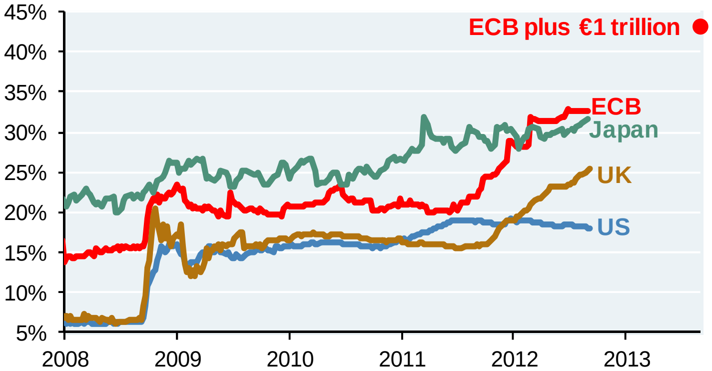
**Topics: The ECB feast is set to continue; all that sidelined cash; the cheapness of technology stocks and cyclicals; reflections on a strange year; the 71% solution (a top tax bracket to solve the US budget deficit problem)**

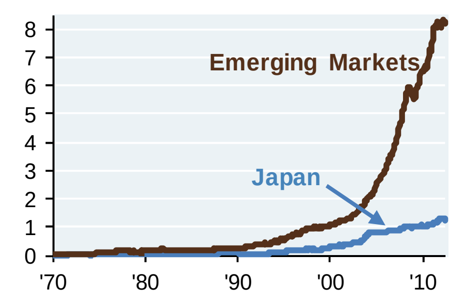
**The European Creosote Bank: The feast continues**
Central bank balance sheets, percent of GDP




Source: FRB, BEA, ECB, Eurostat, BoE, UK Office for National Statistics, BoJ, Japan Cabinet Office.

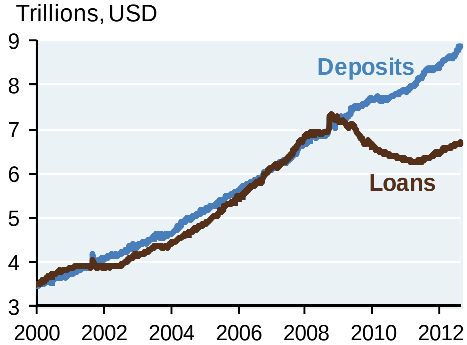
"**Das Kapitulation**" [1], part II. The ECB announced plans to further expand its balance sheet last week, and as expected, markets love the idea since it puts off any restructurings to another day. The European Creosote Bank[2] plan involves conditionality, austerity and loss of face for borrowing countries, but as Malcolm X used to say, Europe's leaders intend to preserve the Euro "by any means necessary". Monetary and fiscal policy have always played a role after recessions but never to this degree before, which is perhaps why there's so much sidelined cash held by sovereign wealth funds, commercial banks, corporations and households waiting to see how it all turns out (see below). It is the partial deployment of this cash, which has been earning negative real returns for 4 years running, that is driving the rise in risky asset prices[3]. This has been a deliberate strategy on the part of the Fed (debase cash to compel investment in higher-risk assets), and now the ECB is playing its part by deferring the risk of a Euro-pocalypse to another day. German resistance to debt monetization has effectively collapsed, a remarkable capitulation after two prior German ECB members resigned in protest. Here is part of the "wall of cash" as we see it:

**Foreign exchange reserves**
Trillions, USD



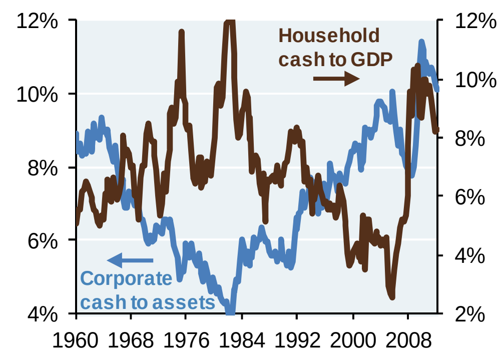

Source: Ministry of Finance Japan, IFS, J.P. Morgan Securities LLC.

**US commercial bank excess deposits**
Trillions, USD




Source: Federal Reserve Board.

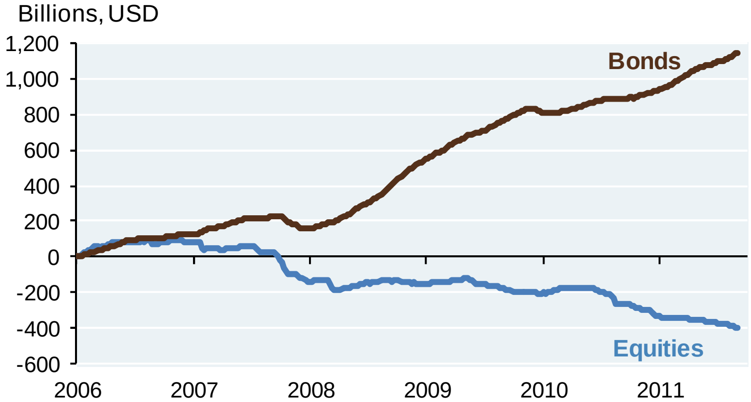
**US cash balances**




Source: Federal Reserve Board, BEA.

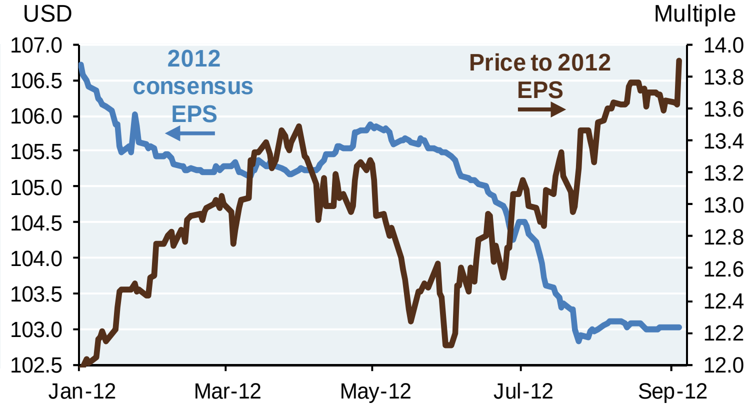
Here's another look at how cautiously investors have been positioned: the last couple of years of mutual fund flows, out of stocks and into bonds. As some of this reverses, P/E multiples are rising even as S&P earnings estimates are falling (2nd chart).

**US mutual fund net flows**
Billions, USD




Source: Investment Company Institute.

**2012 S&P500 rise driven by multiple expansion, not earnings**
USD Multiple




Source: FactSet, Bloomberg.

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[1] The first capitulation by Germany: two large ECB bank lending programs in late 2011 and early 2012. For language geeks, yes, I know that "Die" goes with Kapitulation, but then that wouldn't be as funny as "Das", given the reference to Marx's book. Consider it German humor.
[2] If it wasn't clear, this reference [introduced last week] refers to the film character Mr. Creosote. See Youtube for the grisly details.
[3] Hedge funds are getting more invested as well: the latest Flows & Liquidity report from J.P. Morgan Securities shows that after a period of low beta vs the S&P 500, macro hedge fund returns are tracking rising equity markets more closely.

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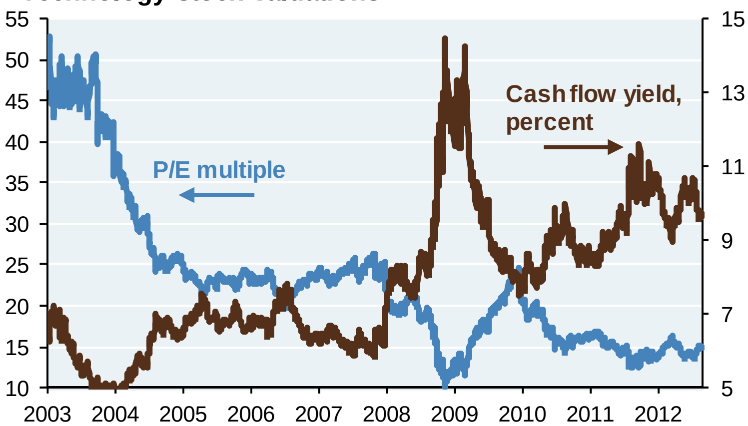
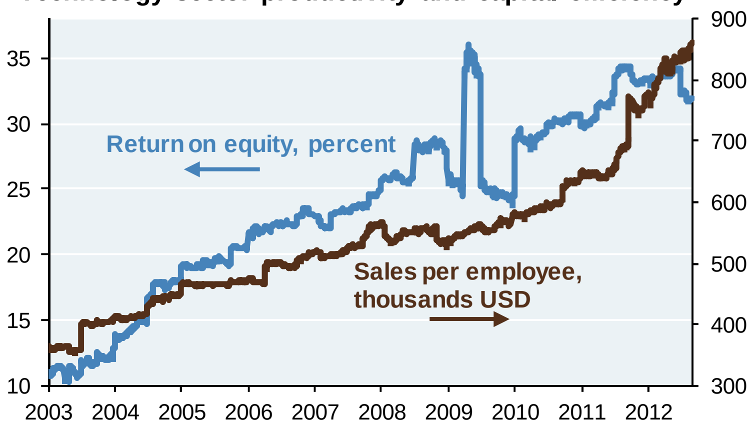
As for stocks themselves, as discussed last week, we think the "death of equities" theme is misplaced and consider equities a cornerstone of portfolios seeking to generate returns above inflation, spending, mandatory outlays and taxation. Within US equity markets, one of our preferred sectors is technology. S&P technology earnings have more than doubled since 2007, yet the sector's P/E has fallen in half. Technology cash flow yields are high, return on equity looks good and rising sales per employee demonstrates continued productivity gains. Stepping back from the tech sector, cyclical stocks more broadly are trading at their largest discount to defensive stocks in decades (3rd chart), another sign of extreme caution.

**Technology stock valuations**




Source: Bloomberg.

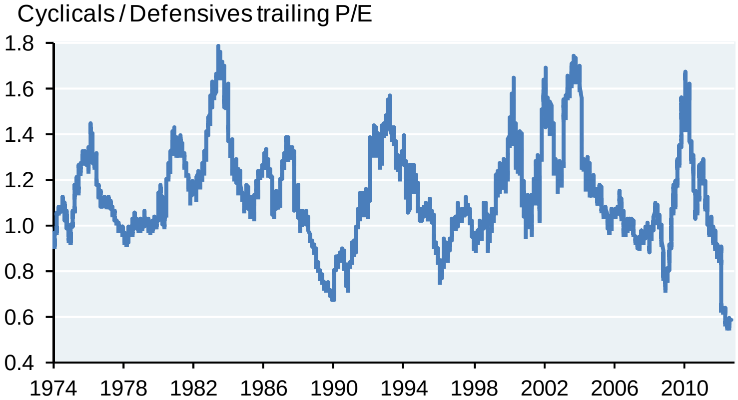
**Technology sector productivity and capital efficiency**




Source: Bloomberg.

**Cyclicals trading very cheaply vs. Defensives**

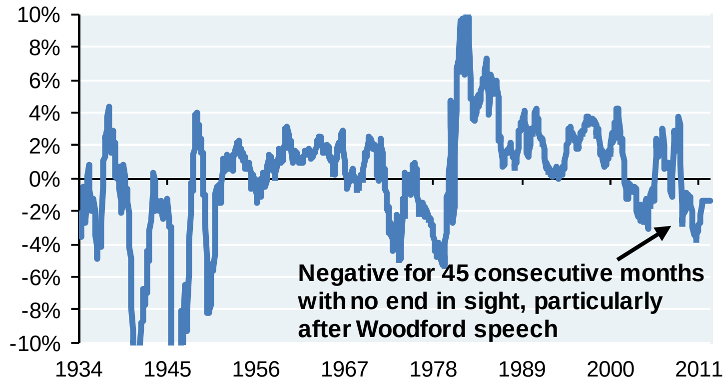
Cyclicals / Defensives trailing P/E




Source: J.P. Morgan Securities LLC.

**Remembrance of things past: negative returns on cash**

Ex-post real return on US t-bills, percent




Source: St. Louis Federal Reserve, Bureau of Labor Statistics.

**It has been a strange year**. If you were concerned about the global economy this year, you were right:

- Leading indicators of manufacturing, such as new orders, are weakening just about everywhere
- Chinese, Korean and Taiwanese exports are slowing sharply; China may be growing at only 6%
- European growth is ~0%, with the periphery in recession. Germany business surveys also fading
- Last week's US jobs report was weak across the board (payrolls, work week, labor force participation and wages)
- US capital spending trends are slowing (e.g., capital goods orders ex-aircraft)
- Countries like Brazil are showing signs of industrial fatigue due to an overly strong currency in 2010-2011
- The US election does not look like it will bring clarity to the US fiscal/debt ceiling divide (polls show Democrats keeping the White House and Republicans keeping the House of Representatives)
- US housing is staging a modest recovery, but it's not a game-changer given its smaller contribution to employment
- Corporate profits are high, but the trend in EPS revisions is negative and profits growth is slowing

However, global equity markets have done well, up 13% so far in 2012. **The bottom line**: **with the world drowning in liquidity, the right portfolio moves this year have been to take advantage of low equity valuations, look through all the economic weakness and expect that continued monetary stimulus will eventually bear fruit.** We have done some of that but not as much as we might have, and as things stand now, global equity markets have outperformed what I had expected. The

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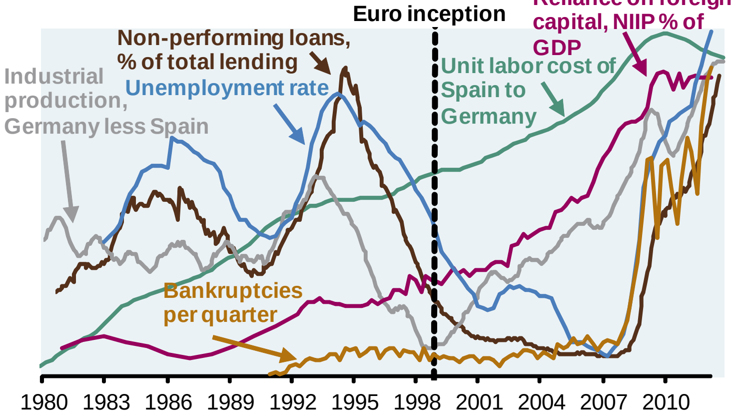
world's Central Banks have made it clear that inflating their way out is preferable to the alternatives, an environment that is conducive to risky assets that are priced very cheaply, until and unless they lose control of inflation.

I still expect Europe to deliver negative surprises, and am not convinced they can ring-fence Spain that easily. By shortening the maturity of Italian and Spanish debt, the ECB may create another (possibly larger) concern three years from now. However, since many investors positioned for an EU blow-up sooner than that, there was room for a rally which pushed US P/E multiples from 12 to 14, as shown on page 1. After 4 straight years of negative real returns on cash shown above (and few prospects for a change after Woodford's Jackson Hole speech), I understand the desperation to earn a return on accumulated savings.

**Spanish Armada runs aground, again**




NIIP = Net International Investment Position. Sources: See appendix.

***"Defeat of the Spanish Armada"***

Philip James de Loutherbourg, 1796, UK National Maritime Museum, Greenwich Hospital Collection. Depicts events from August 1588.

**<u>The 71% solution to the US budget deficit problem: tax the heck out of the rich</u>**

As I was watching the two political conventions, I began to wonder: what if….

- Something like the CBO's Alternative Case scenario came to pass (see Appendix for details)
- Debt markets were no longer willing to fund trillion dollar deficits, so the deficit had to be reduced to 3% of GDP by 2020
- Taxing the rich was the only thing the country could agree on doing

**If this happened, how high would top marginal Federal income tax rates have to go? The answer, after some number-crunching: 71% for the top bracket, and 57% for the second highest bracket**[4]. Add state and local taxes and payroll taxes, and pretty soon, taxes on income would approach 80% in **Blue** states like New York and California. This is not a projection, but an illustration that there are not enough Americans subject to the top brackets to reduce the deficit to 3%. Eventually, the US will more likely have to adopt broader-reaching tax reform (e.g., raising taxes on the middle class), larger spending cuts than those already adopted, and/or Federal Reserve monetization of the public debt. Another option: a set of pro-growth policies that solve the problem by ramping up the denominator. The challenge: under the CBO Alternative Case, real GDP growth would have to average 8.6% per year (rather than the 2.9% that is currently assumed) to get the deficit to 3% by 2020. After seeing what has happened in Europe, it seems likely that debt monetization would be a part of a US solution (in addition of course to the $1.7 trillion in Treasury bonds the Fed already owns).

**One more thing on taxation**. There was a lot of discussion around both conventions about the progressivity of the tax code. On the following page, I have included some history on effective tax rates by bracket, from the CBO. The first table shows *income* tax rates, the second shows *total* Federal tax rates (including payroll and excise taxes). Progressivity, apparently, is in the eye of the beholder. To me, the tables suggest a substantial increase in progressivity since 1979.

Michael Cembalest
J.P. Morgan Asset Management

[4]Before anyone says, "*well, tax rates used to be that high*", consider the details. Marginal tax rates were 80%+ in the 1950's, but applied to the mega-wealthy (income of $3 million+ in today's dollars), rather than the $388,350 that marks today's top bracket. In other words, people had to be 10x wealthier in the 1950's to be subject to ultrahigh marginal rates. There were also more deductions then. For example, in 1979, while the top statutory income tax rate was 70%, the ***effective*** tax rate for the top 1% was less than 25%. See December 13, 2011 EoTM.

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**A look at the progressivity of the US tax system over time, by bracket**

| Average Effective Federal *Income* Tax rate | | | | | | |
|---|---|---|---|---|---|---|
| Quintile: | Low | Second | Middle | Fourth | High | Top 1% |
| 1979 | 0.0% | 4.0% | 7.4% | 10.1% | 15.9% | 22.7% |
| 1984 | 0.7% | 3.9% | 6.5% | 8.9% | 14.0% | 19.6% |
| 1989 | -1.3% | 2.9% | 5.9% | 8.3% | 14.7% | 20.2% |
| 1994 | -3.2% | 1.9% | 5.2% | 7.7% | 15.1% | 23.6% |
| 1999 | -4.5% | 1.7% | 4.9% | 8.0% | 17.2% | 24.3% |
| 2004 | -5.4% | -0.5% | 2.8% | 5.8% | 14.0% | 20.1% |
| 2009 | -9.3% | -2.6% | 1.3% | 4.6% | 13.4% | 21.0% |

| Average Effective Federal *Total* Tax rate | | | | | | |
|---|---|---|---|---|---|---|
| Quintile: | Low | Second | Middle | Fourth | High | Top 1% |
| 1979 | 7.5% | 14.5% | 18.9% | 21.5% | 27.1% | 35.1% |
| 1984 | 9.4% | 14.3% | 17.8% | 20.3% | 23.8% | 27.0% |
| 1989 | 7.6% | 13.5% | 17.7% | 20.6% | 25.1% | 28.3% |
| 1994 | 6.8% | 12.5% | 17.1% | 20.5% | 27.1% | 34.8% |
| 1999 | 6.5% | 12.6% | 16.6% | 20.6% | 27.7% | 32.8% |
| 2004 | 5.1% | 9.6% | 13.7% | 17.4% | 24.9% | 30.1% |
| 2009 | 1.0% | 6.8% | 11.1% | 15.1% | 23.2% | 28.9% |

Source: CBO (both tables)

Note: effective income tax rates for the bottom two quintiles are actually negative due to the value of transfers and tax credits.

**Appendix: assumptions for the top tax bracket analysis**

The Congressional Budget Office (CBO) projects something called the Baseline Case, which assumes that everything that is legislated will come to pass. But in a nod to reality, they also maintain an Alternative Case, which assumes that people may put off difficult fiscal decisions/costs to another day. The Alternative Case assumes:

- *All tax cuts are extended*, no change to current capital gains and dividend rates.
- *Payroll tax holiday in effect since 2011 expires.* The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided a two percentage point payroll tax cut for employees, reducing their Social Security tax withholding rate from 6.2 percent to 4.2 percent of wages paid, with no effect on the employee's future Social Security benefits.
- *Alternative Minimum Tax (AMT) exemption continues to be indexed to inflation*, keeping the number of taxpayers subject to the AMT constant. AMT has been indexed to inflation since 2006 so that the number of taxpayers subject to higher AMT taxes does not rise.
- *Medicare payments to physicians remain unchanged* despite scheduled decreases, which were supposed to start in 2002. Deficit reduction law passed in 1997 called for Medicare physician payments to be set using a sustainable growth rate (SGR). For the first several years, Medicare expenditures did not exceed the target and doctors received modest pay increases. But in 2002, payments dictated by SGR did not keep up with the market rate. So, Congress staved off effective cuts to doctors and has repeated this decision every year since. Medicare payments based on the SGR would be ~27% below current rates.
- *Budget Control Act sequester, designed to reduce defense and non-defense expenditures (excluding Medicaid and other mandatory spending), does not take effect.* When the Joint Select Committee on Deficit Reduction failed to reach agreement on $1.5 trn of deficit cutting measures in 2011, an automatic sequester of $1.2 trn was set to take place in January 2013. Most cuts will come from defense spending, and the Office of Management and Budget will allocate non-defense spending cuts each year.

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Sources for Spanish macro-economic imbalances: Instituto Nacional de Estadística, Banco de España, Statistical Office of the European Communities, Organization for Economic Cooperation & Development.