

From: US GIO <[REDACTED]>

To: Undisclosed recipients;;

Subject: Eye on the Market: Ides of March, 2011

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Inline-Images: image001.png; image002.png; image003.png; image004.png; image007.png

Eye on the Market, March 2, 2011 [the attached PDF is easier to read]

The global recovery vs the Ides of March: the Middle East, European sovereign debt and Asian inflation

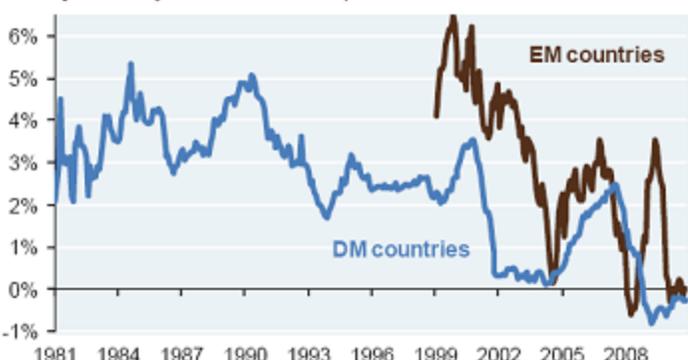
The latest manufacturing surveys show a global economy that is still expanding, particularly in the developed world. This is what “zero cost of money” policies were supposed to create, but nevertheless, it is still reassuring to see it. Improvements include continued strong manufacturing and export data in the US, and a better than expected manufacturing outlook in both Italy and Ireland. In Germany, unemployment has fallen to the lowest rate since Reunification.

Manufacturing surveys: the G-3 takes center stage



Cost of money = zero

Policy rates adjusted for inflation, percent



We are mindful, however, of **The Ides of March**, which begins earlier than the 15<sup>th</sup> this year. We believe we will get through the Ides better than Caesar, but that’s a very low bar given what happened that day in the Roman Senate (Emperor: bludgeoned). While profits and balance sheets are in good shape, and while there’s still a glut of cash looking to invest (from households, corporations and Sovereign Wealth Funds), **2011 looks to be the end of the free money train, and a more volatile year for markets.** The situation in the Eastern Province of Saudi Arabia and Bahrain is also on edge, with tanks rolling into Qatif and oil prices rising as I write this. We consider the median S&P 500 forecast of 1425 to be too high; we’re at 1350-1375. Preferred portfolio exposures: large cap US growth; private lending to real estate/mid-sized corporates; merger arbitrage; distressed European bank loans.

**March 11<sup>th</sup> & 20<sup>th</sup> Saudi nationwide “Days of Rage”, and minority Shi’a protests tomorrow March 3<sup>rd</sup> in oil-rich Qatif**

Opinions on the Middle East are as diverse as the consultants, State Department officials, journalists, think-tank residents, economists and historians on your TV. **The differences between Saudi Arabia and Egypt may be more important than their similarities at this stage;** the table below puts some of them in high relief. We would be surprised to see combustion in Saudi Arabia on March 11 similar to what is occurring in North Africa. But to be clear, this view reflects both a more generous Saudi entitlement system, *and* more effective and pervasive policing. Figuring out which is the more dominant factor is the hard part. It is an odd society that generates enormous oil wealth but cannot create jobs for young people (youth unemployment estimates range from 25%-40%); where massive amounts are spent on education, but where 8<sup>th</sup> grade science and math scores are among the lowest in the world; and where non-Saudis account for 90% of all private sector jobs.

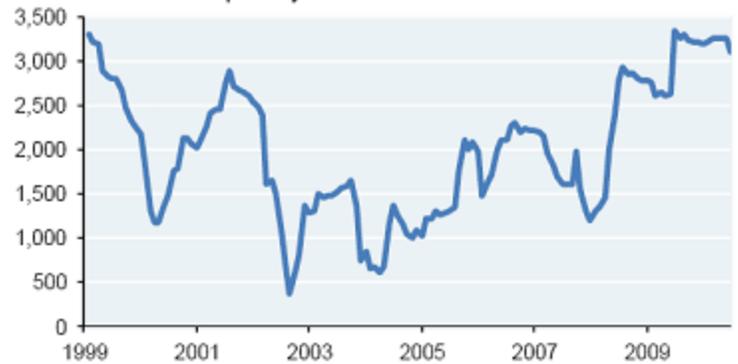
The stability of Saudi Arabia is important to investors, given **reliance on the Saudis to compensate for declines in Libyan and Algerian oil exports** (see more below). Estimates of spare Saudi capacity are subject to debate, but it appears that the Saudis now produce less than what they did in 2005-2008 (lower demand), and have increased their capacity

through new Khurais and expanded Shaybah fields. So, we consider the trend shown below of spare Saudi capacity to be quite feasible.

Rank out of 110 countries (1=best, 110=worst)		Saudi	
		Arabia	Egypt
DIFFERENT	Business and Government Corruption	7	48
	Perceived Job Availability	8	85
	Efforts to Address Poverty	9	23
	Trust in Others	13	67
	Good Environment for Entrepreneurs	16	109
	Confidence in the Judicial System	18	59
	Perceptions of Social Support	23	96
	Human Flight (Emigration)	27	67
	Gross Secondary Enrollment (Education)	38	73
	SIMILAR	Health Problems	96
Political Rights		102	93
Express Political Opinion without Fear		103	89
Personal Freedom Sub-Index Scores		103	109
Civil Liberty and Free Choice		105	97
Tolerance for Ethnic Minorities		105	103
Separation of Powers		106	82

Source: The 2010 Legatum Prosperity Index, Legatum Institute

Saudi Arabia spare capacity  
Thousands barrels per day



Source: Bloomberg.

We are having a client call on March 15 to review Saudi Arabia, Libya, Yemen, Bahrain (where the Shi'a majority are poorer than their Saudi counterparts), etc, with a focus on oil markets. Details to follow from your J.P. Morgan representative. As you absorb the analyses of what is taking place (depending upon what you read, Egypt is turning into either Turkey, Iran, Indonesia or Belgium), keep in mind that this region has been hard to forecast, with some very inapt projections in the past (see *Notes*).

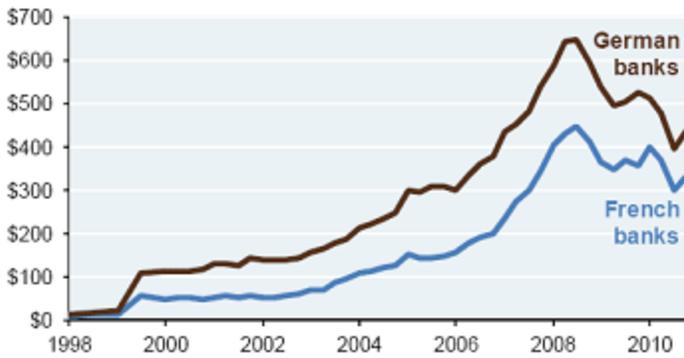
#### **March 11 Eurozone summit, March 14-15 Eurogroup meeting**

There are two tensions at work: how much austerity can the Periphery take, and how much are the Germans willing to help in exchange? As Caesar did, European political elites have crossed the Rubicon, committing to doing "whatever it takes" to save the European project. Whether the citizenry will follow them over the long run is another question entirely. In mid-March, Eurozone members will meet to discuss what else the German bloc will do regarding Ireland (e.g., lower interest rates on multilateral loans) and Portugal (force them to borrow from the EFSF and stop relying on ECB purchases); and what kind of "governance" and "competitiveness adjustments" the Periphery will sign up for. While we don't know how these back-room discussions will play out, **our contacts in Germany indicate the following two core beliefs** among senior Christian Democrats (CDU), Social Democrats (SPD), regulators and economic advisors:

- [1] Germany will do what is necessary to stabilize the system, and a disruptive debt restructuring is undesirable right now
- [2] Germany will confront its parliament with amendments and extensions to existing multilateral financing agreements only if and when it is established that there is an immediate, imminent need to do so (reactive rather than pro-active)

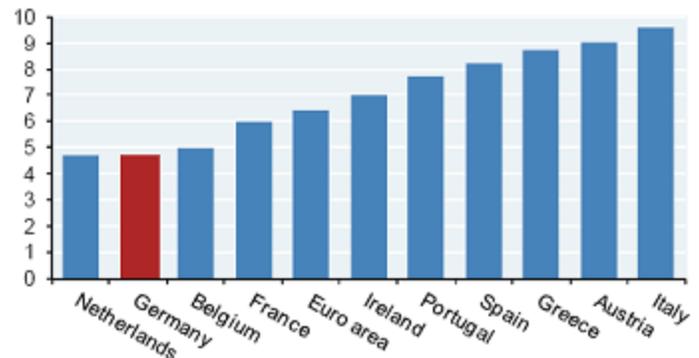
As a result, we ascribe a low probability to an unraveling that would severely disrupt financial markets, and expect compromise. Given Germany's exposure to the Periphery and low levels of bank capital (see first 2 charts), borrowing countries might have as much negotiating power as Germany (e.g., the power of large debtors). Merkel's recent electoral defeats have been ascribed more to local factors rather than to bailout fatigue. We'll see; upcoming elections in Baden-Wuerttemberg and Sachsen-Anhalt may reduce Merkel's ability to offer a lot of concessions. On economics, debt markets have been receptive to Spain, which is borrowing much less from the ECB (see below). But with Periphery growth still stuck in neutral (last chart), there are still a lot of unanswered questions. The European growth outlook was "upgraded" to 1.6% by the European Commission, but now the ECB faces rising inflationary pressures (highest manufacturing input and output price surveys in more than a decade).

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



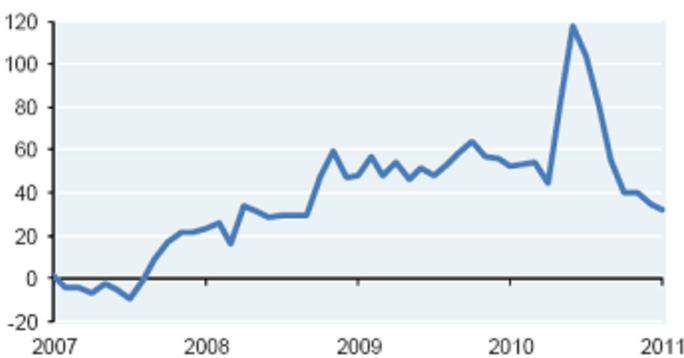
Source: Bank for International Settlements.

**Bank capital and reserves to total assets**  
Percent



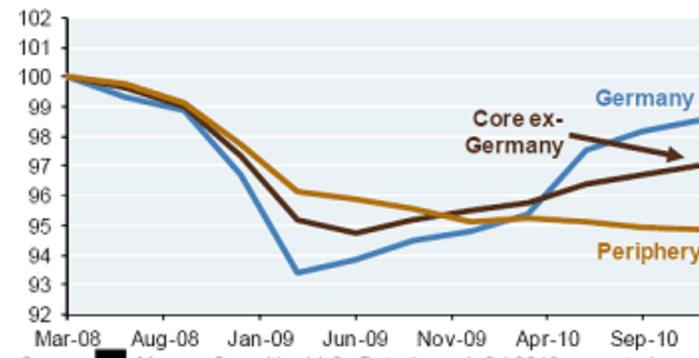
Source: European Central Bank.

**Spanish bank net borrowing from the ECB**  
Billions, Euros



Source: Banco de Espana.

**Euro area real GDP**  
Index - Q1 2008 = 100



Source: Morgan Securities LLC. Data through Q4 2010 - reported figures used where available, estimates utilized otherwise.

**What is interesting about Germany: most credible alternatives to Merkel's CDU are in support of the European Union.** The SPD, which defeated Merkel in Hamburg, lobbied for *more* generous support for Greece, and is *more* pro-Europe than the center-right CDU. So far, the political elites of Germany appear to be in agreement that 2011 (and perhaps 2012) is not the year for destabilizing debt restructurings, and risks around the longevity of the European project.

**March 15 US Federal Reserve Open Market Committee Meeting**

The Fed meeting which takes place on the Ides of March is actually not the hurdle here; it's the meetings held by their counterparts in other countries. Bernanke made it clear in recent testimony that the Fed Funds rate will likely remain low for an extended period. He expressed only mild concern about rising commodity prices, noting that in recent decades, pass-through to core inflation has been low (the Fed's success in relying on empirical history is mixed; see "We've never had a decline in house prices on a nationwide basis", Bernanke, July 2005). As long as private sector wages and employment are weak, the Fed is likely to stay put.

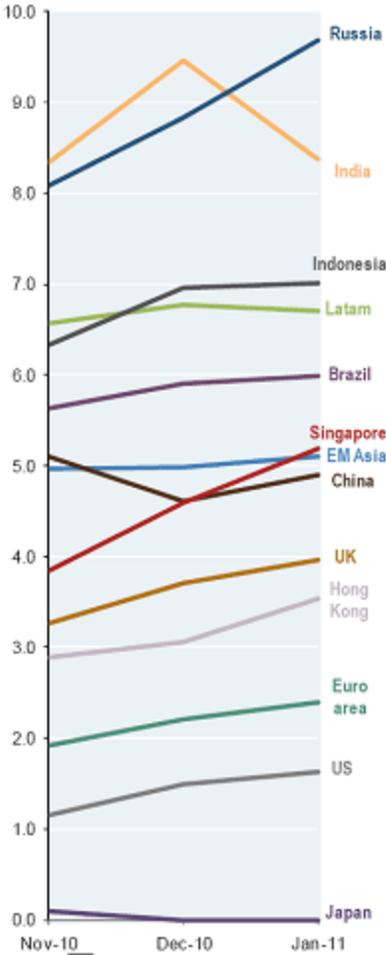
While the Fed is inclined to ignore pass-through risks from higher commodity prices, it seems riskier for the developing world to take the same approach, given much higher food and energy weights in their respective consumption baskets. Yet many of these countries are removing monetary stimulus at a very slow pace. **Despite recent rate hikes by many EM Central Banks, policy rates in the developing world are not far off their 2009 lows, while their economies have recovered sharply since that time.** In China, non-food inflation is at its highest level of the last 13 years. Equity markets are likely to be nervous about the outcome of EM Central Bank meetings until they can get on top of inflation risks and demonstrate that they are under control.

**Something not happening in March: emergency OPEC meeting**

On paper, Saudi Arabia's spare capacity is roughly twice the level of total Libyan and Algerian oil exports (which total 1.8 mm barrels per day). Furthermore, the International Energy Agency could coordinate with its members to release 4 mm bpd for an extended period, drawing on each country's Strategic Petroleum Reserve. As a result, OPEC ministers have indicated that there is no need for an emergency meeting before its next scheduled meeting in June.

But isn't there an oil emergency? Some commentators say that absent the spike in 2008, oil prices are now at their highest level in real terms since 1864. While this might be the case, comments like this ignore the sharp decline in oil intensity (oil consumption per unit of GDP) since 1980. Oil intensity has fallen by 80% in the OECD. **This may explain why the**

Headline inflation high or rising everywhere but Japan, % change - YoY



Source: Morgan Securities LLC.

**oil-driven wage-price spirals of the 1970s have not recurred since.** The ability of the global economy to withstand an oil shock is higher today than in the 1970s. However, at around \$120 oil (and \$4 gasoline), a threshold was reached a couple of years ago in the US which destroyed demand and economic output. The synchronous global manufacturing recovery shown on the first page could be at risk if oil prices rose another \$10-\$20 per barrel and stayed there. The highest levels of GDP sensitivity to rising oil prices: most of Asia, and Emerging Europe.

Michael Cembalest  
Chief Investment Officer

**Middle East Time Capsule, 1979**

Princeton's Richard Falk on Ayatollah Khomeini in 1979: "The depiction of Khomeini as fanatical, reactionary and the bearer of crude prejudices seems certainly and happily false. What is also encouraging is that his entourage of close advisers is uniformly composed of moderate, progressive individuals.....Having created a new model of popular revolution based, for the most part, on nonviolent tactics, Iran may yet provide us with a desperately needed model of humane governance for a third-world country."

- CDU Christlich Demokratische Union Deutschlands (Christian Democratic Union)
- SPD Sozialdemokratische Partei Deutschlands (Social Democratic Party)
- ECB European Central Bank
- EFSF European Financial Stability Facility
- OPEC Organization of the Petroleum Exporting Countries

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