

From: US GIO <[REDACTED]>

To: Undisclosed recipients;;

Subject: Eye on the Market, April 26, 2011

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Attachments: 04-26-11_-_EOTM_-_Crutches.pdf

Inline-Images: image001.png; image002.png; image003.png; image004.png; image005.png; image006.png; image007.png

Eye on the Market, April 26, 2011

There are a lot of charts this week that are much easier to read in the attached PDF

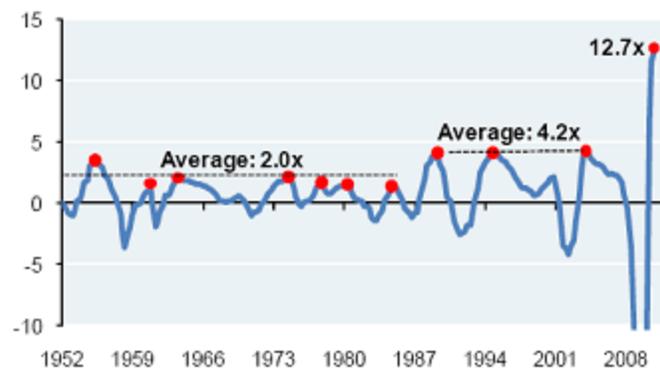
Topics: How dependent are corporate profits on support from Treasuries and Central Banks? And what is Bretton Woods II?

Crutches [a]. The title for this week's piece refers to a question we have grappled with for the last couple of years: how dependent are corporate profits on stimulus? We're about to find out: the Fed's QE2 program is ending in June; China is signaling that "administrative controls" may not be sufficient to control inflation and that more tightening is needed; and fiscal stimulus across the developed world is in withdrawal mode. Our portfolio allocations have been based on the notion that profits growth would drive equity markets higher. While we still believe this, stimulus consequences (higher commodity prices) and withdrawal are likely to slow the rate of equity market appreciation. Our equity allocations are positioned for roughly 10% gains on developed market equities this year. Currently, US equity markets are running ahead of that pace (despite a kitchen sink of problems which appeared in March), but only when measured in local currency terms given the ongoing decline in the US dollar.

This has been a remarkable profits boom considering the mild recovery in GDP. From 1950 to 1985, after recessions, profits recovered at 2x the rate of nominal GDP. During the late 1980s, 1990s and after the 2001-2002 tech collapse, profits recovered at 4x. The current profits-to-GDP recovery of 12.7x has been much sharper, and is influenced by the following:

- ** The continued rise in the contribution of non-US profits, driven by global GDP rather than US GDP (see second chart)
- ** A multi-decade low in labor costs (measured 3 different ways in Appendix II, in attached PDF only)
- ** Non-operating costs (interest, taxes and depreciation) which have stagnated since 2006; at one eighth the size of labor costs, non-operating costs play a much smaller role in the profits equation (also in Appendix II, in attached PDF only)

US profits recovery outpacing economic recovery
Ratio of 2 year earnings growth to 2 year nominal GDP growth



Source: Standard & Poor's, Bureau of Economic Analysis.

US corporate profits sourced from the rest of the world
Percent of GDP



Source: Bureau of Economic Analysis.

Rising non-US profits and falling labor costs contributed to an earnings recovery which caught analysts by surprise. How do we know this? The chart (right) shows the evolution of analyst estimates for each calendar year's profits, starting 2 years beforehand. During the 1990s, analysts tended to overestimate profits, and had to bring estimates down as time passed. Analysts also missed the 2 recent recessions (2001 and 2008) by a country mile. But during the last 2 profits recoveries, **analysts have been behind the curve, having to raise estimates as time passed** (i.e., lines rising over time). Some believe that this is a reflection of Regulation FD (2000), after which analysts are perhaps more beholden to company forecasts, which in turn may be low-balled for the purpose of beating them. While Reg FD may play a role, globalization

(higher revenues, lower costs) has progressed faster than many analysts anticipated. In Q1 2011, with 41% of companies reporting, 79% have beaten estimates while 14% have missed.

S&P 500 EPS Estimate Revisions

Dollars per share, starting two years beforehand



Source: Thomson Reuters Institutional Brokers' Estimate System.

[Please see Appendix I for comments on S&P 500 sector valuations and small cap vs large cap preferences]

What about US stimulus withdrawal? It is not easy to reconcile the recovery in US consumer spending and retail sales with the weakest labor compensation relative to revenues in 60 years. The answer: **a 50-year high in government transfers to US households** to help sustain them. These fiscal transfers are coming to an end, with one example being the pending expiration of payroll tax cuts. Labor markets will have to recover more strongly than they have so far in order to offset this. As for the end of QE2, it looks to us to be less of a factor for financial markets. Why? In our view, it has been priced in for a while. The bigger risk to the stability of the Treasury markets lie with their marginal buyers: Emerging Economy Central Banks. This brings us to the section below: *will the emerging world continue to buy Treasury bonds at the same pace?*

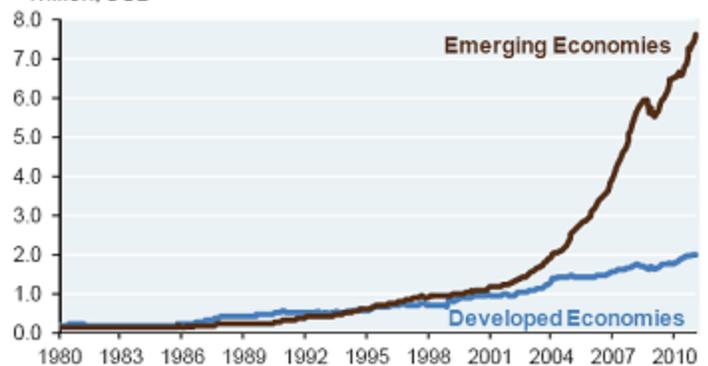
What about stimulus withdrawal in the emerging world? The grid below shows the IMF's growth calculus for 2011. While parts of Europe and Japan are struggling, other developed countries are not (Canada, Germany, Australia), and Asia is booming. The recovering countries represent 80% of global GDP, and are expected to grow 4.25% this year. Emerging economy growth has two benefits, one obvious and the other less so. The obvious benefit is increased demand for goods and services. The less obvious benefit: the impact EM growth has on global interest rates through deployment of FX reserves. The emerging world relies heavily on intervention to prevent their currencies from appreciating. As shown below, **that results in the accumulation of lots and lots of US dollars.** These dollars (and Euros) are then invested in government bonds, corporate bonds, real estate and other financial assets. This is the **"Bretton Woods II"** system in action. Seems like a win-win for everyone, doesn't it?

2011 GDP growth	GDP (bn, USD)	Largest countries
Below 0%	\$513	Greece, Portugal
From 0% to 2%	\$12,617	Japan, France, Italy, Spain, Netherlands, Switzerland, Belgium, Norway, Austria, Ireland, Venezuela
From 2% to 4%	\$29,563	Germany, UK, US, Canada, Australia, Mexico, Turkey, Sweden, Poland, South Africa, UAE, Denmark
More than 4%	\$22,700	China, Brazil, Russia, India, Korea, Indonesia, Saudi Arabia, Taiwan, Thailand, Hong Kong, Malaysia, Colombia, Singapore
More than 2%	\$52,263	80% of global GDP, 4.25% weighted average growth

Source: International Monetary Fund, J.P. Morgan Private Bank.

Global Foreign Exchange Reserves

Trillion, USD

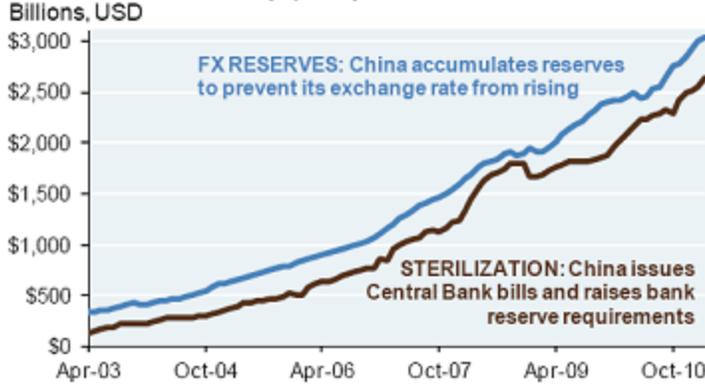


Source: International Monetary Fund, J.P. Morgan Securities LLC.

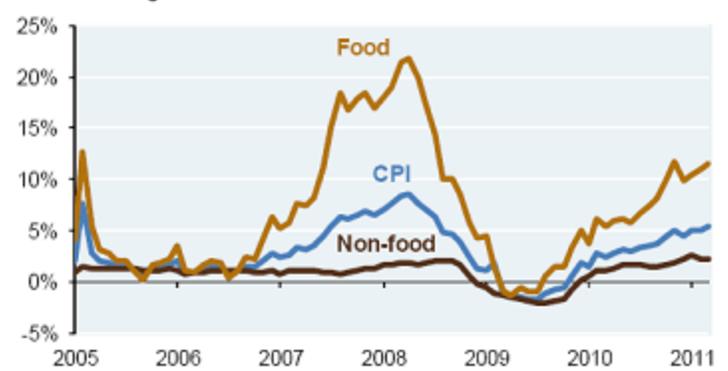
What are the risks to Bretton Woods II? The chart below is one we have shown before. As China accumulates FX reserves, it expands its monetary base to acquire them. To prevent inflation, China then raises reserve requirements on its banks, and also compels banks to purchase bills issued by its Central Bank. The chart suggests that this is working, as China "immobilizes" money at the same pace they create it, thereby eliminating inflation risks. However, **the inflation**

genie seems to be let out of the bottle anyway, as indicated by rising consumer prices (see chart), rapid appreciation of real estate prices, and 10%-20% wage growth for urban and rural households.

How Chinese monetary policy works in one slide

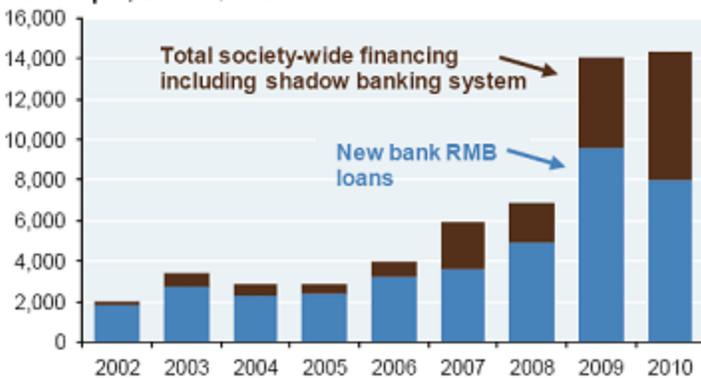


Chinese CPI increases largely driven by food



China relies on **administrative measures** to combat price increases, including the release of government food reserves, crackdowns on hoarding, price controls on power and rail, and the construction of low-end housing units. In doing so, they are channeling the best traditions of Joseph of Canaan, Lenin, Richard Nixon and Robert Moses, respectively. But for the first time, there appear to be concessions from Chinese officials that faster currency appreciation may have to stem inflation (see box). Why might government controls over banks not work perfectly? **The rise of a shadow banking system in China.** As shown in the chart, while new bank loans are on the decline, total system-wide liquidity in China is still quite high. As the US learned over the prior decade, it is difficult to control a shadow banking system unless you raise the cost of money for everyone.

Bank loans are decreasing, but other forms of liquidity are still ample, Billions, RMB



Is a faster rate of RMB appreciation in the cards?

Zhou Xiaochuan, governor of the People's Bank of China, April 19, 2011: "Foreign exchange reserves have exceeded our country's rational demand and too much accumulation has caused excessive liquidity in our markets, adding to the pressure of the central bank's sterilization"

Premier Wen Jiabao, at a meeting last week of the State Council, listed "strengthening the flexibility" of China's exchange rate as one of several tools the government should better use to control prices

Xia Bin, a member of the monetary policy committee of the central bank, said that \$1 trillion U.S. dollars would be sufficient (compared to current holdings of almost \$2 trillion)

Conclusion: corporate profits are not immune from the macroeconomic cycle

US and European profits benefited from the re-ignition of corporate and consumer demand, and from a collapse in labor costs, without suffering what would *usually* be a linkage between them. The lack of linkage is the consequence of policy stimulus. We expect profits to continue to rise (at a slower pace than in 2009/2010). However, fiscal and monetary crutches deployed in the developed and developing world are likely to prevent markets from assigning much permanence to them. That's why we expect P-E ratios to remain range-bound for the foreseeable future, with equity market gains linked to profits growth only.

Our greatest concern: an abandonment of the Bretton Woods II system in place for the last decade. **This is the most challenging aspect of the global economy; most of us have never seen anything like it before.** Brad Setser and his colleague Nouriel Roubini predicted the collapse of Bretton Woods II in 2004 [b], when Setser described its collapse as "almost certain" by 2010. Yet here we are, with Chinese reserves accumulation still on the rise in 2010. What might happen to their government bonds? Let's assume an *eventual* RMB appreciation of 30% against the dollar [c], applied to China's current holdings of ~\$2.3 trillion in Treasuries, Agencies and European government bonds. China's FX losses would be ~12% of GDP. That's a risk China appears willing to take in exchange for export supremacy, industrialization, non-chaotic urbanization and job growth. As shown in the chart, **China has a history of accepting heavy costs** in the

pursuit of goals seen as being in its long term interest, whether these goals turn out well (e.g., using banks to jump start industrialization in the 1990s and paying the cost later), or not (e.g., Great Leap Forward, Cultural Revolution). But now it's not just about FX losses: with rising Chinese inflation *and* concerns about US long-term solvency, the total risks of Bretton Woods II are growing for China. We are all trying to figure out what comes next.

Potential FX losses on China's accumulation of Treasuries and Agencies, in historical context, Percent of GDP



Michael Cembalest
Chief Investment Officer

[a] The title is also a reference to an unfortunate hairline fracture endured by Mary Erdoes, our fearless leader and the head of JP Morgan's Asset Management business. Please join me in wishing Mary a speedy recovery. Does Chanel make crutches?

[b] Bretton Woods I ended in the early 1970s when US deficit financing prompted European governments to redeem their dollars for gold en masse. Nixon closed the gold window for good in 1971, ending convertibility between dollars and gold.

[c] A 2010 paper from the Petersen Institute for International Economics estimates that the RMB is undervalued by 30%.

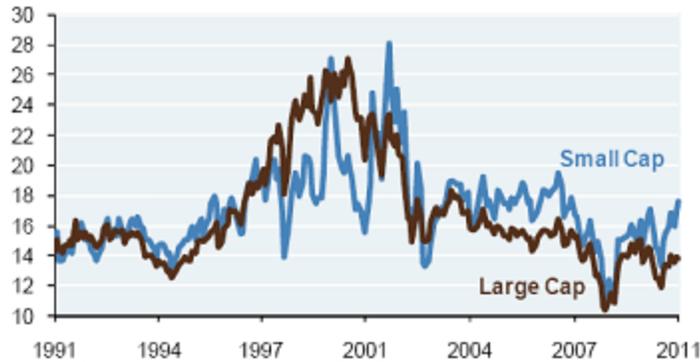
Sources and Notes on the chart showing potential losses on China's FX reserves

Sources for the chart, in addition to our own calculations: US Treasury (Chinese holdings of Treasury bonds), Barclays (Chinese Treasury purchases executed through the UK), Council on Foreign Relations (Chinese holdings of US Agencies), Wesleyan University (1999 cost of banking crisis), China Bureau of Statistics (China growth rates during the 1960's), Petersen Institute for International Economics (estimate of RMB under-valuation using Balassa-Samuelson measures) and China Daily (Chinese holdings of European government bonds). Note that our estimate of potential FX losses are no longer rising, as the pace of reserve accumulation has tracked increases in nominal GDP since 2007.

Appendix I: US capitalization and sector valuations

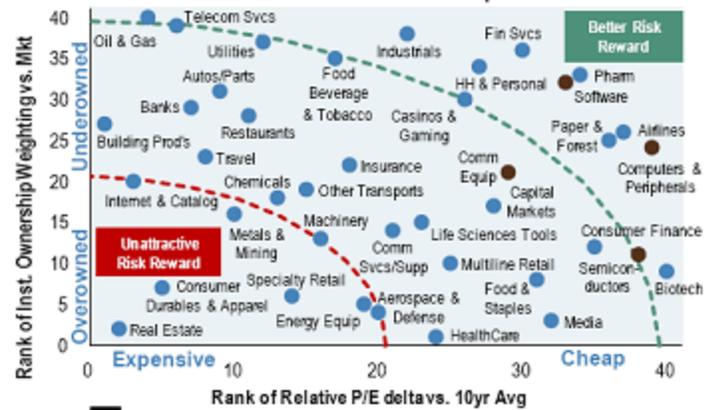
We currently have a preference for large cap over small cap, and for growth over value. The first chart shows the premium paid for small cap over large cap. The second chart takes a look at a cross section of institutional ownership⁴ of different sectors, and their relative valuations. Sectors related to technology are attractively priced and under-owned (brown dots), which is part of the reason for our large cap growth focus at the current time.

Relative value favors large cap after the rally
Russell 1000 and 2000 P/E ratios



Source: Russell Investment Group, IBES, Factset, J.P.Morgan Asset Management.

S&P 500 sector valuation and ownership ranks



Source: Morgan Securities LLC.

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