

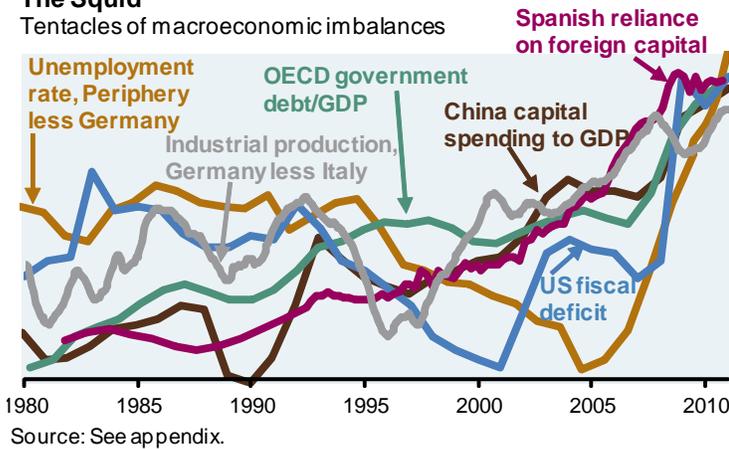
The battle between rising profits/low equity valuations and those macro issues that just won't go away



The Squid and the Whale. Our decision to maintain an underweight position in equities coming into 2012 was based on the view that the battle between the **Squid** (some of the worst macroeconomic imbalances on record) and the **Whale** (rising corporate profits, the lowest equity valuation multiples in decades, and a 50-year high in corporate cash balances) was not over yet. Our view looked too conservative in March, in the positive glow of ECB rescue operations and strong US employment gains. At the time, global equities were up more than 12%. Since then, as we feared and highlighted at the time, the bloom came off the rose in Europe, and the end of weather/census/other distortions brought US payroll growth back down to earth. The markets have followed them, with global equities flat for the year as of last Friday.

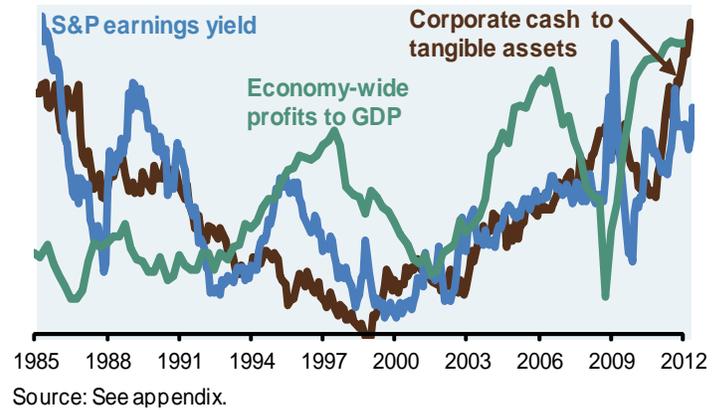
The Squid

Tentacles of macroeconomic imbalances



The Whale

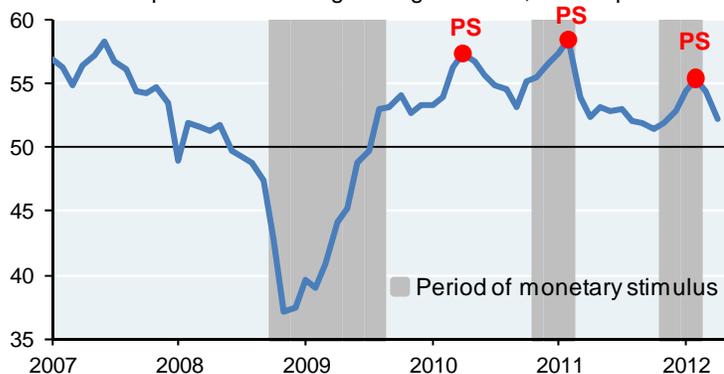
The cheapness of corporate profits and piles of cash



As the squid-whale battle rages on, the global economy has improved in fits and starts. However, as shown below, **as soon as periods of monetary stimulus fade, so have measures of global activity.** For the third year in a row, we've had another Prague Spring¹, a metaphor for better springtime data melting as summer begins. Unsurprisingly, market chatter now shifts to the next rounds of stimulus in both OECD and non-OECD nations. Here we go again. In today's note, a look at Europe, the US and China. While industry Whale Watchers are always on the lookout for the next bull market, I have had the feeling that the squids will be around for a while, and that portfolios should be positioned accordingly.

Another Prague Spring

Global Composite Purchasing manager's index, 50+=expansion

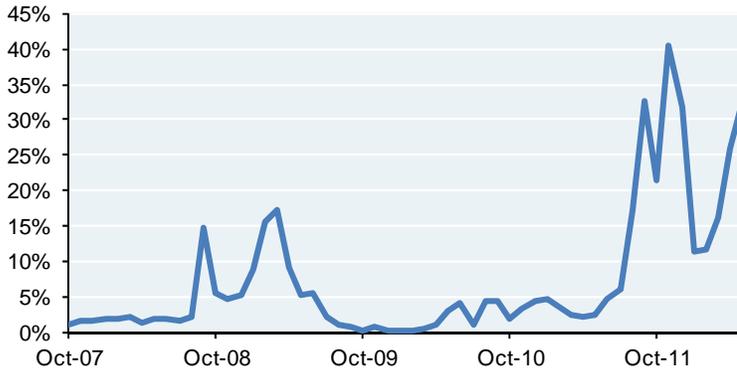


On Europe, some clients (and colleagues) wonder why we spend so much time on it every week. It's not every day that the monetary union of a highly indebted region runs aground, so I consider the answer to that question to be self-evident. In case it's not, here are another couple of things to think about. The first chart below shows the percentage of OECD banking system assets that are held by banks in some kind of distress. I define "distress" as banks with credit spreads of more than 3%. Other levels could have been used, but I chose 3% since it signifies a level of credit risk which offsets part of a bank's net interest and credit lending margins. Around one third of all OECD banking system assets fall into this category, and **the vast majority of banks contributing to this chart are European.** That alone should be enough to get your attention focused on Europe.

¹ A fleeting renaissance of political and social freedoms in Czechoslovakia, abruptly terminated in 1968 by the former Soviet Union.

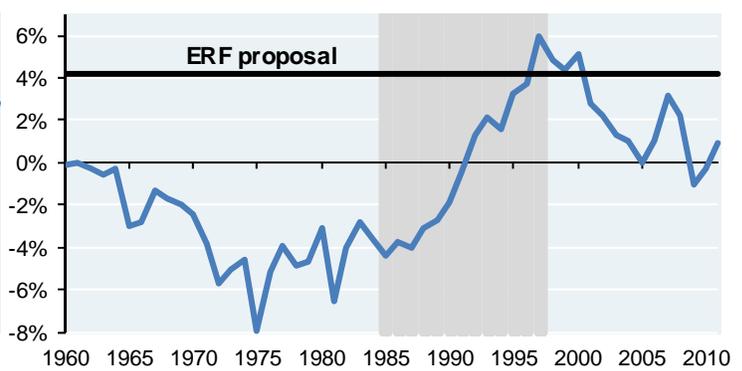
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Percentage of OECD banking system assets in "distressed" banks, Percent, distress = credit spreads > 3%



Source: Bloomberg, Markit, J.P. Morgan Securities LLC, JPMAM.

Italy and a 4.2% primary surplus target: *Ridicolo*
Primary fiscal balance, percent of GDP



Source: OECD.

The second chart deals with the latest trial balloon, drafted by a group of German Wise Men²: the “**European Redemption Fund**”. Vladimir and Estragon covered the ERF in last week’s *Waiting for Godot*, but as a review, the idea is that Germany would sanction the temporary use of joint and severally guaranteed European government bonds if member countries adopt constitutional debt brakes and primary surplus targets that guarantee paydown of these bonds over time, and hit a 60% debt to GDP target after 25 years. In Italy, this would require a primary surplus of 4% every year for 25 years, and a constitutional 60% debt brake which would have been breached 70% of the time since Italian unification in 1861. If the preposterousness of such a plan is not apparent, refer to the second chart above on Italy’s primary surplus since 1960. It was briefly above 4% at the end of the 1990’s (based more on tax collections than spending cuts), but that’s about it. **There is little in European economic or political history that suggests that the ERF’s primary surplus targets are achievable over the long run. Turning Greeks into Germans has proven to be a disaster; I am not sure that turning Italians into Germans will be any more successful.**

As shown in the table below, the money from the ECB’s two rescue operations has now mostly been spent. People who expect Europe to “fix the problem” operate under the assumption that [a] they know how to do it, [b] that countries like Germany can afford it, and [c] that the political will exists to do it. I don’t know about [a] or [c], but as reviewed in *The German Question* (May 21), given Germany’s 80% debt to GDP ratio, I have reservations about [b]. Something is coming in Europe, perhaps a forced recapitalization of Spanish banks after the Bankia nationalization (see table), a banking license for the ESM bailout fund or a fortified bank deposit guarantee fund (deposits in Periphery banks are around 3.6 trillion Euros). But as we wrote last week, you would have to be a Panglossian optimist to assume it will be the defining turning point for the region.

ECB funding for European banks Dec 2011- Feb 2012		
LTR-Over: what banks did with ECB money since December, EUR, billions		
	Spain	Italy
LTRO funding from ECB	195	114
- Purchase of govt. bonds/loans	102	73
- Purchase of other bonds	0	26
- Paydown of interbank liabilities	48	45
- Paydown of bonds	<u>25</u>	<u>18</u>
= Amount left	20	-48

Source: Bridgewater Associates.

Bankia Timeline: Spain’s third largest bank

Jul 2010: Bankia parent companies (Caja Madrid and Bancaja) given clean bill of health in EBA stress test
 July 2011: Bankia IPO raises €3 bn as “good-bank” spinoff
 Dec 2011: European Banking Authority says Bankia parent needs another €1.3 bn
 Feb 2012 Bankia annual report asserts “strong solvency and capital position, with a core capital ratio of 10.1%”
 May 2012: Spanish government converts €4.5bn of preferred shares into voting stock of Bankia parent company
 May 2012: Spanish government announces another €19 bn needed at Bankia’s parent company to cover current and future provisions
 May 2012: Bankia announces Q4 2012 rights offering of €2 bn
 May 2012: DeutscheBank CEO Fitschen describes Spanish bank capital needs as “staggering”; Bankia shares down 72% since July 2011 IPO

Sources: European Banking Authority, Bankia corporate reports, FROB, London Telegraph, Bloomberg.

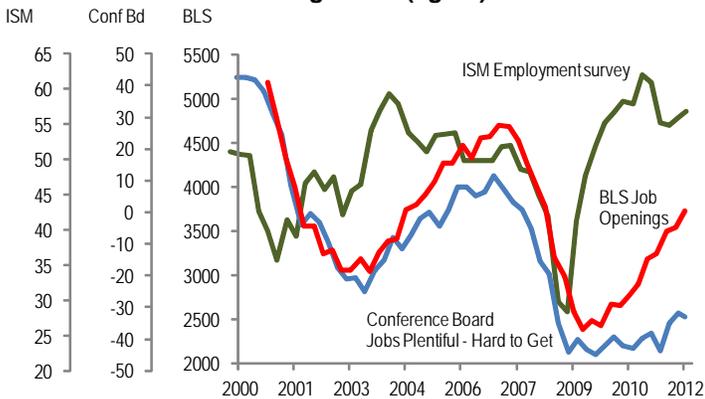
In the **United States**, the payroll report was a letdown, particularly since higher US growth is one of the few things Europe could look to as a stabilizing force. As we head into summer, most economists are taking down US GDP growth numbers (again), with 2012 now converging to 2%. Disposable income growth is weakening, which typically means that business capital spending will remain subdued as well. The decline in gasoline prices and debt service costs has helped prevent a sharp decline in consumer cash flow, but the entire picture does not appear to add up to escape velocity for the US economy.

² When I read about the *Wise Men of Germany*, I could not escape a vision of people who look like Gandalf and Albus Dumbledore

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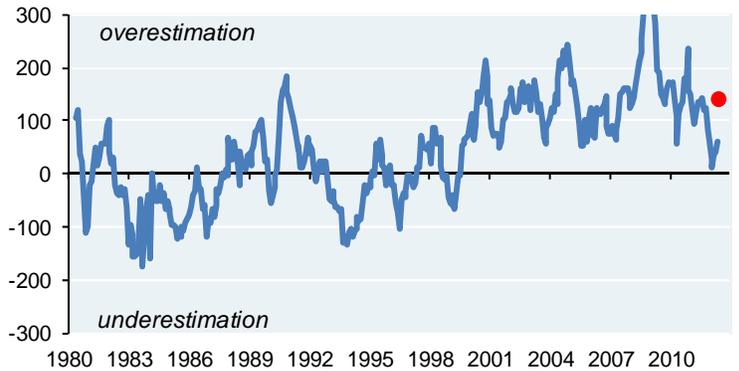
On the payroll report, recently improving labor surveys from the Conference Board, the Institute for Supply Management and the Bureau of Labor Statistics turned out to be misleading (first chart below). It's hard to pinpoint why, but it's important to understand that Conference Board and ISM surveys measure "whether it's easier to find a job", and "whether purchasing managers intend to hire more people". **They measure direction but not magnitude.** As a result, a reading of 55 on the ISM employment survey doesn't always mean the same thing. As shown in the second chart below, a model which predicts payrolls using Conference Board and ISM surveys did a decent job during the 1990's; its estimates ranged from +/- 100k around the monthly payroll report. But over the last decade, this model consistently overestimated payroll growth for reasons that are not easily explained. All we can do is pay attention to the results, and not over-extrapolate what surveys might be telling us about labor demand. We expect better payroll growth in the months ahead (120k or so per month), although that's a pretty low hurdle.

Improving labor market surveys pointed to rising payrolls, but overestimated the magnitude (again)



Source: BLS, ISM, Conference Board, JPMAM.

A model predicting payrolls using employment surveys tends to overestimate them, Payroll prediction error, thousands, 6-month moving average

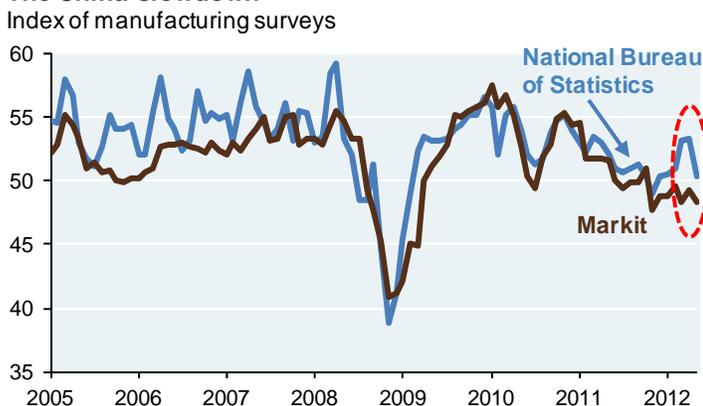


Source: BLS, ISM, Conference Board, JPMAM.

China

When I started at J.P. Morgan in 1987, China's share of global GDP was considerably less than Latin America's. Now, it's almost three times larger, so China deserves a lot of attention. The latest data suggest that Chinese growth is running around 6%, below the government's target and before presumed stimulus measures lift it back up again. The slowdown in China spans all the sectors we look at (investment, demand, production, exports, imports and housing). While China has the ammunition to add stimulus, so far, there appears to be little political desire to engage in anything like the money drop that took place in 2009. Reductions in bank reserve requirements, increased social housing investments, accelerated infrastructure investments, incentives for purchases of energy-efficient autos and appliances, and an expanded credit line for the Ministry of Railways are all notable, but not in the same zip code as 2009's 4 trillion RMB stimulus package. The China slowdown highlights the reality that in 2010 and 2011, Chinese growth became increasingly reliant on credit expansion (second chart). This credit expansion is now slowing, and so is Chinese GDP growth.

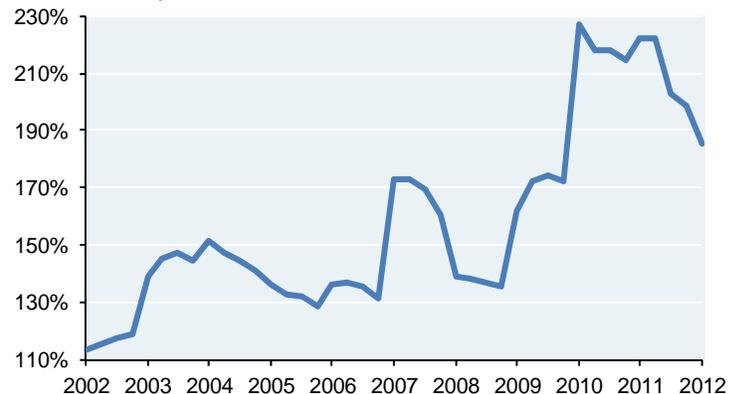
The China slowdown



Source: National Bureau of Statistics, Markit.

Heavy reliance on credit

China's society-wide credit as % of nominal GDP



Source: PBOC, China Bureau of Statistics, J.P. Morgan Asset Management.

The battle between rising profits/low equity valuations and those macro issues that just won't go away**Wrapping up**

Investor caution and elevated market and economic risks always go together; that part is not a surprise. **But I cannot recall such an extreme dichotomy before, characterized by rising profits, mountains of sidelined cash and low equity valuations on one hand, and a set of almost biblical macroeconomic risks on the other.** The most optimistic voices I read often come from people that either ignore the latter, or cannot bear to look at it. If there is one thing that characterizes our investment philosophy, I believe it is that we always try as hard as we can to acknowledge the squid. Government rescues of different kinds may be on the way at some point which will probably stabilize markets, but I find it hard to see the squid-whale battle being decisively resolved in 2012. We will be watching for oversold conditions in large cap stocks, credit and commodities.

Michael Cembalest
J.P. Morgan Asset Management

ECB	European Central Bank
OECD	Organization for Economic Cooperation and Development
LTRO	Long Term Refinancing Operations
ERF	European Redemption Fund
ESM	Exchange Stabilization Mechanism

Sources for The **Squid** chart: US Treasury, BEA, Bank of Spain, Bank of Portugal, OECD, CSO, NSS, IMF, Statistical Office of the European Communities, PBOC, China Bureau of Statistics, Spain National Institute of Statistics, J.P. Morgan Asset Management.

Sources for The **Whale** chart: Federal Reserve Board, Standard & Poor's, BEA.

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