

anyway. In the short term, investing might be that simple, although in the long run, it probably won't be. Here is what we believe may be under discussion:

Monetary policy. The logic works like this: if economic data weakens, the Fed would engage in more "quantitative easing" by buying more long-duration governments and agencies. How much? Reports range from an ad hoc \$100 billion per month to a total program of \$1.5 trillion. This would presumably drive interest rates down further, with two objectives. The first: encourage investors to increase their equity holdings [a] by reducing cash and bonds. This could lead to higher equity markets, which could boost confidence, hiring, capital spending, etc. The second objective: with lower Treasury rates, lower mortgage rates would follow, allowing for a wave of refinancing. Another 1% decline in mortgage rates would mean (in theory) that **90% of all mortgages could be refinanced, boosting disposable income by tens of billions each year.**

Currently, 50% of all mortgages are already refinanceable, with coupons above current mortgage rates. But high loan-to-values have prevented them from being refinanced. Around 40% of all mortgages are underwater, a number we expect to rise as home prices decline by 5%-8% in the months ahead. To maximize the effectiveness of more QE, **policymakers could try to find a way to extend credit to underwater borrowers to refinance** (government agencies already own the credit risk). It would be very unorthodox; perhaps fears of this kind of action explain the largest decline ever last week in foreign holdings of U.S. agency debt, given the heightened prepayment risk.

Fiscal policy. The outcome on the Bush tax cuts cannot be predicted, since the vote will take place after the election. But one iteration involves a permanent extension of middle class tax cuts in exchange for a 1-2 year extension of the tax cuts for the highest two brackets. If such a compromise took place, **it would prevent a drag on disposable income of around 100 billion per year** that was set to go into effect during 2011.

It might be premature to price in Fed intervention on November 3rd. Last week's reports on durable goods shows that orders and shipments are still growing, suggesting that equipment and software spending is strong as well. Bernanke has also voiced concerns about the limitations of QE: "*Central bankers alone cannot solve the world's problems*". After all, interest rates are already low, the FHA lends up to 97% LTV and housing data is still terrible. But should payrolls and/or growth disappoint again between now and November, the Fed might feel compelled to act. The U.S. is experiencing the **lowest private sector money supply growth since the 1930's (around 1%-2%)**, signaling very low growth in nominal GDP.

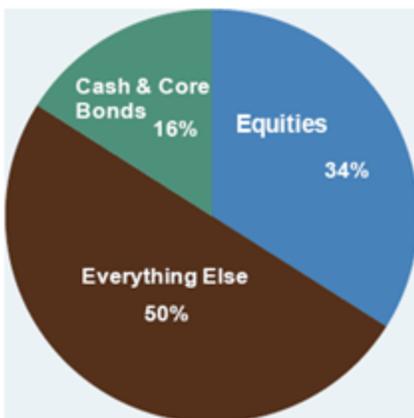
"All-in" intervention and our market/portfolio outlook

The rumored intervention strategies remind me of someone going "**All-In**" in a game of Texas Hold 'Em: it might work, but if it doesn't, you've got a problem. If a stimulus bomb results in higher equity markets, that's fine with us, as we had a high-single digit return view for equity markets this year. As of Friday, global equities were up 4.5%, so a modest rally would put us in line. But a debasement of cash, government bonds [b] and the dollar, as well as further erosion of U.S. public sector finances via higher deficits, is not the way we wanted to get there. Gradual improvement in economic conditions, coupled with confidence by businesses to deploy billions in cash reserves, would be a more sustainable basis for an equity advance.



Since January 2008, the following has been printed by Central Banks, to buy their own government bonds, or bonds of other countries to prevent exchange rate adjustments: 1.2 trillion U.S. dollars, 132 billion British Pounds, 183 billion Swiss Francs, 6.6 trillion Chinese RMB, 7.6 trillion Japanese Yen, 115 billion Brazilian Reais, 825 billion Hong Kong Dollars, 486 billion Saudi Riyals, 3.2 trillion Taiwan dollars, and 1.9 trillion Thai Bhat. **It's hard to be agnostic about the amount of monetary intervention needed to get things jump-started again, given the unintended consequences this may bring.** Guido Mantega, finance minister of Brazil, referred to all of this as an "international currency war" (if so, they are using **Weapons of Mass Devaluation**). The "End of Chimerica" is not here quite yet [c].

On a recent conference call, we presented the following over-simplified pie chart. It represents the kind of portfolio that we think makes sense for the environment we're in, namely the biggest monetary and fiscal policy experiment of the last few hundred years. We hold a barbell of mostly US and Emerging equities at roughly 34% of a Balanced portfolio. The slice entitled "**Everything Else**" includes credit (both public and private), hedge funds (macro, long-short and event-driven), commercial property and commodities, including gold.



Source: J.P. Morgan Private Bank as of September 2010.

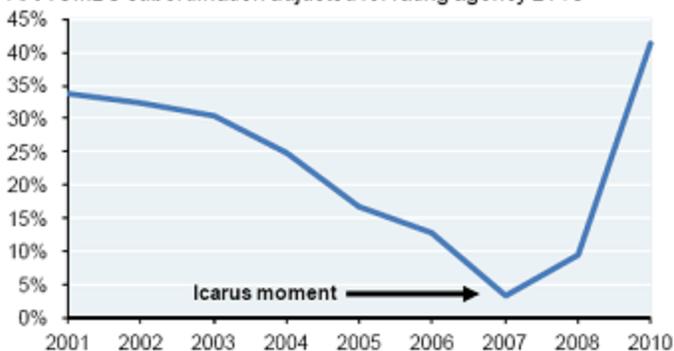
There are substantial market exposures in this latter category, as we do not believe we are in for a double-dip recession. We are trying to position for 2011 being a repeat of 2010: more signs of emergence from the global recession, corporate balance sheets gradually being redeployed (into stock buybacks, M&A, and capital spending) and slow but gradual improvement in household balance sheets. But much of this has been accomplished on the backs of public sector debt increases, monetary policy gambles and beggar-thy-neighbor policies that will, in our view, constrain the market's overall advance.

Charts of the week: commercial real estate lending opportunities

We are currently increasing exposure to loans to commercial real estate borrowers. This takes the form of senior lending through CMBS markets, and mezzanine lending, which refers to subordinated claims in exchange for a higher potential return. The logic behind both strategies: revised underwriting standards after a commercial real estate frenzy that was almost as undisciplined as its residential counterpart.

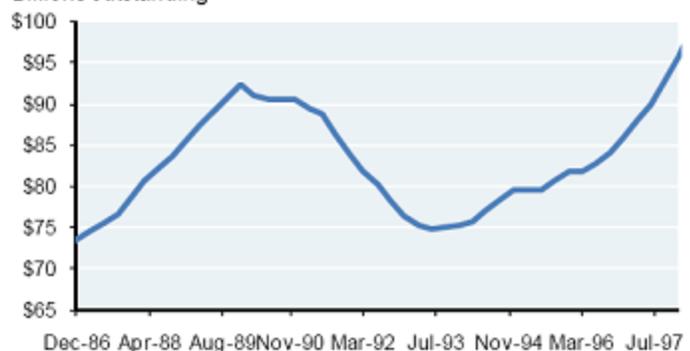
The first chart shows the effective protection for senior-most lenders to commercial property. **At the peak of the market cycle in 2007, property value declines in single digits would already begin to result in losses for senior lenders.** Few charts highlight the terrible lending decisions made in structured credit markets quite like this one. Given today's increased investor credit protection, property declines would have to exceed 35% for losses to impact senior-most lenders. While Fed surveys show a relaxation of lending standards, we find that most banks are reluctant to lend beyond 60% LTV, except under special circumstances. That creates opportunities for mezzanine lending as well, which involves taking exposure in the range of 60%-80% LTV. **We did not do much structured credit or mezzanine investing from 2005 to 2007, due to our concerns about the mispricing of credit.** That has changed, given the sea change in pricing and investor protections.

Property decline cushion for AAA CMBS Investors
AAA CMBS subordination adjusted for rating agency LTVs



Source: Morgan Securities LLC, Trepp, Rating Agencies, Bloomberg.

Commercial real estate lending feast and famine, '87-'97
Billions outstanding



Source: Federal Reserve Board.

A swing from abundant to scarce capital is one of the hallmarks of the schizophrenic markets we have lived through over the last 25 years. The second chart shows the boom and bust in commercial real estate lending around the time of the 1990 recession, the S&L crisis and the repeal of the 1986 Tax Reform Act (which ended the ability to deduct passive losses against active income). **Unsurprisingly, the best returns took place after most of the lenders fled.**

Michael Cembalest

Chief Investment Officer

Notes

[a] This is not what investors have been doing recently. **Institutional pension fund investors now have the lowest equity weights since the mid 1990's. As for retail investors, 19 of the past 20 weeks saw outflows from US equity mutual funds.**

[b] As shown in last week's chart, after another \$1 trillion in Fed purchases, central banks would own **over 60%** of all Treasuries outstanding.

[c] A 2009 paper by Niall Ferguson and Moritz Schularick describing the risks and distortions of a world whose FX and interest rate markets are heavily impacted by **Chinese mercantilism**, and their hopes that the recent financial crisis would bring such a system to an end.

Mortgage refi eligibility statistics from BoA/ML; underwater mortgage universe as per Bridgewater Associates.

QE Quantitative easing

FHA Federal Housing Authority

CMBS Commercial mortgage backed securities

LTV Loan to value

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