Topics: Market and M&A update, taxes and Future Shock

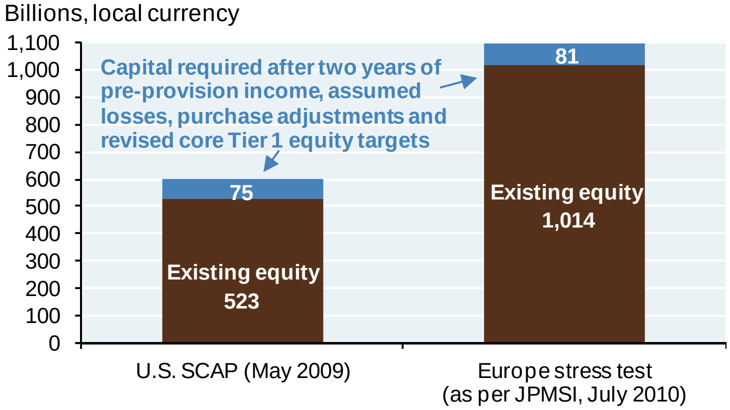
Market update. European bank stress tests will be released July 23. Many securities firms conducted their own analyses in advance, to anticipate potential capital needs. J.P. Morgan Securities published their version last week, estimating that across listed and unlisted banks, capital needs would be around 80 bn EUR. Taken at face value, that should not be challenging for Europe, since in the U.S., similar levels of capital were needed in May 2009 on top of an equity base that was half the size (see first chart). However, there are a truckload of unanswered questions, including:

- Does it make sense that the adverse case will use GDP assumptions that are only 3% below EU Commission forecasts?
- Will investors recapitalize Spanish Cajas and German Landesbanken, which are not strictly run as for-profit enterprises?
- How adequate are their loss assumptions? For Germany, defaulted commercial real estate loans are assigned a 30% loss, but only 5.2% are assumed to default (Barclay's capital shortfall estimates for Landesbanken are 10x higher, given harsher assumptions). In Spain, assumed losses on defaulted residential mortgages are 25%, but only 3.6% are assumed to default. There are more recourse loans in Europe than in the U.S., but these default assumptions may be light given deflationary pressures we have written about often over the last few months.
- Will adverse case losses only be applied to sovereign bonds held in trading accounts, or also to bonds held in "hold to maturity" accounts, which represent 40%-60% of sovereign holdings at Spanish and Greek banks?

We believe that European banks have lost access to debt markets primarily due to (a) excessive reliance on wholesale funding, and (b) questions about respective sovereigns being able to bail them out. More Tier 1 capital always helps, but does little to address either of these concerns. More next week, after the results are announced.

On paper, stress tests should be less stressful for Europe

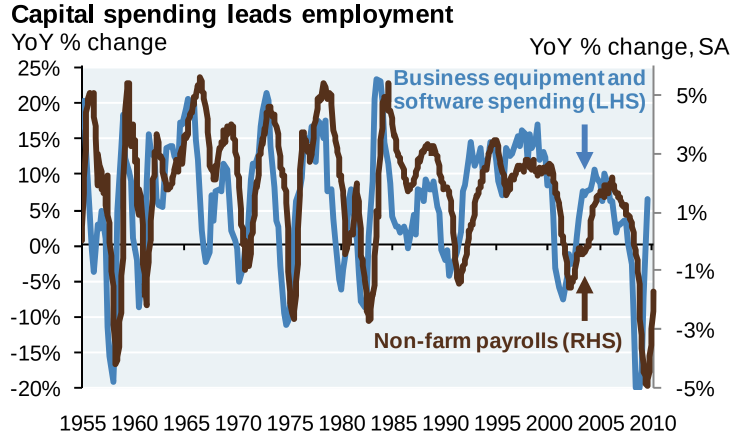
Billions, local currency



Source: U.S. Federal Reserve, J.P. Morgan Securities Inc.

Capital spending leads employment

YoY % change



Source: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics.

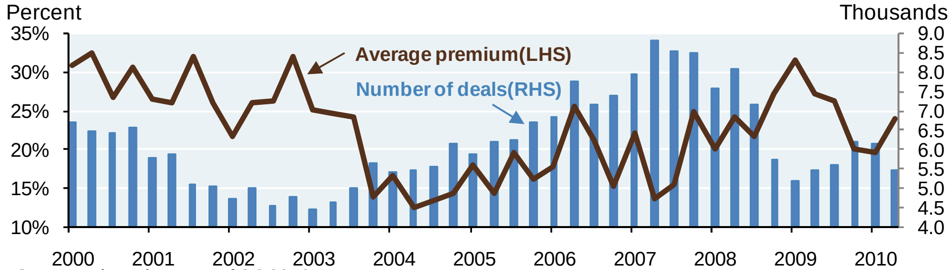
U.S. corporate profits remain a bright spot. We anticipate another strong quarter in Q2, and P/E multiples are low, even after adjusting for excess optimism by analysts. **But that sound you heard last week was the shredding of overly optimistic GDP forecasts for Q2 and the rest of 2010 across the industry.** A slowdown in spending, labor, housing, manufacturing, confidence, small business sentiment and exports began in June. Globally, semiconductor sales hit a 25-year high relative to world GDP, a sign the global economy may be in for a slower pace. A constructive outlook from here rests on better spending and payroll data. The basis for such a view: business spending has been a reliable leading indicator of employment for much of the last 50 years (2nd chart). **All things considered, we remain concerned about the growth impulse in a post-stimulus world, and have positive but muted expectations for growth and equity market returns for the remainder of the year.**

Given this outlook, we have been allocating less to directional equities and more to credit and hedge funds, including merger arbitrage [EoTM March 15]. We've been watching merger arb since last year, when corporate cash balances hit a 50-year high relative to tangible assets. Merger arb strategies tend to benefit from more transactions, and premiums paid in excess of 15%. As shown, we are seeing both trends in place. Recent transaction premiums have been even higher than in Q1; in the last 2 weeks, the average premium has been above 30%. Recent deals include:

- Aon - Hewitt
- United Financial-LSB-Smithtown
- Carlyle - NBTY
- J&J - Micrus Endovascular
- Tyco Electronics - ADC
- Honam Petrochemicals - Titan
- TPG – Healthscope

Rising M&A premiums and transaction volumes

Percent



Source: Bloomberg, as of Q2 2010.

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Twilight

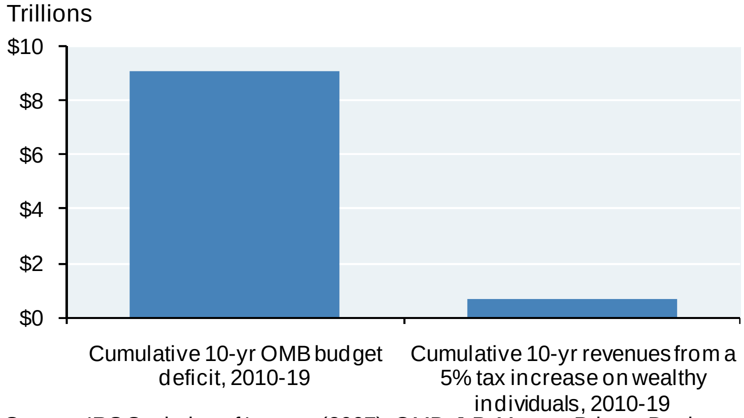
I took a couple of days off last week to attend a spousal family reunion in northern Wisconsin. One of the attendees is well-versed in both economics and taxation, having worked in and around DC for many years with politicians on both sides of the aisle. **The conversation on the U.S. fiscal deficit was sobering**:

- Next steps are likely to include removal of the tax cuts on the wealthy (through both higher rates and the reduction of allowable deductions). This would run counter to history, given the tendency for easier fiscal policy in year 3 of the Presidential cycle. But the current US public debt is at levels not seen in the last 60 years, with little improvement in sight.
- This is the first act of a well-rehearsed play. **All of Washington knows that raising income and capital gains taxes on the wealthy won't solve the deficit problem; there aren't enough of them**. Raising capital gains tax rates also runs into the problem of reduced gains realization, which happened in 1986 (gains realizations rose by 90% before the tax hike).
- The administration is considering changes to corporate taxes (e.g., tighter interest allocation rules which raise effective tax rates on multinationals). These changes **run counter to what other countries are doing** (lowering corporate tax rates, and encouraging overseas expansion).
- Tax increases are already underway at the state/local level, and are **misleading some analysts into seeing cyclically-driven growth in state tax revenues.** According to the Rockefeller Institute, after excluding the impact of legislated tax increases in NY and California, tax revenues across all states are still down 1.5% vs 2009.
- A Value Added Tax could raise revenue, stimulate investment and dampen consumption (150 other countries use them, the U.S. and Saudi Arabia being the only exceptions in the G-20). But a VAT has historically been opposed by Congress, in part since it's harder to manipulate than income taxes to favor certain constituencies via exemptions, preferences and credits
- The simplest and least economically distortive way to raise tax revenue is to raise all brackets by 3%-5%. But this is likely to be opposed for as long as possible. Why? Globalization (in particular, the rise of China and India beginning in the 1990s) set in motion an irreversible process of downward wage convergence of US workers with the rest of the world. Isolationism is a failed strategy, and worker retraining programs can only do so much. As a result, supporters of wealth redistribution see an (even) more progressive tax code as a critical part of maintaining the social fabric.
- The health care bill complicates the problem. The bill did **not introduce any mechanisms for reducing future health care spending**, and its "savings" come from promised reductions in future growth, making them highly suspect.

While none of this is groundbreaking, I was struck by the presumption of its inevitability. On the insufficiency of high net worth individuals to solve the deficit problem, we knew that already. In the September 8, 2009 EoTM, we showed how a 5% tax increase on adjusted gross incomes over $250k barely makes a dent in the OMB's deficit forecast (see first chart).

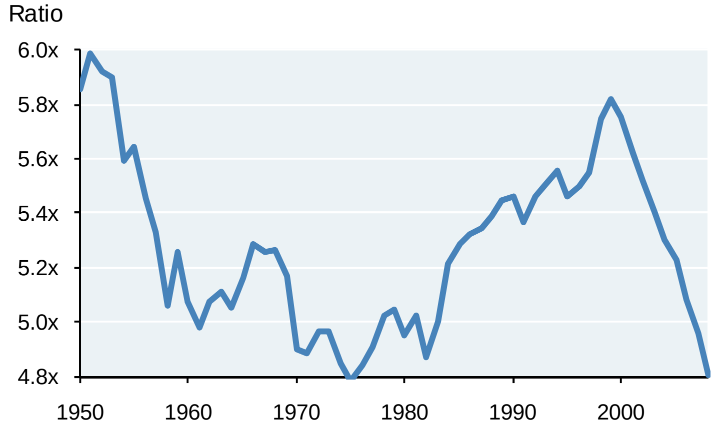
On wage convergence and the decline in America's advantage, per capita GDP relative to the rest of the world does show a declining trend beginning in the mid 1990s, coinciding with the rise of China and India. It's the speed of the decline[1], rather than the level, that is the issue here.

Higher taxes on the wealthy don't solve the budget gap



Source: IRS Statistics of Income (2007), OMB, J.P. Morgan Private Bank.

Per capita GDP: U.S. relative to world ex-U.S.



Source: Historical Statistics for the World Economy - Angus Maddison.

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[1] The rise of under-developed countries is a good thing for the world, and in the abstract, suggests a larger amount of global output that everyone benefits from. But much higher wages and entitlements in developed countries make for a much more complicated outcome. This issue is covered by Clyde Prestowitz in "*Three Billion New Capitalists: The Great Shift of Wealth and Power to the East*".

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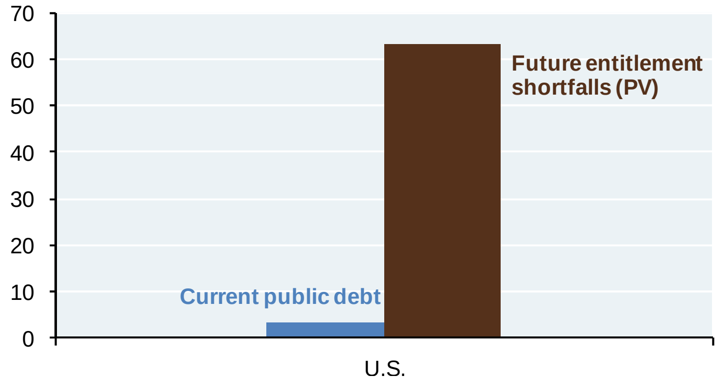
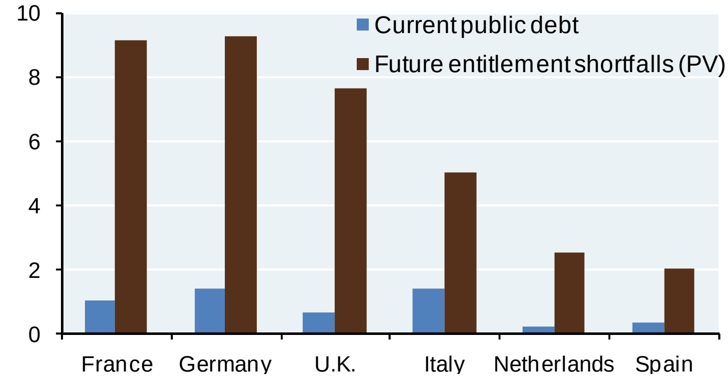
The most jolting part of the discussion was about what's *not* captured by the OMB: **the impact of entitlements on future generations**. A research paper prepared for the European Commission Directorate-General for Economic and Financial Affairs examined unfunded entitlements in both Europe and the U.S[2]. This problem has been well-advertised, but has always existed in the abstract. Horizons are getting shorter, making near-term tax policy decisions hostage to promises made in the past.

The charts below are pretty disturbing. They show the magnitude of unfunded entitlements, relative to the size of each country's existing public debt. **Unfunded entitlements dwarf the size of today's public debt[3]**, usually by a ratio of 8 or 9 to 1.

Unfunded entitlement obligations dwarf existing public debt in the U.S.... (USD, trillions)



... and in Europe
EUR, trillions



Source: "Measuring the Unfunded Obligations of European Countries", Jagadeesh Gokhale, European Commission, European Economy Economic Papers, No. 297, December 2007; National Center For Policy Analysis, Policy Report No. 319, January 2009.

How much might it cost to pay these entitlements when they come due?

- By 2020, the average EU country would need to raise its tax rate to 55 percent of national income to pay promised benefits
- The U.S. could fund its shortfall by doubling the 15.3 percent payroll tax on employers and employees (forever)
- Alternatively, the U.S. could reduce discretionary spending by 80%, on things like education, defense and environmental protection. Why so high? There's not enough discretionary spending left (the OMB estimates that mandatory spending will make up 71% of government expenditures by 2016)
- Of course, the other option would be the printing press (inflation), which would be worse given how much would be needed

Some politicians and think tanks (e.g. the Tax Policy Center) have argued that tax revenues and government spending as a % of US GDP are not that high, so there's room for both to rise. The analysis above renders such claims disingenuous at best. Measures of *current* spending do not capture the scope and size of government programs that already exist, and which will have to be paid for, although no one knows how. Richard Fisher (Dallas Fed President[4]) likens the US entitlement burden to German attacks on the UK in the 20th century, the costs of which eventually sunk the British pound; except this time, the wounds are self-inflicted. **If actual Wall Street and oil industry misdeeds did not exist, politicians would have to invent them, so as to distract the public from what they have created, a leviathan of poorly-disclosed obligations which are 10 times the cost of all wars since the American Revolution[5].**

Talking about the vapid Twilight film series over dinner was bad enough. Talking about the Twilight some of our children will inherit was far worse.

Michael Cembalest
Chief Investment Officer
J.P. Morgan Private Banking

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[2] "Unfunded", meaning **not already paid for by** Social Security payroll taxes, Medicare payroll taxes, membership fees for Medicare B, copays and all other revenue collected under current rules. Medicare Part D (prescription drugs) added several trillion to the problem.

[3] Future fiscal imbalances are a function of demographics, fertility, entitlement programs for health and social welfare, and labor productivity growth. Most governments use cash rather than accrual accounting (exceptions: Sweden and New Zealand). Why cash accounting? FDR originally conceived of social security as a system whereby individuals would fund their own retirements through payroll tax contributions. But Congress realized this would not help those suffering from the Depression, so pay-as-you-go system was used, making each generation's retirement the responsibility of its children. Medicare was also conceived as a self-funded plan; that did not last long.

[4] As per Richard Fisher: how much would it cost for each American family to pre-fund these entitlements? Answer: **$1.3 million**.

[5] "*Costs of Major U.S. Wars*", Congressional Research Service, June 2010, which computes costs in constant FY 2011 US$.

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CEBS	Commission of European Bank Supervisors
OMB	Office of Management and Budget
SCAP	Supervisory Capital Assessment Program

For additional information on the entitlement time bomb, see:
"*The Looming Entitlement Fiscal Burden*," Gary Becker (Nobel Laureate, University of Chicago) and Richard Posner (United States Court of Appeals for the Seventh Circuit in Chicago and a Senior Lecturer at the University of Chicago Law School)
http://uchicagolaw.typepad.com/beckerposner/2010/04/the-looming-entitlement-fiscal-burdenbecker.html

"*Toward a Different Fiscal Future: Tax increases can't plausibly address the coming entitlement crisis*," Glen R. Hubbard, Dean of the Columbia University College of Business, The Wall Street Journal, February 8, 2010
http://online.wsj.com/article/SB10001424052748704041504575045250168889076.html