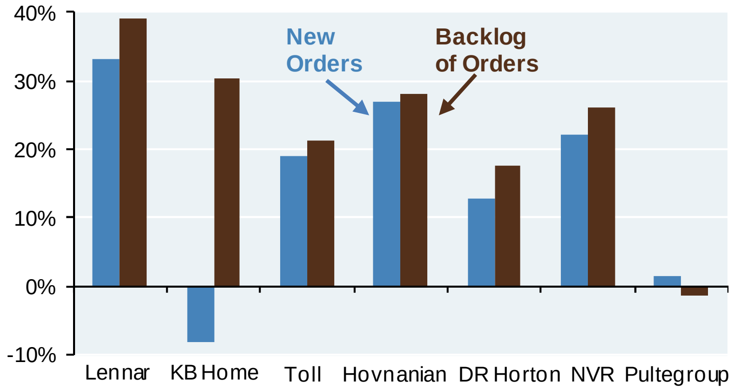
Q&A on the USA, with a watchful eye on the risk of giant man-eating plants; Spain

Our view for 2012 was that economic and equity market conditions in the US and Asia ex-Japan would be better than in Europe. So far, that view is on track. Spain in particular is in difficult shape (see page 5); its banks and government may have to borrow 1.5 trillion Euros over the next 12 months while in recession. Both the ECB and EU will need to keep the spigot open to prevent Spain from becoming a bigger problem. This week, some Q&A on the US recovery, flows into bonds and stocks, profits and P/E multiples, municipal bonds, and the long-term US fiscal situation.

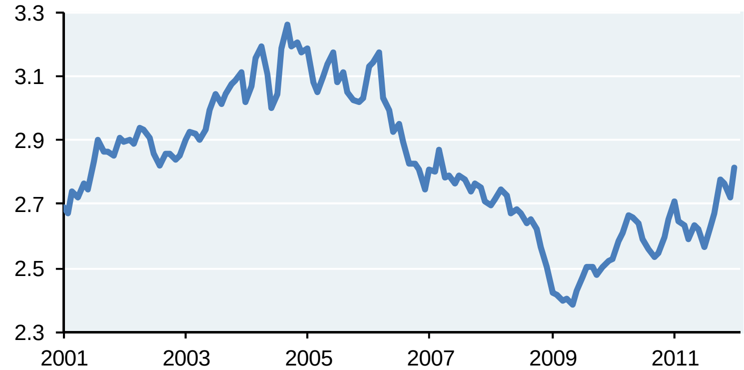
The Fed appears to be saying that no additional monetary easing is needed unless the economy worsens further. Are there any signs that the US recovery is becoming self-reinforcing?
Durable goods consumption, equipment & software spending, vehicle sales, bank loans to companies, manufacturing payrolls (even after Friday's disappointing report) and housing stats (building permits, multifamily housing starts) have improved over the last few months. While delinquency rates are in better shape (credit card delinquencies are back to 2007 levels), household credit growth is still weak. However, homebuilders are seeing stronger demand, and nationwide remodeling continues to rise. We see opportunities in retailing and building products companies that may benefit from a continuation in these trends.

Publicly-held builders reporting stronger demand
Percent change, YoY in latest fiscal quarter



Source: Corporate Reports. Empirical Research Partners.

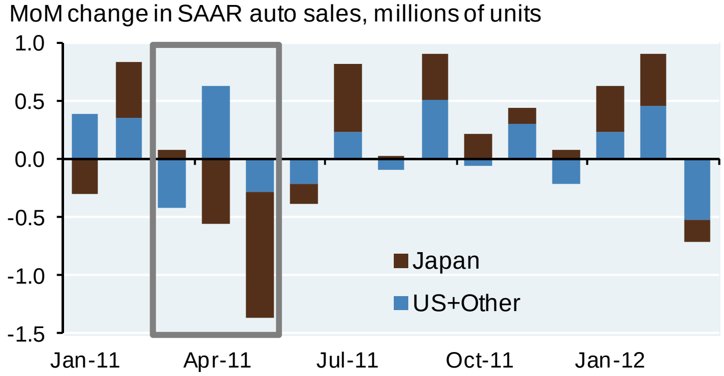
Residential remodeling index
Number of homes, millions, 3-month moving average



Source: BuildFax. Empirical Research Partners.

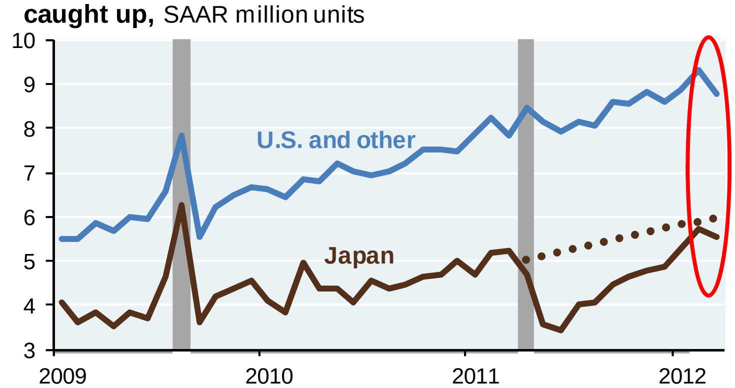
Has the data really been that good? I heard better US economic data has a lot to do with the weather.
Parts of the US experienced the warmest March in recorded history. Measured from December to February, the winter was the 4th warmest on record. I don't think there are reliable models to estimate the impact of demand being pulled forward, so we will have to see how consumer spending, housing and payrolls behave in the months ahead. As our Chief Economist Michael Vaknin reminds me, other distortions come from the **"catch-up" effect from Japan's tsunami**. As shown below, some strength in auto sales came from pent-up demand for Japanese cars, a process which now seems complete.

US auto sales in the wake of Fukushima
MoM change in SAAR auto sales, millions of units



Source: BEA/Wards, DB, J.P. Morgan Private Bank. Box indicates impact of Japanese earthquake.

It looks like pent-up demand for Japanese cars has caught up, SAAR million units



Source: DB, J.P. Morgan Private Bank. Shadings indicate Cash for Clunkers and Japanese earthquake, respectively.

So where does that leave the US payroll and growth picture?
The weakness in the payroll report was almost entirely concentrated in retailing. Net of distortions and seasonal adjustments, it looks like payroll growth is running at 150-175k per month, and GDP growth is running at a 2.25% trend pace, both below prior recoveries. While 2.25% is a barn-burner compared to Europe, it only corresponds to a modest improvement in employment. **That's why 2013 US fiscal policy is so important: this is not a recovery that can withstand much tighter fiscal conditions.**

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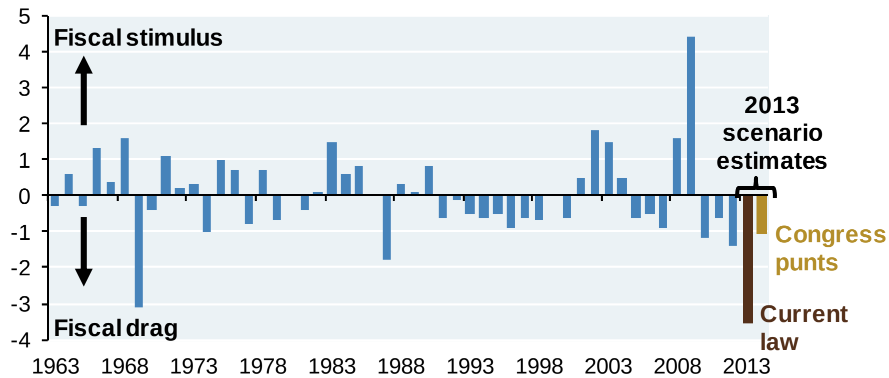
So, how tight is US fiscal policy supposed to get next year?
Very, if you look at what is *supposed* to happen according to current law. In the chart, we show the annual change in the budget deficit over the last 25 years. The impact of all provisions *scheduled* to expire and kick in during 2013 would be very large. But if Congress and the President elect to extend current tax rates, retain lower payroll tax rates and extended jobless benefits, etc, the adjustment would not be as big, and only reflect expiration of Recovery Act provisions, the recently passed Budget Control Act, and some other smaller provisions. There are of course plenty of permutations in between.

Wide range of outcomes for 2013 austerity
Change in cyclically-adjusted federal deficit, % of potential GDP



Source: CBO, IMF, Goldman Sachs, J.P. Morgan Private Bank.

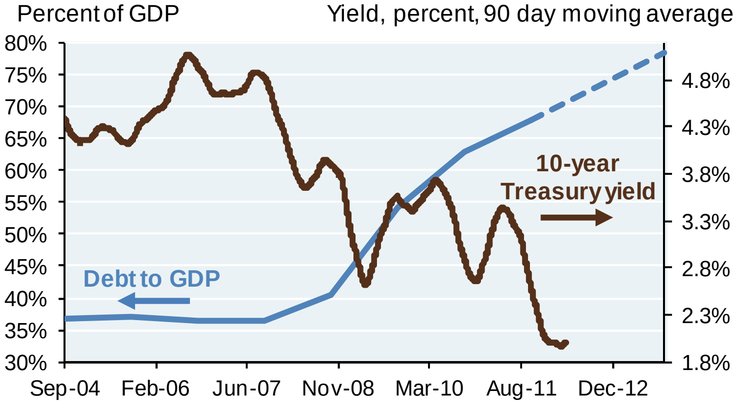
Policies set to expire or take effect under current law	Fiscal Drag (% of 2013 PGDP)
Sequester Automatic Cuts (Discretionary Spending)	-0.4%
Sequester Automatic Cuts (Mandatory Spending)	-0.1%
Bush Tax Cuts ($250k+ Incomes, Estate Tax)	-0.3%
Bush Tax Cuts (Middle Income)	-0.9%
Alternative Minimum Tax	-0.8%
Payroll Tax Cut	-0.6%
Emergency Unemployment Compensation	-0.2%
Affordable Care Act	-0.2%

Source: CBO, Goldman Sachs.

What direction is the Congress heading, and what did Larry Summers and Brad DeLong have to say about this recently?
Political outcomes this fall will affect what Congress does, but I get the sense that they will punt fiscal adjustments into the future if they can, and impose austerity of no more than 1% of GDP in 2013. If so, Congress can point to a March 2012 paper by Summers and DeLong as justification. The bottom line from the paper: **don't tighten fiscal policy when interest rates are near zero**. The authors assert that (a) additional government spending can *ease* the long-term budget constraint in conditions similar to today's, and (b) tightening policy now would risk permanent loss of human capital, lower labor productivity growth and lower trend growth. They have held these views for a while; the paper appears designed to convince others.

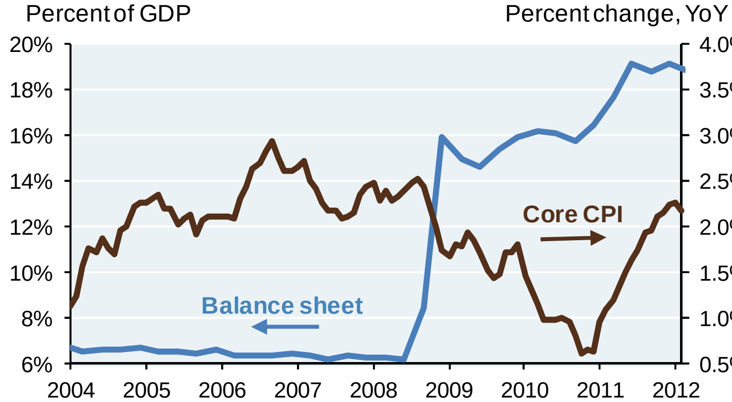
Advocates for more fiscal and monetary stimulus often point to the charts below. Rising Federal debt has not resulted in higher interest rates, so why not keep borrowing more? As for the Fed, balance sheet expansion prevented deflation and hasn't resulted in an inflationary surge (core inflation measured over 3 months just came in *below* 2%), so why not keep doing it? **Aren't these charts amazing?**

Rising Federal debt? No problem for Treasury markets
Percent of GDP | Yield, percent, 90 day moving average



Source: CBO, Bloomberg. Assumes CBO Alternative Case for estimates.

Rising Fed balance sheet? No problem for inflation
Percent of GDP | Percent change, YoY



Source: Federal Reserve Board ,Bureau of Labor Statistics.

They are amazing, but no one knows how long they can be sustained. Even Summers and DeLong concede that "*even if it is granted that the stimulus can be both timely and temporary, the question of how large it can be while preserving these attributes remains for future research*". If one of these trends could not be sustained, my guess is that it would be fiscal constraints rather than monetary ones. While it's great to see rising Federal debt not adversely affecting Treasury markets, the chart on the left reminds me of *The Day of the Triffids*.

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What is ***The Day of the Triffids***?

It's a 1951 science fiction novel. There's a meteor shower, and most people go outside to look at it. The next morning, everyone who looked at the meteor shower ends up blind, and Earth is taken over by giant man-eating venomous plants. The point: **some amazing events which look benign have unforeseen consequences**. Will a pact of going for growth pay the freight of higher Federal debt in the long run? Hard to say; there are not a lot of examples to draw from. Economic theories and their associated debt bubbles don't always work out as planned[1]. After WWII, the US also faced a debt ratio of 80% of GDP. Austerity was not the answer back then; government receipts and outlays as a % of GDP did not change much during the 1950's, and net debt was flat. **So how did US debt/GDP fall from 80% to 46% in just ten years?** Robust annualized real growth of more than 4.0%, and 2.0% inflation. However, unique economic conditions and productivity gains of the 1950's (e.g., interstate highway, rebuilding of Europe and Japan) may not be repeated, and the country was not headed into an entitlement time bomb. If the US does not experience a growth/productivity boom, the burden of higher debt could last for a generation or more. A pro-growth Administration would probably help, but the difficulty lay in defining exactly what that means.

Isn't it amazing?

1950's debt reduction was based on growth, not austerity

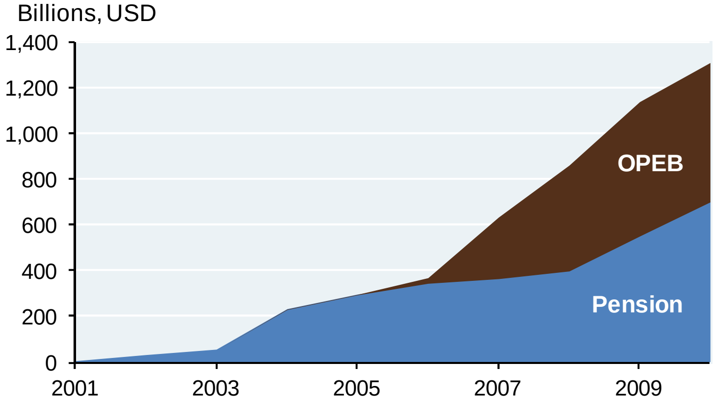
	Net debt (% of GDP)	Net debt (bn)	Nominal GDP (bn)	Real GDP (bn 1950 USD)	Outlays (% of GDP)	Receipts (% of GDP)
1950	80%	$219	$273	$273	16%	14%
1951	67%	$214	$320	$302	14%	16%
1952	62%	$215	$349	$322	19%	19%
1953	59%	$218	$373	$341	21%	19%
1954	60%	$224	$377	$343	19%	19%
1955	57%	$227	$396	$354	17%	17%
1956	52%	$222	$427	$368	17%	18%
1957	49%	$219	$451	$377	17%	18%
1958	49%	$226	$460	$377	18%	17%
1959	48%	$235	$490	$398	19%	16%
1960	46%	$237	$519	$415	18%	18%
Comp. ann'l gr:		0.8%	6.6%	4.3%		

Source: OMB, BEA.

Are there debt vs austerity parallels at the state and local level?

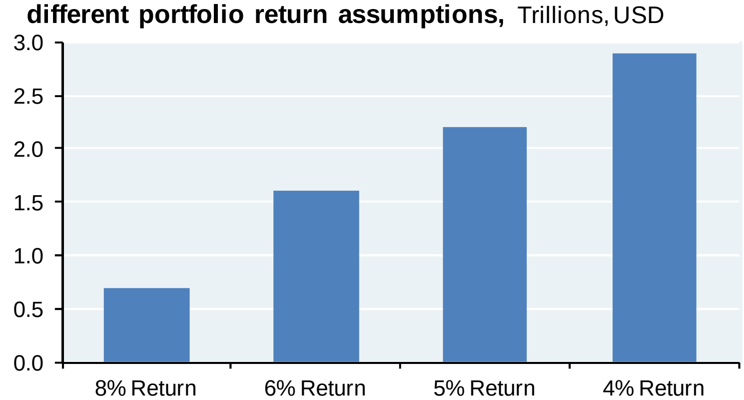
Yes and no. At the state and local level, over last decade, more than 1 trillion in unfunded pension and healthcare (OPEB) related liabilities were recognized (they were accrued over a longer period). Even these "as-reported" estimates, which come from the states, may be underestimated. A 2011 analysis by the Joint Economic Committee shows that lower portfolio return assumptions on pension assets sharply increase the magnitude of underfunded pensions (see chart, right)[2].

As reported unfunded state pension and OPEB liabilities Billions, USD



Source: State Comprehensive Annual Financial Reports.

State and local unfunded pension liabilities under different portfolio return assumptions, Trillions, USD



Source: CBO, Center for Retirement Research.

[1] Example: here's a link to a 2007 article by Austan Goolsbee, former Chairman of the Council of Economic advisors and a member of the Obama Cabinet. Goolsbee praises the benefits of subprime lending and related affordable housing policies, mocks Congress for holding hearings on the subject and cites Federal Reserve papers in saying that the "*mortgage market has become more perfect, not more irresponsible*". Some things are only clear in hindsight. http://www.nytimes.com/2007/03/29/business/29scene.html?_r=2

[2] This is why under-risked pensions may create huge problems for themselves and their associated state/local governments.

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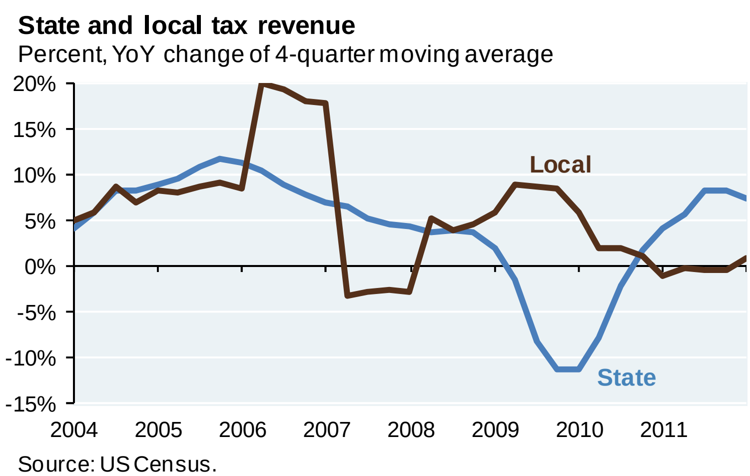
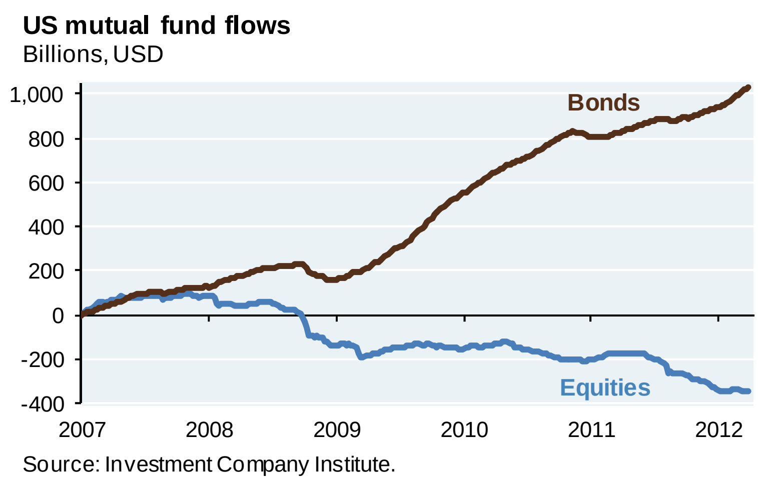
However, there's more of an effort at the state/local level to address this issue than at the Federal level. More than 40 states lowered pension benefit liabilities over the last 3 years according to the National Conference of State Legislatures. Measures taken include raising employee contributions (while lowering employer payments), raising minimum retirement ages, cutting post-employment healthcare benefits and in some cases, switching to defined contribution from defined benefit plans.

The good news, to paraphrase Mark Twain, is that reports of municipal bonds' demise have been greatly exaggerated. From 1970 through to the end of 2011, municipal bonds rated by Moody's experienced a grand total of 71 defaults among 17,700 issuers (11 of which occurred during 2010 and 2011). General obligation bonds accounted for 5 defaults; 29 were related to housing; 22 for hospitals and healthcare; 3-4 each for education and infrastructure. Utilities and cities registered 2 each, while counties, special districts, and water & sewer and experienced 1 each. The average recovery for defaulted munis was 65%, compared to 49% on corporate senior unsecured bonds. Last comment on municipals: while *local* tax collections are weak due to the collapse in home prices, *state* tax collections have been increasing for 7 quarters in a row.



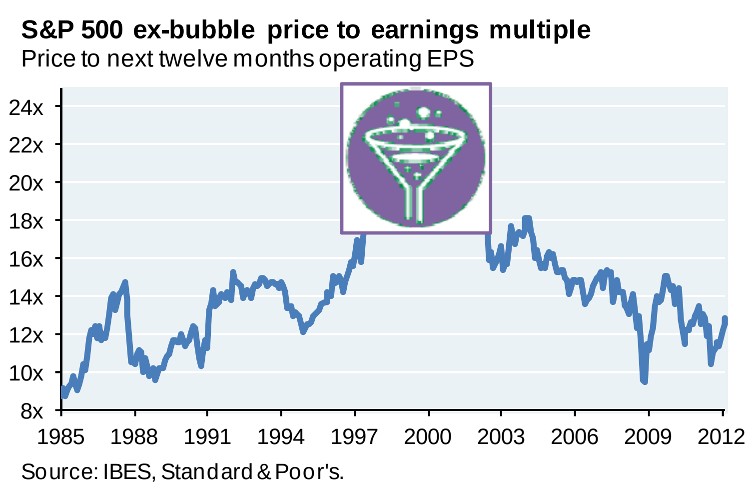


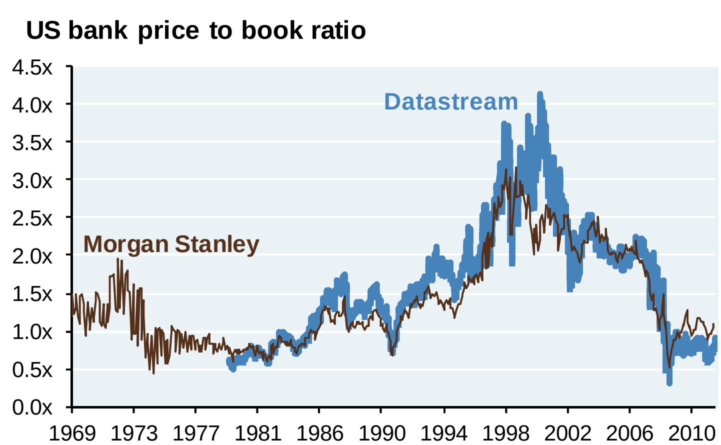
OK, so the US economy is improving, but is still heavily dependent on monetary and fiscal stimulus to grow; and the only belt-tightening one can find is at the state and local level. Since 2009, after equities collapsed and bond prices rose, how have many investors reacted?

By selling more equities and buying **a lot** more bonds. See chart above (a global version of this chart looks roughly the same).

Have investors been positioning this way since stocks are expensive?

Not really. Insert a giant martini glass on the chart below from 1998 to 2001 (I hate using simple averages which include periods when the market had lost its collective mind). The current P/E multiple is in the middle of the ex-bubble range of the last 25 years. Some bank stocks look interesting, even after accounting for reliance on shrinking loan loss reserves to drive income, and ongoing regulatory uncertainty. Most US banks are at or close to Basel 3 funding needs, have considerably fewer capital adequacy questions than their European counterparts, and do not rely on wholesale funding to finance loan portfolios.





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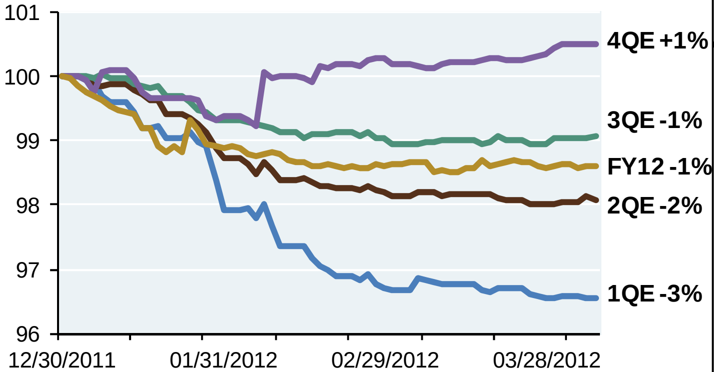
Now that P/E multiples have risen off the bottom, what's the outlook for P/E multiples and earnings from here?
The return on the S&P this year has been a function of P/E multiples rising (from 11.3x to 12.9x), a big part of which has been Apple (3% of the S&P index, 15% of S&P's YTD returns). As shown below, earnings revisions have been negative for 2012, but analysts are still optimistic about 2013. According to Morgan Stanley, analysts are forecasting the highest percentage of companies posting 2013 margin expansion since 1970, and by a very wide margin. In our view, it will be difficult for multiples to rise further unless earnings outperform expectations, particularly if Europe's structural problems take center stage again.

Revisions to consensus EPS by quarter
Index, 12/30/2011 = 100



Source: FactSet.

The place that worries me the most: **Spain**. It ranks at or close to the bottom in a lot of categories (see table), and its growth outlook is poor. Historically, this kind of thing has not ended well. Spain has defaulted 13 times since 1500 AD; it's probably going to take a lot of bilateral aid and ECB financing to prevent another one.

Michael Cembalest
Chief Investment Officer

Win, Place and Show: The problem of Spain	**The only country I can find that's in worse shape than Spain is:**
Number of dwellings to population	Greece
Non-financial corporate debt to GDP	Ireland
Corporate sector debt to cash flow	Portugal
Construction sector debt/assets	None
Banking sector branches per 1,000 people	None
Reliance on foreign capital (Net Int. Inv. Pos.)	Ireland, Portugal
Real estate as % of household assets	None
Housing overhang (as per CEPS)	Ireland
Commercial RE exposure % of bank assets	None
Encumbered banking system assets, %	Greece
World Bank labor rigidity, Europe	None
Intra-European real effective exchange rate	Italy
Shadow economy, % of GDP, OECD	Italy, Greece
Unemployment rate	None
Production time per unit	Italy
Reliance on ECB to finance sovereign debt	None
Bank lending to HH/NFC, last 12 months	None

HH/NFC = households and non-financial corporations
Sources: IMF, OECD, EU, World Bank, CEPS

<u>Sources</u>

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