

From: US GIO <[REDACTED]>

To: Undisclosed recipients;;

Subject: Eye on the Market, February 7, 2011

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Attachments: 02-07-11_-_EOTM_-_Second_Wind,_Third_Wave.pdf

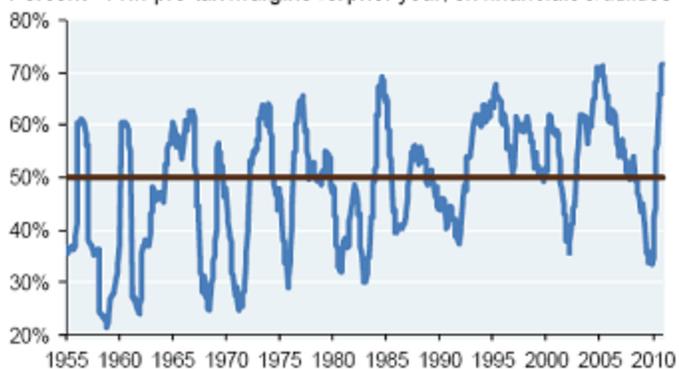
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February 7, 2011 Topics: US equities, Europe and Commodities (attached PDF is easier to read)

US equity update: Q4 2010 was the 6th consecutive quarter of earnings higher than consensus

Our largest regional equity position remains the US. As shown below, the percentage of US stocks with improving margins was at an all-time high at the end of Q4. While rising commodity prices are having an impact on some companies, **high operating leverage and low labor costs continue to dominate the overall earnings equation.** Technology, industrials and consumer staples have posted the best numbers vs expectations. We are beginning to see companies reduce elevated cash balances and increase capital spending, which is supportive for GDP and credit growth. While capital spending grew by 23% in Q4, it's rising from a low base, and we believe it has plenty of room to run. Recall that 2009 was the first year since 1950 when capital spending dipped below the rate of depreciation on the outstanding US capital stock.

Share of large-cap stocks with improving pre-tax margins
Percent - TTM pre-tax margins vs. prior year, ex financials & utilities



Source: NBER, corporate reports, Empirical Research Partners.

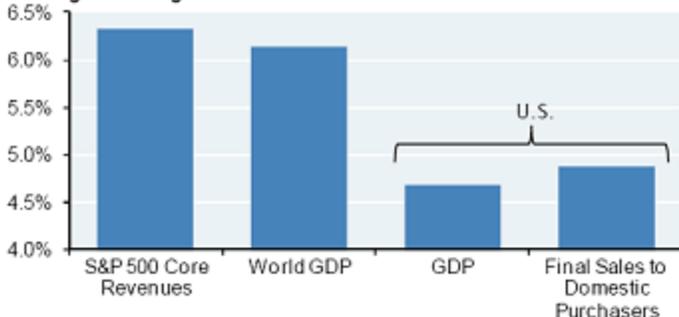
Labor costs as % of sales: lowest in 60 years
Percent



Source: Bureau of Economic Analysis.

To reiterate a point from our 2011 Outlook, S&P 500 revenues over the last 15 years have been considerably more linked to World GDP growth than US GDP growth. The internationalization of profits over the last 15 years is what has allowed US equities to at times be less sensitive to US economic conditions. **As for the outlook for global GDP growth, recent data is suggestive of a "second wind" for the global economy [a].** Global orders, employment, and output have been rising across multiple sectors and countries, and point to global GDP growth in excess of 4% for 2011.

S&P revenues are tied to global growth, not U.S. growth
Average annual growth rates from 1996 - 2010



Source: S&P, U.S. Department of Commerce, IMF, Corporate Reports, Empirical Research Partners Analysis. (S&P 500 revenue growth excludes energy, financials and utilities).

Corporate profits from the rest of the world
% GDP



Source: Bureau of Economic Analysis.

On financials, loan growth increased for the first time since 2008. Loan loss reserves exceed non-performing loans by 1.4 to 1, and we expect future provisioning to decline. Large banks earned 11% returns on equity in 2010, matching the

average for the industry over the last 60 years. Loan demand is increasing from small, medium and large-sized firms. As for capital ratios, most US banks are already at or close to minimum levels required under Basel III, and should be able to reach "well-capitalized" levels through retained earnings well before the 2016-2019 phase-in. **The next hurdle for US equities:** adjusting to higher long-term interest rates, and increases in producer prices. The latest readings for US producer input prices are elevated, with 70%-80% of companies seeing higher non-labor input costs. With labor costs under control and representing the majority of costs for *most* companies, we don't foresee a margin collapse in 2011.

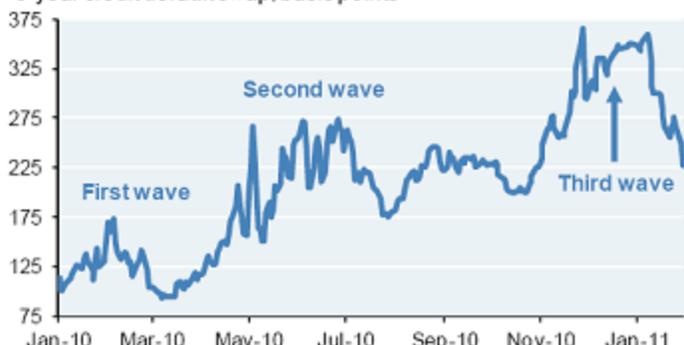
Europe: third wave of sovereign risk pushes Germany closer to underwriting the Periphery

During 2010, Europe tried a number of deposit guarantee, austerity and financing approaches to calming investor fears. None worked for long, resulting in capital market shocks, and a "third wave" of market concern last December (the first two waves were Spring and Summer 2010). In early January 2011, the cost of insuring against a Spanish default was at its highest level since the crisis broke out in November 2009 (first chart). And as shown in the second chart, an austerity package and bailout for Ireland did little to stem deposit outflows, which have been accelerating. At year end, Germany and France faced increasing pressure to defend the European Monetary Union, particularly with Eur 37 billion of maturing Spanish bank debt early in 2011.

The problem: as shown below, German and French bank exposures to Portugal, Greece, Spain and Ireland are enormous, peaking at around \$1 trillion. Even after recent exposure reductions, German and French claims on the GIPS countries are around the same as the total capital of German and French banking systems. Letting the periphery spin out of control appears to be against their economic self-interest. However, Germany also has to balance a range of political, economic and social constituencies that are opposed to "blank checks". In 2010, Germany stopped short of approaches to fully address the market's reluctance to finance governments and banks in countries with no growth, rising unemployment and rising debt burdens.

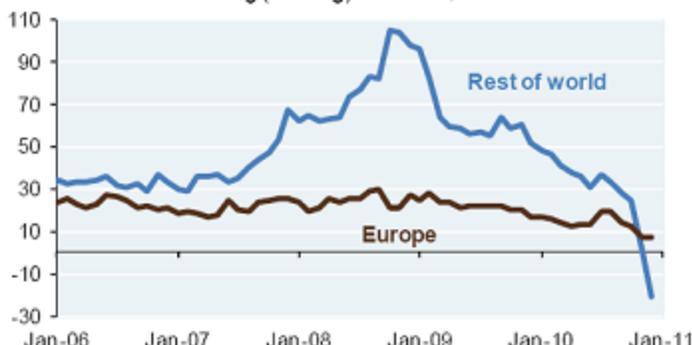
We now see evidence that after the third wave hit, **Germany moved towards an expanded bailout [b]** as being the best of all the bad options (details expected in mid-March). Given the decline in near-term sovereign and bank default risk, last month we reduced our underweight to European equities, funded by reducing exposure to Asian equities, where inflation pressures are rising. There are still a lot of unanswered questions: will the Periphery agree to the steps Germany is pushing for (no more wage indexation, higher retirement ages, etc)? But with Germany recovering (last chart), the region has the economic firepower to prevent an unraveling of the European Monetary Union in 2011. This should allow European equities to be priced more as a reflection of their earnings, with reduced drag from potential sovereign default risk.

Cost of insuring against a Spanish Government Default
5-year credit default swap, basis points



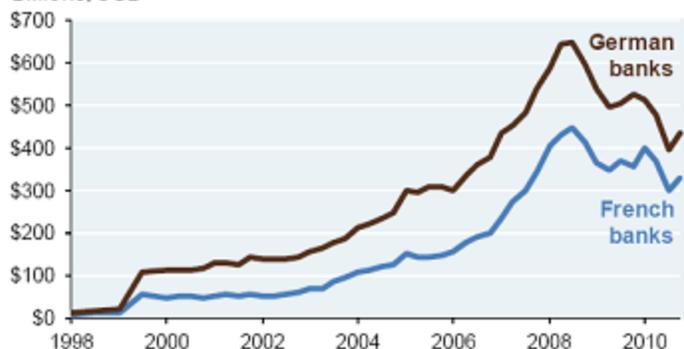
Source: Bloomberg.

Outflows from Irish banks accelerate despite bailout
Irish bank net borrowing (lending) balances, billions



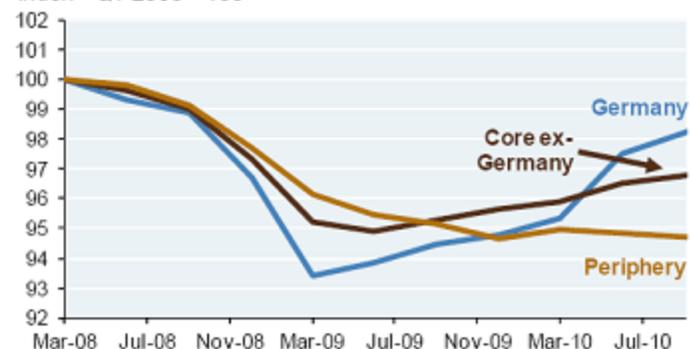
Source: Morgan Securities LLC.

Core bank claims on Portugal, Greece, Ireland and Spain
Billions, USD



Source: Bank for International Settlements.

Euro area real GDP
Index - Q1 2008 = 100



Source: Morgan Securities LLC.

Commodities: an update on our preferred positions

In our 2011 Outlook, we outlined 5 commodities that we find most attractive; most were our preferred positions in 2010 as well. They are generally linked to the global production cycle, and as shown below, 4 of 5 have started the year with modest gains. For many commodities, modest price increases coincide with our views, and our investment strategies are designed to benefit should these levels persist.

Palladium and platinum are unique in their ability to act as catalysts in certain chemical reactions, such as those performed by automatic catalytic converters and particulate filters (for diesel vehicles). As a result, the demand function for platinum and palladium rests heavily on global car sales which are rising sharply (driven primarily by China). On the supply side, a lot depends on South Africa, which accounts for 79% of the world's platinum and 41% of the world's palladium (most of the rest comes from Russia). South Africa presents a very challenging environment for mining companies; problems include labor strife, worker safety, calls for resource nationalization, and electricity shortages. As in 2007/2008, South Africa's mining industry might have to deal with extensive power outages. According to the Financial Times, Eskom (which supplies 90% of the country's electricity) expects a shortfall of 3,000 megawatts this year, which is around 10% of the total grid; its plants are also 30-40 years old. Problems with energy availability may explain why production of platinum and palladium has been falling in South Africa since 2006. The only other country with large untapped platinum reserves: Zimbabwe.

Price performance since September 2010

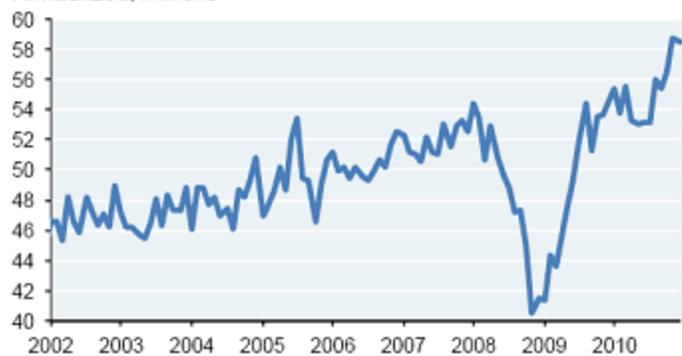
Index, 100 = 9/1/2010



Source: Bloomberg.

Global auto sales

Annualized, millions



Source: Morgan Securities LLC.

On oil, very near-term outcomes depend on how instability in Egypt (as well as Algeria, Jordan, Sudan, and Yemen) is resolved. However, over the medium-term, many OPEC countries are consuming more and more of the oil they produce, while oil importing countries are drawing down existing reserves. **As a result, we see oil prices being sustainable at current levels, and biased higher.** Egypt is one example: its ability to disrupt global oil supplies is low, but that's because it has been consuming a greater share of its own production (see chart).

Egypt consuming more of the oil it produces

Production minus consumption, millions of tonnes



Source: BP Statistical Review of World Energy - June 2010, 13d Research.

As for gold, there were \$3bn in outflows from gold exchange traded funds in January, equivalent to a third of the \$9bn total inflows seen in 2010. CFTC data show that net positions in have been falling since January and are now at their lowest since November 2008. Weakening demand for gold likely reflects increased confidence that the economic recovery will eventually lead to higher interest rates, and the end of a period of exceptionally easy monetary policy. Our enthusiasm for gold has been tempered by the prospects of rate hikes in 2012 in the developed world; we now relegate gold to its normal portfolio role as "tail risk" insurance, and less of a trading vehicle for speculating on fiat currency problems.

Michael Cembalest
Chief Investment Officer

[a] "Surveys signal second wind for global recovery", David Hensley and Joseph Lupton, JP Morgan Global Data Watch, February 4, 2011.

[b] Options the EU has reportedly been discussing: reducing the rate payable to the European Financial Stability Facility by borrowing countries; allowing the EFSF to buy bonds directly in the secondary market; allowing the EFSF to lend money to countries to buy back their debt; and increasing the size of the EFSF. A move towards a broader federal union (supported by France) appears remote right now.

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