Topics: Some positive US recovery signals, offset by the Icarus factor in Europe and China; Bo Xilai

*"**When Anglo-Saxons said that a single central bank and currency without a single state would be inherently unstable, they had a point**"*. Jacques Delors, one of the Euro's founders, in a December 2011 interview with the Daily Telegraph

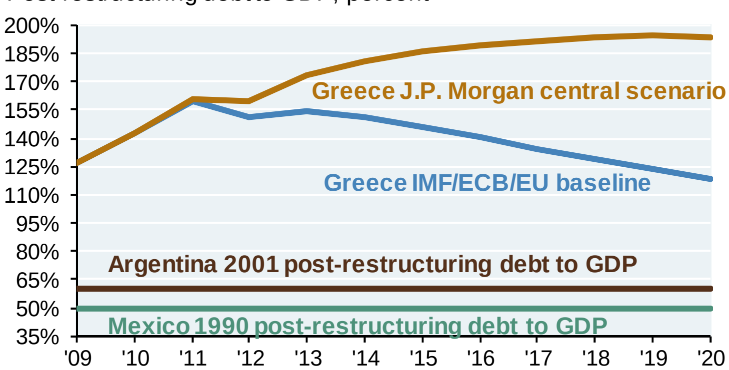
The Fall of Icarus, Jacob Pieter Gowy, 1650
Museo Del Prado, Madrid, Spain

The Icarus painting can be re-imagined as the fathers of the Euro (Delors, Kohl, Mitterand, Padoa-Schioppa, Trichet) watching their project reel in mid-flight. By the time a member country's GDP decline rivals the US Great Depression, suffers youth unemployment greater than 50% and elects communists and neo-nazis to its Parliament, something has gone horribly wrong. That the IMF participated in the program, despite well-documented failures of prior adjustments attempted without a nominal exchange rate decline, is bewildering. Greece's present is bleak, and its future may be as well: future *potential* output may have been damaged by excess austerity.

If the protest vote in Greece seems extreme, consider the chart below on Greek debt after forgiveness by the private sector, and debt in Mexico and Argentina after their debt restructurings. Greece is still in a debtor's prison, and for all the talk of a bailout, 70%-80% of monies advanced to Greece by the EU, ECB and IMF were round-tripped to facilitate foreign and domestic capital flight, and repayment of bondholders. What happens now? The EU may relax some of the Dickensian conditions of the austerity program, but Greece may be too far gone for that to matter. Perhaps the next elections will be a referendum on the Euro, fringe parties will receive fewer votes, PASOK and New Democracy will form a government, and Greece will stay in the Euro for a while longer. Either way, Europe has lost Greece to the Furies, and will struggle to prevent it from appearing as a more extreme blueprint of what other EU countries may face.

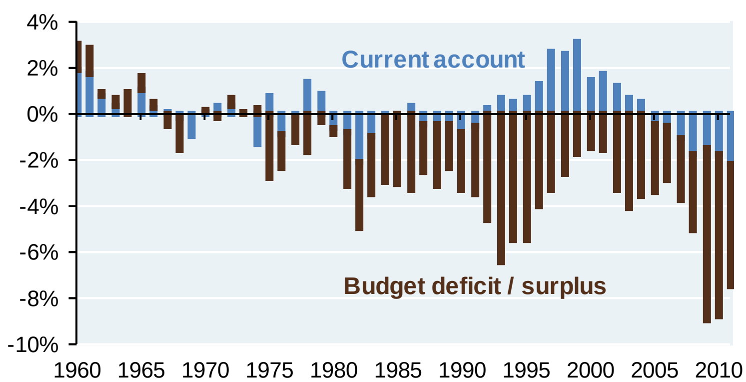
As for France, it's premature to judge what Hollande will do. We expect Hollande to win a majority in the legislative elections, and French Socialists have a history of proving their credentials: Francois Mitterand's nationalization of every French bank except Lazard and creation of a substantial wealth tax; and Lionel Jospin's 35-hour work week. But France is running the largest twin deficit in decades (second chart), and Hollande may be constrained by markets from veering too far off course. Note that Hollande has already backed off proposed changes to the fiscal compact agreed to last year.

Greece's debtor's prison
Post-restructuring debt to GDP, percent



Source: EU, J.P. Morgan Securities LLC, Ministerio de Economía y Producción, IMF.

France's twin deficits may constrain Hollande
Percent of GDP



Source: IMF, NISES, GaveKal.

In **Spain**, forced recapitalization of its 3rd largest bank (Bankia) is welcome, but a lot more money will be needed for other banks. Spain's fully-loaded sovereign debt is approaching 90% of GDP, which will be tough to handle for a low-productivity, service-sector economy. Europe has raised a lot of firewall funds, and they may be needed for Spain, since the several hundred billion Euros provided by the ECB earlier this year to Italy and Spain may run out by the end of 2012. The ECB decision to declare itself senior to other Greek bondholders may be a bad fact for holders of Spanish debt.

Germany is in good shape, and may accept higher inflation to prevent the kind of dispute that led to the Exchange Rate Mechanism collapse in the early 1990's [when Soros made a fortune by speculating that the UK could not afford to remain in it]. German acceptance of higher inflation would postpone tighter monetary policy and help the South, on the margin. As shown

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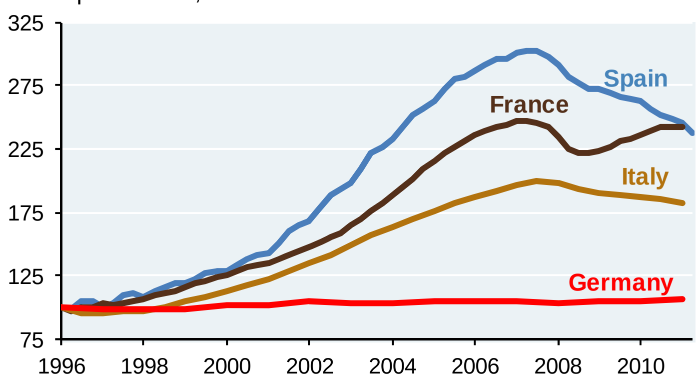
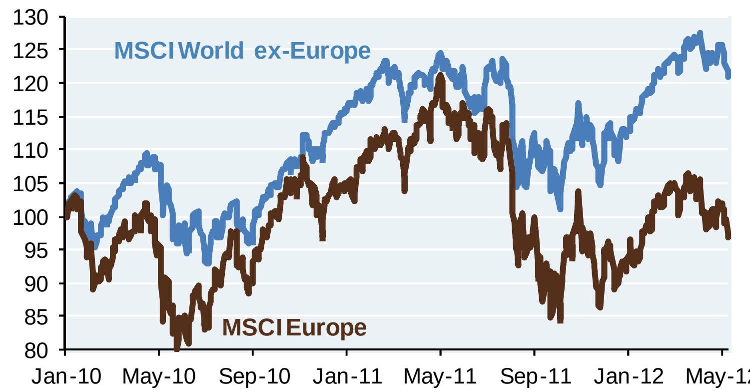
below, for cultural and structural reasons, Germany did not have a housing boom-bust and could *in theory* tolerate more inflation in goods and asset prices. But is "modestly higher inflation" 2.5% or 4.0%? There's no way to know where Germany's inflation tolerance lies. Furthermore, countries like Spain may need more than just 0% interest rates to recover. Meanwhile, **the performance gap between global and European equities continues to widen** (2nd chart). Eventually, problems we keep discussing will be reflected in European equity prices, but I don't think we're there yet. We remain *very* wary.

Germany: some room for easier monetary conditions
House price index, 1996=100



Source: Statistisches Bundesamt, Ministerio de Vivienda, NISES, Osservatorio sul Mercato Immobiliare di Nomisma, GaveKal.

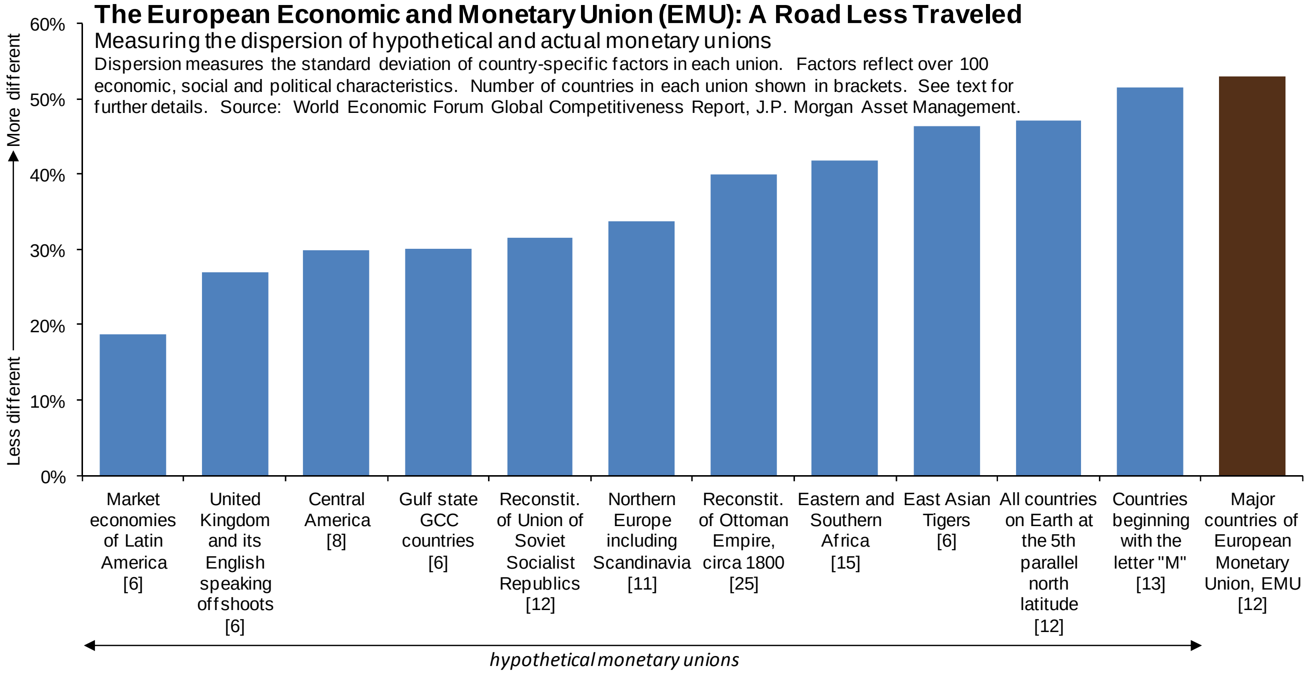
The widening underperformance of European equities
Index, 12/31/09=100



Source: Bloomberg, MSCI.

For anyone that missed it, here's the chart we showed last week on hypothetical monetary unions, and how they compare to the actual European Monetary Union[1]. Now you know what Delors was talking about when he said, "*The finance ministers did not want to see anything disagreeable which they would be forced to deal with*".

The European Economic and Monetary Union (EMU): A Road Less Traveled
Measuring the dispersion of hypothetical and actual monetary unions
Dispersion measures the standard deviation of country-specific factors in each union. Factors reflect over 100 economic, social and political characteristics. Number of countries in each union shown in brackets. See text for further details. Source: World Economic Forum Global Competitiveness Report, J.P. Morgan Asset Management.



Perhaps Germany will convince its citizens to support a real fiscal transfer union; that would certainly help. Our sense is that behind closed doors, Merkel and her team are committed to keeping the Eurozone alive whatever the cost, political or fiscal. If so, Germany may need to concede (a) that Greece is probably never going to pay back its loans, whether they stay in the Eurozone or not; and (b) that the ECB's 1.4 trillion of exposure to the Periphery, **already 14% of the 10 trillion in Peripheral bank and sovereign debt outstanding**, could easily double in the next 12-18 months.

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[1] We have received follow-up questions on the US monetary union. **The dispersion of GDP, wages and productivity across US states is a fraction of the dispersion between EU countries, and US labor mobility is 10x higher**. Furthermore, US citizens pay 66% of all their taxes to Washington DC, and 33% to state and local entities. In Europe, 98% of all taxes are paid directly to member countries where citizens reside, and 2% to support the activities of the EU itself. Let your JP Morgan team know if you'd like to see the charts on this.

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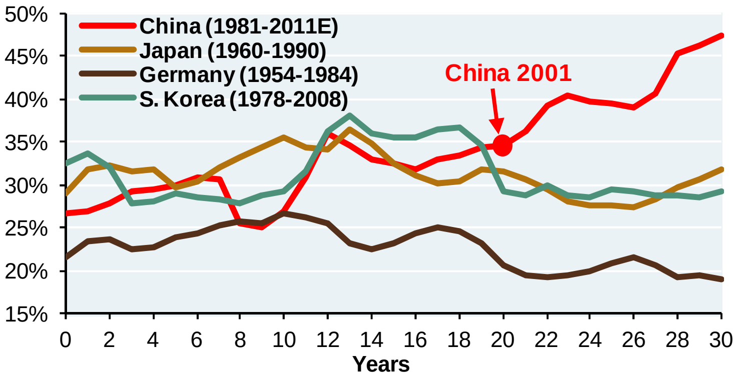
China, the hard/soft landing debate, and the Bo Xilai situation

A lot of multinational companies mentioned the China slowdown in their Q1 earnings releases (Air Products, Alcoa, Caterpillar, Celanese, 3M, Cummins, Eaton, Eastman Chemical and Komatsu). A lot is riding on a China recovery, or at the minimum, no 'hard landing'. Skeptics believe that China is one of those Western movie sets, all façade and resting on wooden stilts, waiting for a gust of wind to knock it over. While we don't have that view, we are concerned about how China's Icarus-like capital spending boom (see below), which is 50% larger than post-war industrializations in Germany, Japan and South Korea.

The current China slowdown is unmistakable, although it's not that easy to distinguish between a structural and more temporary business cycle decline. Last week's reports confirmed that Q1 economic weakness continued into April, with below consensus results for trade, industrial production, electricity production, exports, retail sales, capital spending and the money supply. These results contradict the more positive message in China's recent manufacturing survey (see chart). **The levels to which activity have fallen are more consistent with 8% growth than 5%, which would argue that the soft landing thesis is still intact; but that assumes that the Chinese economy will respond to last week's reserve requirement cut and other stimulus measures.** With another decline in inflation to 3.4% (down from a peak of 6.5% in 2012), there *should* be room for China to ease. China and the rest of Asia are feeling the effects of the European slowdown, so easy money and less appreciation of the RMB will only go so far. A growth rate of less than 8% is a possibility if conditions in Europe do not stabilize sooner.

Chinese investment boom, in context

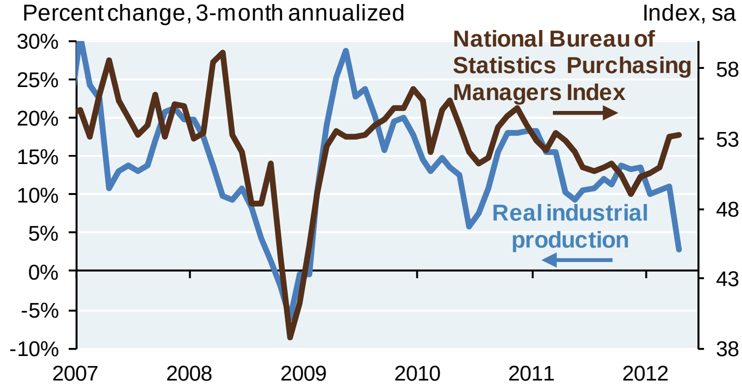
Gross fixed capital formation, percent of country GDP



Source: Haver, J.P. Morgan Asset Management.

Recovering or slowing down?

Percent change, 3-month annualized



Source: National Bureau of Statistics , Haver.

We have received questions on the Bo Xilai situation in Chongqing, and the broader implications of the pending political transition in China for investors. The Bo saga itself reminds me of Huey Long: the rise and fall of a powerful regional populist and possible demagogue who single-handedly taxes the corporate sector to share-the-wealth[2], only to fall afoul of national interests along the way. However salacious it may be, this episode and the broader political transition does not seem to have much of an impact on China's economic trajectory. If anything, policy-making has picked up in recent months: opening private credit channels to small and medium sized businesses; relaxing entitlement eligibility for rural migrants; and enlarging the amount of money that foreign investors can deploy in public companies. My view is that the hard landing vs soft landing debate is likely to be resolved in the economic arena rather than the political one, so we will keep watching the data.

A challenging assignment: the US recovery must overcome the European Divorce and the China slowdown

While the US economy is only growing at 2.0% and regional manufacturing surveys have rolled over, other economic indicators are picking up. Small business optimism, job openings from the Bureau of Labor Statistics and a measure of railcar loadings are on the rise (see charts below; as highlighted in a report from Hamiltonian Associates). We also show rising surveys of top-line sales in airlines, trucking and homebuilding from ISI Group. On housing, inventory levels in Phoenix, Tampa and Las Vegas have fallen by 25%-45% in the last year, and both rents and asking prices are up in single digits. Housing appears to have fallen down a 7-year flight of stairs (since 2005), and has hit bottom. All of this, and falling gasoline prices, may explain improved consumer sentiment reported last week. **These trends will need to coalesce into more household spending (not just on cars) and capital spending in order for the US growth to grow more than 2%.**

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[2] One of Bo's policies was to ask local state-owned firms to contribute 15%-30% of their profits to the government, the highest level in China. This accompanied a 9-fold increase in the amount of state assets from 2002 to 2011. Long relied on a variety of income and license taxes to finance his social programs; tax revenues rose by 75% after he took office. By 1935, Louisiana had the second highest per capita state debt in the country.

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US small business optimism
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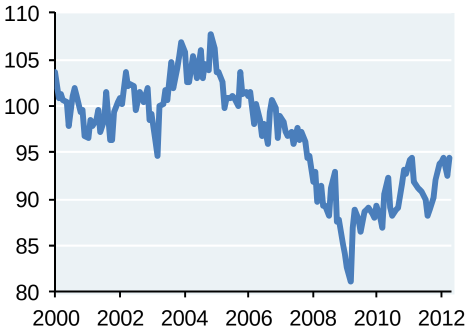
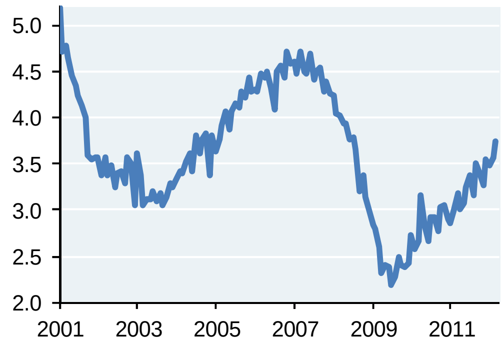


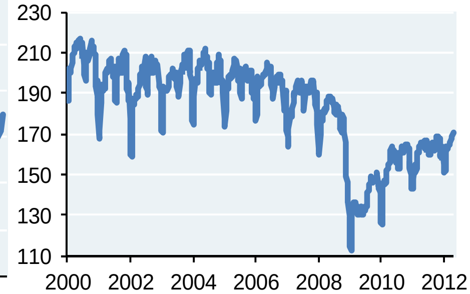
Source: National Federation of Independent Business.

US job openings rising
Millions



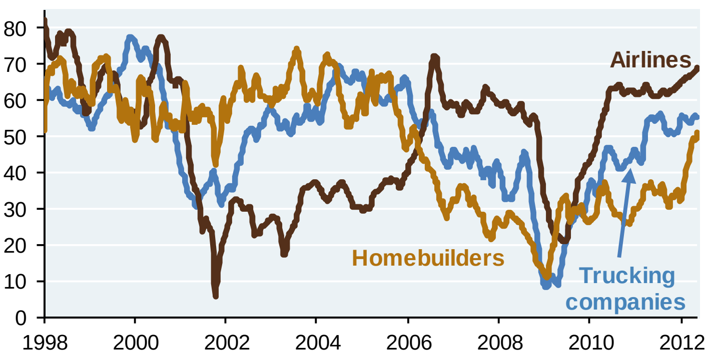
Source: Bureau of Labor Statistics.

Railroad carloads recovering
Thousands of railcars, excluding coal, 4-week moving average



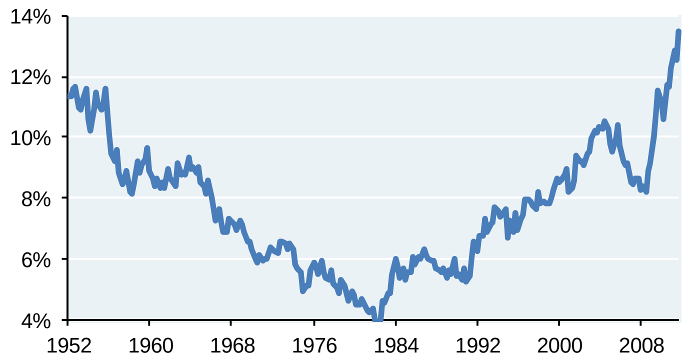
Source: Association of American Railroads and Atlantic Systems.

Company sales surveys upbeat
0=weak, 100=strong, 4-week average



Source: ISI Group.

What will it take to unleash corporate cash?
Cash and equivalents / tangible assets



Source: Federal Reserve Board.

For that to happen, some clarity may be needed on both the "2013 fiscal cliff" and the "long term entitlement bomb", which unfortunately calls for opposing fiscal measures to mitigate them. One question: what policy mix could unleash the mountains of corporate cash? I doubt it would involve more help from the Fed. **There's a debate about whether the Fed should engage in more securities purchases (QE3), but that seems odd when policy rates are already zero and the 10 year Treasury is less than 2%.** Instead of looking to the Fed, aiming for a repeat of the 1950's seems like it might work better. From 1950 to 1960, the US federal debt fell from 80% to 46%. **The US did not inflate its way out, and there was no austerity program[3].** The US *grew* its way out. As a result, following the example of Eisenhower[4], it's tempting to think that an aggressive pro-growth agenda signaled from the White House could be more impactful than QE3.

Wrapping up

It will be hard for the world to grow if China depends on Europe which depends on China which depends on the US which depends on China and Europe. It's an odd market: in the US, **98% of the S&P 500's cumulative 27% return since January 2010 occurred either during corporate earnings season, or right after QE programs.** The rest of the time, the S&P 500 is flat, since the economic news has not been that good. As we have been writing, current circumstances call for modestly less risk than normal, and allocations to distressed residential and commercial real estate, long-term energy projects, private lending and other investments with less exposure to the current macro/business cycle. Exposure to the US and the Pacific Rim (ex-China and ex-Japan) are where we see the best opportunities in both public and private equity.

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[3] From 1950-1960, federal government expenditures were ~17% of GDP, with little deviation except for the onset of the Korean War in 1953. The entire decade was characterized by the closest match between government revenues and expenditures in the last 60 years. As for inflation, it averaged just 2.3%. **Real GDP growth of 4%+ was the driver of debt reduction**.

[4] During the 1950's, taxes were regarded as a greater cause for small business failures than tight money. Eisenhower championed legislation which eased tax burdens on small business and which culminated in a bill eliminating double-taxation (Subchapter S); he also eliminated wage and price controls. The private sector accounted for a post-war peak of 86% of all employment, a level not seen since.

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Sources, References and Acronyms

"*When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950's*", UCLA School of Law in the Pittsburgh Tax Review, Volume 6, 2008

Icarus: A Greek myth in which the title character and his father Daedalus escape from the Labyrinth by flying with wings made of wax. Daedalus advises Icarus not to take too much risk, and to stay away from the sun. Icarus, overcome with hubris and misplaced confidence, ignores him. His wings melt and he falls into the ocean now known as the Icarian Sea, turning opportunity into calamity.

PASOK: The Panhellenic Socialist movement, a centre-left party