April 2011

Outlook on **Europe**

Continental Europe is currently moving out of the recovery phase and into a mid-cycle economic growth phase. In the past three months, the global economy has witnessed a number of significant events, from the humanitarian and nuclear crises in Japan, to the unrest in North Africa and the Middle East. The first quarter started strong but share prices then had a setback, given these macro events. The markets have proven to be relatively robust and bounced back as the quarter has drawn to an end.

We believe that leading economic indicators are close to their peak in both Europe and the United States. Though there are still risks, there now appears to be evidence of self-sustaining economic growth. Germany has experienced a continued drop in unemployment and manufacturing data have beaten analysts' estimates, while the Eurozone as a whole has also seen industrial production rise during the past quarter. Germany's concerns over nuclear power, in the aftermath of the earthquake in Northern Japan, did not significantly affect business confidence as many analysts had expected, emphasizing the strength of the underlying economy.

Other positive indicators in Germany include growth in both mergers & acquisitions (M&A) and organic investment. M&A is picking up from very low levels, and had seen a significant increase over recent weeks. For example, a substantial deal was the recent sale of Deutsche Telekom's U.S. business, valued close to $39 billion.

Corporate profits and balance sheets overall remain robust. While earnings have continued to beat expectations, the momentum of these surprises has slowed, and we have seen some disappointments in some specific areas. We believe the valuation of the market remains compelling, with some areas looking particularly attractive.

Despite a number of factors indicating a more stable economic environment, there are still a number of significant risks to Europe's economies. Sovereign debt issues are unlikely to disappear in the short-term, given the recent focus on the Portuguese economy and political instability. Following Moody's downgrade and the resignation of its prime minister, a bailout has become increasingly likely. In addition, the prospect of a renegotiation of Ireland's debt has brought their struggling economy back into the news, following the recent elections.

As a result of recent macro issues and tax increases in emerging markets, inflation has risen in recent months, which does pose a risk, if prices remain high for a sustained period of time. While the European Central Bank will be sensitive to inflation drivers such as taxes and global events, as opposed to increased demand in Continental Europe, they are likely to raise rates from their currently low levels. Central bankers are clearly uncomfortable with historically low interest rates, combined with increasing inflation, however the prospect of significantly higher rates still seems a long way off.

Although the current market environment appears favorable for corporates, there are still a number of serious issues with regard to a financial system that are still under pressure. The risk of a large policy mistake on either side of the Atlantic remains. Germany and other core European countries, due partly to their history, are enforcing cuts to government spending, in some cases on a significant scale. On the other hand, the United States. continues to take a different approach, recently improving the money supply in the economy and continuing to spend at the government level.

While the attempt to bring finances in line is making some investors nervous, partly with regard to the effect on earnings for companies relying on state contracts, in our view, this should be a long-term positive for efficiency and for removing structural rigidities in Europe. Examples of this would include the changes to Spain's pensions system and changes to the retirement age across Europe.

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Despite a number of possible headwinds, including the re-emergence of sovereign debt issues and inflationary fears, economic indicators are generally pointing toward continued growth. As we move out of the recovery phase and into a more typical cycle of economic growth, we expect the market to remain resilient in the face of macro pressures. We believe company earnings growth should also remain positive, though slightly weaker than the earnings momentum seen during the recovery period last year.

For many global investors, Europe had become a significant underweight and share prices are beginning to benefit as a result of positive fund flows from other asset classes. We still believe Europe is attractive from a bottom-up perspective, as quality companies are undervalued and available on compelling valuations.

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