Figure 1: Printing Press
The illustration represents the money created by various central banks since January 2008 to buy their own government bonds, or bonds of other countries to limit exchange rate adjustments. Crates are labeled by amount created, and expressed as a percentage of GDP. See inside cover for more details.
What is “money”? If you go to the Bureau of Printing and Engraving at the U.S. Treasury, you won’t actually see the machines running in overdrive. In an era of electronic money, the Federal Reserve can increase the monetary base (also known as “high-powered money”) by increasing bank reserves to pay for the Treasury bonds that it purchases. The same applies to government bond purchases in the United Kingdom. The other countries shown engage in a different kind of money creation: an expansion of the monetary base to fund the purchase of foreign assets instead of domestic ones, with the goal of limiting exchange rate appreciation. Most of these countries drain domestic liquidity to try and prevent inflation, but still create two separate distortions. The first is domestic: By maintaining an undervalued currency and very low real interest rates, they risk inflation of wages, goods and asset prices. The second is international: These actions contribute to the global pool of central bank savings invested in U.S. government bonds. What used to be a functioning private sector market with price signals regarding inflation and growth risks is now increasingly subject to price controls and systemic shocks. By the time QE2 is over, more than half of all Treasuries will be owned by U.S. and non-U.S. central banks.

Note how the representative from the European Monetary Union, which is not engaging in this kind of activity to any large degree, looks on in despair from outside the building.
How do you summarize a year that was in many respects indefinable? On one hand, the European sovereign debt crisis, contracting housing markets and high unemployment weighed heavy on all of our minds. But at the same time, record corporate profits and strong emerging markets growth left reason for optimism.

So rather than look back, we’d like to look ahead. Because if there’s one thing we’ve learned from the past few years, it’s that while we can’t predict the future, we can help prepare for it.

Our Global Head of Investment Strategy Michael Cembalest has spent the past several months working to build a comprehensive view of the macroeconomic landscape.

Sharing these perspectives is part of our deep commitment to you and what we focus on each and every day. We are grateful for your continued trust and confidence, and look forward to working with you in 2011.

Most sincerely,

Mary C. Erdoes

Chief Executive Officer
Asset Management
The Printing Press

As we head into 2011, global profits are rising, U.S. household incomes and debt burdens are improving, the Asian production boom continues, global services are starting to rebound, and Germany is seeing its largest manufacturing and consumer revival since reunification. The twin engines of world growth, the U.S. and China, are in expansion mode again (c1).

Given pressures for fiscal tightening in the West, it’s hard to blame monetary authorities around the globe for trying to keep these things moving. That’s why the global monetary experiment captured by the cover art continues uninterrupted. But it may be beyond traditional linear thinking to grasp all the ways this could turn out. The lowest inflation since 1958 and a large output gap in the U.S. (an inexact measure of spare labor/productive capacity) give the Fed justification for its approach (c2). The same cannot be said for Asia, where the output gap is smaller (or may not exist at all), and where inflation is rising.

The chart below is something I have been thinking a lot about (c4). It’s a measure of global imbalances: the extent to which some countries spend more than their incomes, and rely on other countries to finance the difference; how much they intervene in their currency markets; and how much they offset inadequate private sector demand through budget deficits. Does this matter given all the good news above? When P/E multiples on global equity markets (c5) are this low? And when mountains\(^1\) of household, corporate and Sovereign Wealth Fund cash are capable of driving asset prices higher? I think it does, since the risks of unintended consequences are higher when the magnitude of imbalances (and experimentation) is this high as well.

I do not believe that the world will suffer a major relapse, and see attractive opportunities in 2011 for public and private equity, credit, hedge funds, commodities and real estate. However, I expect next year to be like 2010: volatile, and with modest returns on a balanced portfolio of financial assets. That these returns are made more attractive by the world’s Printing Press policy, which renders cash savings useless as a store of value (c6), is a mixed blessing at best.

Michael Cembalest
Global Head of Investment Strategy

\(^1\) A ratio of U.S. corporate sector cash to tangible assets is at its highest level on record. A measure of household cash and bonds as a % of discretionary financial assets is not far off. Sovereign Wealth Fund balances have grown from $1 trillion to $4 trillion since 2005. The sources for all charts and tables, as well as a list of acronyms, appear on page 13.
Fast growth, inflation pressures: a better set of problems in Asia and the emerging world

If we are not in an Asia-dominated world yet, we may be there soon. Asia’s share of world output, even when excluding Japan, is now double that of the U.S. and still growing (c7). As a result, the Asian EM inflation question is a very important one. As shown on page 1, headline and core inflation in Asia and Latin America are rising. Inflation pressures are mostly food-driven (c8, c9), but are beginning to impact wages and prices as well. China’s inflation controls (increased bank reserve requirements, Central Bank bill issuance and legions of administrative measures) may be losing their effectiveness, as shown by frequent large spikes in its residential property markets (c10). This may be why China raised its inflation target to 4% in December. Why so much discussion about China? Like a giant tractor beam (c11), China pulls the emerging world into its orbit. A positive view of the world must assume China can continue to control inflation and deliver ~8% growth, unorthodox model and all (c12).

I expect EM Central Banks to cool things down, after which I expect EM growth to continue. Asian exports are already rising after their Fall slowdown, particularly in countries like Korea, Taiwan and Singapore. EM ex-China bank credit is growing (c13), supporting the business cycle and employment growth (c14). This is in stark contrast with the West, where de-leveraging still rules. Should EM countries overdo monetary tightening, fiscal deficits and debt ratios are generally low enough (c15) to support additional stimulus, with some exceptions (India, Czech Rep.). In China, bank loan and money supply growth of 20% (down from 30% in 2009) indicate that the risk of over-investment and capital misallocation remains high. I believe Asian currencies continue to be undervalued relative to G3 currencies; more on the dollar on page 10.
The United States: modest private sector recovery trumps fiscal problems, for now…

With many emerging economies limiting FX appreciation, a rebalancing of demand to the East will happen more slowly. As a result, the world still relies on the U.S. consumer, whose discretionary and non-discretionary purchases make up 70% of U.S. GDP. Recent spending data have been positive, despite weak job creation. This may reflect two factors. First, labor incomes have risen faster than job growth (c16), and second, household debt service burdens have now erased the last 15 years of excess, courtesy of both lower interest rates and defaults (c17). Credit card and early-stage mortgage delinquency rates are showing marked improvements as well. Based on a variety of recent indicators and surveys, I expect payroll gains of ~200k per month in 2011, and 3.0%-3.5% GDP growth.

Corporate sector cash balances are at a 50-year high, and are finally being spent. Business and equipment spending (c19) and productivity (c20) will probably slow but remain positive. Commercial construction, at its lowest level since 1958, should stop declining. These gains will be partially offset by $80 bn of belt-tightening at the state/local level. NY is one example; absent changes to current law, its structural deficit for 2012 should be $9 bn on $90 bn in expenditures. Housing is still a mess (30% of mortgages underwater, shadow inventory 2x the number of homes for sale), and credit creation remains low.

The elephant in the room: the eventual need for fiscal tightening. The production rebound was consistent with prior ones, but cost a lot more in terms of Federal debt to generate (c21). Tax cut extensions and payroll tax reductions will increase 2011-2012 deficits by $800 bn compared to current law. If this “all-in” strategy results in consistent 4% growth, 2015 budget deficits could fall to 3%. Otherwise, the U.S. will eventually need to make tough choices (the IMF estimates required U.S. 2010-2020 fiscal adjustments that are greater than Spain’s). Bowles-Simpson recommendations tried to spread the pain equitably (tax increases and spending cuts), but were rejected by legislators on the Commission that drafted them. How does the U.S. fiscal picture look to China? A recent paper published by Peking University was entitled “Eying the Crippled Hegemon: China’s Grand Strategy Thinking in the Wake of the Global Financial Crisis”.

A lot of faith resides in the Fed’s “portfolio rebalancing channel” theory of lowering interest rates, driving up equity markets, increasing confidence and consumer spending, and eventually, employment. In its interim stages, it lifts financial asset prices more than employment, destroys the purchasing power of savings, and may result in much higher commodity prices. Jury: still out.
Europe: Irreconcilable Differences?

My writings on Europe in 2010 might have been as long as the EU Constitution. Here’s an abbreviated 5-point summary:

1. Germany is rebounding impressively (c23), but in Q2 and Q3, net exports were the largest contributors to German growth (c24). German export growth does not help pull other EMU countries along.

2. The periphery is stuck in austerity as a quid pro quo for bilateral EU and IMF assistance (c25), which is worsening GDP, unemployment (see c57 on page 12, worst on record) and VAT tax declines. Can it be sustained? In contrast, over in Iceland, real wages, employment, exports, stock markets and tourism are rising after their default/valuation.

3. During crises in Latin America (1980s) and Asia (1990s), Argentina (1984) and Thailand (1997) were first thought to be exceptions, and that problems could be ring-fenced. In both cases, a broken paradigm applied to more countries.

4. Spain is now the Maginot Line. Its international banks should be able to survive a period of low growth, and its regional banks could be fixed for 5%-10% of Spanish GDP. But there’s still all the Spanish private sector non-financial debt, which is among the highest in the world. This is not just a sovereign debt or banking sector problem.

5. Germany and France might have to agree to more direct subsidies, larger bilateral aid facilities or something more explicit, like “European Union government bonds”. Will they do it? Last month, former EU President Jacques Delors said in response to the crisis that Europe needs to find its “soul”. In 2011, we will find out whether the soul of Europe is based on its national identities, or a new Federal one. See page 12 for more on this topic.

(c23) German retail & manufacturing surveys, index, sa

(c24) German GDP driven by exports

Percent contribution to 2010 GDP

(c25) Core vs. periphery GDP

Index, 100 = 2007

Bottom line: while there are some safe zones (e.g., the health of banks and less reliance on foreign bond buyers in Italy; lower public debt in Spain), the concentration of red flash points in my Sovereign Risk Scorecard is high. I expect the question of the periphery to overshadow the German recovery until it is resolved in some way.

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<td>9.5%</td>
<td>116%</td>
<td>17%</td>
<td>(11.7%)</td>
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<td>-0.3%</td>
<td>(102%)</td>
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<td>10.6%</td>
<td>133%</td>
<td>48%</td>
<td>(5.0%)</td>
<td>4%</td>
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<td>(20%)</td>
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<td>0.7%</td>
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<td>33%</td>
<td>(9.6%)</td>
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<td>-10.5%</td>
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<td>80%</td>
<td>56%</td>
<td>(9.3%)</td>
<td>10%</td>
<td>-5.5%</td>
<td>(98%)</td>
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Notes: “Net International Investment Position” measures external debt less external assets (loans, bonds, equity). A larger negative number indicates a greater net external liability; those shown are among the highest in the world. Price/wage differentials vs Germany as of Q3 2010 based on consumer prices and unit labor costs for manufacturing, both indexed to December 1998. The OECD considers the wage measure more relevant for assessing competitiveness. Ireland was never the world’s reserve currency, but according to author Thomas Cahill, its monks safeguarded Western civilization during the Dark Ages by transcribing works before Barbarians burned them.

2 The original “Treaty for a Constitution in Europe” was 784 pages. The 2009 Lisbon Treaty was whittled down to 280 pages.
On markets and investments

Equities: pricing in a fair bit of pessimism

The prior pages refer to challenges the world is still facing; the good news is that equity markets are pricing a lot of them in. Forward P/E multiples for the U.S., Europe and the Emerging Markets are clumped together around 10x-13x (c26). Growth stocks in particular look cheaply priced (c27), although there is something strange going on in the large cap technology space3, where P/E multiples are low and cash holdings are extremely elevated (c28). A ratio of P/E to earnings growth is at a 20-year low for the S&P 500, another sign of market pessimism. Large cap growth outperformed value in 2010, and still show P/E multiples that are only 1.2x higher than value stocks, among the lowest premiums of the last decade. Small cap outperformed large cap in 2010, and at 1.4x the P/E of large cap, is trading close to the highest premium of the last decade.

U.S. profits growth and margins are in good shape. Keep this in mind: S&P 500 revenues over the last 15 years have been more linked to World GDP growth than U.S. GDP growth (c29), driving offshore profits higher as a % of GDP (c30), and to 35% of total U.S. profits. Another support for earnings during the recession: the S&P 500 has less exposure to the U.S. consumer than the U.S. economy, and more exposure to capital spending and energy.

Analysts have underestimated S&P 500 earnings by around 10% per quarter since Jan 2009. During the recession, U.S. companies kept costs down as demand plunged. Now, as demand rises, incremental margins on new revenues are high. I expect this to continue in 2011. I expect 8%-10% earnings growth and stock buybacks (now running at 2% of market cap) to deliver roughly 10%-12% S&P 500 returns in 2011, with bumps along the way.

While U.S. profit margins are high, U.S. corporate sales are at a 50-year low (c32). How can these 2 things co-exist? Because labor costs as a % of revenues are at their lowest levels, by some measures since 1929. That’s why I’m reluctant to forecast much higher P/E multiples; right now, earnings are too reliant on low real wages.

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3 Stocks used for this analysis include: Microsoft, IBM, Apple, Intel, Hewlett-Packard, Cisco, Oracle, Google, Qualcomm, Corning
Over the last 1 and 3 years, portfolio tilts to U.S. and Asian equities have worked well, whether measured in USD or local currency terms (c33). I expect these relative rankings to continue in 2011, and believe there are greater risks associated with European deflation than with Asian inflation, despite the widely-reported contribution of Asian revenues to European companies. Based on my calculations, the effective Asia exposure of European and U.S. companies is similar.

Concentrations in Asian equities have delivered similar returns to emerging markets overall (c33). However, Brazil is undergoing more rapid structural change than other countries in Latin America, and merits a closer look. I am encouraged by the development of the middle class (c34), and increased international trade (its mining, oil and agricultural exports to China have quadrupled since 2004). But there are risks related to inflation, an overvalued exchange rate, and reliance on portfolio inflows rather than foreign direct investment. In addition to long-only equities, I see opportunities in a hedged approach of both long and short positions; private equity investments, particularly in consumer-related companies which are only 10%-15% of the Bovespa (see page 8); and investments in local Brazilian credit and interest rate markets.

**Fixed income: government bonds and credit**

The global Printing Press creates money that needs to find a home. At the same time, fixed income issuance in the U.S. has been negative: while Federal and municipal issuance grew, companies and households reduced issuance at an even faster pace (c35). The result: a supply-demand imbalance that supported global bond prices. By the time QE2 is finished, the Fed should own 1/3 of all Treasuries outstanding in 4-20 year maturities, and finance 94% of the 2011 Treasury deficit. I expect G3 banks and EM Central Banks to continue to buy Treasuries, but see risks of higher yields at some point (see page 11 for more on bond market risks). As explained on the inside cover, Treasuries have temporarily become a price-controlled market, but in the end, that only protects long-duration investors if the public sector is willing to purchase U.S. government bonds without limit.

I expect another year of stable credit spreads, although returns will be markedly lower than in 2009 and 2010 given how much spreads have already tightened. Bank loans and high yield are still reasonably priced at 575 and 600 bps after last year’s rally. The current decline in default rates (c36) helps explain why spreads have tightened this much, but liquidity conditions are undeniably affecting the pricing of credit.

The structured credit market reached its Icarus moment in 2007, when it offered less value to investors than at any time since its inception. At the time, a AAA-CMBS investor could barely sustain any property losses before losing principal (c37). Since then, investor subordination protections have improved substantially, and spreads are wider. As a result, I believe structured credit can play a role in a broader fixed income portfolio, in addition to traditional sovereign and corporate credit.
**U.S. commercial real estate**

I see opportunity in commercial property where capital is scarce and where lending positions can be well-collateralized (commercial mortgage backed securities rollovers, mezzanine lending [c40] and distressed real estate). A silver lining of the residential housing mess: there was less of a commercial overbuilding boom this time around. The worst commercial property boom took place in the mid 1980s (c38), after a 1981 tax reform bill which allowed active income to be offset by passive losses, a provision which ended with the Tax Reform Act of 1986. The next biggest mess: the tech boom of the late 1990s. In contrast, commercial overbuilding during the credit boom (a different concept from overpaying) was less of an issue this time.

The liquidity glut that has led to lower credit spreads has also pushed up real estate prices, but mostly for “bond-like” office and multi-family properties that are well leased, and in major market locations. Opportunities persist in properties with leasing, debt maturity or completion risks that require the experience of an operator and not just a financial buyer.

It will take time for all the vacant space to be absorbed (CB Richard Ellis forecasts that U.S. office vacancy rates won’t peak until the second quarter of 2011). But as is typical with most business cycles, asset prices tend to rise well before their respective fundamentals do. This has been the case in the aftermath of almost all prior recessions, as U.S. and European equities, bank stocks and high yield bonds started to rise well before improvements in unemployment, earnings declines, bank failures and corporate bankruptcies (See EoTM December 6, 2010 for more details).

**Hedge funds**

I am optimistic about prospects for continued merger activity (c41), and hedge funds which benefit from them. I also see opportunity in macro hedge funds, given the world’s unresolved imbalances discussed on the first page. Macro hedge funds often benefit from volatility in equity, commodity, interest rate and FX markets. Credit hedge funds which focus on refinancing and restructuring of overleveraged balance sheets should also have substantial deal flow as the debt mountain matures.

Some hedge funds have faced challenges from the high correlation of individual stocks. In the U.S., the pairwise correlation of stocks is elevated (c42); outside the U.S., stock selection appears to have more promise, given lower correlations. This makes some long-short investing styles such as market-neutral and statistical arbitrage harder to do. Another way to look at this issue: there has been a collapse in the “unexplained alpha” of stock price movements (c43), after stripping out common factors (capitalization, sector, growth vs value, etc), which makes pure sector-neutral stock-picking harder. Over the past few decades, when U.S. market conditions normalized, pairwise correlations tended to fall. No sign of this yet as of November 2010, but such a development would be consistent with my market view.
Private equity: growth opportunities still exist

Chinese Consumption

Asia offers investors an economic backdrop of low sovereign debt, low corporate and personal tax rates, innovation (patent filings in China and Japan are 5x European levels) and an increasing degree of self-reliance (free trade agreements, less sensitivity of Asian industrial profits to U.S. recession). But public markets often do not adequately capture these trends, particularly in China, where public listings are dominated by banks, utilities and other entities which are not strictly run as for-profit enterprises. China’s transmission of GDP growth to public equity market returns has been among the lowest in the emerging world over the last decade.

As a result, private equity capital can be an interesting complement to public equity investing. Some of the best opportunities in China are related to things consumers lack and need: higher-end retailing and consumer staples, food safety/certification, high-end agricultural products, financial services, healthcare, medical equipment, grid infrastructure and water treatment plants. Chinese private equity transactions generally involve purchases from first-generation entrepreneurs. Sellers tend to be very focused on whom can offer ongoing operational expertise, and not just the best purchase price. Logistics account for around 18-20% of the final retail price of goods in China (vs 8% in the U.S.), so there is plenty of room for improvement.

Chinese consumer trends are sometimes obscured by the reported decline in Chinese household consumption as a % of GDP. I consider this one of the more misleading charts floating around cyberspace, as it is mostly a consequence of relative measurements. China’s reliance on capital formation and exports has dominated its GDP growth since 1990, even more than in Germany, Japan and South Korea during their post-war industrializations. That’s why Chinese consumption looks like it is “shrinking”. However, Chinese retail sales (both nominal and per capita) have continuously grown since 1990, at a pace 4%-5% faster than the rate of Chinese inflation. Furthermore, a recent study by the deputy director of NERI, a Chinese economic research institute, found that Chinese household income is around 90% higher than what is reported in household surveys, and 30% higher than what is reported in China’s flow of funds/national account data. These findings are consistent with demand trends I am seeing for consumer products. Increasingly, new opportunities are located outside of Beijing and Shanghai, and are targeting consumers in China’s middle-tier cities with an average population of 6 million and rising disposable income (Guizhou, Hunan, Henan, Sichuan and Hubei).

Brazil: sidestepping the public market focus on commodity exports

While private equity has a long history in Brazil (with BNDES, starting in 1982), its penetration is not deep. Even in the boom-year of 2007, more private equity capital went into both Africa and the Middle East than into Latin America. However, these trends are changing as Brazil evolves. Brazil has made substantial progress on issues valued by private equity investors (c44). The accompanying table shows what these attributes are, according to the Economist Intelligence Unit. The top nine are where Brazil ranks highly, while the last three in italics are where Brazil still has low marks. In aggregate, Brazil’s scores are now similar to countries like Israel, Taiwan and Spain. That may explain why Brazil accounted for 18% of all EM private equity fundraising in 2009.

Services, transports and telecoms (ex-financials) make up around half the Brazilian economy but only make up 15% of the Bovespa, given the latter’s large weights in energy-related commodities and industrial metals (c45). As a result, a lot of private sector output related to the consumer is not represented on Brazil’s publicly traded equity markets, creating opportunity for private capital.

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(c44) EIU Private Equity Attractiveness Index, max = 100

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EIU Brazil PE/VC scorecard

+ Laws regarding VC/PE fund formation
+ Tax treatment of VC/PE funds
+ Protection of minority shareholder rights
+ Restrictions on institutional investment
+ Bankruptcy procedures/creditors rights
+ Capital markets development/exit feasibility
+ Corporate governance requirements
+ Use of international accounting standards
+ Entrepreneurship
- Strength of judiciary
- Perceived corruption
- Protection of intellectual property rights

(c45) Services, Transports and Telecoms, ex-Financials

% Brazilian GDP

% Bovespa

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4 Gavekal/Dragonomics, China Economic Quarterly, December 2010
“Demand for Band”
A decade ago, many business models failed due to excess leverage and the lack of an application that could command premium pricing. However, the infrastructure created has become a foundation for a new generation of electronic content (online and mobile video) and e-commerce. OECD broadband users continue to grow (from 15% of OECD population in 2006 to 25% in 2010), along with bandwidth demands for new services, delivered by new applications (c46, c47). In addition, as cable companies upgraded their networks for HD content starting in 2004 (c48), they increased their network capacity. This in turn has created opportunities for companies involved in digital rights management, bandwidth connectivity, “TV-everywhere” services and software, video content aggregators and applications that enable mobile e-commerce. I will cover this topic in greater detail early next year.

Commodities/The U.S. dollar
I see a year of single-digit positive returns from commodities, and am most positive on copper\(^5\), oil, gold, platinum and palladium. I expect easy monetary policy from the Fed, and only modest steps from emerging markets countries to tighten. Commodity demand is still growing in the emerging world, where job creation tends to take precedence over inflation-fighting (a country like Mexico would be an exception). Emerging economies require a greater share of the world’s natural resources in order to grow (c49). Some of the shares shown have doubled in just 15 years, a remarkable demand shift versus history.

Commodities are a volatile asset class, so no one should be surprised to see substantial bouts of profit-taking in 2011. Over the last 10 and 20 years, their volatilities have been similar to global equities (much higher when using the energy-heavy GS benchmarks). In addition, the “roll yield” which was a substantial contributor to diversified commodity investments from 1970 to 2003 has disappeared, now that more financial investors are interested in the asset class, and are pushing forward prices higher (e.g., no more consistent backwardation at the index level). As a result, commodity investing is mostly about price returns, and the supply-demand relationships which govern them. Some commodity prices are likely to remain range-bound, as oil did in the latter half of 2009 and all of 2010. Investors can leverage a “sideways” view by selling away upside potential above certain price points, effectively increasing the running yield on the position.

\(^5\) Copper-intensive products are flying off the shelves in China: cars, refrigerators, and TV consumption is up 40%-80% since 2008. JPMS estimates that hotels will be constructed at the rate of 1,000 per year, with internal tourism growing at 15%. An increase in electrification in countries like Pakistan, India and Indonesia are also part of the copper demand picture.
Commodities are best analyzed based on scarcity rather than just momentum (see c50 and c52). On oil, gains in Iraq are needed to offset production declines in Mexico, Norway and the UK that began to accelerate in 2004. There have been improvements in oil recovery rates, and the IEA estimates an additional 6 million barrels per day from CO2 injection and other Enhanced Oil Recovery techniques by 2030. However, given the expected loss of many more barrels per day from existing fields, there’s still a huge projected production gap. Overall, I expect spare oil capacity to decline, as demand growth and non-OPEC production losses exceed new OPEC supply of both conventional and non-conventional liquids.

Regarding the merits of active management of commodities, there is less historical data than there is for managers of equities, government bonds, credit and real estate. What is clear is that opportunities for active commodity managers are substantial. As shown in c51, the average correlation among S&P sectors is substantially higher than for commodity sectors. After the price increases seen in 2010, I believe it is increasingly important to find active and passive approaches that protect downside risk.

On gold, I expect its wild ride to continue. While concerns about the dollar’s reserve currency status are premature (see below), the Printing Press increases demand for gold. Many emerging economy Central Banks own gold at less than 5% of their reserves, which might account for increased demand. However, a November surge in Chinese gold imports came from its private sector. China just approved the first “QDII” gold fund, which allows Chinese citizens to buy gold through an ETF. Remember, EM inflation risks play as large a role as U.S. inflation concerns in driving demand for gold. For all the hype, the market cap of gold ETFs is roughly the same as that of Verizon. In other words, a lot of individuals, institutions and sovereign entities are likely to be underinvested relative to some abstract definition of “normal”. There will be bouts of profit-taking, since gold has had a great run. But I expect gold prices to be higher by the end of 2011 rather than lower.

What’s next for the U.S. dollar and reserve currency status?
Roughly 85% of all FX transactions occur in USS (according to the latest BIS data), with 39% in Euros, 19% in Yen, 13% in Sterling and 0.3% in Chinese RMB (the numbers add to 200% given two sides to each FX transaction). No smoking gun here regarding the dollar’s reserve currency status, as these figures are almost identical to what they were 3 years ago.

However, there are longer-term parallels to think about. Between 1860 ad 1914, nearly 60% of the world’s trade was settled in Sterling. But by the middle of the 20th century, Britain’s dominance faded. Members of the British Commonwealth maintained Sterling reserves after WWI and WWII despite Britain’s financial and military decline. Why? It was in their mercenary self-interest given a desire for export-led growth. The Commonwealth countries held on to their Sterling reserve balances until 1967, when Sterling devaluation imposed losses that were too great for them to bear. Eventually, the UK had to guarantee the value of Sterling reserves in U.S. dollars for Sterling area countries.

Why is this relevant? Today’s relationship between EM Central Banks and the U.S. dollar looks similar in some regards. Despite substantial changes in the long-term fiscal position of the U.S., the dollar continues to be the reserve currency of choice, primarily for mercantilist reasons. What would happen if countries accumulating dollar reserves began to worry more about the value of their reserves (or inflation) rather than trade? Would the Fed step in if offshore demand fell too fast too fast? These are unanswerable questions, since we are witnessing the largest currency intervention experiment of the last 300 years. Policy-driven swings in $-Euro are likely to continue (I do not have a high-conviction view on this bilateral pair), but I believe the tide of history and economics leans towards higher values for Asian exchange rates versus the US$ and Euro.

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<table>
<thead>
<tr>
<th>(c50) Commodity supply grid</th>
<th>(c51) Commodity sectors historically less correlated than equities</th>
<th>(c52) Production shortfall, %, trend growth in demand minus 10-yr production</th>
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<tbody>
<tr>
<td>Agriculture</td>
<td>Cocoa, Wheat, Corn, Soybeans</td>
<td>Nickel, Copper, Oil, Tin, Zinc, Silver, Lead, Aluminum</td>
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<td>Energy</td>
<td>Crude oil, Coal, Natural gas</td>
<td>Surplus</td>
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<tr>
<td>Industrial metals</td>
<td>Copper, Lead, Nickel, Aluminum</td>
<td>Shortfalls</td>
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<tr>
<td>Precious metals</td>
<td>Gold, Platinum/Palladium, Silver</td>
<td>Platinum/Palladium, Zinc, Silver</td>
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<tr>
<td>Average correlation among S&amp;P 500 sectors</td>
<td>Average correlation among commodities sectors (DJ UBS)</td>
<td>(c52) Production shortfall, %, trend growth in demand minus 10-yr production</td>
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<td>-0.2</td>
<td>0.0</td>
<td>0.2</td>
<td>0.4</td>
<td>0.6</td>
<td>0.8</td>
<td>1.0</td>
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For more details on this period in British economic history, see “Sterling’s Past, Dollar’s Future: Historical Perspectives on Reserve Currency Competition”, Barry Eichengreen, NBER Research Paper 11336.
Appendix I: there better not be a policy mistake related to interest rates
The good news is that world GDP is driven by as much by countries with low fiscal deficits as by high-deficit countries (c53). The bad news: some high-deficit countries are like unexploded land mines. The cost of servicing public debt is not extremely high in Japan, Italy or the United States, but that’s mostly because interest rates are so low, rather than debt being at a sustainable level. Low servicing costs also reflect low average debt maturities for the U.S. and Japan, at around 4 years.

This “OK-as-long-as-rates-don’t-rise” paradigm extends to households as well. In the U.S., improved household obligations ratios shown on page 3 are more a function of lower interest rates and defaults than paydown of debt (c54). Household debt has only declined from 130% to 118% of disposable income. In Hong Kong, where apartment prices are skyrocketing, some research asserts that affordability ratios don’t look so bad. To me, this is another example of something looking normal only because of abnormally low interest rates. HK affordability looks good (c55) since mortgages only cost 2.5% in a country growing at 9% per year, and where inflation is 2.7%; again, the real cost of money is zero. Another example: a modest rise in Japanese interest rates would render its fiscal accounts inoperable (c56).

Why would rates ever have to rise? Theoretically, the Fed has infinite ability to create money, finance budget deficits and keep rates low. However, there may be economic and political limits preventing them from doing this for too long; see Bernanke’s “change of heart” (box). For whatever reason, if interest rates rose sharply without a commensurate rise in private sector incomes and government tax receipts, I would expect another round of debt problems. There was an article in the LA Times discussing the benefits of plentiful liquidity, too much bearish sentiment, low hurdle rates for stocks, a weaker dollar to stimulate exports, low equity valuations and the scope for dividend increases. The article, “Despite Caution Signs, Market Stirs High Hopes”, was designed to explain how all these things were good for stocks. Publication date: March 8, 1987.

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**Bernanke 2002: The central bank can finance government spending, at no cost:**
“Under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short term nominal interest rate is at zero. . . The U.S. government has a technology, called a printing press (or, today, its electronic equivalent) that allows it to produce as many U.S. dollars as it wishes at essentially no cost.”

**Bernanke 2009: Or maybe not**
“Prompt attention to questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby-boom generation and continued increases in medical costs. . . With the ratio of debt-to-GDP already elevated, we will not be able to continue borrowing indefinitely to meet these demands.”

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7 This chart weights each country according to its purchasing power GDP, rather than its nominal GDP.

8 Japanese equities are priced close to 1x book. However, Japanese equities tend to outperform the US for a quarter or two, and then slip back into extended periods of underperformance. Growth is stalling (5 months of production declines through October), retail sales and bank lending to corporate and households are fading, and deflation is around -1.0% per year. The long-term issues: Japan’s old-age dependency ratio (worst in the world, followed by Italy and Germany); and debt ratios (see “Are JGBs the Short of a Lifetime”, EoTM, August 23, 2010). The best news for Japan: its export reliance on Asia has risen from 40% to 56% since 2000.

9 “Bernanke’s Paradox: Can He Reconcile His Position on the Federal Budget with His Recent Charge to Prevent Deflation?”, Pavlina R. Tcherneva, Bard College, November 2010
Appendix II: European Federalism and the cultural/social divide
The Sovereign Risk Scorecard on page 4 tries to capture the economic and fiscal challenges that Europe is facing. The visual below attempts to capture some of the cultural and social ones. Since 1981, Professors Ron Inglehart (University of Michigan) and Christian Welzel (University of Bremen) have used data from their World Values Surveys to assess belief systems and their impact on social and political change using surveys from 90 countries. After plotting the proxy for each country’s “relative value system” (y axis) and “degree of individualism and self-expression” (x axis), the authors superimpose geographical regions, which fit pretty neatly over the data. Each axis represents a synthesis of 10-15 different survey questions.

Countries in the European Monetary Union share a lot in common regarding the x-axis, as Germany, Italy, Spain, France, Belgium, Portugal and Greece appear in a very tight corridor. However, on the y-axis, they are quite different. These latter differences, for example between Spain and Germany, are large. They are greater than differences between countries in Latin America, Eastern Europe or China/Korea. They’re also greater than differences the authors compute within each country (e.g., university-educated vs rest of sample).

As Europe deals with regional austerity, the highest Periphery unemployment on record (c57) and the need for large fiscal transfers (if not full-blown Federalism), these cultural differences will need to be overcome as part of the process. Recent Eurobarometer polls showing almost the lowest level of support for EU membership since 1973 indicate that Europe’s leaders still have a lot of work to do (see “A Don Quixote Thanksgiving”, EoTM, November 18, 2010).

From the authors
“Cross-national differences dwarf the differences within given societies… Despite globalization, nations remain an important unit of shared experiences, and the predictive power of nationality is much stronger than that of income, education, region or gender.”

“Even today, the nation remains a key unit of shared socialization, and in multiple regression analyses, nationality explains far more of the variance in these attitudes than does education, occupation, income, gender or region.”

(c57) Unemployment in the periphery
Percent, weighted by population

10 “Changing Mass Priorities: The Link between Modernization and Democracy”, Ronald Inglehart and Christian Welzel, Perspectives on Politics, June 2010, Volume 8, Number 2. Their conclusions about the durability of cultural and national differences are similar to Geert Hofstede’s pioneering analysis on the subject. An aggregation of Hofstede’s 4 cultural dimensions show that Spain, Portugal and Greece are considerably more “different” vs Germany than Switzerland, Italy and the entire English-speaking world.
Acronyms


Chart sources

(c1) Institute of Supply Management, CLSA-Markit, Nov 2010
(c2) J.P. Morgan Securities LLC, October 2010
(c3) J.P. Morgan Securities LLC, October 2010
(c4) OECD, J.P. Morgan Securities LLC, September 2010
(c5) Factset, November 2010
(c6) J.P. Morgan Securities LLC, September 2010
(c7) Historical Statistics for the World Economy - Angus Maddison
(c8) J.P. Morgan Securities LLC, November 2010
(c9) National Bureau of Statistics, J.P. Morgan Securities LLC, November 2010
(c10) J.P. Morgan Securities LLC, Centaline, November 2010
(c11) International Monetary Fund, 2009
(c13) Bridgewater Associates, L.P., October 2010
(c14) J.P. Morgan Securities LLC, September 2010
(c15) IMF, European Commission, OECD, Institute of International Finance, Banco Central Do Brasil
(c16) Bureau of Labor Statistics, November 2010
(c17) Federal Reserve Board, Q2 2010
(c18) Census Bureau, November 2010
(c19) Bureau of Economic Analysis, Q3 2010
(c20) Bureau of Labor Statistics, Q3 2010
(c21) Federal Reserve Board, Bureau of Economic Analysis, Office of Management and Budget
(c22) Congressional Budget Office, Q2 2010
(c23) Markit, IFO Institute, December 2010
(c24) German Federal Statistics Office, Q3 2010
(c25) Various central banks, Q3 2010 (Q2 2010 for Ireland)
(c26) Factset, November 2010
(c27) Corporate reports, Empirical Research Partners, Q3 2010
(c28) Factset, Q3 2010
(c30) Bureau of Economic Analysis, Q3 2010
(c31) Bank of America Merrill Lynch, November 2010
(c32) Bureau of Economic Analysis, Q3 2010
(c33) Bloomberg, December 2010
(c34) FGV, IBGE, LCA, Ministerio da Fazenda, September 2010
(c35) Bridgewater Associates, L.P., September 2010
(c36) J.P. Morgan Securities LLC, December 2010
(c37) J.P. Morgan Securities LLC, Trepp, rating agencies, Bloomberg
(c38) Bureau of Economic Analysis, Q3 2010
(c39) Bureau of Economic Analysis, Q3 2010
(c40) J.P. Morgan Securities LLC
(c41) Bloomberg, Q3 2010
(c42) J.P. Morgan Securities LLC, November 2010
(c43) Barclays Quantitative Equity Strategy, November 2010
(c44) Latin American Venture Capital Association – ELU Scorecard Report, 2010
(c45) Economic Commission for Latin America, Bovespa, Q2 2010
(c46) Cisco VNI Mobile, 2010
(c47) Cisco VNI Mobile, 2010
(c48) Kagan Research, December 2009
(c49) Wood Mackenzie, October 2010
(c50) Barclays Capital
(c51) Bloomberg, J.P. Morgan PB, December 2010
(c52) Bridgewater Associates, L.P., November 2010
(c53) IMF, OECD, World Bank, Malaysia Ministry of Finance, Indonesia Ministry of Finance, Empirical Research Partners, October 2010
(c54) Federal Reserve, BEA, Q3 2010
(c55) Gavekal, Centaline, September 2010
(c56) Japan Ministry of Finance, June 2010
(c57) J.P. Morgan PB, Bank of Spain, Bank of Portugal, Greece National Statistics Service, Ireland Central Statistics Office, November 2010

Table sources


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