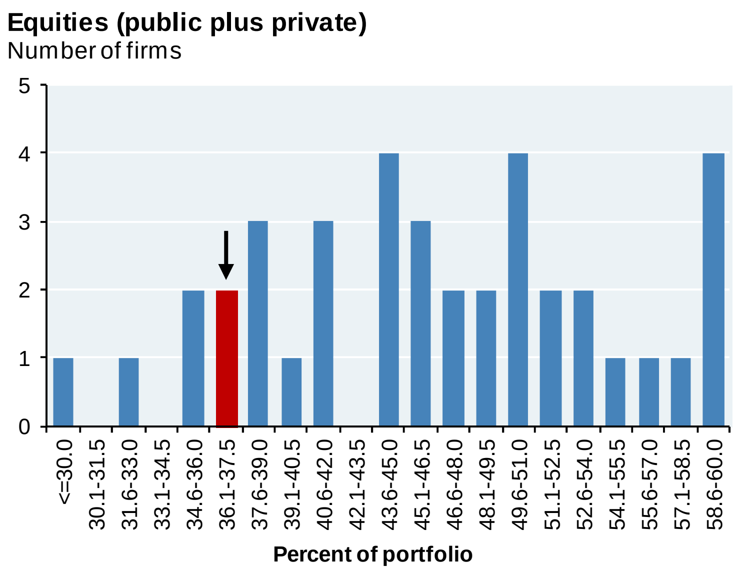
Topics: How our portfolio allocations compare to others; *A Very Long Year in Provence* (France); California vs Greece

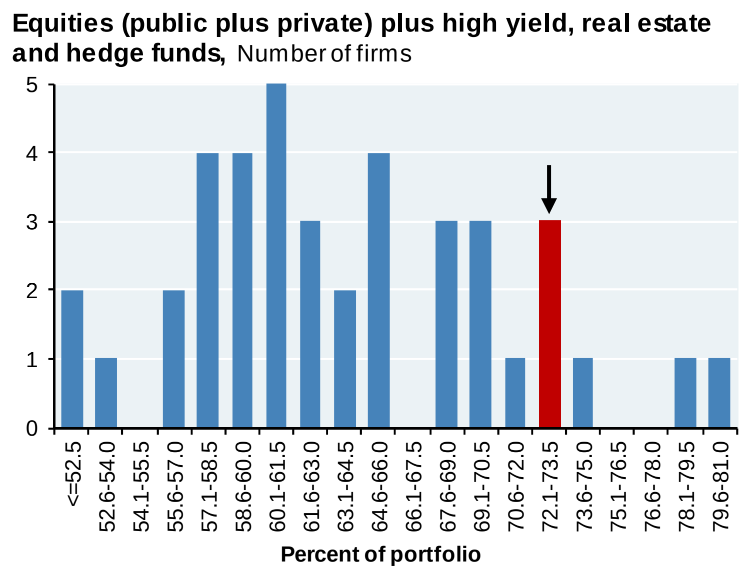
In the midst of the largest monetary and fiscal policy experiment of the last couple of hundred years, we eventually have to put down the charts, valuation models and theories, and arrive at portfolio allocations for money we manage. As in the movie ***Rashomon***[1], reasonable people can disagree on what is happening, and what it means. Now that the ECB has opened the spigot, there's no shortage of optimism: as one example, the head of BlackRock suggests investors be 100% in stocks. And in his latest note, Jeremy Grantham (one of the world's best value investors) joined in, calling for normal global equity allocations, asserting that equities should perform well as an inflation hedge that investors will someday need[2]. Many independent research shops are also quite bullish[3], as optimism is not confined to the "constant as the northern star" broker-dealer community.

Where do we stack up on risk-taking? It depends how you ask. Barron's detailed the asset allocation of 40 large wealth management firms, which is a good way to compare their Balanced portfolio allocations[4] . The first chart shows allocations to public and private equity. We are in the red bar, at the lower end of the range. However, using a broader definition of risk that includes hedge funds, real estate and high yield bonds, we rank at the higher end. One could always risk-adjust the various asset classes (since high yield usually does not entail the same risk as stocks) to normalize the results on the right. Our risk exposure would probably end up in the middle, but with a more diversified set of market factors driving it (see p.3).

Summary of select indicators in Barron's Wealth Management Asset Allocation Survey



Source: Barron's, J.P. Morgan Private Bank.



Source: Barron's, J.P. Morgan Private Bank.

Why not maximize risk this year if the Central Banks bail everyone out and bonds aren't worth owning? I have trouble digesting the "lack of value in bonds = investors will buy more stocks" argument. If Treasuries are not worth owning (due to negative real yields, government intervention[5] and questions about US debt sustainability), does it make sense to maximize equity allocations instead? A more plausible bull market rests on the US generating sustained growth closer to 3% than 2%, and payroll growth closer to 275k than 225k; that's when multiplier effects could really kick in. The jury is out on how strong a US recovery this will be. While vehicle sales have been booming, US non-vehicle consumer spending looks like it's fading as Q1 comes to a close (see chart below). Leading indicators of employment have been positive, so we expect *actual* payrolls to start reflecting that more. Other signals (services surveys, equipment and software spending) have looked good as well, and our CEO contacts have generally been more positive. So, **US growth will probably outperform consensus expectations of 2.2% for 2012**. The challenge: what happens when a large fiscal adjustment hits in 2013; above-trend growth may not be sustainable.

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[1] *Rashomon* is a Japanese art film from the 1950's in which different people interpret the same set of events very differently. Every NYU Film School student has seen this, and debated its meaning in a haze of clove cigarettes, absinthe, and remembrances of Che Guevara.

[2] In a recent piece, Grantham reviews stocks as an inflation hedge going back to 1919. In the very long run, (defined as a ten-year period following an initial 5-year inflation surprise), stocks do fine. Their real returns over these long time frames are not that different from their returns in lower inflation environments. But in the short term, an inflation shock can generate substantially negative equity returns.

[3] ISI (NY), BCA (Montreal), GaveKal (Hong Kong), and Wolfe Trahan (NY) are examples from the universe of reports I read regularly.

[4] Barron's requested allocations for portfolios that result in the "best risk-adjusted returns for investors with a moderate appetite for risk".

[5] In calendar year 2011, the amount of net debt issued by the Treasury was 1.1 trillion, and the Federal Reserve purchased 730 billion in Treasury bonds. It's nice to have friends in DC.

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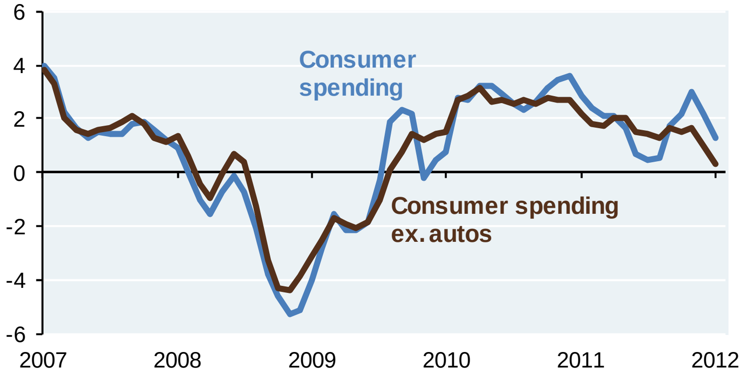
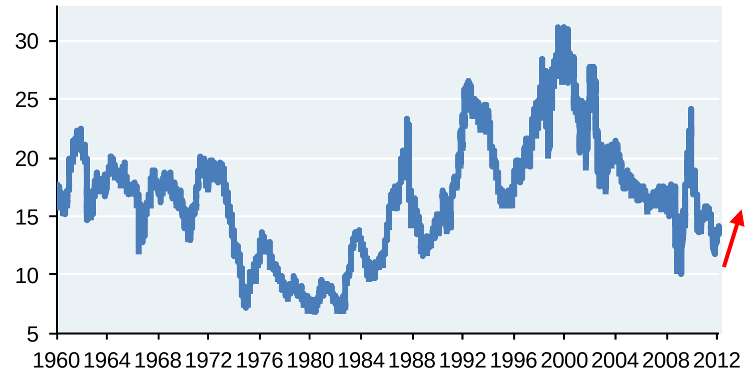
Weakness in US ex. auto consumer demand
3-month rolling QoQ annualized



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

S&P 500 price to earnings multiples
Price divided by trailing 12-month EPS before extraordinary items



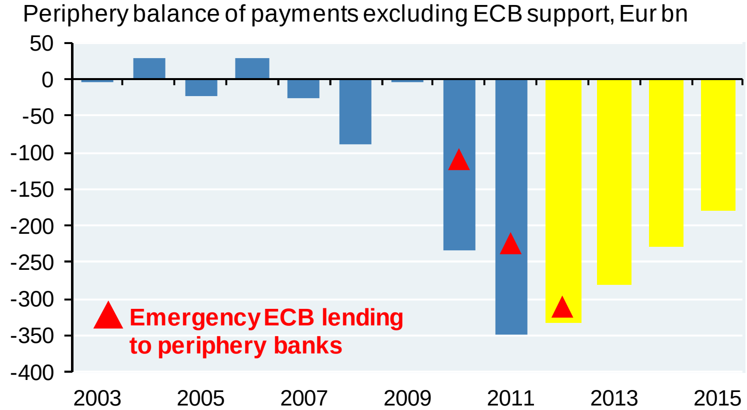
Source: Bloomberg.

So far, a big part of the rally has been a move away from the edge. Now that Europe has stepped back from the possibility of an Italian sovereign default in 2012 and other related disasters, valuations moved from "catastrophic" to simply "inexpensive". As shown, trailing S&P 500 P/E multiples have risen from 12 to 14 since last fall; on a forward P/E basis, they have risen from 10 to around 12. There is some room for continued multiple expansion, even as earnings expectations decline, which is why we are comfortable holding the equity exposures we have.

While Europe was the primary catalyst for the rally since November, it remains an Achilles heel. ECB repo operations have been life-savers for European governments and banks, but will Europe keep printing its way out? Bundesbank head Jens Weidmann reportedly sent a strongly-worded letter to ECB head Mario Draghi regarding Germany's concerns about ECB financing being permanent, and on declining ECB collateral standards. Former German ECB member Stark chimed in this week, calling the quality of the ECB's balance sheet "**shocking**". However, I am inclined to view Weidmann as a paper tiger, and not just because he sent his letter *after* ECB operations already took place. Why believe Weidmann would be any more successful in changing ECB policy after 2 German predecessors already resigned from the ECB over the same thing?

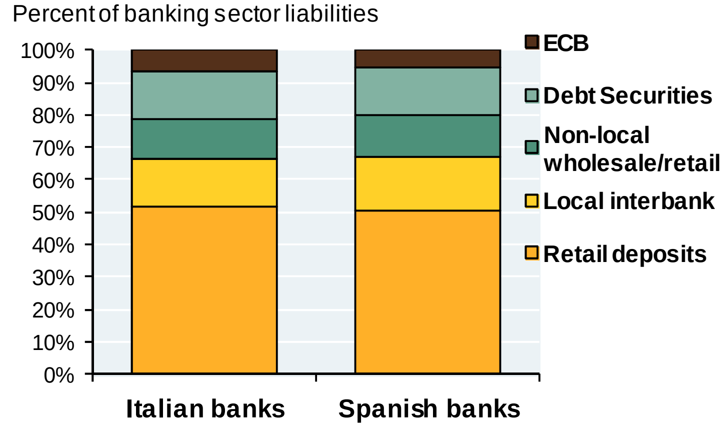
Here's what Weidmann is up against: **the ECB may need to print a LOT more**. I asked our Chief Economist Michael Vaknin to convert what the ECB is doing into a single chart (left, below). The bars in the chart below (left) show the net balance of payments in the periphery, combining their current account and capital account deficits; money has been *flooding* out. The red triangles show how much of these outflows were financed by the ECB. There would probably already have been a banking crisis/default had these rescue operations not taken place. There may be a lot more left for the ECB to finance; our estimates of future outflows are the yellow bars[6]. Will the ECB keep printing? We think they will, but this issue admittedly lies beyond the scope of fundamental investing.

The ECB: financing a rush for the exits
Periphery balance of payments excluding ECB support, Eur bn



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

Bank funding: ECB still a small component
Percent of banking sector liabilities



Source: Bridgewater Associates.

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[6] We assume a gradual closure of the periphery's current account deficit by 2015 (through further improvements in net trade), but that the ECB has to finance the gap in the interim. For the capital account, we assume that foreign lenders only roll half of their maturing positions. For the intrepid, Michael Vaknin is working on an A to Z white paper on the origins and economic mechanics of the EMU debt crisis.

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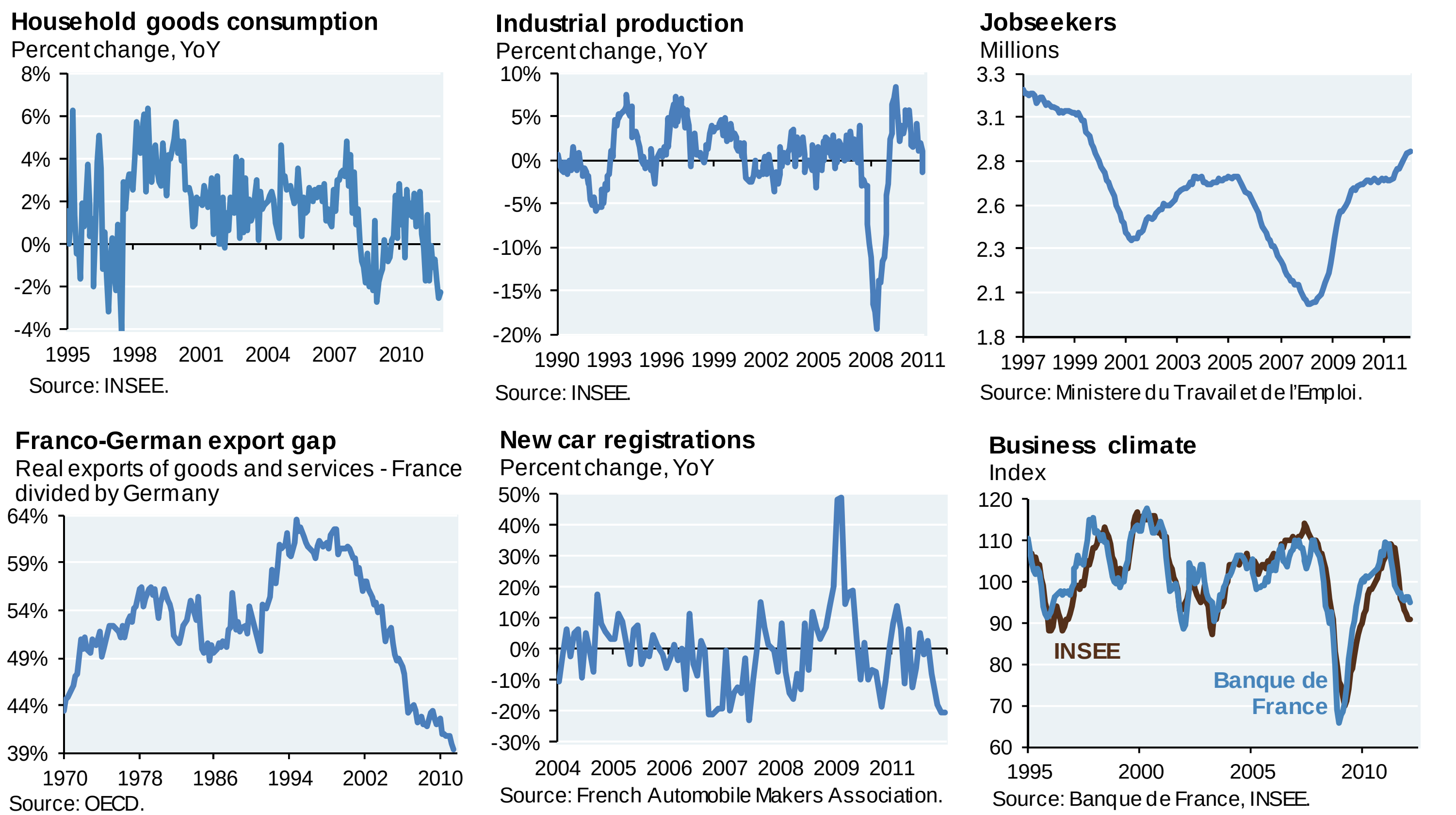
Here's another way to think about how much heavy lifting the ECB may still have to do. **As shown above, despite 645 billion Euros in emergency lending to periphery banks since 2009, the ECB still represents a small portion of bank borrowing in Italy and Spain.** Assume that retail depositors stay put, as do local interbank lenders. What about bondholders and non-local wholesale/retail money; will they keep leaving? It might depend on whether Europe starts growing again. Here, the news is mixed at best. The latest from Spain is dreadful[7], but enough of that; **let's focus on France instead.** The economic momentum in France is only modestly better heading into the election. Sarkozy has trailed Hollande consistently in second-round polling[8] since January, by 56 to 44. The debates may change that, but as things stand now, Hollande is in the lead, and promises to shelve Maastricht 2.0 and start from scratch. A Merkel-Hollande summit would be worth the price of admission, that's for sure. Current IMF and OECD forecasts for French growth this year round to zero, which sounds about right given the data below.

Recent trends in France: A Very Long Year in Provence



There are signs that private sector life is getting back to normal in the US and Asia, but Europe is a wild card, as is Iran. There are a lot of opportunities we have invested in over the last year: private mezzanine lending, oil & gas, distressed commercial real estate, merger and convertible arbitrage, leveraged loans, large cap growth and dividend stocks, Brazil and China private equity, pre-IPO technology investments, etc. But on the question of overall risk, we believe we have plenty for the world we live in.

Michael Cembalest
Chief Investment Officer

Two ships: 18 months ago, there were views expressed in some circles that California was a bigger risk than Greece. This made no sense to me; California's budget gap of $22 billion on a state GNP of $1.6 trillion required 10% of the spending cuts/tax hikes that Greece needed. This week, as Greek approaches default and economic collapse, California's outlook was upgraded by S&P. As we wrote at the time, California faces a *political* problem more than an economic one. The crux of the issue:

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[7] On a fully-loaded basis (including both expected future deficits and other government financing needs related to struggling autonomous regions like Valencia and Catalonia, and recapitalizing banks), Spain's debt to GDP is headed towards 90%. Unemployment is headed to 25%, and almost all the indicators we look at are as bad or worse than they were when we discussed Spain in our 2012 Outlook (p.11).

[8] Marine Le Pen of the National Front is struggling to get the required 500 signatures to be on the first round ballot. Given the 47,000 various elected officials and functionaries that she could get them from, that implies only a 1% required support rate. A very odd situation for a candidate that has been attracting 18% support from voters in polls this year.

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- California has been overly reliant on volatile capital gains taxes to fund spending, and its taxes are already high (48th out of 50th in terms of business tax climate, highest sales tax in the country, 2nd highest individual income tax rate, high taxes on gasoline/lotteries, etc).
- Spending has exceeded the rate of population growth plus inflation consistently since 1990. Part of the reason: the state pays 100% of health care costs for retired state workers and 90% of costs for spouses and dependents; state/local employment per capita has been growing, and state/local salaries are generally 44% higher than private sector counterparts.

But California has the tools to service its debts through some combination of spending cuts and tax increases, and simply needs to figure out how. This is not easy to execute in Sacramento, given the enormous divide between strains of California political and economic thinking (Cesar Chavez vs John Birch; Tom Hayden vs Ronald Reagan; Christy Romer vs John Taylor; Berkeley vs Bakersfield; Oakland vs Orange, etc.). But the scope for spending cuts and tax increases and California's aggregate income are enough to allay concerns about its solvency, which the recent S&P decision reflects.

As for Greece, today's announcement on voluntary private sector participation in its debt exchange is a non-event. As we have pointed out several times, Greece's debt/gdp ratio will still be above 140%. The only difference is that they owe it to the EU and IMF instead of the private sector. For what it's worth, the market is pricing in a substantial risk of re-default on the to-be-issued bonds coming out of the exchange.

BEA: Bureau of Economic Analysis
ECB: European Central Bank
EMU: European Economic and Monetary Union
EPS: Earnings per share
EU: European Union
IMF: International Monetary Fund
INSEE: Institut National de la Statistique et des Etudes Economiques
OECD: Organization for Economic Co-operation and Development
P/E: Price-to-earnings