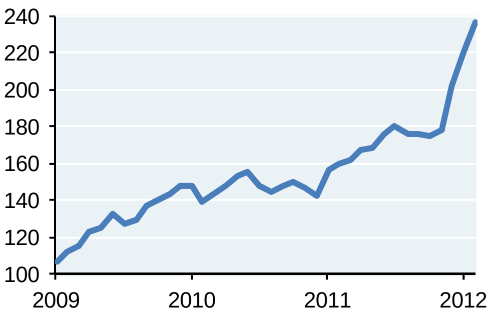
Topics: On some market and economic trends that are skyrocketing

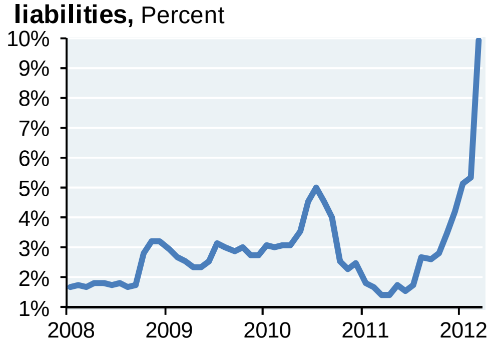
Rocket Man ("it's lonely out in Spain…"). While the US and China converge up and down to 2.5% and 8% growth, respectively, Europe has not lost its capacity for disrupting financial markets. The Spanish experiment is not doing well (see table in Appendix), prompting Spain to rely more on the ECB to finance sovereign debt. Throughout my career, central banks having to buy or finance sovereign debt to avoid a debt crisis was like going to the prom with your sister: there's something very unnerving about it, even though it looks normal from a distance. Markets apparently agree: as Spanish bank holdings of government bonds financed by the ECB skyrocket higher, so has the perceived credit risk of Spain. It did not take long for the honeymoon following the ECB's 2nd LTRO (collateralized lending) operation to end, as shown by the collapse in Spanish and Italian equity markets. Today's T-bill auction in Spain was well-subscribed, but to allay market concerns, Spain will have to issue longer paper than 12-month bills.

Spanish bank holdings of Spanish government bonds, EUR, billions



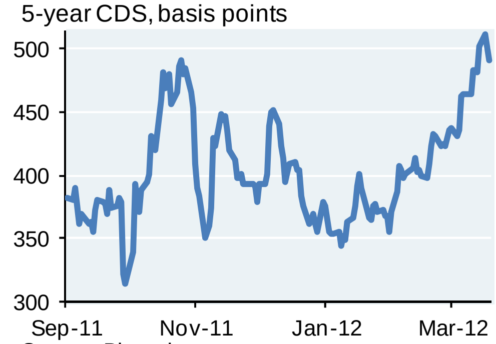
Source: Spanish Treasury, ECB, DataStream.

Spanish banks: ECB lending to total liabilities, Percent



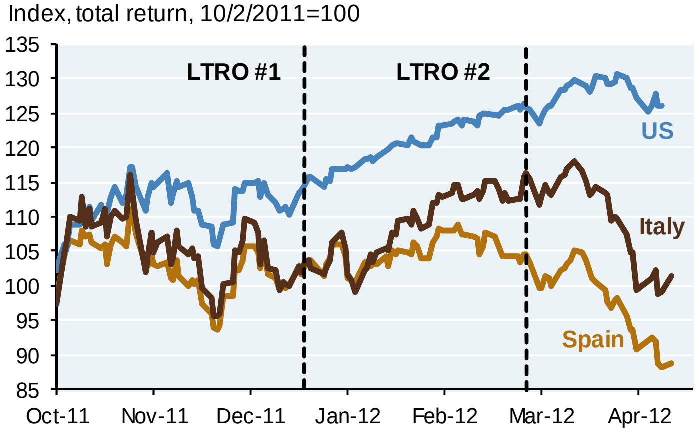
Source: Bank of Spain, ECB.

Spain: credit spreads
5-year CDS, basis points



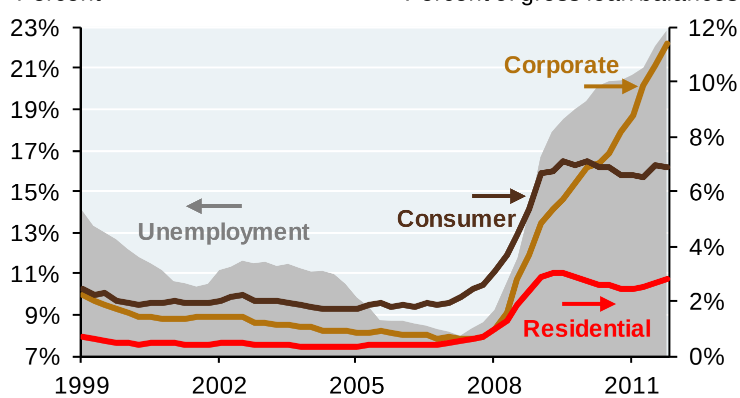
Source: Bloomberg.

LTR-Over? Equity markets, US vs. Periphery
Index, total return, 10/2/2011=100



Source: Bloomberg.

Spanish unemployment and non-performing loans
Percent | Percent of gross loan balances



Source: DataStream, Bank of Spain, Hamiltonian Associates.

The other thing that's rocketing higher in Spain: non-performing corporate loans (see chart). Interestingly, as my friends at Hamiltonian pointed out to me recently, consumer and residential delinquencies are flat, *despite* a surge in unemployment. I recommend taking this data with a giant grain of salt[1], given what one would normally expect. Markets are doing exactly that, which is why Spanish banks trade at less than tangible book value; a bit less than 1.0x for BBVA and Santander, around 0.5x for the domestically-focused Cajas. Note: Caixabank recently purchased Civica at around 0.35 times book value.

We have been underweight European equities since the crisis broke in November 2009; German mid-cap companies (represented by the MDAX Index) have been our preferred market exposure in the region. As explained in our 2012 Outlook, most investors are underweight Europe, valuations are quite low, and ECB liquidity will slow the rate of deleveraging. However, while contrarian market calls are sometimes the best ones, in this case it's not a call we're prepared to make. We remain underweight Europe, and overweight the US. **As shown in the table, being underweight European equities is the gift that keeps on giving.**

Total return (through Apr.16)	MSCI Europe (Euro)	MSCI Europe (USD)	S&P 500
2010	11.9%	4.4%	15.1%
2011	-7.5%	-10.3%	2.1%
2012	4.5%	5.5%	9.6%

Source: Bloomberg.

[1] Spanish bank residential home loans were generally made at lower LTVs than in the US, and are usually full-recourse. But still….

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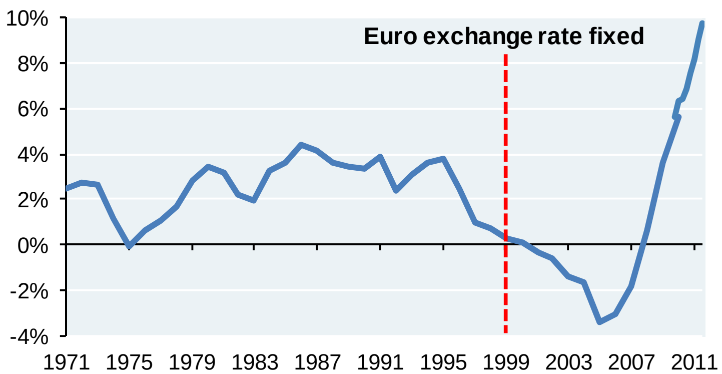
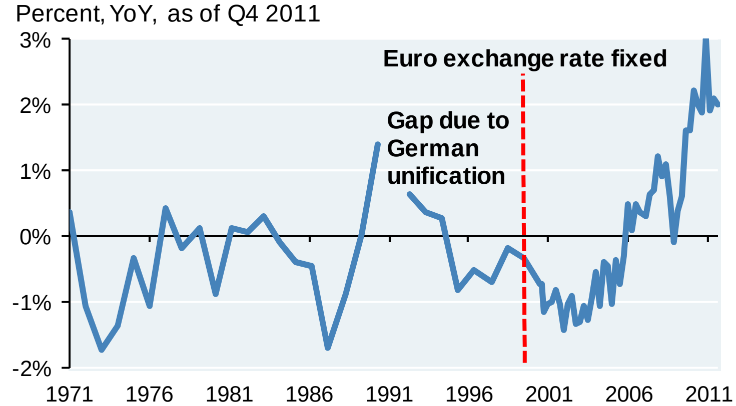
From a 10,000-foot perspective, the North-South imbalances created by the Euro are skyrocketing (see below). They are far greater than any that preceded the Euro, even during the bouts of inflation and devaluation which beset the South in prior decades. Nevertheless, the region appears committed to soldiering on with it, despite the costs. Our sense is that Europe will slog through a period of low growth and complicated politics[2], and that the ECB may have to resuscitate both its 3-year bank repo operations (LTRO) and outright bond purchases (SMP) later this year. These developments are amazing for a project like the Euro, which was designed to *harmonize* and sustain Europe's post-war social, political and economic integration.

Unemployment rate, Periphery minus Germany
Percent, Peripheral rates weighted by population



Source: J.P. Morgan Private Bank, Bank of Spain, Bank of Portugal, OECD, CSO, NSS, IMF, Statistical Office of the European Communities.

Real GDP growth, Core minus Periphery
Percent, YoY, as of Q4 2011

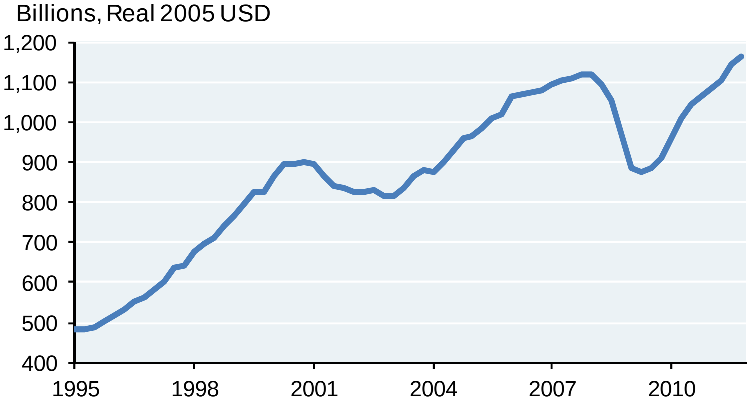


Source: Statistical Office of the European Communities, OECD, IMF, J.P. Morgan Private Bank.

<u>United States: many of the skyrocketing trends are positive</u>

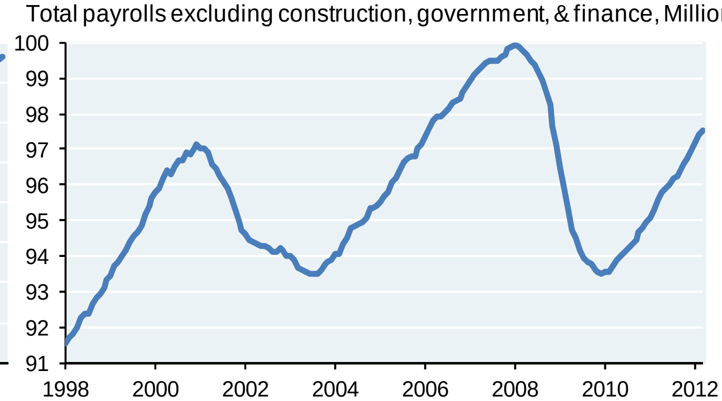
Spending on equipment and software has been on a tear, accounting for roughly 35%-40% of the (admittedly subpar) US growth rate since March 2009. And despite the weak March payroll report, the cyclical component of payrolls (excluding government, construction and finance) continues to march higher, a trend confirmed by other reports showing increasing labor demand, more voluntary separations, and fewer firings (see Appendix). These trends are improving off of a *very* low base, but suggest a labor market that's getting better rather than worse. The retail sales report was also strong, but as mentioned last week, parts of the US experienced the warmest March in recorded history, so we need to wait and see if there is payback later in the year.

US business spending on equipment and software
Billions, Real 2005 USD



Source: Bureau of Economic Analysis.

Improving "cyclical" payrolls
Total payrolls excluding construction, government, & finance, Millions



Source: BLS.

I was also struck by the following chart on **skyrocketing housing affordability**. It computes the percentage of metropolitan statistical areas in which buying is cheaper than renting. It uses monthly rental data, 30 year mortgage rates from Freddie Mac, median home prices and a constant 20% down-payment assumption. Of course, financing conditions tightened substantially in the last 3 years and labor incomes are still very weak, so the universe of potential buyers is not as large as it might seem. But the economics of housing are finally stabilizing, a process we expect to take shape over the next couple of years. We expect the accumulation of household cash balances to eventually drive up residential investment from a low base.

[2] Italian and Spanish politicians have been squabbling over whose sputtering reform program is more responsible for recent market weakness. Meanwhile, French presidential candidate Francois Hollande believes that if the ECB had aggressively purchased Greek debt from the beginning, "we wouldn't be in such a mess". I look forward to his summit meetings with Merkel and the Bundesbank.

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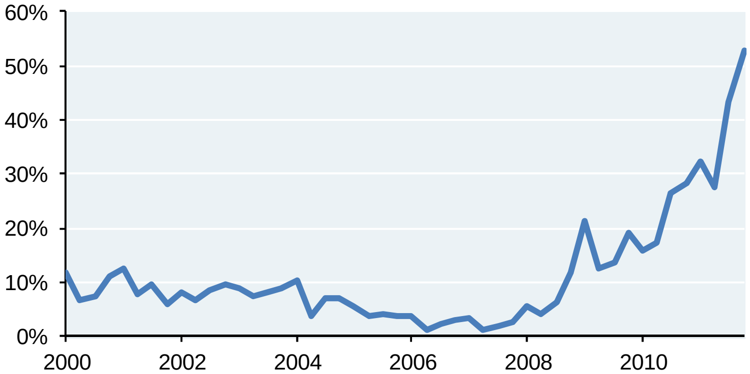
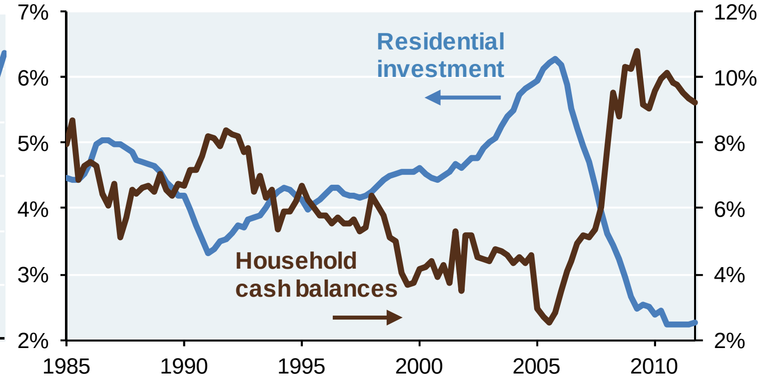
Percent of MSA's where buying is cheaper than renting
MSA = Metropolitan Statistical Area



Source: J.P. Morgan Securities LLC, AxioMetrics, CoreLogic, Freddie Mac.

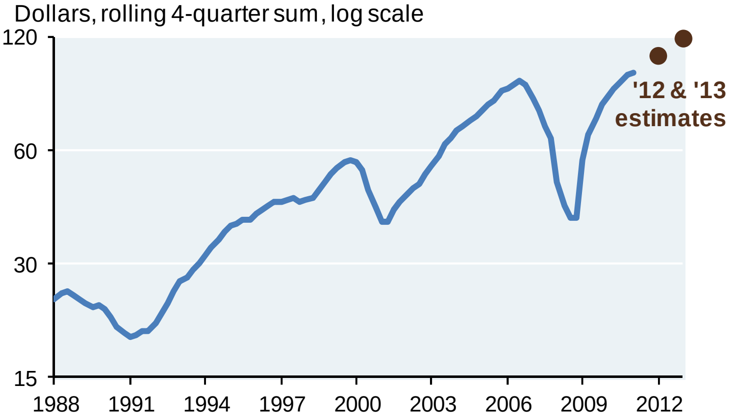
Housing crash has sidelined household cash



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

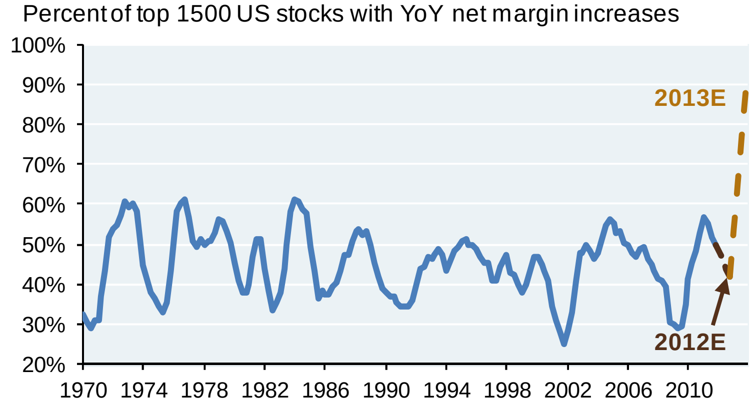
Corporate profits continue to march higher as well. It's early in the quarter (only 10% of companies reporting), but so far, 86% and 77% of companies are beating revenue and earnings estimates. The challenge for 2013: according to analyst estimates, the % of companies whose margins are expected to expand skyrockets to unprecedented levels. Earnings expectations for 2013 may eventually have to come down; this can be offset by a modest expansion in P/E multiples from their currently low levels.

S&P 500 Operating earnings per share
Dollars, rolling 4-quarter sum, log scale



Source: Standard & Poor's.

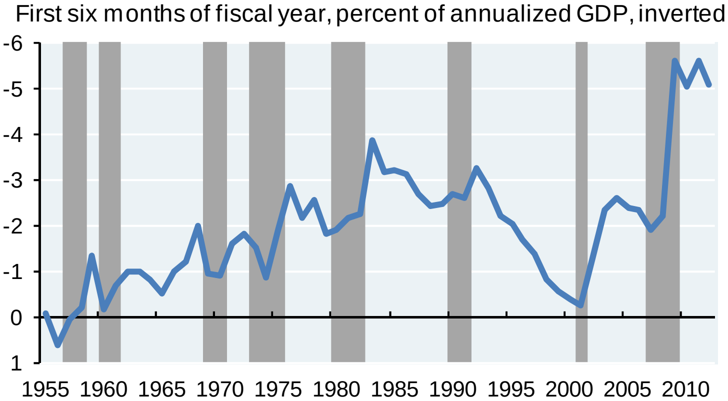
Profit margin expectations for 2013
Percent of top 1500 US stocks with YoY net margin increases



Source: FactSet, Morgan Stanley Research.

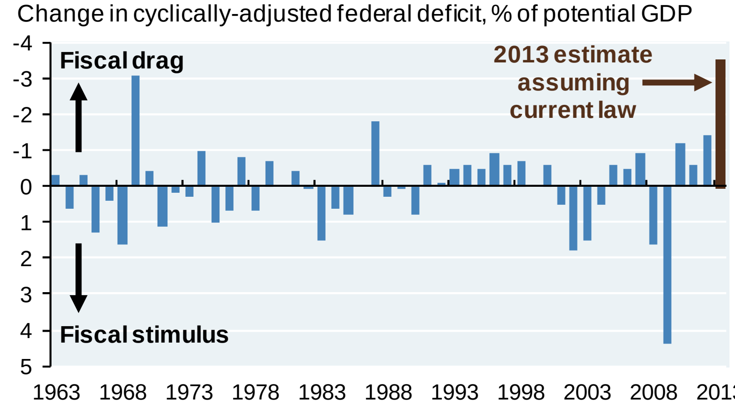
The biggest fly in the ointment is of course the fiscal situation. After having skyrocketed, deficits have not come down meaningfully (below they are measured for the first 6 months of the fiscal year), and are remarkably high three years into a recovery. The "current law" fiscal drag scheduled for 2013 skyrockets as well, although we would be surprised if anything close to current law were actually implemented. We covered this issue in detail last time, and will refrain from doing so again this week, other than to note that bull markets usually do not spring into existence until issues like these are partially resolved.

Fiscal deficits
First six months of fiscal year, percent of annualized GDP, inverted



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

Scheduled austerity for 2013
Change in cyclically-adjusted federal deficit, % of potential GDP



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

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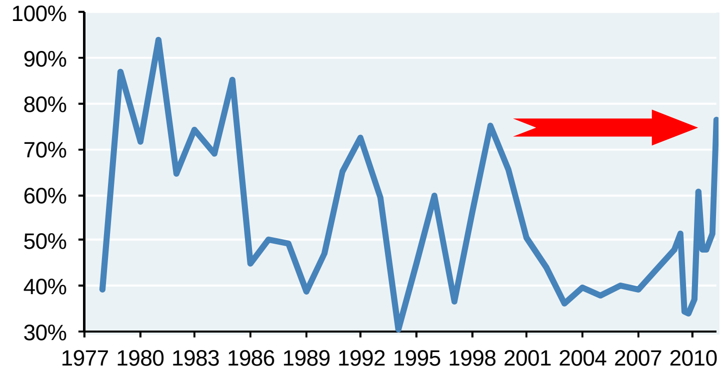
<u>China: a skyrocketing nation of spenders?</u>

While Chinese GDP growth is slowing to ~ 8% (see our China Dashboard from March 15, 2012), the contribution of Chinese consumption to GDP growth has been rising, and is now at its highest level since the late 1990's. This computation benefits from a declining denominator, and furthermore, it would take many quarters like this to move the needle of East-West global imbalances; but it's a start. These results are consistent with our experience in China, having invested in 2010 in an Asian private equity fund focused on consumer oriented businesses. Last year, the Chinese companies in the portfolio grew revenues and operating cash flow at 48% and 59%, respectively.

Contribution of Chinese consumption to GDP growth
Percent



Source: China National Bureau of Statistics, Haver.

On portfolios, no changes to the overall allocations outlined in our March 8 EoTM.

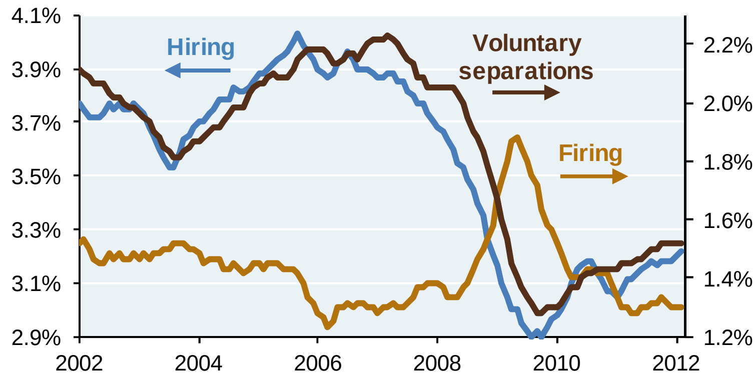
Michael Cembalest

<u>Appendix: a Spanish horse race, and some data from the US Bureau of Labor Statistics</u>

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

US labor conditions improving from a very low base
Percent, 6-month moving average, sa



Source: Bureau of Labor Statistics.