January 2011

Outlook on **Europe**

Despite the current pressures on the euro, a number of indicators from the core of Europe lead us to believe that the recovery remains in place. In particular, economic indicators from Germany have been cheerful for investors, with unemployment continuing to drop and manufacturing data beating analysts' estimates. The country appears to be leading Europe's recovery, but industrial production and consumer confidence rose across the entire Eurozone during the past quarter.

The inflection in household lending and resulting growth have continued, and we expect both to gather momentum as the economy recovers. Given the perceived unwillingness of banks to lend, many observers have estimated that this would be a credit-less recovery, but we believe that it will more likely prove to be more in tune with past recoveries.

However, the periphery of Europe continues to struggle, with the latest chapter being the Irish government's request for assistance from the European Central Bank—a bailout package of €85 billion was agreed upon in order to alleviate fears of contagion. Investors were not overly convinced by the move, and yields on Irish and subsequently Spanish and Portuguese bonds remain high, producing a great deal of volatility. However, we have not seen the European equity market retreat as it did during the Greek debt crisis.

Sovereign debt issues in peripheral countries have also weakened the euro during the quarter, which ironically may be a positive for the economy. Exporting countries should benefit from a weak euro, which may help their domestic economies if the situation endures—a continued pick-up in exports would help companies remain competitive and potentially post the double-digit earnings they are expected to achieve in the coming year. In addition, money remains cheap, and there has finally been an increase in corporate activity, indicating that companies are using the excess cash on their balance sheets, which will likely be a positive for markets and corporate earnings in 2011.

Although the market environment appears favorable for corporations as we move into the new year, there are still a number of serious issues with regard to a financial system still under pressure. The risk of a large policy mistake on either side of the Atlantic is high. Despite record-low interest rates and weak economies at the periphery, Germany and other core European countries, partly driven by their histories, are enforcing cuts to government spending—in some cases on a significant scale. Our concern is that some governments may cut too far, too fast, thus affecting growth. The United States is taking a different approach, continuing to improve the money supply and to spend at the government level, regardless of the effect on its deficit. In both cases the room for error appears very small.

The attempts to bring Eurozone finances in line are making some investors nervous, partly with regard to the possible effect on earnings for companies relying on state contracts. Nonetheless, we believe these actions—including changes to Spain's pensions system and adjustments in the retirement age across Europe—will be positive over the long term as they remove structural rigidities in Europe.

In our view, the market is not overly expensive, and there continues to be a great deal of value in certain areas. However, some areas of the market now appear to be fully valued, stocks are more expensive than earlier in the year, and the median P/E of the FTSE World Europe (ex U.K.) Index is higher than the headline valuation.

We noted last quarter that we were witnessing an extremely correlated equity market due to the domination of macroeconomic news, which in our view was unlikely to last. Some of these correlations did indeed begin to break down during the fourth quarter of 2010; if this trend continues, we expect to see many opportunities to generate alpha in the market. Companies with strong fundamentals and encouraging results have not performed as we expected. We do feel that this situation will change, as in a market environment driven by fundamentals, good-quality companies will generally perform well.

While risks have risen with the re-emergence of sovereign debt issues on the periphery of Europe and the consequent fear of contagion, economic indicators are generally pointing toward continued growth. Overall, we continue to believe that Europe is attractive and that quality companies are available at compelling valuations for a disciplined investor.

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