

From: US GIO <[REDACTED]>

To: Undisclosed recipients;;

Subject: Eye on the Market, February 26, 2013

Date: Tue, 26 Feb 2013 21:45:59 +0000

Attachments: 02-26-2013_-_EOTM_-_The_gift_that_keeps_on_giving.pdf

Inline-Images: image002.png; image004.png; image008.jpg; image009.png

Eye on the Market, February 26, 2013 (the attached PDF is a better place to look at charts that begin in 1820)

Topic: Why being underweight European equities has been the gift that keeps on giving

As shown in the first chart, being underweight European equities vs. the US since the EU debt crisis began has been a good position to implement in portfolios. It would be unlikely for the next three years to result in a similar amount of underperformance, but all things considered, it still feels too early to reverse it. The Draghi “whatever it takes” speech in July of last year narrowed the gap, but so far in 2013, Europe’s dual problems of low growth and weak profit margins are driving the gap higher again, in favor of the US. As things stand now, the gap is not far off its post-crisis peaks. Even so, this week’s vote in Italy may usher in another period of European equity underperformance.

Cumulative outperformance of US vs. European equities, Percent, Total return in USD, Index, 3-trading day moving average, 12/31/2009 = 0%

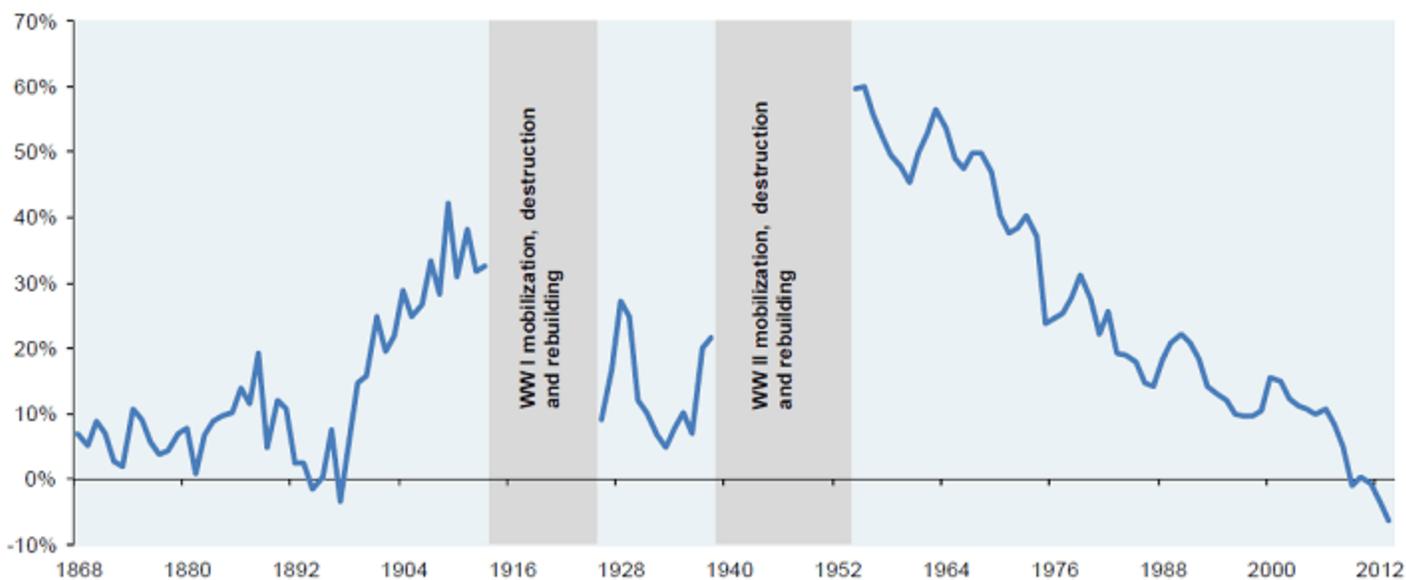


Source: Bloomberg.

Let’s start with the good news: Italy has one of the best fiscal accounts in Europe (its pre-interest budget is in surplus), its current account is in balance (mostly a reflection of a collapse in imports), and Italy finances a lot of its debt on its own without too much reliance on foreign investors (Italy’s Net International Investment Position, a proxy for such reliance, is at -20% of GDP compared to -90% for Spain). However, growth has been very poor: by the end of 2012, **Italy overtook Japan with the worst real GDP growth of all advanced economies since 1991** (0.79% per year, an amazing and sad distinction). Italians are clearly getting tired of austerity against a backdrop of no growth, and around 25% of them voted for a party which reportedly supports renegotiation of Italy’s debt, a referendum on the Euro and a break-up of large Italian state-owned companies (the 5-star movement). The protest vote cast by many Italian citizens this week can perhaps be best understood by looking at the chart below. Other than wartime, the last few years in Italy have been the worst for growth since Italian unification in 1861.

Why a protest vote? Italy's long-run economic decline keeps getting worse

Change in 7-year real Italian GDP, percent, since 1861 (Unification)



Sources: "Statistics on World Population, GDP and Per Capita GDP", University of Groningen; Conference Board, Bloomberg.

The problem for Italy is that the austerity is *not* going to end, a consequence of having too much debt (120% of gdp, to be exact), so large that Italy is the world's 3rd largest sovereign debt issuer despite being 10th in terms of purchasing power. Countries with that much debt generally have to run a budget surplus before interest, since interest payments are so large. Italy has done exactly that, running a cyclically-adjusted primary surplus consistently since 1992. That leaves little room for counter-cyclical stimulus when growth is weak, or when structural reforms create a temporary drag on growth. To be clear about this, the multilateral borrowing facility (the European Stability Mechanism), the lend-against-anything-that-moves policy of the ECB and the commitment by the ECB to purchase government debt (the Outright Monetary Transactions program) **all substantially reduce the risk of sovereign and bank defaults, not just in Italy but across all of Europe**. EU governments and central banks have provided 800 billion Euros so far to finance foreign investors fleeing Italy and Spain, and could provide a lot more. But it is getting harder (particularly after last year's EU equity rally) to dismiss the social and political costs Southern Europe is paying to keep the Euro. In my view, the old system was messier with its periodic bouts of inflation and devaluation, but worked better for Southern Europe given its structural competitiveness gaps with the North, and its own internal fiscal transfer dynamics [a]. Some believe Europe is on a long journey to further integration; I think it is just as likely that parts of Europe are on a long and painful journey to discover that a single currency has more costs than benefits in the long run.

As for **France**, the recent spat between a US tire company CEO and French Industrial Renewal Minister Montebourg got a lot of publicity. There is hyperbole being thrown around by both sides, but we do find evidence that France has created a worker's utopia compared to many other countries. Last year, we showed a chart indicating that France has the most worker-friendly environment of 40 countries analyzed (November 7, 2012), a computation based on labor force participation, ease of hiring and firing, retirement age as % of life expectancy, working hours per year, vacation days, linkage between pay and productivity, unemployment benefits as % of wages, etc. France has been trying to enact reforms, but my sources differ sharply on their potential for success. France has lost a lot of ground to Germany since the Euro was launched, and I'm not sure Industrial Renewal ministers can change that. Here are some stats from Bernard Connolly at Hamiltonian Advisors:

** The share of French corporate profits in gross value added is the smallest of the six major EU countries, and falling

** While Germany has maintained its share of world exports, France has lost one third of its share since the Euro was launched.

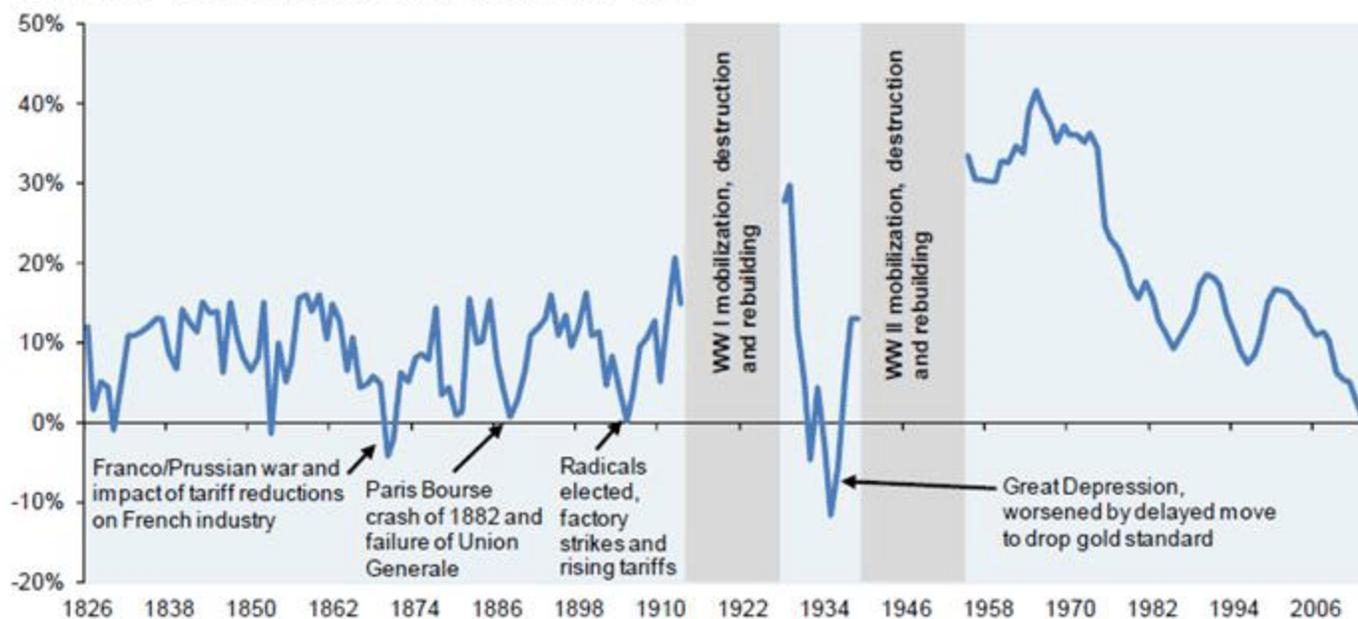
** France's current account deficit is around 6% of GDP (in other words, very large) after taking into account depressed consumption due to high and rising unemployment

The growth challenge for France is something we will have to watch as well. It's not as bad as in Italy, but as shown below, other than during wartime (see Appendix on why wars are excluded from charts like this), this has been a very bad stretch for French growth. A period of no growth over 7 years in France is something seen more frequently during the 19th century. It was also seen during the 1930's when France stuck to the gold standard longer than other countries did, and

paid a price. There are some parallels between the gold standard in Europe in the 1930's and the binding constraint of today's currency union.

Le retour a l'ancien regime: France's zero growth pace mirrors 19th century events

Change in 7-year real French GDP, percent, since 1820



Sources: "Statistics on World Population, GDP and Per Capita GDP", University of Groningen; Conference Board, Bloomberg.

European equities might get cheap enough at some point, but last year the valuation gap vs the US narrowed, particularly among financial stocks, and they don't look cheap enough yet. We don't know where things will go from here in Italy.

Europhiles predictably believe that a grand Italian coalition will form and work together to avoid another round of elections. I understand why, since in Greece, a second round of elections simply ended up increasing fringe party votes. Perhaps what Italians really want is a little less fiscal austerity, and are asking their politicians to figure out how to do it without upsetting German demands for more. I can see Germany agreeing for some forbearance before its own elections to avoid a larger problem.

All things considered, from an investment standpoint, caution continues to be warranted. Our 2013 Outlook included the following at the end of the Europe section: "By primarily relying on unemployment and wages to restore competitiveness, Europe is taking the road less traveled and remains an economic and social experiment of the highest order." Not much has changed since. As always, it's important for investors to avoid over-extrapolating macro issues when there are opportunities to be had in financial markets. However, while European companies earn a substantial amount of revenues outside Europe, their domestic exposures and exposures to other weak EU countries are too large to ignore (see table). The last chart shows a proxy for profit margins by looking at earnings relative to sales for the 3 major regions. **As shown, problems in Europe appear to be taking their toll on EU corporate profitability.** There are some European equity managers that have done a fantastic job generating returns over the MSCI Europe benchmark, some large enough to offset most or all of the index-level gap vs the US shown on the first page. These products make the most sense for current allocations to EU equities.

Michael Cembalest
Morgan Asset Management

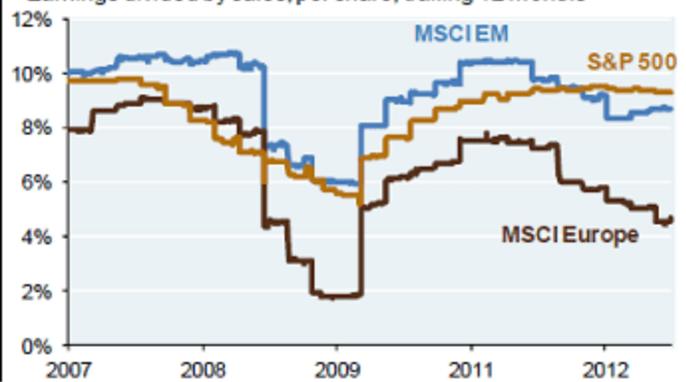
Eurozone corporate revenue breakdown by region

| | Domestic | EMU ex Domestic | Rest of World |
|------------------|----------|-----------------|---------------|
| France (CAC 40) | 29% | 29% | 42% |
| Germany (DAX) | 28% | 30% | 42% |
| Italy (FTSE MIB) | 30% | 22% | 48% |
| Spain (IBEX) | 43% | 20% | 37% |

Source: J.P. Morgan Securities LLC, JPMAM

Eurozone margin proxy weakening

Earnings divided by sales, per share, trailing 12 months



Source: Bloomberg.

Appendix: Why 20th century wartime periods are often excluded from long-run pictures of economic growth

The charts above exclude WWI and WWII. Twentieth century warfare generated extreme outcomes immediately before, during and afterwards. Before wars, mobilization efforts often went into overdrive, boosting production way above sustainable levels. The war itself brought devastation that was often broader than that seen during the 18th and 19th centuries. And afterwards, rebuilding from a devastated base generated spectacular growth booms that petered out once they ran their course. Consider the case of France to grasp the magnitude of destruction and eventual rebuilding:

** During WWII, the Germans stripped France of millions of its workers, either as prisoners of war (around 2 million of them) or as 'voluntary' workers. The lack of volunteers to work for the Germans was enough of a problem to cause the Vichy government to pass a law in November 1942 that effectively deported workers to Germany, where they represented as much as 15% of the entire German-domiciled labor force by 1944. Many of them worked in a Krupp steel works plant in Essen.

** The Germans also stripped 20% of the French food supply, and took direct control of production which was synchronized with German war needs. With the food supply chain in shambles, civilians suffered shortages of basic consumer goods. Rationing of 1,300 calories per day (the Germans had seized half of the meat) led to malnourishment and disease, and to farmers diverting a lot of what was left to black markets. Farm production fell in half due to a lack of fuel, fertilizer and workers.

Notes

[a] Charles Gave of Gavekal Research has written a fascinating, brief essay on the politics of Europe (entrepreneurs vs rentiers and statists), and how local currencies used to work regarding the financing of within-country entitlements and transfers. This equilibrium was maintained since private sector salaries were linked more to the Deutschmark than to domestic currencies.

Sources

Bernard Connolly, "Recalcitrant current accounts and a collapsing austerity strategy: can the ECB hold the line", Hamiltonian Advisors, February 25, 2013

Charles Gave, "Down with Reform", Gavekal Research, February 26, 2013

Françoise Berger, "L'exploitation de la Main-d'oeuvre Française dans l'industrie Siderurgique Allemande pendant la Seconde Guerre Mondiale", Revue D'histoire Moderne et Contemporaine", 2003

E M Collingham, "The Taste of War: World War Two and the Battle for Food", 2011

Kenneth Mouré, "Food Rationing and the Black Market in France (1940–1944)", 2010

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.

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.

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 JP Morgan Chase Bank, N.A. and its affiliates. Securities are offered through J.P. Morgan Securities LLC (JPMS), Member NYSE.

FINRA and SIPC, and its affiliates globally as local legislation permits. 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. High yield bonds are speculative non-investment grade bonds that have higher risk of default or other adverse credit events which are appropriate for high-risk investors only. Investments in commodities carry greater volatility than investments in traditional securities. There are additional risks associated with international investing and may not be suitable for all investors. This material is distributed with the understanding that J.P. Morgan is not rendering accounting, legal or tax advice. You should consult with your independent advisors concerning such matters.

Bank products and services are offered by JPMorgan Chase Bank, N.A. and its affiliates. Securities are offered by J.P. Morgan Securities LLC, member NYSE, FINRA and SIPC, and other affiliates globally as local legislation permits.

In the United Kingdom, this material is approved by J.P. Morgan International Bank Limited (JPMIB) with the registered office located at 25 Bank Street, Canary Wharf, London E14 5JP, registered in England No. 03838766 and is authorised and regulated by the Financial Services Authority. In addition, this material may be distributed by: JPMorgan Chase Bank, N.A. (JPMCB) Paris branch, which is regulated by the French banking authorities Autorité de Contrôle Prudentiel and Autorité des Marchés Financiers; J.P. Morgan (Suisse) SA, regulated by the Swiss Financial Market Supervisory Authority; JPMCB Bahrain branch, licensed as a conventional wholesale bank by the Central Bank of Bahrain (for professional clients only); JPMCB Dubai branch, regulated by the Dubai Financial Services Authority.

In Hong Kong, this material is distributed by JPMorgan Chase Bank, N.A. (JPMCB) Hong Kong branch except to recipients having an account at JPMCB Singapore branch and where this material relates to a Collective Investment Scheme (other than private funds such as private equity and hedge funds) in which case it is distributed by J.P. Morgan Securities (Asia Pacific) Limited (JPMSAPL). Both JPMCB Hong Kong branch and JPMSAPL are regulated by the Hong Kong Monetary Authority.

In Singapore, this material is distributed by JPMCB Singapore branch except to recipients having an account at JPMCB Singapore branch and where this material relates to a Collective Investment Scheme (other than private funds such as a private equity and hedge funds) in which case it is distributed by J.P. Morgan (S.E.A.) Limited (JPMSEAL). Both JPMCB Singapore branch and JPMSEAL are regulated by the Monetary Authority of Singapore.

With respect to countries in Latin America, the distribution of this material may be restricted in certain jurisdictions. Receipt of this material does not constitute an offer or solicitation to any person in any jurisdiction in which such offer or solicitation is not authorized or to any person to whom it would be unlawful to make such offer or solicitation.

Each recipient of this presentation, and each agent thereof, may disclose to any person, without limitation, the US income and franchise tax treatment and tax structure of the transactions described herein and may disclose all materials of any kind (including opinions or other tax analyses) provided to each recipient insofar as the materials relate to a US income or franchise tax strategy provided to such recipient by JPMorgan Chase & Co. and its subsidiaries. Should you have any questions regarding the information contained in this material or about J.P. Morgan products and services, please contact your J.P. Morgan private banking representative. Additional information is available upon request. "J.P. Morgan" is the marketing name for JPMorgan Chase & Co. and its subsidiaries and affiliates worldwide. This material may not be reproduced or circulated without J.P. Morgan's authority. © 2013 JPMorgan Chase & Co. All rights reserved

This email is confidential and subject to important disclaimers and conditions including on offers for the purchase or sale of securities, accuracy and completeness of information, viruses, confidentiality, legal privilege, and legal entity disclaimers, available at <http://www.jpmorgan.com/pages/disclosures/email>.