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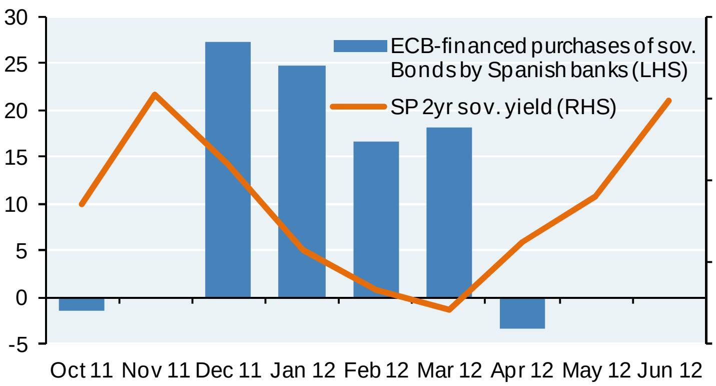
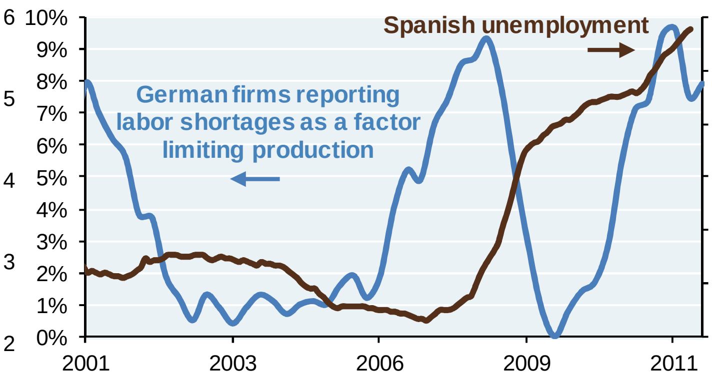
European Safari. I didn't spend much time on Greece last weekend. Think about it this way: if the Eurozone's survival hinges on Greece staying in or not, a country which the Euro has rendered economically bankrupt and politically balkanized, the Eurozone may be even more fragile than it is suspected to be. A bigger preoccupation right now is Spain, where unemployment is 24% despite the highest levels of labor shortages in Germany in 25 years. This year has been tough in Spain: its government bonds only rallied when the ECB provided money to Spanish banks to buy them (the Cyrano effect[1]). Once this ended, Spanish bond yields soared again. Spain, along with Italy and France, then began to barrage Germany with demands to "share the wealth" via region-wide deposit guarantees, more ECB purchases of government bonds, more flexible ECB lending conditions for banks, joint and severally guaranteed Eurobonds, a European Redemption Fund which is more or less the same thing as Eurobonds, and higher inflation tolerance in Germany. **It's like watching a group of hyenas trying to bring down an elephant**. At this point, I would put even money on the hyenas succeeding, as Merkel seems to be tiring of the fight.

Spain, its banks, the ECB and the Cyrano effect
Billions of Euros / Percent



Source: ECB, Reuters. Bank bond holdings as of April 2012.

What kind of monetary union is this?
Percent



Source: European Commission.

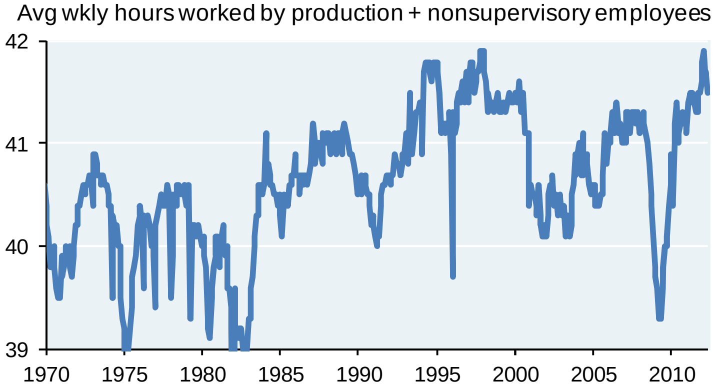
Recent economic news from the US and China has not been strong enough to pull Europe out of its doldrums. In the US, the latest round of weak economic data include the Empire manufacturing survey, retail sales, industrial production, jobless claims and a large May Federal budget deficit. In China, GDP growth is slowing to 6%-7%, with weakness in trade, industrial production, electricity production, exports, retail sales, capital spending and the money supply. **But this week, we will not be discussing any of that.** Instead, given low expectations priced into equity markets (see page 3), we ask a different question….

"WHAT COULD ACTUALLY GO RIGHT"??

[1] The US "manufacturing renaissance"

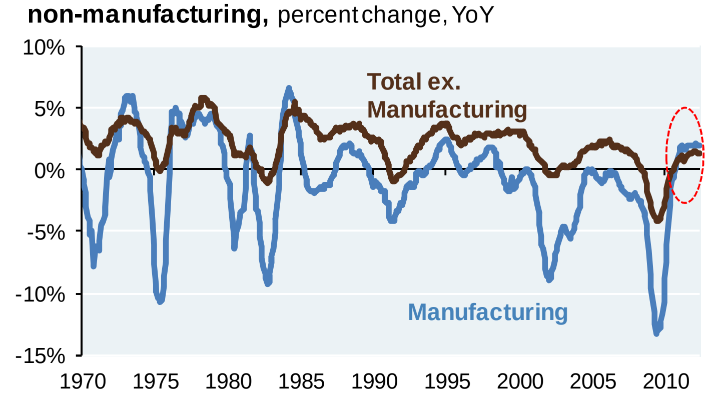
You've probably heard about this in the press already: predictions of a US manufacturing renaissance. The primary catalysts: a cheap US dollar, the natural gas boom, and rapidly rising wages in China, all of which create incentives to bring manufacturing jobs back to the US. Is it already happening? As shown, despite an otherwise lackluster job market, manufacturing has been a bright spot, with the highest work-week in 40 years and faster manufacturing job growth than in services (see Charts 1a, 1b). Unfilled manufacturing jobs have also risen sharply over the last 3 years.

1a: Manufacturing sector hours worked
Avg wkly hours worked by production + nonsupervisory employees



Source: Bureau of Labor Statistics.

1b: Manufacturing employment rising faster than non-manufacturing, percent change, YoY



Source: Bureau of Labor Statistics.

[1] In Cyrano de Bergerac, Roxane was only interested in Christian de Neuvillette when a hidden Cyrano told him what to say to her.

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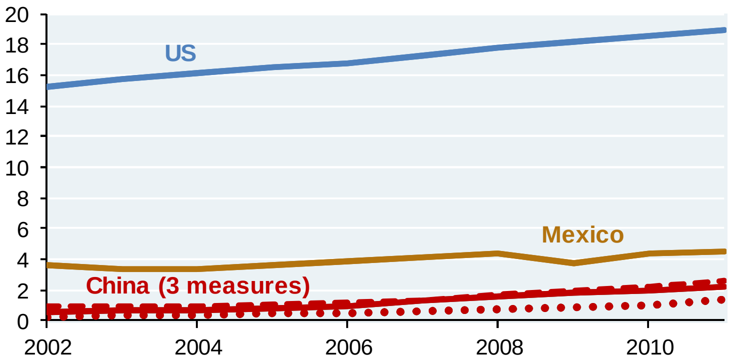
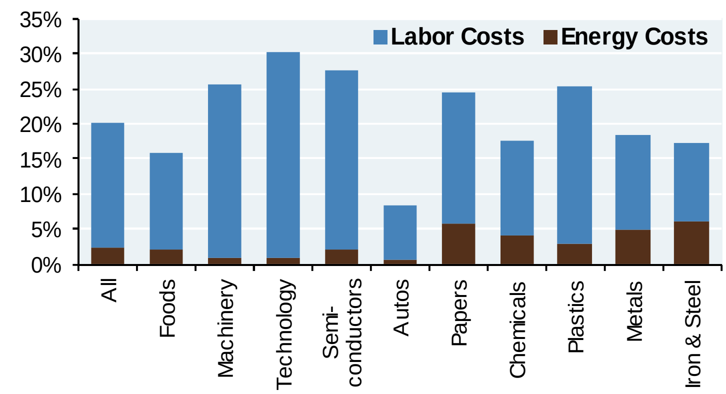
However, it's not clear if these trends are just a temporary cyclical lift, or more structural. As noted by Empirical Research Partners, even after years of 10%-20% annual wage growth in China, the wage gap vs the US is still very high (Chart 1c). While Chinese workers are less productive than their US counterparts (BCG cites Chinese unit productivity that is 30% of US levels), the gap between the two is still large even after accounting for this. Shipping costs help the US job repatriation argument, but are only 6%-7% of the cost of imported goods. Empirical cites research indicating that the rise in oil prices from $26 to $100 only had a small impact on demand for Chinese exports. The US benefits from labor flexibility and enforced intellectual property rights, but this has generally been the case for a while, and isn't getting better in relative terms vs other countries.

1c: Wage inflation in China, the US and Mexico
Manufacturing wages, USD per hour



Source: National Bureau of Statistics, BLS, JPMAM, Boston Consulting Group, Empirical Research Partners.

1d: Labor and energy intensity in US manufacturing
Share of total expenses, percent



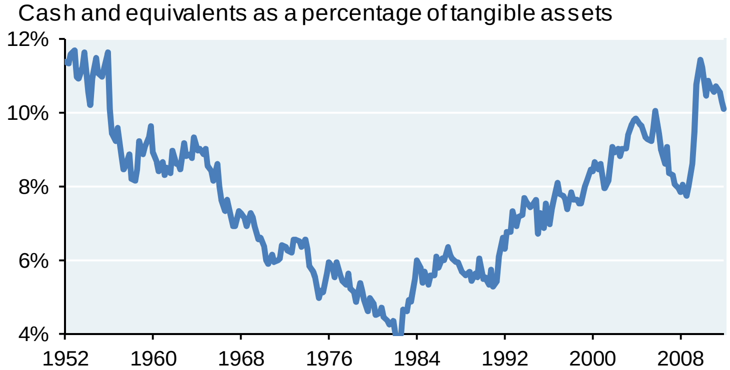
Source: Survey of Manufacturing, Empirical Research Partners.

As for natural gas, ~$3 per mm BTU *should* hold down US electricity prices. In Germany, nat gas prices are $10 (the German government intends to replace nuclear power with offshore wind; good luck with that), and in Korea/Japan, nat gas prices are $15+. But as shown in Chart 1d, in most US manufacturing sectors, energy is less than 5% of total expenses and is dwarfed by labor costs. This math probably understates the multiplier effect benefits of cheap natural gas, but it's important to try to quantify the benefits rather than rely on anecdotes. For US manufacturing to get a *structural* boost, it will probably take continued acceleration of Chinese wages and other expenses (like electricity), *and* a slowdown in Chinese labor productivity gains. On productivity, China has the scope to introduce more robotics into its manufacturing processes[2], so this is far from a foregone conclusion. **The bottom line is that the natural gas boom, the dollar and Chinese wage gains should definitely help the US, but we expect this to be a gradual process, and not a game-changer for US employment in 2012 or 2013.**

[2] The wall of corporate cash starts to crumble

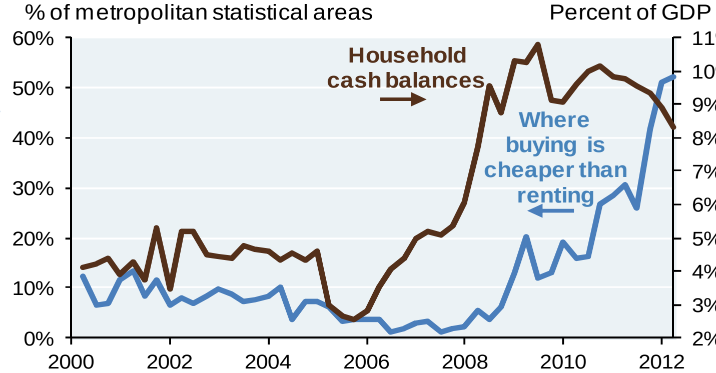
As shown in Chart 2a, US companies have amassed large cash balances relative to assets, close to the highest levels in 50 years. In a recent *Eye on the Market*, we noted that if US corporate cash balances and leverage returned to 1996-2009 averages, S&P non-financial firms could deploy ~$1.4 trillion in M&A, hiring, capital spending and shareholder distributions. Some of this cash is held by technology and healthcare companies offshore, for tax reasons, but there's still a lot of ammunition here. After the election, if there is more clarity on where the US is heading, perhaps this logjam will break.

2a: US corporate cash balances
Cash and equivalents as a percentage of tangible assets



Source: FRB.

3a: Household cash balances and cheaper homes
% of metropolitan statistical areas   Percent of GDP



Source: J.P. Morgan Securities LLC, AxioMetrics, CoreLogic, FHLMC, BEA.

[2] As per Gavekal Research, in the automotive sector, the number of industrial robots per 10,000 employees ranges from 1,200-1,400 in Germany, Japan and the US. In China, that number is around 100. Similar relative ratios hold in the broader category of General Industries.

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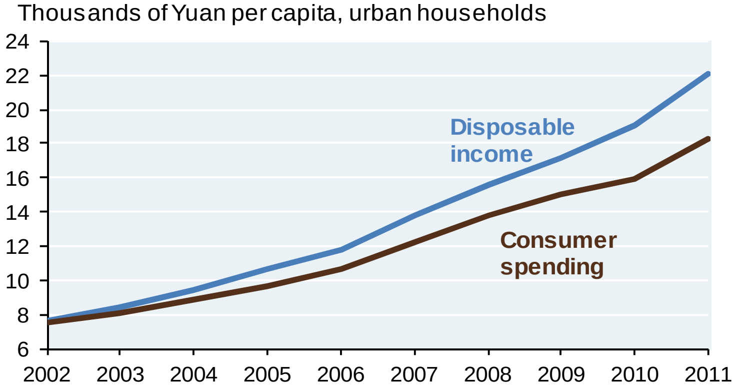
[3] US housing picks up sooner and faster

The number of cities where buying is cheaper than renting continues to grow (Chart 3a). A lot of housing indicators have stabilized, and some are even climbing from a very low base. There is a lot of pent-up demand for housing on a demographic basis, and household cash balances are high. While the hiring and GDP consequences would be limited given how sharp the decline in residential construction was, if housing accelerated, it would be an unexpected positive lift for animal spirits.

[4] Rising household incomes and easier monetary policy prevent a hard landing in China

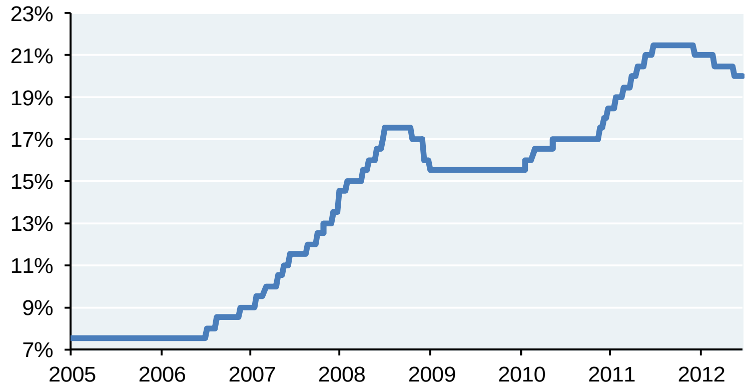
There is a slowdown coming in Chinese capital spending after a boom that is massive compared to other industrializing countries. We have covered this before, comparing China (1990-2011), Japan (1957-1978), Korea (1978-1999) and Germany (1960-1981). The case for a soft landing rests on 2 things: rising consumer spending to offset a decline in fixed investment, and easier monetary conditions. On the former, disposable income and consumer spending have been rising at 10%-12% per year (Chart 4a), which may be enough to sustain 7% overall GDP growth. On the other point, it would be premature to write off the benefits of easier monetary policy, when/if implemented. Financing costs are higher than policy rates would suggest they are, which is why so many companies have been borrowing through the more expensive shadow banking markets. Let's see what happens if bank reserve requirements are reduced again later this year (Chart 4b) as inflation continues to decline.

4a: Disposable income and spending in China
Thousands of Yuan per capita, urban households



Source: China National Bureau of Statistics, IMF.

4b: China reserve requirement ratio for large banks
Percent



Source: People's Bank of China.

[5] After the US election, some kind of breakthrough on US long term budget dynamics

Let's assume that the US gets through the fiscal cliff and debt ceiling debate; that's not the bullish part. A more market-friendly outcome would be a move in 2013 to gradually address the long-term entitlement challenge, highlighted continually by the CBO, the Committee for a Responsible Federal Budget, etc, since there may be no politically viable marginal tax rate to support accumulated US entitlement obligations. What might it look like? On Social Security: raise tax cap to cover 90% of wages; index benefits to CPI, and increase beneficiary ages. On Medicare/Medicaid: create state block grants for Medicaid; apply greater means testing; introduce mechanisms to encourage less consumption; and increase beneficiary ages.

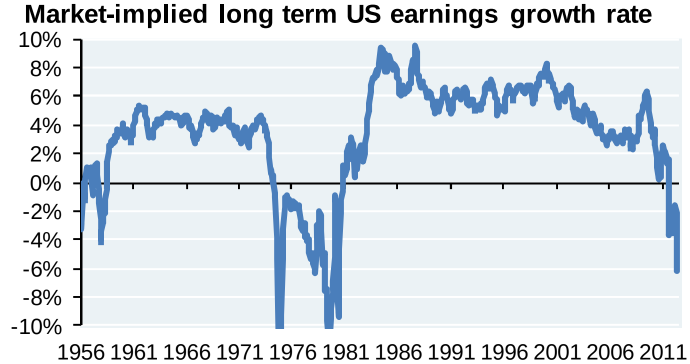
[6] Europe comes up with a magic elixir of policies to stem its public and private sector crisis for more than 3 months

I actually don't have anything to say here. My powers of imagination are high, but not limitless.

Why these are the right questions to ask

This is an unfamiliar exercise, as I am usually more inclined to consider the potential for unexpected negative surprises than positive ones. But now is a time when pessimism abounds. According to our calculations, **US equity markets are now pricing in negative long-term real earnings growth for the first time since the mid 1970s.** Bridgewater Associates had a chart last week which asserted that market expectations for earnings growth were close to the lowest level in 100 years[3]. In a similar vein, an indicator of futures market risk positions shows a current reading only slightly higher than after Lehman failed.

Market-implied long term US earnings growth rate



Source: Robert Shiller data set, J.P.Morgan Asset Management.

[3] Most of these models are similar and are based on perpetuity formulas whose variables include corporate earnings, inflation, risk-free rates, an equity risk premium, and the level of the equity market. One challenge arises when you try to compute historical corporate funding costs as a spread to government bonds when Treasury markets did not float freely with inflation (e.g., after WWI and WWII).

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That's why these questions are as important as the ones we normally focus on, on the world's macro imbalances (See *Squid vs Whale*, June 4 EoTM). **After factoring in the risks of what could go wrong and right, and the price paid for risky assets, we have adopted a portfolio approach with modestly less risk than usual, but not massively so.** Europe remains the epicenter of the market's problems, just as Milton Friedman said it would in 1997, predicting that the Euro would increase political tensions rather than reduce them. Of the various takeaways from the Greek election, this is the most obvious one to me.

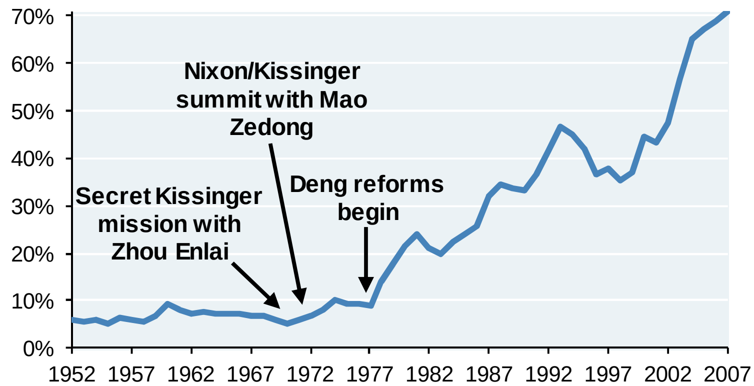
Michael Cembalest
J.P. Morgan Asset Management

Post-script

On China, and the not-so-inevitable clash of civilizations

At a client event in Beijing last week, I had the opportunity to interview Henry Kissinger on the 40th anniversary of his secret 1971 mission to meet with Zhou Enlai, and 1972 summit meeting with Richard Nixon and Mao Zedong. There are not many missions as impactful as this one was: within a few years, China's re-opening began, propelled by Deng Xioping's economic reforms. Reintegrating 20% of the world's population following China's central planning disasters of the 1950's and 1960's has not been easy for China or for the West, which has since benefited from lower imported goods prices from China, but saw an end to post-war manufacturing-led prosperity. The US-China relationship is likely to be one of the most important issues of the 21st century.

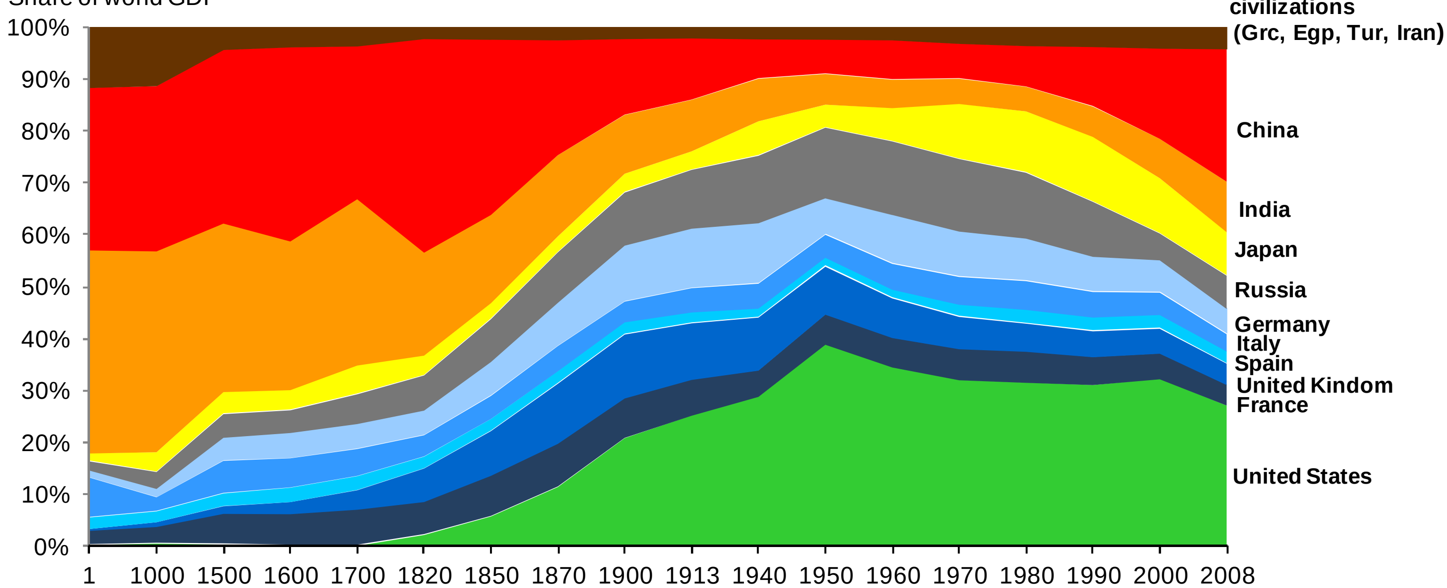
The Kissinger Trip, and China's Re-awakening
Chinese trade as a percentage of GDP



Source: Penn World Tables. December 31, 2007.

One topic we discussed was the question of whether conflict between the US and China is inevitable, a theme which has permeated a lot of academic and political science journals over the last 20 years. The "inevitable conflict" view has been advanced in different degrees by Yale's Paul Kennedy, Princeton's Robert Gilpin and most forcefully, by John Mearshimer at the University of Chicago. Similar concerns are found in "*The End of China's Peaceful Rise*", a 2010 article in Foreign Policy magazine by Elizabeth Economy, Director of Asia Studies at the Council on Foreign Relations. The inevitability view is sometimes explained by the thesis that countries rarely rise economically without also doing so militarily. The chart below looks at the major economic powers of the world since the year 1 at various intervals. Ignore for the moment some of the abstract issues which this kind of data involves; it's pretty clear that China's rise, fall and subsequent rise is something that hasn't happened a lot over the past 2,000 years, and that the United States is on the front lines of having to adjust to it.

Economic history of China and other major powers
Share of world GDP



Source: *"Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD"*, Angus Maddison, University of Groningen.

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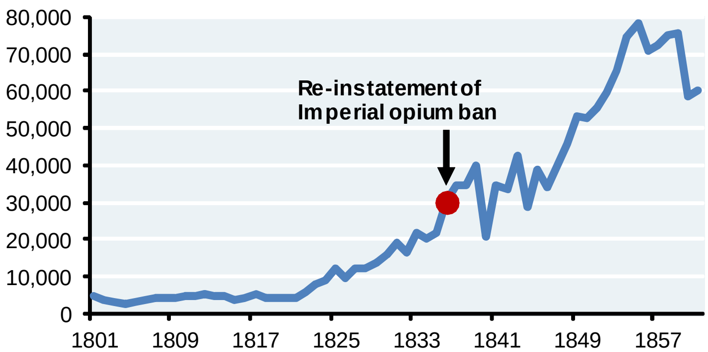
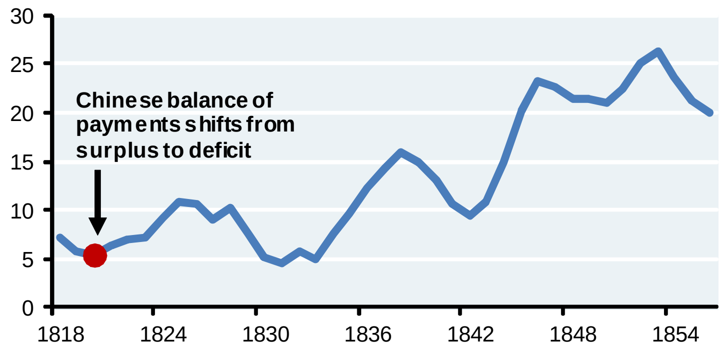
Any discussion of China's engagement with the world needs to factor in China's troubled relations with the West during the 19th century. Kissinger spoke about the impact this era continues to have on China's political consciousness, which you can grasp by looking at some data and charts: opium imported into China which addicted up to 25% of its adult population, the exodus of Chinese silver to England and India to pay for it, and the collapse in China's trade surplus. The Chinese Imperial Commissioner sent a letter to Queen Victoria asking her to cease the opium trade, which was banned in China in 1729 and again in 1836. Britain ignored the request. After a Chinese blockade of opium ships, the British invaded in 1840, and easily defeated the Chinese. China was forced to sign the Treaty of Nanking, one of the more one-sided treaties in history. The opium trade then doubled, leading to another war (and Chinese defeat) 20 years later. The Opium Wars played a large part in the collapse of the Qing Dynasty and subsequent occupation by foreign powers. This is not seen as ancient history in China.

Opium imported into China
Number of chests



Chinese silver outflows to England and India
Silver dollars, millions - 5 year rolling average



Source: *"China Upside Down: Currency, Society, and Ideologies, 1808-1856"*, Man-houng Lin, Harvard University Asia Center, 2007.

With this backdrop, Kissinger encouraged our guests to understand how China might define its interests in different ways than the West would, whether they relate to global energy security, North Korea, global warming, currency management or trade. Kissinger acknowledges the pressures that come from an ideological predisposition in the US to confront the non-democratic world[4], and Chinese tendencies to sometimes view cooperation with the US as being self-defeating. However, engagement with the West is now central to China achieving its economic goals, and incoming governments in both China and the United States have every incentive to maintain the status quo. According to Kissinger, while conventional theories of realism in international politics point to potential conflict, it would be an overly literal interpretation to consider conflict inevitable. Both sides have a lot to lose and little to gain from conflict escalation, creating conditions in which compromises should be able to be found. If he's right, US-China relations would be another thing that could go right in the world, confounding more negative expectations.

Sources

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"*Made in America, Again: Why Manufacturing will return to the US*", Boston Consulting Group (BCG).
"*The Euro: Monetary Unity to Political Disunity?*", Milton Friedman, August 1997
"*Cyrano De Bergerac*", Edmond Rostand, 1897.

ECB = European Central Bank
BTU = British Thermal Unit
BCG = Boston Consulting Group
CPI = Consumer Price Index
CBO = Congressional Budget Office

[4] Think about how this reads in China. From Princeton's Aaron Friedberg, former Deputy Assistant for National Security Affairs: "a liberal democratic China will have little cause to fear its democratic counterparts, still less to use force against them." Therefore, "stripped of diplomatic niceties, the ultimate aim of the American strategy [should be] to **hasten a revolution, albeit a peaceful one, that will sweep away China's one-party authoritarian state and leave a liberal democracy in its place**."

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