

From: Justin X Gratz <[REDACTED]>

To: Undisclosed recipients;;

Subject: Eye on the Market, April 7, 2010

Date: Mon, 10 May 2010 10:40:00 +0000

Attachments: 5-07-10_-_EOTM_-_The_Maginot_Line.pdf

Inline-Images: image017.png; image018.png; image019.png; image020.png; image021.png; image022.png; image023.png; image024.png

Eye on the Market, April 7, 2010 *(the attached PDF of this email is much easier to read)*

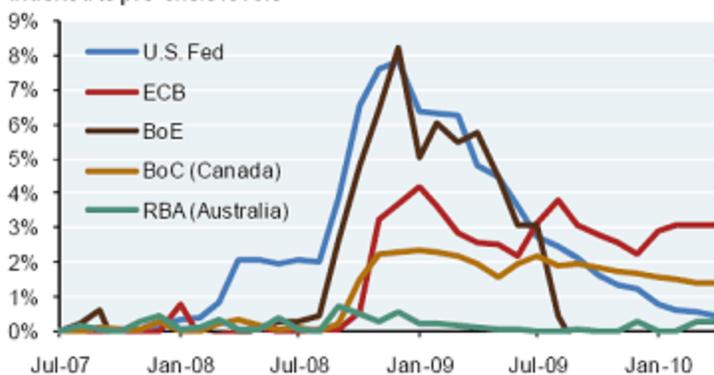
Topics: European contagion spreads

There's a correction underway and I want to make sure to communicate our take on this, and how it's affecting portfolios. Let's start in Europe. From the onset, many policymakers, investors and analysts have been way too optimistic and not cognizant enough of the realities. "Greece is not Argentina", they said; they're right, but only because Greece is actually worse (a). Some are critical of the ECB; [REDACTED] not sure that's fair, since their options are all pretty terrible. The Sovereign Default Time Capsule we published in March remains the lens through which we see this crisis, and explains the short Euro, underweight European equity/bond positions we've held all year long, and that our portfolios are not in typical post-recession growth mode.

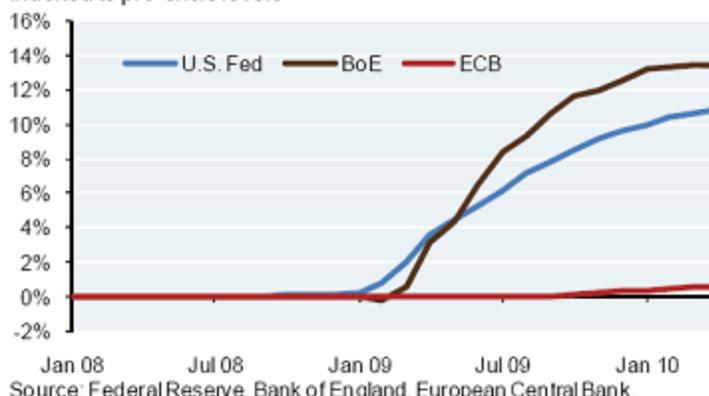
First, what has the European Central Bank (ECB) done so far to help?

As shown, the ECB is now lending more to its financial system than other Central Banks [as an aside, the Fed/BoE were proven correct, in that repayment of their credit facilities demonstrates that part of the crisis was a liquidity squeeze]. But unlike the Fed and Bank of England, the ECB has done almost no "quantitative easing" (QE), which refers to the printing of money to buy government bonds. That is exactly what the ECB is being pushed to do by market participants: buy government bonds, and give peripheral European countries a chance to enact fiscal adjustments without having to access debt markets at the same time.

Lending facilities to financial institutions as % of GDP
Indexed to pre-crisis levels



Direct asset purchases (QE) as % of GDP
Indexed to pre-crisis levels



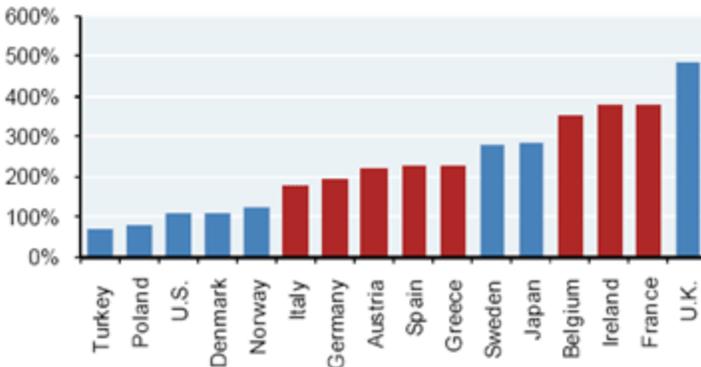
Why hasn't the ECB engaged in QE, like the Federal Reserve and Bank of England?

Some of my colleagues assume the ECB is blind not to be already buying government bonds. ■ not so sure, for 4 reasons:

1. Monetization of government deficits used to be a dirty word in public finance. It was akin to taking your sister to the prom, and was often the province of poorly managed countries that could not place Treasury bonds with their own citizens (b). The Fed and BoE have legitimized the practice, but in neither case do we know what the final cost might be in the long run. You can't blame the ECB for being concerned about potential QE risks, primarily related to inflation.

2. Banks are much bigger in Europe. If the ECB goes down the road of increasing its balance sheet to buy government bonds from banks, it might have to increase in size way more than the Fed did. Banks are much bigger in Europe, and hold 25%-30% of Eurozone government debt. Even with the support shown above, the ECB is still only financing 2% of Eurozone bank assets.

Bigger banks, bigger problems
Bank liabilities as % of GDP

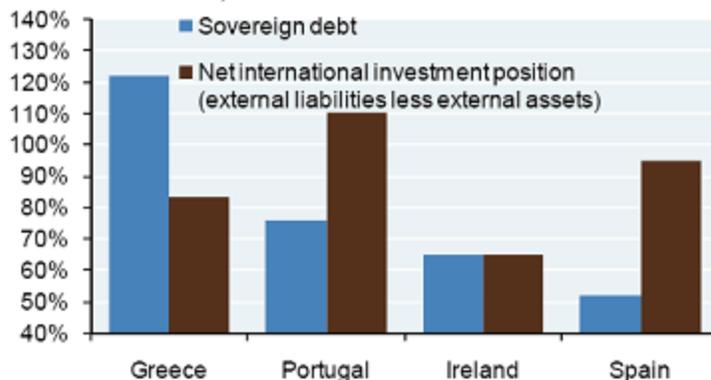


Source: Central Banks.

3. The U.S. engaged in QE during a frenzy of de-leveraging, and in UK, to boost demand. **In Europe, it would be for neither reason,** but to monetize deficits of member countries. As a result, markets might not respond as well to QE as its supporters believe. **Again, this is not just about Greece, and not just about government debt.** As shown in the chart below, while *sovereign* debt of Spain, Ireland and Portugal is lower than in Greece, these countries suffer from similar problems regarding overall debt, deflation and competitiveness vs Germany. Greece's fiscal condition is so poor that it might be a mistake to assume it defines the Maginot Line here.

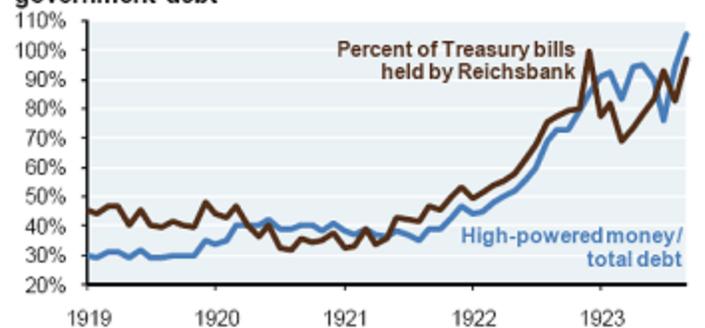
4. Americans may under-appreciate the shadows of history. The bad memories of debt monetization in Europe are still alive, and affected how Germany sacrificed its monetary policy and joined the EMU: with strings attached. As shown below, the Weimar Republic's debt was completely monetized, leading to hyperinflation and calamity by 1923, the year my mother was born in Vienna. It is not that long ago.

Greece vs the rest: Higher sovereign risk, but similar overall debt levels, % GDP



Source: Bridgewater Associates, LP.

Remembrance of things past: Monetization of Weimar era government debt



Source: "The Supply of Money and Reichsbank Financing of Government and Corporate Debt in Germany", 1919-1923, Steven B. Webb, 1984; *The German Inflation 1914-1923*, Carl-Ludwig Holtfrerich, 1986.

What may happen next, and the example of the UK

There will likely be a flurry of activity over the coming days, during which a lot of things are possible:

* ECB and Federal Reserve may re-open swap lines to provide liquidity to European banks that borrow in US\$. Around 2/3 of all commercial paper and certificates of deposit owned by U.S. prime money market funds are issued by European banks

* ECB may expand repo lines, and relax collateral rules further (at this point, I imagine you can borrow against art and chocolate with the ECB)

* ECB and IMF may announce broader credit facility for Spain, Ireland and Portugal; the IMF lent 30x its quota for Greece

* ECB may reverse the course of history and engage in quantitative easing (buying government bonds)

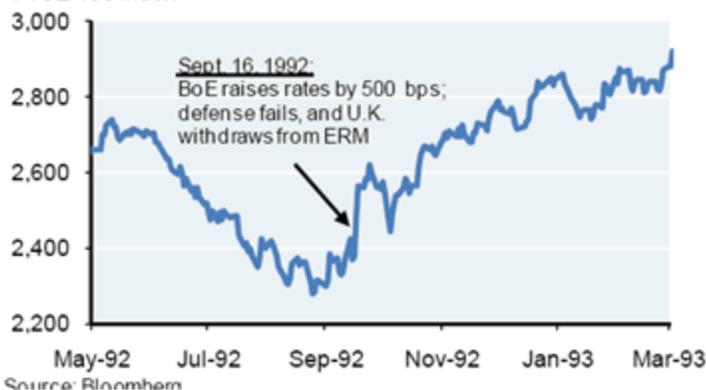
* G3 Central Banks may intervene and buy the Euro, as they did after the 1985 Plaza Accord (when they bought DM)

But these things may take time to pull together, and the last few months show that the wheels of crisis management turn slowly in Europe. **The other risk is that they do little to change the problems of a European Monetary Union lacking some components of a durable monetary union, particularly during a deep recession.** Where will it end? I think we've done a good job of predicting we would get here, and quickly. But now it's more complicated, as governments have tough choices to make, and comments like these from Chancellor Merkel are at best very confusing: "*Governments must regain supremacy. It is a fight against markets and I am determined to win this fight*".

Sometimes, equity markets only rally for good when a flawed monetary system is abandoned. In September 1992, the FTSE (UK) Index started to rise, not because the huge increase in short term rates by the BoE was expected to work; **it's because it was expected to fail**, and bring to an end an adjustment delivered by austerity alone. I have included in the appendix the chart from last week showing how unlikely it is for Greece (or Spain, for that matter) to endure a massive adjustment without a weaker currency. **None of the Fed/ECB policy options above will solve that.**

U.K. stock market, 1992 - 1993: better off alone

FTSE 100 Index



European Monetary Union: Survivability Checklist

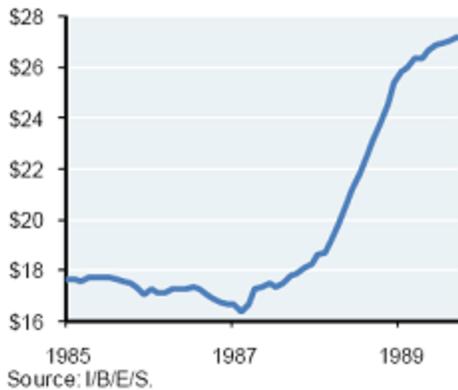
* Capital mobility	Yes
* Lender of last resort	Yes
* Labor mobility	Not really (10x < US)
* Regional transfers	Not seamless or cyclical
* Constraints on regional indebtedness	On paper only
* Tight band of productivity differentials	Worsening from EMU inception

On portfolios, profits and equity market forecasts

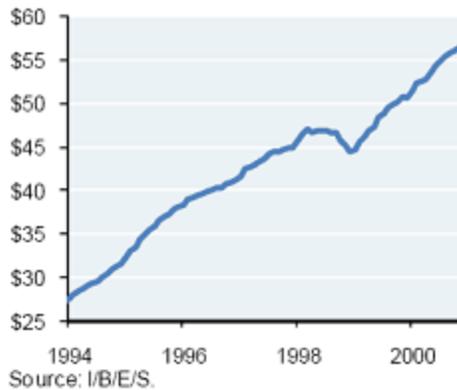
Europe's financial condition was the very first risk factor we talked about in our 2010 Outlook. This latest episode highlights the pitfalls of only looking at corporate profits when deriving investment portfolio allocations. During the early stages of a recovery, rising corporate profits can be a powerful driver, resulting in increased hiring, capital spending, consumption, confidence, etc. But as shown below, **some severe corrections in equities took place when profits were**

still rising. If you were not paying attention to other imbalances in the global financial system, you walked right off a cliff.

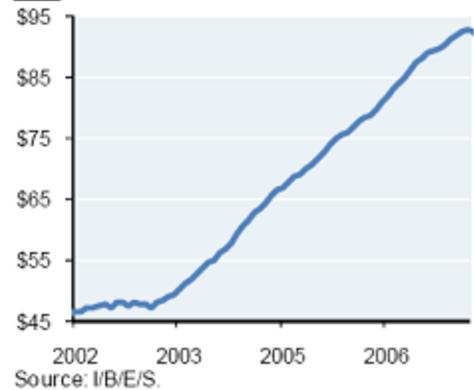
Before the S&L collapse...
S&P 500 12 month trailing EPS



Before the tech collapse...
S&P 500 12 month trailing EPS



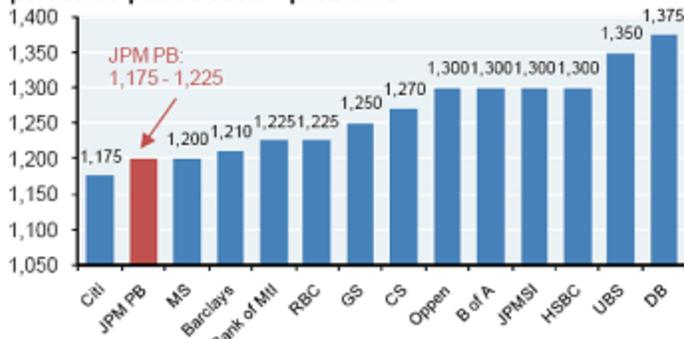
Before the credit crisis...
S&P 500 12 month trailing EPS



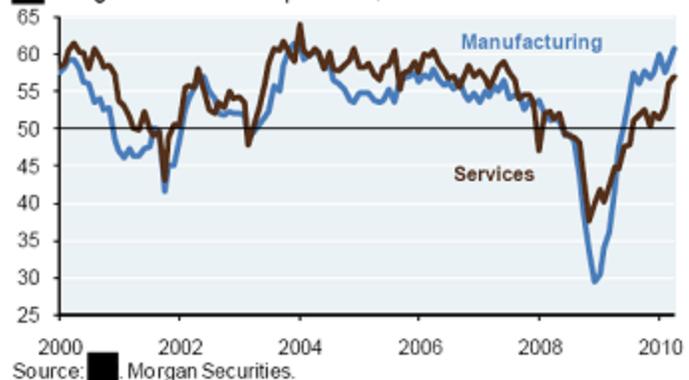
The U.S. payroll report today was quite positive, and confirms the view expressed in prior notes that leading indicators of employment were looking better, both in the U.S and outside it. U.S. profit margins and productivity are close to their highest levels over the last 40 years (that's one reason we are so overweight the US vs other regions). In addition, the global production boom is still in full swing, even in Europe, where German factory orders rose 5% in March, and German industrial production was up 4%. Regional manufacturing surveys are even rising in Spain, Ireland and Italy (at least through the end of April).

But there are limits to cyclical improvements when structural problems get in the way. That's why we think many sell side forecasts for 2010 equity market returns are too high. We expect U.S. equities to post +7% to +9% returns this year, with a lot of volatility along the way. Even with an earnings rebound and a cyclical recovery, our view does not argue for very large allocations to equities, which is why they are at 35%-40% in our Balanced Portfolios, with downside protection on large components of those equity positions. Allocations to commodities, credit and hedge funds with low net exposures make up most of the difference. The portfolios we put together back in December were meant for a year of cyclical improvements and jolting disappointments linked to the recession's aftermath, the latter of which we are getting in spades.

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



Global rebound still on track for now
Morgan Global PMI output index, sa



Chief Investment Officer

J.P. Morgan Private Banking

Notes

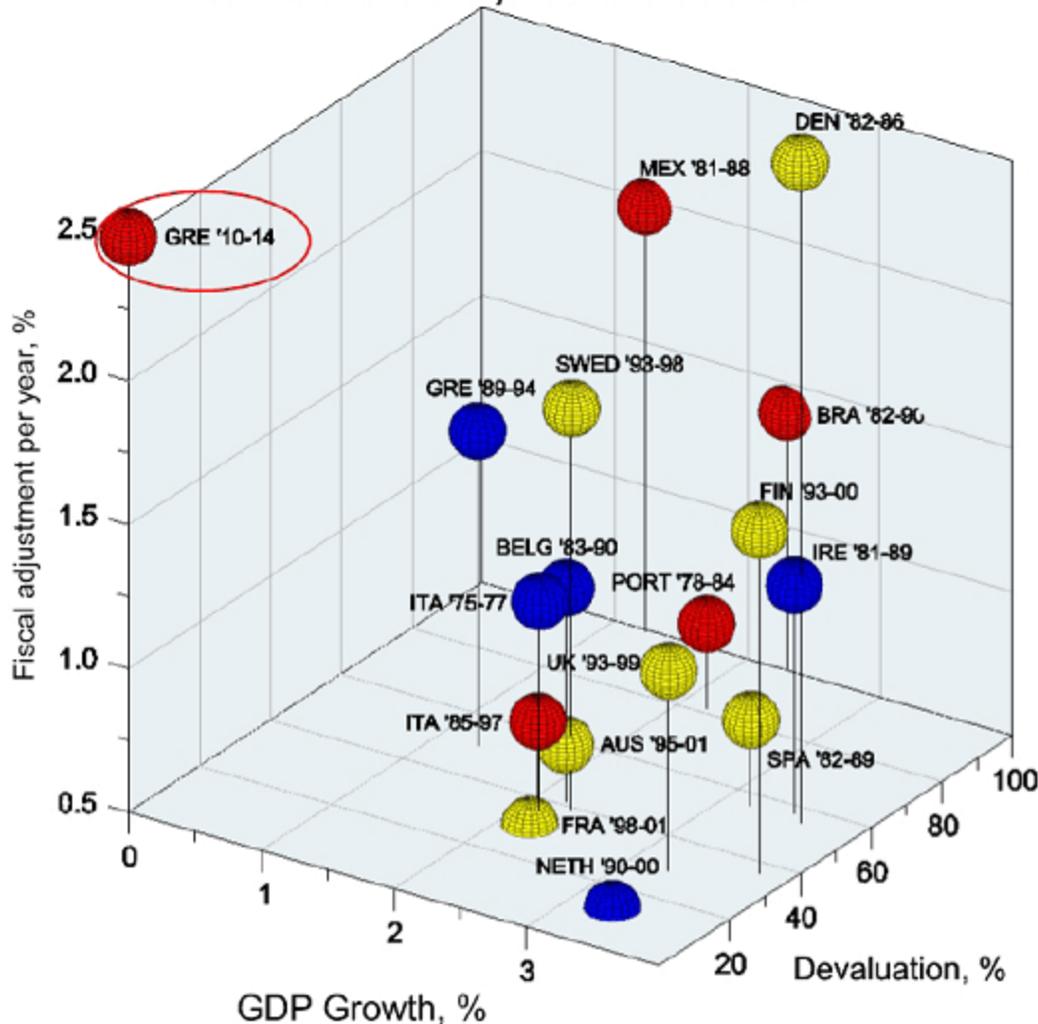
(a) 2001 Argentina debt/GDP, current account deficit and budget deficit: 62%, 1.7% and 6.4%. Greece 2009: 114%, 11.2% and 12.7%. Both countries lost competitiveness by 20% over the prior decade, pricing themselves out of export markets and boosting consumption of imports.

(b) Recent examples include Venezuela, where the Central Bank transferred ~\$30 bn to Fonden, an agency whose operations include activities normally funded through the Treasury.

Appendix: Greece's fiscal adjustment, in four dimensions

We showed this chart last week to convey what we've been writing for months: **austerity alone is a difficult and unproven road**. The March 2012 Greek government bond price is falling, even though it matures within the window of the Eurozone-IMF facility, since markets do not believe Greece will deliver on its austerity promises. From the perspective of this chart, it would be a miracle if they did. In this version, we added 1980s **Mexico and Brazil** as further evidence of our conclusions.

2010 Greece Fiscal Adjustment: No Man's Land



Color indicates size of beginning of period tradables sector/GDP: Red <45%, Yellow 45%-75%, Blue >75%.

The material contained herein is intended as a general market commentary. Opinions expressed herein are those of Michael Cembalest and may differ from those of other J.P. Morgan employees and affiliates. This information in no way constitutes J.P. Morgan research and should not be treated as such. Further, the views expressed herein may differ from that contained in J.P. Morgan research reports. The above summary/prices/quotes/statistics have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness, any yield referenced is indicative and subject to change. Past performance is not a guarantee of future results. Securities are offered through J.P. Morgan Securities Inc. (JPMSI), Member NYSE, FINRA and SIPC. Securities products purchased or sold through JPMSI are not insured by the Federal Deposit Insurance Corporation ("FDIC"); are not deposits or other obligations of its bank or thrift affiliates and are not guaranteed by its bank or thrift affiliates; and are subject to investment risks, including possible loss of the principal invested. Not all investment ideas referenced are suitable for all investors. These recommendations may not be suitable for all investors. Speak with your J.P. Morgan Representative concerning your personal situation. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Private Investments often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuation information to investors and may involve complex tax structures and delays in distributing important tax information. Typically such investment ideas can only be offered to suitable investors through a confidential offering memorandum which fully describes all terms, conditions, and risks. IRS Circular 230 Disclosure: JPMorgan Chase & Co. and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with JPMorgan Chase & Co. of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties. Note that J.P. Morgan is not a licensed insurance provider. © 2010 JPMorgan Chase & Co