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To: Undisclosed recipients;

Subject: Eye on the Market, April 1, 2013: US vs EU Roulette

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Attachments: 04-01-2013_-_EOTM_-_Roulette-pdf.zip

Inline-Images: image019.png; image004.png; image008.png; image009.png; image010.png; image011.png; image012.jpg; image013.png; image014.jpg

Eye on the Market, April 1, 2013 (PDF is easier to read this week, particularly the Roulette wheel)

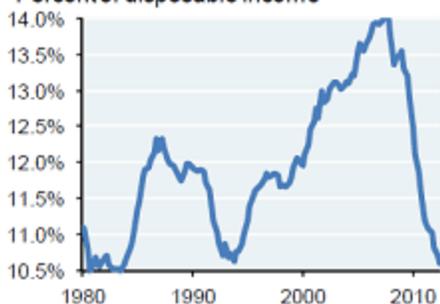
Topics: American vs European Roulette, rising US equity markets and continued European underperformance

Compared to Europe, the US is running easier monetary and fiscal policy, and playing a game of American Roulette: gambling that eventual withdrawals will take place at a time of higher growth, and will thus be less disruptive. On fiscal policy, after the cyclical increase in tax receipts and decline in unemployment insurance, the US fiscal deficit is projected to be ~5.5% by the end of 2013. Assuming the sequester remains in place *and* interest rates remain low, CBO projects a deficit of 3.7% for 2014 and 2.5% for 2015, with debt stabilizing at ~75% of GDP. However, in 2015, mandatory entitlement spending and interest start to grow more rapidly. The US is tabling this issue to another day; US equity markets seem to like the idea.

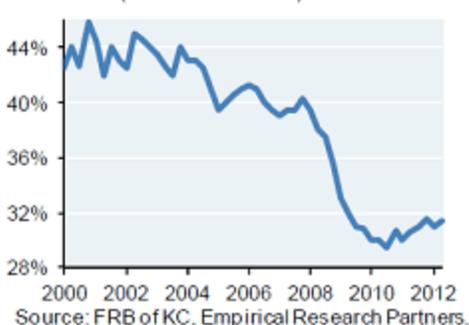
There is evidence that with the help of easy money, the US private sector is recovering. As shown below, household debt service has declined to 1990 levels, and the number of consumers using credit is rising again (from a low base). Modest payroll gains and fewer jobless claims have contributed to rising auto sales and consumer spending; this is a mild surprise given recent increases in payroll and income tax rates. Housing is on the mend (particularly in states worst-hit by the crisis), and inventories continue to decline. Home sales and home prices are rising in most locations, which are driving furniture and building supply sales. By the end of 2013, the % of Americans with underwater mortgages should decline below 20% from 35%+ at the peak. However, housing is improving off such a low base that the contribution to GDP from residential construction is only ~0.5%. And while labor markets are getting better, they are not showing the substantial improvement the Fed cites as the criteria for ending its asset purchases. As a result, the Fed is adding to its 50 Trades of Grey (\$2.5 trillion of US Treasury and Agency purchases and counting, measured in 10-year equivalents). We expect GDP growth of ~2.5% by the end of the year.

US household debt service

Percent of disposable income



Percent of consumers increasing debt balances (ex-student loans)



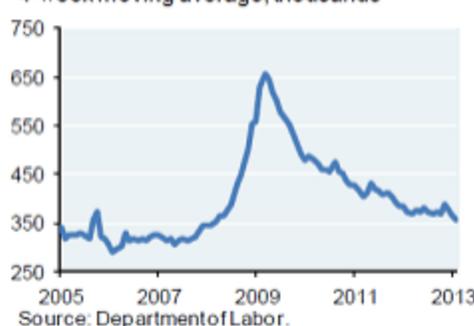
US vs. European employment

Percent change, QoQ, saar



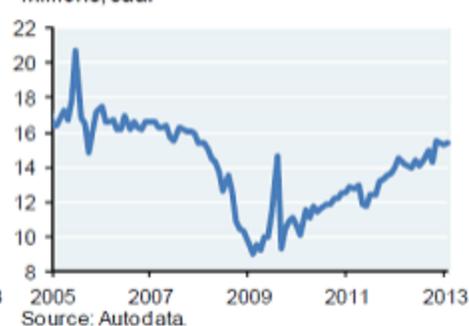
US initial jobless claims

4-week moving average, thousands



US auto sales

Millions, saar

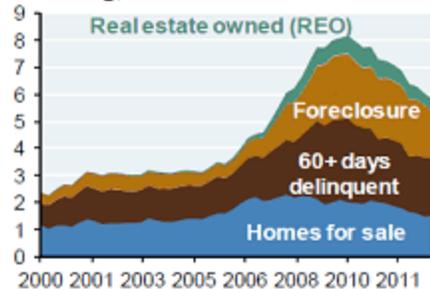


Real Personal Consumption

Expenditures, 3-mo. % change-annualized

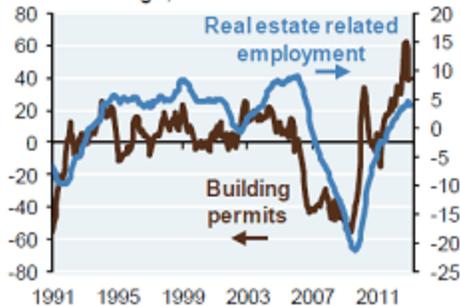


US housing inventory is steadily declining, Million units



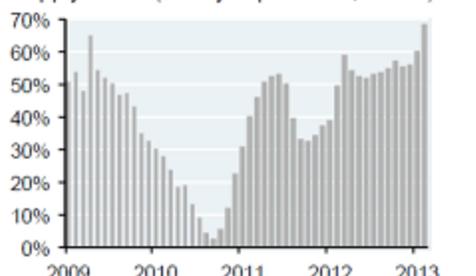
Source: J.P. Morgan Securities Loan Performance, MBA.

AZ, NV, FL & CA: Phoenix rising



Source: BLS, Census, Empirical Research Partners.

Fifty Trades of Grey: Fed purchases of Treasuries and Agencies, % of total net supply issued (in 10-yr equivalents, 6mma)

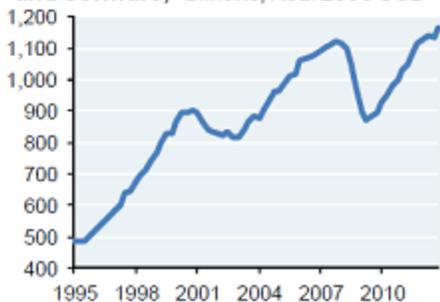


Source: Nomura Securities, J.P. Morgan Securities.

US business conditions are also improving, after pausing last fall during the elections and fiscal cliff debates.

Spending on equipment and software is rising, and durable goods orders are headed in the right direction. Capacity utilization is almost back to normal, and the **number of private establishments is growing**, a sign that the US private sector has a pulse. Commercial real estate transactions are picking up, along with a revival in securitized lending through commercial real estate and C&I loans.

US business spending on equipment and software, Billions, Real 2005 USD



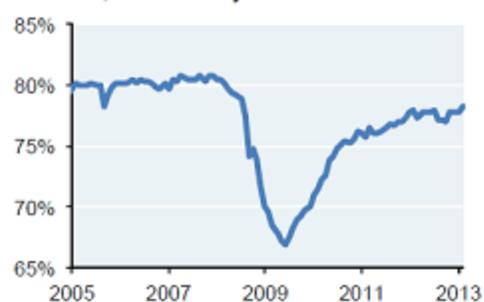
Source: Bureau of Economic Analysis.

Business spending: durable goods orders, USD, bn, non-defense ex-aircraft



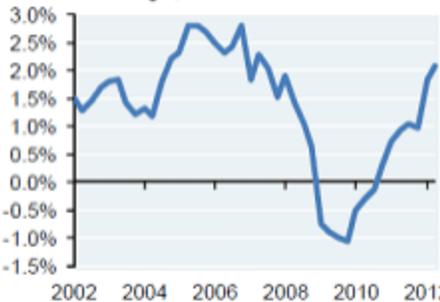
Source: Census Bureau.

US production capacity utilization Percent, total industry



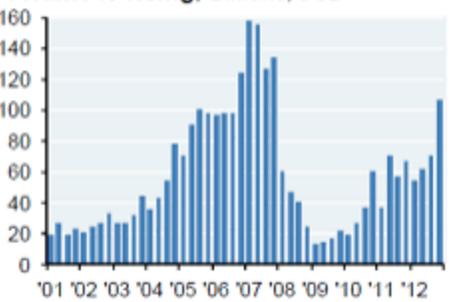
Source: Federal Reserve Board.

Number of private establishments Percent change, YoY



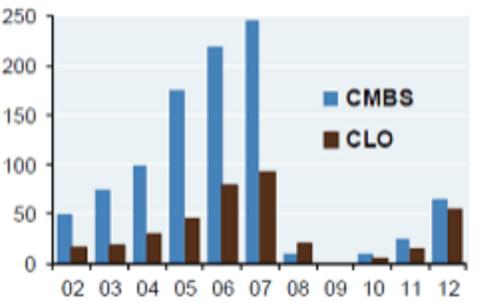
Source: Bureau of Labor Statistics.

Commercial real estate transaction volume is rising, Billions, USD



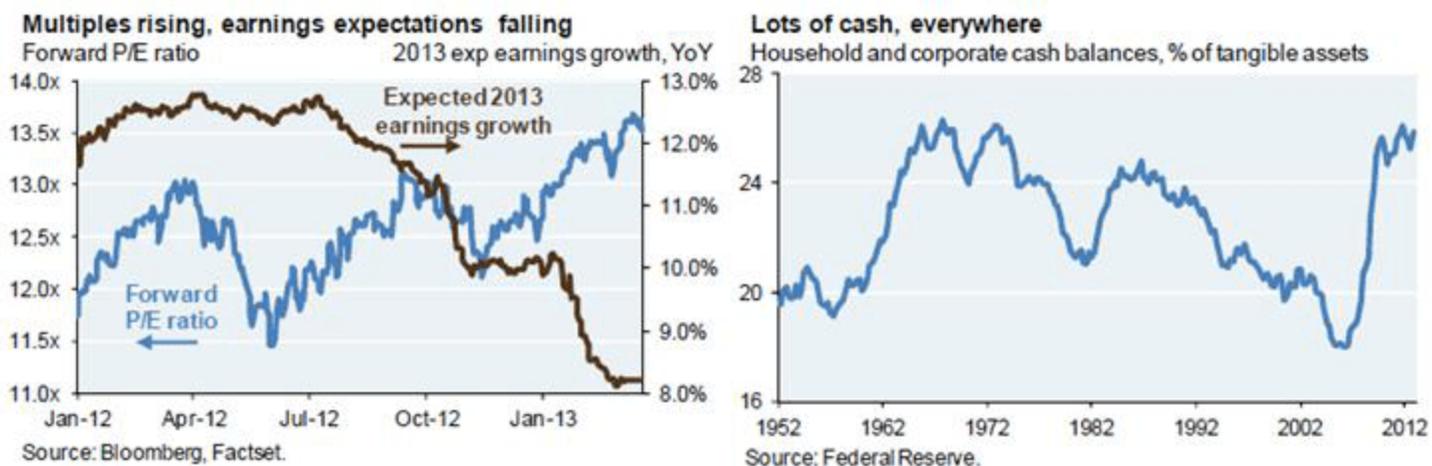
Source: Real Capital Analytics.

Gross CLO and CMBS issuance Billions, USD



Source: Bridgewater.

These are the improvements that rallying equity markets anticipated: as shown in the first below, P/E multiples on the S&P 500 rose over the last year despite falling earnings growth. Earnings expectations for 2013 have been falling across most sectors, and may weaken further before year-end; and the ratio of negative to positive earnings guidance is at its highest level in three years. Consequently, the latest positive economic news may be mostly a validation of the market's prior advance. While growth is still weak compared to prior recoveries, the recession that the Economic Cycle Research Institute was so sure about for 2012 never happened. We felt that 2012 and 2013 would be one of those anomalous years when equity markets would do better than what growth conditions alone would imply; this view still seems to be on track as the S&P 500 hits new highs. Better economic conditions may eventually drive households and corporations to reduce their cash holdings, which are still close to the highest levels on record. The Fed won't be making it easy for holders of cash: short-term policy rates may not rise until 2015-2016. **Overall, no change to the benign view we outlined for US economics and markets in our 2013 Outlook.**



Roulette: the European Version. The \$13 billion bailout in Cyprus is small (in 2011, France and Germany made \$80 billion of loans and grants to developing countries) and the situation is in many ways unique. However, the latest melodrama reinforces the inconsistent and chaotic nature of EU policy-making. Bondholders, equity investors, bank depositors and citizens of Europe are at risk of unpredictable outcomes as they play *Eurozone Roulette*. Here's where they might land on any given spin:



Depositor confiscation and subordination: The EU eventually backed off, but the initial proposal for Cyprus involved a confiscatory tax on small and large Cyprus depositors, both foreign and domestic, with no loss to senior bond-holders (effectively subordinating the depositors). It was a shocking policy proposal in a region where confidence is everything: uninsured bank deposits range from 45% (Spain, Germany) to 80% (UK, Italy) of total bank deposits. Note: Laiki bank branches in the UK were not subject to deposit withdrawal restrictions, even though their branches in Cyprus were.

Zero risk weight applied to sovereign bonds: Even after Greek bonds suffered principal losses, EU banks have the flexibility to use 0% risk weights on EU sovereign

debt as per “IRB permanent partial use rules”, regardless of the country’s credit rating.

Maastricht Ja/Nein!!!: From the inception of the Maastricht treaty in 1992 to 2008, there was not a single year when both France and Germany were in compliance with Maastricht debt and deficit targets. Today, Southern Europe is pushed to get in line ASAP.

Loss of tax rate sovereignty: Throughout all the difficult negotiations and bailouts, Ireland was able to keep its 12.5% corporate tax rate despite pressure from the EU to raise it. No such luck for Cyprus, which is being forced to raise its corporate tax rate from 10%. As far as I know, homogenization of EU personal or corporate tax rates was never a condition for Eurozone membership.

Changing protections for senior bank bondholders: There is nothing wrong with bondholders, uninsured depositors or other creditors suffering losses when they are owed by insolvent banks whose asset values are insufficient to cover them. In Ireland however, a bailout was structured to avoid losses on some unguaranteed senior bank bonds which were subsequently repaid (a wealth transfer from Irish citizens to bondholders). In Cyprus, some senior bank bondholders are no longer protected.

Tax Haven Designation: Germany’s Federal Intelligence Service concluded last fall that an aid program for Cyprus would benefit certain Russian depositors with billions of dollars in deposits in Cyprus, and that “Cyprus is a gateway for money laundering activities in the EU”. Fair enough; Cyprus is seen as a personal tax haven. But according to a US Congressional Research Service report in January 2013, tax havens cater to both individuals *and* corporations. One measure of a corporate tax haven is when foreign sourced profits are very large relative to GDP, such that in the words of the CRS, “*profits in these countries do not appear to derive from economic motives related to productive inputs or markets, but rather reflect income easily transferred to low-tax jurisdictions*”. On this measure, Luxembourg leads the pack at 18% of GDP, 2x higher than Cyprus and 6x higher than Switzerland, Singapore and Panama. The degree, time and place of EU concern about tax havens can vary substantially.

ECB asserts preferred creditor status: The ECB owned ~50 billion Euros of Greek sovereign debt that was not restructured along with the private sector. Typically, preferred creditor status is reserved only for entities like the IMF and World Bank.

Proposed bonus caps on stand-alone asset management firms and UCITS funds (including regulated hedge funds): Because their investment activities played such a large role in the EU sovereign debt crisis? Because they were beneficiaries of official sector deposit insurance and lots of ECB lending? I can’t find evidence of either one happening, but maybe I am not looking hard enough.

OK, enough about Cyprus. The bigger issue is that long-term growth conditions in Spain, Italy and France are as weak as they have been (other than during wartime) in over a century, as we first showed in October of last year and again last February. The chart below tells the story. While European sovereign debt spreads have rallied across the board, European bank lending to households and businesses is still declining, and the cost of small business loans in Italy and Spain is higher than both real and nominal growth. That may explain why European equity markets [a] are still trailing US counterparts (see table). As for Japan, we had a piece on March 18th that walked through why we believe its equity markets may keep rising this year despite economic data that is still pretty weak: some data is *so* bad (deflation actually worsened in February) that it may lead to a seismic shift in monetary and fiscal policy. On Emerging Market equities, this year’s returns are a disappointment, although over most longer-term time horizons, they have generated better returns.

Equity market returns by region

	Year to date		2007-2012	
	US\$	Local Cur	US\$	Local Cur
S&P 500	10.6%	10.6%	15%	15%
MSCI Europe	2.8%	7.1%	-5%	-4%
MSCI EMU	-0.6%	2.4%	-17%	-17%
Euro Stoxx	-2.8%	0.0%	-17%	-17%
MSCI Japan	11.8%	21.6%	-22%	-44%
Nikkei	9.4%	19.5%	-7%	-33%
MSCI EM	-1.8%	-0.7%	36%	39%

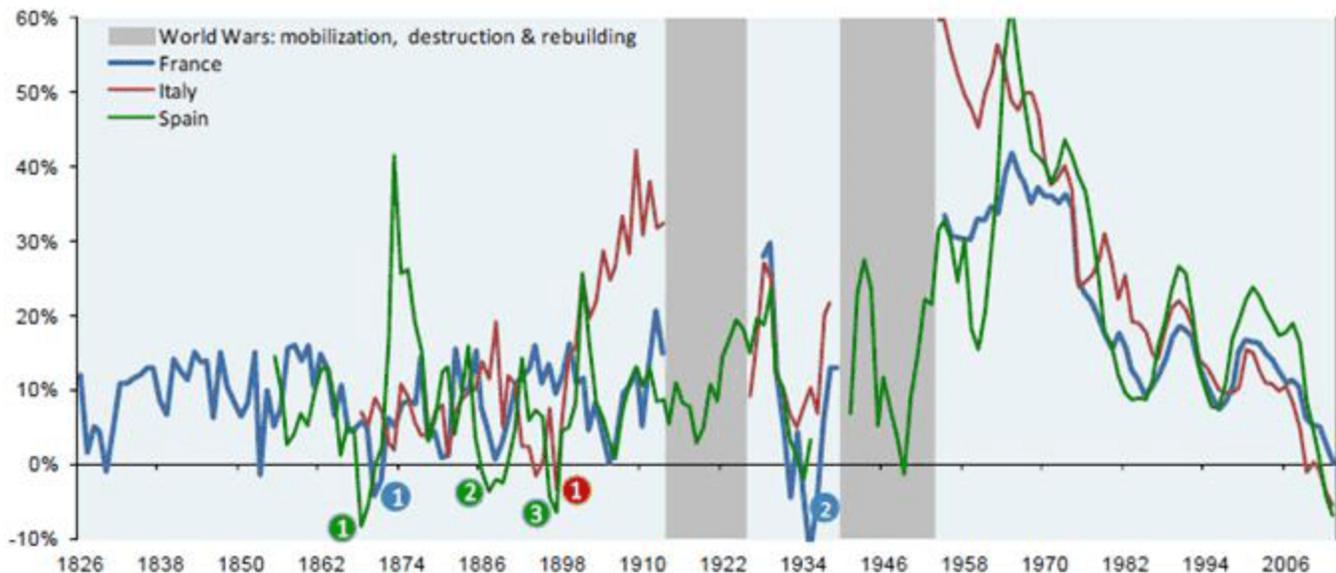
Source: Bloomberg. Data as of March 28, 2013.

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[a] There are two indices most often referred to as “European equities”: the Eurostoxx 50 and the MSCI Europe index. They are quite different. From a constituency standpoint, there is only a 26% overlap in companies included due to the higher concentration and larger capitalization sizes in the Eurostoxx index. The other big difference is that the MSCI Europe index (which has outperformed in recent years) has very large exposures to the UK (34%) and Switzerland (14%), while the Eurostoxx has none. As such, the Eurostoxx is a better measure of the performance of Eurozone (EMU) equities, along with the MSCI EMU (European Monetary Union) index.

Current long-term growth rates in France, Italy and Spain: That 19th Century Feeling

Change in 7-year real GDP, percent, since 1820; WWI, WWII and Spanish Civil War excluded



Sources: "Statistics on World Population, GDP and Per Capita GDP", University of Groningen; Conference Board, Bloomberg. Data as of February 2013.

See attached PDF for circled references to prior periods of long-term growth rates below zero.

BLS Bureau of Labor Statistics
CBO Congressional Budget Office
C&I Commercial & Industrial
ECB European Central Bank
FRB Federal Reserve Board
UCITS Undertakings for the Collective Investment of Transferable Securities

“Tax Havens: International Tax Avoidance and Evasion”, US Congressional Research Service, Jane Gravelle, January 2013

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