

**From:** Justin X Gratz <[REDACTED]>

**To:** Undisclosed recipients,;

**Subject:** Eye on the Market, April 27, 2010

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**Inline-Images:** image001.png; image002.png; image004.jpg; image007.png; image008.png; image013.jpg

**Eye on the Market, April 27, 2010** (the attached PDF of this email is much easier to read)

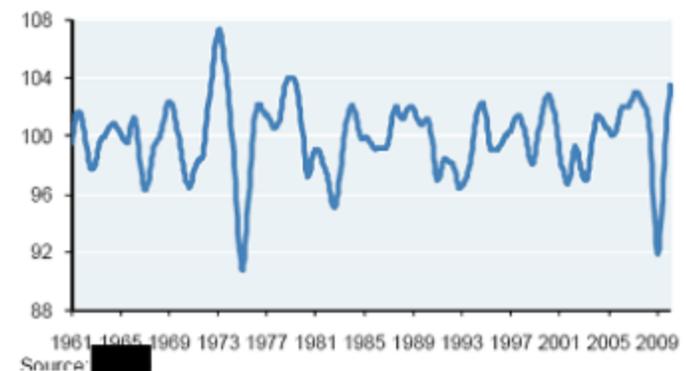
**Topics: Fundamentals vs speculation; Greece, unraveling; investing in commodities and the tech upgrade cycle**

The hardest part of this investment cycle will be determining when asset prices move past fundamentals into speculation. So far, improvements in global profits and manufacturing/services appear to justify modest gains in equities (the MSCI World's total return index is up 6% this year). As shown last week, our profit and margin models suggest another quarter or two of 30%+ y/y profits growth in the U.S., and the OECD leading indicator is as high as its been in 30 years. Recent positive reports include U.S. durable goods, Chinese GDP growth, and improvements in Federal, State and local tax receipts from individuals. Treasury estimates of TARP costs continue to decline, with losses mostly related to AIG and automakers.

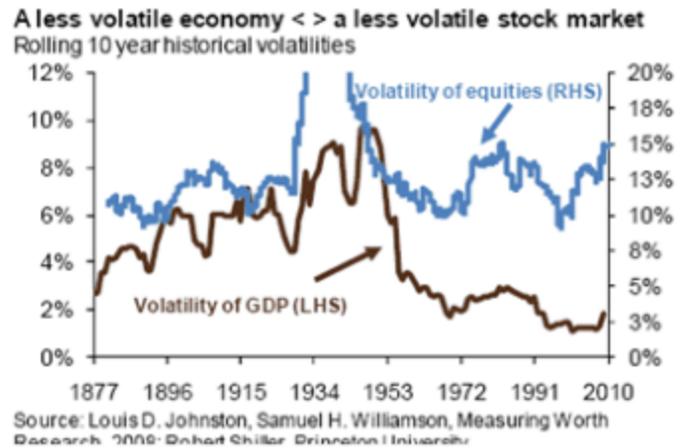
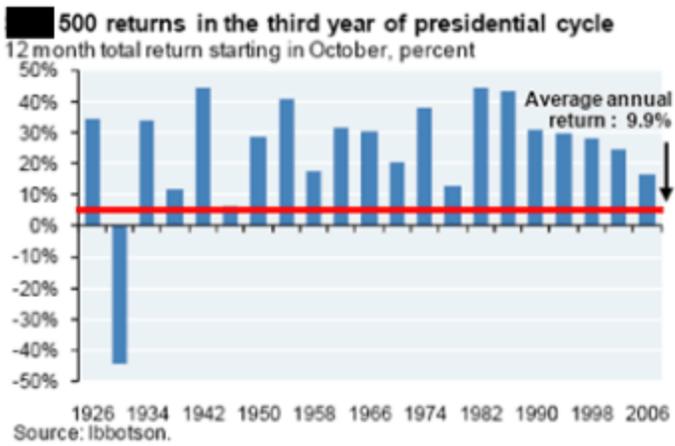
**U.S. corporate profits: model vs actual**  
% change, YoY



**OECD global leading indicator**  
Index, amplitude adjusted



**But there are concerns about the real cost of money being set so close to zero**, which makes it harder to distinguish between well-founded and reckless risk-taking. Jeremy Grantham (and others) have highlighted investor dynamics that the Fed and other central banks may be fostering. For the third time in a decade, investors are encouraged to bid up asset prices, believing that the cost of money/return on savings (a) will be low for an extended period. Add some cynicism on Grantham's part regarding the Fed's role in helping incumbent administrations get re-elected: he cites higher-than-average equity market returns in the third year of Presidential cycles since 1932, a trend we have illustrated below. His concern is an unsustainable rally, which then results in another severe correction, but at a time when government resources to address it are depleted.

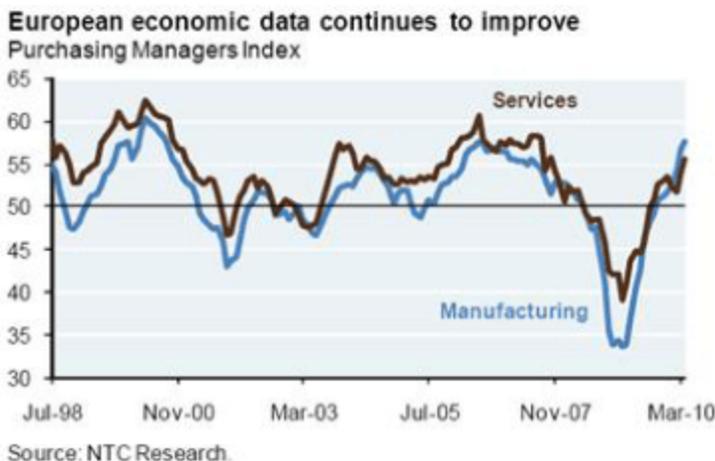


**We share some of his concerns.** Our former Chief Economist John Lipsky used to show the chart above (right): over the last 70 years, the volatility of U.S. GDP declined massively, after the establishment of deposit and unemployment insurance, entitlements, the Fed, regional transfers from the Treasury during recessions, and other safeguards. **Unfortunately, equity market volatility has not come down commensurately, as shown by the line I've added to John's chart.** It's a fierce debate, but the policies of allowing asset bubbles to form and then stimulating out of them has proven to be a wild ride for investors.

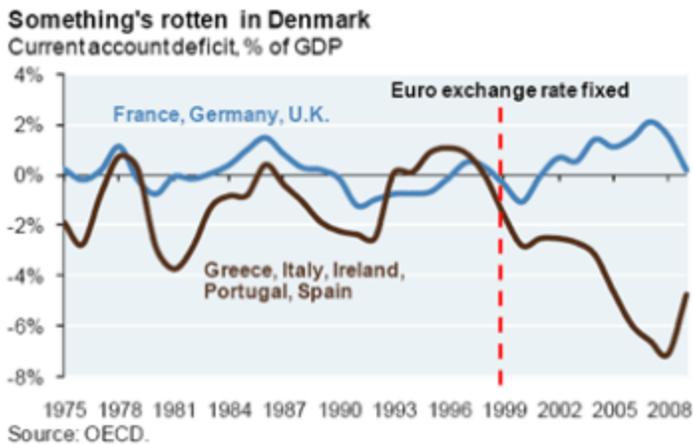
That's why our Balanced portfolios own equities at 35%-40%, but also own other strategies that we discuss in detail in these notes each week. **We consider these complementary strategies better suited to withstand market gyrations which may be endemic to how the Fed and their counterparts in Europe, Japan and China address economic cycles: "Ease First and Ask Questions Later".** As for John Lipsky himself, he's now the First Deputy Managing Director at the IMF. That leads us to...

### Greece unravels; implications for portfolios

As Greece continues to struggle (bond prices plummeting by 10 points in the last week, Athens stock exchange down 25% YTD, disclosure of additional fiscal deficit understatement in 2009), the need for a Eurozone/IMF bailout accelerates rapidly. Meanwhile, broader European economic indicators are improving. As shown below, both manufacturing and service sector surveys are above 50 (e.g., expanding), and there have been some off-the-bottom improvements in investor confidence, French consumer spending and Euro area automobile purchases. We don't want to get *too* bearish on Europe with respect to regional equity allocations. Europe already **trades at a modest discount to U.S. equities (see second chart)**, and as discussed below, we're already underweight Europe, which has benefited our portfolios (European equities trail the U.S. by 10% YTD).



But despite better cyclical news, **there's still something rotten in Denmark**. For much of the post-war era, the European peripheral model involved unwelcome bouts of inflation and devaluation. A common currency brought down inflation, and allowed for a consumption and real estate boom. But this led to even larger imbalances (see chart) which are now being unwound, perhaps **at a greater economic and social cost** than in prior recessions (current Spanish unemployment of 20% is no different than pre-EMU peaks, and may last a lot longer this time). There are questions that a doubling of the Greek bailout to EUR 90 bn, which Bundesbank President Weber warned may be needed, still won't solve. The IMF and Eurozone have a delicate task on their hands to placate public opinion, and prevent contagion to Spain and Portugal, whose credit spreads are rising. **Referring back to our February 11<sup>th</sup> paper, we must continue to be Cynics, and weigh the risk of unthinkable outcomes in the European Monetary Union.**



#### **Portfolio implications of the Greek crisis: remain cautious on Europe**

- We began 2010 by reducing exposure to long EUR vs US\$ positions; our long-term target is 1.15 US\$/EUR
- We purged Greek bonds from separate accounts and diversified fixed income funds at higher prices
- We are 10% underweight European equities relative to our normal weights, based on the MSCI all-country world index
- We are overweight Germany relative to the rest of the region, and within Germany, our exposure is linked to mid-market exporters rather than larger, domestically-oriented firms. Both of these decisions have added value in portfolios this year
- While regional positioning by hedge funds is fluid and subject to change, our managers are generally underweight European equities relative to other regions which have outperformed this year (the U.S., Asia and Japan)

#### **For litigants and bondholders only: A Greek debt restructuring?**

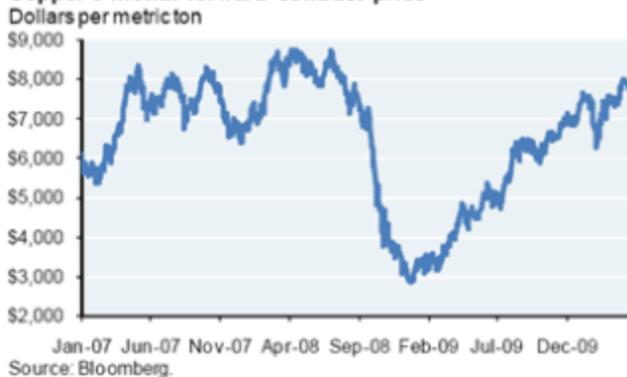
There are many permutations of what a debt restructuring might look like, and it's too early to speculate on them now. But a recent presentation made by an expert on these topics from Cleary Gottlieb (counsel to defaulting sovereigns everywhere) provided some clues. It highlighted the flexibility associated with the 90% of Greek bonds that are subject to Greek (and not U.K.) law, even if denominated in Euros. Examples: no cross-default, no negative pledge, and no collective action clauses. As a result, Greece's options are expanded regarding leverage in debt exchanges, and bondholder subordination to official creditors like the IMF. This might help Greece in the short term, but not sure that peripheral Europe would benefit from capital markets disputes highlighting the differences in their respective legal systems. According to BIS data, 75% of Greek bonds are held by Greek and other European banks who may have little room to absorb large losses.

## A quick note on commodity investing: China and Copper

In August of 2009, we did an in-depth analysis of China and its commodity consumption. While China consumes a lot of commodities, it produces them as well: China meets almost all of its zinc, lead, aluminum, corn and natural gas demand through domestic production. The commodity with one of the greatest imbalances is copper, met only 70% by internal Chinese production.

But by August of 2009, the reflation rally had resulted in a doubling of copper prices from the bottom in March. At the time, we were still optimistic on copper prices, but sought to manage downside risk and still capture some upside. Our investments were structured to terminate and pay a specified return should certain price targets be met, which has been taking place during the continued copper price increase early this year. More broadly, we continue to invest in commodities using strategies which trade away upside in exchange for substantial downside protection.

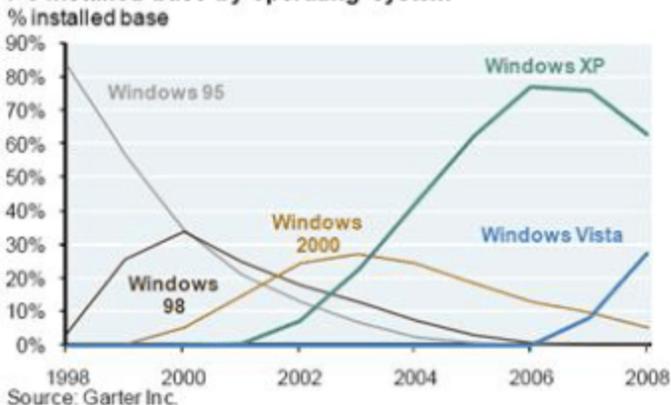
**Copper 3 month forward contract price**



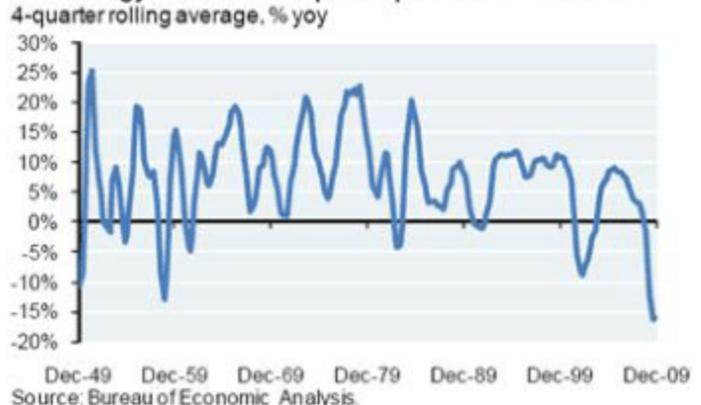
## The technology upgrade cycle

The average age of the U.S. capital stock at 8.7 years is as high as it has been since the late 1940s. With the profits rebound and corporate cash balances at elevated levels, firms are beginning to resume capital spending plans. Although tech and software capital spending has been in decline since 3Q 2008, North American semiconductor bookings are up 400% year-on-year and have returned to late 2007 levels. A few months ago, we showed the chart below (left, below) highlighting the limited adoption of the Vista operating system, and the reliance on older operating systems like XP. We expect Windows 7 to get a better reception and spur a stronger replacement cycle. For investors interested in individual stocks, we're analyzing companies linked to software solutions (security and systems management) as well as hardware and components for PCs and mobile devices. On average these sectors are trading at a 25-30% discount to their prior 5-year average P/E.

**PC installed base by operating system**



**Technology & software capex is poised for a rebound**



Michael Cembalest

Chief Investment Officer

J.P. Morgan Private Banking

## Notes

Jeremy Grantham is the Chairman of Boston-based asset management firm Grantham Mayo Van Otterloo, and is one of the scions of the investment industry. EMU = European Monetary Union; OECD = Organization for Economic Co-operation and Development; MSCI = Morgan Stanley Capital International; TARP = Troubled Asset Relief Program.

(a) In a prior EoTM, we estimated the annual subsidy from savers to borrowers at ~\$70 bn due to a 0% Fed Funds rate.

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