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Eye on the Market, November 29, 2010 [this week in particular, the PDF is easier to read]

Topics: The EMU unraveling; China and the Koreas heat up; the selloff in US municipal bonds

Most of this week's note is on North/South Korea and China, but given yesterday's Europe headlines, here's an update. Germany is booming, with manufacturing and retail surveys at their highest levels since reunification. On the Ireland bailout, it might be seen as good news that there were no losses imposed on senior bank debt, and no *automatic* bondholder loss-sharing provisions for the future. However, both results might be temporary or beside the point. Last week's EoTM summarized our take on the market, economic, political and investment implications of the continued unraveling of the European Monetary Union. What would change our views? A full-scale German underwriting of the EMU problem. How likely is that? Wenn Schweine fliegen können (when pigs fly).....

A few things to keep in mind:

[1] **Bailouts don't change the level of debt that countries owe, it just shifts the creditors around.** The latest steps remind me of the desperate attempts by US banks to lend more money on top of prior money during the late 1980s to Latin America, when Citibank chairman Walter Wriston's "countries cannot default" thesis was left in ruins. For everyone that said last spring that "Greece 2009 is not Argentina 2001", they're right; Greece's budget/trade deficits and debt/GDP were much worse.

[2] **GDP figures can be misleading indicators of risk.** Greece, Ireland, Spain and Portugal (GISP) are small in GDP terms relative to Germany and France. But their banking systems grew to be very large (e.g., a 20% haircut on French bank exposure to GISP countries would wipe out French bank equity). Irish Finance Minister Lehinan intimated that Ireland *asked* to be able to apply haircuts to senior bank debt, and was told by the EU **that it would make no money available if there were any haircuts, due to fears of contagion.** What does that tell you about the risk of small countries, or the European banking system?

[3] **This crisis is not just about sovereign debt/deficits.** Ireland and Spain were model EMU citizens, with deficits inside of the 3% Maastricht level for years. The problem: *total* sovereign, corporate, financial and household debt, and each country's ability to service it. Despite reductions in its budget deficit and reduced reliance on ECB funding, we're still very nervous about Spain. Why? Its economy is still on the brink of recession. **Were it not for the ongoing collapse in imports, Spain's GDP would have declined in Q3.** BBVA and Santander should be able to ride out a recession due to international diversification, but the other half of the banking system (Caja banks) is another story entirely. Risks in Spain are not just about the banks; *non*-financial private sector debt is 220% of GDP, the highest in the world.

[4] **The politics may get more divisive.** The EU imposed a deal on Ireland's lame duck government that consigns the country to a very painful future*. The continued gutting of the Irish national pension fund is, to put it mildly, a controversial decision**. Meanwhile, Eurogroup president Jean Claude Juncker said this over the weekend: "I am concerned that in Germany, the federal and local authorities are slowly losing sight of the European common good". As per last week's EoTM, I am not sure anyone knows what that really means right now, or if such a concept was ever properly established as it relates to the European Monetary Union.

* The Irish "bailout", with its **EUR 54,800 cost per household**, is by all accounts a modern-era "Long Day's Journey Into Night". Ireland's future, by the way, **looks a lot more bleak than Iceland's**. Iceland took a different path (default and a devaluation of 60%). Two years on, Iceland is rebounding: exports and manufacturing are growing by 20%, tourism is back near all-time highs, real wages are rising, unemployment is declining sharply, interest rates fell from 18% to 5.5% and the stock market rebounded 50% from its lows. In Ireland, GDP is contracting at a 9.7% rate; real wages, price levels, the money supply and exports are falling; and unemployment is stuck at 14%.

** Ireland's National Pension Reserve Fund was a global, diversified pool of assets heading into the crisis. Around 25% is now invested in Irish bank stocks, with another 50% subject to liquidation to fund the bailout. This follows on similar decisions in Spain, Hungary and France to repurpose diversified pension funds into government bonds.

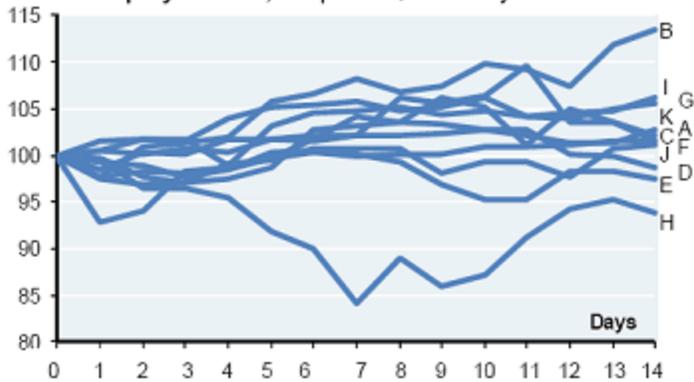
The Koreas: playing with fire

We wrote about India recently ("*From Nehru to Now*", October 26), and outlined our optimism its long-term fundamentals. Our view on Korea is more mixed, both as a reflection of **shareholder value issues and risks surrounding North Korea**.

Korean equities don't look expensive at 10-11x earnings, but this reflects the heavy weight of large cyclicals such as Samsung, Hyundai and Posco. Samsung and Hyundai have diversified their international revenue base, which has helped reduce the volatility of Korean industrial profits. Another positive: the Korean Won looks cheap (Korea reinstated a tax on foreign investors in local bonds to try and keep it that way). However, while Korean companies are good at generating cash, they are more reluctant to return it to shareholders. Korean dividends are only 1%, among the lowest in the region. Some of our managers see this as a vestige of the *Chaebol* era, when cash was used to finance businesses owned by the conglomerate***. Korea's banks also have the highest loan-to-deposit ratios in region, a risk should capital ever become scarce again; admittedly, that seems remote right now. [Note: Korea's weight in most Asian equity benchmarks is the second highest, behind China but slightly larger than India and Taiwan. Most of our managers are modestly overweight Korea].

As for North Korea, it has typically not been a lasting problem for South Korean equities. The chart below shows each "episode" since 1998, covering an array of missile launches, naval clashes, border closings and nuclear tests. The chart is measured in *days*; in all but one episode, the equity market impact of North Korean actions was reversed within two weeks with little lasting effect (the exception was November 2008, when global equity markets went haywire).

North Korean provocations and impact on South Korean equity market, Kospi Index, 100 = day before event



Source: Bloomberg.

	Date	Event
A	August-1998	Daepdong-1 missile launch
B	June-1999	Navel firefight in Yeon-pyong-do
C	June-2002	Naval clash on the Yellow Sea
D	September-2004	Ballistic missile fire test
E	July-2006	Daepdong-2 missile launch
F	October-2006	First nuclear test
G	March-2008	Barrage of short-range missiles
H	November-2008	Border is closed off
I	April-2009	Long-range missile launch
J	May-2009	Second nuclear test
K	March-2010	Sinking of naval ship Cheonan

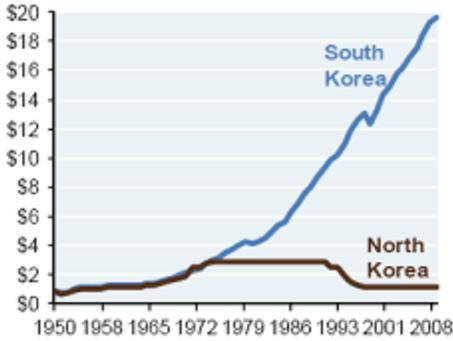
Why does North Korea do these things? The standard logic is that North Korea is looking for leverage in the 6-Party talks. The world hopes to convince North Korea to be receptive to a “peace dividend”, similar to Eastern Europe 20 years ago. During the peak of the Cold War in 1987, global military spending was \$1 trillion; by 1995, it declined by 30% to \$700 billion. In addition to reduced capital spent, soldiers can be remobilized into more productive roles. Since 1989, Germans serving in East and West armies fell by more than half.

With this in mind, in exchange for denuclearization, South Korea has offered to raise North Korean per capita GDP threefold over ten years, via a \$40 billion “international cooperation fund” and a Korean unification tax. The plan would entail massive worker retraining, medical assistance, reforestation and infrastructure. So far, North Korea is not interested, describing the plan as an “**unpardonable and intolerable provocation**”. There must be a Minister of Hyperbole working somewhere in the North Korean government.

The risk of a miscalculation by North Korea may be growing. Last week marked the first time since the Korean War that North Korea attacked South Korean territory. Further increasing tensions, North Korea appears to have had help from abroad in the construction of 2,000 recently disclosed centrifuges capable of producing enriched uranium (as per Sigfried Hecker, Emeritus Director of Los Alamos Laboratory, in a speech last week after visiting the sites). In the wake of this disclosure, South Korea is considering whether to redeploy US tactical nuclear weapons on its territory as a deterrent.

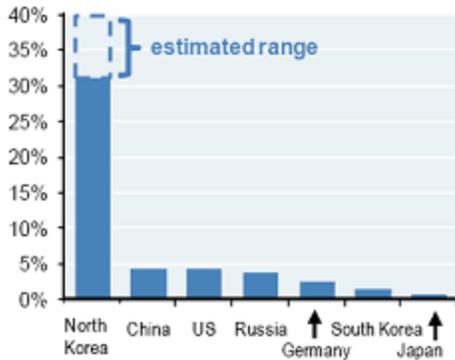
It may be impossible to apply conventional logic to what looks like the world’s most totalitarian state. See charts below: North Korea is an unmitigated economic disaster (*the only country to experience a worse decline in the World Hunger Index from 1990-2010 was the Democratic Republic of the Congo*), and is one of the most militarized states since Ancient Sparta. Including reserve troops (which the chart below does not do), almost one in four North Koreans qualify as military personnel.

Per capita GDP
Thousands, USD



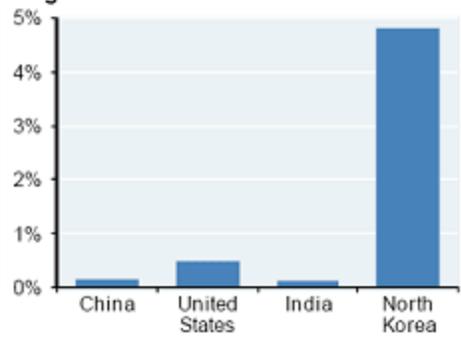
Source: "Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD", Angus Maddison, University of Groningen.

Military expenditures as a % of GDP



Source: Korean Economic Institute of America.

Troop-to-population ratio of the four largest armies



Source: "The Military Balance", International Institute for Strategic Studies (2005), CIA World Factbook.

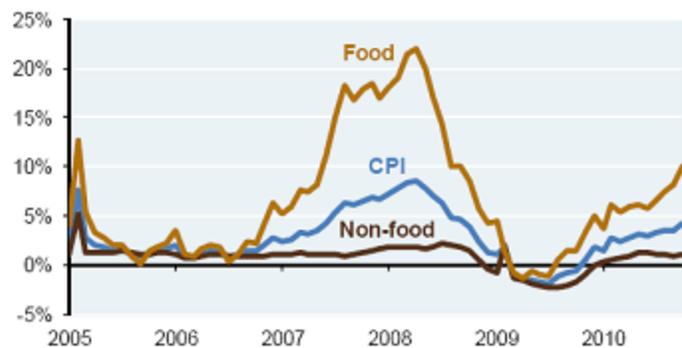
North Korea will likely remain a drag on South Korean and regional equity valuations. **I've been reading about North Korea's unavoidable implosion for a long time** (e.g., "No way out: North Korea's impending collapse", *Kyung-Won Kim, Harvard International Review, March 1996*), and now even Kim Jong-Il's eldest son living in exile in China believes it will collapse as well. Unfortunately, North Korea's staying power may be underestimated, and an accidental military escalation seems just as likely as anything else.

*** "While holding company regulation has been greatly improved, the general mindset has not yet shifted. In many cases this has left the management of larger companies with a **tendency to retain earnings for no seemingly valid reason**, at times engaging in investments that may be detrimental to shareholder value". *Jesper Madsen, Portfolio Manager, Matthews International Capital Management.*

China, overheating

Just as the US is showing signs of emerging from its consumption and employment slumber [a], China is heating up. Defending its currency peg is getting harder, even before the Federal Reserve ratchets up the pressure with QE2. As shown below, Chinese inflation is on the march again, as are Chinese real estate markets. Price satisfaction surveys conducted by the Central Bank show that Chinese consumers see inflation as a bigger issue than government CPI figures suggest.

Chinese CPI increases largely driven by food
Percent change - YoY



Source: National Bureau of Statistics, Morgan Securities, LLC.

China's property market is heating up again
Residential units sold, 5-day moving average

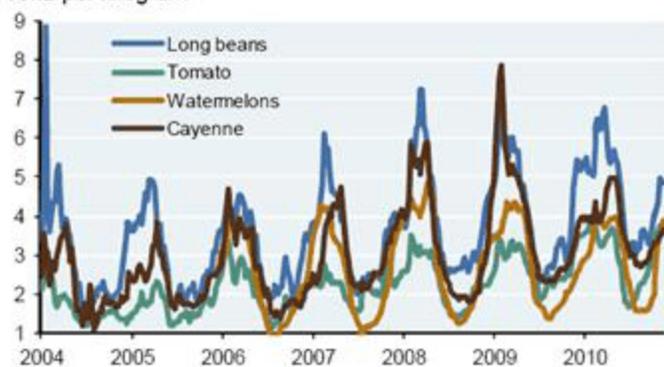


Source: BCA Research, ISI Group.

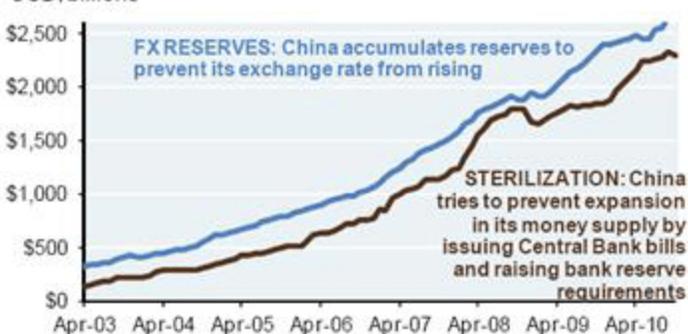
Some clarifications are in order. First, inflation in China is mostly related to food (32% of Chinese CPI). **Chinese government responses have a distinct historical ring to them:** it will sell government food reserves (*Joseph and the release of the temple granaries, Genesis 41:1-57*), and clamp down on “hoarding” (*Lenin’s prosecution of Russian speculators*). China will also reduce the cost of power, gas and rail for some industries, ramp up oil production, and hike commodity futures exchange margin requirements. As shown below, part of the problem may be resolved as short growing-season agricultural products are brought to market.

However, there are more cracks showing in China’s battle against inflation. In theory, China prevents an explosion in its money supply by “sterilizing” the inflow of foreign exchange reserves through Central Bank issuance of sterilization bills and increased bank reserve requirements (see chart). But interest rates are still very low relative to China’s growth rate, which has resulted in intermittent bouts of inflation of goods, wages and/or real estate. Furthermore, while 2008 food inflation appeared to be about inadequate supply (in part due to pig viruses), this time, it appears to be about too much liquidity and/or rapidly rising incomes. Grain output has not been affected much by this year’s floods, and China is on track for a record harvest. China is also not a huge food importer (apart from soybeans), so the rise in agricultural prices does not seem to be an imported problem.

Cyclicality of Chinese wholesale food prices
RMB per kilogram



How Chinese monetary policy works, in one simple chart
USD, billions



On real estate, China raised down-payment requirements and lending rates, cancelled tax waivers on second homes, and banned multiple unit purchases in some cities on the East Coast. It also ramped up construction of low-end government housing (target of 15 mm units by 2012). But it might take more than administrative measures to resolve this: one of our research providers estimates that China needs an additional 50 mm housing units, while at the same time, 30 mm households own more than one unit. As a result, **high vacancy rates co-exist with a shortage of affordable housing.** The United States, Spain and Ireland have apparently not cornered the market on housing imbalances.

As China gradually exhausts its supply of excess labor (the urban labor demand-supply ratio is now in balance) and industrial capacity (now not far from its 2006 peak), its inflation-fighting tools may lose their effectiveness.

Implications for our Asian investments: Asia heats up, but hang on

Even with recent inflation and military risks rising, Asia ex-Japan equity markets have almost doubled returns on US stocks this year, and have only given up a small amount of that since early November. Asian P/E multiples are similar to developed market multiples; so far, Asian earnings have kept pace with rising expectations. We hold roughly 20% of our overall equity exposures in Asia ex-Japan, and plan to maintain these allocations in 2011. Roughly 70%-80% of Chinese household assets are still in cash (compared to 45% in Korea); over time, we expect Asian equities to benefit as they are gradually invested.

Asia appears to be undergoing a more classical business cycle in which policymakers are forced into more exchange rate appreciation and/or higher interest rates to cool things off. There has also been a sharp decline recently in Chinese leading indicators, reflecting some of these measures. But after these adjustments play out, we expect Asia to continue leading the world in terms of growth, with increased contributions from consumption. In China, urban and rural incomes are increasing by 7%-9% ; Singapore may be the world's fastest growing country at 15%; Taiwan grew by 9% in Q3; and even Thailand grew by 6%, another sign that in Asia, growth can co-exist with fractious politics. And in stark contrast with the West, Asia's fiscal accounts are in excellent shape should they be needed to respond to another round of global weakness.

Michael Cembalest

Chief Investment Officer

Sources

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"China real estate and construction market review, November 2010", Arthur Kroeber, Dragonomics Research & Advisory

2010 World Hunger Report, International Food Policy Research Institute

2010 US holiday sales expectations as per the National Retail Federation, the Consumer Federation of America, the Credit Union National Association, and FTI Consulting; Black Friday results from ShopperTrak

[a] Jobless claims measure the rate of firing, not the rate of hiring, which is still low by any measure. But over the last year, jobless claims have tracked private payroll gains pretty closely. We think payroll forecasts of 150-200k per month are reasonable. **On the US consumer, while Black Friday sales were only up 0.3% vs last year, overall holiday season sales are expected to be up 2%-3% vs 2009.**

Appendix: a quick note on U.S. municipals: the recent selloff looks more technical than fundamental

There are a lot of long term issues facing US states. State/local debt is at the highest level in 30 years, state rainy day funds have been heavily depleted, and the property tax decline resulting from lower home prices hasn't really kicked in yet (property taxes represent 30%-40% of state/local revenues). In addition, states are grappling with the potential cost of lowering expected returns on pension plan assets (CalSTRS is considering a reduction from 8% to 7.5%, which would increase its required pension contributions by 17%). We advocate diversified portfolios by state, and believe that it's worth paying out-of-state tax on high quality bonds. **But the recent municipal selloff looks to be more a reflection of supply-demand issues than credit risk:**

* The week ending 11/19 was the heaviest issuance week of the year by a wide margin

* That same week also coincided with the smallest inflows into municipal bond funds since January 2009

* There are concerns that the "Build America Bonds" program will not be extended, which could result in a doubling of long-term tax exempt issuance vs current trends (*we see a 75% chance that the BAB program is extended for 1 year with a*

slightly smaller subsidy for the States). BAB issuers have been rushing deals to market before year-end

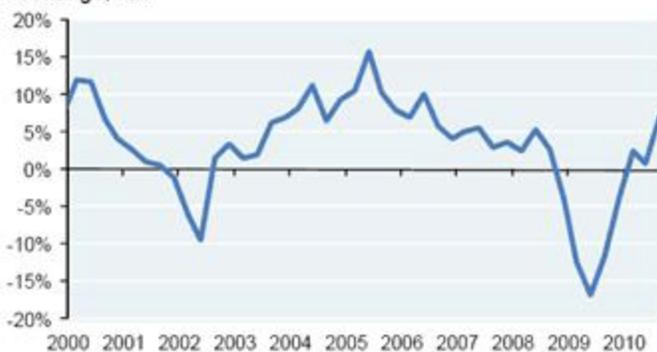
* There has also been a rise in long-term Treasury yields, and as a long-duration asset, municipals typically follow along

Transfers from the Federal government to the states have been offsetting declines in income and sales tax receipts, and a large part of these transfers will end in June 2011. But as shown below, state tax revenue is finally starting to pick up, and like every other fixed income issuer in the world, municipalities benefit from low interest rates. Tax revenues need to grow by at least this much to offset the decline in Federal transfers.

We have believed throughout the crisis that high quality municipal issuers would take the painful steps (mostly spending cuts and some tax increases) necessary to remain solvent. Recent developments in California are part of the trend: its voters approved two Propositions which make it easier for the legislature to pass a budget, and make it harder for the legislature to raise taxes to do it. **That's why we have been much more concerned about the negative impact on US growth from state/local belt-tightening than about municipal credit risk per se.** State/local contributions to GDP have been sharply negative over the past two years for the first time since 1981 and 1977, despite substantial transfer programs from the Federal government.

A rebound in state tax revenue

% change, YoY



Source: Census.

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