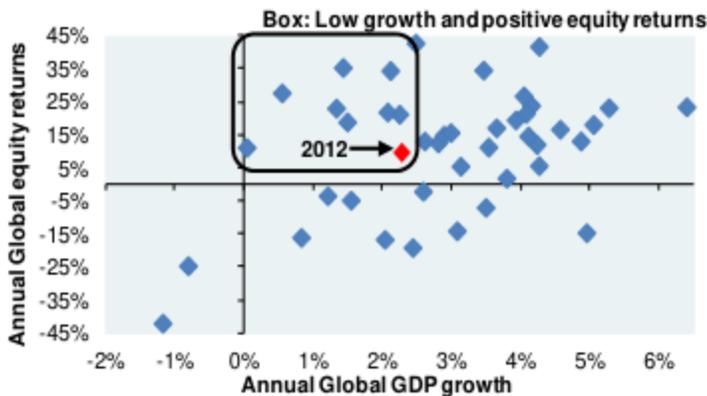


**How investors have been rewarded (so far) by assuming Europe will monetize the debt no one else wants to own; Mark Twain and the Death of Equities**

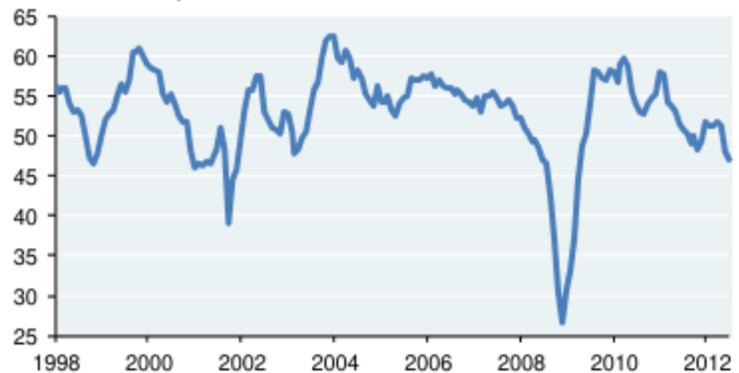
**Most of the time, corporate profits and equity market gains coincide with decent economic growth; but not all the time, and so far, not in 2012.** As you can see below, GDP growth has disappointed this year and leading manufacturing indicators are weak. There are recent signs of improved consumer activity in the US and China, but growth has been considerably slower than consensus and IMF expectations. Nevertheless, global equity markets are up 10%. US equities have led the way, followed by Asia ex-Japan, Europe and then (as usual) China and Japan, an order we anticipated in January's Outlook.

**Global equity returns vs GDP growth, 1970-2012**



Source: Bloomberg, OECD, Haver, J.P. Morgan Securities, LLC, JPMAM. For 2012, Equity return is from 12/31 to 08/30; GDP is 1H annualized.

**New global manufacturing orders, slowing down again**  
Index, 50+=expansion



Source: J.P. Morgan Securities LLC.

**Why are equity markets doing this well?** Hard to say for sure, but it appears to be due to a new high in S&P profits in Q2 (although profits *growth* is slowing); low P/E multiples to start the year (12x in the US and 9x in Europe); assumptions that the US fiscal cliff (i.e., legislated tax drag) will be negotiated from ~3.5% of GDP to ~1.5%; a lot of investor bearishness a few months ago (when there was a peak in the ratio of put options bought relative to calls on the CBOE); the promise of more easy monetary policy from the Fed; and most importantly, the actions and statements of the **“European Creosote Bank”**.

On the last item, let's back up. A year ago, we published the *“European Minifigure Union”* with a diorama of plastic figures to illustrate the debate in the EU as to who should pay for the debt crisis. The diorama showed that France, Spain, Italy, most parties in Germany, future potential EMU members like Poland, and the community of bondholders and stockholders, all want the European Central Bank to foot the bill. **A year later, it looks like they will get their wish.** ECB President Draghi said all steps will be taken to preserve the Eurozone, and that elevated Periphery credit spreads are interfering with EU monetary policy. As a result, he will presumably step in to correct them by either buying bonds or lending to entities that will do it for him.

In doing so, the ECB's balance sheet could easily grow by another trillion Euros (see below), at which point it's fair to describe it as the **European Creosote Bank**. I can't go into much detail as to what I mean by that; it has to do with a fictional character who sat down for dinner and ate several plates of mussels, pate de foie gras, beluga caviar, eggs benedict, leek tart, frogs' legs, and quail's eggs; a plate of jugged hare with truffles, bacon, Grand Marnier, anchovies and cream; all washed down with six bottles of Château Latour, a jeroboam of champagne and six crates of brown ale. The results in this case were not pretty.

**How will it work out in Europe? The immediate benefits of central bank debt purchases feel great:** defaults by banks and governments are postponed, banks benefit from increased net income due to cheap funding from the central bank, and there's a perception of normalcy as the ECB forces short-term bond yields back down. Markets get a respite from bad news, since investors don't have to wake up every morning to see what happened in Europe that day. And for the intrepid, European stocks *might* be seen as a bargain. As shown on the next page, European stocks *might* be seen as a bargain. As shown on the next page, European stocks trade at a large discount to the US after a ferocious period of underperformance (readers of this note were advised this was likely to happen three years ago). The tally: since January 2010, the S&P returned 33%, compared to 1.5% for MSCI Europe (which includes the UK and Scandinavia), and -14% for the European Monetary Union countries alone.

**The European Creosote Bank?**

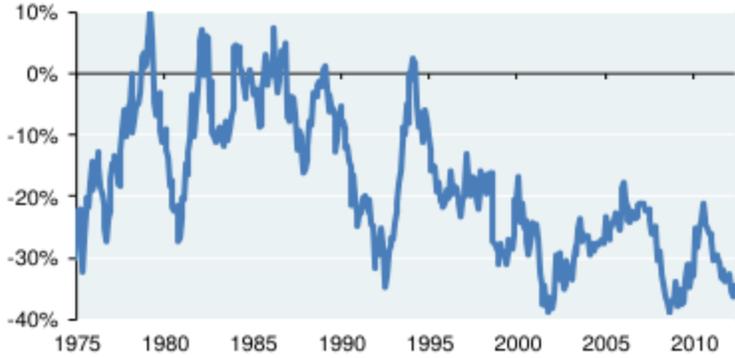
Central bank balance sheets, percent of GDP



Source: FRB, BEA, ECB, Eurostat, BoE, UK Office for National Statistics, BoJ, Japan Cabinet Office.

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**European stocks trading at a large discount to the US**  
Composite premium/discount using P/E, P/B and P/Dividend



Source: MSCI, Morgan Stanley.

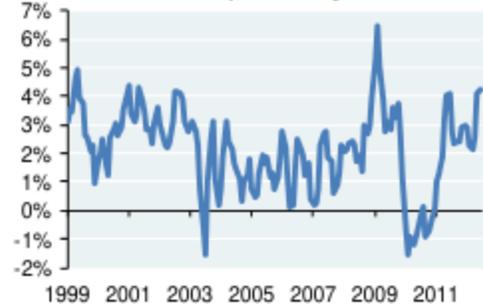
**US stocks have crushed their European counterparts**  
Cumulative USD return, January 2008 to August 2012



Source: Bloomberg.

**What are the costs and risks of ECB “debt monetization”?** There aren’t many precedents for what the ECB indicates they may do. Of course, one thing we are watching is inflation in Germany. While wage gains are starting to pick up and home prices are rising modestly for the first time in a long while, economy-wide German price increases are still well below 2%.

**Germany: wage inflation (industry incl. construction), % change, YoY, 3mma**



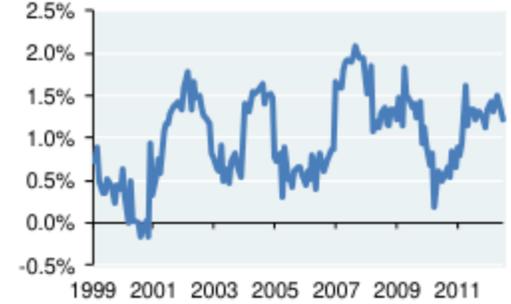
Source: Deutsche Bundesbank.

**Germany: house prices**  
Percent change, YoY



Source: Statistisches Bundesamt.

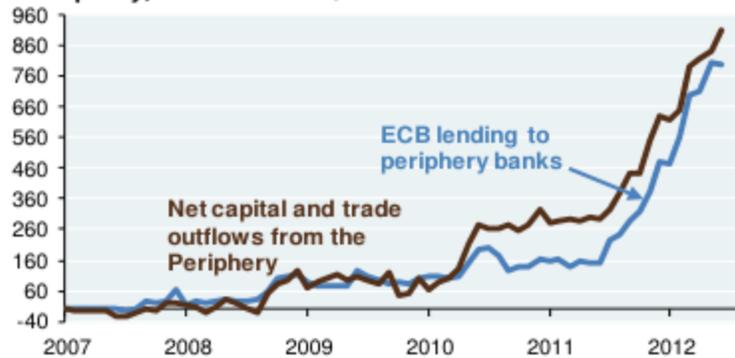
**Germany: core inflation**  
Percent change, YoY



Source: Eurostat.

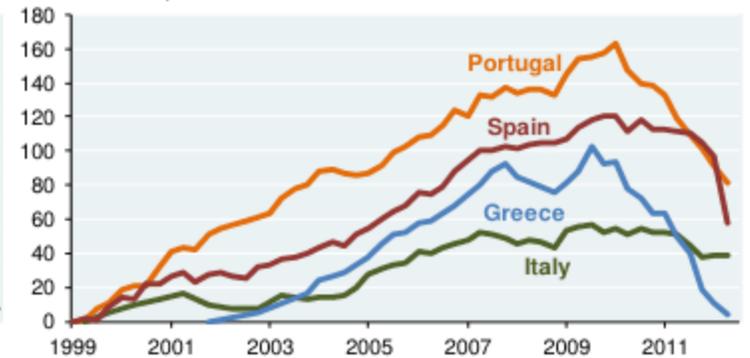
**Another risk relates to losses at the ECB.** Central banks can recognize losses over long periods of time, and do not have to disclose how or when. They can even earn “seigniorage”, which refers to the difference between the yield on bonds they buy or lend against, and their cost of money (zero). Eventually, however, the ECB might have to engineer a massive “Paris Club” debt renegotiation, which is how governments forgive and restructure debt owed by developing countries. A Paris Club outcome seems more likely than the ECB having an actual exit strategy for its purchases and loans. **After all, let’s remember why the ECB is printing like crazy: southern Europe is seeing the largest outflow of capital that the modern world may have ever seen (see below). Pictured from above, it rivals the great annual migration of the wildebeest across the Serengeti, and the chaotic migration of millions of Hindus, Sikhs and Muslims when British India was divided into India and Pakistan in 1947.** Without the ECB, there would probably already have been more sovereign and/or bank defaults in Europe.

**ECB lending keeping pace with capital flight from the Periphery, Billions of Euros, cumulative**



Source: JPMAM, Haver.

**Running of the bulls: outflow of foreign private investment**  
Cumulative, percent of GDP



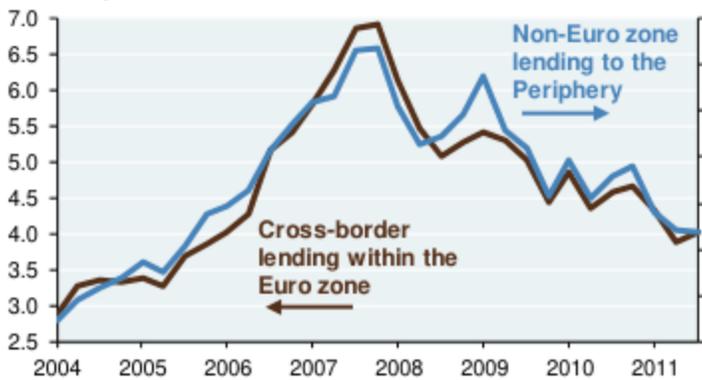
Source: National central banks, JPMAM.

**How investors have been rewarded (so far) by assuming Europe will monetize the debt no one else wants to own; Mark Twain and the Death of Equities**

Here's another look at how EU financial integration is being unwound: cross-border lending within the Eurozone is collapsing, as is lending to Europe from banks outside it. The news in Spain is mostly dreadful: 25% unemployment, rising bank non-performing loans, deposit flight, surging corporate bankruptcies (see chart), etc. Italy does not have all the severe problems that Spain does, but Italian growth is expected to be -2% this year, and the prospects for a strong recovery seem remote.

**The unwind of EU financial integration**

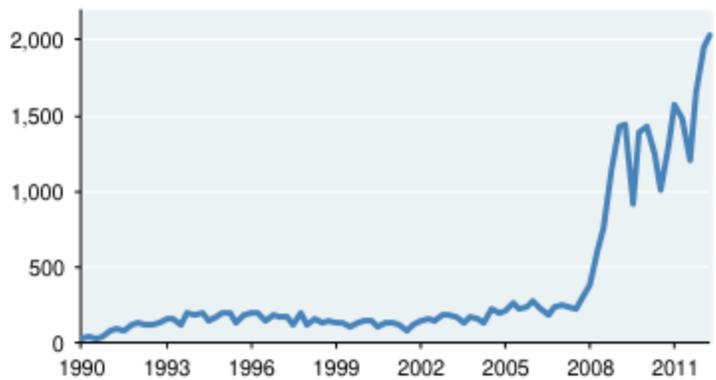
Trillions, USD



Source: BIS. Data as of Q1 2012.

**National bankruptcies in Spain**

Number of companies filing each quarter

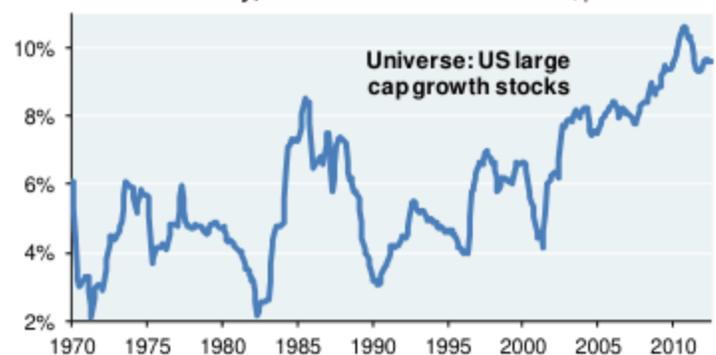


Source: INE.

So now, we wait to see if the ECB will “save” Spain and Italy again; the owners of €9 trillion Spanish and Italian sovereign and bank bonds are patiently waiting. Many economists (see Appendix) believe the cost of keeping the Eurozone together is much smaller than the cost of a break-up, an epiphany that seems to have occurred in Germany as well. Even so, the cost is likely to increase this fall; let’s see if Germany will pay it. If so, markets would love it, at least in the short term. However; while the easy money from shorting Europe vs. the US has already been made, and while EU equity valuations are low, we continue to have most of our equity exposure elsewhere. **Europe is conducting one of the most unorthodox experiments of the last 100 years (a competitiveness adjustment mostly through wage and price declines instead of currency devaluation), and they are making it up as they go.** The average maturity of Spanish and Italian government bonds has fallen sharply, suggesting that the ECB will face continued days of reckoning over the next couple of years. The ECB’s balance sheet will grow, but what no one knows is when or how it will deal with the indigestion of radically relaxed collateral terms, and trillions in loans and bonds that the private sector won’t want to own unless there is a miraculous rebound in growth and employment. I read a report from Bridgewater today outlining the steady erosion of non-commodity exports in Europe since the year 2000 (other than from Germany), yet another indication of the choke hold that the Euro has put on countries in its periphery.

**One last thing.** While the challenges the world faces are substantial, the “death of equities” stuff is a little overboard. This kind of commentary has a checkered history: Business Week and Time covers in 1979 and 1980 talked about the death of equities and asked whether or not capitalism is working, and were followed by two decades of substantial equity returns. Similarly, the timing of bearish articles like “Dow 5,000” (September 2002) and “Dow 5,000 Redux” (December 2008) also preceded substantial equity gains. The death of equities discussion made more sense in the mid 1970’s and early 1980’s, when companies weren’t making much money, and most of it got inflated away. That’s quite different today; as shown, the free cash flow to asset ratio of US large cap growth stocks is at the highest level in decades.

**“Death of equities” made more sense when companies didn’t make money, Free cash flow to assets ratio, percent**



Source: Corporate reports, Empirical Research Partners.

We can debate the multiples they deserve, but the US corporate sector is generating substantial profits in both real and nominal terms. On equities as an asset class, Twain’s comment that reports of his death had been greatly exaggerated comes to mind.

Michael Cembalest  
J.P. Morgan Asset Management

See appendix on following page

## How investors have been rewarded (so far) by assuming Europe will monetize the debt no one else wants to own; Mark Twain and the Death of Equities

### Appendix: Most economists argue that Europe should stay in its bad marriage since the divorce would cost too much

Why is Europe so important? When the Soviet Union disintegrated, the Rouble region accounted for only 2.5% of global GDP, compared to 20% for the Eurozone. Furthermore, economic output may understate Europe's impact; Eurozone banks account for 35% of global bank assets and global cross-border lending (although a lot of that is intra-Europe). The Eurozone also represents 20% of global debt markets, 10% of worldwide equity market capitalization and 25% of global FX reserves. In other words, the outcome of its economic problems matter a lot.

Most economists referenced below did not see the crisis coming, and underestimated its severity along the way. But for completeness' sake, here are some of their estimates on why it's cheaper for Europe to stay together than to break up (another example of where a pre-nuptial agreement<sup>1</sup> would have helped). The list ends with Bernard Connolly, who disagrees with the consensus; he's an important voice to listen to, given how accurately his predictions have played out so far.

- **Citi:** Willem Buiter has cornered the market in apocalyptic language when describing a Eurozone break-up: "chaotic", "pandemonium", "collapse of systemically important financial institutions throughout the European Union and North America and years of global depression". An Italian default could result in a global GDP decline of 10%, and 20% unemployment in the West. (December 2011)
- **UBS:** estimated cost of leaving the Eurozone: 40%-50% of GDP in the first year for a Periphery country, and 20%-25% of GDP for Germany. Cost to Germany to keep it together: a fraction of the break-up cost. (September 2011). UBS estimates the cost to European taxpayers of Greece leaving as being 225 billion Euros, 4x higher than the cost of restructuring Greece's debt and keeping them in. (May 2012)
- **ING:** total core country exposure to the Periphery is 2.2 trillion Euros, equal to 36% of core country GDP. A break-up would crystallize losses on this exposure, and dwarf the cost of keeping the Eurozone together. "Fixing it far cheaper than breaking it" (August 2012). First year GDP decline of 9% across the Eurozone under break-up scenario. (December 2011)
- **Petersen Institute for International Economics:** "The Economic and Monetary Union must be maintained at almost any cost. All the economic problems in the current crisis can be resolved within the EMU. A devaluation may be only a palliative or a postponement of resolution of the real problem, as has so often been the case, while the costs of the dissolution of the Euro area could be truly monumental. The exit of any single country from the EMU, at the present time when large imbalances have been accumulated, would likely lead to a bank run, which would cause the EMU payments system to break down and with it the EMU itself." (Anders Aslund, August 2012)
- **The German Ministry of Finance,** as reported by Der Spiegel: in the first year following a Euro collapse, the German economy would shrink by up to 10 percent and the ranks of the unemployed would double. (June 2012)
- **J.P. Morgan Securities:** Regarding a break-up of the EMU, the investment bank's economists believe that "the economic and financial impact for all of Europe would be worse than Lehman, which was only the most intense credit crunch in modern financial history. EMU breakup would combine that credit event with the collapse of Europe's payments and settlement system due to contract uncertainty"; a break-up would be "the economic equivalent of mutually assured destruction". (December 2011)
- **Nomura** disagrees, at least in part: "A limited break-up can be managed...Our estimates suggest that the fall-out, in terms of financial losses for banks and sovereigns, can be managed in a scenario where 3-5 countries exit the Eurozone. In addition, such a limited break-up would leave hope that a certain degree of European cooperation can be preserved following break-up. Managing a limited break-up will require a) that it is done simultaneously, not sequentially, b) that comprehensive contingency plans are formed in advance, and c) that remaining core Eurozone countries move clearly toward fiscal union". (June 2012)
- **Bernard Connolly at Connolly Insight** agrees that a Eurozone breakup would probably create a financial crisis via the bursting of a very large European sovereign, bank and corporate credit bubble. However, he also believes that if the Eurozone stays on its current path, its austerity plus lending approach will have even more disastrous consequences, by making the bubble bigger and its inevitable bursting more explosive than a dismantling of the present Eurozone.

<sup>1</sup> I spoke with Joanne Johnson in our Trust and Estate area about pre-nuptial agreements in the US. While half of marriages end in divorce and the average duration of a marriage is less than 20 years, children from wealthy families are often reluctant to press the issue of a pre-nup with a future spouse. In that case, Joanne recommends taking steps to avoid having separate assets morphing into marital assets (particularly in states like NY) through the use of trusts with trustee discretion on disbursements rather than automatic disbursements; by avoiding outright gifts; by having children not draw on trusts to fund marital expenses if they don't need to; by using "pot trusts" for multiple children instead of for specific children; and by structuring assets with other layers of entity protection. In some states, even these steps may not fully protect assets from being declared marital assets in divorce. Disclosure: I married for love without any money and was not asked to sign one.

## How investors have been rewarded (so far) by assuming Europe will monetize the debt no one else wants to own; Mark Twain and the Death of Equities

CBOE: Chicago Board Options Exchange; ECB: European Central Bank; MSCI: Morgan Stanley Capital International

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