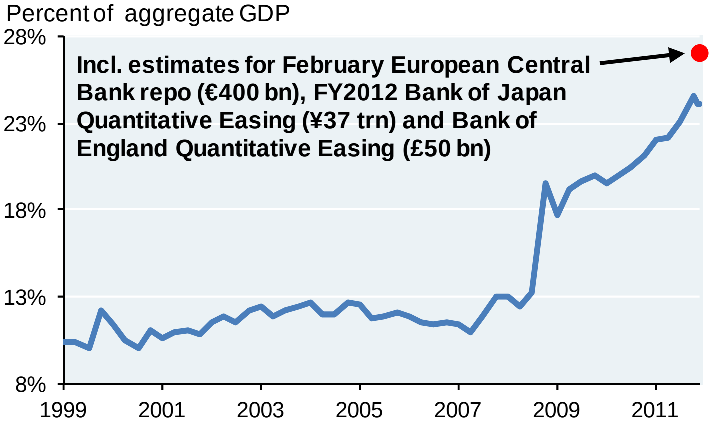
"*Nothing Else Matters*", Metallica, 1991

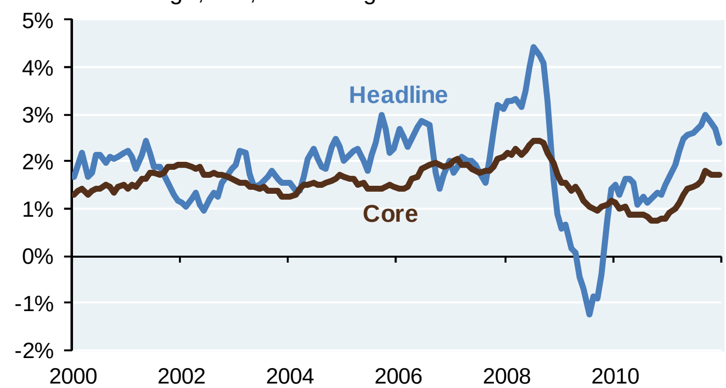
As far as markets are concerned, I don't think anything has mattered this year other than the 2 charts below. The first shows the rise in select central bank balance sheets and the second shows why central bankers feel safe doing it: low inflation. The goals: generate positive inflation in regions beset by deflation (Japan); boost bank capital and avoid insolvency by unlimited lending against a liberal definition of collateral (Europe); provide a lifeline to households, and pull forward future demand for consumer durables (US, UK); finance governments so markets don't have to do as much (everywhere); encourage investor risk-taking by devaluing cash savings (also everywhere); then wait for private sector to recover. The caveat: stop if there are signs of inflation. As shown in the second chart, inflation looks pretty tame (also see OECD output gap, p.2), although like the disclaimer says, "*past performance is not indicative of future results*". On commodity prices, central bankers see them as mean-reverting, and generally disavow connections between monetary stimulus and demand-based commodity price increases.

Central bank balance sheets: Japan, EU, US, UK, Swiss
Percent of aggregate GDP



Source: J.P. Morgan Private Bank. Country sources.

Inflation: Japan, EU, US, UK, Swiss
Percent change, YoY, GDP-weighted

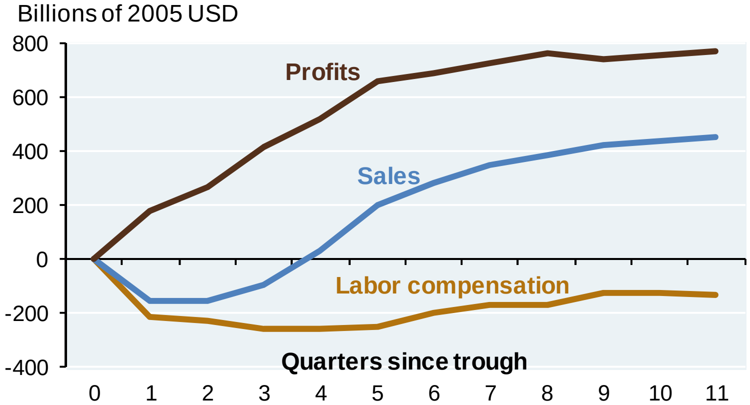


Source: J.P. Morgan Private Bank. Country statistics offices.

Like obscenity and modern art, these charts mean different things to different people. Larry Fink at BlackRock said in recent interviews that investors should be 100% in stocks. Byron Wien at Blackstone talked about revising his S&P 500 target to 1,500 from 1,400. Barron's is on the bandwagon (its *Dow 15,000* cover), and even the ghoulish Roubini is positive, at least for now. Every investor has to judge how much capital they will risk on this experiment. Our risk-taking is more moderate than the ones mentioned; we own a bit less equities than usual (5%-10% under "normal" allocations), with the difference in credit, hedge funds, distressed real estate and gold/oil, coupled with an underweight to government bonds. We will see how it turns out in the end. There's no denying the ferocious bid that free money can put under financial assets. At this stage, European money-printing in particular has created a lot more market lift than I anticipated.

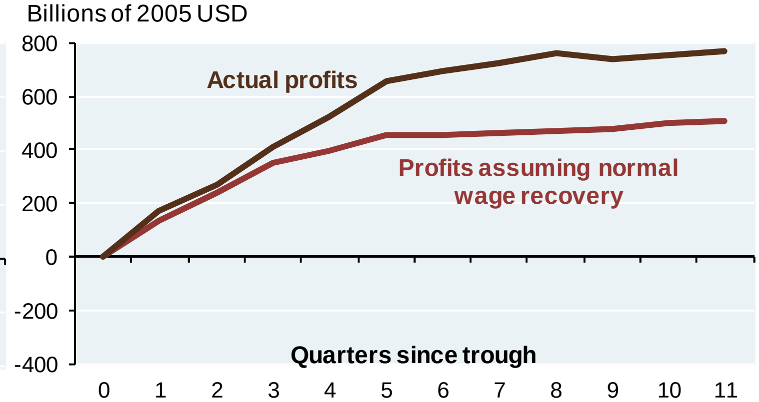
Some argue that the **US economic expansion** is the driver behind the rally. No disagreement about positive signs (see *RxUSA* from Feb 8), but let's be realistic: US growth is projected to be ~2.5% for 2012. That's better than last year's 1.7%, but still below the 3% growth rate that lost George HW Bush the "*It's the economy, stupid*" election in 1992. Some argue that **profits** are the driver, and they are doing well. But their strength did not prevent market relapses in 2010 and 2011, and look at where a lot of these profits come from. If compensation grew at trends comparable to prior recoveries, a big chunk of current-cycle profits would disappear. This doesn't mean that today's profits aren't real; it just means they come with related costs, such as weak household income and bloated government budget deficits, which have a cost as well (don't they?).

The current recovery
Billions of 2005 USD



Source: BEA, J.P. Morgan Private Bank.

What if labor compensation weren't so weak?
Billions of 2005 USD



Source: BEA, J.P. Morgan Private Bank.

"*Nothing Else Matters*", Metallica, 1991

Some argue that **European growth** surprised positively in Q4, but the surprises were confined to France and Germany. The periphery is in recession and expected to remain that way, and the Netherlands had a small decline as well. The best argument for optimism has been the amount of **fear that was priced into markets**. As shown on p.3, real earnings yields on the S&P 500 last November were as high as they have been in many decades, and are still on the cheap side of history. Still today, the cost of buying out of the money puts is very high; a lot of people want disaster protection, in case the experiment goes wrong.

To sum up, super-easy monetary policy supports markets right now, after reversing last fall's market collapse and near-default experience in Europe. By the way, add Brazil, Russia, Indonesia, Australia, Chile and Thailand to the club, since they also cut policy rates. On China, while it cut bank reserve requirements for the 2nd time after 12 increases, its money supply target is still tight (see p.3), so we do not expect that much total easing. Based on things central bankers look at, it appears most will keep money machines pumping for a while longer, and give the private sector a chance to get back on its feet again.

Risk #1: Iran. I was struck by Dennis Ross' February 14th NYT Op-Ed indicating that sanctions are working, and that Iran may be ready to talk. Ross, a former State Department and National Security Council official for both parties, is a good source. The last two US Defense Secretaries also do not appear anxious to engage militarily, citing "unintended consequences", and the Israeli Mossad also appears to have major concerns (*see Ronan Bergman's excellent January 25 NYT piece*). Anticipating more sanctions, Iran announced oil export bans to the UK and France (which weren't buying much Iranian oil), and repositioned a warship near Syria. The good news: since July 2010, Saudi Arabia, Kuwait and the UAE ramped up production by 2 mm bpd (see chart, p3), and increased Libyan/Iraqi output can help as well, eventually on the order of around 1.5 mm bpd. But oil prices are rising, out of the fear that the situation will escalate, and perhaps as a reflection of unlimited money creation.

Risk #2: the Bay of PIIGS. I expect the EU to soldier on with its failed Greek austerity program until it dies of social, political and economic exhaustion. In the near term, it looks like Greek leaders will support austerity plans even after the April elections (if they happen). As noted last week in greater detail, Greece's government debt of 145% of GDP (yes, that's *after* private sector debt forgiveness) will mostly be owed to the official sector. That *should* reduce the market impact of what happens from here, unless depression-like conditions bring Greece's ill-fated involvement in the Euro to an abrupt end. In that case, it might take even more than the 2.7 trillion Euros already printed by the ECB to calm things down again.

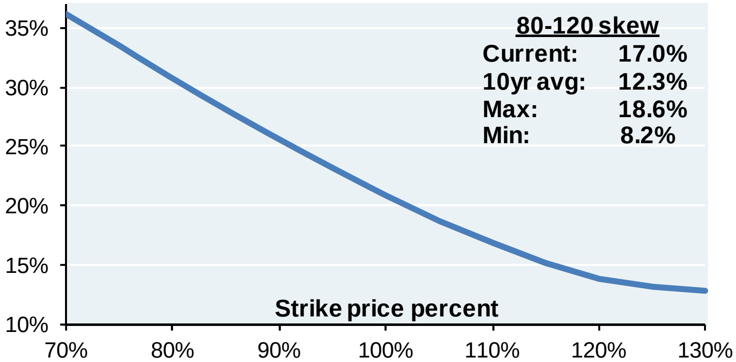
Who knew that unlimited money printing ($6 trillion and counting, since the fall of 2007) would be such a clean and simple solution to the world's problems? I would love to read a book called "*Reliable Central Bank Exit Strategies*", but I don't think it has been written yet. Enjoy the ride.

Michael Cembalest
Chief Investment Officer

Supplemental charts: the high cost of put options, economic slack in the OECD, attractive real S&P earnings yields, who made up for Libya production's decline, and how China is still focused on inflation despite cutting reserve requirements

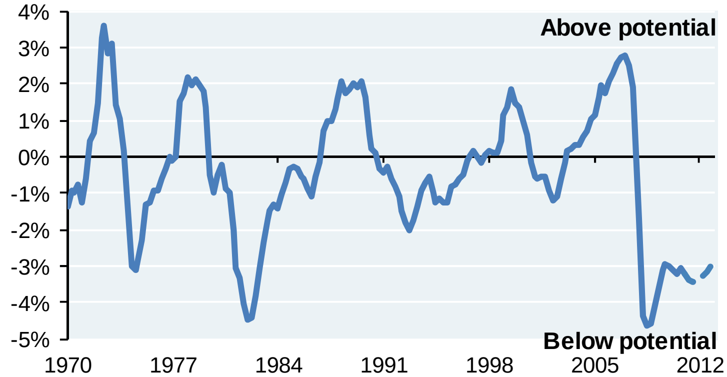
The first chart shows the cost of hedging with out of the money put options. Currently, as puts become farther out of the money, implied volatility and option premiums rise. As call options become farther out of the money, implied volatility flattens. There is normally a skew like this, but this is as steep as it has been in many years. The second chart shows the **"OECD output gap"**, an estimate of the deviation between current and potential output. When it's negative, it means that aggregate demand is running below aggregate supply, creating deflationary pressure. Other measures, such as US capacity utilization, have been rising more quickly. In the past, the Fed tightened well before capacity utilization hit its peak, but not when labor markets were this weak.

The elevated costs of buying puts
Implied volatility, 6-month S&P 500 options contracts



Source: J.P. Morgan Securities, LLC.

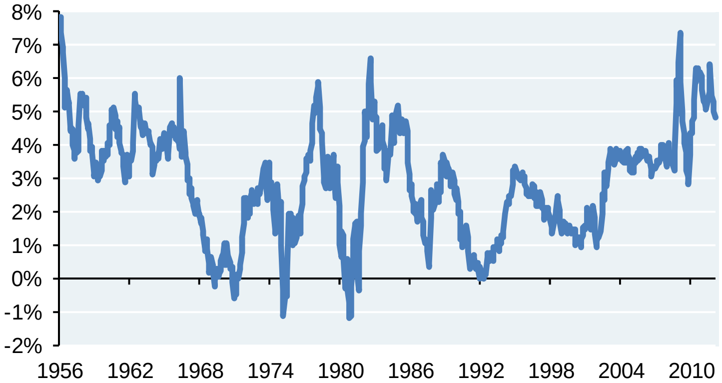
Output gap of OECD countries
Percent of potential GDP



Source: OECD.

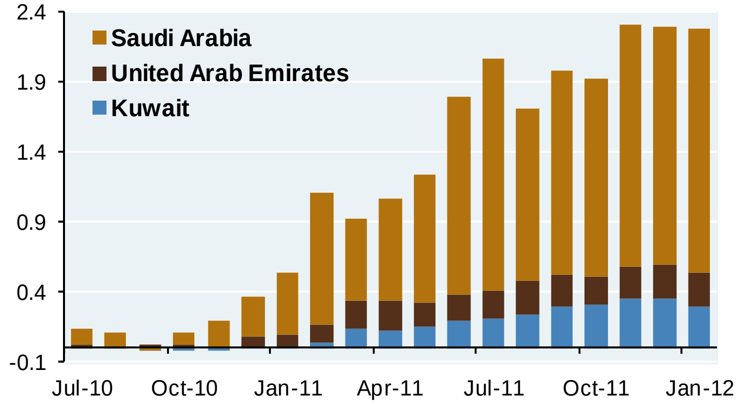
"*Nothing Else Matters*", Metallica, 1991

Real S&P 500 earnings yield
Trailing earnings yield less core CPI



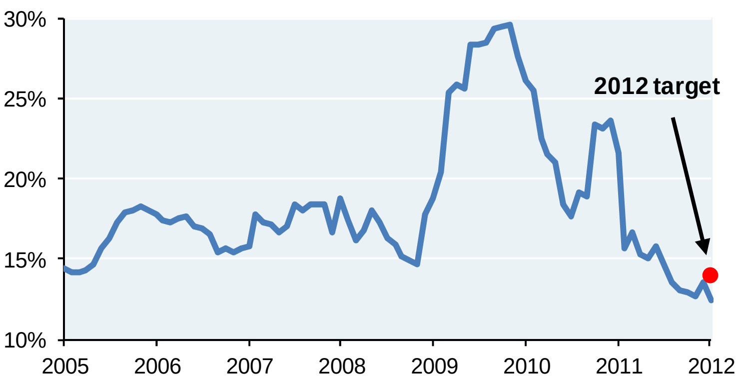
Source: Bloomberg, Bureau of Labor Statistics, Empirical Research Partners.

Increased crude oil production vs. mid-2010 output
Millions of barrels per day



Source: J.P. Morgan Securities LLC, Government Agencies, News Reports.

China money supply target signals continued caution
China money supply: M2, percent change, YoY



Source: People's Bank of China.

<u>Corrections Department</u>

Last week's, we stated that the President's budget excludes charitable deductions from the limitations on deductions imposed on high income taxpayers. That was incorrect; charitable deductions would be limited as well. Apologies to all charities.

OECD: Organization for Economic Cooperation and Development
BEA: US Bureau of Economic Analysis
BPD: Barrels per day
EMU: European Economic and Monetary Union
UAE: United Arab Emirates
PIIGS: An acronym that for better or worse has become part of the vernacular of the debt crisis (Portugal, Ireland, Italy, Greece and Spain)