

**Scenes from a Marriage (Europe, US equity strategists, a brief history of taxing the rich, and Chinese equities)**

Note: our 2012 "Eye on the Market" Outlook on financial markets, economics and portfolio investments will be released on January 2<sup>nd</sup>. This week is the annual Christmas essay.

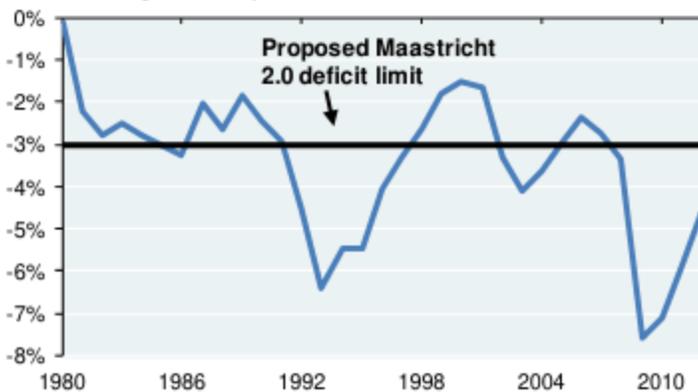
Bergman's *Scenes from a Marriage*<sup>1</sup> is the most apt metaphor I can think of regarding the last two years in Europe: a long-winded, claustrophobic and ultimately unresolved narrative of a divorce. I remember watching it with my parents in 1974. The recent EU summit brought back some memories: there were some significant compromises made, but I still doubt the various parties have what it takes to make the marriage work in the long run. The compromises made include:

- 26 of 27 Eurozone members appear to have agreed to adopt and enforce constitutional deficit and debt brakes
- The deficit brake is 3%, with a "structural" deficit limit of 0.5% (e.g., after adjusting for swings in the economic cycle)
- They agreed to sanctions from a supranational body if they do not adhere to the limits
- Only qualified majorities are needed from now on to disburse one of the bilateral bailout funds
- EU central banks will lend money to the IMF's General Account (in other words, available to all countries, not just European ones). Perhaps other countries like China and Russia will follow suit
- The ECB will finance (at low rates and for 3 years) just about any asset that could conceivably be owned by a bank, providing annual subsidies worth tens of billions of Euros. Deutsche Bank has some excellent Gerard Richter works at 60 Wall Street that may soon have an ECB repo tag on them
- Vague language suggesting that if bilateral lending facilities for sovereigns are too small, they will revisit in March to discuss raising them

This is all well and good, and reduces the immediate divorce risk substantially. EU banks have a lender of last resort, and the ECB has the justification they were looking for to buy sovereign bonds (e.g., "the era of fiscal prudence is upon us"). However, let's pause for a minute here. I find it difficult to believe that countries like France really intend to suddenly live under Teutonic fiscal discipline, no matter what they agree to in principle. Imagine the irony of Socialist Presidential candidate Francois Hollande having to wear a fiscal chastity belt; I don't think it will look very good on him.

**How would France cope with a 3% deficit constraint?**

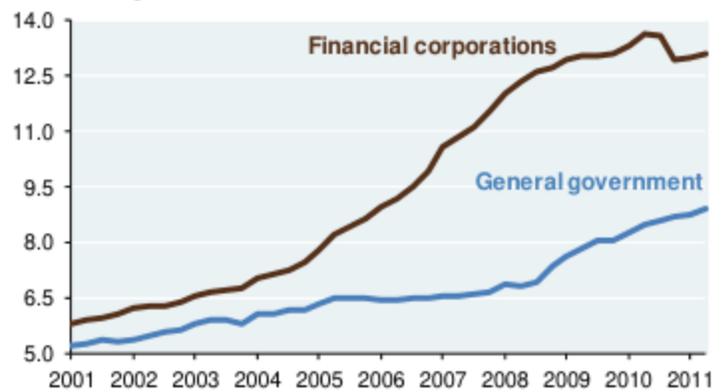
French budget deficit, percent of GDP



Source: IMF.

**EU/ECB/IMF: Open the pod bay doors...**

Outstanding debt in Euro area, trillions, EUR



Source: Statistical Office of the European Communities, Haver Analytics.

But let's give them the benefit of the doubt that they are going to stick to this. Where will these austerity plans end? Badly in Italy, I fear, and probably worse in Spain, whose economy is in free-fall other than a recovery in exports (a lot more on this in the 2012 Outlook). **As an investor, growth gets me comfortable with a lot of things. I don't see prospects of that coming out of the EU summit.** Holding assets of countries suffocating themselves is not something that sounds very rewarding, unless prices get extremely cheap. The ECB, IMF and other non-economic buyers<sup>2</sup> are likely to have to own/finance all the sovereign debt they can handle. Even so, 20 trillion Euros of financial sector and sovereign debt may prove too much for them all to take on if the private sector wants out (see second chart).

At the end of *Scenes from a Marriage*, the former couple decide that they are incapable of marriage, but still, they cannot bear to separate. They acknowledge their emotional illiteracy, and lumber on in a bleak partnership of undetermined meaning. As things stand now, that's a good metaphor for *Europe 2012*.

<sup>1</sup> You can get your own copy from the highly recommended *Criterion Collection*, which is a great place to look for holiday gifts, such as *The Wages of Fear*, which I watch before every Italian debt auction, just to prepare myself.

<sup>2</sup> Perhaps we should include EU banks here, which still apply zero percent risk weights to all bonds issued by EU sovereigns.

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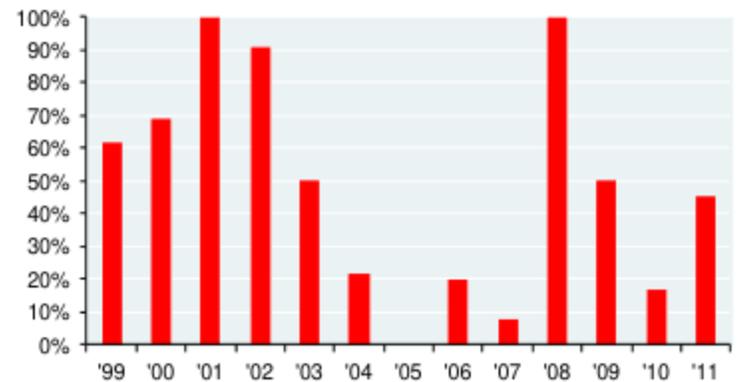
**US sell-side equity strategists: “promises, promises.....”**

Another uneasy marriage is the one between the S&P 500 and sell-side US equity strategist forecasts. One could dismiss the value in the entire exercise, due to its intermittent inaccuracy, and the fact that there is not much of a cost to them for being wrong. On the first point, there are a few years when they do a pretty good job. As shown in the first chart, during the last bull market, the majority of sell-side strategists were within +/- 10% of the market for 4 years in a row (2004-2007). A 10% threshold seemed reasonable to me; to others, it might be too wide or too narrow.

However, there are other observations one can draw as well:

- The strategist community has struggled with both the existence of the credit bubble and its aftermath, as shown by the results in 2008, 2009 and 2011.
- In 2010, they were arguably bailed out by the Fed, when things got so bad that QE2 was launched, driving the S&P from 1080 on September 1 to 1257 by year-end. Let’s give them the benefit of the doubt that QE2 was part of their implicit forecasts.
- As for the 1999-2002 cycle, strategists got burned in 1999 by under-estimating the growth stock rally, and then vastly over-estimated market returns for 4 years in a row. Given that cycle’s connection to balance sheets and income statements (rather than complex macro issues), the misses are harder to explain as time passes.
- Another figure to keep in mind: when strategists miss, they miss *big*. The average miss for all forecasts off by 10% or more: 28%.

**Percent of sell-side firms whose S&P forecasts were off by more than 10%**



Source: Bloomberg. 2011 est. is based upon S&P 500 value on 12/12/2011.

With that out of the way, let’s take a closer look at 2011/2012. In 2011, the strategist community got the earnings picture mostly right: earnings appear to be coming in around \$98, pretty close (and a bit above) the forecasts. **However, strategists missed the implications of everything else going on in the world, and were way over on their S&P market levels.** Price-to-earnings multiples do not exist in a vacuum, and are often impacted by factors affecting governments, households and the corporate sector. Strategist earnings estimates for 2012 look reasonable, as they only pencil in modest increases from 2011. However, it does not strike us that 2012 will be the year of multiple expansion. Anything over 12.5x looks too optimistic. If 2012 is a good year for equities, expanding multiples will likely be the reason.

**Sell-side securities firm S&P 500 forecasts**

| Company                    | 2011YE Forecast in Dec. 2010 |              |              | 2012YE Forecast in Dec. 2011 |           |          |
|----------------------------|------------------------------|--------------|--------------|------------------------------|-----------|----------|
|                            | Earnings                     | S&P Level    | Multiple     | Earnings                     | S&P Level | Multiple |
| Bank of America            | \$93.00                      | 1,400        | 15.1x        | \$104.50                     | 1,350     | 12.9x    |
| Barclays                   | \$91.00                      | 1,420        | 15.6x        | \$103.00                     | 1,330     | 12.9x    |
| Citigroup                  | \$94.50                      | 1,300        | 13.8x        | \$101.00                     | 1,375     | 13.6x    |
| Credit Suisse              | \$91.00                      | 1,350        | 14.8x        | N/A                          | 1,340     | N/A      |
| Deutsche Bank              | \$96.00                      | 1,550        | 16.1x        | \$106.00                     | 1,500     | 14.2x    |
| Goldman Sachs              | \$94.00                      | 1,450        | 15.4x        | \$100.00                     | 1,250     | 12.5x    |
| HSBC                       | N/A                          | 1,320        | N/A          | N/A                          | 1,190     | N/A      |
| J.P. Morgan Securities LLC | \$94.00                      | 1,425        | 15.2x        | \$105.00                     | 1,430     | 13.6x    |
| Oppenheimer                | \$88.50                      | 1,325        | 15.0x        | \$101.00                     | 1,400     | 13.9x    |
| UBS                        | \$93.00                      | 1,325        | 14.2x        | \$99.00                      | 1,325     | 13.4x    |
| <b>Actual</b>              | <b>\$98.00</b>               | <b>1,231</b> | <b>12.6x</b> |                              |           |          |

Source: Bloomberg, J.P. Morgan Securities LLC, Factset, First Call. 2011YE Targets as of 12/10/10. 2012YE Targets as of 12/12/11.

**Like most portfolio investors, we hold ourselves to a slightly different standard than point estimate forecasting.** What’s similar is that we try to have more exposure when times are good, and less when times are bad. But there are tradeoffs we are happy to make along the way, sacrificing return for less risk or more safety, and when the time is right, taking risk even though it might be early in the cycle. In the end, it’s the risk-adjusted portfolio performance over a business cycle that counts. We are entering 2012 with an underweight to equities (the US is our top regional allocation), with various public and private credit, macro hedge fund, energy, gold and distressed debt investments making much up the difference. Not that different than 2011.

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**The Marriage Table: navigating arguments about the history of taxing the rich**

I was at a party the other night with a friend (let's call him John Q Troublemaker), who got into a dinner table argument with his in-laws on taxes and the wealthy. My friend John explained to his in-laws that he and other wealthy Americans should be willing to pay higher income taxes, since on the margin, tax rates on the wealthy used to be much higher. The chart on the right is what John was looking at. It's something you would find on lots of blogs looking at the history of tax rates applied to the wealthy. As the argument goes, an increase from today's top statutory rate of 35% to something like 39.6% is very modest. Case closed?

The problem with this line of thinking is that a chart on the highest statutory rate doesn't tell you anything about how many people paid it, on what levels of income it was applied, or what loopholes or deductions existed. In other words, it doesn't tell us anything about what the real-life "effective" tax rates of the rich used to be.

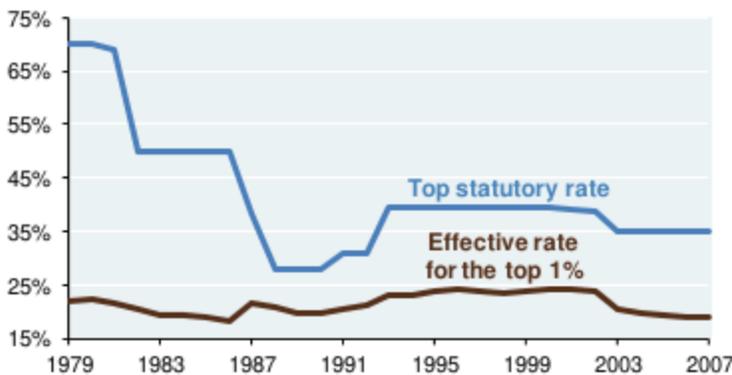
**Top statutory individual income tax rate**  
Percent



Source: Congressional Budget Office.

The Congressional Budget Office publishes effective tax rates by income bracket going back to 1979. As shown in the first chart below, **effective tax rates on the top 1% were nowhere near 70% in 1980**; they were less than half that amount, as shown by the effective tax rate line. There were more loopholes then, and the threshold for the top statutory rate was higher. The second chart explains how, by taking the brackets that the top marginal tax rates applied to, and converting them into "2005 dollars" (to adjust for inflation). **As you can see, the top bracket kicks in at around \$380,000 today; during the War years, the top bracket threshold was almost 10 times higher, reserved for the mega-wealthy.** During the 1950's and 1960's, top marginal rates were still reserved for a very small subset of the rich. It is not until the late 1960's and the need to finance the Great Society and the Vietnam War that the top marginal rate was applied to a much broader group of affluent individuals. While we do not have effective tax rates for the pre-1979 era, it seems reasonable to assume that the pattern looked a lot like it did from 1979 to 1986, when effective tax rates were much lower than top statutory rates.

**Effective tax rate: what people really pay**  
Percent



Source: Congressional Budget Office.

**Bracket threshold for top statutory tax rate**  
Real 2005 USD



Source: IRS, BLS.

What does all this mean? It means that discussions on top statutory rates relative to prior levels are potentially misleading. Tax hikes on the wealthy may be merited by the severity of the deficit; they may be merited by the severity of the jobs problem; and they may be merited by the unequal distribution of income. However, discussions around the dinner table should focus on the history of *effective* income tax rates. As shown below, while effective income tax rates declines for the top quintile after the Bush tax cuts, they have been declining for all brackets; and the top quintile rates are not that far off their 1979 levels.

|      | Quintile |        |        |        |         | Top 1% |
|------|----------|--------|--------|--------|---------|--------|
|      | Lowest   | Second | Middle | Fourth | Highest |        |
| 1979 | 0.0%     | 4.1%   | 7.5%   | 10.1%  | 15.7%   | 21.8%  |
| 1993 | -2.3%    | 2.3%   | 5.4%   | 7.8%   | 14.9%   | 23.2%  |
| 2000 | -4.6%    | 1.5%   | 5.0%   | 8.1%   | 17.5%   | 24.2%  |
| 2007 | -6.8%    | -0.4%  | 3.3%   | 6.2%   | 14.4%   | 19.0%  |

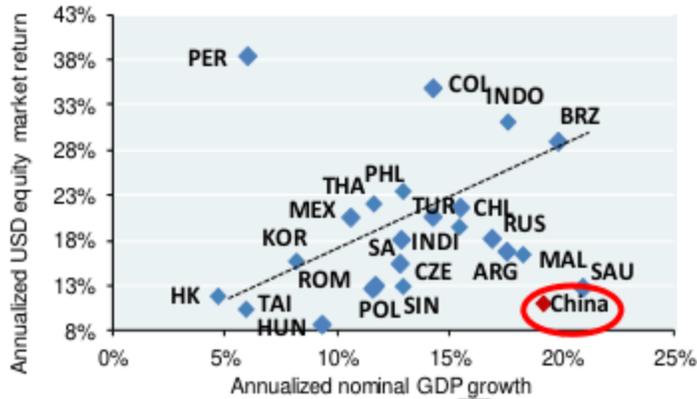
*Note: effective income tax rates for the bottom quintile are negative due to the value of transfers and tax credits*

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**Chinese GDP growth and Chinese equity market returns: This marriage needs an intervention!**

Chinese equity markets have the worst translation from nominal GDP growth to equity market returns among all emerging economies. We have published this chart before, and nothing has changed. We continue to take exposure through Asia ex-Japan, and generally avoid explicit exposure to Chinese public equity markets. Over the last 3 years, Asia ex-Japan has substantially outperformed Chinese equity markets in both US dollar and local currency terms.

Equity markets vs. GDP growth - 2003 to Dec. 11, 2011



Source: International Monetary Fund, Bloomberg, Morgan Private Bank.

Have a happy holiday season; I look forward to seeing many of you in the New Year, after LSU wins the BCS.

Michael Cembalest  
Chief Investment Officer

Acronyms of the week

- EU European Union
- IMF International Monetary Fund
- ECB European Central Bank
- GDP Gross Domestic Product
- S&P Standard and Poor's
- QE Quantitative Easing
- IRS Internal Revenue Service
- BLS Bureau of Labor Statistics
- LSU Louisiana State University
- BCS Bowl Championship Series

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