Topics: What would make us more optimistic about European and US equity markets; My generation

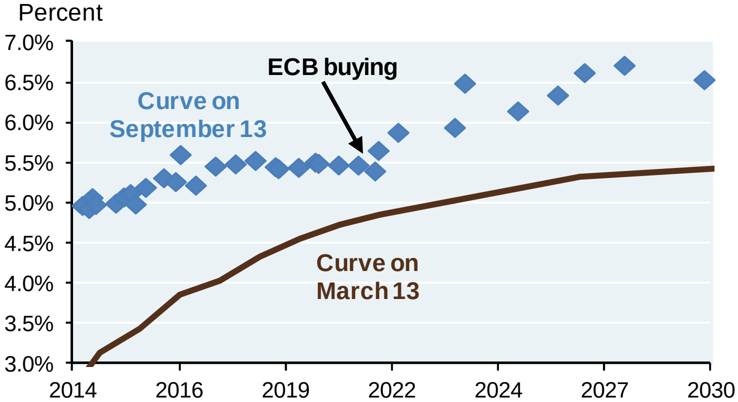
Has the Eurobond Rubicon been crossed?

Jürgen Stark's resignation from the ECB begs the question of what he resigned about: the prospects of ECB debt monetization (money-printing), or the prospects of joint and severally guaranteed Eurobonds. My first thought was the former, but news reports indicate it might be the latter. The French paper *Liberation* reported that Merkel met in private with CDU members and explained she is ready to support Eurobonds if necessary; the article suggests that Kohl's criticism may have shaken up the CDU leadership. And according to news reports from *El Mundo*, Spain's Secretary of State to the EU Lopez Garrido said changes to the Spanish Constitution on the balanced budget were done as a quid-pro-quo for Eurobonds. If so, the Eurobond Rubicon has been crossed, at least by certain political constituencies. If that's the case, the Northern European EU taxpayers presented in thermoplastic form in last week's EoTM will foot the bill, but without much political input into the decision.

Why are these political developments happening? Markets reactions to the European impasse are getting worse:

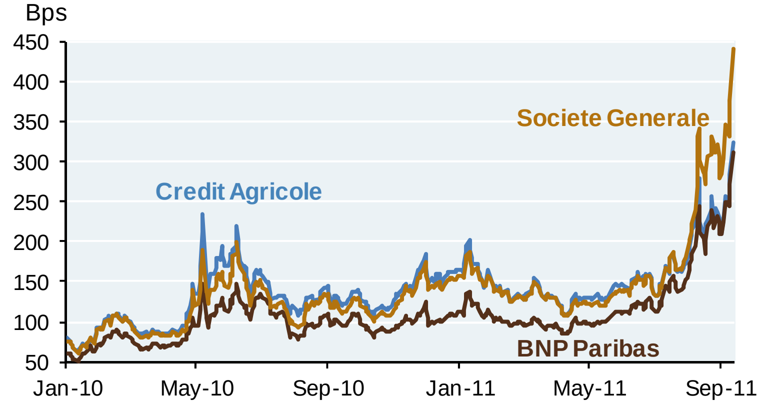
- Italian government bond yields continue to rise, even with substantial ECB buying of 10 year paper (see chart on the ECB distortion of Italian yield curve). Despite an austere annual *budget*, Italy's existing debt *levels* (the highest non-wartime levels since reunification in 1861) have entered the public consciousness in a way that may be difficult to reverse
- French bank credit default swap spreads have risen to all-time highs (2nd chart); no EU bank senior/unsecured debt issuance for the last 2 months, as banks who need capital are relying on the ECB instead
- As of Sep 12, MSCI's index of European Union equities is down 21% ytd, compared to a 6.3% decline for the S&P 500
- Markets are pricing in a default in Greece, which is experiencing depression-like conditions

The Italian yield curve
Percent



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

French bank 5-year senior CDS
Bps



Source: Bloomberg.

As we mentioned last week, underweight exposures to Europe have been rewarded during this entire crisis. In our sovereign default time capsule published in May 2010, we included examples from prior crises and how constructive statements from politicians, economists and analysts misled investors into false optimism. [News stories of "*Chinese government buying will solve it*" are another example of this]. Having seen this movie before, we were not inclined to sit through it.

But if the Eurobond Rubicon has now been crossed, does that change our view on European equities, perhaps the most unloved asset class of all (even more than Japan)? After all, most Italian, Spanish and French banks are trading well below book value. However, in addition to whatever "Eurobonds" might mean in practice, here is what we would need to see:

- Greece defaults and receives 60%-70% debt forgiveness. Critical as a sign that reality is setting in.
- The expanded bilateral lending facility (EFSF) is approved, and used by sovereigns who borrow from it to recapitalize their banks, who in turn mark their compromised sovereign *and* corporate positions to market
- The ECB commits to provide as much secured financing to banks as they need to offset retail/institutional deposit flight
- If ECB bond purchases are needed, acceptance by Germany of a weaker Euro and the risk of higher inflation
- Absent a sizable Euro decline, signs that Spain and Italy are undergoing the same kind of internal devaluation as Ireland is (so far they are not, as shown in the chart on the next page)
- Finally, as Ray Dalio at Bridgewater suggests, the EU creates a "*provision for allowing countries to exit from the Eurozone in an orderly manner, rather than making believe that this is an impossibility*"[1].

Our list is a long one and may be too cautious; but so far during this crisis, Geduld ist eine Tugend (patience is a virtue).

[1] Some believe that a country exiting EMU is unlikely since the Treaty does not contemplate it. Perhaps, but the ECB wrote this in 2009: "*As a practical matter if a Member State were determined to withdraw, the EEC has no sanctions that can be applied to compel lawful compliance with the Treaty. Thus, from this point of view,* ***it really is of no consequence whether a legal right of withdrawal exists****.*"

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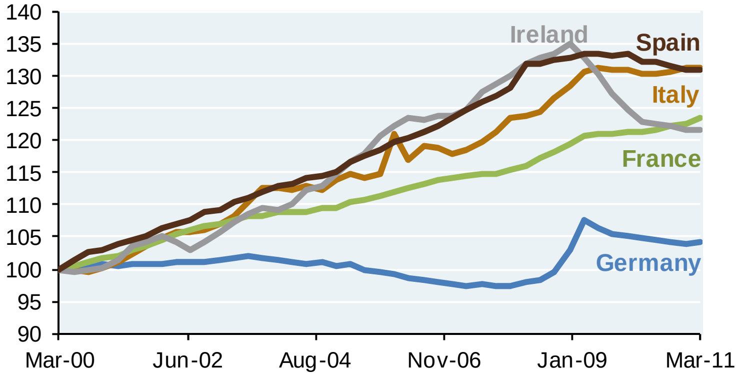
As for Eurobonds, they may come with a steep cost to borrowers. In an interview with Der Spiegel, Eurobond advocate, SPD member and former German finance minister Peer Steinbrück said that in exchange for Eurobonds, **countries must yield part of their budgetary sovereignty to independent institutions**. Is Europe really ready for that? There is also the issue of the "Intergovernmental Approach" (France and Germany effectively run things) vs the "Community Approach" (they do not).

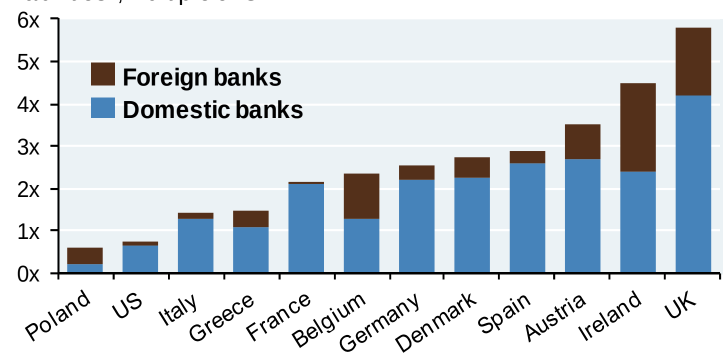
One more thing: **what makes Europe so complicated is the size of its banking system relative to its GDP**. The size of domestic banks operating in Germany, Spain, France and Ireland are much larger than their US counterparts, as shown below.

Internal devaluation? So far, only in Ireland
Unit labor cost, index, Q1 2000 = 100, sa



Source: OECD.

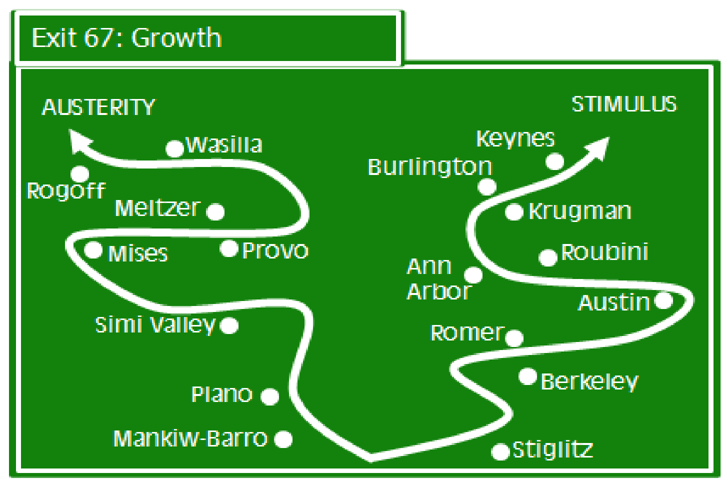
Bigger banks, bigger problems
Liabilities*, Multiple of GDP



Source: Federal Reserve, ECB, J.P. Morgan Private Bank. Data as of 2Q10.
*Select liabities include deposits and other debt securities.

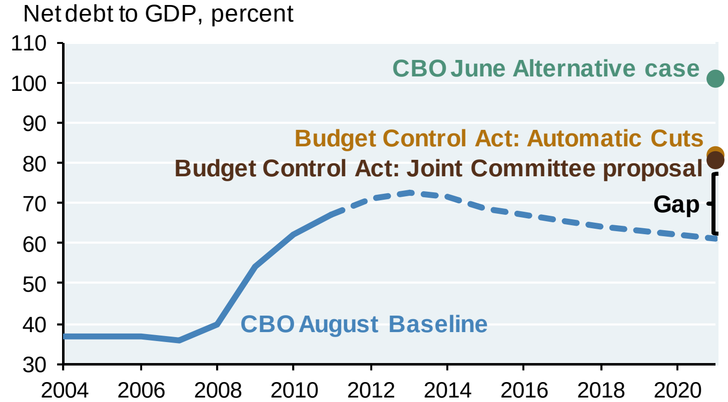
<u>**United States: where's the exit? (from low growth)**</u>

After the summer swoon in growth and employment, the Fed seems committed to additional monetary stimulus. However, our colleagues at J.P. Morgan Securities LLC estimate the potential benefit of *Operation Twist* at only 10 basis points at the long end of the Treasury curve[2]. It's time perhaps to stop thinking about monetary policy. Bernanke himself acknowledges that most economic policies that "**support robust economic growth in the long run are outside the province of the central bank**". These are code words for fiscal policy, although you can be forgiven for not knowing exactly what he means: more stimulus, or less? Entitlement cuts or tax increases? The divide between Keynesian and Neo-classical economists is as stark as ever, and little has been settled by the poor return on fiscal stimulus so far. As for the President's stimulus bill, designed to be paid for primarily through reduction in itemized deductions for high income taxpayers, it is unlikely to be passed in its current form.



The chart shows what the Federal debt situation looks like now that the Budget Control Act is law. Geometric debt growth projected in the CBO's June *Alternative* Case has been taken off the table. **However, substantial distance remains between a realistic scoring of the Budget Control Act and the cresting of the Federal debt implied by the latest CBO baseline.** The latter baseline assumes all tax cuts expire, that the Alternative Minimum Tax is no longer indexed to inflation, and that the Medicare "doc fix" is implemented (even though it never has). **The cumulative 10-year deficit gap between the BCA and the CBO baseline is ~$5 trillion.** In other words, that's how much deficit reduction would still be needed, even after the BCA, to deliver the debt sustainability represented by the CBO baseline.

U.S. long-term debt scenarios
Net debt to GDP, percent



Source: Congressional Budget Office, J.P. Morgan Private Bank.

[2] "*Demystifying Operation Twist*", JP Morgan US Fixed Income Strategy, September 9, 2011.

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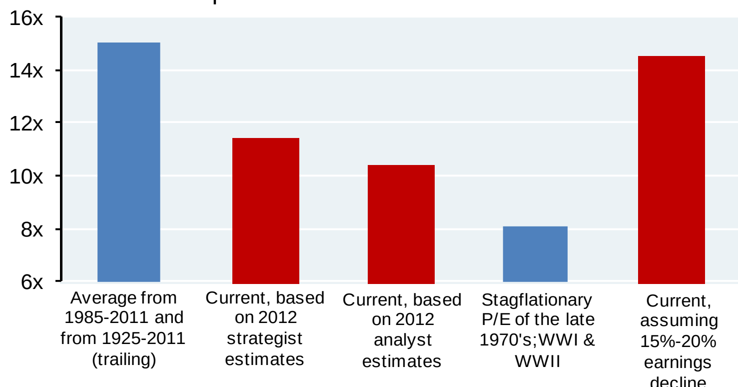
What would make us much more optimistic on the US? An organic recovery in domestic demand would be the most obvious one, but as things look now, leading indicators are pointing to low growth. **We don't think there will be a recession**, but 1.5% growth is not that great either. As with Europe, are there policy measures in the US that would make us more optimistic on markets? Here's what we would need to see:

- The Joint Select Committee on Deficit Reduction recommends $2.0 to $2.5 trillion in long term deficit reduction (independent of the stimulus plan and associated offsets) rather than just the $1.5 trillion it was asked to look for; and the Congress passes it. This would be reminiscent of the reported super-deal being discussed by the President and Speaker of the House, the Gang of Six recommendations and the Bowles-Simpson Commission.
- In all likelihood, if deficit reduction of this magnitude were accomplished, it would incorporate changes to entitlement formulas, something which S&P noted was absent in the Budget Control Act when it downgraded the US.

How valuable are valuations?

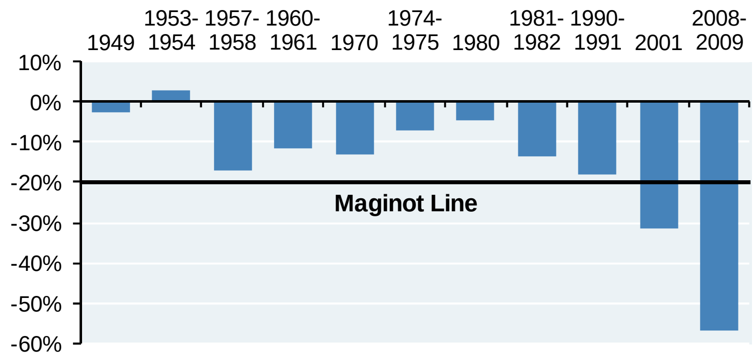
In these notes over the last few weeks, we have included the following charts on what markets are pricing in with respect to earnings. US P/E multiples look very low compared to consensus earnings, and look about average when compared to earnings that are haircut by 15%-20%. As shown at the right, such an earnings decline would be a "par-for-the-course" recession, but not the last two when earnings declined much more.

P/E ratios on the S&P500, using Sept. 8th level of 1180
Forward P/E multiple



Source: Standard & Poor's, I/B/E/S, Empirical Research Partners, J.P. Morgan Private Bank.

Earnings declines during US recessions
Percent decline - peak to trough



Source: Haver Analytics, Barclays Capital.

However, investing simply based on multiples is risky, as anyone who has been caught in a value trap can tell you: the stocks(s) just keep looking cheaper all the way down. We have outlined above the two political outcomes that would markedly increase our optimism for European and US equity markets. Absent these events taking place, we expect equity markets to remain range-bound, with corporate earnings exceeding expectations, but markets not paying much for them. **For now, we retain our single digit return forecast for large cap US equities for 2011, under the assumption of a modest improvement in US economic data this fall; Asian equities represent the largest part of our remaining global equity exposure.** As complements to cash, which global central banks continue to debase, we are focused on the strategies discussed in last week's note: leveraged loans, other private market "mezzanine" lending, US bank preferred stock, merger arbitrage, asset sales by European banks, Asian currencies and select multinational large cap stocks with high dividends and a global presence.

Michael Cembalest
Chief Investment Officer

Sources

"*Withdrawal and Expulsion from the EU and EMU: Some reflections*", European Central Bank Working Paper #10, December 2009.

SPD = Social Democratic Party
CDU = Christian Democratic Party
BCA = Budget Control Act
CBO = Congressional Budget Office

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Appendix: My generation

During the 5-day Hurricane-driven power outage on Long Island, I used a Honda EB 11,000 gasoline-powered generator to keep the lights, refrigeration, septic systems and aquarium going. Aside from the noise and the trips to the gas station, it worked pretty well. However, I was curious about energy storage innovation, and if there were other options I could consider. I reached out to Vaclav Smil, an expert on energy matters of all kinds (www.vaclavsmil.com).

- Here's what Vaclav had to say: "There has been no commercial breakthrough in designing either high-density, high-efficiency low-cost batteries for small-to-medium scale applications (such as homes) or inexpensive high-power devices that would fit the multi-MW to GW-sized systems of modern electricity generation. The former reality means that it is still not cheap and convenient to store electricity in a basement. And only the latter achievement would make it possible to decouple the timing of generation and consumption of electricity and allow entire systems to rely for periods of time solely on solar- or wind-generated electricity and individual consumers to be grid-independent for many hours. The battery business is bursting with new claims, but realities of any affordable mass-scale storage remain beyond its reach.[3]"
- Compressed air storage is technically feasible, but its low energy density limits its application. To illustrate, gasoline has a volumetric density of 34 gigajoules per cubic meter, compared to 0.2 for compressed air (at 300 bars). So, in theory, I would need a compressed air device that's 170 times larger than my Honda generator to store the same amount of potential energy. That's the same size as the neighbor's house, and why commercial applications require caverns, aquifers and salt domes.
- Flywheels have been around for a long time as an energy storage concept. In fact, there was an article in *Popular Science* Magazine in October 1979 entitled "*Basement Flywheel Stores Solar Energy at 15,000 rpm*". However, not much has been done since then for residential use. Flywheels may offer some promise at a commercial level to perform "frequency regulation leveling": this summer, the world's largest (20 MW) flywheel energy storage facility opened in upstate NY.
- For 15-20 times the cost of my gasoline powered generator, I could in theory purchase an inverter (converting 48 volt DC to 240 volt AC), a fuel cell system, a 48 volt battery, an electrolyser and a hydrogen storage tank. Massive overkill, and mostly an expensive source of primary power rather than a backup-power plan.

In other words, little has been accomplished yet as an inexpensive and reliable alternative for my Honda EB 11000 on a household scale, and we still have no practical large-scale means of storing electricity besides pumped storage.

One of the other frustrations about the Hurricane was the amount of downed power lines from falling trees, which seems like a 19th century problem. According to Vaclav, new underground high-voltage transmission lines cost 8 to 10 times more than the overhead wire mounted on steel towers, and new underground distribution lines (< 35 kV) cost four to six times more than the aboveground wires that typically hang on wooden or concrete poles. Add in the retrofitting costs, and it's clear why many municipalities are still delivering electricity the same way they did 100 years ago.

[3] In a presentation entitled "*Progress in Electrical Energy Storage*" from February 2011, the Department of Energy notes new battery technologies based on lithium ion, vanadium redox, lead/carbon, zinc bromide and sodium ion. However, most of these options provide around 1-4 hours of backup power and are used for grid-smoothing and leveling purposes, rather than longer-term backup power for outage or off-grid situations.