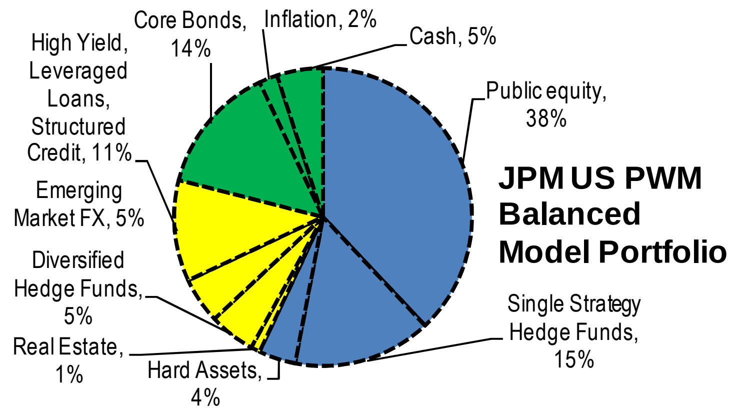
Topics: Portfolios, US corporate profits and the Twilight of the Gods (in the US, Europe, China and the IEA)

Here's what our U.S. Balanced portfolio looks like right now[1]. This week's note reviews some of the factors that affect these allocations: **healthy private sector profits, problems left over from the recession, and interventions by the world's legislatures, treasuries, central banks and multilateral agencies.** This latter group reminds me of the ancient Greek Gods: they are very powerful, but sometimes flawed, as their interventions in the world did not always work as planned. We are getting closer to the *Twilight of the Gods*, a time when they are either running out of ammunition, or the ability to use it without causing even more problems. If so, the private sector will have to recover on its own. The consequence of these cross-currents: we invest in equities, but hold 10%-15% less than what we normally would at this point of the business cycle, and are positioning for a single-digit year on equities.

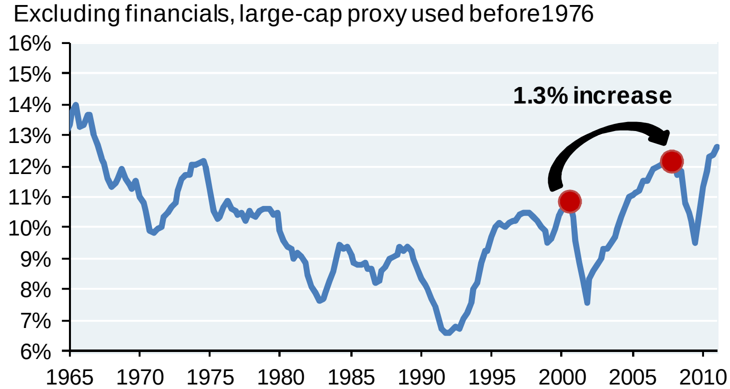


Source: J.P. Morgan Private Wealth Management, as of July 2011. These portfolios may not be suitable for all investors & are shown for illustrative purposes only

PROFITS

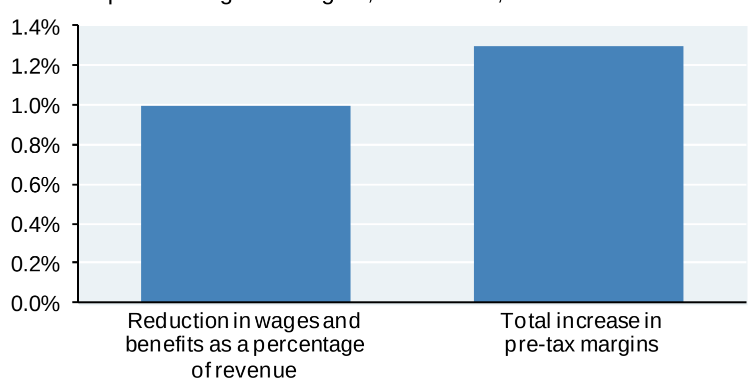
The primary (and perhaps sole) justification for carrying the levels of risk shown above relates to corporate profits. As shown below, profit margins have reached levels not seen in decades. The challenge, which we have discussed many times before: what is driving these margins[2]? One useful way to deconstruct profits is to measure them from peak to peak, and analyze what changed. As shown in the first chart, S&P 500 profit margins increased by ~1.3% from 2000 to 2007. There are a lot of moving parts in the margin equation, but as shown in the second chart, **reductions in wages and benefits explain the majority of the net improvement in margins**. This trend has continued; as we have shown several times over the last two years, US labor compensation is now at a 50-year low relative to both company sales and US GDP (see EoTM April 26, 2011).

S&P 500 pre-tax margins
Excluding financials, large-cap proxy used before1976



Source: Corporate reports, Empirical Research Partners. Past performance is not indicative of future results.

Labor cost reductions driving the margin expansion
Peak to peak change in margins, 2000-2007, S&P 500 constituents



Source: Standard & Poor's, Empirical Research Partners.

Last week's train wreck of a labor report included the dour news that labor compensation is now firmly negative in real terms. Why is US labor compensation so low? The lingering excess labor supply from the recession is one reason, but the 2 billion people in Asia joining the global labor force over the last two decades is another. As shown on next page, EM wages for production workers remain well below US levels[3]. Another factor helping profit margins: increased US imports of intermediate goods from Asia. As shown in the accompanying chart, imports from Asia have been rising, and over the same time frame, Asian import prices only increased at around 1% per year.

[1] We use these portfolios to manage assets for clients who give us discretion over their funds, and to provide recommendations to those who don't. This is one of several model portfolios we manage globally. They differ by jurisdiction, risk tolerance, tax treatment, eligibility to purchase vehicles designated for qualified purchasers, and other factors.
[2] Empirical Research Partners does more work on corporate profits than anyone else we've seen. This section draws on research that Mike Goldstein at Empirical shared with us at a recent investment committee meeting.
[3] A recent study from Boston Consulting Group maintains that the gap between China and the US will close in 5 years. BCG believes that with Chinese wages growing at 15%-20% per year, US wages growing at 3% per year, higher productivity in the US and rising shipping and inventory costs, the China advantage will disappear within the decade. Some of these assumptions seem aggressive to apply in perpetuity.

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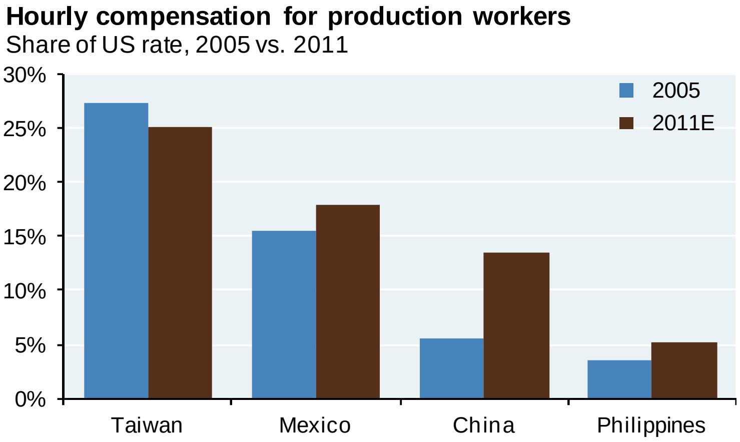
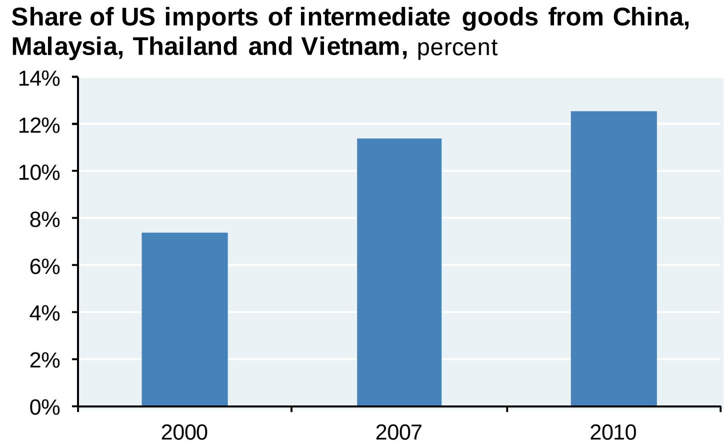


Source: Bureau of Labor Statistics, Empirical Research Partners.



Source: UN Comtrade, Empirical Research Partners.

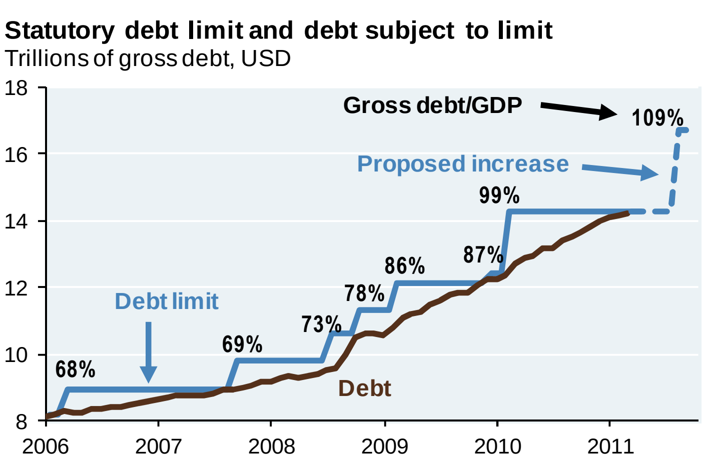
To summarize, we expect today's margins to last a while longer, since relative costs won't converge overnight. But we are not inclined to pay a high multiple for them, given their reliance on weak labor compensation, which in turn requires large government transfers. The good news: markets are not applying high multiples right now, which is why we own the equities we do. **However, questions about the large but shrinking public sector toolkit knock 10%-15% off of our equity allocations, compared to where we would normally expect to be 2 years after a recession. We walk through 4 instances of this below, as it relates to US fiscal policy, oil prices, Chinese inflation and the European periphery**.

Twilight of the Gods, part 1: Limited room for fiscal policy to invigorate the US recovery

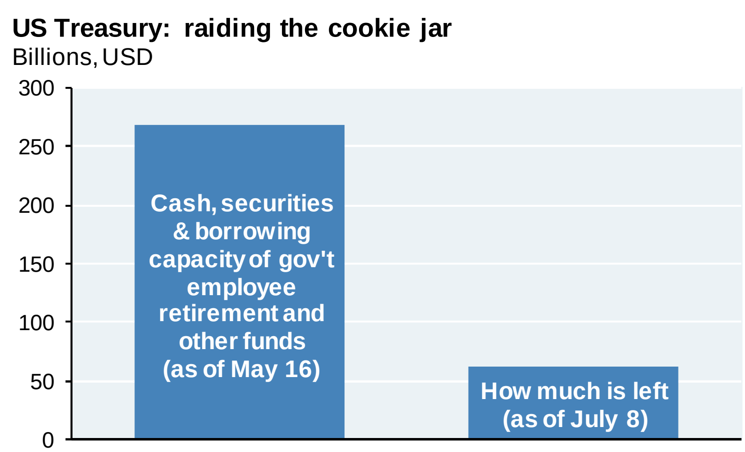
Here's what we know for sure about the US Federal debt ceiling debate:

- The government is facing the unappealing task of having to increase the Federal debt ceiling above 100% of GDP for the first time since the end of WWII, and only the second time since the debt ceiling was established in 1917
- The government has already run out of money from traditional sources. As shown below, since May 16, 2011, the US Treasury has been raiding the cash, securities and borrowing capacity of government employee retirement and other funds. Of $270 billion of such balances which existed in May, around 75% has already been used up. There's not much leeway left, which is why the government will probably run out of money some time in August.
- The debate about the *existing* Federal debt is the lesser of two problems. As shown on the following page, the present value of unfunded entitlement obligations (e.g., *future* debt) dwarfs the existing debt. That's why there's so much talk about a deal to stabilize the long term trajectory of the budget deficit.

The rest is all speculation. The table on the next page shows the revenue and spending factors in play. It's too early to know what kind of deal will be crafted. We believe that the deal will be composed of 80% spending cuts and 20% revenue/tax increases (rather than 50-50), and will be closer to $2 trillion than $4 trillion. **While it's possible that another dose of fiscal stimulus will be built into the debt ceiling agreement, it might not be that large, and its impact could easily be offset by a subdued consumer response due to expectations of higher taxes in the long run (e.g., Ricardian equivalence).**



Source: US Department of the Treasury, J.P. Morgan Securities LLC, J.P. Morgan Private Bank.



Source: Stone & McCarthy. Gov't funds include G-Fund, Exchange Stabilization Fund and Civil Service Retirement and Disability Fund.

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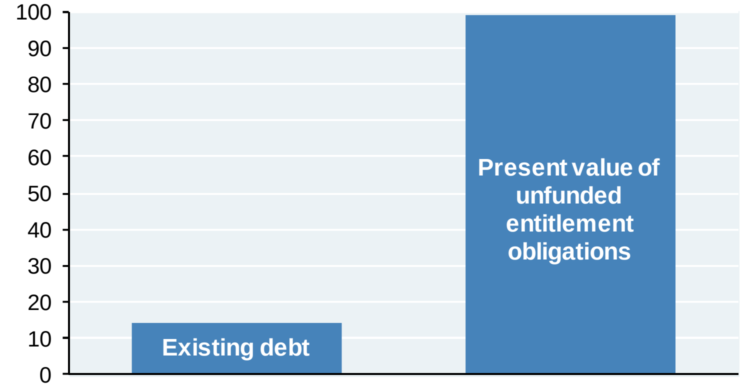
The existing Federal debt is the lesser of 2 problems
Trillions, USD



Source: US Department of the Treasury, J.P. Morgan Private Bank.

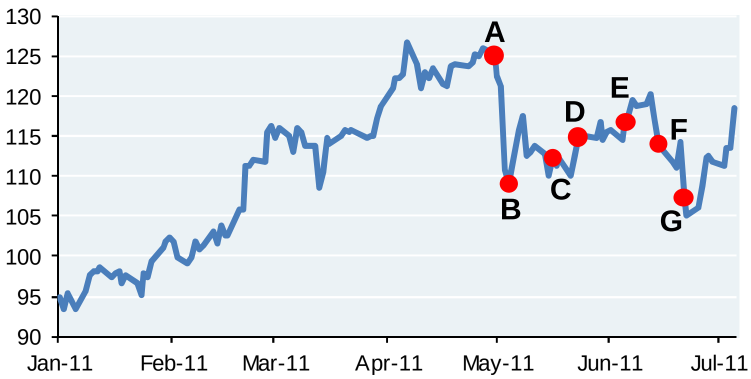
Items on the table in discussions to reduce the deficit

Revenue raises	Spending cuts
Carried interest taxed at ordinary income rates	Discretionary spending cuts
Increased taxes on ordinary income, capital gains and qualified dividends	Changing formulas affecting inflation indexation for entitlements
"Bracket creep": higher tax brackets applying to lower incomes more quickly	Defense spending cuts
Phase-out of personal exemptions or caps on itemized deductions	Expenditure caps
Changes to grantor retained annuity trust required terms	Change in entitlement eligibility requirements

<u>Twilight of the Gods, part 2: Can releases of strategic oil reserves keep oil prices down for more than a few weeks?</u>

International Energy Agency member countries agreed to release strategic petroleum reserves to bring oil prices down. They have a lot of ammunition to do so; government-controlled oil inventories are at least 1.5 *billion* barrels, and so far, all they have done is authorize the release of 60 *million* barrels. The timeline suggests that oil markets began focusing on the release of the SPR after the Libyan shutdown, the lack of a sufficient OPEC supply response, and weak economic data in the US. As shown below, oil prices have been *rising* since the announcement of the supply increase. Are IEA members committed to doing it again if oil prices reach their May levels?

Brent oil price and timeline of SPR release
USD/bbl



Source: Bloomberg.

[A] May 2: Advisors lay out SPR release plan to Obama

[B] May 6: Obama calls Abdullah (S.A.) and Sabah al-Ahmad (Kuw) to discuss SPR release

[C] May 19: IEA urges OPEC to increase production or else member nations are prepared to use "all tools" to protect global economy

[D] May 27: Former White House energy advisor predicts IEA SPR release

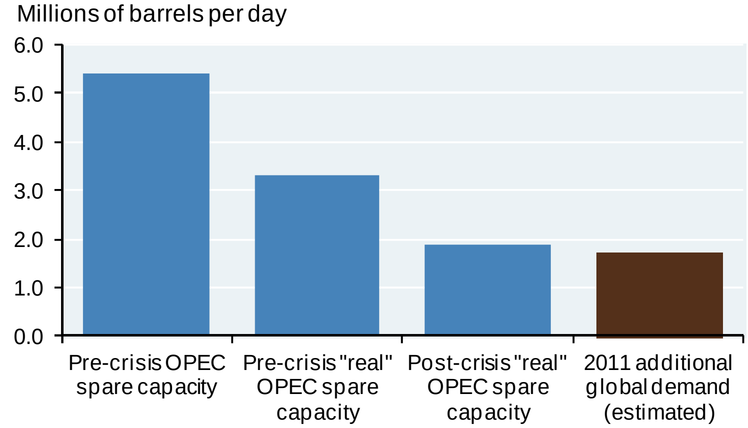
[E] June 8: OPEC does not agree on production increase

[F] June 17: Obama authorizes IEA-SPR release feasibility study

[G] June 23: SPR release announced

The problem for the IEA is that the tightness in oil markets is not just a sudden supply shock. As shown in the bottom chart we first published in March, there was not much slack even before the Libyan shutdown, and oil demand is expected to rise 1-2 mm bpd as the developed and emerging world continue to grow. One of our colleagues used to work at the IEA, and in a recent piece[4], argued that the impact of the SPR release will be limited to Q3 2011, and that upside oil price risks to 2012 have increased. Why? The SPR release came at a time when OPEC tanker traffic made it clear that producing countries were having problems meeting prior pledges: "*As such, it is difficult to conclude anything except that there is little or no spare capacity in the oil market*". If that's the case, future interventions may not have a lasting impact either.

Post-Libya OPEC spare capacity running out
Millions of barrels per day



Source: J.P. Morgan Securities LLC.

[4] "*Oil Market Monthly: Living with No Spare Capacity*", Lawrence Eagles, Commodities Research, JP Morgan Chase Bank NA, 7/7/ 2011

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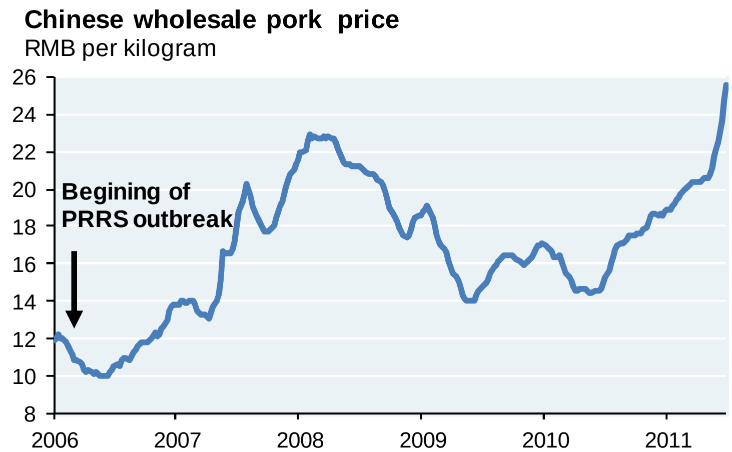
Twilight of the Gods part 3: Why is everyone assuming that the next Chinese tightening is the last one?

Every time China tightened monetary policy this year, most China research maintained that the tightening cycle is close to its end. Perhaps; Premier Wen has stated that the country's efforts to control inflation have worked, that price stability is in an acceptable range, and that it will drop steadily from here. But last week's headline inflation release of 6.4% hit a three year high, and it is not clear to us that China is about to end its various inflation control policy measures.

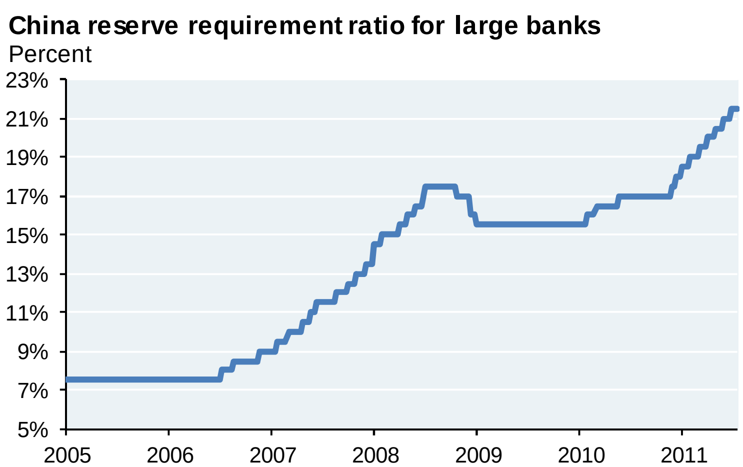
In favor of Wen's argument, food inflation has been a large contributor, some of which should be transitory. Blue-ear pig virus (PRRS) killed hundreds of thousands of pigs in 2010, which affected this year's supply (2006 was worse). As shown below, pork prices have soared, but *should* come down if the supply situation normalizes. [*Note: a "Strategic Pork Reserve" can be released to mitigate price increases*]. However, according to the Food and Agriculture Organization[5], new virulent strains of the virus have a fatality rate of 20% (even higher for piglets), and **what is considered a temporary supply shock may be more permanent.** Chinese pig facilities have the highest animal densities in the world, contributing to the spread of disease to 25 of China's 33 provinces. Antibiotics have proven ineffective, and once one pig gets the disease, it tends to spread to the entire herd in 7-10 days. China has vaccinated 100 million of its 500 million pigs, but existing vaccines do not prevent infection, they only slow the rate of transmission to other pigs.

Source: National Bureau of Statistics of China.

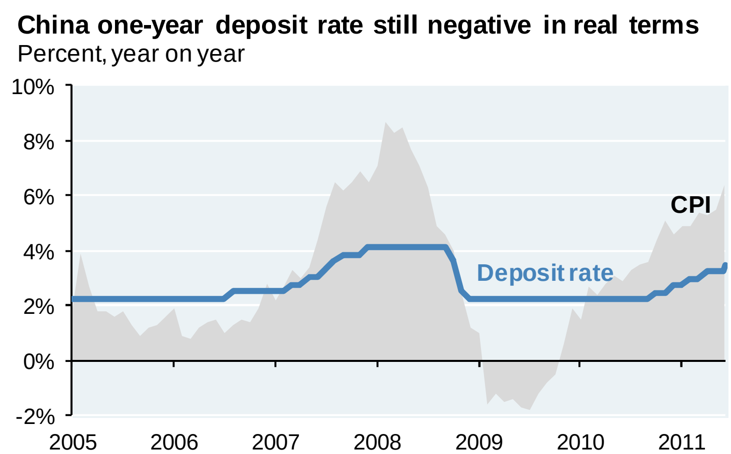


Source: China Ministry of Commerce.

A separate issue is that China is doing a lot more to control the ***supply*** of money than the ***cost*** of money. As shown below, there have been a lot more increases in bank reserve requirements than interest rate increases. Deposit rates are still negative in real terms, and bank reserve requirements only affect banks, and not the shadow banking system, which is growing in China.



Source: People's Bank of China.



Source: People's Bank of China, National Bureau of Statistics.

Forward-looking manufacturing surveys have declined and interbank lending rates (Shibor) have surged, so it's clear that the tightening steps are working. But private sector credit is still growing in China, and real estate prices are still rising. **The bottom line is that the substantial stimulus provided by Chinese and other Asian policymakers in the wake of the recession has not yet been adequately withdrawn, and that more steps will need to be taken to do so.**

[5] "*Porcine reproductive and respiratory syndrome (PRRS) virulence jumps and persistent circulation in Southeast Asia*", Food and Agriculture Organization Emergency Prevention System, Issue number 5, 2011.

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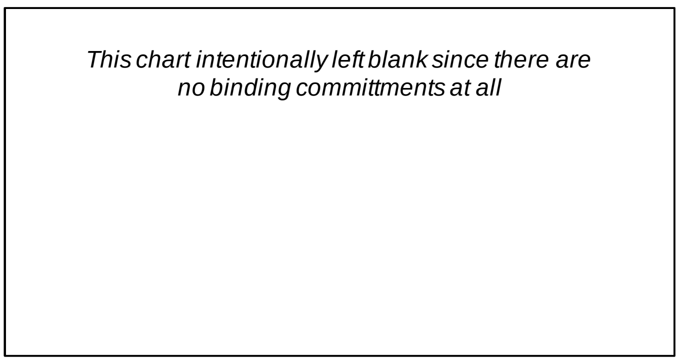
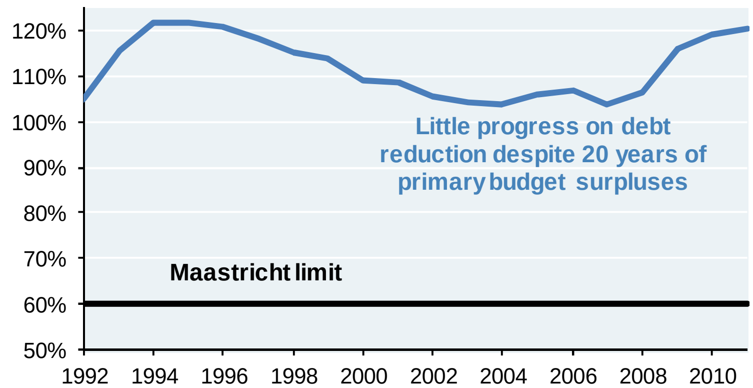
Twilight of the Gods, part 4:
<u>Is Europe just trying to save its banking system, or is a more comprehensive move towards Federalism underway?</u>
I expected French proposals on a Greek debt exchange to begin to spell out the sacrifices private sector investors will have to make as Greece spirals towards insolvency. As shown below, I was wrong about that. French proposals don't entail any specific commitments by banks, and are merely non-binding indications of interest by banks to roll over debt at some point in the future as it matures. If bank rollovers of Greek debt or Greek government asset sales fall short of the mark, the EU and IMF appear committed to providing Greece with funds to pay off maturing debt anyway. The EU taxpayer continues to foot the bill.

Binding commitments from EU banks to roll over Greek debt as per French proposal, Euros in billions



Italy gross debt to GDP
Percent



Source: International Monetary Fund.

So to be clear, the *Twilight of the Gods* has not arrived in Europe, since the EU appears determined to spend more money to prevent a sovereign default. I see why they are worried about contagion. The latest signs: Portugal downgraded to junk; long-term debt of 3 French banks put on downgrade watch; and stress in European unsecured interbank markets[6], now affecting **Italian banks** which rely heavily on them. Italian bank and insurance company holdings of their own government bonds is 2x-3x higher than the rest of the region, creating the potential for a vicious circle if something goes wrong. Italian banks are better-capitalized and have higher quality assets than banks in other European countries, since Italy did not experience a large boom-bust in residential property, or a consumer debt binge. However, like Greece and Ireland, Italy's debt/GDP ratio is above 100%, and the country suffers from low growth (the lowest in the world from 2000-2010 other than Zimbabwe and Haiti, according to the *Economist*). Think about this: **Italy has run a primary budget surplus (i.e. ex-interest payments) every year since 1992, but still hasn't been able to bring its debt ratios below 100% of GDP**. Italy was making progress, but the recession derailed them, leaving Italy with the same elevated debt burden they started with 20 years ago.

I believe that eventually, the constituency of the European Monetary Union will have to change. However, my colleagues in J.P. Morgan Securities' economics group disagree. They believe that the EMU will survive intact, and believe that Europe is moving towards Federalism, with this crisis as the basis for putting it in place. I have been a skeptic of this idea; **how can a region use the structural failures of its current model as an excuse for expanding it**, particularly when popular support for the European project is at such low levels[7]? The history of Europe does show that revolutions are often imposed from above (e.g., Peter the Great, Otto von Bismarck, Napoleon) rather than below, so anything is possible. If my colleagues are right, losses suffered by holders of Greek, Irish and Portuguese debt may be a lot less than what's priced in right now. I don't have the conviction to make that kind of call, at least not yet; geopolitical investing is a very hard thing to do. **We remain cautious on Europe; are underinvested in government debt, corporate credit and equities across the region; and expect a Greek sovereign debt restructuring within the next 18 months (**see chart from "*Five Stages of Greece*", June 30, 2011).

Michael Cembalest
Chief Investment Officer

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[6] JP Morgan's Prime Money Market Fund is indicative of industry concerns about a liquidity squeeze. The fund holds no Greece, Portugal, Ireland or Spain. Its Italy holdings are less than 2% of the fund, and the portfolio manager does not expect to roll them when they mature.

[7] A 2010 Eurobarometer Poll showed very low readings on whether "Membership in the EU is a good thing". More recently, the centre-left Foundation for European Progressive Studies polled EU civil servants (a pro-EU constituency if there ever was one) and found that a majority believe that "the European model has entered into a lasting crisis". Only a quarter of respondents saw the EU as having evolved positively over the last decade, or believe that the December 2009 Lisbon Treaty has had a positive effect.

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