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To: Undisclosed recipients,;

Subject: Eye on the Market, May 20, 2010

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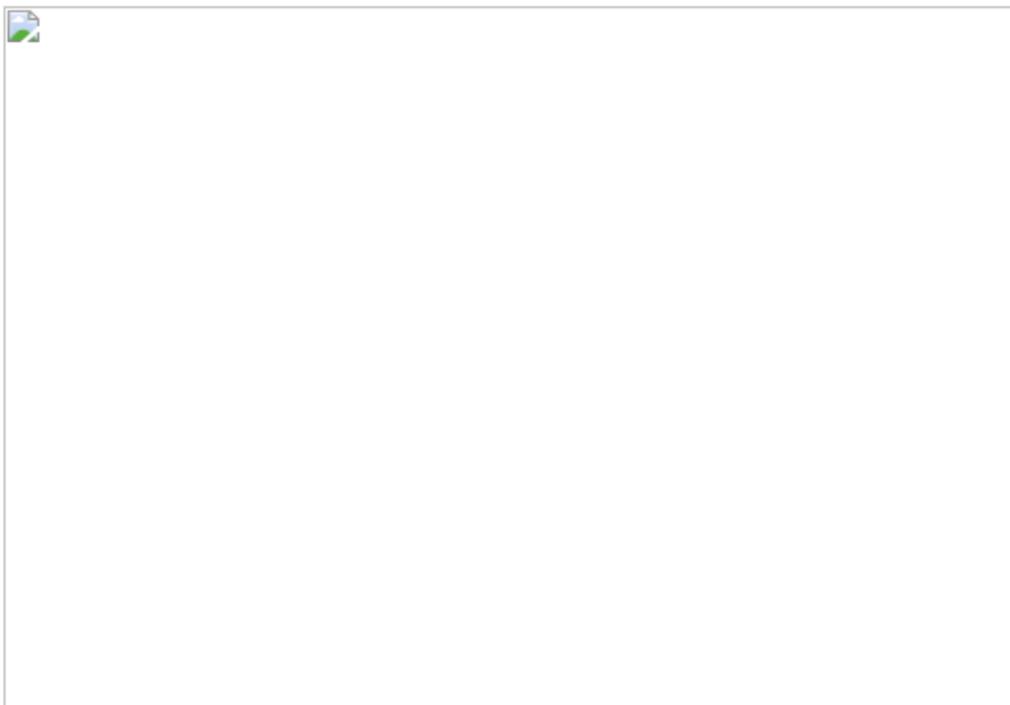
Attachments: 5-20-10_-_EOTM_-_Leaner_Pastures.pdf

Inline-Images: image006.png; image008.jpg; image010.jpg; image012.png; image016.jpg; image020.jpg; image021.png; image023.png

Eye on the Market, May 20, 2010 *(the attached PDF of this email is easier to read)*

Topics: Market and portfolio outlook, the question of Italy, and Asian consumption

Leaner Pastures. In preparing for mid-year portfolios updates, I looked back at the 2010 Outlook we published at the end of last year. At the time, there was a lot of enthusiasm for the blizzard of stimulus programs unleashed around the world. But as the **Year of the Ox** came to a close, we relied on bovine anatomy to convey the risks of a recovery riding on an unprecedented wave of governmental support. We believed that 2010 would be the year during which the costs would begin to come home to roost, and that equity market returns would be a shadow of their 2009 levels; single digit returns would be a great outcome. Unfortunately, it looks like our caution was on the right track, and it will take a second half recovery to get back to our forecast: global equities are down 5% YTD, and tumbling further today.



I've highlighted in red the sections of our Ox that are weighing on markets, with descriptions below of how these various stimulus programs did not come without a price:

* **Stimulus in China in 2009**, when measured by money supply or loans extended by banks, was higher than anything we have ever seen or studied. So it was not a surprise that China was forced to rein things in this year (loan quotas, bank reserve and mortgage down-payment requirements, liquidity withdrawals, restrictions on Trust companies, tighter collateral rules). But M2 growth is still on track to grow by 20%+ this year, and both goods and property prices are still

rising (China's national property price index rose by 12.8% in April), so more tightening is in store. The boom-bust cycle is having a predictable impact on Asian equity markets: bad.

* **Relaxation of ECB collateral rules** seemed like a free lunch...except that it lit a fuse of concern about why this was needed, particularly when credit facilities at the Fed and Bank of England had been almost entirely repaid. The greater role the ECB plays in European credit markets put in high relief the possible domino effects of a failure in a small country like Greece. European banks are 3x-4x larger (relative to GDP) than U.S. counterparts, and hold 6x-8x more of their own sovereign debt. This web has just begun to be dismantled, courtesy of the IMF and European taxpayers. We have been very bearish on Europe's weakest links, which unraveled even faster than we initially thought.

* **The largest peacetime deficits in US history** are headed for the chopping block after the mid-term elections. Deficit reduction is likely to rely more on tax hikes than spending cuts or entitlement reform (despite its being on track to represent 70% of gov't expenditures by 2015). Concerns about VAT taxes, higher taxes on multinationals, and carbon taxes are contributing to lower P/E multiples applied to future profits. There is a **similar post-election tax hike debate underway in the UK**, where capital gains tax rates may rise from 18% to 40%-50%.

* **US, UK and European government guarantees of investor deposits & bank bonds, asset guarantee programs and equity recapitalization** did what they were supposed to: reverse the disintegration of credit markets. But they came with a steep political cost that is now more clear. The list shown (below) is not all-inclusive, and keeps growing. Some analyses estimate a 20-30% reduction in pre-provision earnings for some financial institutions if all provisions are enacted.

STRINGS ATTACHED

- * too-big-to-fail taxes
- * restrictions on derivatives (capital, clearinghouse, etc)
- * constraints on Fed/FDIC ability to act independent of Congress
- * higher capital/liquidity ratios, limitations on preferred stock
- * financial transactions taxes
- * caps on credit card interest rates
- * regulations on debit card interchange fees
- * restrictions on hedge funds, private equity and prop trading
- * narrowing in scope of Federal pre-emption of state laws
- * securitization retention rules
- * segregation of bank swap desks
- * to be continued...

None of these consequences are the market equivalent of Halley's comet; they are the natural by-products of the stimulus machine put in motion last year. Investment managers that explicitly factored them into their forecasts and portfolios should be better able to navigate current market conditions.

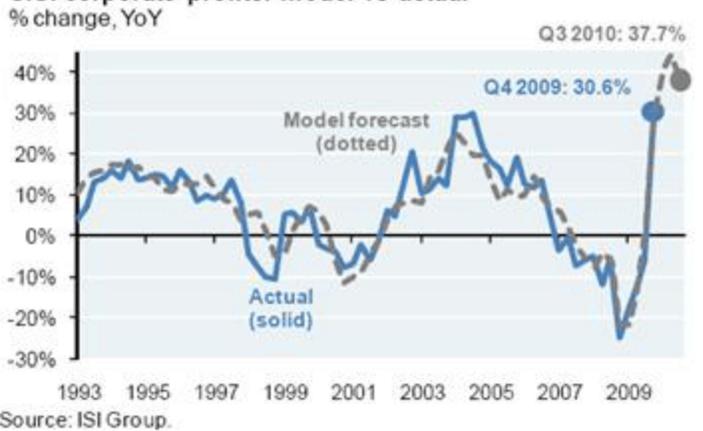
ON PORTFOLIOS. Some clients have been asking whether we intend to reduce portfolio risk. There are two reasons why we are not. First, our portfolios were put together with current market conditions in mind. While individual client portfolios differ, we track monthly returns for a proxy for our Balanced portfolio[†]. **Its return volatility has been below 10%, similar to the level generated by a portfolio with 60% in fixed income.** Yet we have much fewer bonds than that, and have instead relied on credit, commodities, currencies and hedge funds to reduce directional equity risk. Volatility has also been reduced by the use of equity investments whose downside risk is bounded through the use of principal protection, particularly in Europe.

The second reason: we are still constructive on the U.S. profit outlook, which the charts below summarize. However, it would be a mistake for us (or anyone) to weigh this view too heavily in portfolio construction; equity markets are NOT a simple univariate consequence of corporate profits. As shown a couple of weeks ago (and again below), **we believe most 2010 S&P 500 market forecasts are way too high, and ignore the unique challenge of private sector profits co-existing beside public sector problems.** Our less optimistic view: with the Fed at bay (core inflation at its lowest level since 1961) and modest profit momentum intact, single digit returns on developed market equities are still our expected outcome this year.

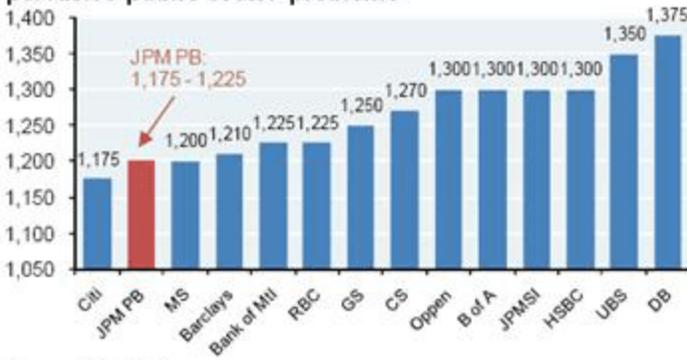
We do not have a double dip view on corporate profits



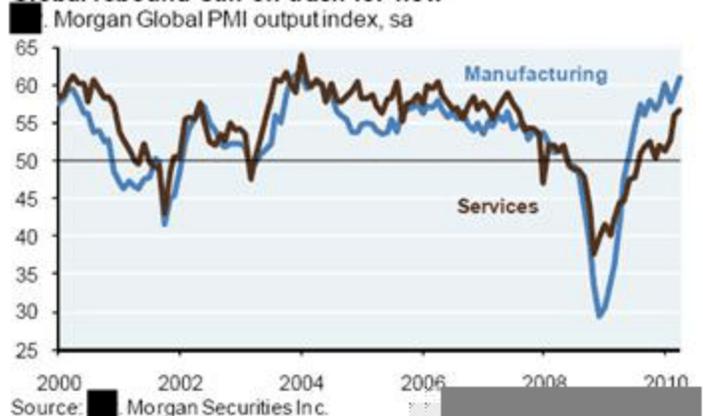
U.S. corporate profits: model vs actual



2010 S&P 500 projections: too high in a world of pervasive public sector problems

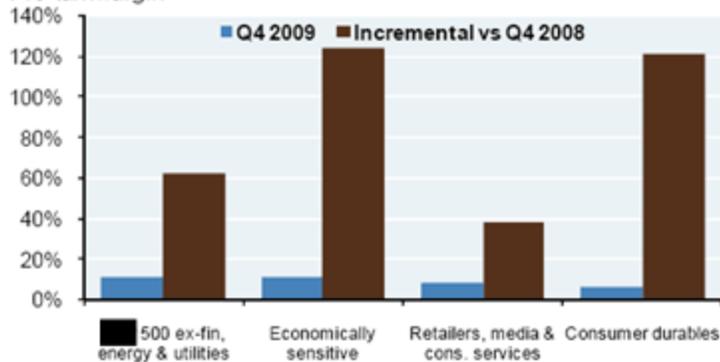


Global rebound still on track for now



High operating leverage supporting corporate profits

Pre-tax margin



Source: Empirical Research Partners. Economically sensitive sectors: commodities, capital goods, consumer cyclicals and technology.

La Forza del Destino: contagion risks in Italy appear subdued, for now

In our client conference call last week, we showed the first chart below when reviewing the adequacy of the European ring-fencing bailout. We separated Italy (whose GDP is equal to Spain, Portugal, Ireland and Greece combined) from the other countries involved for this purpose. Why?

* **Italy has a much smaller budget deficit problem.** Greece's 2009 primary deficit (ex-interest) was 9%, while Italy's was less than 1%. As a result, Italy needs a much smaller fiscal adjustment after a deep recession.

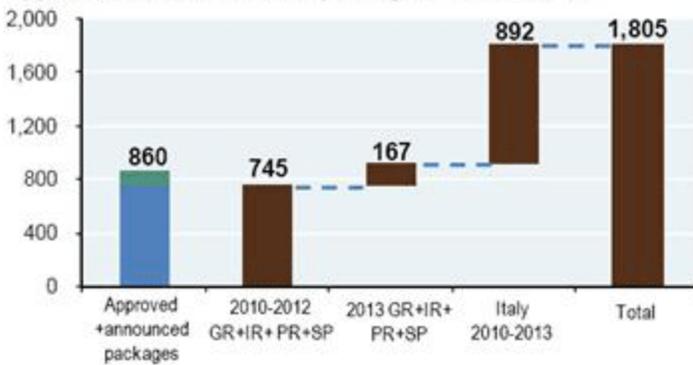
* Italy and Greece stand out in terms of having the highest sovereign debt/GDP ratios in Europe (see 2nd chart). But as is the case with Japan, it's not just a question of how much debt you've got, but who owns it. **Italy's domestic residents own 45% of its government debt**, compared to 25% for Greece (and 14% for Ireland).

* **Italy's reliance on foreign capital is much lower.** Italy has a 3% current account deficit, compared to 9%-12% for Portugal and Greece (3rd chart). Italy's "net international investment position" is close to balanced, and highly negative for the rest; this measures the extent of liabilities to non-residents not offset by holdings of foreign assets.

* **Italy's banking sector is well-funded**, with deposits more than 100% of loans, reducing the need for wholesale or other funding markets. As shown (4th chart), Italy's peak and current reliance on the ECB to finance banking sector assets is the **lowest across Europe**, including France and Germany. This is probably the most telling chart of all.

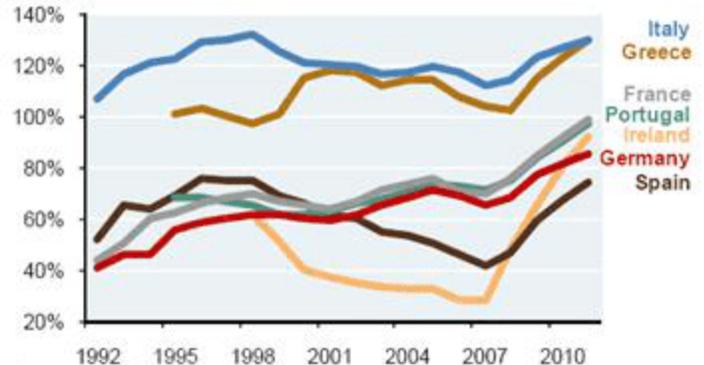
As a result, we do not consider Italy nearly as much of a flashpoint as the other 4 countries.

Gross financing needs (maturities + deficits) vs. approved and announced packages, Euros, billions



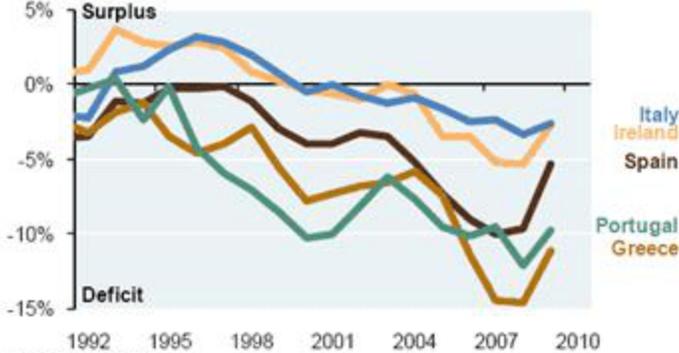
Source: Eurostat, Bloomberg, Ministries of Finance, Barclays Capital.

Gross sovereign debt as % of GDP
Percent



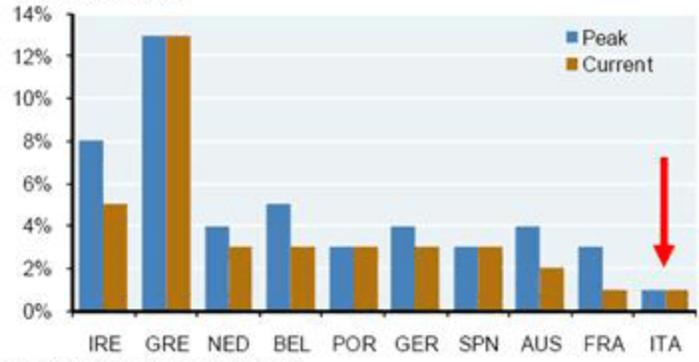
Source: OECD.

Current account balance as % of GDP
Percent



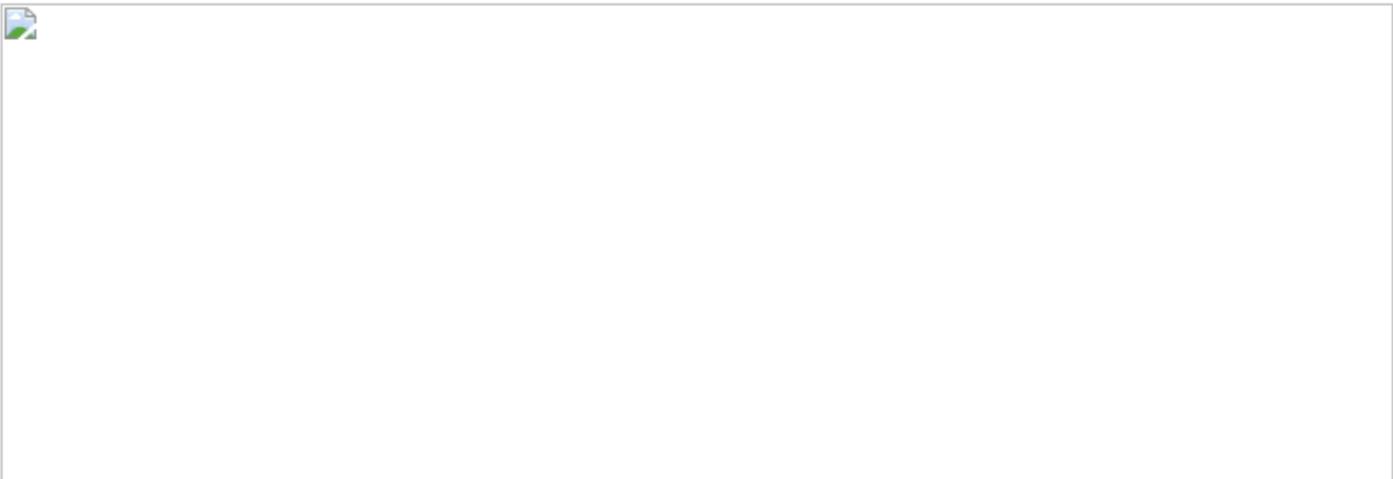
Source: OECD.

Total borrowing from the European Central Bank
% of bank assets



Source: Bridgewater Associates.

Our concerns about Italy are longer-term in nature, and more structural. In our “Sick Man of Europe” article back in February, we showed how Italy’s shadow economy is quite large, second only to Greece across all of Europe. This week, a look at some indicators that the World Bank believes are correlated over the long run to growth, productivity, per capita incomes, etc. They include issues related to the rule of law (a), government effectiveness, corruption, etc. As shown below, **Italy is much more similar to Greece than the rest of the region.** Were it not for concerns about Spanish political stability, Italy and Greece would trail the pack in each case.



Another concern: Italy's [REDACTED] expenditures are low compared to its peers (first table), its companies are smaller at a time when countries compete on scale (second table), and economy is still centered on sectors such as textiles which are produced more cheaply elsewhere. These factors may explain why Italy's growth rate has trailed the regional average in recent years.

Italy is now enjoying a bounce in industrial production, as is the rest of the Euro area. And as explained above, we do not see Italy as a weak link that will require the EMU to make large additions to the EUR 750 bn bilateral/IMF package of loans and guarantees (b). But the combination of low growth and high government debt does raise longer-term questions about where Italy goes from here. In this regard, the United States is better, but only modestly. We continue to look for ways to invest capital in parts of the world where incomes are growing, government debt burdens are not a binding constraint and where the terms of trade are still positive. That generally means Asia. As shown below, vehicle consumption as another window on the changing face of global consumption and wealth creation. Next week, we plan to review some investment strategies for China and the rest of the Asian region.



Michael Cembalest

Chief Investment Officer

[REDACTED] Morgan Private Banking

Notes

EMU = European Monetary Union

VAT = Value Added Taxes

IMF = International Monetary Fund

ECB = European Central Bank

† The proxy refers to a model portfolio constructed by [REDACTED] Morgan

(a) Includes losses and costs of crime, enforceability of government contracts, kidnapping, quality of police, money laundering, property rights, independence of judiciary and fairness of the court system.

(b) We had a chart last week on the economic and political risks in Germany related to passage of the European Stabilization Mechanism. On May 18, FDP head Frank Schaeffler (Merkel's CDU allies) announced he would step down after disagreeing with his party's intention to vote for the act. That being said, **we expect the legislation to pass both the Bundestag and the Bundesrat tomorrow with a simply majority.**

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