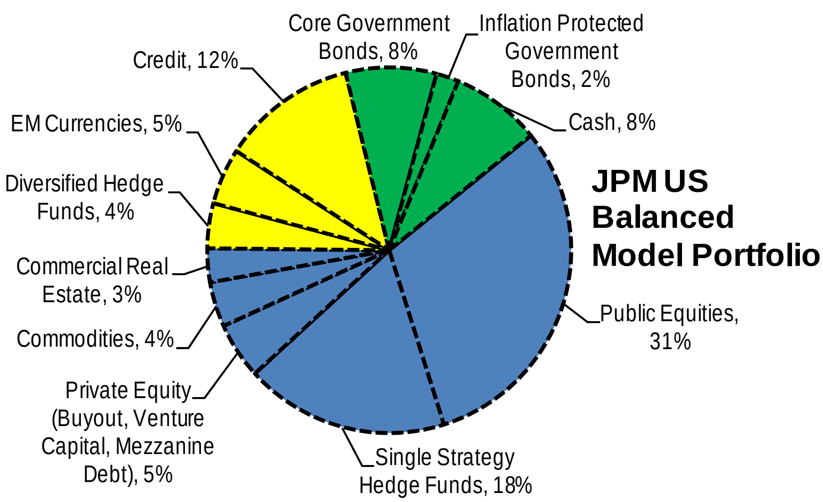
Topics: translating views into portfolio investments at a time of ever-expanding government safety nets; Greece

There's some excitement in financial markets about unlimited ECB money and declines in European government bond yields, better Chinese economic data after a few months of deteriorating conditions, and some signs of a self-reinforcing expansion in the US (growth in consumer credit, improved small business sentiment and labor market outlook, etc). The usual suspects see this as an all-clear signal, but (a) the loudest voices tend to come from people that don't actually manage or invest money, and (b) things are a bit more complicated than that. After filtering through the profits, valuation, economic, political and intangible factors that drive markets, we make explicit portfolio decisions on behalf of clients whose money we manage. Conditions are far from normal (see page 2), so we have taken a different approach towards investing than we usually would in a post-recession recovery. Our equity allocations are lower, and credit and hedge fund allocations are higher. The chart below shows these allocations in our US Balanced Model Portfolio. There are 3 things to keep in mind as you look at this:

- Institutional, endowment, sovereign wealth fund and high net worth clients have risk tolerances that vary greatly. Some are interested in capital preservation; others are focused on funding defined benefit pension obligations, and others on growing national wealth on behalf of citizens that haven't been born yet. As a result, we also manage Capital Preservation and Growth portfolios that complement the Balanced one below, and which have risk allocations that vary accordingly.
- The portfolio includes allocations to some investments whose returns involve tradeoffs between return and illiquidity, such as private equity, hedge funds and some credit strategies. In some jurisdictions, individuals must demonstrate sufficient net worth before investing in them; and in others, tax treatment of such strategies can be onerous (sometimes both conditions apply). As a result, some portfolios exclude them, and have higher exposure to public equities instead.
- The overly simplified color scheme is meant to convey high, medium and lower levels of risk, and is based on historical market volatilities for each asset class. However, there are periods during which EM currencies and credit, for example, can generate as much risk as publicly tradable equities.



Source: J.P. Morgan Private Bank as of Jan. 2012.
This portfolio may not be suitable for all investors and is shown for illustrative purposes only.

We walked through the rationale for these allocations in the 2012 Outlook. Here are a few summary comments on the underlying strategies, starting clockwise from public equities:

- Our **equity** allocations are heavily weighted towards the US, with much smaller allocations to Europe, Japan and Asia. The US outperformed the other regions in 2011, which we believe will continue in 2012. If Europe does better than we expect, the US and the emerging economies should benefit as well.
- Regarding **hedge funds with a specific strategy**, our current preferences continue to be macro, event-driven (merger arbitrage, spinoffs, divestitures, etc.) and distressed corporate debt. Many (but not all) long-short managers had a difficult 2011, coincident with what we described last week as being a difficult year for active equity management.
- On **private investments**, we are focused on private lending (mezzanine debt), growth equity capital focused on technology, and opportunities in traditional non-renewable energy. We include in this category illiquid investments in European bank portfolios, sold at deep discounts to face value.
- Most of our current **commodity** investments are based on gold and oil.
- Our **real estate** allocations are focused on income-producing office properties, and "distressed" properties, which include off-market locations, properties with lease and financing rollover risks, and undercapitalized owners.
- We have been reducing diversified, **multi-strategy hedge funds** in favor of more focused ones, given the ability to channel capital towards our highest-conviction views.

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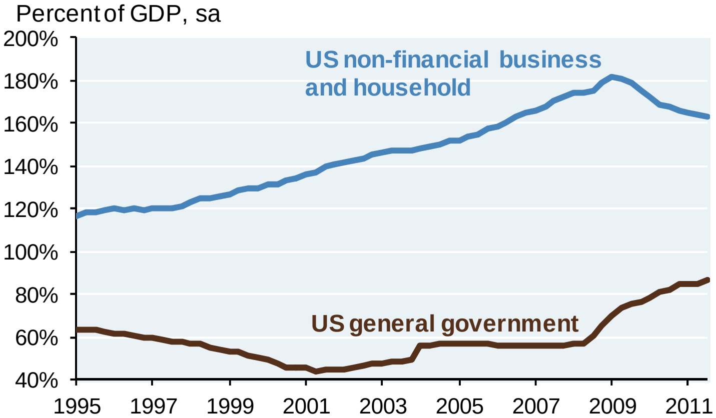
- **EM currencies** includes cash and term debt, as well as other non-dollar currency exposure. These positions sold off sharply in September (wiping out their income gains for the year), but have since begun to recover. Some EM countries are running down FX reserves to *support* their currencies (after having spent a couple of years trying to weaken them).
- **Credit** is a large allocation that includes leveraged loans, high yield and "structured" credit. The latter category refers to senior positions in securitized corporate bonds, and commercial/residential real estate. As we showed last week, given our below-trend GDP forecasts for the US and the rest of the world, credit merits a larger than normal allocation.
- In **core government bond holdings**, our average maturities are around 2-3 years; they are 1-2 years longer for US taxable clients holding municipal bonds. Our below-average maturities hurt us in 2011, given the substantial rally in government bond markets. For example, 10-year US Treasuries rallied from 3.5% in February 2011 to below 2% by year-end. We do not foresee the same thing happening again in 2012.
- We hold fewer **inflation-protected government bonds** than usual; right now, the break-even headline inflation rate for 10-year US Treasury Inflation Protected Securities is around 2%.
- **Cash**, which yields nothing, but which can be deployed if and when opportunities present themselves. Anyone seeking to compute the total subsidy transferred from savers to borrowers needs to include an estimate of foregone interest income on tens of billions of dollars of accumulated earnings, held as cash.

Free lunch?

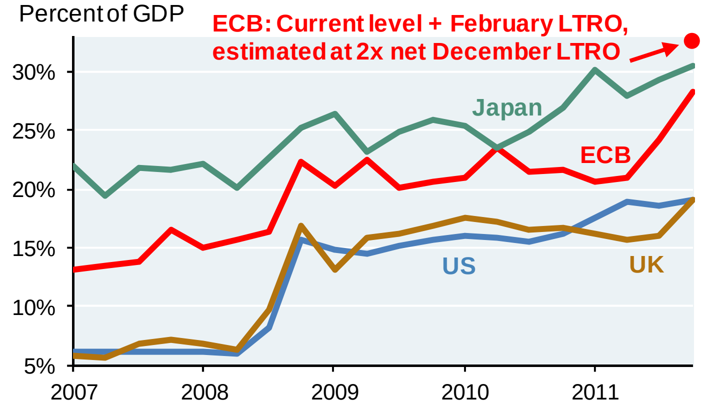
Most people do not describe me as a wide-eyed optimist, but our portfolios are optimistic once you consider the foundation the global private sector recovery rests on. For all the talk of de-leveraging, there hasn't been that much of it in the US economy, as public sector debt has risen to offset the decline in private debt (1st chart). And in Europe, improved sentiment is based on a (permanent?) shelving of German opposition to monetary expansion (2nd chart; LTRO = Long Term Refinancing Operations). **As US deficit financing and the ECB's balance sheet grows, the more optimistic markets have become, despite the lack of a plan from either on how to resolve/unwind them**. The ECB strategy in particular is discussed as a "free lunch" (benefits: huge, costs: none), but I have doubts about that, and whether this policy will do enough to prevent a severe credit contraction and worsening conditions in the periphery. In the short term, the ECB can help indirectly finance *budget* deficits in Italy and Spain, and even part of their *current account* deficits (that's mostly what LTROs are doing). But what will tempt the private sector to ever return en masse? This is the "hole" in the recovery story that prevents us from adding more risk to the pie chart on the prior page. **The bottom line: we consider our portfolio risks "right-sized" for a muddle-through global economy experimenting with policy tools it has limited experience with.**

Deleveraging + Releveraging = Same old US leverage
Percent of GDP, sa



Source: Federal Reserve Board, Haver Analytics.

Central bank balance sheets
Percent of GDP



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

For sure, there's pent-up investor cash waiting for conditions to normalize. Here's another take on the same concept: *balance sheet normalization*. According to colleagues at J.P. Morgan Securities LLC, if corporate cash (relative to assets) and leverage were to return to their 1996-2009 averages, S&P non-financial firms would have around **$1.4 trillion dollars available for M&A and shareholder distributions**[1]. That's a lot of idle purchasing power. How long normalization will take to arrive is anybody's guess. As for markets and investments, we have made our choices, which appear in the pie chart on the first page.

[1] The concept of excess cash was calculated by applying the difference between Q3 2011 cash to assets (11.3%) over the historical median from 1996-2009 of 7.3%. Incremental debt was calculated by applying the difference between Q3 2011 debt/EBITDA (2.0x) over the historical median from 1996-2009 of 2.4x. The authors then included 2012 free cash flow, and subtracted expected share repurchases and dividends. From "*Striking Facts*" Corporate Finance Advisory Brief, Zenner and Berinstein, J.P. Morgan Securities LLC, December 2011.

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Greece: Sisyphus revisited

We noted 2 years ago that despite being only 2% of European GDP, Greece would probably end up having disproportionate consequences for markets. That remains true today as it stumbles through to some kind of restructuring of its private sector debt (see table for one possible iteration). To be clear, the debt exchange is a bit of a farce on its own, since even *after* the debt reduction shown in the table, Greece's debt/GDP ratio is still well above 100%. Greece will almost certainly have to default on/ restructure official sector debt as well, at a time and place of the EU's choosing. Nevertheless, here are 3 things to watch as this process unfolds that can have broader ramifications:

Even Sisyphus thinks this exchange is ridiculous

	Total holdings	Assumed participation rate in exchange	Assumed participation in exchange
EU and IMF loans	73	0%	-
Private loans	17	0%	-
T-bills	25	0%	-
Bonds:			
ECB	50	0%	-
Central Bank of Greece	7	100%	7
Greek social security funds	25	100%	25
Greek banks	50	100%	50
Other European banks	35	100%	35
Insurance companies	10	100%	10
Everyone else*	83	50%	42
* Sovereign wealth funds, hedge funds, asset managers, etc			
Totals	375		169
Apply haircut to existing debt		60%	101
Post exchange debt outstanding			274
Greek GDP as of Q3 2011			218
Post exchange Greek debt/GDP			126%

Sources: J.P. Morgan Securities LLC, J.P. Morgan Private Bank

- How will the ECB behave? **There are no justifications I know of for the ECB to assert preferred creditor status, which would entitle it to avoid being restructured (as the IMF does).** So far, however, ECB comments indicate a reluctance to participate with the private sector rabble. If the ECB is treated as a preferred creditor, does that mean that all 217 billion of its sovereign debt purchases so far should be seen as effectively senior to private investors? This issue could be solved by having the ECB sell its bonds at cost to the EU before the exchange.
- **Will Greece put "collective action clauses" (CAC) in place?** Without getting too detailed, many Greek bonds were issued under language known as "universal consent", which means that *all* creditors have to agree to changes to maturity, interest or principal. A CAC allows the issuer to obtain a *plurality* of support from bondholders for changes to the bond indenture, and then impose them on any hold-out creditors. There's nothing wrong with CACs, except for the fact that applying them retroactively changes the rules of the game, and makes a mockery of the quaint notion of contract law. As we explained in Appendix C in our 2012 Outlook, contract law protections for investors in sovereign debt are very weak. Don't like retroactive CACs? Go sue in an Athens court; good luck to you.
- **Will credit default swaps (CDS) end up being triggered?** If there are no missed payments and everyone voluntarily participates in an exchange (no matter how coercive the process, or how large the debt forgiveness), then a default even as per CDS rules has not occurred. I have no objection to adherence to contract terms; but how will this affect users of CDS contracts that assumed they could hold bonds and hedge with CDS, now that they face losses on their cash positions without their hedges paying off? From now on, investors will be incented to sell their bonds, since their hedges won't "work" in the way they thought they would. By the way, why is the EU so intent on avoiding a trigger of CDS contracts? Could it be that some EU banks are long Greece through CDS? We may never know for sure.

Michael Cembalest
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