

From: Justin X Gratz <[REDACTED]>

To: Undisclosed recipients;;

Subject: Eye on the Market, August 9, 2010

Date: Tue, 10 Aug 2010 11:29:04 +0000

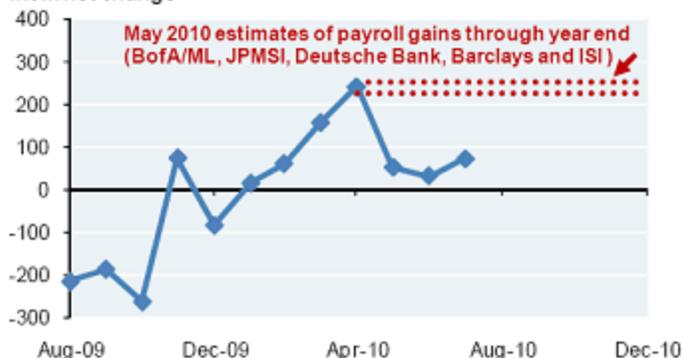
Attachments: 8-09-10_-_EOTM_-_Escape_from_New_York.pdf

Inline-Images: image002.png; image004.png; image006.png; image008.png; image015.png

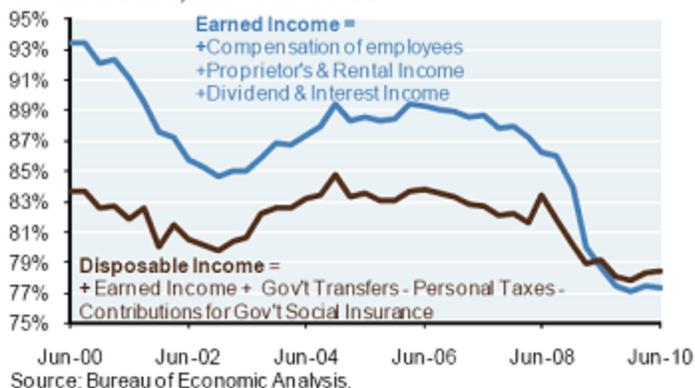
The U.S. payroll report was pretty bad (see box, below). In April, many economic indicators were bouncing, one of which was private sector payrolls. At the time, the positive momentum convinced a lot of firms to pencil in strong payroll gains for the remainder of the year (red line in first chart), leading to bullish forecasts for GDP growth and equity market returns. There is nothing we would have preferred more than to have agreed with them. But we have been skeptical of that view all year, highlighting week after week the risks of fiscal stimulus withdrawal, fading contributions from inventories, tighter monetary policy in Asia, and US consumption in excess of earned income. On the latter point, *disposable* income did hold up well during the recession. But *earned* income (which excludes government transfers and tax cuts) has fallen sharply, leading to our concerns about consumption in the months ahead.

Private sector payrolls hit a speed bump

MoM net change



Government transfers and tax cuts mitigate the decline in earned income; Income as % of GDP



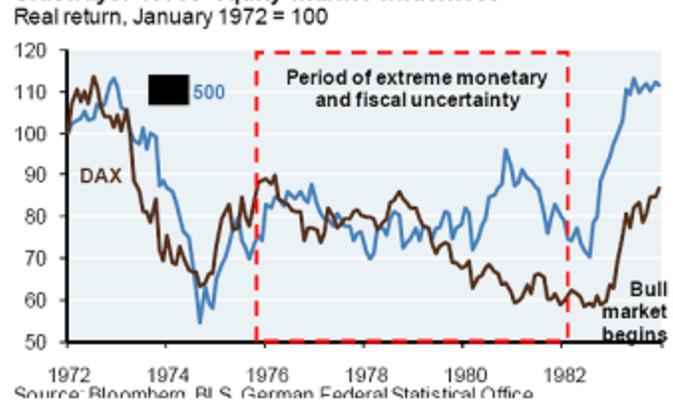
The recent decline in manufacturing orders relative to production and inventories suggests a slower period ahead, in which case 225k-250k in monthly payroll gains shown above may be hard to achieve. Since the cow diagram from our 2010 outlook publication, our market view has been that this is *not* a garden variety recession to recovery transition. We have been preparing for sideways markets ahead, perhaps for a long time, a replay of the 7 year period at the end of the 1970s, when monetary and fiscal policy were equally uncertain. We have tried to reflect this view in portfolios, seeking opportunities in public/private credit markets and long-short hedge funds as alternatives to directional equity investing. **As discussed last week, another round of quantitative easing by the Fed would likely be only a modest benefit for markets, given the negative growth dynamics it would reflect.**

A slowdown in manufacturing orders



Source: Institute for Supply Management

Sideways: 1970s equity market wilderness



Source: Bloomberg, ILS, German Federal Statistical Office

How bad was the U.S. payroll report? Let me count the ways...

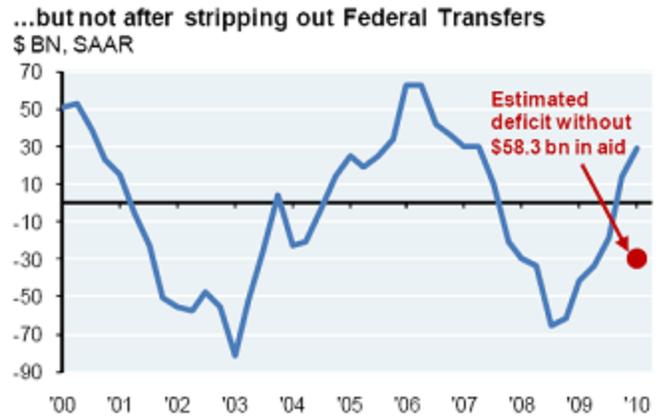
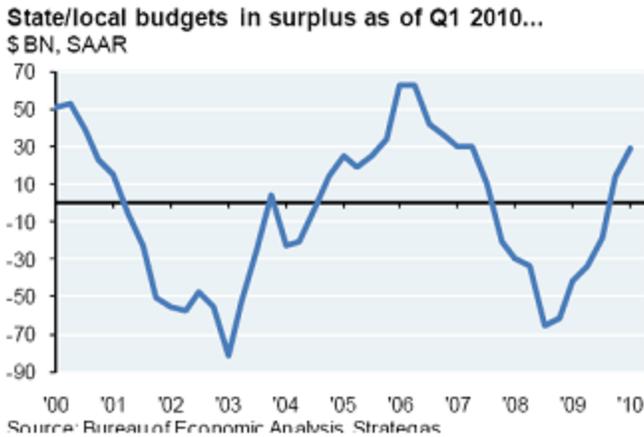
- * anemic payroll growth in the service sector, and sharp payroll cuts at the state/local level
- * temporary employment (a leading indicator) declined, and has been on a declining trend all year
- * the oft-mentioned bullish trend of rising labor income is fading, from 5.3% in Q1, to 4.6% in Q2, to 2.3% so far in Q3
- * the labor participation rate of college graduates is now at the lowest level since being first computed in 1992; the employment-to-population ratio at 58.4% is only 0.2% above the cycle low. **Assuming a normalized labor participation rate, unemployment would be somewhere between 12% and 13% (rather than the stated 9.5%)**
- * In addition to a weak establishment survey (payrolls), the household employment survey has fallen 3 months in a row

Escape from New York

The first chart below regarding municipal risk is making the rounds these days. It shows that state/local budgets returned to surplus as of Q1 2010. When looking at the underlying data, some states have taken steps to address budget gaps (Georgia, Louisiana, Oklahoma, Florida, Utah and South Carolina cut expenditures by more than 15% since 2008), and there has been some modest revenue growth. However, this is another case where we would love to agree with the most optimistic view, but don't. We have 3 primary objections to this chart:

- * **Budget data compiled by the Bureau of Economic Analysis includes Federal transfers.** Without emergency Federal aid, state/local budgets would still be in deficit (see red dot, second chart). Federal transfers won't last forever. BEA data is also nationally aggregated, that it doesn't say much about any individual state or local municipal investment.
- * **These are very preliminary numbers.** More work needs to be done to properly distinguish between capital and operating budgets, and to make sure that bond issuance proceeds have not been included as revenues. BEA revisions are often large.
- * **Some states have been taking advantage of borrowing, and the absence of accrual accounting requirements, to get budgets passed. This highlights a substantial misunderstanding about municipal investment risk.** Market observers often refer to the notion that "49 of 50 states have to balance their budgets". True, but such "balancing" can (and often does) include the use of explicit and implicit debt financing. Explicit meaning borrowing in the debt markets, and implicit meaning delays in payments to vendors, school districts and other constituents, as Illinois has been doing. Fitch

describes Illinois' recently enacted budget as "not beginning to address the current operating gap, relying almost entirely on various forms of deficit financing to close it".



Cash flow shifting and other similar gimmicks is not limited to Illinois. Another example is the state of New York. During recent budget negotiations, Lieutenant Governor Ravitch proposed allowing partial financing of the state's deficit in bond markets. The proposal wasn't passed, suggesting New York would close its budget gap through lower spending and some tax increases. However, New York's budget includes over \$2 billion in "savings" through deferred payment of tax credits owed to local businesses, and allows deferral of required payments into pension funds.

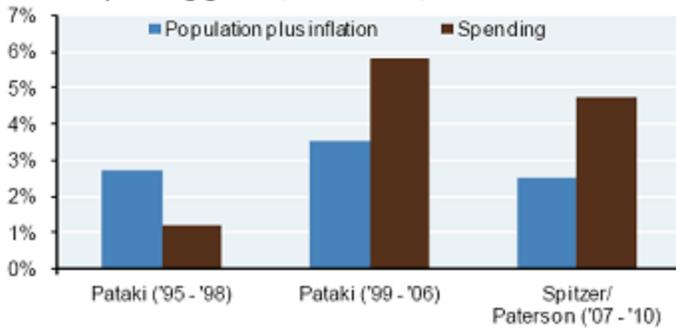
The broader issue is that spending in New York is out of control, highlighted in our initial piece on the subject in April 2009. As shown in the chart (below), New York per capita personal taxes and spending are in a league of their own. The corporate tax version of this chart is similar: New York's corporate taxes per capita are 25% higher than the next highest state (New Hampshire).



Here's another look. During the first Pataki administration, spending was below the growth rate of inflation plus population. **But since Pataki II and through Spitzer/Paterson, spending growth has been substantially faster (see first chart below).** The budget passed last week is no exception: including all forms of expenditures, New York State spending will rise by 8%. So far, the newfound budget discipline seen in New Jersey has not made its way through the Holland Tunnel. **One of the by-products of the highest state and local taxes per capita in the country: a large exodus**

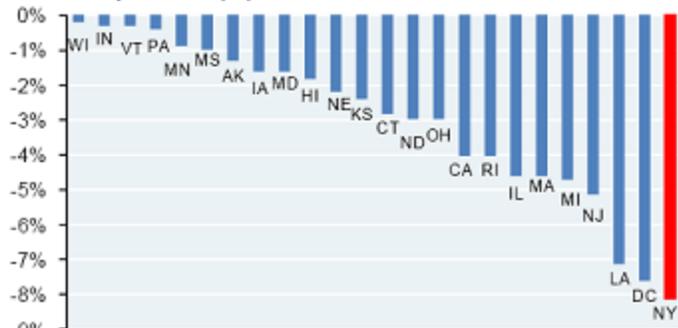
of people, as shown in the bar chart below. The weighted average state tax rate of places New Yorkers move to is half the NY rate. Florida, North Carolina, Virginia, Connecticut and Pennsylvania are among the most frequent destinations.

New York: Annual population plus inflation growth vs. annual spending growth, 1995 - 2010, Percent



Source: Public Policy Institute of New York. Spending growth excludes federal funds

States with net migration population loss, 2000-2008
Percent of year 2000 population



Source: U.S. Census Bureau; Empire Center for New York State Policy

New York's 2009 budget included the largest tax and user fee increases in the state's history, and is impacting the state's competitive position in various ways. Even before the latest budget, New York ranked next to last on the Tax Foundation's Business Tax Climate Index, and in the next-to-last quintile regarding overall state competitiveness. This puts New York in a position of being "poached" by its neighbors. Connecticut Governor Jodi Rell recently invited some New York hedge fund managers to dinner in Darien, with the following message to the New York Hedge Fund Roundtable:

*"As lawmakers in Albany consider a proposal to vastly increase the tax liability of hedge fund professionals who work in New York - many of whom have already wisely decided to live in Connecticut - I would like to convey a very simple, yet heartfelt, message: **Connecticut welcomes you!**"*

New York is a strange place. Senators, Governors, Congressmen and State Legislators in states dominated by auto, oil, agriculture, agri-fuel and technology companies vigorously protect their largest industries; **in this regard, New York's politicians are the exception.** There are 94 bills before the New York State Legislature that add taxes and restrict business operations of financial services companies. The total cost could be as high as \$12 bn per year on the industry, which accounts for 40% of all wage income and personal income taxes paid in the state.

All of these trends lead to the following 3 recommendations:

- * **Diversify out of concentrated New York municipal portfolios**
- * **Diversify out of concentrated New York municipal portfolios**
- * **Diversify out of concentrated New York municipal portfolios**

Within New York portfolio exposures, we focus on pre-refunded bonds, and essential service water, sewer, environmental and other revenue bonds (where Chapter 9 rules state that interest is paid right after the issuer's operating costs, and cannot be delayed or interfered with by a bankruptcy of the municipality itself). **We are reluctant** to hold non-appropriated tobacco bonds, single-site hospitals, nursing homes and other health care related issuers. In addition, we generally avoid many upstate New York issuers (county GOs and school districts) with limited economic potential, and which are subject to net outward migration as discussed above. But the broader issue is that in an era of possibly insolvent municipal bond

insurers and depleted Federal resources, municipal diversification is important, in spite of preferential tax treatment of in-state municipals. As a New York resident, as far as municipal investments are concerned, "New York is Not My Home" (Jim Croce, 1972).

Michael Cembalest

Chief Investment Officer

J.P. Morgan Private Banking

The material contained herein is intended as a general market commentary. Opinions expressed herein are those of Michael Cembalest and may differ from those of other J.P. Morgan employees and affiliates. This information in no way constitutes J.P. Morgan research and should not be treated as such. Further, the views expressed herein may differ from that contained in J.P. Morgan research reports. The above summary/prices/quotes/statistics have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness, any yield referenced is indicative and subject to change. Past performance is not a guarantee of future results. References to the performance or character of our portfolios generally refer to our Balanced Model Portfolios constructed by J.P. Morgan. It is a proxy for client performance and may not represent actual transactions or investments in client accounts. The model portfolio can be implemented across brokerage or managed accounts depending on the unique objectives of each client and is serviced through distinct legal entities licensed for specific activities. Bank, trust and investment management services are provided by J.P. Morgan Chase Bank, N.A. and its affiliates. Securities are offered through J.P. Morgan Securities Inc. (JPMSI), Member NYSE, FINRA and SIPC. Securities products purchased or sold through JPMSI are not insured by the Federal Deposit Insurance Corporation ("FDIC"); are not deposits or other obligations of its bank or thrift affiliates and are not guaranteed by its bank or thrift affiliates; and are subject to investment risks, including possible loss of the principal invested. Not all investment ideas referenced are suitable for all investors. These recommendations may not be suitable for all investors. Speak with your J.P. Morgan Representative concerning your personal situation. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Private Investments may engage in leveraging and other speculative practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuations to investors and may involve complex tax structures and delays in distributing important tax information. Typically such investment ideas can only be offered to suitable investors through a confidential offering memorandum which fully describes all terms, conditions, and risks.

IRS Circular 230 Disclosure: JPMorgan Chase & Co. and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with JPMorgan Chase & Co. of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties. Note that J.P. Morgan is not a licensed insurance provider.

© 2010 JPMorgan Chase & Co