

A brief Q1 2012 medical check-up on the United States; The Shooting Party

R_x

Patient Name: United States of America

Address: 1600 Pennsylvania Avenue, Washington DC

Notes: patient came in for routine check up. In a replay of Q1 2011 visit, pulse of patient's expansion is improving. Patient's job prospects (see Note A), confidence and delinquency rates all looking better. Flow of credit rising, along with increased automobile, rail and freight activity. Patient's inclination to spend picking up, but this appears more a function of lower savings than rising earned income. An improving manufacturing outlook in Asia (new orders up, inventories and inflation down) helps as well.

Vehicle sales

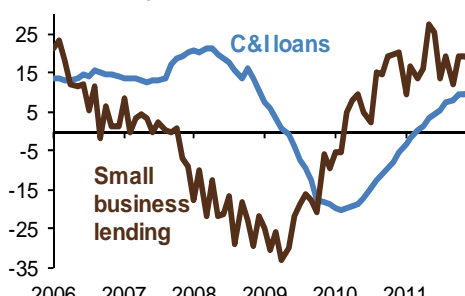
Millions, saar



Source: Bloomberg.

Loan growth

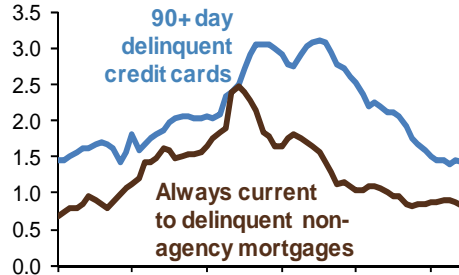
Percent change, YoY



Source: Federal Reserve Board, Haver, Thomson Reuters, PayNet.

Credit card & mortgage delinquencies

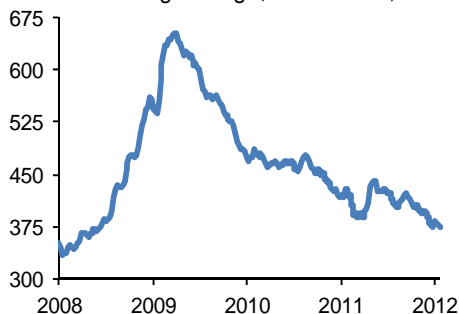
Percent



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

Initial jobless claims

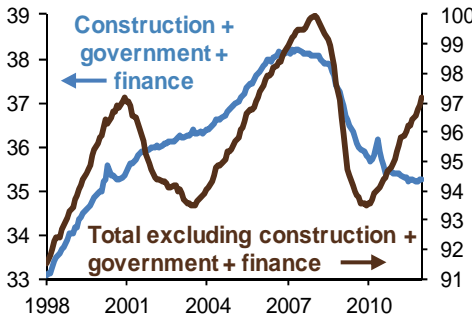
4-week moving average, Thousands, sa



Source: US Department of Labor.

Improving "cyclical" payrolls

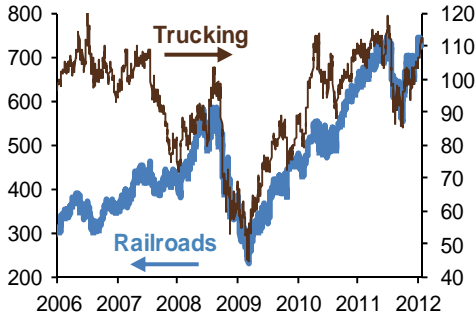
Millions



Source: BLS.

Railroad and Trucking stocks

Index



Source: Standard and Poor's, Bloomberg.

Manufacturing - export / new orders

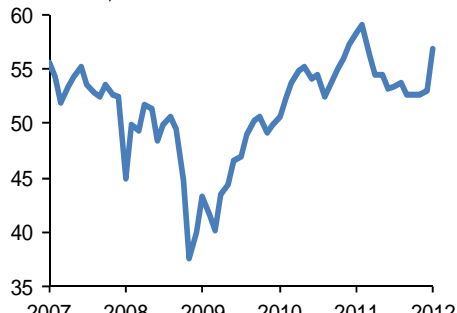
ISM Index, sa



Source: ISM.

Economy-wide service sector survey

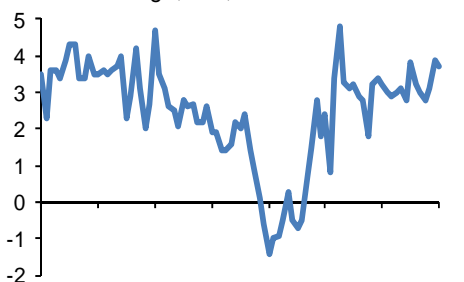
ISM Index, sa



Source: ISM.

US retail chain store sales

Percent change, YoY, sa



Source: ICSC - Goldman Sachs.

Current prescription medications:

- **Xenical**, for weight loss; as per the OECD, the US is the world's most obese country (34% of all adults)
- **Anti-hyperlipidemics (e.g., Lipitor)**; as per the CDC, 11.4% of the US population takes cholesterol reducing agents, the largest percentage for any prescription medication
- **Antibiotics (e.g., Zithromax)**: the US ranks in the top 5 countries regarding per capita antibiotic prescriptions

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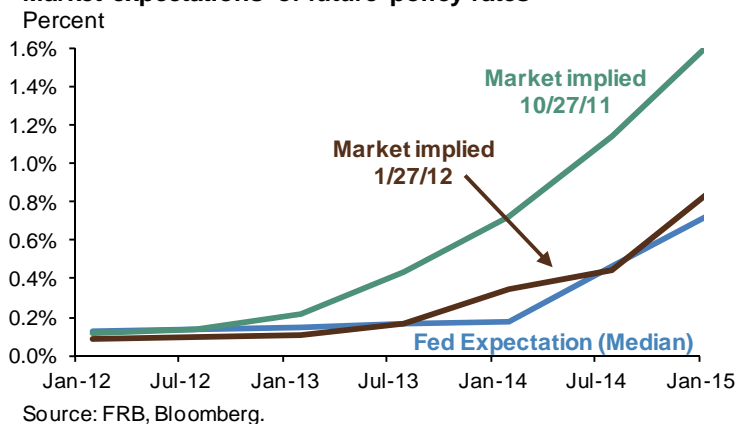
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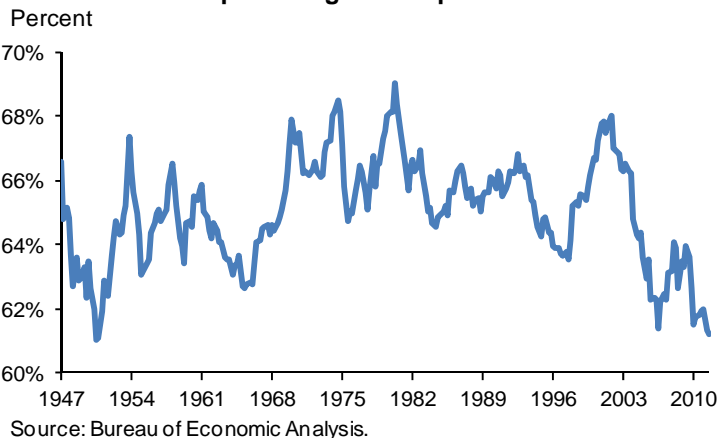
Address: 1600 Pennsylvania Avenue, Washington DC

Addictions: Patient still heavily addicted to free money from the Federal Reserve, cheap labor to boost corporate profits, government transfers to households, and imported energy. Patient also too reliant on apples (see below). If inflation were to rise, patient would have to undergo monetary bed-rest. On energy, while patient is now a small net exporter of *refined* petroleum products, patient still imports 8-9 million bpd of *crude oil*, and is also a large net importer of natural gas, electricity and uranium oxide.

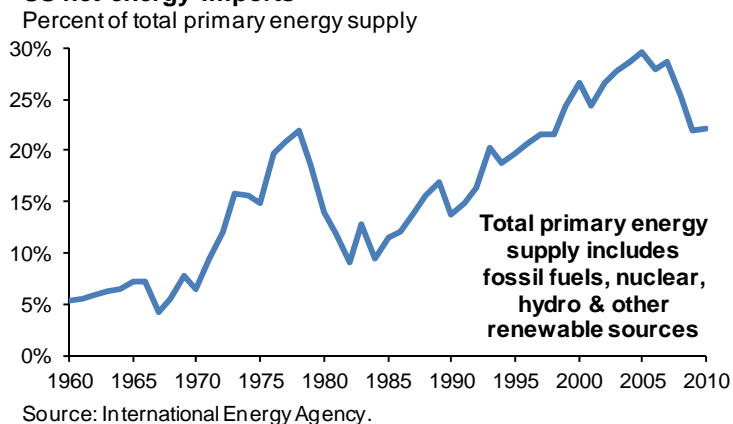
Market expectations of future policy rates



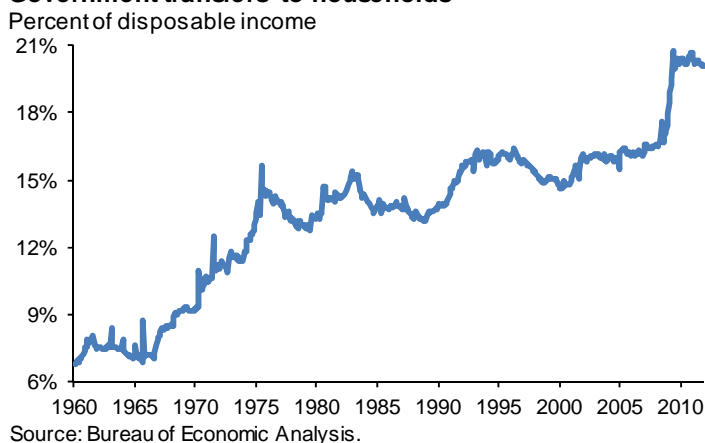
Labor costs as a percentage of corporate sales



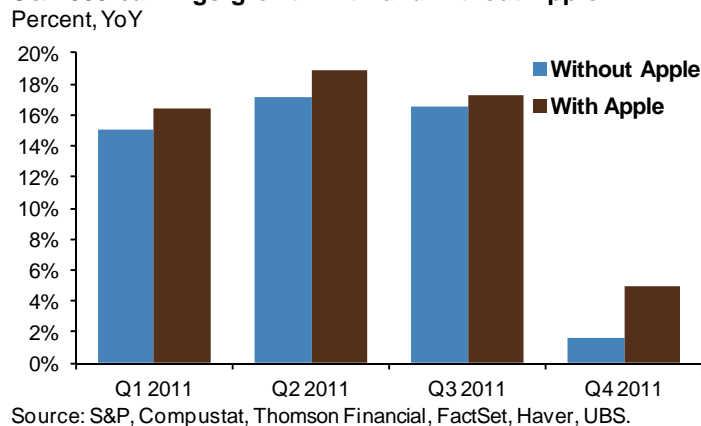
US net energy imports



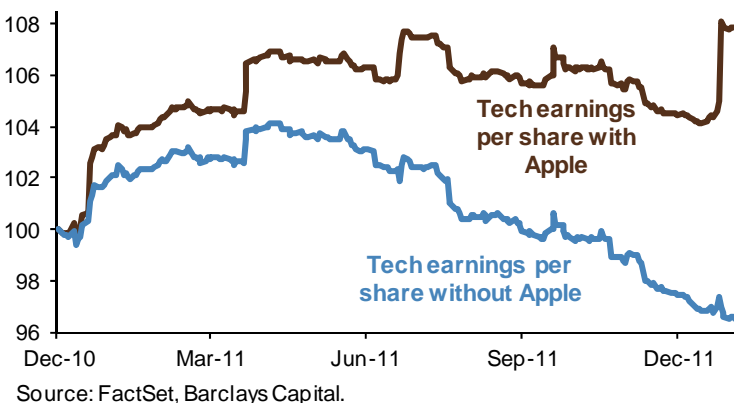
Government transfers to households



S&P 500 earnings growth with and without Apple



S&P 500 tech earnings outlook with and without Apple
Index, 12/31/2010 = 100



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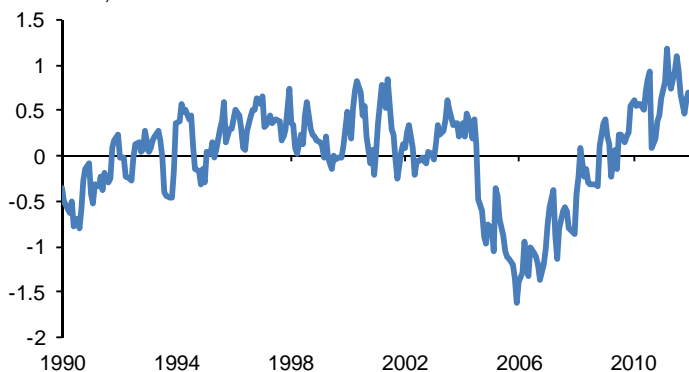
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Patient Name: United States of America Address: 1600 Pennsylvania Avenue, Washington DC

The Home Front: Patient exhibits significant pent-up demand to buy a new home given how cheap they are. However, patient (a) fears impact of shadow inventory on existing home prices, (b) is stuck in a home with negative equity, and (c) is struggling with the increase in average FICO scores on new prime mortgages (from 725 to 775). After stripping out distressed sales and the 4 housing disaster states, home prices are stabilizing, but that's a subset of a subset. At least new home sales and housing starts have bottomed. Consumer durable purchases as a share of GDP are at a 50-year low and are likely to rise.

Pent-up demand (household formation vs. trend)

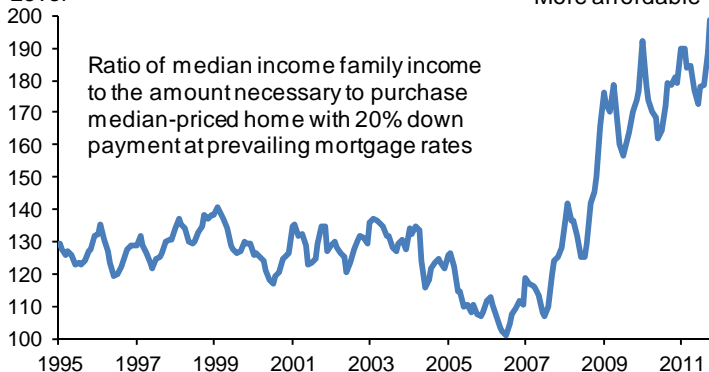
Millions, households



Source: Census Bureau, J.P. Morgan Private Bank.

Housing affordability Index

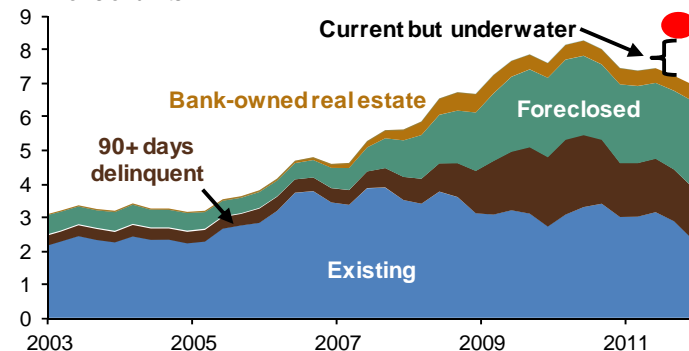
Level



Source: National Association of Realtors.

Shadow housing inventory

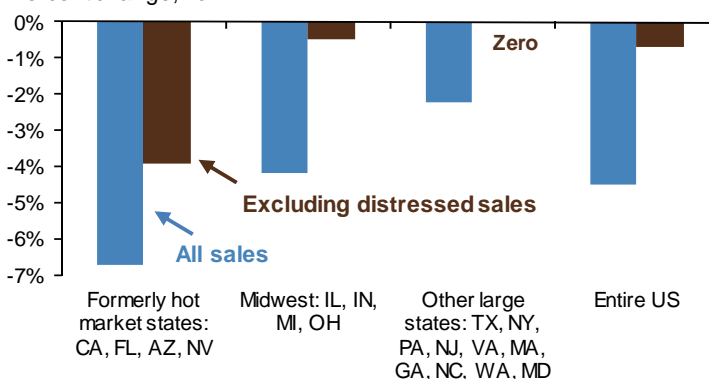
Millions of units



Source: National Association of Realtors, J.P. Morgan Securities LLC, Amherst Securities, Mortgage Bankers Association.

Home prices including and excluding distressed sales

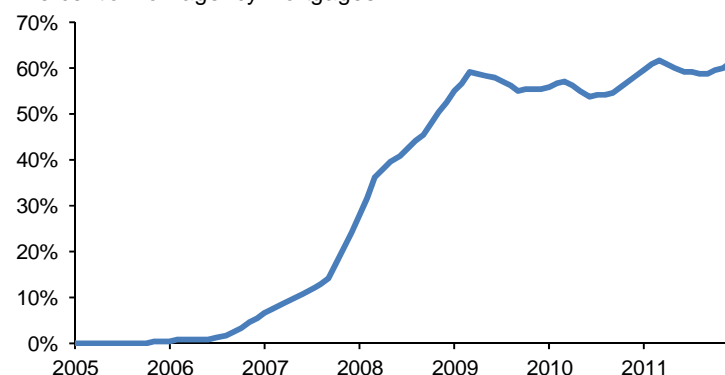
Percent change, YoY



Source: First American Core Logic, Empirical Research Partners Analysis.

Mortgages with negative equity

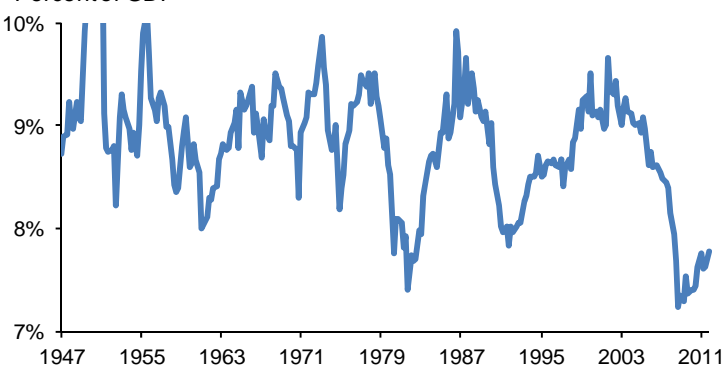
Percent of non-agency mortgages



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

Personal consumption of durable goods

Percent of GDP



Source: Bureau of Economic Analysis.

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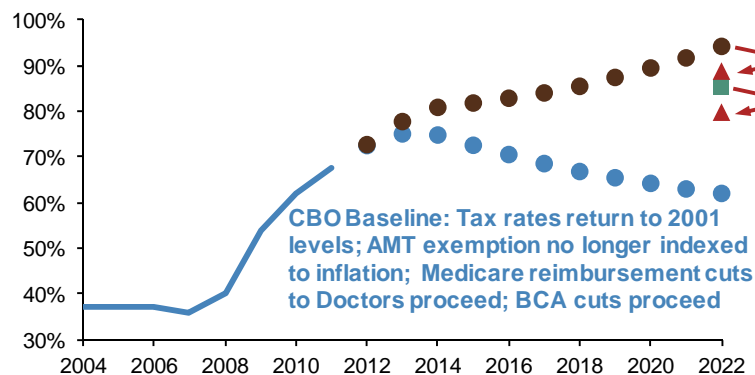
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Long-term prognosis: still concerning, as patient combines European welfare state with libertarian tax policy. Doctors at the CBO outline a possible healthy baseline case, but only if patient allows all Bush tax cuts to expire, ends the AMT inflation patch (a move that would subject an extra 28 million taxpayers to higher taxes), and cuts Medicare reimbursements to doctors like myself. Adequate official and private sector demand for Treasuries, even at an ~8% deficit, make this a recessive gene rather than an active one.

US long-term debt scenarios

Net debt to GDP, percent



● CBO Alternative Case: Realistic Case below, PLUS:

- * Shelving of planned automatic BCA cuts
- * Extension of expiring business and household tax incentives and relief (there are ~80 different credits)

▲ Tax the Rich, as per administration's proposals:

- * Tax rates return to 2001 levels for AGI > \$250k
- * Carried interest is taxed as ordinary income
- * Taxpayers with AGI > \$1 million are subject to a minimum 30% effective tax rate on AGI

Note: proposals shown relative to both Alternative and Realistic Cases, and include associated interest savings

■ "Realistic" Case:

- * All 2001-2003 income tax cuts extended
 - * AMT exemption continues to be indexed to inflation
 - * No Medicare reimbursement cuts, but BCA cuts proceed
- Note: CBO estimate of the first two items has increased by 700 billion since its August 2011 report

Source: CBO, OMB, IRS, J.P. Morgan Private Bank. AGI is adjusted gross income.

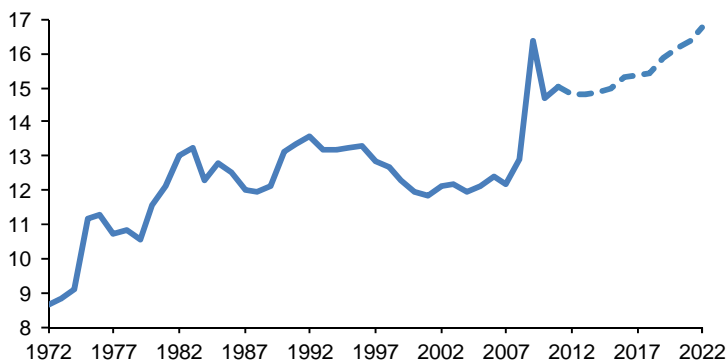
**** CBO physicians also laid out patient's fiscal future if baseline decisions are *not* made**, if automatic "sequestered" Budget Control Act cuts are shelved, and if business and household tax relief is extended (**Alternative Case**). Some medical experts advocate a tax-the-rich strategy, but on its own, it wouldn't stabilize the Federal debt. Assume Bush tax cuts expire on the wealthy (AGI > \$250k), a minimum effective tax rate of 30% on AGI > \$1 million, and carried interest taxed as ordinary income; the fiscal future only looks modestly better. As an alternative to the **explicit** tax-the-rich approach shown above, patient could instead enact an **implicit** one by ending deductibility of state/local taxes and mortgage interest for everyone. However, CBO doctors estimate that these steps would save roughly the same amount as the explicit tax-the-rich approach, leaving the long-term deficit outlook still unresolved.

**** Other options:** increase income tax rates across all brackets, reduce entitlements (since as shown below, discretionary spending is *already* scheduled to be cut to a 40-year low), or make a Krugman-esque leap into the unknown, hoping that growth solves the problem, and if it doesn't, have the Fed monetize deficits if necessary. The Fed is getting a head start: since "Operation Twist" began last October, the Fed has effectively monetized 90% of all 20y-30y Treasury issuance.

**** Current Treasury demand is more than sufficient to finance patient's 2012 fiscal deficit**, given interest from Asian and Middle Eastern Central Banks, US commercial banks flooded with deposits, pension buyers looking to immunize long-duration liabilities, and the Federal Reserve. However, this is a recessive gene that may mutate without much warning.

Mandatory spending and interest costs

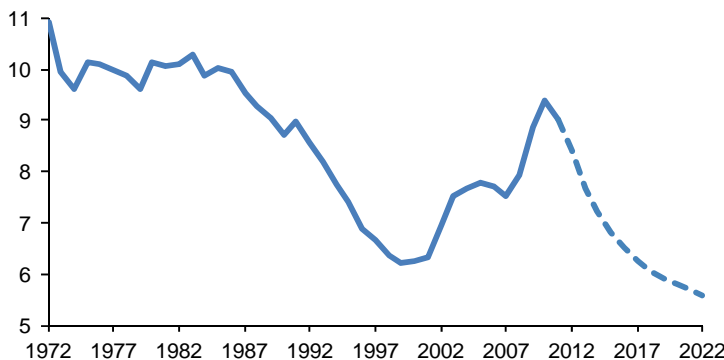
Percent of GDP



Source: Congressional Budget Office. Forecasts assume Baseline Case.

Discretionary spending

Percent of GDP



Source: Congressional Budget Office. Forecasts assume Baseline Case.

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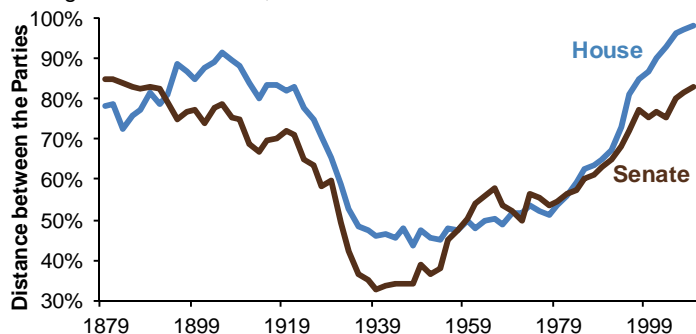
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Psychiatric evaluation: patient exhibits multiple personality disorder, characterized by increasingly visible strains between left and right sides of the brain. Patient struggles with conflict resolution, and no longer exhibits inclination toward compromise, unlike more conciliatory post-war period. **Note to self:** schedule app't for patient's cousin, the ECB, which faces possible GI failure from 170 bn in exposure to Greece.

Congressional polarization at an all time high

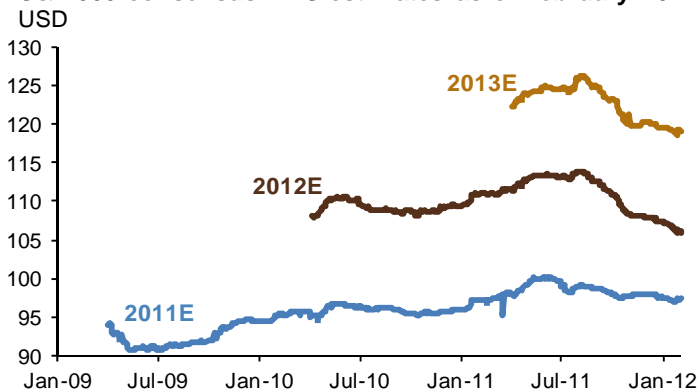
Degree of partisanship as measured through analysis of all Congressional roll calls, 1879-2010



Source: Keith T. Poole, University of California - San Diego, January 2011.

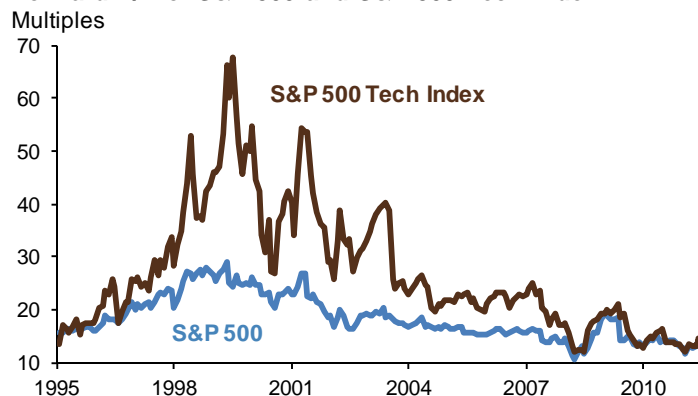
Summary: improved pulse of economic activity could not have come at a better time. Patient's earnings growth and breadth weakened into year-end, and Q4 2011 saw highest ratio of negative-to-positive earnings guidance in several quarters. Positive economic momentum will need to be sustained for multiple expansion to offset decline in earnings expectations. It looks like we may get it, but we cannot rule out possible infection from shock therapy treatments being applied in Southern Europe. Tech stocks look attractive, given the lack of any premium to the market, and improved free cash flow and capital efficiency metrics. A modestly better world could unleash decade-high levels of US corporate cash. **For now, maintain regional overweight to US equities; monitor spring labor reports for signs of follow-through.**

S&P 500 consensus EPS estimates as of February 2012



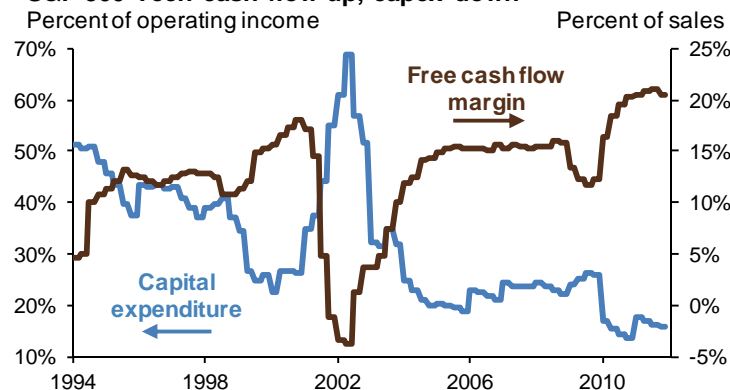
Source: FactSet.

Forward P/E of S&P 500 and S&P 500 Tech Index



Source: FactSet.

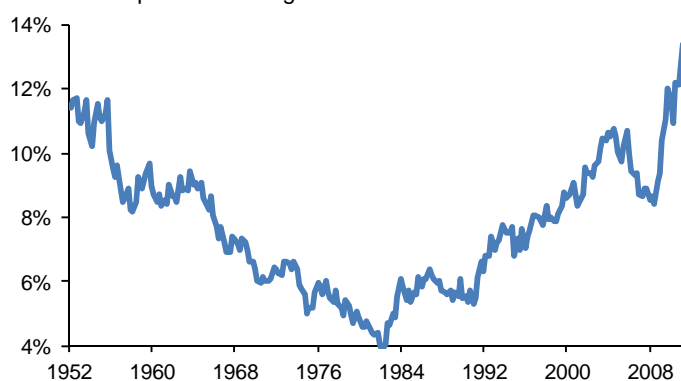
S&P 500 Tech cash flow up, capex down



Source: FactSet.

US corporate cash balances

Cash and equivalents / tangible assets



Source: Federal Reserve Board.

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The Shooting Party

We had dinner for eight to celebrate my wife's birthday. The discussion veered towards politics, and rather than go along with the other seven, I mentioned that I was not planning to support their candidate in the next Presidential election. Warning: **do not try this at home**, particularly with those very active in their party. As per the chart above, there's no oxygen left in the political middle any more. The fiscal conservatism of Nunn and Robb and the moderate Republicanism of Danforth and Hatfield are almost extinct, subjecting the politically outnumbered to howls of derision from one's astonished counterparts, who having occupied the moral high ground, cannot really hear you from that far away, and assume that opposing views are not just ill-advised but immoral. I believe our guests left wondering whether my wife would have grounds for annulment. The good news is that according to Article 9 of the New York State Domestic Relations Law (§§140-146), she would not qualify. Note to spouse: I should have known better; next time, let's go dancing instead.

Note A: On the January payroll report

A lot of internet ink was spilled last weekend regarding both seasonal and census adjustments to the January payroll report. In the hopes of simplifying this:

- The 10-year census data finally found its way into BLS estimates of the US population, with additions to young and old cohorts. The resulting further decline in the labor force participation rate is a long-term concern, given the related negative consequences for what potential output might be, and increased future entitlement costs not supported by active workers. It is not, however, a real-time measure of the employment cycle, and not a sign that a bunch of people decided to suddenly drop out of the labor force.
- The January seasonal payroll adjustment was large, and converted an actual loss of 2.7 million jobs into a 243k seasonally adjusted gain. But it was consistent with seasonal adjustments in prior years, and in a very transparent way. I find it difficult to believe that seasonal adjustment factors are influenced by anything other than agnostic BLS models run by people who watch Doctor Who and Big Bang Theory.

The bottom line is that there are structural problems with the labor force, but there are also cyclical improvements that are corroborated by other data/surveys. The January payroll report was, in our view, a positive.

Sources and Acronyms

- Tax Policy Center, Alternative Minimum Tax Projections: 2011-2022 (Table T11-0147), June 3, 2011
- Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options, March 2011
- Barclays Capital, Fed's Treasury Purchases/Sales as of February 2, 2012, February 2, 2012

AGI = Adjusted gross income; AMT = Alternative minimum tax; BCA = Budget Control Act

BLS = Bureau of Labor Statistics; CBO = Congressional Budget Office; CDC = Centers for Disease Control

ECB = European Central Bank; GI = Gastro-intestinal; NAIRU = Non-accelerating inflation rate of unemployment

OMB = Office of Management and Budget; OECD = Organization for Economic Cooperation and Development

PMI = Purchasing Manager's Index; SOTU = State of the Union

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