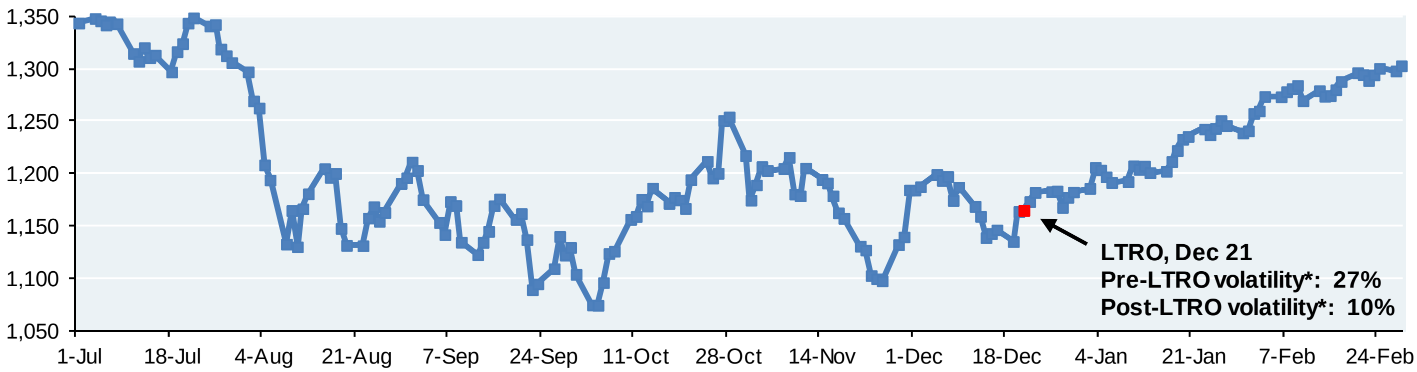
Topics: Riding the central bank reflation machine; Q1 US economic data, and an offset to rising oil prices (nat gas/coal)

CTRL-P. Many people weren't convinced, including yours truly, about what the first European Central Bank unlimited bank lending program (LTRO #1) could do for European economies and markets. While the former is an open question, the latter is not. So far, LTRO #1 has been a tremendous salve for global equities (see below). The calmness of the rally relative to what preceded it indicates that markets were waiting for Europe to stop falling down the stairs (think of LTRO as an ATM machine that spits out money from someone else's account and lends it to you for 3 years in unlimited amounts at 1%). Following LTRO #1, bond auctions have been well-bid, sovereign spreads rallied, banks prefunded 2012 and 2013 bond maturities, bank debt markets reopened, and the decline in US money market fund exposures to European banks finally ended. There's a long way to go, since Italy and Spain are only 20%-30% of their way to their 2012 funding goals and they are still in recession. But isn't the point of LTRO that Germany has capitulated and in 2012 at least, will pay the price[1] to prevent worst-case outcomes? There's no reason to believe that LTRO #2 will be the last one, if another is needed. Weimar Republic memories, R.I.P.

MSCI World Equities

Level

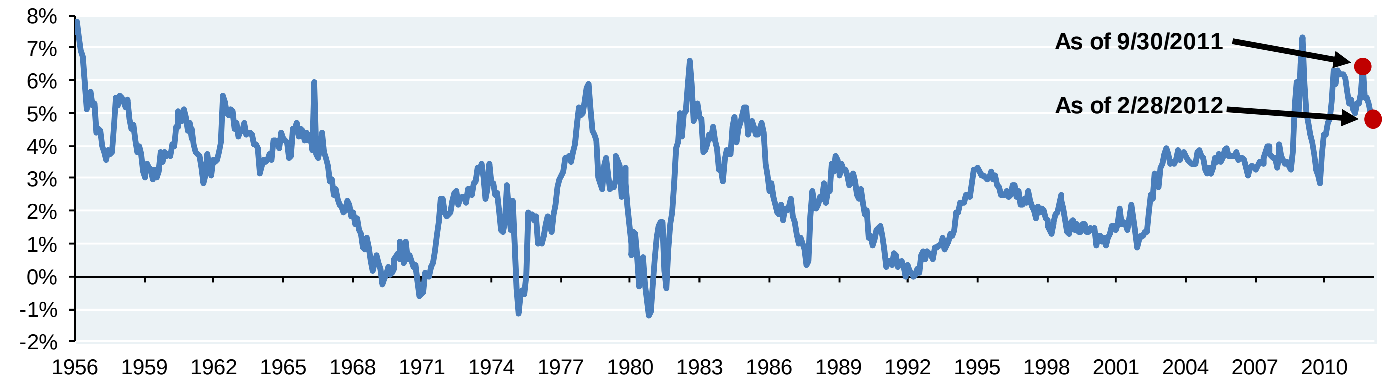


Source: Bloomberg. It is not possible to invest directly in an index. *Average of historical w eekly volatility.

LTRO market reaction. For most of the last two decades, equity markets were priced closer to "fair value", and accompanying risks were modest as well. But last September, this was not the case. Equities were very cheap, using a barometer of S&P real earnings yields (see chart). The risks were exaggerated as well: a potential Italian sovereign default, an unresolved US budget situation and the risk of more ratings downgrades, the unholy reliance of profits on low labor compensation, etc. To accompany that, the largest sidelined cash balances[2] I have seen in 25 years. Last fall, it's as if everyone was standing outside waiting for a 2012 Mayan collapse, and then the Central Banks decided it would *not* happen on their watch (see chart on next page). If there's an inflation tax, someone in the future will have to worry about that. As we wrote 2 weeks ago, while excess manufacturing and labor capacity are gradually shrinking, they do not appear tight enough yet to scare today's collection of Central Bankers.

Real S&P 500 earnings yield

Earnings yield less core CPI (earnings yield = earnings/price, using 12-month trailing earnings per share before extraordinary items)



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

[1] **More signs of German capitulation**: Germany may now allow the ESM and EFSF facilities to run in parallel (effectively increasing the firewall), it may increase the size of the ESM, and has also already agreed to pay its share of the ESM cash earlier. Germany may also need to agree to soften the terms of the Irish bailout, if the EU wants to ensure a "Yes" vote on the referendum Ireland will hold on the Maastricht 2.0 fiscal treaty. While the EU was able to defuse the Greek referendum by effectively firing Papandreou, it will be harder to do in Ireland.

[2] Empirical Research estimates that **$1 trillion left managed equity funds from 2008 through 2011**. Some of this went into ETFs and index funds, but it does capture the broader trend of some investors de-equitizing their portfolios after a disappointing decade.

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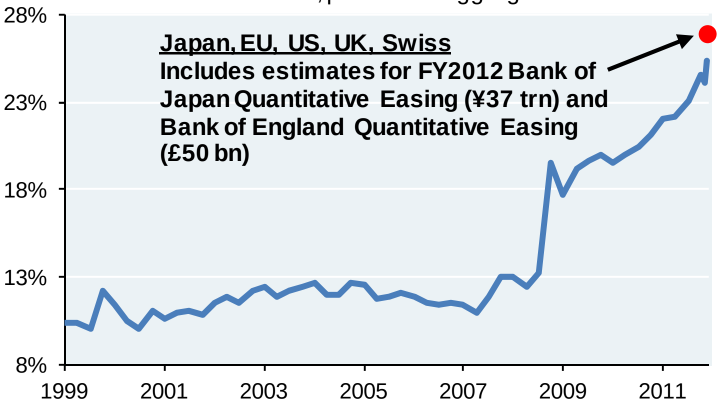
How to invest in periods like this, with exaggerated risks coupled with boatloads of sidelined cash, and earnings priced cheaply? Going into 2012, we decided to split the difference. We hold equities at a bit below normal levels, with the difference in credit, commodities and hedge funds. “A bit below” means different things to different people. In our Balanced portfolio[3], public + private equity is around 35%, and that excludes whatever directional equity risks reside in our 22% hedge fund allocation[4]. To me, that seems “**just right**”, given the risks and opportunities. As a business, we have never invested based on “S&P 500 year-end targets” or things like that, and aren’t going to start now. Our portfolio allocations reflect our best thinking given all the prevailing risks and opportunities that we chronicle each week, and they will remain as the primary way our investors communicate with you. On the notion of a “goldilocks” market, one thing’s for sure: **this is a different kind of stock market rally.** In the second chart, we look at periods like March 2009 until today, when S&P 500 returns have been up over 75%. In the past, accompanying gold returns have been much lower, and in the 1990s, they were negative. The market’s current verdict reflects both the enthusiasm and potential risks inherent in the Central Bank solution.

Not on my watch

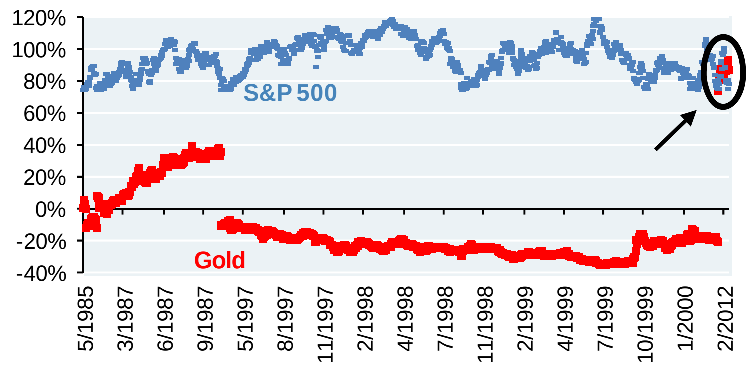
Central bank balance sheets, percent of aggregate GDP



Source: Country sources. Includes today's ECB LTRO.

Goldilocks indeed: a different kind of stock market rally

1000-day cumulative price return for stocks and gold when S&P 500 returns exceed 75%



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

There are clients who disagree with us, on both sides of the risk spectrum. I gave a talk at our 726 Madison Avenue office last night. It is a rare occurrence when a group of clients can out-do me in “paint a picture of unavoidable catastrophe”, but this group succeeded. If we had served arsenic in the hors d’oeuvres, it would have matched the temperament of the crowd regarding their appetite for risk and their opinion of the future of the United States, Europe and Japan. I get the risk part; what was missing was their assessment of how much *certainty* to place on their views, and how they would translate that into their portfolios. Over the last 100 years, there have only been a handful of times when it made sense to position for Armageddon. If someone with a normal portfolio risk allocation of 55% (to meet their goals regarding net worth after taxes, inflation and spending) is at 20%, I would argue that they are putting an enormous amount of certainty on a Mayan outcome.

Where does all of that leave us on portfolios? The world still has a lot of healing to do. This can be seen in retrenching household balance sheets, outsized government deficits and debt burdens, depressed labor compensation and housing activity, below-trend OECD growth, etc. **In the aftermath, Central Banks are trying to allow their respective economies to heal at their own pace, not one dictated by a Hoover/Mises-style liquidation frenzy.** That’s what the Central Bank money-printing is all about. If inflation remains under control, they may succeed in time. There are signs in the US that it’s working (see page 3), and it *better* work, given the amount of debt the public sector has to pay back. In Europe, I do not think the Periphery will ever un-Humpty Dumpty itself back into robust economic health[5], regardless of the monetary policy employed.

We do not have nearly enough certainty to say that a bull market has begun, nor do we believe that the Central Banks are all doomed to failure. As a result, our portfolios are positioned somewhere in between. This view may seem to you like Hamlet (indecisive and spineless), but in this case, I prefer Terence over Shakespeare: **“All things in moderation”**.

Michael Cembalest
Chief Investment Officer

(see following page for details on LTRO #2, US Q1 trends, and a quick oil/gas follow-up)

[3] This portfolio may not be suitable for all investors and is mentioned for illustrative purposes only.
[4] Growth portfolios of course have more equities, and Capital Preservation portfolios have less.
[5] One example: while Peripheral current account deficits are closing, **these countries would need a lot more foreign capital if employment ever went back to normal levels**. As such, “cyclically-adjusted current account deficits” are a better measure of the large competitiveness gaps that remain in the Periphery, gaps that will need to be closed by years of deflationary austerity (if the Euro holds together).

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For anyone interested in the details of LTRO #2:

- The ECB allotted EUR 529 bn of liquidity, with demand from 800 banks. The take-up is a bit higher than that at the December 3y LTRO (EUR 489 bn), and the number of bidders is higher as well (800 vs. 523 in December).
- The estimated net new borrowing in today's LTRO was around EUR 313bn. After today, more than 90% of the ECB liquidity operations are in the two 3y LTROs.
- There will likely be no official detail on the take up by the banking system or individual banks in the coming weeks. The latest LTRO settles on March 1st, and will be reflected only in the end-of-March national central bank balance sheet data, typically released in early April. There will be no detail on the type of collateral used in the LTRO, as the ECB only shows a chart in its annual report averaging the types of collateral used.
- If someone told me that Unicredito was able to borrow from the ECB against a vintage movie poster of *Il Gattopardo* signed by Claudia Cardinale, I would believe it.

An assessment of high-frequency US economic data, looking at Jan/Feb 2012 vs Q4 2011

Stronger: vehicle sales, consumer confidence, ISM manufacturing, service sector and employment surveys, NFIB small business survey, non-farm payrolls and household employment survey, hours worked, jobless claims, existing home sales, NAHB housing market index

Weaker: real retail sales, industrial production, capital goods orders, MBA mortgage purchase applications, durable goods

The relative strength of these trends is what probably led to Bernanke's not giving any explicit guidance in today's Congressional testimony regarding future quantitative easing.

Offsets to oil price increase: softness in other energy commodity prices

While oil prices have risen recently, unlike 2010's oil price spike, they have not been accompanied by other rising energy commodity prices. In fact, this time, coal and natural gas prices are down. It's complicated to weight these changes across the consumer and industrial basket, but it's fair to say that the aggregate impact of the oil price increase is only a third or so of what it might have been had coal and natural gas behaved as they did in 2010. According to the most recent EIA data, US coal + natural gas consumption is slightly greater in BTU terms than oil consumption.

BTU	British Thermal Unit
EIA	Energy Information Administration
ECB	European Central Bank
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
LTRO	Long Term Refinancing Operation
MBA	Mortgage Bankers Association
NAHB	National Association of Home Builders
NFIB	National Federation of Independent Business
OECD	Organization for Economic Cooperation and Development