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Subject: Eye on the Market, June 15, 2010

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Inline-Images: image010.png; image011.png; image012.jpg; image014.jpg; image016.jpg; image017.png

Eye on the Market, June 15, 2010 (*the attached PDF is much easier to read*)

Topics: 2006-07 vintage private equity; market update; a Europe debate; an index of unwelcome events

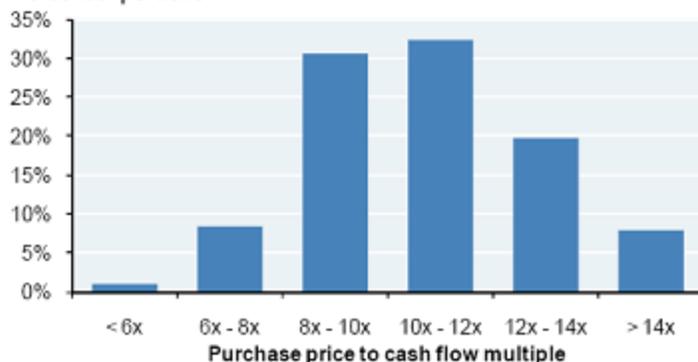
“Peace with Honor”, updated: 2006-2007 vintage private equity and the return of capital

For liquidity and valuation reasons, we maintained Balanced Portfolio private equity allocations at 5%-7% over the last few years, diversified by vintage year and strategy (buyout, mezzanine, regional funds). The Yale model (a) was migrating so quickly from endowments to individuals that we penned a cautionary note to clients in 2006 entitled, **“The Difference between You and the Yale Endowment”**. However, while our exposures were generally a fraction of endowment levels, they are worth reviewing given the pressure that the recession put on highly leveraged companies.

Last August, we published a note on our diversified 2006-2007 private equity exposure (the “LBO Composite”), and concluded at the time that the return of original capital appeared within reach. Since then, **debt market improvements and earnings results from the 43 LBO companies in the Composite reinforce our original conclusions.**

As we discussed last year, the prices paid in 2006 and 2007 for companies in the Composite were high using any historical standard (see first chart). In the spring of 2009, when debt markets collapsed, concerns about private equity intensified. If the debt of a highly leveraged LBO company was trading well below par, *how could the equity be worth anything?* We felt strongly about two things. First, debt markets were suffering from selling by leveraged credit hedge funds and unleveraged buyers experiencing ratings downgrade shock. Second, we believed that a cyclical earnings bounce would improve the debt service potential of many of the companies in the Composite.

Leveraged buyout (LBO) Composite purchase multiples
Percent of portfolio



Source: J.P. Morgan Private Bank.

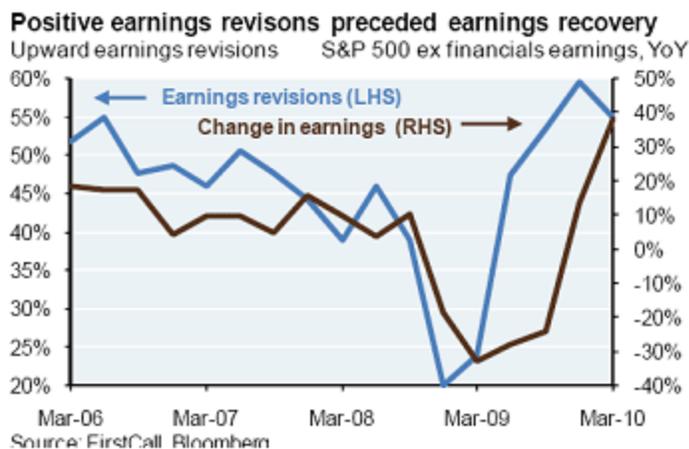
High yield & leveraged loan prices back to pre-crisis levels, price index



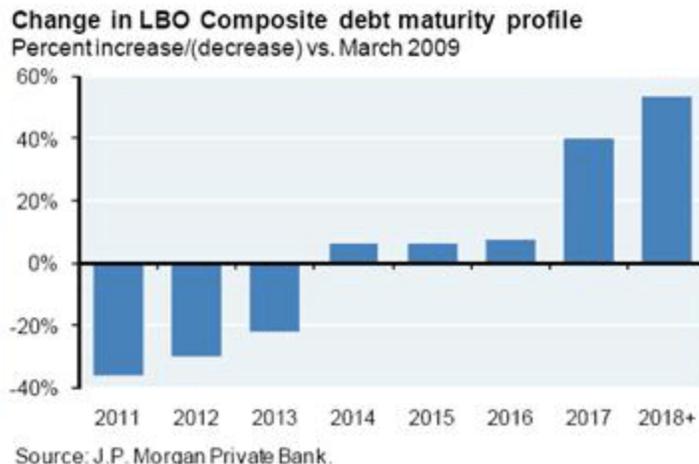
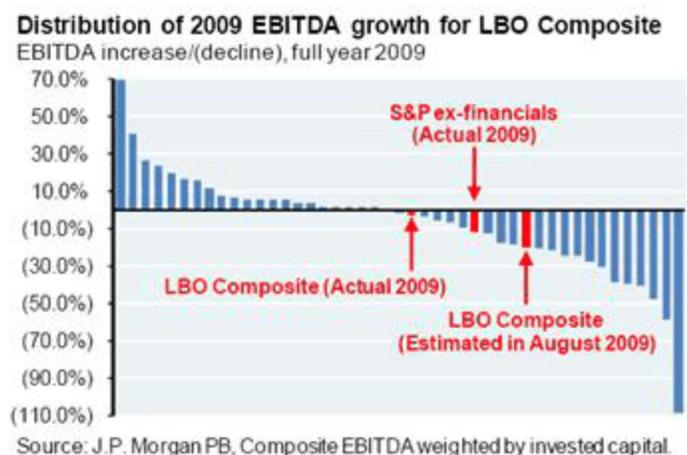
Source: S&P/LTSA, Merrill Lynch, Bloomberg.

As an update on the first point, selling pressure did subside. Both leveraged loan and high yield markets recovered from their spring lows, with average prices back to summer 2008 levels (see second chart). In hindsight, debt markets did not turn out to be reliable predictors of insolvency. Despite average Composite loan and debt prices of \$79 in August 2009, **all**

but one of the companies in our Composite was in compliance with debt covenants and interest obligations as of March 2010. On the second (and more important) point, ISM manufacturing surveys and earnings revisions turned out to be good predictors of improvements in corporate profits, as shown below.



Earnings improvements are visible in the LBO Composite as well. The first chart below shows 2009 EBITDA (b) results for the Composite companies, and the weighted average of -3%. This result compares favorably with the -20% estimate we made last August, and actual EBITDA results for the S&P ex-financials index (-13%). As with most portfolios, there is a wide dispersion of results, and some companies may struggle to generate enough earnings to grow their way out of their problems.



Of course, there's more to returning capital than EBITDA, particularly when companies have a lot of leverage.

Some companies issued in high yield markets to refinance loans with near-term maturities. The second chart shows the percentage change in debt by year for the Composite, accomplished by companies restructuring, repurchasing and refinancing their debt (debt repurchase benefits were furthered by a tax law change deferring recognition of "cancellation of debt" income). Composite funds also benefited from debt purchases made for investment purposes (in portfolio companies and unrelated ones).

We re-ran our prior analysis with the latest earnings, debt profile, exit multiple and capital markets assumptions. Precise predictions are impossible, and it will be several years before the books are closed on this era. Some companies may struggle to return any capital (we estimate that 15% of the Composite will not return any). **But overall, the return of original Composite capital appears closer than it did last August.** The U.S. productivity surge (three quarters in a row of 6%+) has been a boon to corporate profits and LBO companies in particular, which creates upside potential above the

“return of capital” scenario. As the jobless recovery in the U.S. enters its post-stimulus phase, the LBO Composite will face its next test: staying power.

Market and portfolio update: China, and US equities-housing-spending-employment

- * After P/E multiples peaked near 45x in 2007 and 25x in 2009, the reality of Chinese stimulus withdrawal appears closer to being priced in, as forward P/E multiples have fallen to 15x. **We are slowly adding back to Asian equities.**
- * For the first time in 5 years, National Bureau of Statistics data show a greater number of job openings than applicants in China. Another **positive for Chinese consumption** (see EoTM on the topic, June 1, 2010).
- * Despite China’s 48% y/y export growth, Euro weakness may delay China’s appetite to revalue the RMB. But when forward markets price in expected RMB appreciation of only 1%, we consider **forward RMB positions** to be worth buying
- * Distressed U.S. home sales (foreclosure sales and short sales) continue to dominate many weaker markets, and make up 60%-70% of total sales. We are still **bearish on most things related to US residential investment**.
- * With the global production boom still in place (manufacturing, trade, capital spending, etc), **our single-digit equity return forecasts for 2010 are unchanged**. Using consensus earnings, forward P/Es on U.S. equities are roughly 12x-13x, but consensus earnings look too high for a period of sub-trend GDP growth.
- * U.S. real consumer spending downshifted from 3.5% growth in Q1 to 2.5% in Q2. A lot rides on an improvement, given the out-performance of retail stocks vs the market, and the elevated level of sell side “buy” recommendations on consumer discretionary stocks. **Both trends are close to the highest levels of the last 15 years**. Leading indicators of US employment point to improvements over May’s disappointing report; global manpower and employment surveys are positive as well.

The way out for Europe, from a true believer in European Federalism

We invited Gilles Moec from Deutsche Bank to come our internal Monday investment session. Gilles was the Head of the International Economics Division of the Banque de France in 2006, and part of the working group on forecasting at the ECB. Gilles holds a more optimistic vision of Europe than we do, and his analysis had more depth than the usual Panglossian fare.

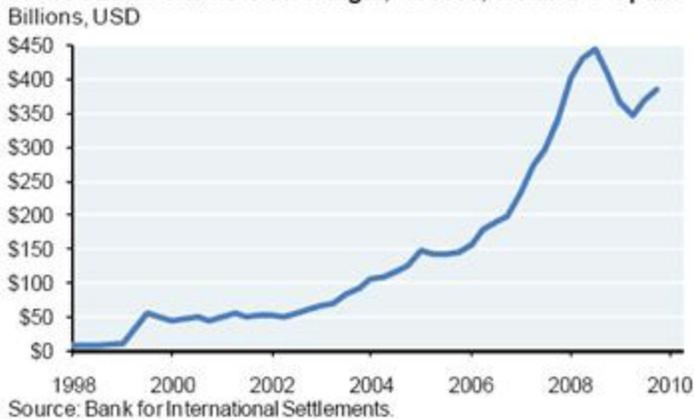
Gilles’ main points (as interpreted by me):

- * Peripheral countries don’t have to regain the competitiveness they lost, they only have to stop losing more
- * There is a non-deflationary path for Spain; he believes that rising exports and consumption can result in 2% GDP growth
- * Europe is more about Germany than people realize; German production and exports will solidify the European recovery
- * Improved labor mobility and other reforms will mark the next phase of the European march toward Federalism

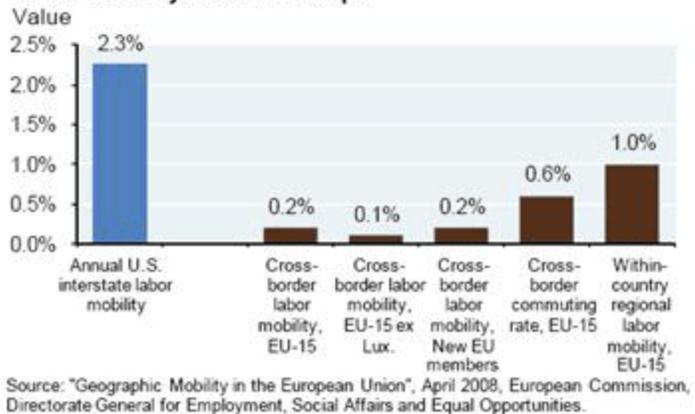
On the first point, agreed, except he did not explain why productivity gaps will not widen again in a recovery. We also concede the following: just because large fiscal adjustments are almost always accompanied by huge currency devaluations doesn’t mean they *have* to be. The challenge is **convincing private sector capital to stick around and see if 2% growth (in his optimistic case) and EUR 3.4 trillion of Spanish household and corporate debt make for a viable combination**.

Europe is all about Germany? Yes, when looking at German exports (Germany exported as much as China in 2008). **But the fortunes of Europe are linked to the periphery as well, once you consider the banks.** The first chart shows \$400 bn in claims (loans, bonds, FDI) of French banks on Spain, Portugal, Greece and Ireland. For context, a 20% write-down on these claims would more or less wipe out the capital base of the French banking system. We are not suggesting such a write-down is merited, but this demonstrates how simple GDP comparisons miss the risks of widespread deflation in the periphery.

French bank claims on Portugal, Greece, Ireland & Spain



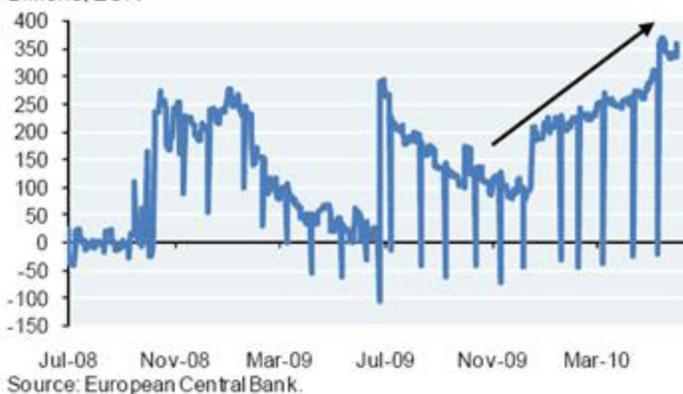
Labor mobility: U.S. vs Europe



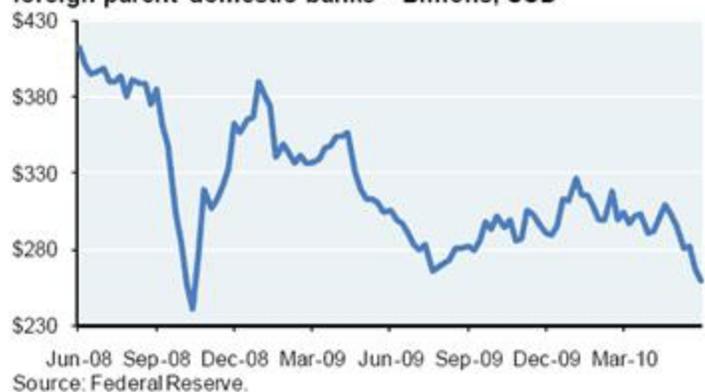
On structural reform, Spain is trying, with bills reducing severance payments and public sector wages. But the bigger issue after a massive collapse in construction is the need for more labor mobility. European labor mobility is just 5% of U.S. levels when measuring movement across the continent. Even when measuring movement within countries, it's less than half. Many of our European clients are deeply skeptical on this issue being resolved through a slate of labor market reforms.

Spain placed EUR 4 billion last week, but how much was bought by Spanish banks, financed by the ECB? It's not clear yet. **The broader issue is that European sovereign debt problems are morphing into European banking system problems.** European banks have not had access to debt markets for several weeks, bank loans *from* the ECB are rising, and CP issued by foreign banks in the US continues to fall (see charts below). As for European equities, they trade in line with historical averages vs world equities at a 15% P/E discount, so we are not in a rush to add back exposure. Within Europe, we prefer German equities, given a higher weight to cyclicals, higher level of earnings from outside Europe and a lower weight to financials.

Net liquidity provided by the ECB to member banks



Outstanding U.S. commercial paper issued by foreign & foreign-parent domestic banks - Billions, USD



The Gulf spill and an index of unwelcome events

One of our research providers (Gavekal Securities) suggests that the Gulf spill be put in context of barrels produced that were *not* spilled. Gavekal's data: since 1978, 27 million barrels have spilled out of 800 billion barrels produced. Using a decidedly unscientific approach, I compiled some other industrial accidents/failures to try to make sense of these numbers (see table below). **While the oil extraction hazard ratio is better than other failure rates shown, this was an unconvincing exercise.** Bridge collapses, medical errors and contaminations generally do not have long aftershocks for the community or the environment. I also could not find statistically meaningful data on nuclear power risks (power plants, military installations, processing, disposal, etc). The need for uninterrupted supplies of energy presents unique risks that are hard to compare.

Event	Occurrence	Source
Chickens contaminated with salmonella	1 in 7	Consumer Reports
Medical prescription error rate	1 in 9	Baylor Medical Center, Brigham & Women's Hospital (Mass)
Cluster bomb failure rate	1 in 20	Nellis Air Force Base, Nevada
Public well water contamination rate	1 in 22	U.S. Geological Survey; resulting from man-made substances
Vasectomy failure rate	1 in 150	Elsevier Urology Magazine
U.S. bridge collapse rate, 1966-2005	1 in 400	Texas Transportation Institute, U.S. Highway Administration
Failure rate of Firestone tires, recalled 2001	1 in 5,000	Ford Motor Company; 3 yr-old Wilderness AT Tires
Barrels of oil spilled per barrel produced, 1978-2010 (Gulf incident included)	1 in 25,000	Gavekal Securities; Bloomberg article estimating 4 million barrels released in the Gulf by the time its all over
Barrels of oil spilled per barrel produced, 1978-2009	1 in 30,000	Gavekal Securities
Fatalities due to pacemaker malfunctions	1 in 43,000	U.S. Food and Drug Administration
Sony lithium battery failure rate, recalled 2006	1 in 200,000	Associated Press, CNET; as used in Apple/Dell laptops
Contaminated blood transfusions resulting in Hepatitis C	1 in 2 million	American Cancer Society
Fatal airline accidents per departure, 1990-2007	1 in 4.5 million	U.S. National Transportation Safety Board

Since 1850 when kerosene was introduced as an alternative to whale oil, life expectancies as per U.S. Census Data steadily rose from 39.5 to 77.4 years. Fossil fuels and electricity unleashed a productivity and longevity boom linked to improvements in agriculture, medicine, transportation, refrigeration and communication. But the improvements did not come without intermittent and sometimes severe failures. We are wondering what long term impact the BP spill will have on energy supplies, and energy policy. **As shown in the June 1 EoTM analysis on the scope of alternative energy expansion needed to replace offshore drilling, sometimes there are no easy answers.**

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J.P. Morgan Private Banking

Notes:

(a) Yale's alternative investment allocations are elevated, but not unique. Overall alternative investment allocations (including hedge funds, venture capital and real estate) at the Ivies ranged from 50%-60% as of June 2008, with other endowments like UVA following suit.

(b) Buyout companies are analyzed based on gross cash flow available for servicing debt/taxes, and reinvesting in the business. This is computed as "earnings before interest, taxes and non-cash charges such as depreciation and amortization" (EBITDA).

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