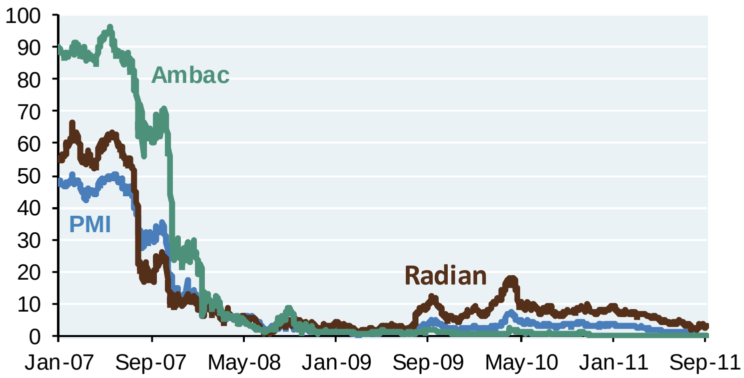
How bad can Europe get; how fast can China grow; how progressive can tax policy be; how independent can the Fed remain

Something notable happened over the last 2 months: the financial markets have finally priced in our dire view of the European Monetary Union. Call it "*The European Reality Show*". EU equities have underperformed the S&P 500 by 16% this year, following an additional 10% underperformance in 2010 . Debt markets price in 50%-60% probabilities of default for Portugal and Ireland and 100% for Greece, French bank credit default swap spreads have tripled as US money market funds reduce exposure, German equities trade at less than 10 times earnings, many European banks trade below 0.5 times book value and 70% of fund managers are underweight European banks. During the last 2 years, an aggressive underweight to Europe has been the right place to be, ignoring the wistful delusions of policymakers, analysts, economists, etc who believed the EMU could right itself through austerity-based lending and some structural reforms. However, now that this view has become consensus, we need to start thinking about whether a set-it-and-forget-it underweight to Europe will keep working from here.

Over the weekend, I was thinking about other situations where it made sense to underweight or short something, and maintain that view until the position became rubble. The US mortgage and municipal insurers shown in the first chart are one example: 1% equity capitalization, a recession and terrible underwriting standards will do that. Lehman Brothers is another; 3% equity capitalization, illiquid principal investments, reliance on wholesale funding, etc; you know the story.

Ambac, PMI, and Radian: no way out
Common share price, USD



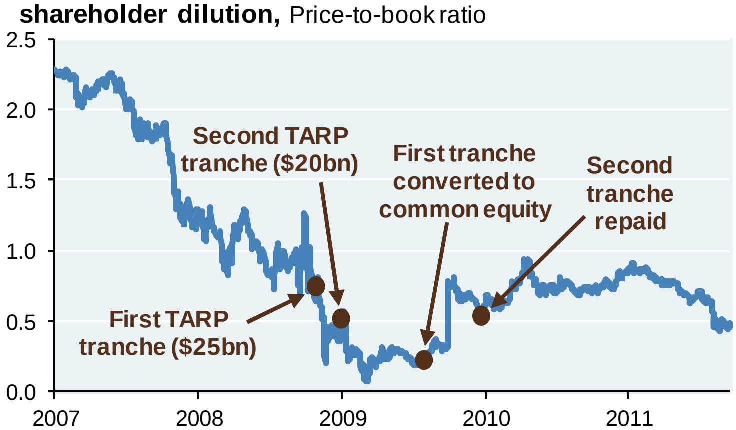
Source: Bloomberg.

Same for Lehman Brothers
Common share price, USD

Source: Bloomberg.

Perhaps a better paradigm for EU banks would be Citigroup, due to its systemic risks. When the Treasury first injected preferred capital into Citigroup, the price to book value on its common shares fell to 0.7. The price/book ratio fell to 0.5 upon the second injection, and eventually bottomed at 0.2 times book value in the spring of 2009. As shown on the right, EU banks are getting there, with price-to-book ratios close to 2009 levels [note: EU bank price to *tangible* book value is ~ 0.15 higher].

Systemic risk + government recapitalization = Citigroup shareholder dilution, Price-to-book ratio



Source: Bloomberg, Citigroup.

EuroStoxx Banks Index: reality finally sets in
Price-to-book ratio

Source: Bloomberg.

The problem for Europe, of course, is that EU banks are a lot bigger than US banks, making the problems harder to solve. As shown in the chart on the following page, many EU banks dwarf their US counterparts. In addition, while 0.5 times tangible book value has been the *average* trough level during severe banking crises, there is a very wide range of outcomes, including 0.15 in Korea (1997) and 0.30 in Sweden (1991). We have covered in prior notes the greater reliance of EU banks on volatile wholesale funding relative to US and Japanese counterparts, and the shutdown in unsecured European bank debt markets this summer. On top of that, the latest EU business, money and credit surveys point to a sharp slowdown in growth,

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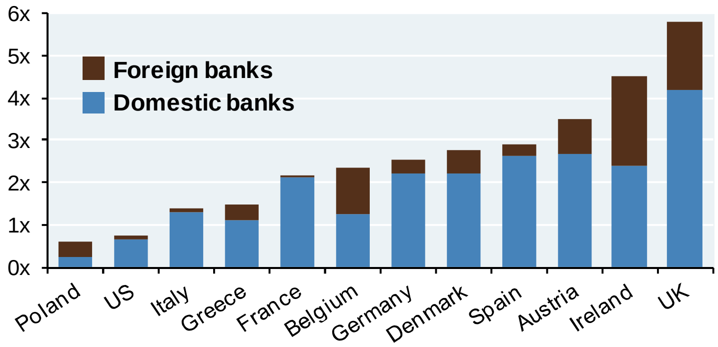
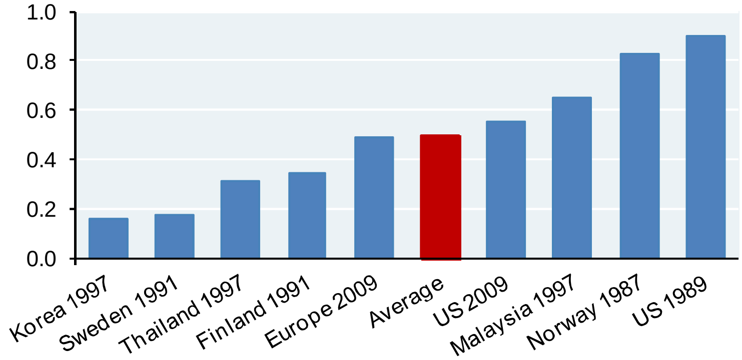
particularly in the periphery, where conditions are terrible. As a result, it's *not* just sovereign risk exposures that European banks have to worry about, but EU corporate exposures too. **Bottom line: there's plenty to be worried about regarding EU banks. The question now becomes, what (if anything) Europe does about it.** Various delays suggest the EFSF will not be operational until November at the earliest. But eventually, if Italy, Spain and other countries borrow from the EFSF to recapitalize banks, there could be a positive market reaction to postponing the day of reckoning. How much capital do EU banks need? Depends whom you ask. The Committee of European Banking Supervisors said Eur 2.5 bn (I thought this was just for Andorra and that they were going alphabetically, but they meant the entire EU). Wall Street estimates range from 30-80 bn, and the IMF's number is 200 bn. The German Institute DIW believes the 10 largest German banks *alone* need 127 bn.

Europe: bigger banks, bigger problems
Liabilities*, Multiple of GDP



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

How bad can banks get in a crisis?
Trough price to tangible book during historical banking crises



Source: Estimates based on Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

Until a few weeks ago, the reliable strategy was to assume European assets would underperform, since policymakers would only react after a market riot. Now there has been one, and the range of outcomes is hard to predict (default, ECB debt monetization, turning EFSF into a bank to quintuple its buying power, federalization through Eurobonds or just a massive muddle-through). We have no idea if, how or when markets will ever look at Italy the same way again (see Appendix). We still maintain large underweights to Europe given the uncertainties, and our inability to figure out how they can fix it. **But policy options remain, and given how consensus our views now are, the risk of short squeezes and relief rallies is rising**.

<u>**China: an afternoon with True Believers**</u>

Every week, we invite outside speakers to present to us on different topics. This week, we hosted Arthur Kroeber from Dragonomics in Hong Kong to talk about his view on China's economic sustainability. Arthur is a true believer, and does not see China as being ripe for a hard landing. I am often skeptical of research firms located in the developing countries they cover, since they can get a case of *Stockholm Syndrome* and miss the Reality Show happening around them. In the 1990's, I recall firms like Renaissance Capital and Troika Dialog being perma-bullish on Russia, which was the wrong place to be when Russia defaulted. The same goes for many Argentina research firms that believed that Peso-dollar convertibility would last forever. However, Dragonomics strikes me as much more balanced and less ideological, so we wanted to hear what Arthur had to say.

There are (at least) three fundamental arguments that Chinese economic growth is unsustainable: that consumption is way too small as a % of GDP; that capital is massively misallocated in favor of capital spending and infrastructure; and that China is running out of workers, leading to the risk of wage inflation that will soon erode China's competitiveness. Since these are essentially macro arguments at heart, I thought it was reasonable for Arthur to offer macro arguments to rebut them.

As per the first chart below, while consumption is falling as a % of GDP, **on an absolute basis retail sales are doing fine**, growing at 15%-20% per year. Retail sales are a partially flawed measure since they *include* government and business purchases of consumer goods, and *exclude* consumer purchases of services. But other measures like urban household consumption show the same trend. In the second chart, Arthur highlights how falling consumption as a % of GDP is not abnormal for industrializing Asian economies; the only notable point is that China's starting level was much lower.

Regarding misallocation of capital, we have often noted how capital spending to GDP in China exceeds similar measures during industrialization in Japan, Korea and Germany. The risk of capital misallocation is a collapse in industrial profits, asset price bubbles and a banking crisis. However, as Arthur points out, **China's starting point was much lower, since the Cultural Revolution and Great Leap Forward destroyed much of China's accumulated post-war capital stock**. The third chart shows how low China's estimated capital stock per capita is compared to the US, and compared in real terms to the US of the 1930's. Per capita measures can be misleading, particularly in China's case. But we think the overall point is a reasonable one.

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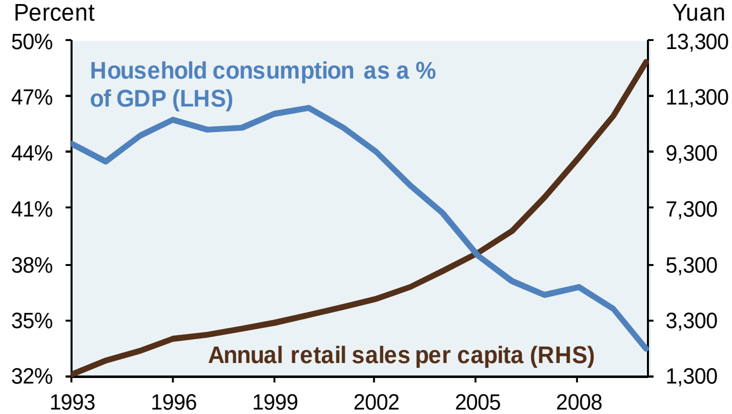
The more convincing point is that China's capital-to-output ratio is *lower* than other countries in Asia, at least as of 2007. There has since been a construction boom, so we will need to see how these ratios look when they are updated. But they do show that Chinese growth through 2007 was not excessively reliant on its capital stock, compared to other Asian countries.

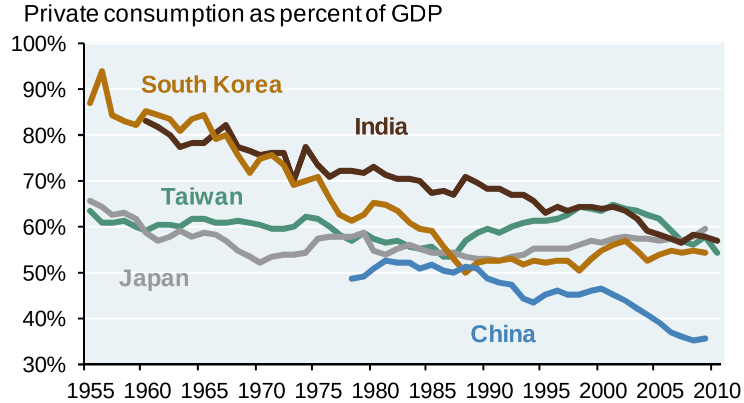
Arthur's last point was that China is not running out of workers. The fifth chart shows Chinese urbanization in context of other countries in Asia. The pace of urbanization did not slow in these countries until the agricultural work force fell below 20%. To be clear, the days of 11% GDP growth and 1% inflation in China are over. A variety of factors have led to faster wage growth for Chinese workers, and **we should now think about 8%-9% growth and 5% inflation instead**. But Arthur believes this paradigm can be sustained, without the inevitable hard landing that some China-watchers have been waiting (and waiting) for.

Consumer spending: watch its level, not the share



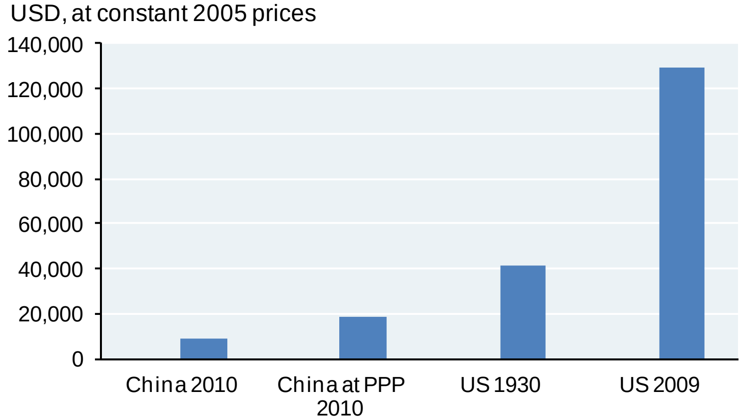
Source: IMF, China State Statistical Bureau, China Nat'l Bureau of Statistics.

Consumption ratios in major Asian economies



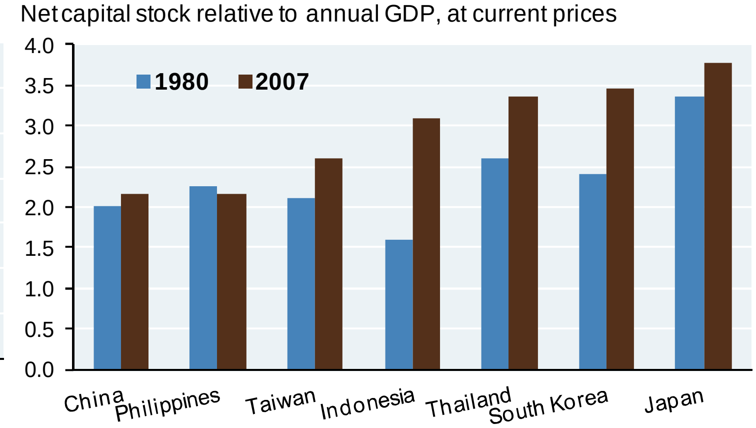
Source: IMF, OECD, Gavekal Dragonomics.

Capital stock per capita in China and US



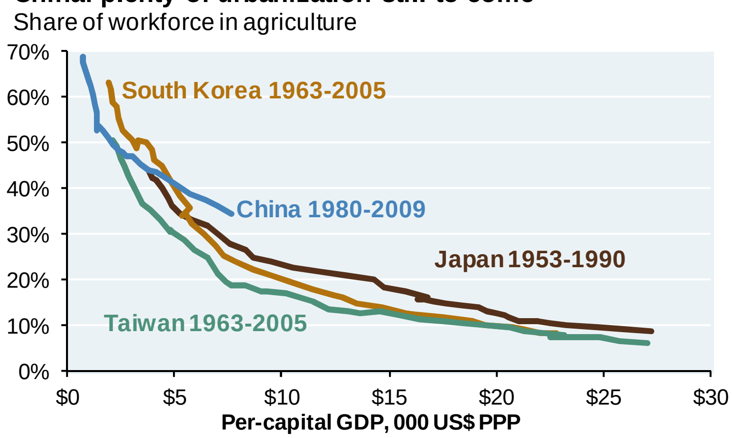
Source: Gavekal Dragonomics, US Bureau of Economic Analysis.

Capital-output ratios in Asia: China looks normal



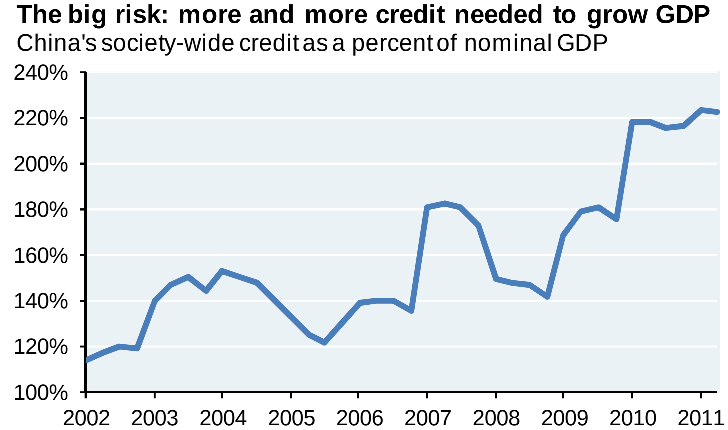
Source: Asian Productivity Organization, Gavekal Dragonomics.

China: plenty of urbanization still to come



Source: Gavekal Dragonomics.

The big risk: more and more credit needed to grow GDP



Source: PBOC, China Bureau of Statistics, J.P. Morgan Private Bank.

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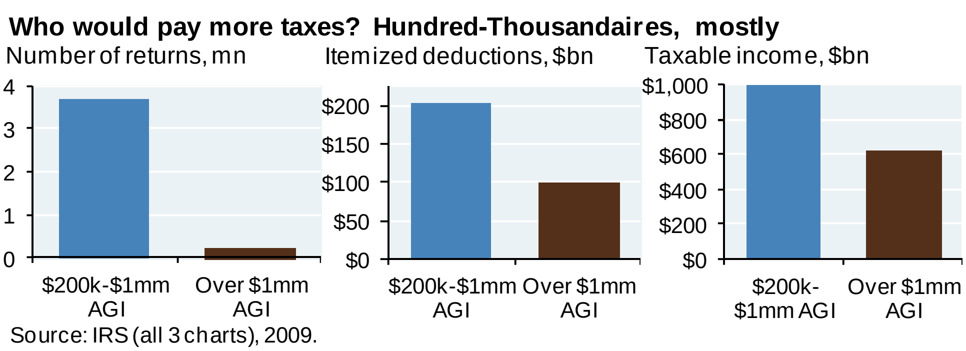
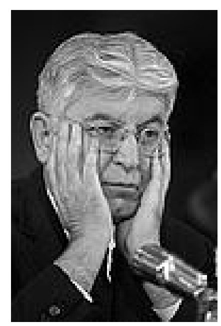
Now the bad news: **the Achilles heel in China is the increased reliance on debt to generate growth**. The last chart is our own, and looks at how much society-wide credit (household, corporate and sovereign) it takes to generate nominal growth. The recent spike occurred due to a rapid rise in China's shadow banking system. China has nowhere near the sovereign debt problems the West has; its Federal debt is only 45% of GDP with another 27% from municipalities, with almost all of it funded domestically. But increased use of debt to finance growth, and rising inflation, raise some red flags about sustainability.

All things considered, we are bullish on China regarding its contribution to Asian growth, rather than its contribution to Chinese equity markets (which have been among the worst in the developing world). We do not subscribe to the *China is a Mirage* view that ghost cities[1] and unneeded infrastructure projects will result in a huge crash; China can probably survive the moderate correction that will come when bank NPLs rise. As China tightens monetary and credit policy further (which they need to do, even after recent increases in reserve requirements applied to margin accounts and other measures), we will learn more in 2012 and 2013 about who's right.

Obama Deficit Reduction Plan: tax increases (a lot), legislated spending cuts (less) and entitlement reform (even less)
A larger-than-expected deficit reduction plan could be bullish for US P/E multiples. At first read, the President's proposal seemed to be exactly that: $4.4 trillion in deficit reduction over 10 years. However, two caveats. First, the $4.4 trillion headline number includes $1.2 trillion from spending caps already passed during Phase 1 of the Budget Control Act. Second, another $1.1 trillion is based on projected troop withdrawals, savings determined as much by circumstance and exogenous forces as by the Congress. As a result, tangible incremental proposed legislative changes amount to $2.1 trillion (not $4.4 trillion), 75% of which are tax increases rather than spending cuts; and only 10% of the overall deficit reduction plan is entitlement reform.

The details. The rhetoric behind the President's proposed tax reform refers to raising taxes by $1.5 trillion on "millionaires and billionaires". **Upon closer review, "hundred-thousandaires" seems more accurate**. The foundations of the President's proposed reform are an end to the Bush tax cuts on taxpayers earning more than $200,000-$250,000 per year (which raises $800 billion over 10 years), and limitations on itemized deductions and exclusions applied to this same demographic (which raises $400 billion). As shown in the charts below, raising taxes on income and reducing deductions will fall at least as hard, if not harder, on those earning $200k-$1 million as on those earning more than $1 million. Is this really what Buffett had in mind?




Squeezed: Fed Chair Arthur Burns, circa 1971

Finally, there was a Republican letter to the Fed this week asking it to refrain from Qe3. To wit: "*It is our understanding that the Board Members of the Federal Reserve will meet later this week to consider additional monetary stimulus proposals. We write to express our reservations about any such measures. Respectfully, we submit that the board should resist further extraordinary intervention in the U.S. economy, particularly without a clear articulation of the goals of such a policy, direction for success, ample data proving a case for economic action and quantifiable benefits to the American people.*"

As a reminder, politicizing the Fed goes back a long way, though in the past, Republicans favored *easier* money. In the 1970's, when Fed Chairman Arthur Burns resisted pressure to guarantee full employment through low policy rates, the White House planted negative stories about him in the press, attacking his competence and compensation. Nixon's people also floated stories about diluting the Fed Chairman's power by doubling the number of Federal Reserve Board members. Nixon wrote to Burns: "*There is no doubt in my mind that if the Fed continues to keep the lid on with regard to increases in money supply and if the economy does not expand, the blame will be placed squarely on the Fed.*" In 1971, H.R. Haldeman spoke about the effectiveness of Nixon's strategy: "***We have Arthur Burns by the b*lls on the money supply***". Sometimes, US politics are the best Reality Show of all. No comment on *Operation Twist*, since a few basis points at the end of the curve doesn't mean much.

Michael Cembalest, Chief Investment Officer

[1] For every ghost town example (e.g. Ordos in Inner Mongolia), there are others (Pudong, Linyi, Zhengzhou, Kunming, Dachang) where urban populations have, over time, absorbed vacant space and created viable commercial and residential centers.

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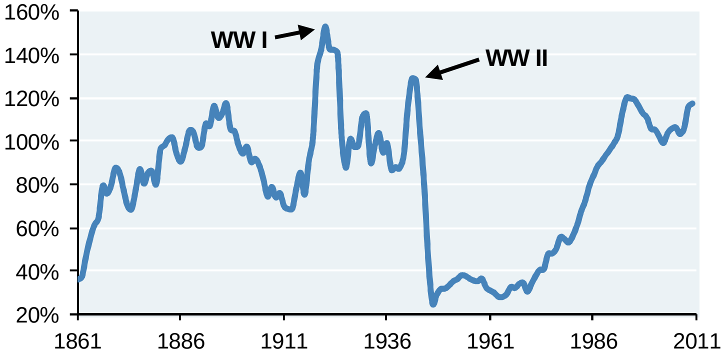
<u>Will the markets ever look at Italy the same way again? Solvibilità è negli occhi di chi guarda</u>

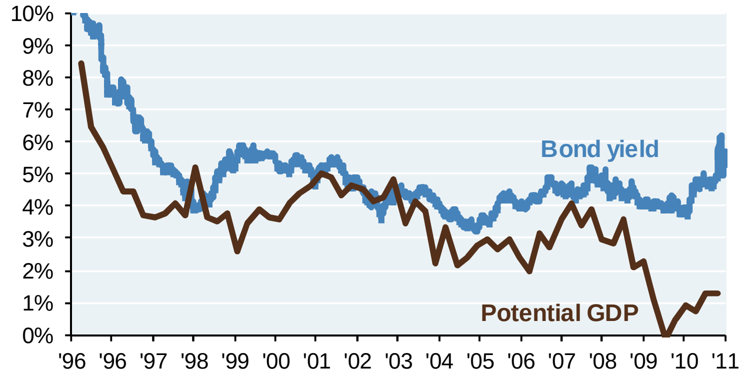
The charts below show Italy's elevated debt levels, its bond yields versus its potential growth rates (one of the largest gaps I have ever seen), the lack of internal devaluation to reduce its competitiveness gap with Germany, the evisceration of Italian industrial production that began like clockwork with the inception of the European Monetary Union, the worst production time per unit in the EU, and the need for a lot of foreign capital (e.g, a large current account deficit). Will the markets ever finance Italy at 30 basis points over Germany again, as they did from 2004 to 2009? And how will a balanced budget bill solve any of these problems? Translation of header: "solvency is in the eye of the beholder".

Italy's debt/GDP: highest since unification other than wartime, Total gross general government debt/GDP, Percent



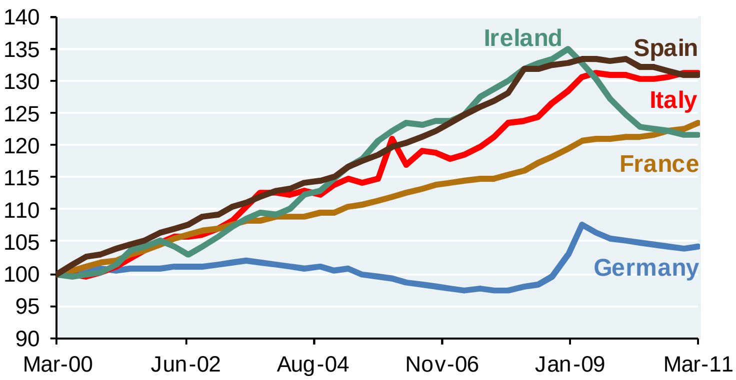
Source: Reinhart, Camen M. and Kenneth S. Rogoff, "From Financial Crash to Debt Crisis," NBER Working Paper 15795, March 2010.

Italy sovereign bond yield vs. potential GDP
10-year generic yield, potential GDP YoY%



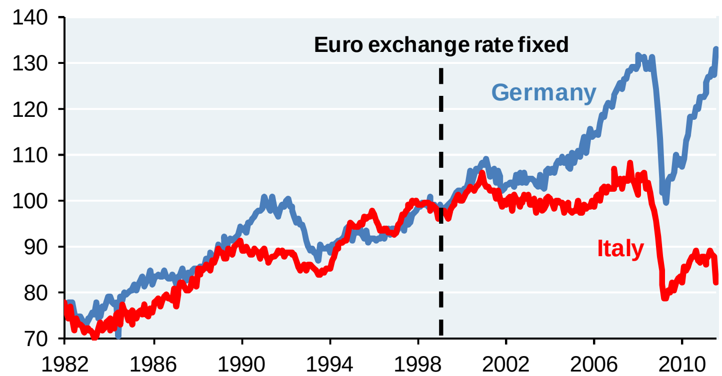
Source: OECD, Bloomberg.

Internal devaluation? So far, only in Ireland
Unit labor cost, index, 3/31/2000 = 100, sa



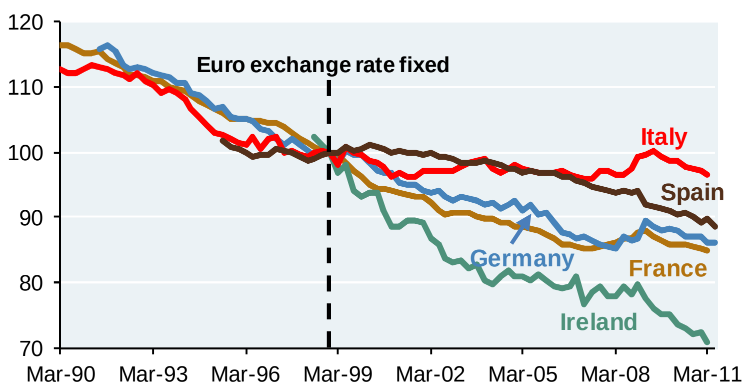
Source: OECD.

Industrial production in Germany and Italy
Index, 12/31/1998 = 100, sa



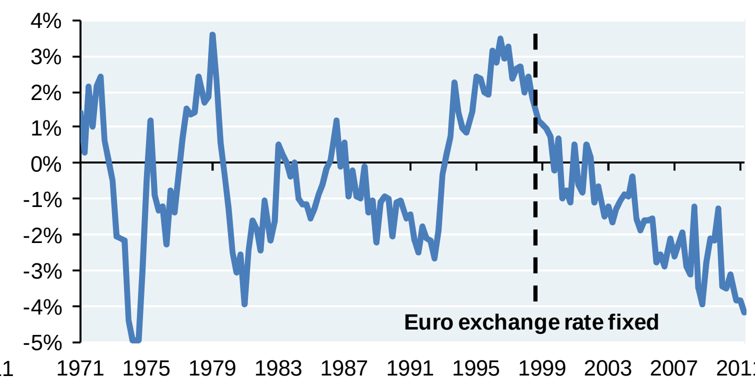
Source: OECD.

Production time per unit
Index, 12/31/1998 = 100



Source: Statistical Office of the European Communities.

Italy's current account
Percent of GDP



Source: OECD.

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EMU	European Monetary Union
EU	European Union
EFSF	European Financial Stability Facility
ECB	European Central Bank
CP	Commercial paper
NPL	Non-performing loans

Sources include "*Secrets of the Temple: How the Federal Reserve Runs the Country*" by William Greider, "*Before the Fall: An Inside View of the Pre-Watergate White House*" by William Safire; and "*Monetary Policy and the Great Inflation in the United States: The Federal Reserve System and the Failure of Macroeconomic Policy 1965-79*" by Thomas Mayer. Picture of disgruntled Arthur Burns from Corbis Images.