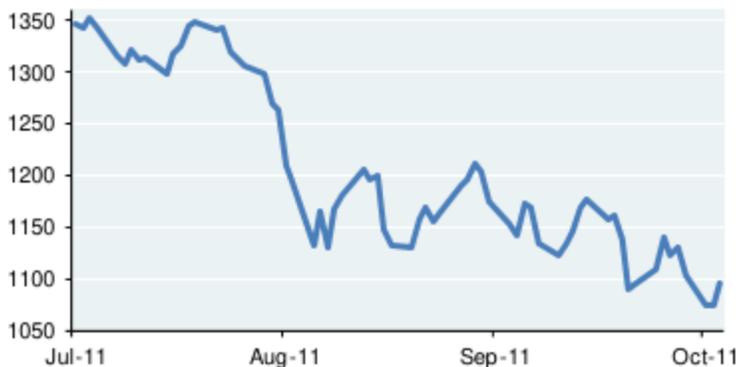


What may be coming in Europe: a multi-faceted muddle-through plan that could reduce systemic risk

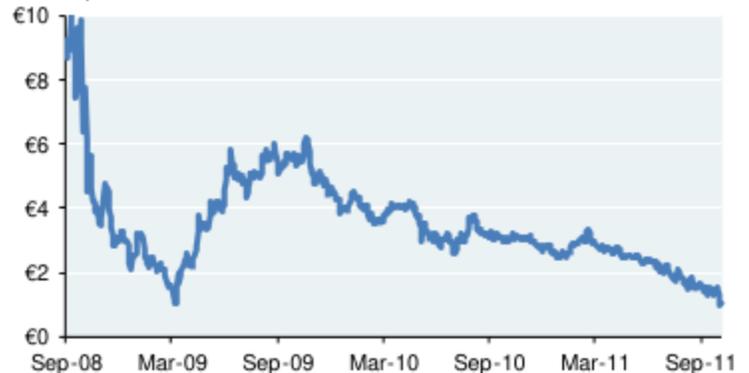
As shown below, the last couple of months have seen no fewer than 10 inflection points in global equities. The latest surveys show that Europe is heading for recession, but that has been known for some time. **What most of these gyrations reflect is perception of systemic risk emanating from the European banks¹.** 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 minister that Dexia's bad assets would be placed in a Bad Bank², 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 read 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*" mode³. 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.

¹ 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.

² Bad assets are placed into a bank whose liabilities are guaranteed by the government, leaving a clean bank to face markets and depositors.

³ 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.

What may be coming in Europe: a multi-faceted muddle-through plan that could reduce systemic risk

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.

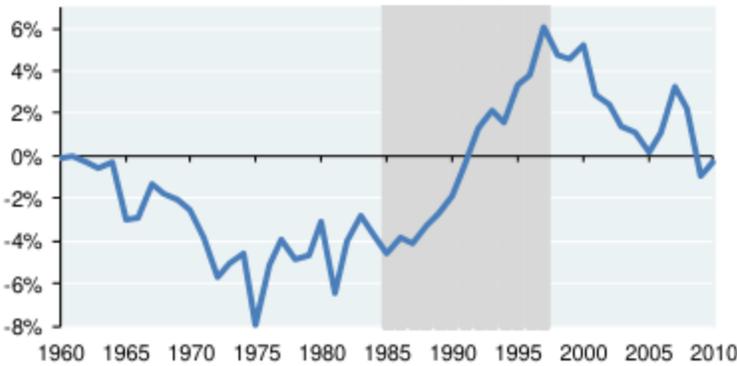
Next hurdle: what if the US Joint Select Committee on Deficit Reduction cannot agree on anything?⁴

Michael Cembalest
Chief Investment Officer

Appendix: "A 5% primary budget surplus in Italy? No problem!" Not so fast.....

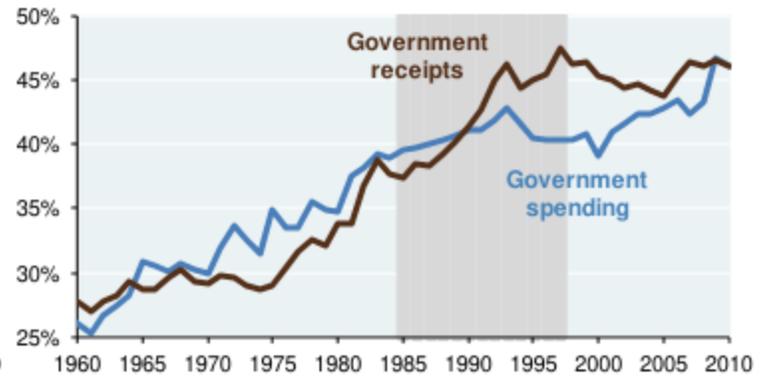
Believers in Italian debt sustainability tell me Italy has run a primary balance of 5% before, in the late 1990's. A closer look indicates this will be a very tall order now. As shown, Italy did run a primary surplus of 5% of GDP in 1997-98. However, this primary balance was based on increased tax receipts, 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



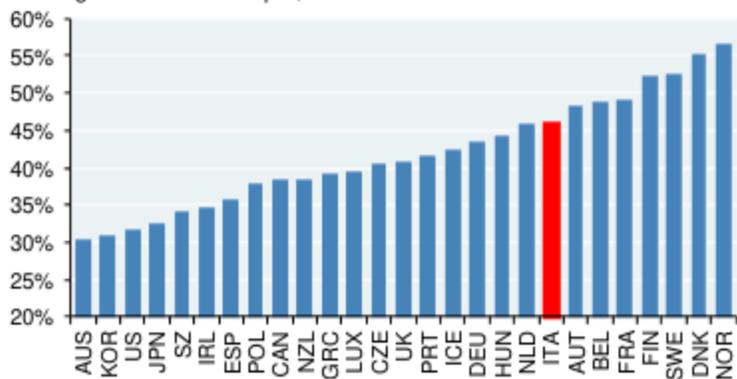
Source: OECD.

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



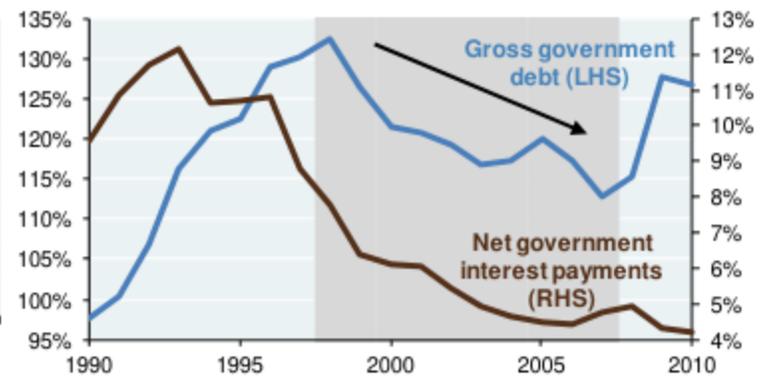
Source: OECD.

Italy: already heavily taxed
Total government receipts, Percent of GDP



Source: OECD.

Italy's EMU convergence: one-trick pony
Percent of GDP



Source: OECD.

⁴ 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.

What may be coming in Europe: a multi-faceted muddle-through plan that could reduce systemic risk

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

The material contained herein is intended as a general market commentary. Opinions expressed herein are those of Michael Cembalest and may differ from those of other J.P. Morgan employees and affiliates. This information in no way constitutes J.P. Morgan research and should not be treated as such. Further, the views expressed herein may differ from that contained in J.P. Morgan research reports. The above summary/prices/quotes/statistics have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness, any yield referenced is indicative and subject to change. Past performance is not a guarantee of future results. References to the performance or character of our portfolios generally refer to our Balanced Model Portfolios constructed by J.P. Morgan. It is a proxy for client performance and may not represent actual transactions or investments in client accounts. The model portfolio can be implemented across brokerage or managed accounts depending on the unique objectives of each client and is serviced through distinct legal entities licensed for specific activities. Bank, trust and investment management services are provided by J.P. Morgan Chase Bank, N.A. and its affiliates. Securities are offered through J.P. Morgan Securities LLC (JPMS), Member NYSE, FINRA and SIPC. Securities products purchased or sold through JPMS are not insured by the Federal Deposit Insurance Corporation ("FDIC"); are not deposits or other obligations of its bank or thrift affiliates and are not guaranteed by its bank or thrift affiliates; and are subject to investment risks, including possible loss of the principal invested. Not all investment ideas referenced are suitable for all investors. Speak with your J.P. Morgan Representative concerning your personal situation. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Private Investments may engage in leveraging and other speculative practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuations to investors and may involve complex tax structures and delays in distributing important tax information. Typically such investment ideas can only be offered to suitable investors through a confidential offering memorandum which fully describes all terms, conditions, and risks.

IRS Circular 230 Disclosure: JPMorgan Chase & Co. and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with JPMorgan Chase & Co. of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties. Note that J.P. Morgan is not a licensed insurance provider.

© 2011 JPMorgan Chase & Co; All rights reserved