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Outlook on Europe

Recently, Europe has been at the center of growing unease about the state of the global economy. While corporate management is not seeing signs of a significant slowdown, many investors are now concerned that the current uncertainty will feed into the real economy, which could curtail growth and exacerbate the sovereign debt crisis. The European market has fallen to 2008 levels, following the Lehman bankruptcy, and we find valuations across a range of companies increasingly compelling. In the near term, we believe equity markets are likely to remain driven by sentiment, with political news and economic data being the most significant swing factors.

News headlines have been dominated by discussions of a Eurozone rescue package among the 17 governments. In coming months, markets are likely to continue to force the hand of European governments on a decision. This is likely to exacerbate the current event-driven nature of the market and make indices increasingly opaque.

Regardless of whether European politicians can come to an agreement on a solution to the Greek debt crisis, Europe's economy is entering a slower period. This soft patch may be worsened by the escalating uncertainty about economic growth, which we believe will sap consumer and business confidence. Although growth indicators worldwide have weakened, they have not slowed as much as predicted, which leaves some room for optimism. It is also worth noting that summer is a traditionally slower period for companies in Europe, which has created a degree of uncertainty about the extent of the effects of the debt crisis on European businesses.

While earnings prospects have dimmed, we do not anticipate a significant decrease in corporate profits. Although many companies are reining in their earnings outlooks, most firms are not expecting the profit declines witnessed in 2008 and 2009. In our view, the majority of European businesses are much healthier today than they were in the wake of the financial crisis, as stronger cash flows, balance sheets, and business models have acted as a buffer against economic headwinds.

We believe that Eurozone economies should benefit from low borrowing costs now and for the foreseeable future. The possibility that the European Central Bank will reverse this year's interest rate hike should also benefit European businesses and consumers. We have concluded that, at worst, interest rates are likely to be frozen well into next year.

High stock correlations have offered good opportunities for stock pickers. Many quality companies with strong profit margins and cash flows have suffered, as the recent market sell-off has been relatively indiscriminate. In addition, in our view, equities offer attractive yields compared to other financial instruments. We believe the current weakness in equity markets should allow us to improve the risk/return profile of our European strategies as we seek to improve the quality of companies in our strategies at attractive prices.

In our view, it is clear that geopolitical risks are on the rise. Financial market volatility is likely to remain elevated as well, at least until European sovereign debt issues are resolved. We find the risk of economic contraction to be an area of concern as that would add more pressure on sovereign debt issues. On the other hand, current market conditions in Europe have resulted in attractive valuations, in our opinion, and we continue to find significant opportunities.

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