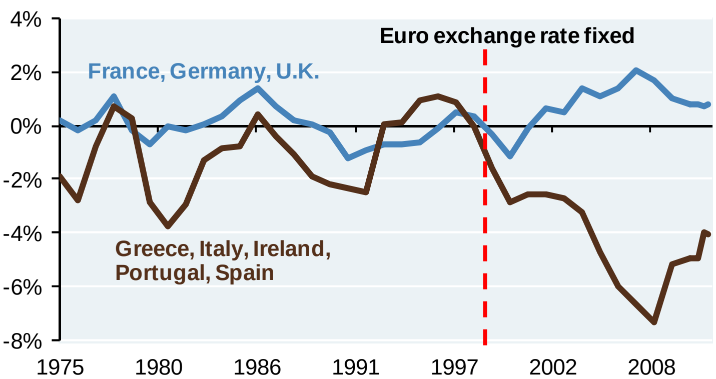
Topics: The debt crisis in the European Monetary Union as seen by a 9-year old, and US recession risks

For the last 2 years, if the *Eye on the Market* had a single dominant theme, it was that a common monetary policy does not by itself create a durable monetary union; that European asset markets were not adequately pricing in the risk that the European Monetary Union could fail, or require massive transfers to save it; and that austerity with no FX devaluation is doomed to failure. During this time, our skepticism about the EMU and European asset markets has been rewarded at every turn. For those interested, here's the latest grisly news of the week….

- European manufacturing and new orders surveys are generating the worst readings since May 2009 (particularly sharp declines in France and Italy); German growth fell from 5.0% in Q1 to 0.5% in Q2
- Both Italy and Spain struggled in August to attract interest in their public debt, and now both countries face much bigger auction schedules in the fall. Spanish and Italian banks also have large funding needs which are likely to be a problem if their respective sovereigns cannot borrow from the debt markets. Asian buying is critical; Spain relies on Asia for 5x the demand they get from the US. Current IMF and bilateral EU borrowing facilities are not big enough if Italy needs to access them.
- EU bank shares have plummeted due to funding concerns, as the IMF and EU argue about capital adequacy of EU banks
- Italian government bond yields rose by 0.5% yesterday as Italy struggles with ECB demands for a zero-deficit plan[1] by 2013; the ECB does not appear to be in a rush to restore stability before the Italian plan is "fully confirmed and implemented"
- The IMF-sponsored Greece adjustment program is in shambles[2], for all the reasons we expected it would be
- Imbalances at the root of the region's problems have not improved fast enough (see chart). Without an FX devaluation to close the gap, the periphery is consigned to a self-reinforcing cycle of low growth and austerity. While many see the EMU as an integration project, it has resulted in the **largest growth and employment disparities** in decades (see charts on page 5).

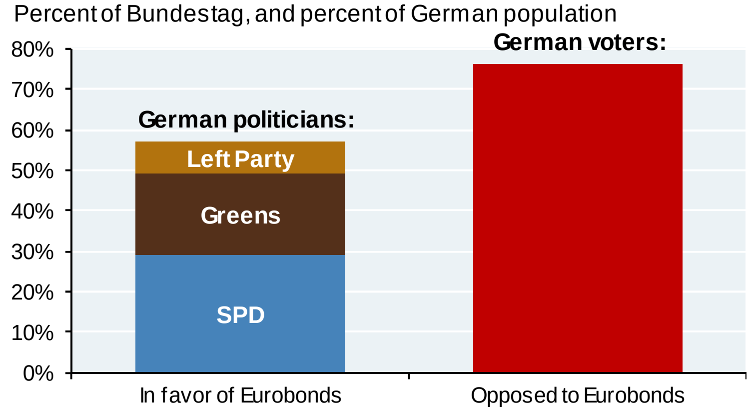
This saga has been going on now for 24 months, making it the *Berlin Alexanderplatz* of Sovereign Debt Crises. However, I think we're moving closer to the end-game, which begins and ends in Germany. German political parties likely to run the Bundestag after the next elections are in favor of socializing these problems through Eurobonds, if necessary. But the German public generally *opposes* Eurobonds (see chart), perhaps since the potential cost of a permanent fiscal transfer union rivals the cost of German unification and post-WWI Versailles reparations (see EoTM August 6, 2011).

Something's still rotten near Denmark
Current account deficit, % of GDP



Source: OECD, J.P. Morgan Private Bank, U.K. Office of National Statistics.

No Federalization without Representation?
Percent of Bundestag, and percent of German population



Source: Der Spiegel, TNS Emnid Global Market Research, N24 Media GmbH.

The end-game is mostly about who pays for the accumulated, unrealized losses of the last decade, and who finances the transition to whatever comes next. Markets are nervous, since Europe has not figured this out yet. To examine the various factions, I consulted Peter Cembalest, who specializes in conceptualization of such phenomena. Peter (age 9) uses Lego Minifigures as a medium, and assisted me with the diorama on the next page. It identifies the **12 players in the EMU Debt Crisis most likely to affect policy from here;** red lines indicate who each entity believes should be stuck with the cost. The attribution of views is my own, based on an analysis of what people have said, what they have done, and how they have voted.

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[1] Italy runs practically the tightest budget deficit in Europe; the burden of prior debt is the bigger problem. Italy was able to bring debt levels down in the 1990's, but this resulted from four factors: higher growth resulting from an undervalued exchange rate from 1992 to 1997; EMU convergence which brought down interest rates from 12% to 3%; popular support for austerity, with the promise of integration and all it would bring; and financial engineering (off balance sheet swaps). **None of these tailwinds exist today**.

[2] July/August Greek retail sales fell at the fastest rate in three years, bank deposit flight continues, its privatization efforts are off to a very slow start, and the government may miss its fiscal deficit target by 1% or so. **What is happening in Greece is a textbook response to austerity without an FX adjustment and easy monetary policy**, according to the IMF's own handbook ("*Macroeconomic Effects of Fiscal Consolidation*", October 2010). **The IMF's reported disappointment with Greece, given this context, is ridiculous.**

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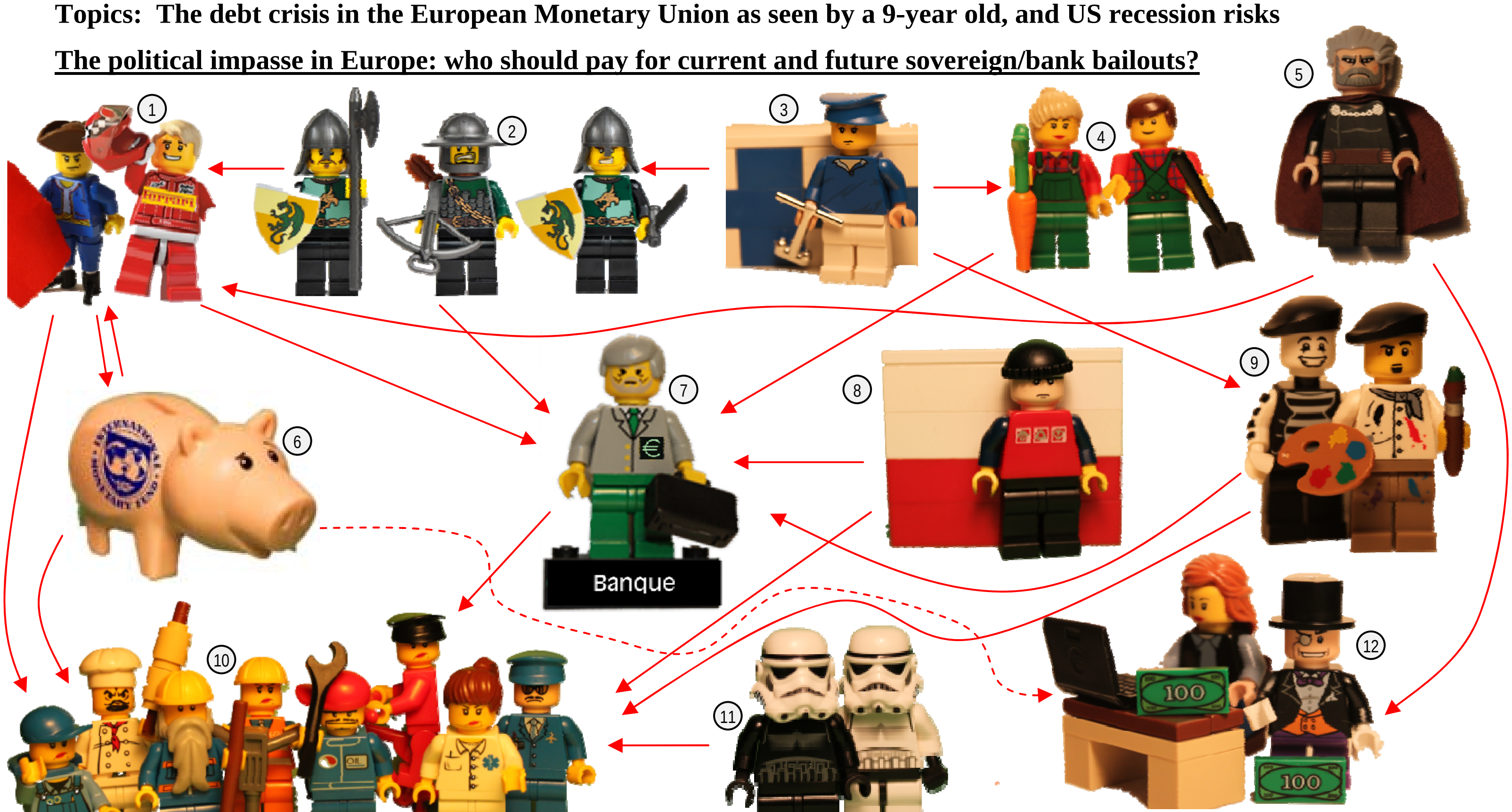
The political impasse in Europe: who should pay for current and future sovereign/bank bailouts?



***Key**: Arrows denote where each entity would shift the burden of bailout costs*

[1] **Spain, Italy and the rest of the Euro Periphery** believe the ECB should buy bonds, prevent spreads from rising and give them time to implement austerity plans. Italy is the flash point, with sovereign debt equal to 25% of GDP rolling in the next year, plus 100 bn in Italian bank debt. Italy has undergone austerity before (1990's), but that was when the promise of EMU integration was the carrot. This promise has proven to be illusory; Italy grew faster before joining the EMU.

[4] The **Social Democrats** and **Greens** are opposition parties in the Bundestag, but if an early election were held today, polls suggest they would be in control. Both parties support expanding the EFSF beyond 440 bn if needed, and may accept fiscal federalization if necessary to preserve the EMU.

[7] The **European Central Bank** is purchasing Spanish and Italian bonds in the secondary market to bring yields down with the intention of facilitating better primary auctions. This did not work in Ireland, Greece or Portugal. Spain and Italy yields declined by 1% once the ECB began buying, but have since drifted higher. The ECB does not like its current role as fiscal agent, and believes that EU taxpayers should bear the cost of solving the crisis.

[2] The **CDU, CSU** and **FDP** are the 3 German parties which control the Bundestag and are against doing more than what Germany has already committed to. Minority factions within all 3 are against proposed EFSF expansion in size and scope. The CSU circulated a paper calling for an 'insolvency procedure" for Euro-zone sovereigns instead of an open-ended transfer union. The 3 parties seek greater labor and pension reforms in the Periphery, and are strongly opposed to premature introduction of Eurobonds. If more than 440 bn is needed, they would begrudgingly accept more ECB buying.

[5] The **Bundesbank** is the ultimate protector of German monetary and fiscal interests, and is very concerned with steps already taken to deal with the crisis. Their strong preference would be for EMU countries looking for aid to first implement austerity and pension and labor market reforms (i.e., German Reunification steps). Bondholder losses ("creditor participation") should take place before shareholders are subsidized by taxpayers.

[10] **EU taxpayers in Core countries** would be affected by various efforts to federalize costs of the EMU sovereign debt crisis, either through EFSF expansion, or introduction of Eurobonds. Lots of arrows point in this general direction.

[3] By requiring collateral for its share of EFSF exposure to Greece, **Finland** raised the ante on France and Germany, whose banks have much more exposure to the Periphery. Finland wants the bailout to reflect actual exposure, rather than ECB capital weights. The **Dutch** now want the same treatment.

[6] The **IMF** has taken a mostly passive role, lending money and overseeing austerity plans in Greece that are failing miserably. Ken Rogoff at Harvard refers to their role as "sycophantic". Comments on bank shareholder dilution by new IMF head LaGarde may suggest a change in attitude (hence the dotted line).

[9] **France** is relying on the ECB to handle what the EFSF cannot. While France supports greater fiscal federalization, if this were done via further EFSF enlargement, it could risk France's AAA rating.

[11] The **EU Commission** and **Euro Group Finance Ministers**, chaired by Jose Manuel Barroso and Jean-Claude Juncker, support ECB bond buying and fiscal federalization in a variety of forms. They oppose Franco-German incrementalism, but may not have enough power to change it.

[12] So far, **EU bondholders** and **shareholders** have been subsidized by the ECB and EU taxpayers. The latest EU bank stress tests called for an additional Eur 2.5 billion of capital. This is not a misprint.

[8] **Poland**, after a long period of wanting to enter the EMU, is waiting for a clearer picture of who will bear the costs of the sovereign debt crisis. The Polish Finance Minster is calling for more ECB buying of sovereign debt, a much larger EFSF, and warned that Poland will not want to join the EMU until the Euro is earthquake-proof. "The fundamental problem of the Eurozone is not an economic but a political one," he explained. "The choice is: much deeper macroeconomic integration in the Eurozone or its collapse. There is no third way."

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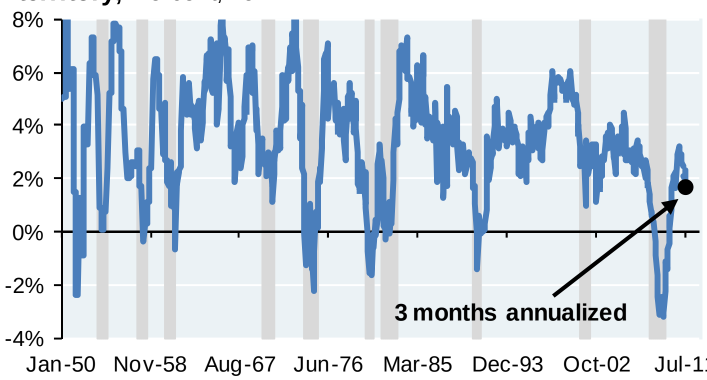
Iceland

There wasn't room for every entity that impacts European decision-making. The German Constitutional Court is another unique agent, and could disrupt the bailout process in a variety of ways. We also could have included **Iceland**, whose influence lay in its different and more successful adjustment. Iceland struggled with high inflation and unemployment after its 2009 devaluation, but now benefits from rapidly improving economic and financial market prospects[3]. **If today's diorama analysis borders on the absurd, so does maintaining the fiction that accumulation of massive public and private sector claims in Europe can somehow be engineered away.** European banking sector liabilities are 3 to 4 times the size of European GDP, which dwarfs the roughly 1:1 ratio in the US. To be clear, there are few signs of systemic funding strains in the interbank market, and most European banks are well funded for the next couple of months. But if sovereign risk continues to rise, this would be the next flashpoint in the crisis. Bottom line: we remain underinvested in Europe in a big way.

As for the United States, arguing that US growth will be 1.0%-1.5% and not negative might seem like debating how many angels can dance on the head of a pin (in other words, a poor use of time, since both are below what is needed for a durable recovery). But for what it's worth, that's our view right now: 1% and not a recession. Housing and labor market data are pretty bad, and consumer confidence surveys plummeted in August. However, confidence surveys have under-predicted actual consumer spending for the last couple of years, and as of July, spending was well above levels indicative of recessions.

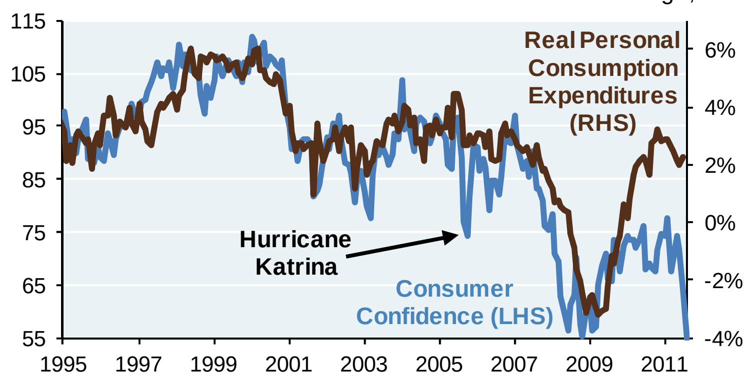
Consumption growth below trend but far from recession territory, Percent, YoY



Source: Bureau of Economic Analysis. Shaded bars denote recessions.

Recent gap between spending and confidence

Index | Percent change, YoY

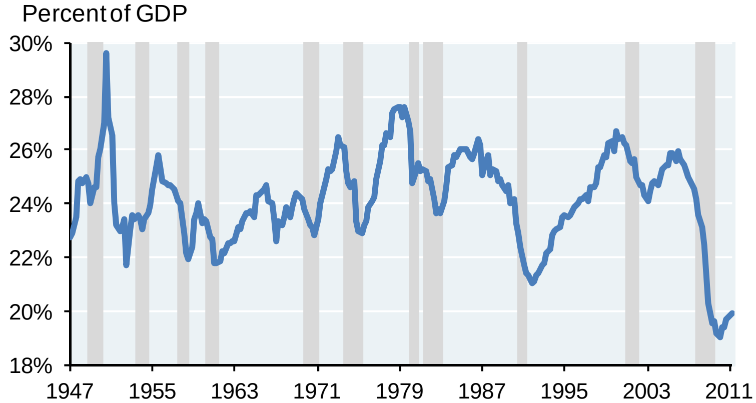


Source: University of Michigan, Bureau of Economic Analysis.

Manufacturing also held up through July, and while there were signs of weakness, the August ISM manufacturing survey is not pointing to recession. **However, the best argument against a recession is unfortunately also an indictment for how weak the recovery is.** The chart below shows the combined level of durable goods spending (by consumers) and fixed investment (by businesses, in property and equipment). At 20% of GDP, it's close to its lowest level in more than 50 years. Since a decline in this measure tends to *cause* recessions, our view is that there's barely enough of this kind of spending to fall in the first place.

Durable goods and fixed investment at multi-cycle lows

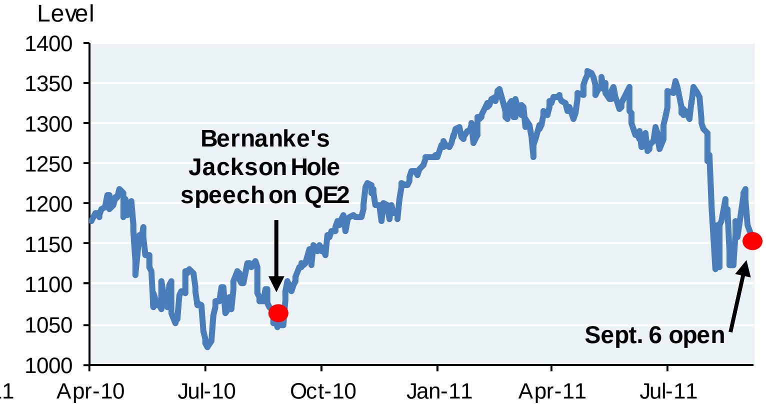
Percent of GDP



Source: Bureau of Economic Analysis. Shaded bars denote recessions.

S&P 500 price since April 2010

Level



Source: Bloomberg.

[3] In Iceland, inflation is back at 2%, its growth rates are projected at 3.5%-4.0%, unemployment of 9% is half of EU periphery levels, and its recent 5-year bond issue was 2 times oversubscribed.

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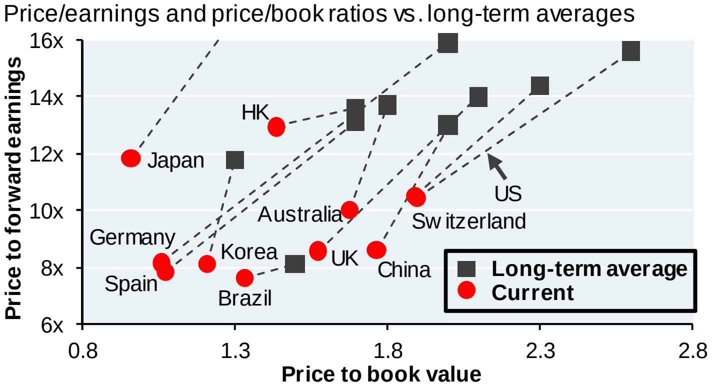
Either way, whether growth is 1% or 0%, the Fed is likely to respond with additional quantitative easing (QE) of some kind at its September meeting. As we noted last time, there are reasons to question the long-term benefits of such actions:

- Make long-term interest rates lower? They're already low (2% on 10 year Treasuries)
- Add liquidity through asset purchases? There's plenty of liquidity in the system already
- "Encourage" banks to lend more money by eliminating interest on excess reserves held at the Fed? Banks are struggling with insufficient loan demand, a glut of deposits, and surveys show a substantial relaxation of lending standards
- Buy corporate bonds? Investment grade spreads are already 85% of their way back to 2007 levels

The beneficial impact of QE2 on the US economy was not sufficient, which is partly why US equity markets eventually gave back much of the speculative gains which took place in Q4 2010. We have little reason to think that the outcome will be different next time. Equity markets are priced cheaply relative to expectations of future earnings, but without more evidence that QE is having more of a positive impact on the US economy, we believe QE-driven equity market gains will be temporary.

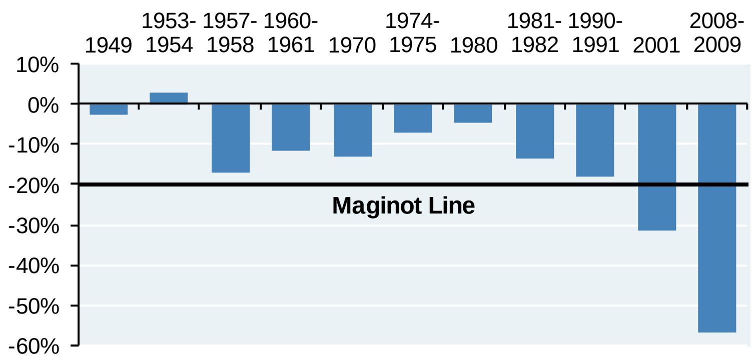
As a consequence of problems in Europe and the US, low equity valuations are widespread. As we showed a couple of weeks ago, multiples applied to earnings and book value are pricing in a high likelihood of a recession (see chart). This is understandable, as countries like Italy are forced into "zero-deficit" plans by markets increasingly nervous about the highest levels of government debt since Italian unification in 1861. Our sense is that US equity markets are pricing in around a 15%-20% decline in earnings, which is consistent with recessions *before* the tech collapse and credit crisis, which were much worse.

The men who fell to earth
Price/earnings and price/book ratios vs. long-term averages



Source: J.P. Morgan Securities LLC. P/B long-term avgs since 1980 except for Korea, China, Brazil (1995). Fwd P/E long-term avgs since 1987 except for Brazil, China (1995).

Earnings declines during US recessions
Percent decline - peak to trough



Source: Haver Analytics, Barclays Capital.

The investment opportunities that make the most sense to us in this environment:

- Leveraged loans, after recent price declines
- Opportunities in merger arbitrage, where deal spreads[4] have widened from 8% to 16% in August
- Asian currencies, given the Fed's "zero-or-Nero" monetary policy[5]
- Equity notes which allow for upside participation, but also provide protection down to spring-2009 levels. Some of our favorite global large-cap companies (domiciled in the US, Europe and Asia) now trade with dividend yields of close to 5%.
- US bank preferred stock (both Trust Preferreds trading at or below Par, and those eligible for qualified dividend treatment). While the earnings of some issuing banks may be under pressure due to ongoing litigation risks, declining net interest margins and the lack of a recovery in home prices, we consider these risks more of an issue for common stock, rather than preferred stock. As one indication of magnitude, Morgan Stanley's Large Cap Bank Analyst Team cut 2012 EPS estimates by 6% last month, which would not entail payment risks for preferred stock.
- Inflation is an easier problem to deal with than deleveraging, deflation and austerity budgets. As a result, we are looking at opportunities in Asian equities and credit, which we expect to improve once the monetary tightening cycle is complete.

Michael Cembalest
Chief Investment Officer

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[4] Deal spreads refer to the difference between the announced acquisition price of a given target company, and where it is currently trading. This difference primarily reflects the uncertainty around the deal closing, and the cost of capital. The numbers above were computed for August 1 and August 30, for all announced US transactions above $500 million.

[5] The Fed appears to believe that without zero interest rates, the US would face an environment of asset liquidation and Nero-like disarray.

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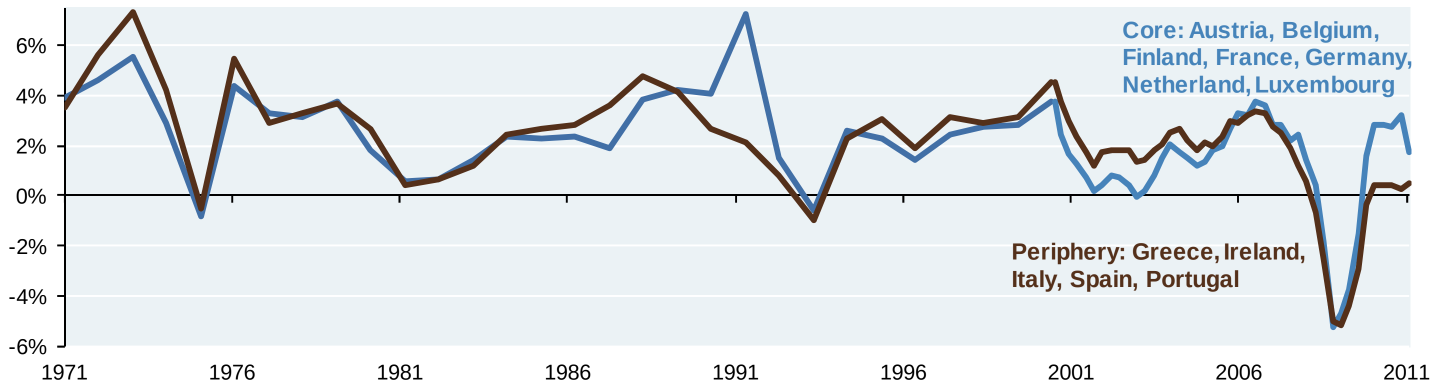
Appendix charts

The likely political successors to the CDU in Germany support Federalization of these problems through Eurobonds, if necessary. However, it has become increasingly less clear that restructuring debt, recapitalizing systemically-important banks and allowing for orderly exits from the EMU would be a more costly option than the one Europe is now pursuing.. **What the charts below show is that the European Monetary Union, designed to harmonize European differences, has ended up exacerbating them**.

European Periphery: stuck in neutral
Real GDP growth, percent, YoY, as of Q2 2011

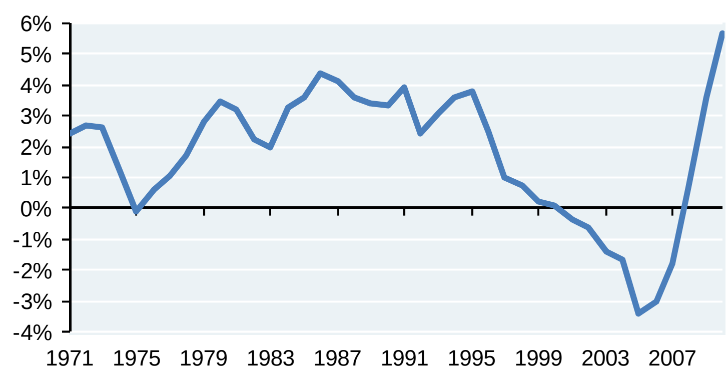


Source: Statistical Office of the European Communities, OECD, IMF, J.P. Morgan Private Bank.

ISM	Institute for Supply Management
QE	Quantitative Easing
EU	European Union
ECB	European Central Bank
EMU	European Monetary Union
EFSF	European Financial Stability Facility
CDU	Christian Democratic Union
CSU	Christian Social Union of Bavaria
FDP	Free Democratic Party

Berlin Alexanderplatz is a 15.5 hour film by Rainer Werner Fassbinder produced in 1980. Lego Minifigures were first produced in 1978; 3.7 billion have been produced since then.

Unemployment rate difference between Periphery and Germany, Percent, Peripheral rates weighted by population



Source: J.P. Morgan Private Bank, Bank of Spain, Bank of Portugal, OECD, CSO, NSS, IMF.