As I write this letter, the turbulence that began in the second half of

2007 continues to wreak havoc on the financial markets today. Given

the magnitude and unprecedented nature of events as they continue to

unfold, it is a year that will be written about for a long time. We do not

know when this cycle will end or the extent of the damage it will cause.

But we do know that no financial company operating under these

conditions will emerge from them unchanged. And, while we are long-term

optimists about the future of the U.S. economy and our company,

we remain focused on the current crisis. In this context, I will review

how we performed in 2007 and how we are preparing to weather the

ongoing storm.

I would like to start by saying how gratifying it is that JPMorgan Chase was

able to report record revenue and earnings for 2007 despite the intense

credit and capital markets issues we faced during the second half of the

year. These issues continue to confront us today, particularly in both our

Investment Bank and home lending businesses. That said, we must be

prepared for a severe economic downturn that could affect all of our

businesses. We intend to navigate through the turbulence, protect our

company and capitalize on any opportunities that present themselves.

It is during these tough times that we can distinguish ourselves with our

clients. As a firm, we have a history of showing leadership during times

of financial crisis, and we will continue to build on that legacy.

As you read this letter, I hope you will agree that our expectations are

rational, our approach is consistent and measured, and our operating

philosophy is sound. I also hope you will feel as I do – that while our

company still faces many risks in these challenging times, we will

continue to grow our franchise, outperform many of our competitors

and win where it matters most: with customers in the marketplace.

I. REVIEW OF 2007

Over the past few years, we have not only worked hard

to instill management discipline, but we have also spent

considerable time and resources developing a strong

foundation for long-term growth. So when we measure

our performance, we not only review financial results –

by line of business and for the company overall – but

we also look at multiple indicators of health. These measures

help us gauge the progress we have made by expanding

and extending our capabilities, geographic reach,

client coverage, product offerings and technology and

by attracting, training and retaining talented people.

Meaningful progress in any of the areas mentioned above

takes a considerable investment of time and money.

We generate both by operating efficiently and maintaining

a fortress balance sheet. So, there are three intrinsically

linked imperatives that are fundamental to our success:

**strong financial results**, **quality growth** and **capital**

**strength**. I will focus on each in the following review

of our 2007 results.

A. Financial Results by Line of Business

We delivered record 2007 full-year earnings of $15.4

billion on record revenue of $71.4 billion. This represented

total revenue growth of 15%, most of which was

organic. Earnings per share – also a record at $4.38 – were

up 15% from 2006. Our return on tangible common

equity was 23%. Record or near-record earnings in many

of our businesses and the diversified nature of our company

helped offset areas of cyclical weakness. Our results –

by line of business – are reviewed below.

*The Investment Bank reported net income of $3.1 billion*

*with an ROE of 15%*

The Investment Bank delivered a record first half of the

year, with a return on equity (ROE) averaging about 26%.

Difficult market conditions reduced our ROE to about

4% for the second half of 2007. Given the natural volatility

of this business, these results are not surprising. That

said, our goal remains to earn 20% ROE through a business

cycle. Ideally, this means we’ll produce ROE of 30%

or higher in good years, 10% in tougher years and no

worse than 0% in a particularly bad quarter. Our subjective

assessment of how we performed in 2007 is that the

26% ROE in the beginning of the year was a solid result.

However, our 4% ROE in the second half of the year

could have been better, e.g., perhaps a 7%-10% ROE.

Even though we had hoped to do better, relative to the

performance of most of our competitors, many of whom

sustained large losses, our Investment Bank’s results were

rather good. Most of the adverse results in the second

half were confined to the sales and trading areas of the

Investment Bank. Within sales and trading, the majority of

the issues were in mortgage-related trading and leveraged

finance (which we will cover in a later section). Equities,

rates and currencies had excellent full-year results.

We are particularly pleased to have ended the year ranked

No. 1 in investment banking fees and with an increased

market share in global equities and global debt. This performance

is a testament to our capital raising capabilities and

the quality of the coverage, support and advice we provide to

corporations, institutions and investors around the world.

JPMorgan is now a top-ranked player in virtually every major

investment banking product. We are proud of this progress

and are pleased to see it noted in several independent client

surveys and reports (e.g., *Institutional Investor,* which rated

JPMorgan the No. 1 Investment Bank, Greenwich Research

and *Risk* magazine). We believe by working hard to earn our

clients’ trust, we will sustain our leadership position and build

the best investment bank in the world.

*Retail Financial Services (RFS) reported net income of*

*$3 billion with an ROE of 19%*

RFS, our retail bank, offers consumers and small businesses

checking and savings accounts, credit cards, mortgages,

home equity and business loans, and investments across

our 17-state footprint from New York to Arizona. We also

provide home lending products nationally through our

5,200 loan officers and our network of brokers and correspondents.

Additionally, we work with more than 14,500

car dealerships to provide their customers with auto loans

and with more than 5,200 colleges and universities to loan

students the funds they need to complete their education.

RFS had a good year and showed strong organic growth.

For example, in 2007:

• Total checking accounts grew 8% to almost 11 million

accounts.

• Business banking loans grew 9% to more than $15 billion.

• Credit card and investment sales in the branches both

increased 23%, while mortgage loans in the branches

increased by 31%.

• Mortgage loan originations grew 34% overall (even

with much tighter underwriting standards).

• Use of electronic payments rose, with more than a 20%

increase in our online customer base. Nearly 6 million

customers now use our electronic services to bank with

us – anytime, anywhere.

Despite this progress, however, overall RFS earnings were

down 6% year-over-year. This was largely a function of

increased credit costs in our home equity business and in

subprime home loans (which we will describe in detail

later). However, unlike other lenders that are pulling back

or closing down, we have not abandoned this business.

To the contrary, while we have materially tightened our

underwriting standards, we have also nearly doubled our

home lending market share to 11% in the fourth quarter

(up from 6% a year ago). We have done this because we

believe it is a strong, sustainable business that continues

to meet an important financial priority for many people

throughout this country.

*Card Services reported net income of $2.9 billion with an*

*ROE of 21%*

We are the second-largest credit card issuer in the United

States, with approximately 155 million credit cards in circulation.

In 2007, while growth in outstanding balances

was relatively low at 4%, merchandise spending on our

cards increased nicely, by 9%, particularly in our co-branded

partner and small business card portfolios. We added

more than 16 million new accounts and raised the level of

charge volume by $15 billion. In addition, to drive growth

and better serve cardmembers, the new CEO of Card

Services reorganized the business into five units: the mass

affluent segment, individuals of high net worth, small

businesses, and co-brand and retail/private label partners.

This customer-focused approach will enable us to specifically

tailor products and services to meet the financial

needs of these important customer groups.

While we’re pleased with our 2007 performance in Card

Services, we are preparing for the impact of a weakening

economy on loan losses. We expect losses to increase by

about 4.5%-5% of outstanding balances from about

3.7% in 2007. (In a prolonged recession, the losses could

be considerably worse.)

*Commercial Banking reported net income of $1.1 billion*

*with an ROE of 17%*

Commercial Banking serves more than 30,000 customers

across America, including corporations, municipalities,

financial institutions and not-for-profit entities.

Commercial Banking produced record revenue, up 8%,

and record profits, up 12%, from a year ago. Loans grew

14%, liability balances grew 19% and we added more

than 2,200 new banking relationships.

Over the past few years – in addition to providing cash

management products to its customers – Commercial

Banking has been able to better meet our customers’ needs

by increasingly making investment banking products and

services available to them. This includes M&A advisory

and equity and debt underwriting, which are made

possible by a strong collaboration between Commercial

Banking and the Investment Bank. This capability is a

competitive advantage for us. In 2005 – the year after

the merger with Bank One – we generated about $550

million in Investment Bank-related revenue through this

cross-sell opportunity. By the end of 2007, Commercial

Banking had achieved record Investment Bank-related

revenue of about $890 million. We also launched Chase

Capital to provide equity and mezzanine debt financing to

our customers to eliminate the need for them to seek such

capital elsewhere. It is important to note that of the total

revenue Commercial Banking generated in 2007, only

35% now relates to the lending product.

While we recognize the value of cross selling, we are also

keenly aware of the risks associated with trying to drive

growth in certain product areas. As such, we have resisted

growth in areas where we felt inadequately compensated

for that risk. For example, our real estate lending has

actually shrunk over the past few years and currently

represents only 12% of our total loans. Commercial

Banking also increased loan loss reserves by $225 million,

bringing total reserves to a very strong 2.8% of average

loans at year-end.

*Treasury & Securities Services (TSS) reported net income*

*of $1.4 billion with an ROE of 47%*

TSS is a business that holds, values, clears and services

securities and provides cash management, corporate card

and liquidity products and trade finance services to the

world’s leading companies and institutional investors. TSS

delivered exceptional financial results, with record revenue,

up 14%, and record profits, up 28%. This business has

generated higher volume across all of its products, grown

consistently over time, produced good margins, and

maintained great global scale and long-standing client

relationships. It is a business that would be extremely hard

to duplicate. Notably, TSS assets under custody increased

by 15% to $15.9 trillion, and average liability balances

were up 21% to about $230 billion. The group grew its

revenue from countries outside the U.S. by more than

26% over the past year. The ability to make significant

progress on this important priority reflects the strong

foundation we are building abroad. Highlights include

receiving regulatory approval to connect to China’s

electronic clearing system, establishing a staff presence

in 41 countries and branches in 25 countries worldwide,

and extending our international capabilities for clients

around the globe.

*Asset Management reported net income of $2 billion*

*with an ROE of 51%*

Asset Management provides our institutional, high-networth

and individual investor clients with global investment

management in equities, fixed income, real estate,

hedge funds, private equity and liquidity. The headline

numbers for Asset Management were terrific. The business

delivered strong growth in 2007, with profits up 40% and

revenue up 27% – both record levels. Assets under management

were up 18% (or $180 billion), driven mainly

by $115 billion of new flows, and were further fueled by

market growth during the year. We increased alternative

assets (hedge funds, private equity, etc.) by more than

20%, to end the year with $121 billion in alternative

assets under management.

As the world’s largest manager of hedge funds, we grew

our total hedge funds by 30% last year, including increasing

assets under management in our Highbridge funds by

68% in 2007. Since late 2004, when JPMorgan acquired a

majority interest in Highbridge, its assets under management

have grown from $7 billion to about $28 billion in

early 2008. In addition, the Private Bank and Private

Client Services set a record by increasing assets under

supervision for clients by $80 billion in 2007. A note of

caution, however: The earnings momentum of this business

has slowed in 2008 and will continue to lag rates of

growth produced in prior years. Investment performance,

particularly in certain fixed income and statistical arbitrage

funds, was affected by the extreme conditions of the latter

half of the year. Last summer, when the five-year bull

market ended, we began to see a shift in our clients’ portfolios

from higher-yielding assets (equities and alternative

assets) to lower-yielding assets (fixed income and cash).

We believe it is reasonable to assume that current market

conditions will impede Asset Management’s ability to

deliver another year of record earnings in 2008.

*In Private Equity, we had an outstanding year with*

*pre-tax gains of more than $4 billion*

One Equity Partners (OEP) delivered stellar results in 2007.

I hope you all join me in giving them our gratitude for this

banner-year performance, in which OEP contributed twothirds

of total private equity gains. OEP has now generated

a life-to-date realized internal rate of return of more than

50% on its investments. We are thrilled with this achievement

and happy to report the high returns of last year, but

we also appreciate that this level of performance is exceptional.

As such, we do not expect it to be repeated this year.

B. Leading Indicators of Real Growth

We are committed to achieving high quality of earnings.

This means consistently investing in our businesses. This

does not mean increasing short-term earnings by reducing

investments for the future. So even while our margins

went up, we continued to invest in geographic expansion,

client coverage, product extensions, technology enhancements,

employee development and corporate responsibility.

These are areas we believe will drive good, strong

growth in our businesses for decades to come. They are

discussed in more detail below.

*We expanded our footprint both internationally and*

*domestically*

Internationally, our growth strategy connects the wholesale

businesses of the Investment Bank, Asset Management,

Commercial Banking and TSS to deliver the right products

and services in the right way to our customers. Because we

look at the world from the point of view of the customer,

we rely upon a local presence and regional operating models

to develop, bundle and provide an appropriate level of

financial support to our clients. So while one line of business

can bring us into a market, our growth over time is

intended to cut across all of these businesses.

In Japan, Korea, India and China, we are using this strategy

to develop and tailor our wholesale platform of products

and services across the region. From four branch locations

in China – Beijing, Shanghai, Tianjin and Shenzhen –

our 260 employees provide Investment Bank, TSS and

Asset Management services. Commercial Banking opened

new offices in Mumbai and Singapore in 2007. Our total

headcount in Asia increased by 26% to more than 19,000

employees, and our overall revenue in the region increased

by 47%. Three years ago, in mainland China, Asset

Management had no clients and no assets under management.

Today, our joint venture is a top-10 asset manager in

China, with more than 5 million customers and $13 billion

in assets under management. Our first Qualified Domestic

Institutional Investor product (which allowed residents in

mainland China to invest overseas), launched last year, was

oversubscribed by almost four times. On the first day of the

initial public offering (IPO), it raised a record $15.4 billion

from 1.9 million customers. We were granted licenses

and launched businesses in Korea and India and ended

the year there with onshore assets under management of

$700 million and $600 million, respectively.

On the domestic front, Commercial Banking opened new

offices in North America, extending our presence to Atlanta,

Nashville, Philadelphia, Seattle and Vancouver. We also

opened 127 retail bank branches and added 680 ATMs and

2,568 in-branch salespeople to help our customers.

*We increased client coverage*

Over the years, the Investment Bank has invested hundreds

of millions of dollars in Asia and in other emerging

markets to increase our client coverage, particularly in

countries like China, India and Russia. We will now be

supporting more than 500 companies in those three

countries, which will mean more research coverage, sales

and trading capability, and, we anticipate, more revenue.

Outside the emerging markets, we added experienced

traders to our energy business. It is an important sector

that continues to be a priority in 2008. We also added

more than 200 new client advisors within the Private

Bank and Private Client Services, a substantial increase

of staff over prior years.

*We extended products and expanded services to better*

*meet our customers’ needs*

TSS completed various bolt-on acquisitions to expand

parts of the business, including our healthcare electronic

payment services and our U.S. fund services business,

which provides fund accounting and reporting to mutual

funds of various sizes. As asset managers and pension

funds are increasingly investing in private equity and

hedge fund assets, TSS continues to build product

capabilities to support the processing of these alternative

investments for our clients. Over the past year, TSS has

increased its alternative assets under administration by

more than 80%, and we will be expanding these services

internationally to support clients in Hong Kong, Australia,

Luxembourg and the United Kingdom.

Card Services continues to increase its annual spending on

credit card marketing and reward programs to build out

its slate of innovative card products and refine the reward

options (particularly on the Chase Freedom credit card).

And we continue to improve our electronic systems,

payments and services that offer 24/7 access. For example,

we introduced Chase Mobile, a new text messaging service

that gives U.S. customers easy access through their phones

to account balances, payment histories and due dates.

*We focused on technology to improve customer service,*

*sales, marketing and innovation*

In addition to increasing the number of new bankers,

branches and salespeople and as part of our commitment

to expand our products, services and international reach,

we will continue to invest in technology. We believe this

investment will be a key driver of growth over the next

decade. Our first step was to operate from one platform.

After a tremendous amount of work on our technology,

systems and data centers, we can now essentially do

that. This was an enormous accomplishment. Highlights

this year include:

• Flawlessly completing a highly complex wholesale

deposit conversion (the largest in the firm’s history); in

one weekend, we converted more than 250,000 corporate

clients on all continents, representing $10 trillion

a day in global deposit transactions, to a single deposit

platform supporting both retail and wholesale clients

with 19 million accounts and $393 billion in balances.

• Insourcing our credit card processing platform (another

“biggest” in banking history) to improve flexibility and

lower our cost structure.

• Seamlessly converting, in one weekend in the first

quarter of 2007, all 339 Bank of New York branches,

adding 1.2 million deposit accounts to our platform.

• Upgrading and consolidating our banking data centers

over the last three years, from 109 to 67. Our goal is to

continue to reduce our data centers to 39 by 2010.

Having accomplished the above, we can now refocus our

technology and operational expertise and abilities to the

important and complex process of improving customer

service and quality.

*We continued to get the most out of our model*

We are a global bank with scale, diversification and

collaboration across our six lines of business – all of which

deliver financial services to individuals and institutions.

That’s our model. We have described this in detail in prior

letters and will not repeat it here. But what really matters is

how well we are able to leverage our collective strength to

create the most value for our customers and shareholders.

We invest in all of our businesses to ensure that each is a

leader in its specific industry and is able to grow organically.

While these businesses do well individually, we believe

they all create great competitive advantage for each other,

too. Over the course of 2007, we’ve clearly seen how each

of our businesses benefits from the links across our product

set and how every business gains from being a part of a

strong, respected JPMorgan Chase. It is not about cross

selling for the sake of cross selling. Rather, it is about

focusing our resources and expertise on pursuing natural

product extensions that make things easier and more cost

effective **for our customers**.

Below are a few of the tangible examples of how this

approach has benefited our company and, more

importantly, our clients:

• Asset Management’s partnership with our other businesses

reached record levels in 2007. Referrals from the

Investment Bank and Commercial Banking resulted

in new clients with $19 billion in assets, representing

$48 million in annualized new revenue, an increase of

20% in new revenue and 46% in new assets from

referrals in 2006.

• TSS continues to capitalize on the Investment Bank’s

IPO underwriting relationships to secure depositary

receipt mandates worldwide. TSS also leverages the

Investment Bank’s advisory relationships to generate

cash management and escrow business. On the other

side of the ledger, TSS clients with sweep accounts have

that money invested in money market funds with

JPMorgan Asset Management (accounting for more

than 20% of Asset Management’s global money market

fund assets).

• Our broad consumer businesses are collaboratively

building our brand and investing in joint sales and

marketing efforts. We launched a single new brand

campaign across Retail Financial Services and Card

Services under the “Chase What Matters” message.

This unified message aligns our values with those of

our customers – by focusing on what matters to them

(e.g., access, protection, advocacy, rewards and value).

Our goal is to make Chase the best brand in consumer

financial services.

*We advanced our ongoing efforts to recruit, train and*

*retain top talent and enrich the diversity of our company*

Our business, people and reputation are critically important

assets. We are absolutely committed to attracting and

retaining outstanding individuals. Today, throughout our

company and at every level, you will find exceptionally

talented people. This requires an ongoing commitment –

not a stop-and-start approach. A strong pipeline of talent

produces great managers. Over the past three years, we

have been improving our recruiting efforts on campuses

around the world. Our efforts are paying off. We have

significantly increased the number of students who accept

our full-time employment offers in the Investment Bank

and have been recognized by *BusinessWeek* for the quality

of our internship and training programs. Increasingly,

outstanding students with considerable options agree that

JPMorgan is “the place you want to be.”

We have also continued to build on solid gains in 2007

to enhance the diversity of our employee base. To step up

our employment efforts, we have asked one of our top

executives to work directly with me and the human

resources team to focus 100% of his time on recruiting

and retaining outstanding minorities. And as a result, last

year, our company was fortunate to hire more exceptional

minority executives in senior positions than ever before.

We have also increased supplier diversity spending by

32%. Last year, we did more than $700 million of

business with diversely owned companies.

*We intensified our corporate responsibility efforts*

We believe an integral part of our growth strategy is to

focus our resources where they will do the most good by

supporting the organizations that can make a meaningful

difference to the people who live in communities in which

we operate. Our Foundation now provides more than

$110 million in grants annually, more than doubling the

amount from $45 million in 2000. Investments range from

building affordable housing in Dallas and New Orleans

to training New York City public school principals.

We are also committed to the environment. In developing

our environmental footprint, we adhere to the most stringent

guidelines. We also do our part to contribute innovative

solutions to environmental issues. 2007 highlights

include: creating several conservation programs in-house,

piloting green branches, building a “LEED” platinum

certificate building in London, and renovating our world

headquarters in New York to meet the highest environmental

standards.

We have also worked closely with the U.S. government and

with a number of other institutions to create programs

to help keep borrowers in their homes. Through our charitable

support and in helping to develop strong public

policies, we are determined to materially enhance our

efforts in this area – whether it’s through working with

governments, not-for-profits or other community organizations.

We have much more to say about the work we are

doing in this area, which we will express in a detailed

report on corporate responsibility over the coming months.

C. Operating Efficiency and Capital Strength

Our 2007 progress with regard to these two priorities is

reviewed below.

*We continued to boost efforts to increase operating*

*efficiency and reinvest in the business*

Many of the investments described in the previous section

were funded by cost savings. By eliminating waste, we were

not only able to run a more efficient and effective company,

but we were also able to invest more where it counts

most. For example, over the course of 2007, we shed

4.3 million square feet of excess real estate globally; since

2003, we have shed 13 million square feet of excess space.

Eliminating this excess real estate has enabled us to become

more, not less, accessible to our customers. In 2007, these

redeployed savings were used to develop new branches,

international presence and electronic capabilities. We will

stay vigilant to reduce unnecessary expenses and invest in

areas that will also make us stronger down the road.

*We remained disciplined and committed to preserving a*

*fortress balance sheet*

We operate in risky businesses, and having a fortress balance

sheet is a strategic imperative, not a philosophical bent. It is

also a critical differentiator for us – especially in uncertain

times. We achieved it through the following elements:

• Appropriately conservative accounting.

• Strong loan loss reserves.

• Diligent review of all assets and liabilities (on and off

our balance sheet).

• Disciplined reporting and regular reviews across our

businesses.

• A detailed and deep understanding of – and constant

focus on – the margins and returns of each business

(often at the product level).

• Recognition of market cyclicality and continuous

analysis of our own businesses so that we deliver solid

returns through the cycle – not just in good times.

*We maintained strength to operate in any environment by:*

• Sustaining a strong capital ratio, whether measured

by Tier 1 capital (we had 8.4%) or tangible common

equity to assets (we had a ratio of 5%). Under the new

Basel II capital rules, we expect our Tier 1 capital ratio

would be even stronger than we report today.

• Capitalizing on favorable market conditions early in

2007 to pre-fund a substantial amount of our company’s

need for capital and long-term debt. This gave us

flexibility when evaluating financing alternatives during

the second half of the year.

• Maintaining (and continuing to maintain) extremely

high liquidity. This means that your company currently

has on average a range of $20 billion to $50 billion in

overnight investments. This has served us well under

the current market conditions.

• Increasing our dividend by 12% from the previous year

– for the first time in six years. We believe that paying

out 30%-40% of earnings as dividends is generally the

appropriate amount.

• Repurchasing approximately $8 billion of our stock

because we believe it is a good investment and is consistent

with our capital needs. To give us more flexibility

as we entered a turbulent time, however, we essentially

stopped buying back stock in the third and fourth

quarters of last year.

*We avoided seeking expensive capital from outside sources*

We continually stress test our capital and liquidity needs. To

simplify, what we essentially try to do is stay properly capitalized,

at current levels, even if called to fund up to $100 billion

of cash needs for our clients or for the corporation. We

think these are conservative (if not worst-case) assumptions,

but if the environment trends more negative, we think our

Tier 1 ratio would remain very strong (particularly relative to

our peers in this type of scenario). Our goal is to continue

serving our clients and building our business without being

pressured to seek expensive equity or debt capital elsewhere.

*We used our strong foundation to further our objectives*

Not only did our strong balance sheet and liquidity

allow us to sleep better at night, but it also made it

possible for us to:

• Support our clients by fulfilling their capital requirements

prudently with credit – especially as the markets

began to deteriorate in the latter half of 2007.

• Build our business. For example, we took advantage of

what we believed was an opportune time to strengthen

our presence in the mortgage business.

• Prepare ourselves to take advantage of emerging

opportunities, which could include buying good assets

at a reasonable price or evaluating other strategic

acquisitions that make sense for our shareholders.

II. KEY ISSUES AND LESSONS OF 2007

In the fall of 2007, my daughter called and asked me,

“Dad, what is a financial crisis?” I answered her by saying,

without intending to be funny, “It’s something that

happens every five to 10 years.” She then asked, “So

why is everyone so surprised?”

The United States and the world have, in fact, had

various financial crises every five to seven years, probably

for as long as financial history has been recorded. In

recent times, there was the recession of 1982; the stock

market crash of 1987; the savings-and-loan and commercial

real estate crisis of 1990-1991; the market panic of

1997-1998, brought about by the Long Term Capital

Management and emerging-market crises. Finally, in

2001, the Internet bubble burst, knocking the stock

market down 40%.

Looking at all of these crises, some attributes were different,

but many were the same. The triggering event in

2007 was the bursting of the housing bubble and the

related bad mortgage underwriting standards. In the 10

years from 1995-2005, housing prices in the U.S. rose135%,

far exceeding normal home price increases and outstripping

traditional measures of affordability. While some

thought the gains were justifiable, it is clear now that they

were not. As of today, housing prices nationally are down

on average almost 10% since the end of 2006, and it

looks as if they will continue to deteriorate. It is also clear,

in hindsight, that increasingly poor underwriting standards

(e.g., loan-to-value ratios up to 100%, lax verification

of income and inflated appraisals) added fuel to the

speculation and froth in the markets. Many of these poor

mortgage products were also repackaged and dispersed

widely through various securities, thus distributing the

problems more broadly.

As Warren Buffett says, “When the tide goes out, you

can see who’s swimming naked.” In this crisis, as the tide

went out, we saw subprime concerns first, then mortgage-related

collateralized debt obligations (CDOs), structured

investment vehicles (SIVs), Alt-A mortgages, mortgage

real estate investment trusts (REITs), the impact on

monolines and, finally, very unfortunately for us, home

equity loans. And the tide is still going out.

As this chapter of history continues to be written, we cannot

have the full benefit of hindsight. However, there are

some lessons we have already learned and others we can

draw upon from past crises. In the context of today’s crisis,

they are worth revisiting.

A. Issues and Insights Specific to the 2007 Financial Crisis

We generally avoided many – but not all – of the issues

associated with the storm of 2007. Let’s talk about some

of them in detail.

*SIVs served no business purpose*

We deliberately steered clear of most SIVs because we

viewed them as arbitrage vehicles with plenty of risk, a limited

business purpose and a flawed design (we sold a small

SIV back in 2005). We also minimized our financing to

SIVs for the same reasons. SIVs will probably disappear –

except for the few that demonstrate a sustainable business

purpose – and the world will not miss them. That said, there

were two things related to SIVs that did catch us by surprise:

• *Their growth and its impact.* SIVs had grown to a very

large size as an industry segment – to approximately $500

billion. And they owned a substantial amount of mortgage

securities, CDOs and bank securities.

• *Their propensity to fund long-dated and sometimes*

*illiquid assets with short-term commercial paper.* When

people started questioning the viability of SIVs, the

markets became unwilling to refinance their commercial

paper, and, therefore, many of the SIVs were forced

to liquidate their assets. The banks and money market

funds that were holding SIVs’ commercial paper began

to experience stress of their own. Fortunately, our

Investment Bank was not directly affected by this issue

because we provided almost no backup credit facilities

to SIVs, and our Asset Management group contained

its exposure to SIVs by limiting its investment to only

the few high-quality, well-structured SIVs.

*Subprime mortgages and subprime CDOs were more*

*dangerous than we thought*

In 2006, we thought we focused early on the subprime

issue – and, in fact, we addressed the subject at length in

last year’s Shareholder letter. We became increasingly vigilant

in our underwriting and avoided underwriting loans

we were not comfortable holding to maturity. Even so,

we still found ourselves having to tighten our underwriting

of subprime mortgage loans six times through the end of

2007. (Yes, this means our standards were not tough

enough the first five times.) In last year’s letter, we thought

our losses could increase substantially from 2006 levels.

In fact, we saw them go up from $47 million in 2006 to

$157 million in 2007. And we think they could significantly

elevate in 2008 if economic conditions worsen.

Within our Investment Bank, we avoided large exposure to

subprime loans, mostly by reducing our positions or actively

hedging them. We also chose not to become a major

player in subprime-related CDOs. Even so, we did lose

substantially more than we expected: $1.4 billion on subprime

mortgage and subprime-related CDOs. Although we

generally treat off-balance sheet obligations like on-balance

sheet obligations, a large share of our losses came in certain

off-balance sheet transactions. We will redouble our efforts

to ensure that this does not happen again.

Keeping the above in mind, we still believe that subprime

mortgages are a good product. When subprime loans are

properly underwritten, they serve a meaningful purpose.

They can make a real difference to young families, to those

who experienced financial problems earlier in life, to immigrants

with little credit history and to the self-employed.

These loans have helped many people achieve the

American dream by buying homes they can afford. While

tighter underwriting standards have now materially

reduced our production of subprime mortgage loans, we

will continue to find a prudent way to be in this business.

*Home equity deteriorated dramatically*

Home equity is important to our company. We retain all of

our home equity production on our balance sheet, and, at

the end of 2007, we had about $95 billion in our home

equity portfolio. The losses in this portfolio are increasing

rapidly and rising at a higher rate than we ever could have

expected, even in a severe recession. In 2007, our net

charge-offs were $564 million, and we added $1.0 billion to

reserves. In 2008, we think charge-offs in the first quarter

could reach $450 million and possibly double by the

fourth quarter (as a function of the level of home price

depreciation). Since loan loss reserves reflect expected losses,

this will require us to significantly increase these reserves.

There will undoubtedly be more lessons to come as the

deterioration of the home equity business continues, but

there are three lessons we have already learned the hard way:

• *We underestimated the size of the housing bubble and the*

*rapid rate of depreciation.* While we recognized the existence

of a housing bubble, the rate and severity of the

housing price depreciation surprised us. We also missed

the impact of increasingly aggressive underwriting

standards on housing price appreciation and increased

speculation and froth in the market. Finally, we did not

see that the ever rising housing prices over the 10-year

period were masking potential losses. When these losses

came into clear view, as a result of the increasingly

aggressive underwriting standards, much of the damage

had already been done.

• *We misjudged the impact of more aggressive underwriting*

*standards.* Over many years, loan-to-value (LTV) ratios

had increased from 80% to 85% to 90%, etc.; income

verification became a less important part of the process;

and appraisals became overly optimistic. These trends

led to far more aggressive underwriting. While each

individual change seemed reasonable at the time and

losses seemed to be contained, we now know that was

a mirage. Multiple changes occurring over many years

have essentially altered the nature of the product.

We should have acted sooner and more substantially to

reduce the LTV rates at which we lent, given the

increased risk of falling prices in a market of highly

inflated housing values. We also should have tightened

all other standards (e.g., income verification) in response

to growing speculation in the market and the increasing

propensity of people to respond to aggressive lending

standards by buying houses they could barely afford.

• *We would have been better off had we imposed tighter*

*controls on the outside mortgage broker business.* We used

the same underwriting guidelines for outside mortgage

brokers as we did for our own mortgage bankers. In

hindsight, this was a mistake. We wish we had applied

tighter standards to outside brokers. Losses attributable

to outside brokers have always been two to three times

greater than losses on mortgages we produce internally.

That is the reason we closed the broker business at

Bank One. We have now materially tightened standards

across the board, and our standards for outside brokers

are even tighter. Although home equity production

through the broker channel decreased by as much as

60% by the fourth quarter of 2007, we believe the

quality of underwriting has improved significantly.

The home equity business seems to have fundamentally

changed from the way it was meant to be: a means of conservatively

giving people access to cash from equity in their

house. It has since evolved into a business that has allowed

people to take leveraged bets on the assumption that the

value of their home will increase. When home equity

returns to its original purpose and practice, it will be a

very good business again. For that reason, we intend not

only to stay in it but to become the best in the business.

*Leveraged lending had a tough year, but it will continue*

*to be part of our core business*

In 2007, we continued to hold the No.1 market position

in global syndicated finance and high-yield debt, and we

intend to maintain these top rankings. Leveraged lending is

an activity that has long been – and will continue to be – a

critically important way for us to serve our clients. In total,

over the last five years, our syndicated leveraged finance

business has generated average annual revenue of $1.2

billion. In 2007, after taking losses of $1.3 billion, net of

fees (which makes us very unhappy), this business still

generated $475 million in revenue. We made some mistakes

this past year, and we’ve learned the following:

• *We should have been more diligent when negotiating and*

*structuring commitment letters.* A few years ago, commitments

to fund future transactions were not reflected on

our balance sheet until the details were finalized and the

final, binding letter was signed. In the event of a material

change in market conditions, this practice provided

lenders with the ability to make important amendments

to the letter and/or to the price at which it could be

sold. Over time, however, this flexibility disappeared,

but we were still held to the original terms of the

commitment letters. This meant that when the market

deteriorated, we still had to fund the transaction. Upon

funding, instead of making an average fee of 2% to 3%,

we lost 5%. These commitment letters had essentially

become puts on the market. That is, if the markets were

strong, things were fine, but if the markets collapsed (as

they did), we would be stuck with the original price and

could lose a substantial amount of money. This is a one-sided

bet and one that subjects us to losses every time

the markets crash – an occurrence that is as inevitable

as it is painful. Now, having recognized the value of

these puts, we fully acknowledge the risks we are taking

when we sign these letters.

*We cannot allow ourselves to be pushed into positions that*

*are too risky.* We simply cannot follow the market like

lemmings or allow ourselves to succumb to demands or

pressures that compromise our credit standards and lead

to bad decisions. In every deal we do, we must insist on

fair treatment and adequate compensation for the risk we

are asked to assume. A lot of people with whom we do

business in leveraged finance are among the most sophisticated,

creative and tough businesspeople we know. But

true long-term partners understand that a healthy business

relationship is a two-way street that must work for

both parties over a long period of time. Bad financial

practices, like equity bridges or excessive leverage, are not

good for us or, ultimately, for our partners.

B. Lessons Learned: Some Old, Some New

Different triggering events ignite each financial crisis.

Once under way, however, these crises have much in common.

As they say, history may not repeat, but it rhymes.

Hard lessons learned from past crises have relevance for

us today. Let’s revisit a number of them as follows:

*Markets can get very volatile*

For years, the financial industry had been the beneficiary

of relatively stable financial conditions. From 2001

through the first half of 2007, markets were fairly benign,

making it easier to get lulled into a false sense of security

and to lose sight of how risky the financial environment

can be. We must always remind ourselves that markets

can become volatile very quickly and when least expected.

For those traders who began their careers after the crisis

of 1998, it was especially hard to accept that spreads and

prices could widen by 250 basis points in a matter of days.

Our responsibility as managers is to ensure, at every level

of trading, there exists a consistency in our approach and

a deep respect for unpredictability of markets.

*There is no substitute for good judgment and strong oversight*

Risk models are valuable tools, but they have limitations.

Because they are backward-looking by design, they tend

to miss certain factors. The value of stress testing is also

a function of time frame. For example, scenarios may

be compromised because the data may not go back far

enough. We use value-at-risk (VAR) and stress testing, but

they are only part of what we consider good risk management.

Good, sound, old-fashioned human judgment is

critical. Strong risk management entails constant reporting

and review, exposure by exposure, and the ability to size

up exposures instantly with the right systems. Managers

must know the tough questions to ask – especially with

regard to stress-test loss scenarios – and have the ability to

stay on top of all the important issues. Intense oversight

by and information-sharing with managers is absolutely

key, as is access to the expertise of independent pricing

and valuation groups. Finally, assumptions need to be

tested constantly. That said, we all know even when everything

is done right, there still will be volatile results and

mistakes. But if things are not done correctly, then the

outcomes can be disastrous.

*When markets get volatile, almost all risky assets reprice*

This is not a surprise – it has happened almost every time

markets get volatile.

*In difficult market conditions, liquid assets become illiquid*

What happened to jumbo mortgages, commercial mortgage-backed

securities, leveraged loans and CDOs are examples

of this phenomenon. And because financial companies have

assets that are no longer easily sold, they are less willing

to take additional risk in the marketplace. This not only

compounds the problem, but it also creates a new problem:

skepticism about whether or not a company with illiquid

assets can meet its short-term obligations.

*Problems occur when there is too much short-term*

*financing funding long-term assets*

There is one financial commandment that cannot be

violated: Do not borrow short to invest long – particularly

against illiquid, long-term assets. As it turns out, some

hedge funds, REITs, SIVs, CDOs and certain financial

institutions did exactly that. In these kinds of markets,

when the value of short-term investments is questioned,

such as money market funds or commercial paper, a crisis

can easily ensue. Individuals, acting rationally to protect

their own interests, race to sell securities; but, in aggregate,

this process by market participants can easily take on a life

of its own and escalate into a panic.

*A fortress balance sheet protects the franchise*

As I mentioned earlier, a fortress balance sheet is a strategic

imperative – especially in turbulent market conditions

like these. No matter what conditions are, we always want

to have the capital, liquidity, reserves and overall strength

to be there for our clients and to continue investing wisely

in the business.

*Irrational expectations impede quality growth*

Sometimes there’s so much pressure on companies to

expand their businesses that they end up pushing their

own people to grow, grow, grow. Often people feel this

pressure most when market conditions are good. But it

is when markets turn bad that such pressure can lead to

dangerous outcomes for all businesses – and especially for

volatile businesses like investment banking that take risks.

Standards are reduced, too many compromises are made

and there’s a lack of focus on what is in the best interest

of clients. It is easy to grow a business when taking on

additional risk – but that is often the worst thing to do.

Growth expectations need to be rational. We know there

are times when we should not strive to grow certain areas

of the business. This is an operating philosophy that

protects us from the costly consequences of bad growth.

*Risk models that rationalize a lower level of capital*

*contribute to poor judgment*

To maximize the size of a potential risk position, models

are often designed to justify *as little capital* as possible. For

example, numerous triple-A, super-senior CDOs drew little

regulatory capital and, therefore, looked safe with good

returns. That safety and those returns turned out to be an

illusion. This is why it is important for us to understand our

risks inside and out and to maintain sufficient economic

capital against that risk. We measure risk by how bad things

could be – not how good they are.

*Financial turmoil increases the chance of recession – and*

*the specter of recession weighs heavily on the market*

It is important to note that the turbulence we’ve experienced

occurred in a good economy. And while financial

conditions have a serious impact on the global economy,

they do not – in and of themselves – necessarily cause a

recession. In fact, many severe financial crises have not

resulted in recessions. That said, the weaker the economy

gets, the greater the impact could be across all our lines of

business. Tight financial conditions (e.g., the reduction of

credit, the outright removal of credit in certain markets

and the higher costs of credit) make it harder and more

costly for individuals and companies to borrow money

and, therefore, weaken the economy.

As these conditions worsen, the possibility of a deep recession

increases. As the specter of a recession weighs more

heavily on the normal functioning of capital markets,

so too does the fear about the possibility of a recession.

Why take additional risk when we might be in a recession?

Investors decide they don’t want to take the risk so they

may remove money from banks, commercial paper and

money market funds in order to buy treasuries. Such a

reaction isn’t necessarily unwise or inappropriate, but it

does help to create a self-fulfilling prophesy.

I I I . ON TO 2008 (AND LOOKING FORWARD

TO 2009)

In the summer of 2007, we began to prepare for a downturn

in the market. While we have successfully weathered the

storm thus far, we face new uncertainties every day. Despite

the continued turmoil, we are encouraged to see many of the

problems resolving at a fairly decent pace. Yet, while we

hope the remaining issues will be sorted out expeditiously

and a lengthy recession will be averted, we cannot count on

this being the case. We need to confront the possibility that

today’s upheaval could result in serious market deterioration

that the U.S. has not experienced since 1982. To prepare for

this possibility, we need to have a clear sense of our risks.

A. Key Potential Risks

What follows is a discussion of the risks that concern us

most and some of our thoughts about how to address them.

*There is still substantial risk on our balance sheet*

We are generally comfortable with the values, the hedging

and the loan reserves on our balance sheet. But we also

recognize that many of our positions, while somewhat

hedged, are still quite risky. Hedges, by their very nature,

are imperfect. We focus on this risk by viewing our assets

on a gross basis. Relying solely upon a net basis implies that

it is not possible to lose money on both sides of a complex

trade. We know, however, that this is quite possible.

Some of our largest exposures in the Investment Bank as of

year-end are listed below:

• $26.4 billion in funded and unfunded leveraged loans:

We have written these loans down by more than 6% but

acknowledge that they could easily deteriorate more in

value. However, at current levels, we believe they represent

a good long-term value. So, in early 2008, we decided

to add $4.9 billion to the $3.2 billion of leveraged

loans we were already holding as long-term investments.

• $15.5 billion in commercial mortgage-backed exposure:

The majority of this exposure is securities and loans, actively

credit-hedged and risk-managed; 64% is triple-A rated.

• $2.7 billion in subprime mortgage and subprime CDO-related

exposure: Approximately $200 million of this

exposure is subprime CDO; the remainder is comprised

of subprime loans, residuals and bonds.

• $5.5 billion in CDO warehouse and unsold positions:

92% are corporate loan underlying; subprime is negligible.

• $6.4 billion in Alt-A mortgage exposure: Most are triple-

A securities and first-lien mortgages. Most of these exposures

are marked-to-market daily. While

they can fluctuate considerably in value on a single day and

can dramatically affect any one quarter’s results, we believe

many of them now have decent long-term value. It is also

worth noting that our gross exposures are, in general, lower

than those of most of our competitors.

I have already discussed our subprime and home equity

exposures. With regard to our Commercial Bank, an exposure

worth bringing to your attention is the $16.5 billion

in commercial real estate exposure. This position is well-diversified

and represents only 12% of our total Commercial

Bank credit portfolio. We have been very conservative in

growing this exposure in recent years. On a percentage

and absolute basis, it represents less than half the average

exposure of our Commercial Bank peers.

*The financial stability of some monoline bond insurers*

*remains an issue*

Some market analysts believe there could be a downgrading

of the monoline bond insurers – from their triple-A rating

status to double-A status or worse – and possibly one or

more defaults. Our gross exposures to monolines are significant

and cut across multiple product lines and businesses.

However, in spite of the market talk around this issue, we

do not regard a downgrade to double-A as a major event.

While no one could know all of the ramifications of a

worst-case default scenario, we believe the impact – while

costly for JPMorgan Chase – would be manageable.

*New products often will have problems*

We need to keep a close eye on the design, trading and operational

aspects of new financial products. Almost all new products

go through periods of stress and market-testing, which,

in turn, causes problems of one sort or another. At one time,

even basic equity trading nearly brought Wall Street to its

knees when the volume of trades exceeded the systems’

processing capacity. There have been similar problems with

exotic mortgage products, options, foreign exchange, highyield

bonds, hybrid derivatives and so on. In many cases,

these issues were eventually resolved through the creation of

standardized contracts and standard industry exchanges and

clearinghouses. These, in turn, facilitated more efficiency in

the clearing and netting of risk, provided better regulatory

controls and led to stronger management oversight.

Many market participants expected derivatives to be at the

heart of the next financial crisis. So far, most derivatives

markets have averted the storm, and derivatives have served

as an essential tool for some companies to use in shedding

or hedging risk That said, there are some legitimate concerns.

A severe economic downturn could put extreme pressure

on the settlement and clearance functions in some of

the derivatives markets. With this and other concerns in

mind, we can assure you that we are paying close attention

to our derivatives positions and exposure. In addition, we

are strongly in favor of regulatory and industry efforts to

coordinate and improve the control environment.

*A recession will have a significant impact on credit*

Our business is cyclical, and one of the largest risks we

face is the impact of a recession on credit in general. In

last year’s letter, we addressed the recession and credit

issue, and what we said then bears repeating now:

*We continuously analyze and measure our risk. In fact,*

*during budget planning, we ask our management teams*

*to prepare – on all levels – for difficult operating environments.*

*While the risk comes in many forms, such as recession,*

*market turmoil and geopolitical turbulence, one of*

*our largest risks is still the credit cycle. Credit losses, both*

*consumer and wholesale, have been extremely low, perhaps*

*among the best we’ll see in our lifetimes. We must be*

*prepared for a return to the norm in the credit cycle.*

*In a tougher credit environment, credit losses could rise*

*significantly, by as much as $5 billion over time, which*

*may require increases in loan loss reserves. Investment*

*Bank revenue could drop, and the yield curve could*

*sharply invert. This could have a significant negative*

*effect on JPMorgan Chase’s earnings. That said, these*

*events generally do not occur simultaneously, and there*

*would likely be mitigating factors to lift our earnings*

*(e.g., compensation pools would probably go down, some*

*customer fees and spreads would probably go up, and*

*funding costs could decrease).*

*It’s important to share these scenarios with you, not to*

*worry you but to be as transparent as possible about the*

*potential impact of these negative scenarios and to let you*

*know how we are preparing for them. We do not know*

*exactly what will occur or when, but we do know that*

*bad things happen. There is no question that our company’s*

*earnings could go down substantially in a recessionary*

*environment. But if we are prepared, we can both*

*minimize the damage to our company and capitalize on*

*opportunities in the marketplace.*

(Shareholder letter, 2006)

Because of the extreme drop in home equity and subprime

loan value, the losses I referred to last year could be even

greater in 2008. However, we believe our strong capital

and the increase of our loan loss reserves have put us in

good shape. In 2007, we added $2 billion to loan loss

reserves, and we expect to continue adding to those

reserves in 2008. Our reserve positions across all of our

businesses are among the best in the industry.

*Managing in a downturn requires a different strategy*

The impact of a downturn – and its effect on earnings –

varies considerably by line of business. Therefore, it

requires each of our businesses to develop its own strategy

for dealing with the unique set of risks and mitigating

factors it could face. In some cases, returns could actually

increase (because of higher spreads), while in other cases

they could decrease (because of lower volumes). In any

case, however, we will remain committed to building the

business. As such, we will not sacrifice long-term value and

meaningful customer service to get better quarterly earnings.

In fact, in certain situations, we may actually trade

off near-term earnings to gain customers and build market

share in businesses that are financially viable and of strategic

importance. In those instances, we are also confident

that healthy earnings will return. We believe the only time

to sacrifice good growth is to protect the financial standing

of the company. Fortunately, we are not in that position.

B. Looking Forward

*We believe the mortgage business will rebound*

In spite of all the difficulties in the mortgage markets, we

remain committed to building the country’s best mortgage

company. The mortgage product is, and will continue to

be, the largest and arguably one of the single most important

financial products in the world. With our brand,

scale, systems, retail branches and our ability to trade,

hedge and underwrite mortgages (which include prime,

subprime, Alt-A, jumbo and home equity loans), we have

what it takes to be a winner in this business. During the

latter part of 2007, we set out to increase our home lending

market share and have, so far, succeeded. By the end

of the fourth quarter of 2007, our share had grown to

11% from 6% a year earlier. As a result of our liquidity

and capital strength, we were able to underwrite these

loans when others could not. Although we may pay for

probably starting this expansion a little too early, we

remain committed to the goal.

*The risks and rewards of highly structured products will*

*be re-evaluated and changed, but “securitization” will*

*remain viable*

JPMorgan is a large participant in the asset-backed securities

market (which includes CDOs), and we try to focus

on products we believe are transparent and offer reasonable

risks and rewards to investors. We deliberately chose

to avoid the more structured CDO products because we

believed the inherent risks were too high. Additionally,

our knowledge of the subprime business informed our

decision to remain very cautious about any subprime

CDOs, where the bulk of the problems has occurred.

We think there’s a place for structured CDOs but not in

their most complicated forms, such as “CDO-squared.”

Standards will be materially enhanced (in terms of accounting,

operations and ratings guidelines), and many overly

complex products will go the way of the dinosaur.

We also believe that while there will likely be changes

to the securitization markets, securitization of assets will

not go away. Securitization is a highly effective way to

finance assets. In fact, many securitized products, like

credit cards, have been tested through the market cycle

and have not had significant problems. Securitization of

subprime assets will probably reopen, too – but the

standards will be more conservative, and there will be far

more clarity (e.g., better underwriting standards, more

capital, etc.). Market discipline, in some form, will also

come to bear at each stage of the production chain – from

the originator to the packager to the seller – and require

each to have the right amount of skin in the game. We are

not sure how it will change, but, between regulation and

the market, we know it will – and probably for the better.

*Accounting can be abused and misused*

There’s been a lot of discussion about the pros and cons of

the mark-to-model versus the mark-to-market approach.

We believe it is critically important to trust the value of

the assets and liabilities on (and off ) one’s balance sheet.

Regardless of the method one uses (mark-to-market,

mark-to-model, etc.), accounting can be abused. This letter

is not the right place in which to carry on this debate,

but suffice it to say, accounting has become increasingly

complex. Much of this complexity is unnecessary and

leads to questionable results, adds to earnings volatility

and creates **more** room for shenanigans, not less. More

work needs to be done to fix this.

*Many of our accounting and regulatory capital requirements*

*are pro-cyclical*

Many of the methods we use to calculate capital and loan

loss reserves are pro-cyclical. In fact, loan loss reserves and

capital are often at their lowest levels at precisely the point

at which a cyclical downturn begins. In addition, I would

argue that fair value accounting rules, margining requirements,

rating agencies and regulatory rules add to procyclical

behavior. Thoughtful policy changes could provide

a substantial cushion to the pro-cyclical forces that make a

financial crisis worse. A comprehensive effort between all

parties involved (regulators, government and financial institutions)

is needed to develop and drive forward these

important policy changes.

*More assets on the books of banks or financial companies*

*are illiquid (or can quickly become illiquid)*

Given this trend, regulators and rating agencies will probably

insist that the rise of illiquid assets requires higher

levels of capital and proper funding with longer-term debt.

*There will be a recovery*

We simply cannot know how long this slowdown (or

recession) will last or the extent of the damage it will

cause. Today’s most brilliant economists have various

strong, well-argued current views on the subject – they

just don’t all agree. In any case, our goal is to be prepared.

In reality, our financial system has fairly rapidly and successfully,

if not painfully, been dealing with most of the

issues I’ve discussed in this letter. Losses have been taken,

substantial capital has been raised and massive deleveraging

has already taken place in hedge funds, SIVs, financial

companies, REITs, collateralized loan obligations (CLOs)

and CDOs. While all losses may not be recognized yet,

our sense is that a lot have been (at least for U.S. companies).

Importantly, the creation of new potential-problem

assets (leveraged loans, subprime assets, CLOs, CDOs and

commercial mortgage-backed securities) has virtually ceased.

So, demand will eventually catch up with an ever diminishing

supply of increasingly attractively priced

assets. It is unlikely that the pace of deleveraging will

intensify. Therefore, it is probable that the financial crisis

will mitigate by year-end. In addition, fairly large fiscal

and monetary stimulation and the new mortgage rules

for Fannie Mae, Freddie Mac and the Federal Housing

Authority (which will bring more capital to the mortgage

market) could have a positive effect on the markets overall.

Yet, even if financial conditions improve, the economy could

continue to erode, causing us to remain in a recessionary

environment for a while. And it may sound peculiar (if, in

fact, we are going into a recession) that we are also preparing

for interest rates that may trend a lot higher over the next

several years (we won’t go into the reasons now).

We would also like to assure you, all of our shareholders,

that while we are preparing for an extended financial crisis,

we will never lose sight of our primary purpose to build a

strong company and great franchise for the long term.

IV. IN CLOSING

Finally, I would like to make a few comments about your

management team. You don’t get to see these professionals

in action as I do, but if you did, you would be extremely

proud of them. Not only are they ethical, disciplined

and thoughtful, but the tougher conditions became, the

more they stepped up to support the firm. People canceled

time off and worked or flew through the night to quickly

respond to the extraordinary circumstances of the past

year. Everyone shared information, offered to help and

actively demonstrated how much they care about the work

they do and the customers they serve. I am privileged to

be part of this great team.

Our senior managers are all shareholders – they retain

75% of any restricted stock and options they receive as

compensation. In this and countless other ways, the

management team sets a stellar example for all employees

of what it means to be invested in the company’s longterm

success. Currently, 140,000 out of 180,000

employees own stock in the company.

All of us are dedicated to building a great company of

which you, our shareholders, our customers and all of our

employees can be proud … and we are well on our way.

Jamie Dimon

Chairman and Chief Executive Officer

March 10, 2008