

Topic: The intersection of politics and economics comes to a head in the US, Italy and Greece; Chart of the Year

I can't remember a time when stock price movements were quite so heavily affected by macroeconomic developments. One of our models indicates that 75%-80% of stock price movements for the S&P 100 are now explained by macro forces, a new all-time high. With that in mind, here are the latest developments in countries facing the political realities of fiscal austerity. This is not a fun time to be a politician in the birthplace of Western Democracy (Italy, Greece), or its 18th century offshoot (the US).

The United States, and the Incredible Shrinking Expectations for the Joint Select Committee on Deficit Reduction

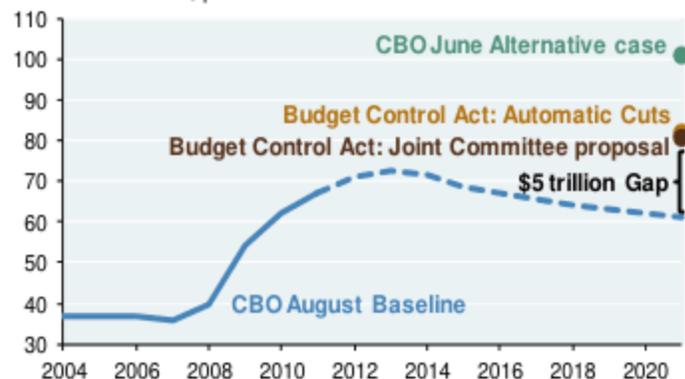
The chorus of voices calling for compromise and "big bang" long-term deficit reduction includes a bipartisan group of 100 House Democrats and Republicans in a letter to the Deficit Reduction Committee (DRC). However, so far, most policy proposals we hear about are far less ambitious, while others are already back-tracking on the Budget Control Act:

- A November 3 letter to the DRC by 33 Republican Senators calling for tax reform that lowers rates with no net tax increase
- A plan to have the DRC agree to a few hundred million of revenue increases, but then assign the task of finding them to other congressional committees, whose decisions would not be binding
- Using lower forecasts of war funding assumptions (declines in "Overseas Contingency Operations") to get to the targeted deficit reduction, rather than tackling structural deficits
- If the DRC does not come to agreement on \$1.2 trillion in deficit reduction, there are mandated, "sequestered" cuts that would impact Medicare payments, security/defense allocations and non-defense spending. The latest reports indicate that Republican senators are working on legislation to *derail* mandated cuts to on defense spending, which of course has led to calls from Democratic legislators to defuse mandatory domestic spending cuts if defense cuts are derailed

We wrote a piece on why financial markets are likely to pay close attention to the DRC (the paper, which was entered into Senate testimony on October 4th by Maya MacGuineas of the Committee for a Responsible Federal Budget, can be found here: http://www.politico.com/pdf/PPM223_financial.pdf). The accompanying chart is the starting point in the discussion. As shown, even if the DRC *does* find \$1.2 trillion in deficit reduction over ten years as per the Budget Control Act, the debt trajectory of the United States is still not stabilized, and will continue to rise based on CBO (and our) projections for growth, spending and revenues. **Celebrating the Committee's ability to get to \$1.2 trillion in deficit reduction would be like having a national holiday commemorating the U.S. military victory over Grenada.** Something like \$3 trillion in 10-year deficit reduction would be needed to ensure that the United States controls its own economic destiny¹. The current imperative for the US is job growth, which cures a lot of ills, so why consider tax increases and spending cuts at all? One of the common denominators of countries whose private sector job growth is healthy is the backdrop of a public sector that is not at risk of a sudden, destabilizing withdrawal of foreign capital. What's happening in Italy and Greece are examples of what can take place when that is no longer the case.

U.S. long-term debt scenarios

Net debt to GDP, percent



Source: Congressional Budget Office, J.P. Morgan Private Bank.

Italy, Economics > Politics, and the Chart of the Year

To keep this note limited to 3 pages, we cannot spend too much time describing the workings of the Italian Parliament (there have been 14 Italian governments since the inception of the European Monetary Union). As reported by Il Corriere, finance minister Tremonti warned Prime Minister Berlusconi that if he did not step down, there could be a "disaster in financial markets"; Berlusconi replied that the problems were more a function of Tremonti "speaking ill about me". All we can say is that a technocratic government may be getting closer if Berlusconi continues to lose support in the Popolo della Libertà, perhaps led by former EU Competition Commissioner Mario Monti (known in some circles for his decision to block the 2000 GE/Honeywell merger, and fines levied against Microsoft). Monti is a supporter of EU Federalization; although given the subsidies for countries like Italy that Federalization implies, I can't imagine why any Italian economist would ever oppose it.

While markets might welcome a technocratic government, keep in mind that the lesson of the last 2 years is that in the long run, **economics trump politics**. Here are 5 things to keep in mind about Italy's economy, with references to when we included the corresponding charts in the EoTM:

¹ If it doesn't, be prepared to read more editorials like this: http://news.xinhuanet.com/english2010/indepth/2011-08/06/c_131032986.htm

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1. Other than during its participation in WWI/WWII, Italy's debt is at the highest level since reunification in 1861 (Sep 21)
2. Italy has not experienced the labor competitiveness adjustments seen in Ireland, has among the worst "production time per unit" in Europe, and relies more on foreign capital than at any time since 1975 (Sep 21)
3. The decline in Italy's debt-to-GDP ratio during the late 1990's was heavily based on EMU convergence which resulted in Italian interest expenditures to GDP falling from 11% to 4% (Oct 5); this is a one-trick pony that is now going in reverse
4. The primary budget surplus Italy ran in the 1990's was based mostly on higher taxes rather than reduced spending (Oct 5), providing less of a blueprint for the current period, when the primary surplus will also need to be around 4%-5%
5. Loan loss provisions held by Italian banks on their performing loans are 15%-25% of comparable levels in the US (Nov 1)

On top of these structural issues, the latest surveys show a sharp decline in output in Italy, suggesting that a recession is coming (see right). Our Chief Economist Michael Vaknin estimates that even with a primary surplus of 3%, if accompanied by a modest recession of 1.5% of GDP in 2012, 5% interest rates and 1% inflation, Italian debt would rise rather than fall over the next 3 years.

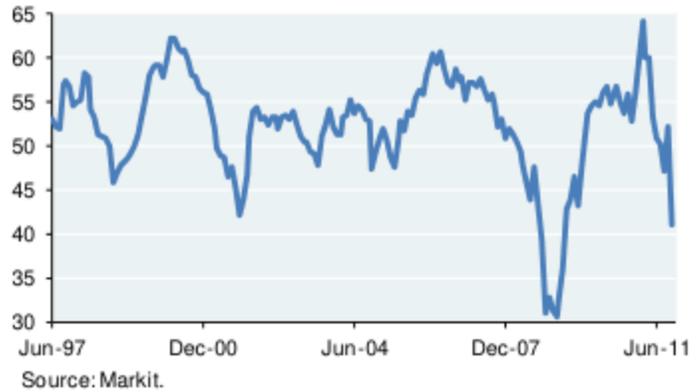
The ECB would like to see the Italian Parliament do the following: reform collective wage bargaining, allowing companies to tailor wages and working conditions to firm-specific needs; review rules regulating hiring and dismissal of employees; create a fund to help with worker reallocation; and tighten pension eligibility criteria. Whether this would unleash a productive surge in Italy is anyone's guess². **Italy's stubborn growth and productivity gap with Germany brings us to the Chart of the Year.**

Chart of the Year. This was a difficult choice, as we have shown 511 different charts in the *Eye on the Market* so far this year. To be eligible, the chart has to capture a trend that had a large impact on markets, and also has to be easy to understand (not the case for all our charts). **The winner: the one showing the divergence between German and Italian industrial production, which began like clockwork when the Euro was adopted.** Instead of explaining the reasons that this chart won, I will summarize as follows. If I told you that this economic outcome was the by-product of belated efforts by the Allied Powers of the 1940's to sow dissension and discord in the ranks of the Axis Powers, it would make more sense than to discover that this is the result of an economic model *willfully adopted by the countries themselves*. As a reminder, Italy has more debt outstanding than Germany, despite being a considerably smaller economy.

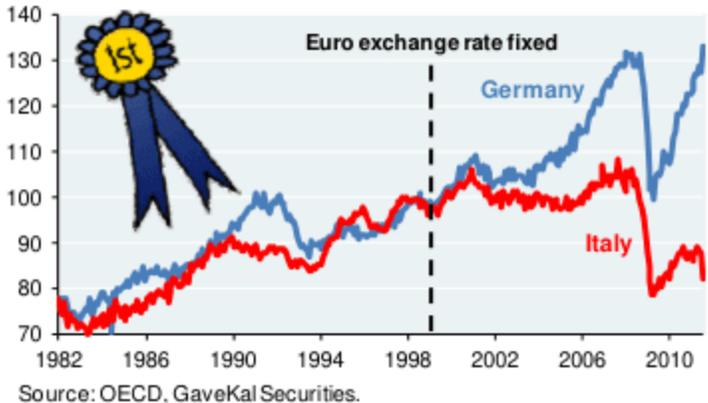
Greece and Chaos theory

At times like this, it's worth remembering that "chaos" is a word of Greek origin (χάος). Over the past 48 hours, Greece has been contemplating public referendums (the way Ancient Athens used to sort things out), early elections, national unity governments, etc. As with Italy, the Greek government needs an explicit vote of support, either from the opposition parties or the public at large, to continue with its failed, IMF-approved experiment of fiscal austerity within the confines of a fixed exchange rate. Markets might like the fact that there will be no referendum or early elections; **I think that is a mistake**. The political and social fabric of Greece is in shreds; the lack of a safety valve allowing public consent to continued austerity is potentially dangerous. A national unity government designed to simply re-approve austerity plans and secure the next EU disbursement may have no more political legitimacy than the current one.

Plunge in Italian manufacturing survey points to recession
PMI, output index, sa



Industrial production in Germany and Italy
Index, 12/31/1998 = 100, sa

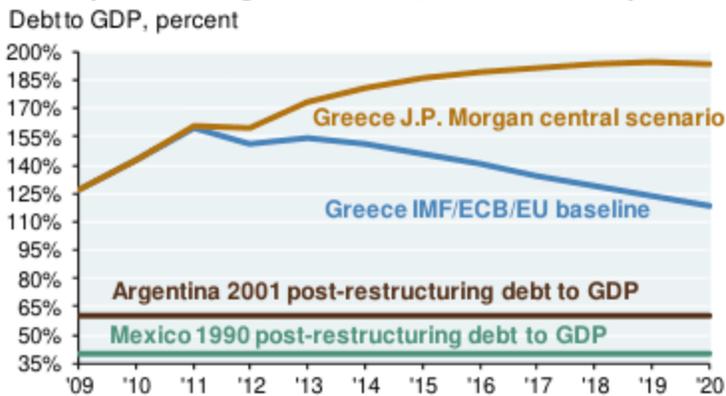


²Unfortunately for Italy, of all reforms, labor market reforms are the ones with the largest short-term negative impact on growth. See "Fostering structural reforms in industrial countries", IMF, 2004, Chapter 3, Exhibit 3.9.

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Why isn't the recently proposed debt exchange calming things down? The proposed debt exchange is designed to include the "voluntary" participation of European banks, which own 85 billion out of Greece's 375 billion in debt. There's another 100 billion or so held by a variety of private sector entities that might participate, but the incentives at the current time are unclear³. The remainder is held by the IMF, ECB, EU and Greek Social Security Funds, which are reportedly not participating. As a result, as shown in the first chart, Greece's debt burden is still crushing, even assuming 50% debt forgiveness and 150 billion of participation. All the scenarios are bad, even the one crafted by the IMF; compare them to prior post-restructuring debt levels in Mexico and Argentina. **The EU approach to Greece from the beginning has violated the principles the official sector learned a long time ago:** you cannot impose austerity from outside without visible contributions by external creditors that make the country's finances sustainable (see box).

Greek post-exchange debt levels, with some comparisons



Source: EU, J.P. Morgan Securities LLC, Banco de México, Ministerio de Economía y Producción.

A lesson that EU policymakers forgot to read

From the World Bank's archives, in 1990:

"Mexicans have made such enormous adjustments, accepted such a large reduction in living standards, that any package without an extensive and visible contribution by external creditors would not be acceptable domestically"

"Mexico's External Debt Restructuring in 1989-90", June 1990, S. van Wijnbergen, World Bank Regional Working Paper 424.

For what it's worth, I do not subscribe to the economic orthodoxy that it is axiomatic that Greece would be worse off defaulting and exiting the Euro. This is speculation, and my opinion doesn't matter anyway. But I find it interesting that some people who have misjudged the severity of the EMU crisis from the beginning are the voices most convinced that an exit from the EU would result in a greater disaster for Greece worse than the one that is already upon them.

Let's start with this table. These are estimates of Greece's "primary balance", the budget deficit they must close by increasing taxes or cutting spending, before considering interest expense.

The bottom line: by 2012, Greece will be much closer to being in balance before interest, raising the incentive to default on its external debt. A default and exit from the Euro would most likely knock Greek GDP for a loop (again), which could reintroduce a primary deficit. But there's no question that Greece is closer now than it was a year ago to being able to consider a default/exit option that does not automatically entail another massive fiscal contraction.

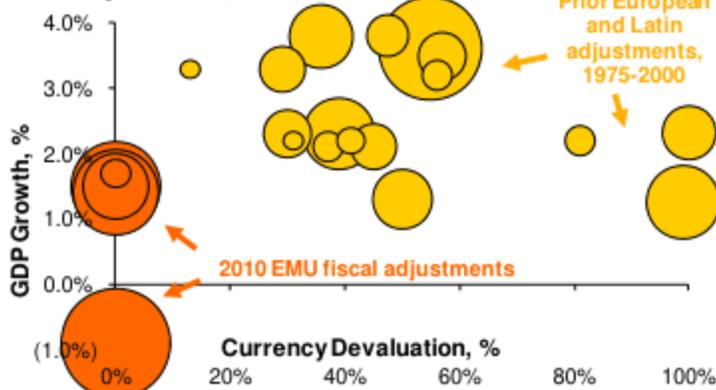
Greece primary balance, % of GDP				
Source	2010	2011	2012	As of:
JPMS LLC	-4.90	-2.30	0.80	10/28/2011
IMF/ECB/EU	-4.90	-2.30	1.40	10/28/2011
IMF	-4.95	-1.29	0.79	Sep-11
OECD	-5.08	-1.93	-0.94	7/1/2011
Eurostat	-4.90	-2.80	-1.80	Spring 2011
BofA/ML Research	-4.90	-1.30	0.80	9/26/2011

The unshakable conclusion that Greece would be worse off if it left the European Monetary Union is also inconveniently challenged by the recent recovery in Iceland (see Appendix), the recovery of the United Kingdom in 1992 after leaving the ERM (Exchange Rate Mechanism), and the last 40 years of history regarding fiscal adjustments, growth and currency devaluation. There is very little precedent for what the Europeans are trying to do: large fiscal adjustments at a time of low growth and without currency devaluation (see orange circles on chart below). These efforts are in stark contrast to the last 40 years of history in Europe and Latin America regarding how such crises are typically resolved (yellow circles).

³ A lot depends on whether participants in the first exchange (if it happens) could be defaulted upon a second time in the future. In other words, if any new bonds are cross-defaulted with existing Greek debt, and in 2012 Greece defaults on those who did not participate the first time, there's no reason to participate today, since you will be defaulted upon twice. To avoid this outcome, the bonds offered in the current exchange would have to either be subject to UK law (as opposed to Greek law), or collateralized in some reliable way.

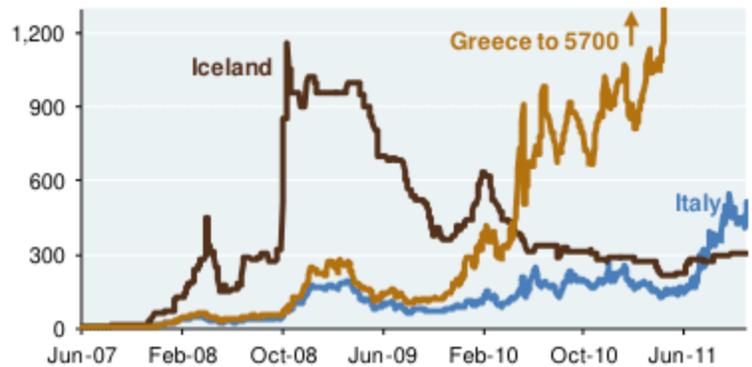
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Fiscal adjustments, then and now



Source: International Monetary Fund, Organization for Economic Co-Operation and Development, Barclay's Capital, Bloomberg.

Iceland took the normal route, and is now recovering
Sovereign credit default swap spread, basis points



Source: J.P. Morgan Securities LLC.

There is no question that there would be severe costs to Greece if it defaulted and exited the Euro. If Greece had to rely on its central bank to finance budget deficits, they would risk a substantial rise in inflation (which could erode the devaluation benefit), and in turn, further damage the credibility of the Bank of Greece. There could also be disruptions to trade finance (which could be ameliorated by the IMF in ways that more constructive for Greece than what they are doing now). The question is whether exiting offers the chance of something better for Greece than the certainty of failure associated with staying in the Euro. That is what Greece is in the process of debating; a temporary government is unlikely to be the last word on this.

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The Sun Also Rises: Iceland's post-devaluation recovery

Unlike the rest of Southern Europe, Iceland pursued the traditional formula: fiscal austerity, a large currency devaluation (which led to a rapid improvement in its current account deficit), an IMF loan and most importantly, the refusal to take on the obligations of Icelandic banks. Iceland's debt/gdp ratio is now around 100% (having risen from 40% a few years ago), so why are Iceland's credit spreads so much tighter than in Ireland and Portugal and tighter than Italy? Iceland suffered a huge spike in inflation and unemployment in 2009, and a terrible collapse in GDP and private consumption as well. But by 2010, the standard adjustment started to play out, in which GDP, trade, private consumption and capital spending are now rebounding. Inflation, which hit 18% in 2009, is back at 2%. The budget deficit is 4.5% of GDP, requiring less austerity going forward than Southern Europe. Iceland is expected to grow at around 3.5% to 4.0%, which helps solve a lot of problems, and puts the government debt ratio on a trajectory to decline rather than rise. Iceland's unemployment has risen to 9%, but is stable and now half the rate in Southern Europe. A fiercely independent country, it also controls its own destiny.



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