

From: US GIO <[REDACTED]>

To: Undisclosed recipients;;

Subject: UPDATE: Conf Call on Equity Implications of USA Downgrade : Also joining: Bruce Kasman, JPM Chief Economist, Mon 8/8 at 11am ET

Date: Mon, 08 Aug 2011 12:39:43 +0000

Attachments: JPM_US_Equity_Strategy_F_2011-08-07_651492[1].pdf;
JPM_UPDATE__Conf_Call_o_2011-08-08_651589[1].pdf

Inline-Images: image001.gif

J.P.Morgan

UPDATE: Conf Call on Equity Implications of USA Downgrade

- Hosted by:
 - Thomas Lee, Chief U.S. Equity Strategist;
 - Terry Belton, Managing Director and Head of Fixed Income and FX Strategy; and
 - Bruce Kasman, Managing Director and Chief Economist.
 - Details and specifics:
 - Monday, August 8, at 11:00am ET
 - DIAL-IN: [REDACTED] (US); [REDACTED] (outside US); Passcode: Strategy.
 - Replay through 8/15: [REDACTED] (US); [REDACTED] (outside US); Passcode: 8052. Replay available approximately one hour after the call ends.
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- Please join us for a conference call on Monday, August 8, at 11:00am ET hosted by Thomas Lee and Terry Belton (Managing Director and Head of Fixed Income and FX Strategy) to discuss the equity implications of the S&P downgrade of the US sovereign rating from AAA to AA+.
 - The dial-in is [REDACTED] (US); +[REDACTED] (outside US); Passcode: Strategy. A replay is available through 8/15: [REDACTED] (US); +[REDACTED] (outside US); Passcode: 8052. Replay available approximately one hour after the call ends.
 - The downgrade of the USA sovereign credit is coming at a vulnerable time for equities given the (i) recent 10% decline (in 10 days), (ii) downward revisions to US economic outlook (JPM sees 2H GDP of 2.0% vs. 2.5% previously, despite a solid July jobs report), and (iii) mounting stresses in Eurozone sovereign credit markets.
 - In conversations over the weekend, investors have one of two views, either: (i) US downgrade is a sideshow—eyes are really on Europe, and the S&P downgrade simply the "band-aid" getting pulled off and thus, cause little turbulence; (ii) more reasons to reduce risk—this is further proof global policy makers lack credibility and thus another reason to sell.
 - Our take? Downgrade itself has minimal medium/long-term impact. We believe the medium to long-term effects of the US sovereign downgrade are minimal, even as the short impact (next two weeks) could be turbulent. The reason for our view is based on our analysis of the four transmission mechanisms of the US downgrade.
 - #1: Change in long-term interest rates: minimal, 5-15bp near term, 60bp 2 yrs out. According to Belton/Ramaswamy, JPM Fixed Income Strategists, the immediate impact on 10-yr rates is minimal, reflecting lack of forced selling as well as the fact that Moody's & Fitch maintained AAA. Interest rates have moved in a 122bp range over the past year, thus, even a 60bp move would place it within its recent range and thus have diminished impact on budget deficits. This is consistent with historical debt market reaction to sovereign downgrades, which is a modest move in rates (Figure 1).
 - #2: Change to economic forecast: minimal, as a 5-15bp change in funding costs creates minimal fiscal drag. According to our Economics team, a more sizable rise in funding costs is needed to create meaningful fiscal drag. Thus, current forecast of 2H GDP growth of 2.0% (from 2.5%) and 2012 2.6% (from 3.0%) is not affected by the change in sovereign rating.
 - #3: Risk of downgrade of financial institutions and state/local/municipalities: limited; this will not be a case of hundreds of issuers being downgraded. There are 5 states with AAA ratings that might see downgrades, especially "pre refunded" bonds, but consider this within a universe of hundreds or thousands of individual securities that are backed by Treasuries. The negative effect on the economy would have been magnified by the knock-on risk of downgrades of banks (which get implicit government support) or cities and towns due to the USA loss of AAA. However, S&P has not indicated any such rating changes are forthcoming.

- #4: Further diminishment of risk appetite (more fear, less greed): meaningful risk, but short-lived. The primary transmission mechanism of a sovereign downgrade is further motivation for investors to de-risk. Macro concerns remain significant, particularly given growing stresses in financial markets in Europe. One thing to remember, however, is that equity markets are oversold (RSI at 23 was last at this level in March 09) and thus further motivation to de-risk comes at a time of markets near capitulation. Obviously, if risk aversion remains elevated (which we don't expect), this could hurt the business cycle by the negative wealth effect and also impairing business confidence.
- #5: History suggest markets take sovereign downgrades in stride. There have been 7 AAA sovereign downgrades by rating agencies, and historically equity markets (in those local countries) gain 12% in the 6-months following a downgrade with Cyclical outperforming 86% of the time (Figure 3). In other words, history suggests equities actually do quite well. The exception was Spain's 2009 downgrade, but that was accompanied by significant stress in sovereign funding markets.

Bottom line: the tone of markets has certainly changed in the past two weeks, reflecting significant mounting stresses in Europe, but the US economy remains in recovery with the July labor report showing reasonable momentum. Markets remain nervous, and we are mindful that liquidity in equity and credit markets has slowed, amplifying market volatility. Taking a step back on 2Q, Cyclical overall performance has been impressive with top-line growth of 11% and EPS growth of 20%—that in the face of supply chain disruptions, higher oil, and sovereign uncertainty. 3Q economic momentum is slightly better than 2Q. In our view, corporates have gained significant credibility against sovereigns, and given their impressive gains (share of GDP) argue for lower equity risk premia—and thus, we expect equities to regain traction following a return of visibility on sovereign debt markets.

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