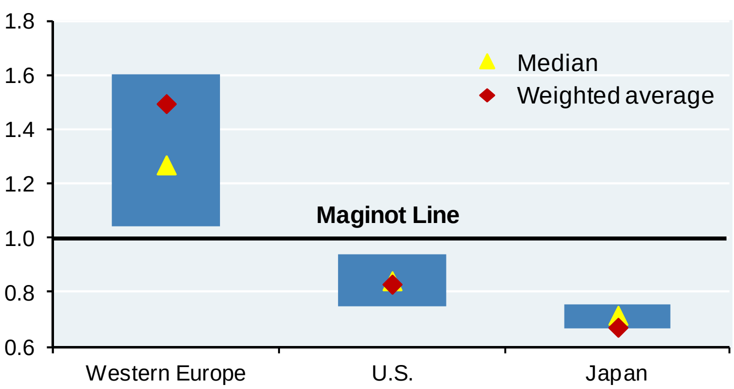
Source: Statistical Office of the European Communities, OECD, IMF, J.P. Morgan Private Bank.

The Maginot Lines crossed by European banks make this crisis harder to navigate and assess:

- Listed Western European banks rely much more than US or Japanese banks on volatile wholesale (non-retail) funding. We have seen reports from Gavekal Securities which suggest that US branches of EU banks have at least 33% of their assets in cash. This could be an indication that they are preparing for a pretty severe storm.
- Many European banking systems, relative to their economies, are much larger than the US banking system
- European banks have raised roughly half the capital (as a % of total assets) compared to US banks since March 2009

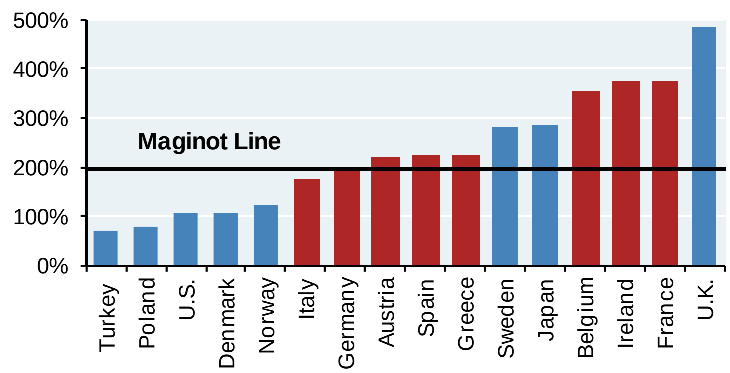
Message to the ECB, quoting Police Chief Martin Brody: “I think you’re gonna need a bigger boat” *(Jaws, 1975)*.

G-3 banking sector loan to deposit ratios
Ratio



Source: J.P. Morgan Securities LLC, Bloomberg.

Bigger banks, bigger problems
Bank liabilities as % of GDP



Source: Central Banks. Data as of 2009.

[2] The Maginot Line was considered an amazing achievement at the time: a series of anti-tank barriers, bunkers, fortresses and heavy artillery, all connected by road and underground rail, stretching for hundreds of km from Luxembourg to Switzerland, and which was often 25 km deep. Cost back then: 5-6 billion francs. In 1964, the French government began to sell off parts of the Line through public auction. The purchasers (many from Germany) turned the casements and shelters into holiday chalets, garages, mushroom farms and a disco.

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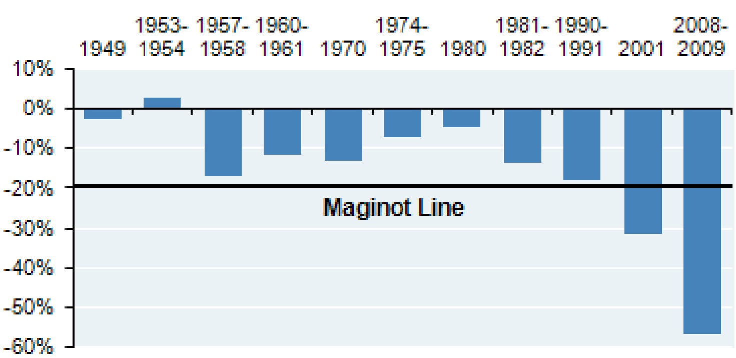
<u>What kind of earnings drawdown is priced into US equities at 1,150 on the S&P 500?</u>

On our conference call, we mentioned that US equities are pricing in a 20% earnings decline. How so? First, annualize Q2 corporate profits, and haircut them by 20%. At an S&P 500 level of 1,150, the P/E multiple on these (presumably) trough earnings would be around 14x, consistent with the average P/E multiple of the last 30 and 80 years. As shown below, the last 2 recessions resulted in earnings declines that were much *greater* than 20%. But before that, recessionary earnings declines ranged from 10% to 20%. **So, it appears that a mild earnings recession is already priced in at 1,150, but a deeper one beyond that earnings Maginot Line is definitely not.**

Our view is that the US is headed for a growth scare rather than a recession, but this is a very close call. Today's housing and manufacturing reports were decidedly negative. A recession monitor we have been using is ~75% of the way to its "fault line". At this fault line, the model has a hit rate of predicting 12 of the last 8 recessions (in other words, it was wrong 4 times, when there was a growth scare instead). If we're right and we get a growth scare instead of a recession, single digit equity market returns this year (which has been our forecast) still looks possible. **Some argue that since consumer and business capital spending is at its lowest combined level as a share of GDP in 60 years, that there's not that much economic activity left to decline**. That's reasonable, but the potential impact from Europe, the source of 15% of S&P revenues, is unknowable.

During the selloff, stock correlations have risen to levels only seen a few times in the last century; this is typically indicative of indiscriminate risk reduction. The rise in volatility has created an opportunity to add equity risk with downside protection down to levels which prevailed in the spring of 2009. While we added some equity exposure using this approach last week, we remain underweight versus our normal risk levels.

Earnings declines during US recessions
Percent decline - peak to trough



Source: Haver Analytics, Barclays Capital.

Our model predicted 12 out of the last 8 recessions
Actual outcome in years when the model predicted a recession

Recession (got it right)		Growth Scare (got it wrong)
1957	1978	1966
1959	1981	1984
1969	2000	1995
1973	2008	1998

Source: J.P. Morgan Securities LLC.

<u>The community of the under-taxed, and their policy proposals</u>

Last week, Warren Buffet argued for increasing income tax rates for taxpayers in the top brackets, which is consistent in spirit with a website urging patriotic citizens to sign a petition calling for similar increases (http://patrioticmillionaires.org/). Their proposals led me to take a look at my overall tax burden. Unlike Buffet and the website signatories, I do not consider myself to be under-taxed, since the lion's share of my income as a New Yorker is taxed at:

- **Federal tax rate of 35%** ➢ Scheduled to rise to 39.6% when/if Bush tax cuts sunset
- **State tax rate of 8.97%** ➢ A rate applied to all income (not graduated like Federal rates); inclusive of a 2.1% surcharge which may or may not expire in 2012
- **NYC tax of 3.87%** ➢ State and local taxes are currently deductible for Federal tax purposes, but tax reform may phase out or eliminate this "tax preference item"
- **Medicare tax rate of 1.45%** ➢ Rising to 2.35% in 2013, in addition to a 4.2% Social Security tax on the first $106k (rising to 6.2% next year)

The result is that I face a marginal income tax rate of almost 45% and an effective tax rate in excess of 40%, excluding property taxes and 8.875% non-deductible sales taxes. As existing legislated tax changes take effect, I will approach the Maginot Line of a 50% tax rate. Buffet, on the other hand, describes his effective federal tax rate as being 17.4%. This makes sense since his income appears to be dominated by long-term capital gains (which can be generated at the time of one's choosing) and qualified dividends, both taxed at 15%[3], and tax-free municipal income.

[3] Another wrinkle: assets which generate capital gains are more readily incorporated into estate planning vehicles than ordinary income.

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It seems to me that the "*tax me more*" crowd should be more explicit about *how* they want to be taxed more, since it's not clear how their proposals will be interpreted by legislators. **If their proposals result in an increase in the top two *ordinary* income brackets (e.g. affecting joint filers with adjusted gross incomes over $212,000), the irony is that Buffett and many of the website signatories may not be that impacted by it.** If instead, the under-taxed are arguing for a unification of capital gains and ordinary income rates (which existed for a short period from 1988-1990), that's different, and perhaps more consistent with concerns about under-taxation. But there's not enough detail to know, leading to conjecture about possible outcomes affecting income demographics quite different from their own.

I agree with the Bowles-Simpson commission, the Gang of Six, S&P and other voices that at some point, revenues are going to have to play a part in long-term deficit reduction; the country cannot *just* rely on entitlement reform. What this exercise highlights is that the choices are complicated, and that we will all be weighing our own respective, abstract visions of fairness.

Michael Cembalest
Chief Investment Officer

Additional sources: "*Ground Warfare, An International Encyclopedia*", Volume 1, Stanley Sandler, 2002.