Topics: Is US data as good as it looks? Is Chinese data as bad as it looks? Is European data as bizarre as it looks?

What a diff'rence a day makes. Ever since the ECB gift-wrapped 650 billion Euros for EU banks, the news has been pretty good, particularly in the US. Most of the market's focus is on the US consumer, for the simple reason that US households are the largest single economic force in the world (see table). Even after deconstructing the labor report for signs of false positives[1], the message is clear: US job markets are gradually getting better, and so is spending. The capital position of US banks is in good shape[2], so we expect access to credit to remain easy[3]. A US GDP growth rate of 2.25% is still below trend, but a long way from the unavoidable recession articulated by the ECRI last fall. I agree with those who think the US economy could not withstand a withdrawal of stimulus right now, but I also do not see the Fed actively withdrawing it. Whatever rain dance the Fed is doing to keep inflation low, they better keep doing it.

The importance of the US consumer

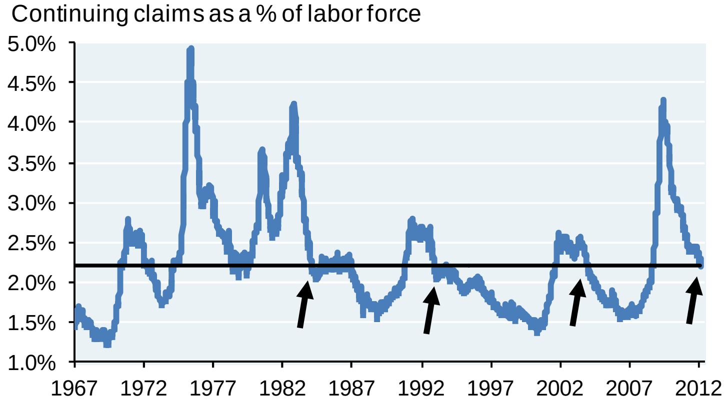
Billions of USD	Private Consumption	Investment	Gov. Spending	Net exports
US	10,417	1,818	3,020	(500)
Asia	8,231	4,614	3,449	424
Asia ex. CN/JPN	2,761	597	1,482	134
Japan	3,501	1,185	1,175	58
China	1,969	2,832	792	232
Europe	9,670	3,148	3,662	130
EMU	7,145	2,386	2,704	145
Latin America	2,747	754	1,010	28

Source: Haver. Data as of Q4 2010.

A chart I saw on the history of jobless claims (below, left) was meant to show how good things may get. In the prior 3 business cycles, when continuing claims fell through 2.2% of the labor force (1982, 1993, 2003), it was a great time to add risk in portfolios. Improving claims signaled that the business cycle was picking up enough steam to be self-sustaining, and last week, the US crossed through this barrier again. But as Big Bird used to say, ***one of these things is not like the other:* the US primary budget deficit which supports this recovery is a bigger now**. So, the US economy *better* improve markedly in order to pay the freight. When will this chart on the primary deficit (below, right) matter to financial markets? Only when it becomes a binding constraint, either due to a lack of demand to finance the deficit at current yields, or due to the economic cost of closing it. The timing is uncertain, given Central Bank purchases of Treasury bonds, and a Congress which may leave the problem for another day (or generation). I lose a lot of sleep over this, but I don't know a lot of other people that do. As discussed last week, portfolio allocations given today's private and public sector realities vary substantially across wealth management firms. Ours rely on hedge funds, credit and real estate as complements to public and private equity.

In past cycles, claims were a great market signal

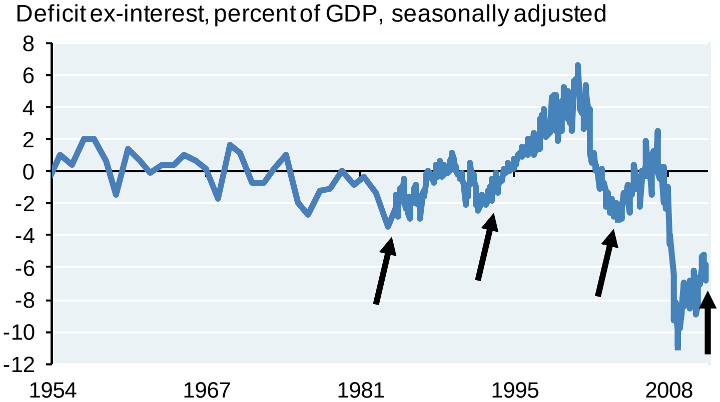
Continuing claims as a % of labor force



Source: Department of Labor, BLS, Empirical Research Partners.

Paging Dick Cheney: Do Deficits Matter?

Deficit ex-interest, percent of GDP, seasonally adjusted



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

[1] Our chief economist Michael Vaknin has analyzed the various seasonal adjustments that the Bureau of Labor Statistics uses when it reports payrolls. After adjusting for better weather, the Lehman shock and other factors, payroll growth does not look quite as good as reported, but is still positive. The trend is supported by the latest Manpower surveys, Institute for Supply Management surveys, JOLTS surveys, etc, all of which show growing demand for labor. Even state and local government firing has finally come to an end, which was a constant fixture of the last two years. So far, hourly earnings remain very weak, and typically do not grow until later in the cycle.

[2] **The latest US bank stress tests were pretty stressful**. Two-year loss assumptions applied by the Fed were higher than those experienced during 2008 and 2009, and comparable in almost every category to realized losses during the Great Depression. Almost every institution passed the test, and even the ones that didn't are expected to reach required capital levels in short order. US banks have sharply reduced reliance on "hot money" (time deposits, commercial paper and repo), relying instead on core retail deposits to finance their balance sheets. Comparing the rigor of US and European bank stress tests is like comparing the rigors of actual football to Wii football.

[3] So far, net household borrowing other than student loans is weak; loan growth is almost exclusively from companies rather than households.

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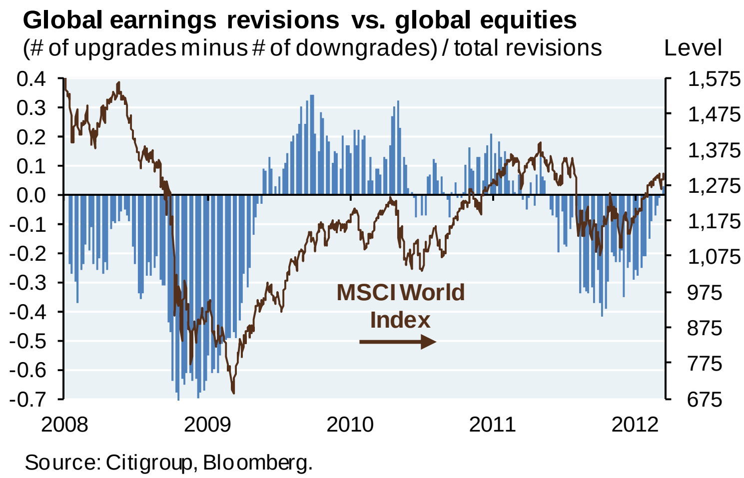
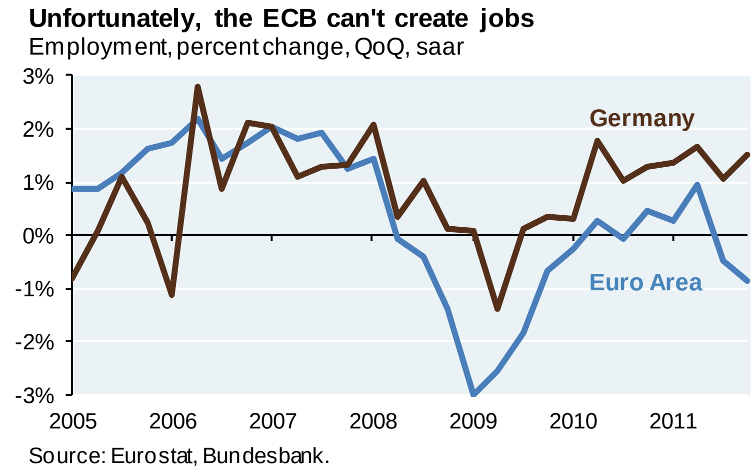
There's also some good news on the global profit outlook, or at least an end to the bad news. A measure of global earnings revisions had been running negative for 40 weeks in a row until last week when it turned slightly positive. Other corroborating evidence comes from conversations we've had with private equity firms, whose portfolio companies are generally planning for 10%-20% increases in capital spending budgets this year.





After four years that challenge some of the basic assumptions of efficient markets and laissez-faire capitalism, there is a pent-up demand for normalcy among individual investors, money managers, CEOs, corporate treasurers, pension funds, regulators, etc. Through massive money creation, Central Banks have provided the veneer of normalcy which has allowed the private sector to get moving again in the US, or at least in the case of Europe, to stop declining. Markets love it. Is the ECB's Mario Draghi a genius? Only time will tell. The last time the term *Maestro* got thrown around, it was a case of premature exaltation.

The latest from Europe: my head is hot and my feet are freezing

Angela Merkel described Europe as being "a good way up the mountain path" regarding the debt crisis. Courtesy of the ECB, there has been a dramatic improvement in sovereign and bank debt markets. However, in the real economy, improvements are much harder to find. In contrast to improving labor markets in the US, Europe still looks pretty bad outside Germany (see chart above; the declining Euro Area line *includes* the better data from Germany). Other variables related to production and consumption show the same regional divergences. The challenge for Spain looks particularly daunting, given a less open economy than countries like Ireland, escalating costs associated with bank recapitalization and municipal funding shortfalls, and the likely continued withdrawal of foreign capital from the private sector. Even with continued German assistance, it's going to be a long and freezing mountain hike for the periphery.

On investments, we saw a lot of things we recognized in a 76-page Morgan Stanley paper on bank deleveraging and real estate. This has been one of our primary investment themes over the last year. **MS estimates 3 trillion Euros of deleveraging by European banks in the next 3-5 years, even *with* ECB repo facilities slowing the pace of asset dispositions, and a more relaxed approach to Basel 3**. Europe's greater reliance on banks to finance commercial property investments (versus capital markets) is a primary driver here. One example: amazingly, Spanish banks have more domestic commercial real estate loans than UK and German banks combined. There are likely to be opportunities in purchasing loan portfolios, and in providing capital to refinance existing loans. In an environment of low growth, perpetual austerity and rising consumer stress, and the lingering possibility of a devaluation in some countries, buyer portfolio discounts need to be large enough to make sense.

Where is China heading?

There is a roiling epistemological debate as to whether China's current decline is structural or cyclical. As an aside, two of JP Morgan's investment banking analysts (one an economist, the other an equity market strategist) have taken opposite sides of the debate, which is in and of itself a healthy thing. Like the question about whether Italy has a liquidity crisis or a solvency crisis, the answer depends on your definition, and definitions can change depending on how governments respond. On the following page, we include our own China Dashboard we use to track what's going on. Now that we have February data as well as January and can adjust for some of the New Year effects, it's pretty clear that China is slowing. Markets are still nervous, since Premier Wen stated that the government is still concerned about elevated home prices, and that they will continue tight policies on property markets. Home price to income ratios in some major cities exceed peak 2006 California levels.

But with the collapse in Chinese inflation, the government has room to re-stimulate a bit. Recently, the Chinese government has injected more liquidity; expanded the quota for foreign equity investment; cut bank reserve requirements; delayed tighter capital

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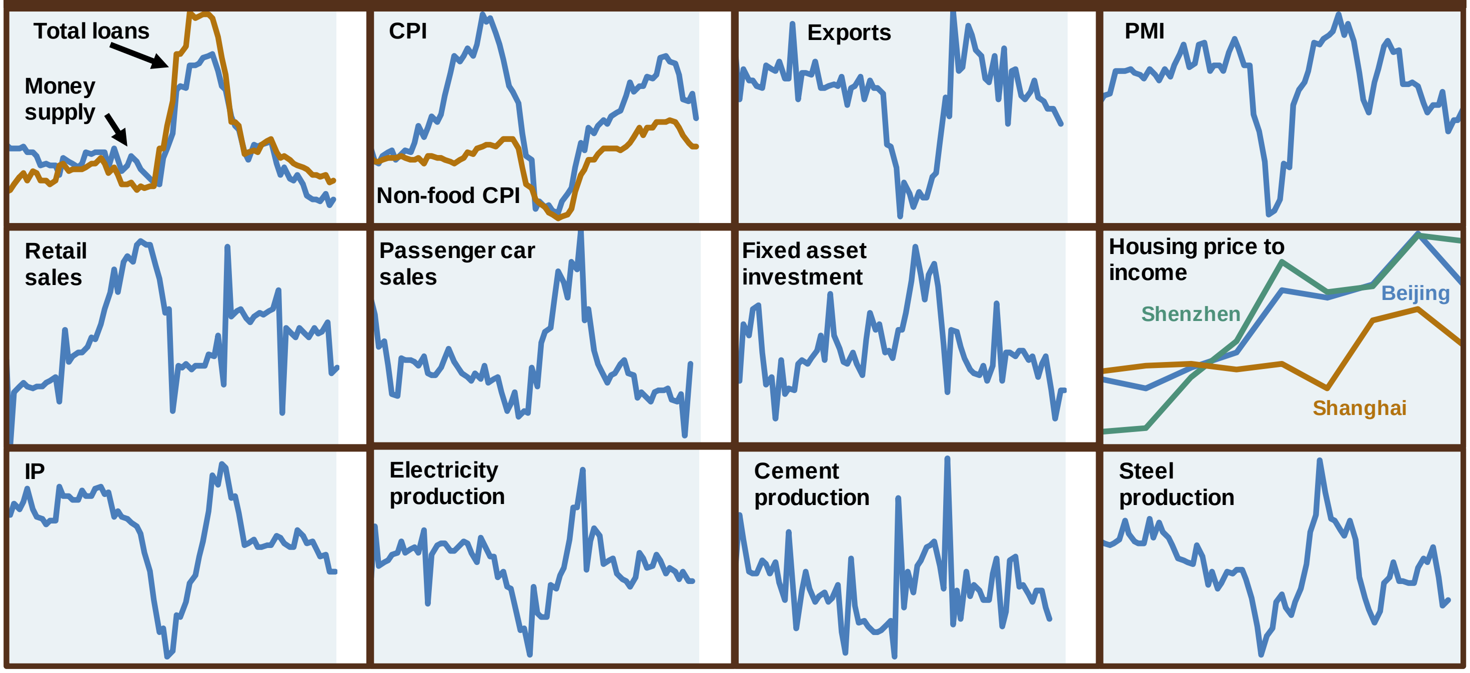
adequacy rules; created a program through which municipalities can issue bonds with government guarantees (rather than having to borrow from banks); eased first time homebuyer restrictions; and injected capital into its biggest banks. **What the China debate is really about is whether these measures will reinvigorate growth or not.** Since much of the recent slowdown was self-imposed due to inflation concerns, it seems reasonable to us to expect the Chinese economy to respond positively to stimulus should it be reapplied. **We are not big buyers of Chinese onshore equities for reasons we have explained before, but we do rely on 7%-8% Chinese GDP growth to fuel economic activity in Asia that underpins many of our investments there. As things stand now, we see no reason why this growth target will not be achieved.**

Chinese economic monitor, percent change*, YoY, sa, 2006 to present



Source: National Bureau of Statistics, PBOC, China Automotive Information, China Economic Information Network, CLSA-Markit, Haver Analytics. J.P. Morgan Securities LLC, ISI Group, J.P. Morgan Private Bank. * PMI data are index level. Housing price to income, cement production and steel production are as of Dec. 2011. All the other data are as of Feb. 2012.

Michael Cembalest
Chief Investment Officer

"*What a diff'rence a day makes*", Dinah Washington, 1959, Mercury Records

"*Banks Deleveraging and Real Estate*", Morgan Stanley Research, Francesca Tondi, March 15, 2012

The ECRI (Economic Cycle Research Institute) claims papal infallibility on its historical recession predictions. ECB = European Central Bank. EMU = European Economic and Monetary Union