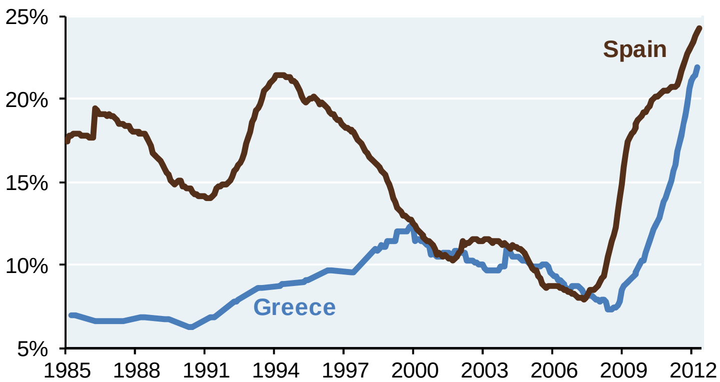
Topics: The upcoming EU summit, the Fed's efforts to jumpstart growth, how hard a US budget compromise is going to be, and a look at one rare aspect of the 2012 US Presidential election

(Another) EU summit. I think everyone understands by now why Europe matters. In a recent note, we showed how one third of all OECD banks are in some kind of distress[1], most of them being European (June 4). As for US corporate profits, Europe matters a lot as well. Around 15% of S&P 500 revenues and 23% of S&P industrial revenues come from Europe[2]. For technology companies, these numbers are even greater: roughly 30%, with some subsectors even higher (PWC estimates that 36% of global software sales are in Europe).

The summit is likely to focus on bank recapitalization, easier repayment timetables for Greece, bank deposit guarantees and an alleged "roadmap" for EU integration. The challenge for Germany, as we have discussed before, is that it cannot afford a blank check given debt levels already over 80% of GDP. However, if policymakers don't do something about growth in the Periphery (bailouts primarily designed to aid German and French banks don't count[3]), the North-South divide will continue to widen, putting pressure on the ECB and EU taxpayers. **Sometimes there are no easy answers.** Italy, Spain, Greece and Portugal are contracting at a 2%-5% annualized pace, and unemployment in Spain and Greece is sky-rocketing (1st chart). These levels are notable from an historical perspective. As shown in the 2nd chart, 20%+ unemployment was the level at which National Socialists in Germany began to take seats away from liberal democratic parties during the 1930's. If the jobs picture does not improve, other EU policy decisions may not matter much: the Wyman/Berger loss estimates for Spanish banks would almost certainly be too low, lower GDP growth would continue to result in lower tax collections, fringe parties may gain further support in the Periphery, and the whole European project may seem way too risky to non-EU investors.

Spanish and Greek unemployment

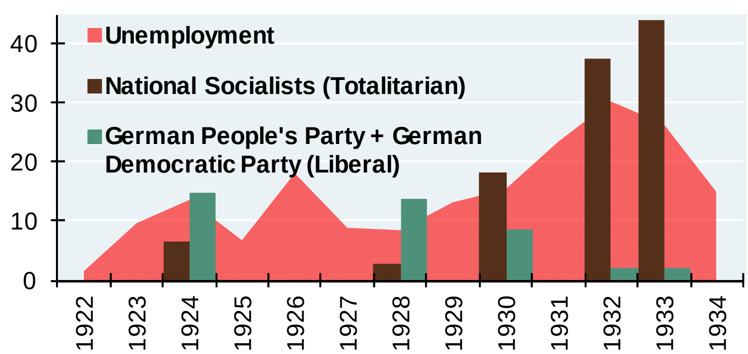
Percent



Source: Statistical Office of the European Communities.

Unemployment and the end of liberal capitalism, 1930's

German unemployment and Reichstag seats by party, percent



Source: International Historical Statistics, Europe 1750-1988, *Historische Ausstellung Des Deutschen Bundestages.*

In its attempts to manage the crisis, the EU has taken steps which may impair its image in the eyes of institutional investors. Case in point: a Rating Agency Reform draft passed last week by the EU's Economic and Monetary Committee, designed to regulate rating agencies and reduce reliance on them. The draft requires banks, insurance companies and fund managers (!!) to develop their own internal ratings capacity instead, and states that rating agencies can be held liable for "methodological mistakes". Rating agencies aren't perfect, but at a time like this, such proposals are not a confidence builder, and suggest that EU policymakers do not want to hear opinions they might disagree with. In other related news, **Galileo Galilei** was posthumously exhumed and re-sentenced to house arrest for his heretical theories on the earth revolving around the sun.

Anyway, back to the summit. Here's a worrisome data point they might discuss: Spanish banks are borrowing over 300 billion Euros from the ECB, but that only represents 12% of Spanish bank liabilities (a quote from the movie *Jaws* comes to mind: "*you're going to need a bigger boat*"). While it is tempting to see Europe as facing a sovereign debt crisis and/or a banking system crisis, **Europe's challenges are broader than that**, encompassing the totality of its private sector economies and their incompatibility in a single monetary union, a concept best explained in our June 4th note/chart on the subject. I saw a chart this morning showing that even after all the austerity so far, the **cyclically-adjusted current account deficits of the Periphery countries are not that different from what they were three years ago.** Europe has a long, long way to go.

---

[1] Distress defined as banks with credit spreads wider than 3% over risk-free interest rates

[2] Companies lowering Q2 2012 earnings guidance: Pall, Nucor, Ryder, Proctor & Gamble, Cardinal Health, Texas Instruments, Starbucks, Autodesk, Fedex, Jabil Circuit and Adobe Systems. As per Goldman Sachs, problems in Europe rank at the top of the list of catalysts.

[3] In a recent note, J.P. Morgan Securities estimated that of the €410bn of total rescue packages for Greece over the past two years, **only €15bn has likely entered the real economy in Greece**. The rest was used to bail out or protect private and official creditors.

Topics: The upcoming EU summit, the Fed's efforts to jumpstart growth, how hard a US budget compromise is going to be, and a look at one rare aspect of the 2012 US Presidential election

The Fed's efforts to jumpstart US growth, and what it would take to resolve the long-term US budget impasse

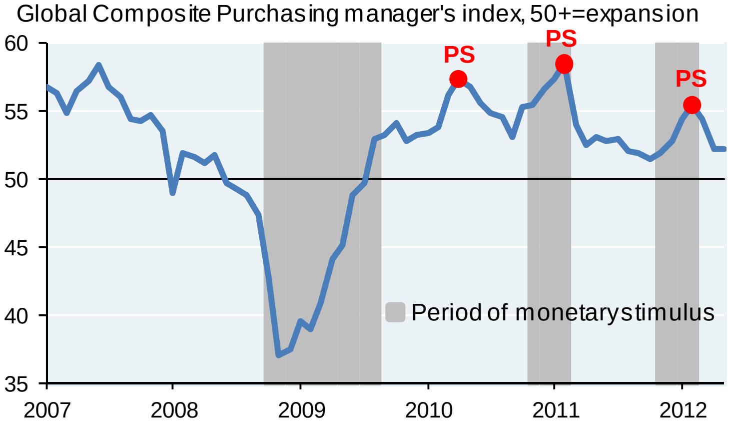
It's not just Europe that has been posting weaker economic data recently:

- The 1st chart shows a global purchasing managers survey through May, confirming that another 'Prague Spring' took place this year. The next data point is due on July 5th; early estimates are weak for the US, China, Europe and Japan.
- A high frequency coincident indicator we look at shows that the world is growing at around 1.5%-2.0%, compared with 5% during post-stimulus periods in 2009 and 2010.
- Another measure shows that 80% of the world is seeing slower rather than higher growth rates right now.

A lot of people want the Fed to do more, but with 10 year rates at 1.6%, what is left for the Fed to do except commit to keep them there forever? The idea behind quantitative easing is that low interest rates promote business formation, and also force investors into riskier portfolios. These riskier portfolios presumably lower the cost of capital and increase equity market returns, which in turn are presumed to promote capital spending, consumption, and eventually, hiring. Is this a bad time to point out that this sounds a lot like **supply-side economics**, which many of the Fed's supporters detested? Anyway, I don't blame the Fed for trying, but these tools may be less potent given where rates are now, which the Fed probably knows but cannot concede. In the US, profits have been outrunning GDP by the widest margin in decades (see 2nd chart on the ratio of profits to GDP growth), but it's hard to envision any multiple expansion unless growth and employment catch up to profits.

Another Prague Spring (PS)

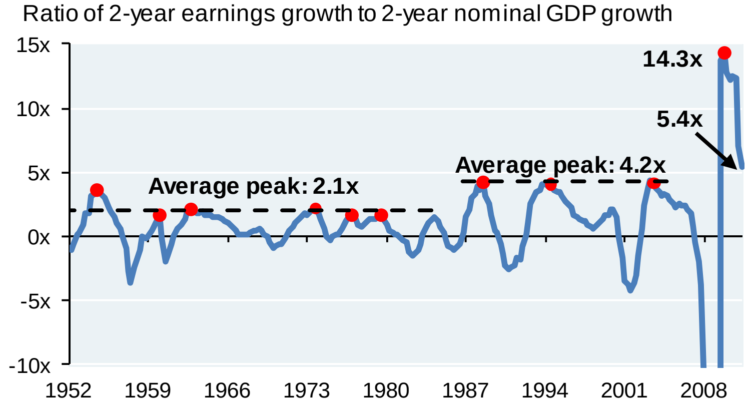
Global Composite Purchasing manager's index, 50+=expansion



Source: J.P. Morgan Asset Management, Markit, J.P. Morgan Securities LLC.

Earnings still outperforming the economy

Ratio of 2-year earnings growth to 2-year nominal GDP growth

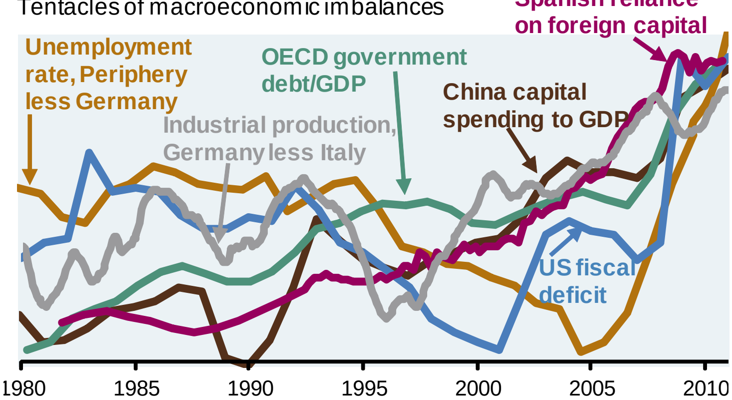


Source: Standard & Poor's, BEA, J.P. Morgan Asset Management.

Is there something other than Fed easing that could jumpstart growth, confidence and the deployment of corporate cash? Let's look again at our Squid vs Whale charts on today's elevated macroeconomic risks, and how valuations and corporate cash balances have adjusted to reflect them (the S&P earnings yield is the inverse of the P/E ratio). The biggest US imbalance is the fiscal situation. While many market participants are anxious for the fiscal cliff to be deferred, the US cannot sustain a libertarian tax policy and a Scandinavian welfare state forever. This gap will have to be closed someday; so far, most bipartisan groups that look at the issue come up with something that looks like the Bowles Simpson plan. **How reasonable is it to think that something like it can be passed, even after the election?**

The Squid

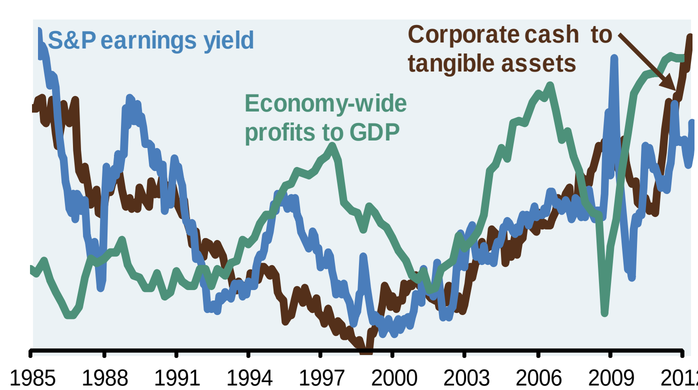
Tentacles of macroeconomic imbalances



Source: See appendix.

The Whale

The cheapness of corporate profits and piles of cash



Source: See appendix.

Topics: The upcoming EU summit, the Fed's efforts to jumpstart growth, how hard a US budget compromise is going to be, and a look at one rare aspect of the 2012 US Presidential election

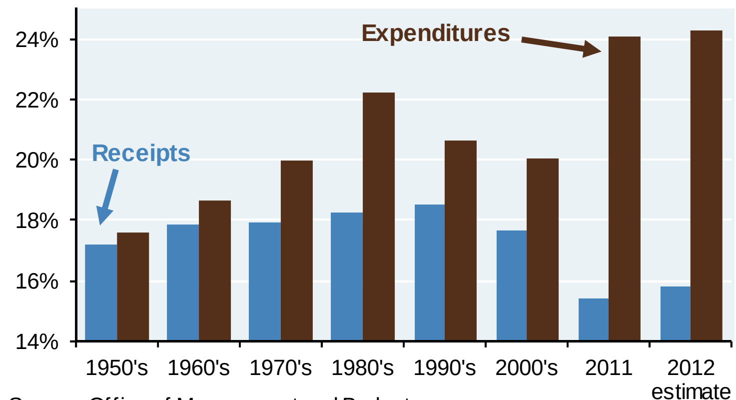
The table below shows the $5 trillion in deficit reduction contemplated by the Bowles Simpson plan over 10 years, and how much has been accomplished so far through the Budget Control Acts (by spending caps, sequestration and related interest savings). After we adjust for the revenue increases and spending cuts proposed by Bowles Simpson that would *not* require major tax reform, there's still a huge hole of $1.8 trillion. **In other words, to get to "US debt sustainability" along a Bowles Simpson path, comprehensive tax reform that incorporates revenue increases will be needed. If it happens, it could be a confidence builder for financial markets, but there is virtually no chance of this before the election and considerable uncertainty about it afterwards, since neither party looks like they are going to win decisively.**

How much of the original deficit reduction in the Bowles Simpson (B/S) plan has already been accomplished, or could be accomplished without major tax reform?

	$ bn
Proposed B/S deficit reduction over 10 years	5,123
Deficit reduction accomplished by BCA, via spending caps, sequestration and interest savings	1,975
Deficit reduction left to do	3,148
Implied interest savings	348
Non-interest deficit reduction left to do	2,800
Without major tax reform	
Spending cuts proposed by B/S (health care reform, soc. sec. reform and other mandatory savings)	656
Revenue increases proposed by B/S (raise soc. sec. taxable wage base, 15 cent gas tax hike, use chain weighted CPI for entitlement payments)	348
Total deficit reduction passable without tax reform	1,004
Remaining deficit reduction that would have to be accomplished via comprehensive tax reform	1,796

National Commission on Fiscal Responsibility and Reform, ISI Group

US: libertarian tax policy and Scandinavian expenditures do not mix, Percent of GDP



Source: Office of Management and Budget.

The reason for exploring these topics is simple: we are trying to figure out what set of policies would be conducive to a more vibrant US economic recovery. When the recession hit in 2008-2009, the estimated tax cut and government spending multipliers from the President's Council of Economic Advisors were 3:1 and 1.6:1. If this had been the case, the US would already have recovered vigorously. The Fed has brought the real cost of money to zero, so that's not holding things back either. Once you have thrown the fiscal and monetary kitchen sinks at the problem, it's time to consider other potential impediments. The possible confidence drag from the erosion in the long-term fiscal health of the US is a reasonable suspect.

On investments, we have not made any material changes to our strategy articulated in January: overweight US equities vs other regions, modest underweight to equities vs normal levels, an overweight to credit, and considerable focus on investments we see as having less direct exposure to the global macro cycle. These investments include oil & gas property resuscitation (March 22), distressed real estate sold at deep discounts to replacement cost (January 31, 2012), and the provision of credit to private companies who lack access to public debt markets at a reasonable cost (June 11, 2012). On US equities, we consider them attractively priced at 1,300 or below on the S&P for long-term investors, but it could take 5-7 years to see if we're right.

In the Appendix this week, a look at one unique aspect of the 2012 Presidential election: the relative lack of prior public sector experience of both candidates combined.

Michael Cembalest
J.P. Morgan Asset Management

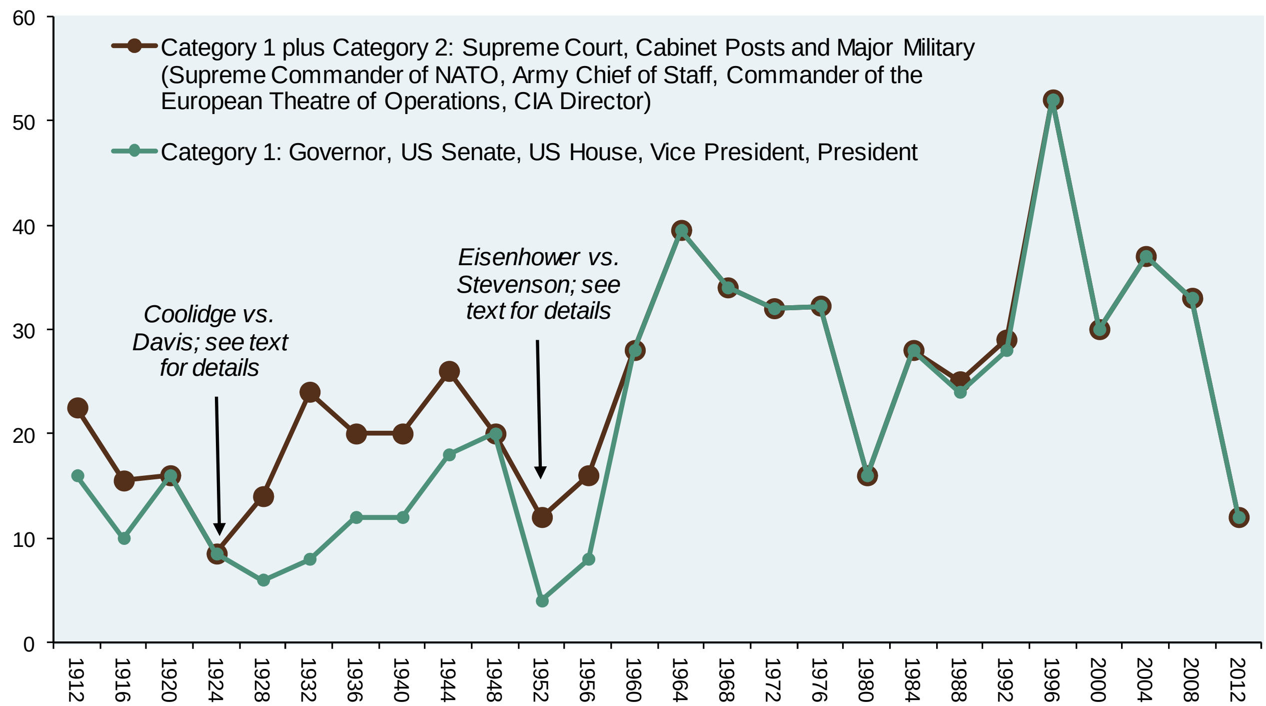
(see next page)

Topics: The upcoming EU summit, the Fed's efforts to jumpstart growth, how hard a US budget compromise is going to be, and a look at one rare aspect of the 2012 US Presidential election

Appendix: Presidential Politics, 2012

Apart from substantial policy differences, the upcoming Presidential election is notable in another way as well. **The upcoming election offers voters the least amount of prior "high level public service experience" (as defined in the chart below[4]) in many decades**. We started our analysis in 1912 (right before the 1913 adoption of the 17th Amendment providing for direct election of Senators), and added the combined prior experience of both candidates. Given Obama's experience as a Senator and Romney's single term as Massachusetts governor, the 2012 election is as light on this front as the 1952 election between Eisenhower and Adlai Stevenson. However, the 1952 candidates had a lot more public sector heft than our chart shows. Our methodology excludes Eisenhower's military background as a senior staff officer for Generals Fox Connor, Moseley and MacArthur in the 1920s and 1930s, *and* Stevenson's experience in the State and Navy departments during WW II, and as a member of the US delegation to the UN during its formative years. So, to find an election this light on public sector experience, you have to go back to the 1924 election between Coolidge and John W Davis, the latter a compromise candidate who had spent 5 years as US Solicitor General. Both Coolidge and Davis had only spent a couple of years as either Governor or in Congress before running. **That's one strange context of the 2012 election: a couple of "one-termers", with neither having much prior experience at the highest levels of public service (12 years combined, by our count)**. The implications are subject to debate, but there's no question that it's an anomaly; or at a minimum, a throwback to the elections of the 19th century, when this kind of thing was more common.

US Presidential Elections: prior years of high level public sector experience of both candidates combined, 1912-2012



Source: J.P. Morgan Asset Management.

At a time when confidence in all institutions (non-financial business, banks, Congress, the Fed, etc) are close to multi-decade lows, this is not a surprise. Why should experience count for anything? Throw the bums out and hand the reins over to outsiders! Still, I find this chart disconcerting, even though it's hard to explain why. Do politicians who have not wielded substantial power underestimate the consequences of being wrong? It's easy to be dead sure about something if you haven't created a public policy train wreck of your own.

---

[4] We debated whether to include experience in State Legislatures as "high level public sector experience". We did not, mostly due to the gradual loss of power at the state legislative level during the 20th century, ceded to Congress, the Executive Branch and the Federal Judiciary. This decision was perhaps influenced by my residence in the State of New York. **The Brennan Center for Justice at NYU School of Law describes the New York State legislature as the least deliberative, most dysfunctional, and on many important counts, worst legislature in the country**. See next page for details.

Topics: The upcoming EU summit, the Fed's efforts to jumpstart growth, how hard a US budget compromise is going to be, and a look at one rare aspect of the 2012 US Presidential election

"*The New York State Legislative Process: An Evaluation and Blueprint for Reform*", "*Unfinished Business: New York State Legislative Reform*", and "*Still Broken: New York State Legislative Reform*", Brennan Center for Justice at NYU School of Law, 2004, 2006 and 2008. **The 2008 report reads like a Woody Allen satire:** New York State legislators introduced more than 18,000 bills in 2008, triple the number introduced in the next highest state legislature, and 50% more than in the entire US Congress. However, more than 90% of these bills only made it as far as press releases, and then vanished without serious consideration. New York State legislative committees rarely meet but it doesn't matter anyway: the Assembly Speaker and Senate majority leader keep iron-fisted control over every decision, and get bills passed unanimously. Of 8,500 votes cast in the Assembly in 2006, only 76 were "no" votes. This represents a 99.1% approval rate, which roughly matches the re-election margins for Fidel Castro and Kim Jong Il.

Sources for The Squid chart: US Treasury, BEA, Bank of Spain, Bank of Portugal, OECD, CSO, NSS, IMF, Statistical Office of the European Communities, PBOC, China Bureau of Statistics, Spain National Institute of Statistics, J.P. Morgan Asset Management.

Sources for The Whale chart: Federal Reserve Board, Standard & Poor's, BEA.

Loss estimates for Spanish banks were derived by consulting firms Oliver Wyman and Roland Berger based on scenarios prepared by the Bank of Spain, the EU Commission, the European Banking Authority and the IMF. They have in general been overly optimistic since the crisis began in 2009.