From: US GIO <[redacted]>
To: Undisclosed recipients:;
Subject: J.P. Morgan Eye on the Market - Dexia and the endgame in Europe
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Inline-Images: image001.png; image002.png; image003.png

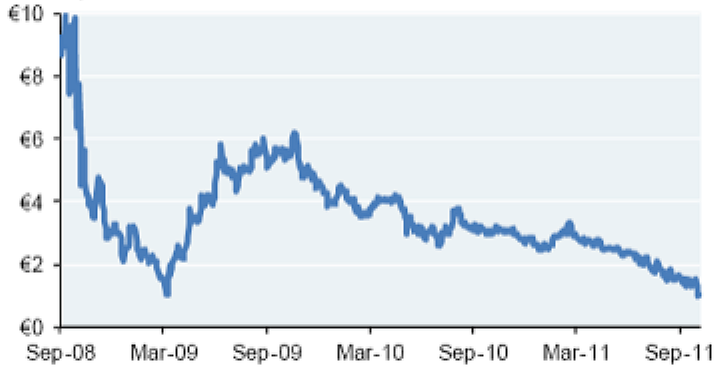
Eye on the Market, October 5, 2011
What may be coming in Europe: a multi-faceted muddle-through plan that could reduce systemic risk

As shown below, the last couple of months have seen no fewer than 10 inflection points in global equities. The latest surveys show that Europe is heading for recession, but that has been known for some time. **What most of these gyrations reflect is perception of systemic risk emanating from the European banks [a]**. Earlier this week, we wrote that there is downside risk ahead, since the resolution of the European problem is still too distant and unclear to make out. The Dexia announcement *may* have changed things by accelerating the end-game. Dexia's share price collapse reflects the pressure European banks are under. Dexia ($750 bn in assets), which passed the translucent EBA stress tests with flying colors (twice), saw its market capitalization fall *below* the face value of its exposure to Greece on Tuesday. Options for France and Belgium were running out; it is unclear how many assets Dexia had left that it could pledge with the ECB. A hurried announcement was made by the Belgian finance minster that Dexia's bad assets would be placed in a Bad Bank [b], thereby protecting depositors and other senior creditors.

World Equity Index: confused and sometimes misled
Level

Source: MSCI, Bloomberg.

Dexia's share price collapse
Price per share, Euros



Source: Bloomberg.

So, let me offer the following *possible* events that Dexia *might* set in motion that *could* reduce systemic risk from Europe:

** Before the EFSF is ratified, France and Germany independently guarantee/recapitalize their national champion banks; they presumably will not leave Dexia as the safest one. With the bad bank approach, losses would be worked off over time, as in prior iterations of this approach (e.g, China after 2000) and the US GSEs (Fannie Mae, Freddie Mac).
** Unlike Germany and France, Italy and Spain may not have the resources to recapitalize or guarantee their banks. So the EFSF issues 50-100 bn Euros, and lends it to Spain and Italy to recapitalize their banks.
** The bank recapitalization and clean-up actions may not be sufficient to result in such banks regaining access to unsecured debt markets, so the European Central Bank would need to be prepared to lend even more against their assets. Even so, we expect a large wave of asset-selling by European bad banks, depressing prices (and creating opportunity).
** After subtracting disbursements and commitments to Ireland, Greece and Portugal, and bank recap loans mentioned above, the EFSF would have 150-200 bn left. You may have seen the "first-loss" idea: the EFSF provides a 20% first loss guarantee to buyers of Italian or Spanish debt in primary markets. On such bonds, buyers lose money if there is a default, and salvage value is less than 80%. This would create ~800 bn in borrowing capacity for Spain and Italy, enough for them to borrow for one year. While it might violate the spirit and/or letter of agreements with national parliaments, at this point, Europe has entered "*the ends justify the means*" mode [c]. This approach appears to not require parliamentary approval. **I consider this the riskiest part of such a plan, since it's not clear that there would be enough depth/demand in the**

market for these bonds, given their unorthodox nature and the fact that it only pushes the problem out one year. However, we discussed this idea with some sovereign wealth funds and money managers; there may be *some* interest at 2%-3% over EFSF borrowing spreads. We'll see; if Italy ever restructured, 20% loss protection would not be *nearly* enough.
** Greece defaults, of course, and that's what the bank ring-fencing is all about. After they do, Portugal and Ireland may ask for increased debt forgiveness, claiming to be model citizens on austerity compared to Greece. This potential development increases the need for a comprehensive solution, which is what all of the above would presumably be designed for.

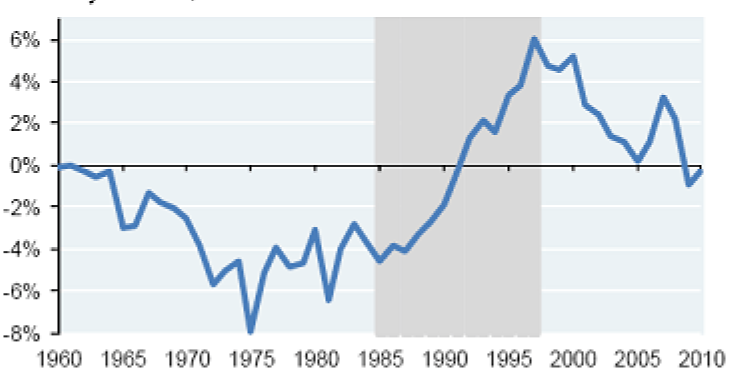
Then, the last step: a year or two from now, Europe moves towards greater fiscal integration once all countries run German-style fiscal policies. Before you send me notes with all the reasons this won't work, you don't have to. I agree that it's risky, and given the high likelihood of a European recession, 2012 will be ***The Year Of Living Dangerously*** in Europe. Who knows what this would do to France's credit rating; how is Italy supposed to move to a primary budget surplus of 5% in recession (see Appendix); and will Europe impose a financial transactions tax as a quid pro quo? Also, if it took a 20% first loss guarantee to sell Italian debt, what does that suggest as fair value for unsecured Italian bonds? **However, if systemic European bank risk (defined as losses to creditors, depositors and derivatives counterparties) is avoided, short positions could be forced to cover for a while, and we might be able to focus on growth, profits and valuations again.** Maybe. I am trying (for once) to be optimistic in the face of a monetary union imploding due to its own internal contradictions.

Next hurdle: what if the US Joint Select Committee on Deficit Reduction cannot agree on *anything*? [d]

Michael Cembalest
Chief Investment Officer

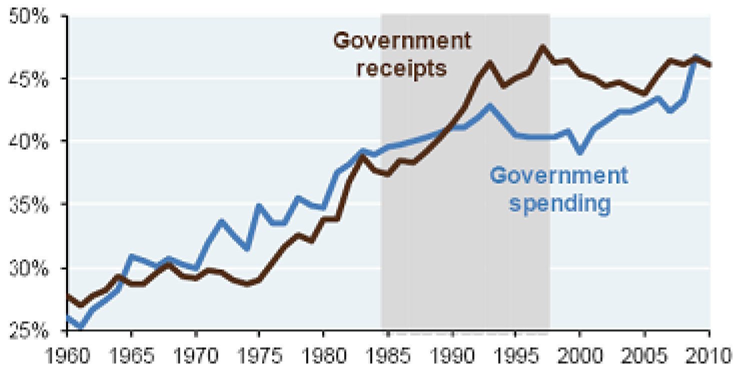
<u>Appendix: "A 5% primary budget surplus in Italy? No problem!" Not so fast…..</u>
Believers in Italian debt sustainability tell me Italy has run a primary balance of 5% before, in the late 1990's. A closer look indicates this will be a very tall order now. As shown, Italy did run a primary surplus of 5% of GDP in 1997-98. However, this primary balance **was based on increased tax receipts, rather than spending cuts**. We cannot find evidence that Italy has sustained a fiscal adjustment based on spending cuts. Might Italy increase its tax revenue base again? Perhaps, but Italy is already at the upper end of tax collections to GDP, and the Nordics are outliers (third chart). As for the decline in Italy's debt burden from 130% to 110% of GDP, **that was based mostly due to a decline in interest rates (from 14% to 4%) which occurred during the EMU convergence era**. It's unlikely, and almost mathematically impossible, for that to happen again.

Italy did run a primary balance of 5% before...
Primary balance, Percent of GDP

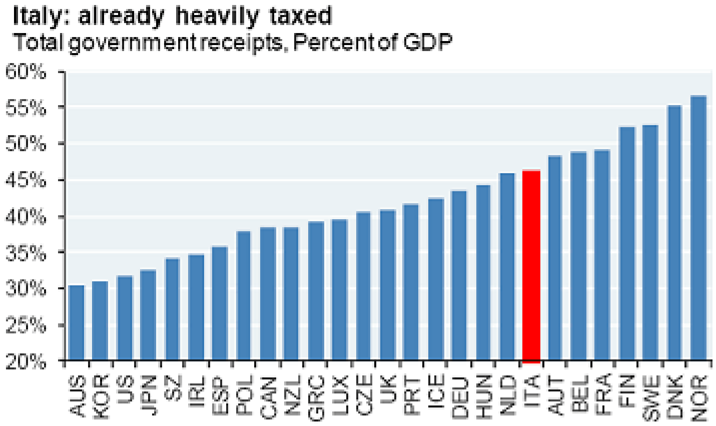


Source: OECD.

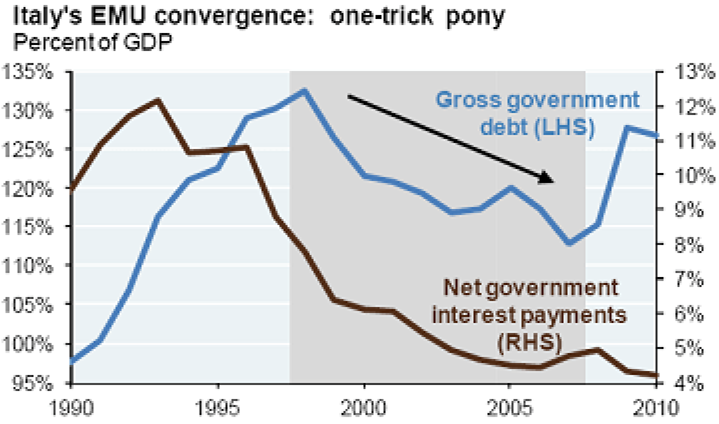
...but it was based on higher taxes, not spending cuts
Percent of GDP



Source: OECD.



Source: OECD.



Source: OECD.

Notes

[a] Sometimes it seems like European banking risks are the modern day version of viruses transmitted to the New World 300 years ago (plague, cholera, influenza, scarlet fever, smallpox, etc). If this sounds extreme, in May 2011, 70% of US money market funds were composed of exposure to European banks; and 70% of all developed world lending to Asia comes from European banks that are now in the process of shrinking. On the other hand, the US bank and broker-dealer insolvencies of 2008 may be the pinnacle of systemic risk exported abroad.

[b] Bad assets are placed into a bank whose liabilities are guaranteed by the government, leaving a clean bank to face markets and depositors.

[c] I am reminded of the Clinton administration's use of the Exchange Stabilization Fund to save Mexico in 1994 to avoid Congressional opposition to the President's plan to provide $40 billion in loan guarantees. The Fund was created for purposes of stabilizing the dollar.

[d] We have prepared a piece on the "*10 reasons why financial markets will focus on the Deficit Reduction Committee*" that is being shared with policymakers in Washington, via our government relations team. Ask your JPM representative if you would like to see a copy.

EFSF = European Financial Stability Facility
GSE = Government-sponsored enterprise
EBA = European Banking Authority
ECB = European Central Bank
EMU = European Monetary Union
Primary surplus = budget surplus before interest on government debt