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2012 OUTLOOK
EUROPEAN MARKET COMMENTARY

European Equities: Not Expensive But Not Compelling

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2012 Outlook European Market Commentary

European Equities: Not Expensive But Not Compelling

Wade O'Brien & Andrew Beatty

European equity valuations are not expensive, but political risks justify a discount and the lack of easy fixes to Europe's sovereign debt crisis may make volatility a recurring feature of the market.

"Europe has few levers. And no amount of bank recapitalization or leveraging of bailout facilities will boost Italian growth."—Richard Barley, "For Euro, All Roads Lead to Rome," Wall Street Journal, *October 25, 2011.*

"There is very little precedent for what the Europeans are trying to do: large fiscal adjustments at a time of low growth and without currency devaluation. These efforts are in stark contrast to the last 40 years of history in Europe and Latin America regarding how such crises are typically resolved."—Michael Cembalest, "Eye on the Market," November 4, 2011.

It is difficult to say with a high degree of confidence what 2012 will bring for European markets. In assessing equity investment opportunities, we typically examine valuations, historical and expected earnings, and whether macro conditions warrant relative optimism or pessimism. In Europe, the macro outlook is a significant swing factor—the region faces a sovereign debt crisis of unprecedented scale. Even as valuations look inexpensive on a historical basis, they could be weighed down by the macro environment for an extended amount of time.

Looking at the year ahead, potential outcomes for the European debt crisis and thus equity returns span a broad range. At one end, beleaguered sovereigns restore growth and debt burdens start to ease; at the other, a disorderly default occurs or the membership of the Eurozone changes. In the middle is perhaps the most likely outcome—a compromise that allows authorities to attempt to muddle along and make promises about future fiscal reform and integration, while the European Central Bank (ECB) agrees to stabilize sovereign bond markets in the meantime. The problem for investors is that these outcomes seem to hinge on political dynamics, which are often unpredictable. For example, most EU members recently committed to greater fiscal discipline and integration, presumably as a price for further action by the ECB. However, the devil is in the details, and potential pitfalls remain. Verbal commitments may prove insufficient for the ECB, especially if attempts to codify them run afoul of local parliaments or are deemed unenforceable under existing EU treaties.

Extreme scenarios seem unlikely, though the negative outcome less so as markets begin to tire of agreements and announcements that continue to treat symptoms and not causes. Restoring competiveness and thus growth in the periphery is a multi-faceted problem that necessitates difficult decisions. If growth continues to disappoint, and as austerity measures across the region begin to bite, debt dynamics and/or the political situation may force such decisions to be made more quickly. In such a scenario, previous bailout agreements could be nullified and trigger more volatility. Recent events have significantly eroded confidence in certain debtors; it is unclear when or if investors will rush to re-embrace certain types of risk.

In our 2011 Outlook European Market Commentary *European Equities: Cautiously More Optimistic*, we discussed the debt crisis extensively, noting that imbalances that had been years in the making would be hard to fix in the short term. Offsetting these negatives, we noted several positives, including the resolve of politicians to ease

the crisis, healthy corporate profits, and unchallenging equity valuations.

Looking back at 2011, it is clear that macro developments drove equity markets. Markets that were in the center of the storm underperformed, while those farther removed (such the United Kingdom) fared relatively better. In a similar vein, sectors like financials significantly trailed more defensive sectors such as health care.

Looking ahead to 2012, we again find ourselves in a conundrum. Valuations are even more compelling and authorities have struck even bolder bailout agreements. However, the imbalances are greater, growth is deteriorating, and many attempted fixes have proven inadequate. As austerity measures become more inevitable, the precedent from early movers such as the United Kingdom is not promising, and growth and employment have suffered. On the Continent, the situation in Italy is severely testing the ability of authorities to "kick the can down the road," as both ECB bond buying and a new government have been unable to calm investor concerns.

Until policymakers and the central bank provide a more detailed game plan, we suspect European equities may trade at a discount. Within Europe, this discount will likely vary depending on exposure to sovereign debt worries, with U.K. and Swiss equities less affected than those in Spain and Italy, for example. However, even specific assurances may be insufficient to generate an equity recovery if investors focus on the lack of improvement in the underlying issues. In the meantime, political tail risks are significant—voters may resist austerity measures that in many cases are just now being implemented.

Given all this, even as valuations are somewhat compelling, we would recommend investors remain underweight index-like allocations to European equities. However, for those using active regional or global managers that potentially will leverage the crisis to source attractively priced assets, we could envisage upping allocations. Of course, many investors use managers with wide geographic mandates that make such decisions for them.

2011 in Review: Macro Driven

Macro themes drove European and global equities in 2011, with highly correlated markets often moving in synchronicity and creating "risk-on" or "risk-off" days. The European sovereign debt crisis dominated headlines, as a steady drip of news about progress with austerity targets, negotiations with the "troika,"[1] the health of banks, and political protests moved markets and overshadowed fundamentals much of the time.

During the first few months of the year, this was less the case—Eurozone bailouts were in their infancy and thus given a grace period to prove workable. Globally, risk appetite was strong on the hope that the world economic recovery would become more self-sustaining. By late spring, several dynamics combined to undermine sentiment, and by the end of July early equity gains were but a memory. Some bailout recipients, most notably Greece, were slipping behind on bailout targets, and European authorities appeared to be fundamentally at odds over sourcing additional resources and whether in fact such support was even needed. Finally, economic data started to deteriorate, and news that Eurozone GDP had grown only 0.2% (quarter-over-quarter) in the second quarter seemed to confirm fears that the economy was flatlining (Exhibit 1).

[1] Over the course of the crisis, attempts by the ECB, European Union, and International Monetary Fund (IMF) to present a unified front in negotiations have resulted in them being referred to jointly as the troika.

Weakening growth in offshore markets also undermined sentiment during this time. In a reversal of 2010, when European equity investors seemed to take comfort in the relative health of export markets, in 2011 news from these markets only frayed investor nerves further. Emerging markets growth started to slow, and fears grew over a hard landing in China. Second quarter U.S. GDP figures also disappointed, and political wrangling over raising the debt ceiling and continued political paralysis weakened confidence. Strained budgets limited options for western governments to ease the pain; some, such as the United Kingdom, turned back to quantitative easing, while the United States moved on "Operation Twist," manipulating the shape of the interest rate curve.

In July, after seeming on their back foot for most of this period, European leaders agreed to rework bailouts. Borrowers saw their loan terms ease and the European Financial Stability Facility (EFSF) received greater powers. The calm proved fleeting, however, as the reworked austerity targets still looked beyond reach and committed resources were seen as insufficient to ever assist Spain or Italy. Spanish and Italian sovereign bond yields began to soar, and the ECB was forced to reopen its Securities Market Program and stabilize these yields through bond purchases (Exhibit 2).

Equity markets began to swoon at this point, as speculation mounted about what a self-fulfilling debt crisis would do to various sectors of the economy. European equities returned -19.9% during the third quarter, with more than half the decline coming in August. The FTSE® All-Share also fell 13.5% over the period. Across sectors, European financial stocks returned -27.7%, given worries over sovereign write-downs and thus capital levels; however, materials actually performed slightly worse (-27.9%) as worries over a global slowdown (including a hard landing in China) were added to the mix.

Prodded by markets, European officials met again in October to hash out new proposals for everything from bank recapitalizations and funding assistance to leveraging up the EFSF and reducing the Greek debt burden. The MSCI Europe ex U.K. and FTSE® All-Share indices each rallied around 8% for the month. The U.K. index may also have received a boost from the Bank of England's announcement in October that it was expanding its quantitative easing effort. However, weaker U.K. domestic economic data somewhat offset the impact of this announcement and suggest markets were moving in "risk-on, risk-off" synchronicity.

In a repeat of a pattern seen throughout the year, markets again started to wobble in early November. Sovereign bond yields soared as a result of worries over insufficient demand, and the ECB seemed to be on the sidelines given German opposition to further bond purchases without promises of austerity and greater fiscal intervention in return. In addition, as the ink dried on the latest proposals, critics started to flag practical considerations, such as whether investors would really buy sovereign bonds that carried partial guarantees or if in fact their appetite had been permanently impaired. In response to these tensions, the announcement that central banks in Europe and the United States had coordinated to provide more liquidity to the banking sector triggered a massive rally on the last day of the month and trimmed some of the index losses for the year.

As we go to print in mid-December, history seems to be repeating itself, and this rally has started to fade. The reasons are varied, but include the fact that investors have now had time to parse the December summit announcements and realize concrete assurances are lacking. Attention is focused on the refinancing market for sovereign debt in the first quarter—with the

ECB noncommittal, sovereign bond yields are again starting to rise.

While often overshadowed by the macro, there were some positive improvements in fundamentals over the course of 2011. Non-financial corporate profits proved surprisingly resilient, and many companies used historically low interest rates to raise funds and strengthen balance sheets. Economic data, while softer going into year-end, were not uniformly poor. Core European economies like Germany continued to generate solid production and export data, growth resumed in at least one bailout recipient (Ireland), and European households strengthened balance sheets. Fears over inflation started to fade, as commodity prices declined and emerging markets growth began to cool. Finally, low gilt yields in the United Kingdom suggested that investors were treating fiscal tightening favorably, though the possibility for further quantitative easing also may have played a role.

The United Kingdom

Performance in 2011

The FTSE® All-Share Index had returned -4.3% through the end of November 2011, outperforming most continental European bourses and the broader MSCI All Country World Index. In line with other global equity markets, U.K. indices were down significantly through the end of September, though seeming progress with the Eurozone sovereign debt crisis triggered a nearly 8% rally in October that helped trim losses for the year.

Valuations Have Slightly Improved

Valuations for U.K. equities improved over the course of 2011. Our composite price-earnings (P/E) ratio, incorporating a blend of normalized earnings, dropped to 11.0 (Exhibit 3), further below its long-term average of 12.9. All normalized valuation metrics suggested U.K. equities became more attractive over the course of the year, with the largest improvement seen in the return on equity (ROE)–adjusted P/E.

Trailing 12-month P/E metrics (Exhibit 4) showed an even more dramatic improvement given the increase in earnings and the drop in share prices. Trailing earnings for the FTSE® All-Share[2] had increased over 20% through the end of November from the start of the year, paced by strong improvements from the energy and materials sectors. As a result, the FTSE® All-Share traded at 9.6 times trailing 12-month earnings at the end of November, down from 12.9 at the start of the year and the 16.4 long-term average. Meanwhile, the dividend yield (DY) on the FTSE® All-Share also improved, though at 3.6% it remained below its 4.2% historical average. DYs surpassed ten-year U.K. gilt yields in July (Exhibit 5), reflecting how the sovereign debt crisis has pushed the two assets in opposite directions.

Given their relative outperformance, U.K. equity valuations richened very slightly over the course of 2011 compared with those in continental markets (Exhibit 6). In contrast, relative to developed world peers, U.K. equities were mainly unchanged, though some metrics improved slightly (Exhibit 7).

We currently view U.K. equities as fairly valued, given normalized metrics below long-term averages but an uncertain macro outlook. Valuations will provide some cushion should weakening growth put pressure on earnings, especially for those that focus on shorter-term valuation metrics. However, whether this cushion will prove sufficient should the sovereign debt crisis escalate or austerity bite further is an open question.

[2] We have used FTSE® All-Share data for current valuations as recent earnings data have been less volatile.

The Investment Outlook

The investment outlook for U.K. equities is cloudy, given conflicting macro and fundamental signals. U.K. equity markets are somewhat unique in terms of the domicile and exposure offered by the listed companies, so any outlook needs to consider not just what will happen to the domestic economy and how this will impact local corporate earnings, but also what will happen farther afield.

Starting with the domestic economy, as 2011 drew to a close the growth outlook was weakening. Third quarter GDP growth was just 0.5%, after nearly flatlining in the second quarter. Currently, consensus estimates put growth in U.K. GDP at 1.7% for 2012, though the OECD's estimate is just 0.5%, perhaps due to recent disappointments in manufacturing and labor data. The risk of the United Kingdom slipping into recession in 2012 is not negligible, particularly given that the government's recently announced austerity measures will be increased because of insufficient improvement in the budget thus far. One bright spot for consumers may be easing price pressures, as the effect of tax hikes rolling over means that consumer price inflation cools from its current 5%+ rate.

Looking farther afield, the health of the Eurozone economy is crucial, as it absorbs almost 50% of the U.K.'s exports. While France, Germany, and the Netherlands are the largest trading partners, exports to troubled peripherals such as Italy and Spain are also meaningful. As such, the risk that the Eurozone tips into recession in 2012, or the debt crisis escalates, is significant for U.K. equity investors, particularly given the state of the domestic economy. The OECD recently revised its expectation for Eurozone growth in 2012 downward to 0.2%, and some private sector forecasts are even more pessimistic. From an earnings perspective, emerging markets growth is also important. Here the outlook is somewhat brighter—the OECD expects GDP growth to cool, but still remain at a comparatively robust 6.7%.

Whether analysts have fully factored the macro headwinds into their earnings expectations is equally important for the U.K. equity outlook. At the end of 2010, consensus estimates called for a 17% increase in 2011 earnings per share (EPS). This estimate has proven too optimistic (Exhibit 8), and downward revisions have recently weighed on stock performance. In parallel, 2012 figures also have been revised lower, with the consensus now expecting an 8% increase.

Whether these targets can be met will depend in large part on the financial, oil & gas, and basic materials sectors, which together contribute 50% of MSCI U.K. market cap (Exhibit 9). Analysts' expectations for these cyclical sectors are for earnings growth to decelerate significantly given the macro backdrop. For example, the materials sector is expected to grow EPS by just 8% next year after 40%+ growth in 2011. Emerging markets growth is key—these sectors feature many companies either based in these regions or highly exposed to them via their business models. The currency could help—a weakening of the pound would boost the bottom line of many U.K. companies with offshore earnings.

Financials are worth digging into more deeply, given the turmoil of the recent past. Currently, the consensus expects a 16% increase in sector earnings for 2012; these estimates have fallen over the course of the year given the dramatic deterioration in third quarter earnings and downbeat outlooks offered by managements over the past couple of months. U.K. financials are seeing larger impairments, higher funding costs, and lower investment banking revenue than was anticipated just a few months ago. They also have significant exposures to the peripheral economies at the heart of the crisis, though arguably limited

direct exposure via holdings of sovereign bonds. Growing regulatory and capital requirements will also dampen profitability. To a certain extent some of this may be priced in, with U.K. financials trading at just 0.8 times book value, a 60% discount to their historical average. However, further earnings disappointment still might weigh on bank equities in 2012, as would any attempts to raise more equity.

One positive for U.K. financials, and indeed for the wider economy, is that U.K. corporate (ex financial) balance sheets are in rude health and cash balances are high. This should help to keep a lid on defaults and thus loan loss provisions, and could even spur investment and thus growth. However, whether U.K. corporate spending could offset the expected spending reductions by U.K. households and the government is another matter entirely. Another positive for the sector, as well as the wider index, is that despite high levels of indebtedness, the United Kingdom does not suffer from the same "monetary without fiscal union" issue as the Eurozone, and thus its sovereign bond market is less likely to come under as ferocious an attack. This somewhat explains the willingness of the United Kingdom to opt out of the recent pan-European agreement for closer fiscal integration. However, whether the United Kingdom comes to regret this severing of ties with the Continent remains to be seen. Forthcoming EU regulatory changes will have a significant impact on U.K. financials, which now may find their negotiating position much weaker.

One of several scenarios needs to play out in 2012 for U.K. equity investors to see attractive returns. Earnings forecasts could be met, which would be easier given recent cuts to forecasts. One could even argue that earnings could slightly disappoint, given that U.K. stocks currently trade at 9.7 times forward earnings, around a 25% discount to their recent average (Exhibit 10). However, if earnings dip, the context in which they do so is important. Discounts to historical valuations are unlikely to disappear (and thus multiples rise) until the macro environment improves and investors have better visibility on several fronts.

Europe ex U.K.

Performance in 2011[3]

The MSCI Europe ex U.K. Index has returned -13.6% for the year through November 30. Performance again varied significantly across the region, with many countries reversing year-earlier under (or over) performance. For example, Ireland recovered from a -12.4% return in 2010 to post the best overall performance (5.9%), while Denmark returned -14.6% after posting one of the strongest returns in 2010 (40.0%) (Exhibit 11). Larger-cap indices like France and Germany posted returns close to that of the overall index, though Italy (-19.8%) underperformed as it became the focal point of the sovereign debt crisis.

Debt Crisis Further Improves Valuations

As was the case in the United Kingdom, continental European valuations improved in 2011 given the decline in share prices. Whether improving earnings would also boost valuations seemed questionable going into year-end, as consensus 2011 EPS growth forecasts had been slashed from 15% one year ago to -3% as we went to print. Europe ex U.K. equities traded at 10.8 times trailing 12-month earnings in October, down from 14.2 in January (Exhibit 12).

Normalized valuation metrics cheapened to a similar degree. Our composite P/E, which uses a blend of normalized earnings, fell to 12.4, further below its long-term average of 15.6. Among other

[3] Returns in this section are in local currency terms.

normalized metrics, the Shiller multiple showed the biggest improvement, dropping to 12.4 from 15.8 at the end of 2010 (Exhibit 13).

These multiples are near levels that would suggest that European equities are undervalued. However, a few things are worth considering. Inexpensive valuations are not a recent phenomenon in Europe, as the Shiller P/E, for example, has been below its long-term average since September 2008. As well, the steep sell-off in financials, the largest component of European indices, has caused some of the improvement in index valuations. Excluding financials, Europe ex U.K. valuations have not improved as substantially (Exhibit 14). For example, the Shiller multiple has only improved from 17.5 to 13.9. The reliance of European indices on financials matters because the sustainability of their business models is now in question; deleveraging, greater regulation, and the implications of the sovereign debt crisis could lead to a secular drop in profits.

Concerns over financials also suggest that improvement in the price-to–book value metric is less meaningful. Financials have been reluctant to accurately mark assets to market, which may be inflating book values. Finally, the DY for Europe ex U.K. equities has also risen over the course of 2011. As of this writing, the 4.4% DY was more than double the yield available on ten-year German bunds, a historical anomaly. Given fragmentation in the European sovereign bond market, however, comparing individual country DYs with their respective sovereign benchmarks would generate less favorable comparisons.

The Investment Outlook

We have written extensively about the European sovereign debt crisis over the course of 2011[4] and continue to believe that how this situation unfolds will drive equity market performance. If anything, transmission channels are multiplying for the debt crisis. Whereas markets once thought financials would be the primary victim, it is now likely that uncertainty and required austerity measures will impact valuations and earnings across a variety of sectors. Recent economic data have already shown deterioration, and earnings forecasts have been cut for the year ahead. Economic growth may be barely above zero on the Continent in 2012, with some now forecasting a recession. For the market as a whole, this should place earnings under pressure.

We are cautious about the equity outlook for 2012 because we do not believe 2011 has seen any real progress in addressing the underlying causes of the crisis, which include the structural lack of competitiveness across the peripheral economies and their inability to address this through currency devaluation. In addition, sovereign debt burdens have continued to grow throughout 2011, and the risk of recession in 2012 means that existing plans to stabilize sovereign finances are already in doubt. Even larger spending cuts would further impact employment and corporate earnings.

European leaders have become increasingly creative in trying to address the crisis, but their ever more elaborate short-term fixes have increasing execution risks. The agreements at the end of October to try to repair the Greek bailouts, which involved complicated haircuts for creditors and a plan to lever up the EFSF through financial engineering, exemplify this problem.

There is a chance that our caution heading into 2012 will prove excessive. Italy has become the focal point of the crisis, and the lack of Eurozone resources to effectively backstop the country's

[4] Please see our July 2011 Market Commentary *European Update: Kicking An Ever Bigger Can* and our September 2011 Market Commentary *European Update: Market Hopes for a Silver Bullet May Be Misplaced*.

€1.9 trillion debt burden may mean that this is where the sovereign debt crisis rubber hits the road. In one scenario, new governments in Italy and Greece, and across the Eurozone, bend to German demands for greater fiscal integration and reform, and place government spending and growth on a more sustainable trajectory. In exchange, the ECB effectively agrees to support its sovereign bond markets indefinitely, and intervenes to provide liquidity for sectors such as financials. In principal, at least, recent agreements seem to provide a runway for this, though detailed timelines and the exact extent of ECB involvement remain frustratingly elusive.

Optimists on Europe would also point out that European equity valuations are not expensive on a historical basis, earnings held up in 2011 despite a weak macro backdrop, and forward earnings expectations are not aggressive. The consensus expects 10% EPS growth for Eurozone companies in 2012 (Exhibit 15), though some strategists are calling for far less improvement given building macro worries.[5] The MSCI Europe ex U.K. Index currently trades at 9.6 times forward earnings, around a 24% discount to historical averages; as in the United Kingdom, one could argue disappointment is already priced in. Earnings could be supported by a weaker euro (Exhibit 16) generating some upside for exporters, with the ECB's recent rate cut seen as a first step toward a more nuanced view of its inflation-fighting mandate. Earnings could also see a boost if households and corporations pick up their spending, as their balance sheets are, in most instances, in much better shape than the sovereigns (Exhibit 17). With so many investors underweight Europe, small positive surprises could generate significant upward movements in stock prices, as we saw on the last day of November when hope rose for the December summit and as the ECB announced liquidity interventions.

European equities could also hold up better in 2012 if investors differentiate and reward sectors and companies that have less exposure to the crisis. German industrial firms with large emerging markets exposure, Swiss health care companies with diversified international revenues, and French luxury goods firms with large Chinese exposure are all examples of where earnings are somewhat better insulated from the debt crisis.

However, we still return to the macro, and see several significant risks for markets in 2012. Even if commitments for greater fiscal discipline and integration are made, or unilateral gestures (like balanced budget amendments) implemented, political changes or popular resistance to austerity and reforms could jeopardize some of the progress. Government spending in Europe is huge relative to the size of local economies (on average accounting for over 50% of GDP), and austerity measures that depress incomes and thus corporate earnings are a tough sell politically. As well, treaty changes could require political referendums in some countries, which might not pass in the current environment.

ECB purchases of peripheral sovereign bonds have thus far struggled to stabilize markets, and the situation may worsen in 2012 as the pace of sovereign bond refinancing increases. The ECB may step up its purchases, but is unlikely to do so without further steps toward fiscal integration. Recent events would appear to provide more political cover for monetizing, but the ECB's seemingly nonplussed reaction regarding the December pact suggests that more effort may be required to earn its good graces.

Looking at the Greek precedent, ECB purchases are problematic from a different perspective.

[5] See, for example, BofA Merrill Lynch, "Agreement on Earnings Haircut," November 8, 2011.

Official creditors such as the IMF and ECB refused (some would say were unable) to take haircuts on Greek bonds, effectively triggering larger write-downs for private sector creditors. If potential investors in peripheral debt thought they might suffer a similar fate, they may go on strike indefinitely and force the ECB to purchase far more bonds than intended.

With respect to fundamentals, foreign earnings will ease the pain for some firms, but given that 75% of European corporate revenues come from either Europe or the United States, hopes for continued resilience in emerging markets growth will not solve corporate Europe's problems. Earnings expectations may be managed, but the fact that the consensus now expects a 3% decline in Eurozone earnings in 2011 versus 15% at the start of the year suggests analysts are often late to pick up some obvious macro cues. Finally, while we continue to believe that during "baby thrown out with the bathwater" situations high-quality global businesses may sell at depressed valuations, we acknowledge that a drawn-out debt crisis may prolong the period over which they bounce back.

Conclusion and Advice

Normalized valuations for U.K. and European equities have improved over the course of 2011, with an even greater cheapening seen in 12-month trailing P/E metrics. Continental European markets have significantly underperformed those in the United Kingdom, though recent announcements may trim this gap going into year-end.

Looking back at 2011, equity markets were macro-driven and took their cues from the bond markets. Sell-offs of peripheral sovereign bonds tended to coincide with large down days for stocks. This dynamic was self-fulfilling, in that higher yields sparked worries over the solvency of sovereign bond holders like banks and the sustainability of debt for sovereigns, in turn generating concern about credit growth, further austerity, and other linkages throughout the economy. Somewhat lost amid these macro-driven moves was that some individual markets like the United Kingdom saw healthy earnings growth, and that direct exposure to the crisis varies greatly by region and by sector.

European leaders have attempted to take decisive steps to quell the crisis over the course of 2011, though mostly to little avail. The problem is that the underlying issues, such as excessive debt burdens and the lack of competitiveness of peripheral economies, are difficult to fix. Thus far these leaders have bought time through verbal assurances and limited amounts of ECB intervention, providing an opportunity to see whether reforms were working and if indebted sovereigns would fall into line.

As we go to print, recent coordinated central bank actions have boosted markets, and hopes are high that new governments in countries like Italy will implement spending cuts and labor market liberalizations. In addition, hopes are growing that the recently announced pact among most EU members to promote greater fiscal discipline and integration will be enough to encourage Germany and other core countries to bless further attempts by the ECB to stabilize markets. Investors should not underestimate the task of the ECB if conditions worsen—2012 alone will see €1.1 trillion in European sovereign redemptions (Exhibit 18). The key question is what authorities will do if the markets force their hand—e.g., if markets do not give sovereigns time to improve their finances and dislocated markets mean debt burdens cannot be refinanced.

Providing advice is difficult when markets are moving violently and the number of potential outcomes is high. Elections and political

negotiations are difficult to handicap, as is how citizens will deal with further austerity measures. Negotiations between creditors and sovereign debtors are ongoing, and both still have cards left to play. We cannot rule out a peripheral like Greece resorting to default or even leaving the Eurozone, but continue to believe that interests are aligned for most countries to stay in the currency union.

Generally speaking, we believe that European equities' exposure to emerging markets will help them, and highlight that some U.K. businesses are either domiciled in these regions or derive the majority of their revenue from them. This said, we acknowledge that imbalances have built up in countries like China and that asset bubbles may need to deflate. Geographic revenue exposure is not the only thing that will move stock prices. A global recession will not be kind to U.K. materials and energy firms; Latin American exposure may not save Spanish financials if Spain's sovereign debt situation worsens.

Putting these caveats aside, we believe the advice we provided in our September 2011 Market Commentary *Market Hopes for a Silver Bullet May Be Misplaced* should continue to serve investors well. We summarize our views here and add a few refinements.

- **Equity:** Valuations are not expensive, but they may improve further given the scale of the crisis and lack of easy fixes. We believe investors should maintain tactical underweights to Europe. Investors that obtain exposure to Europe via active managers with wide geographic mandates may not need to do anything as managers make this relative value decision for them. We continue to favor active over passive because we believe some sectors (like financials) and geographies present macro risks that are difficult to discount and simply may be univestable. Some skilled active managers should be able to avoid these areas and identify situations instead where high-quality businesses have sold off in sympathy with the market on macro concerns.

- **Equity Relative Value:** European equity valuations have improved, but the spillover from the crisis has impacted risk appetite globally and improved the valuation of many other types of equities. For example, valuations of emerging markets equities have become more attractive, despite offering better underlying macro fundamentals and growth prospects. Earnings prospects in some of these regions may also be better than they are in Europe.

- **Credit:** The dislocation in European markets has already created investment opportunities across different credit asset classes, and we believe these may expand as the pace of European bank deleveraging accelerates. However, it is difficult to say how quickly this will occur, as a bank's decision to sell an asset can be influenced by a variety of factors. On one hand, some banks have taken write-downs on assets or face higher capital charges and thus are open to sales, while on the other, significant government equity stakes in banks (in Belgium, Ireland, the United Kingdom, etc.) and the availability of liquidity (e.g., via repo lines) means that the pressure to sell assets may be reduced. We believe investors should consider staggering commitments to European distressed funds over time, though we recognize that some European distressed funds are already finding attractive opportunities, and that some funds will offer vintage year diversification through a multiyear capital call structure. In terms of other current opportunities, we believe European banks' continued reductions in loan commitments are creating a

vacuum. Both hedge funds and private equity firms are stepping in to fill this role, and are seeing particularly attractive opportunities where companies are distressed or suffering difficulties.

- **Sovereign Bonds:** We view sovereign bonds as a way to provide some protection to portfolios in the event of continued economic contraction or deflation. For such mandates, we continue to favor high-quality sovereigns, which at the moment mainly mean bunds for euro-based investors and gilts for sterling-based investors. We also see a role for non-European sovereigns, such as U.S. Treasuries, in this basket to diversify against policy error. For now, bunds and gilts have maintained their low yields, but this could change, particularly if Germany's obligations related to the financial bailout increase materially. Foreign currency sovereign bonds, particularly those held in U.S. dollars or other "safe harbor" currencies, could be held unhedged for those worried about a weakening of the euro. On the Continent, peripheral sovereign bonds are vulnerable to political risks that we have no ability to handicap, such as whether the ECB will support these bonds and whether the governments of these countries will opt to exit the euro.

  The extreme overvaluation of sovereign bonds means investors should shorten duration and potentially increase holdings of cash (T-bills). To the extent that it is not practical to exclusively invest short-term holdings in German T-bills due to limited supply, we are also comfortable with select high-quality European money market funds that hold other short-term assets (like Dutch T-bills).

- **Private Equity and Venture Capital:** Investors should carefully consider the pros and cons of investing in illiquid assets in Europe over the next several years, given the unknowns we have already discussed. In practice, it may be prohibitively expensive or technically quite difficult to try to hedge against specific risks, such as a peripheral economy leaving the European Monetary Union and redenominating its currency. Investors cannot always know the future geographic profile of fund holdings, and the existence of a new Greek or other currency is purely theoretical. Therefore, investors should expect to receive a premium to take these risks in an illiquid format. Understanding how managers intend to deal with such eventualities should be a critical part of the due diligence process for putting fresh capital to work in illiquid investments that may seek to invest in companies in the Eurozone.

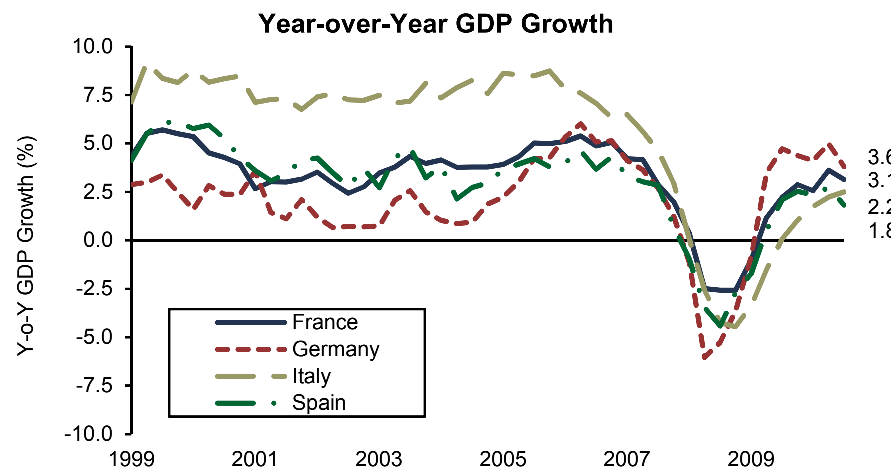
- **Currency:** Any near-term worsening of the sovereign debt situation is likely to be reflected in a weakening of the euro. This could be driven by technicals, as panicked investors rush to sell the currency against those with more stable fundamentals, but also by fundamentals if the ECB begins to cut rates to ease debt burdens or embarks on quantitative easing. Under more extreme circumstances, a country could even leave the Eurozone or the currency block could split up. It is impossible to predict what would happen to the shared currency in this scenario, but it seems likely that the currency and capital markets would fall, at least in the short term, given uncertainties such as what would happen when assets and liabilities are redenominated. Longer term, of course, anything is possible, including the euro appreciating against other currencies if weaker members leave in an orderly manner. On balance, we continue to believe *non-euro-based* investors with existing or potential investments in Europe should consider

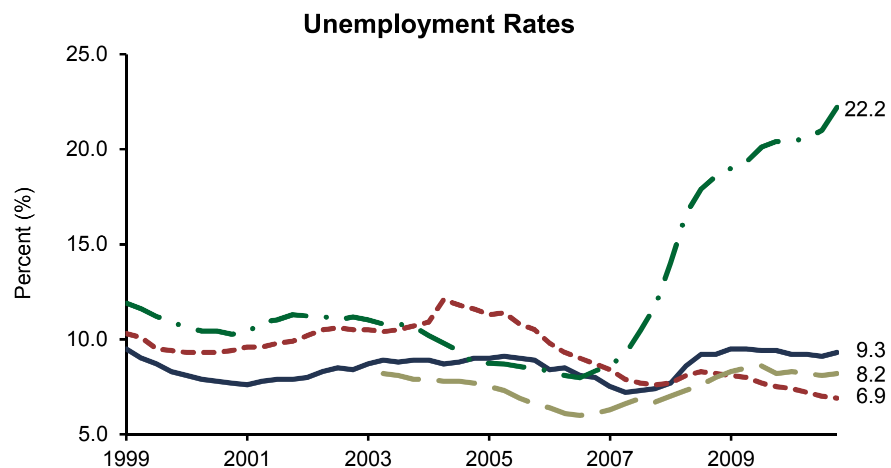
hedging some of their exposure back to their base currency, while *euro-based* investors should reduce the size of existing hedges for US$-denominated assets. Investors undertaking such hedges should carefully scrutinize the creditworthiness and domicile of hedge counterparties. ■

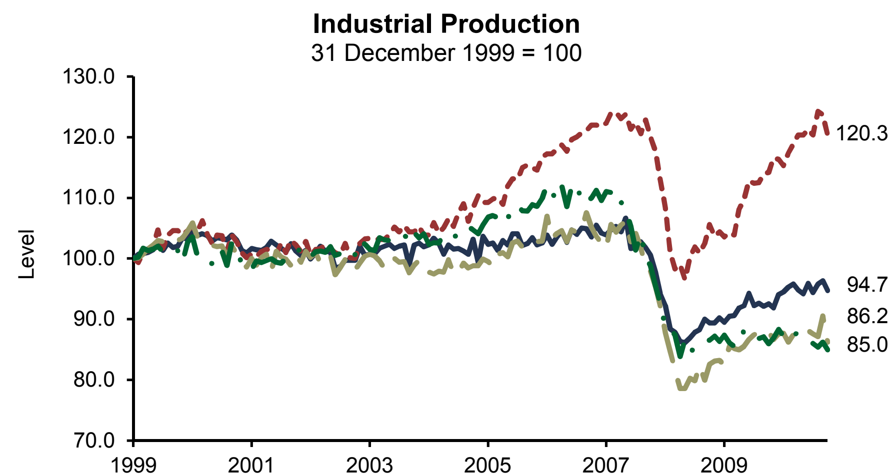
Exhibit 1

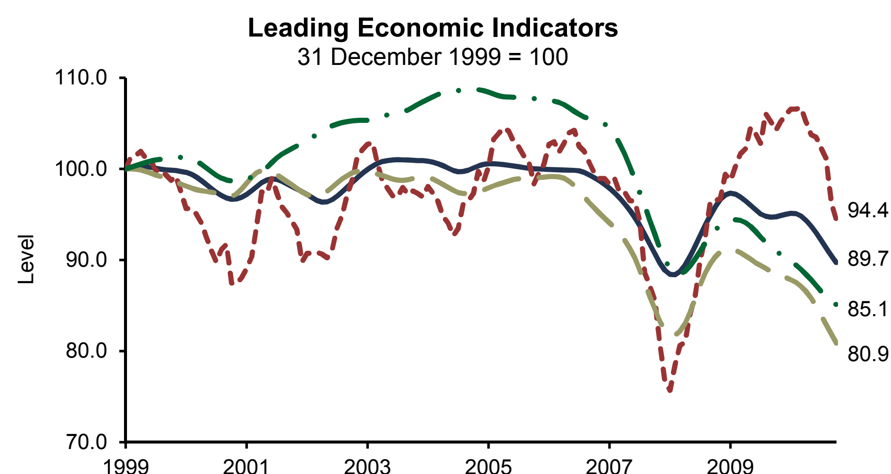
Selected European Macroeconomic Statistics

31 December 1999 – 30 September 2011







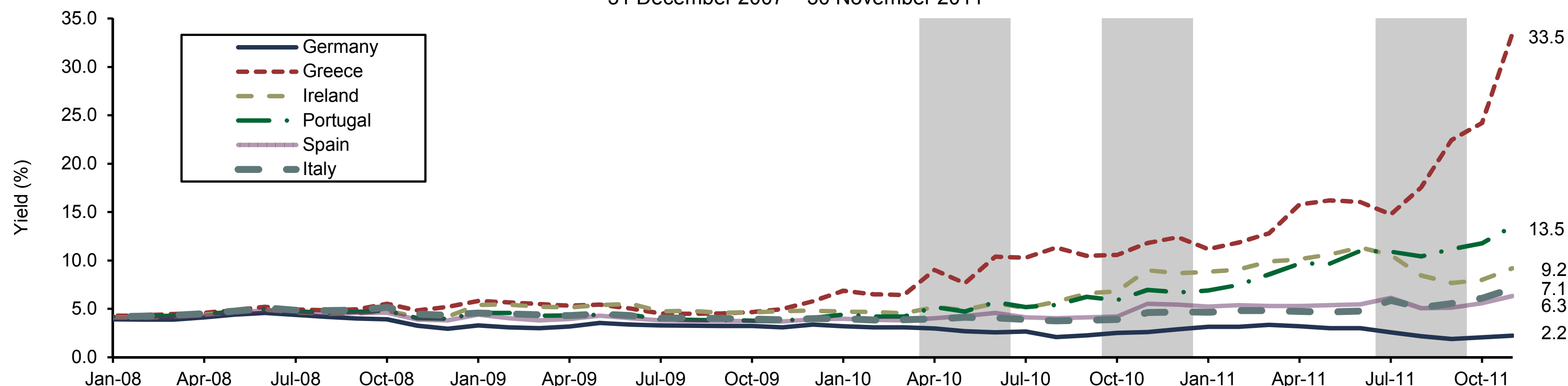


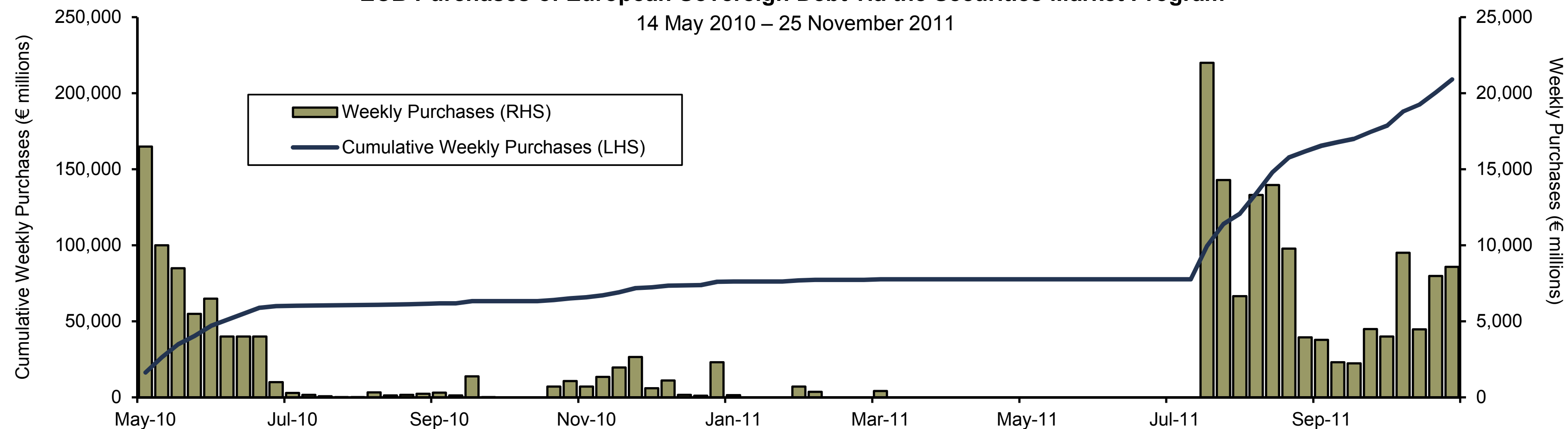
Sources: Deutsche Bundesbank, INSEE (National Institute of Statistics and Economic Studies), Istituto Nazionale di Statistica, Ministerio de Economía y Hacienda, and Thomson Datastream.

Notes: Unemployment data for Italy begin 31 March 2004 and are quarterly. GDP data for Italy are as of June 2011.

Exhibit 2

European Government Debt and Securities Market Program Statistics



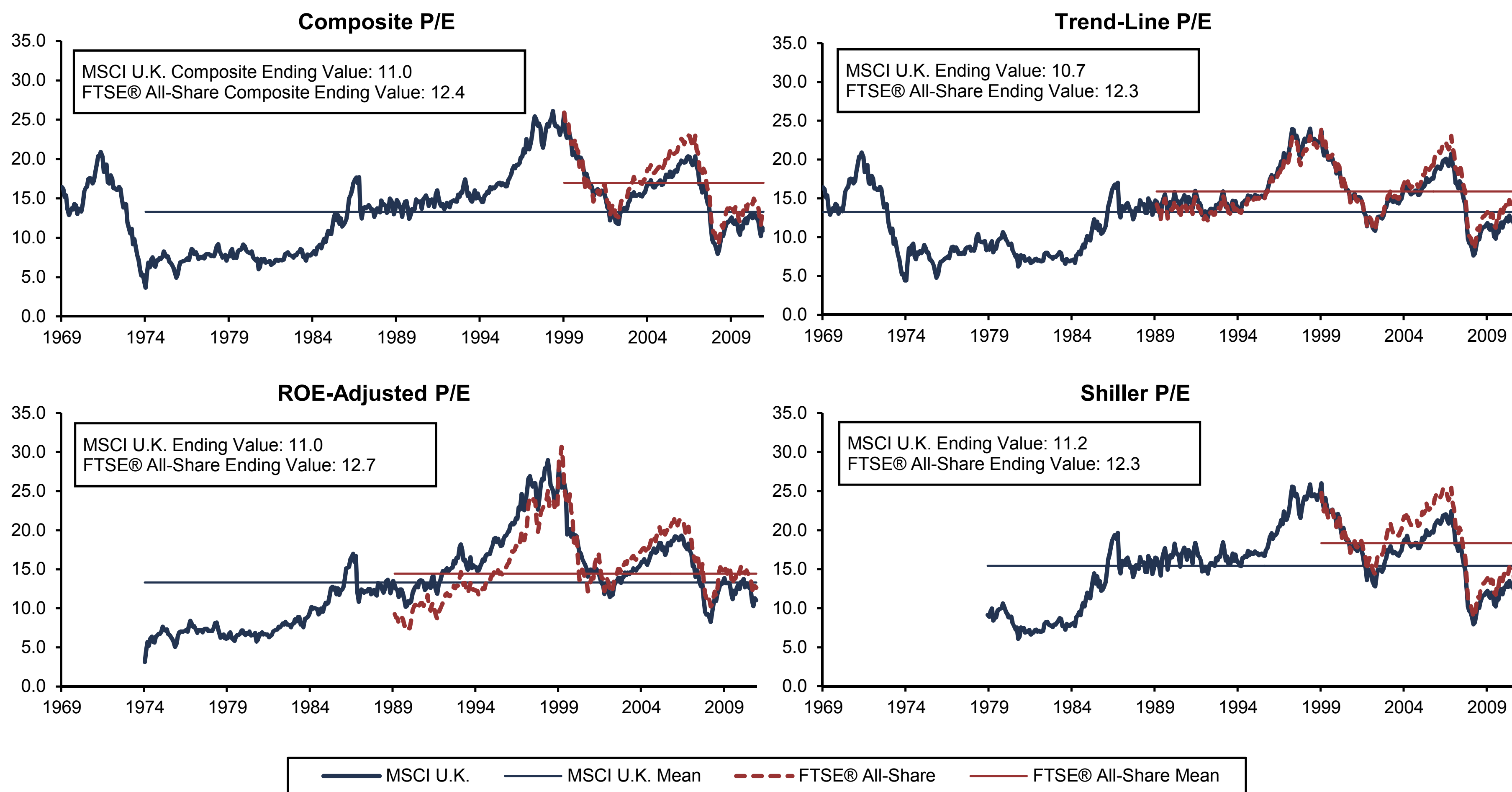


Sources: Bloomberg L.P. and Thomson Datastream.
Notes: Shaded areas represent periods of high activity in the European Central Bank's Securities Market Program. Data are monthly for government bond yields and weekly for ECB purchases.

Exhibit 3

MSCI U.K. and FTSE® All-Share Index Price-Earnings Valuations

31 December 1969 – 30 November 2011

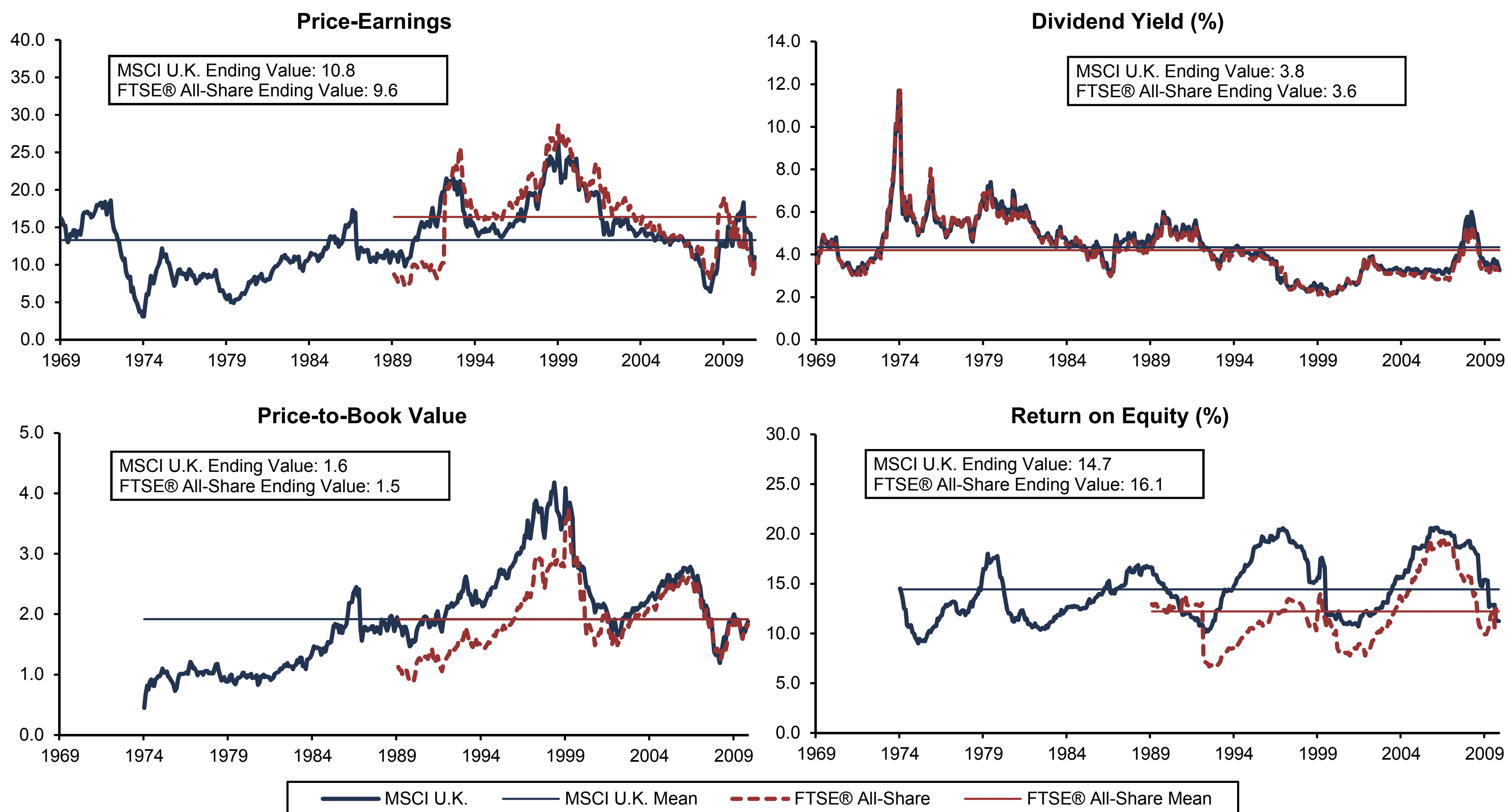


Sources: FactSet Research Systems, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite price-earnings (P/E) ratio is a simple average of the trend-line P/E, return on equity (ROE)–adjusted P/E and Shiller P/E. Earnings deflated by CPI-U. ROE is calculated by dividing the index's price-to-book value ratio by its P/E ratio. FTSE composite P/E data begin November 31, 2000. FTSE trend-line P/E data begin January 31, 1990. The MSCI ROE-adjusted P/E, data start on 31 December 1974 and the FTSE on 31 January 1990. The MSCI Shiller P/E data start on 30 November 1979 and the FTSE on 31 December 1999. To minimize the impact of bubble periods on valuations, we have excluded the years 1998–2000 from our historical average and standard deviation calculations for the ROE-adjusted P/E.

Exhibit 4

U.K. Index Valuations: MSCI U.K. and FTSE® All-Share

31 December 1969 – 30 November 2011

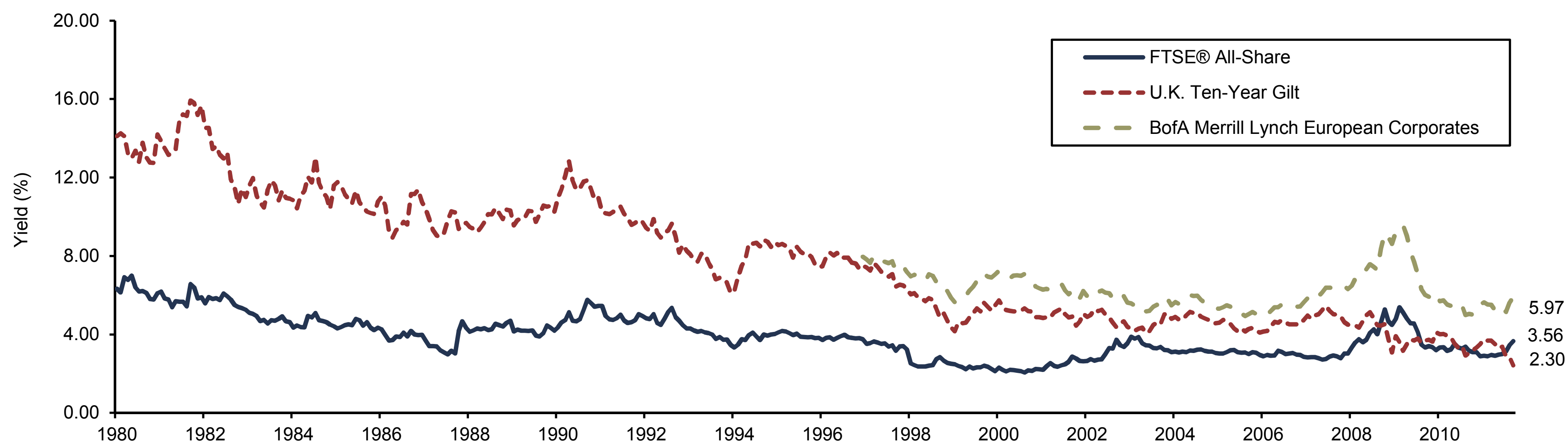


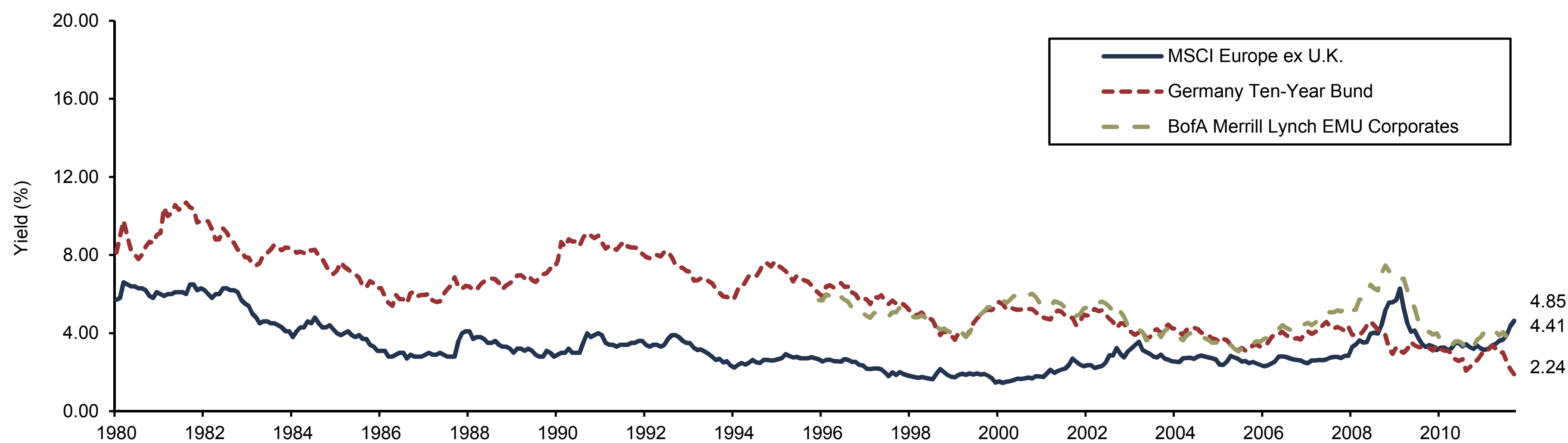
Sources: FactSet Reseach Systems, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book (P/B) value ratio by its price-earnings (P/E) ratio. The MSCI P/E data start on 31 December 1969 and the FTSE on 31 January 1990. The MSCI P/B data start on 31 December 1974 and the FTSE on 31 January 1990. The MSCI ROE data begin 31 December 1974 and the FTSE on 31 January 1990.

Exhibit 5

Yield Comparisons

31 January 1980 – 30 November 2011



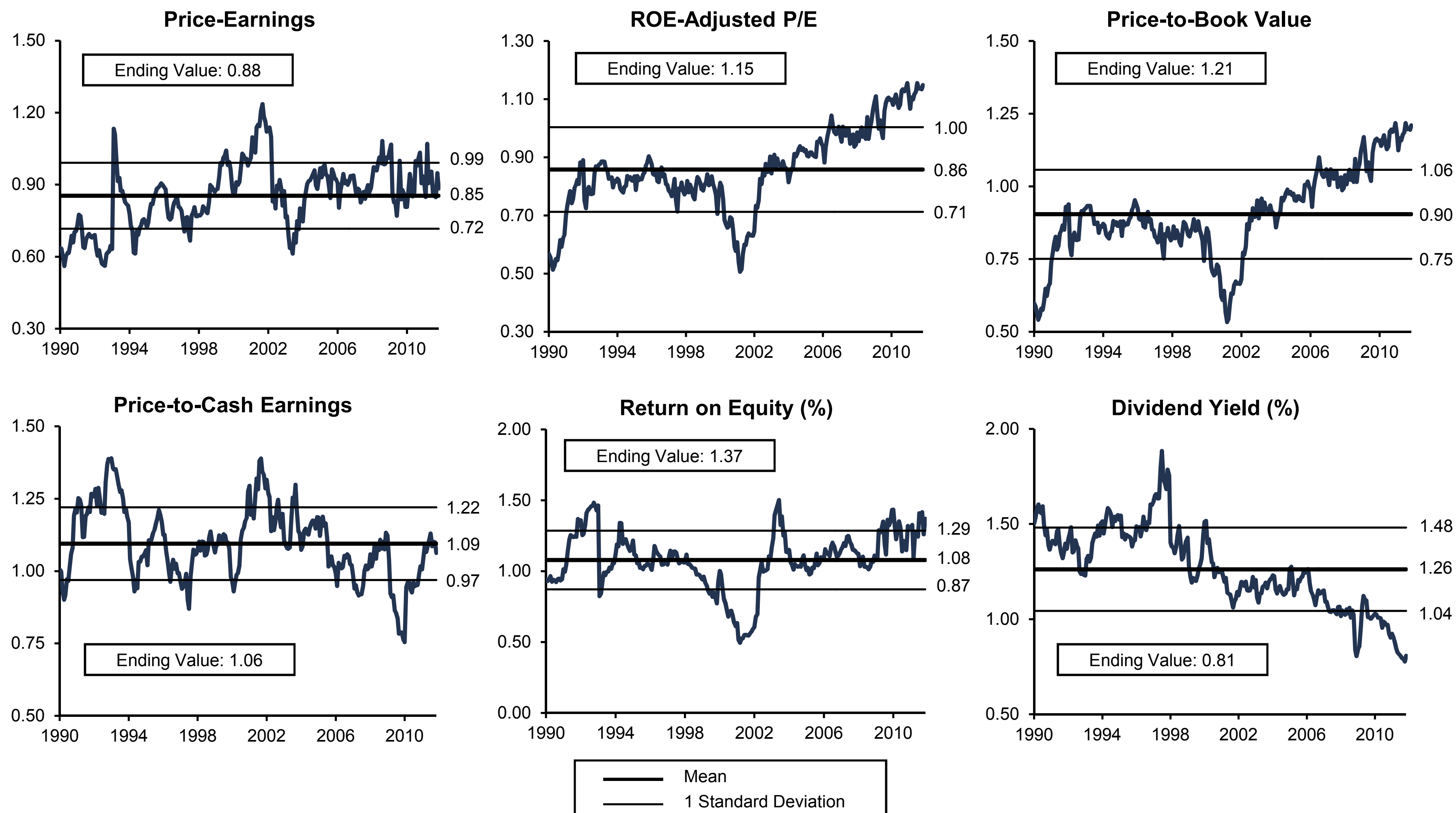


Sources: BofA Merrill Lynch, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Exhibit 6

FTSE® All-Share Relative to MSCI Europe ex U.K.

31 January 1990 – 30 November 2011

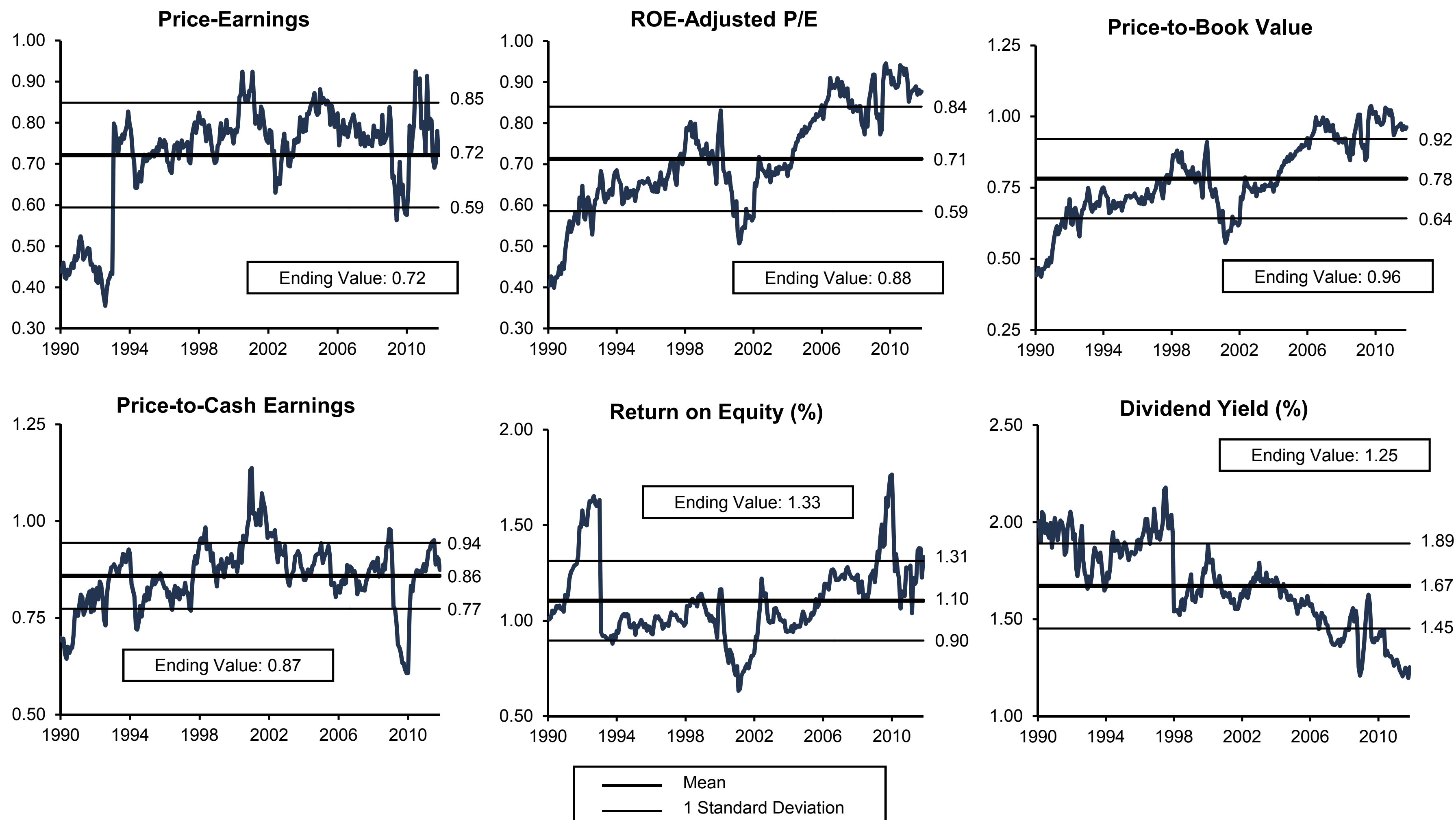


Sources: FactSet Research Systems, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE.

Exhibit 7

FTSE® All-Share Relative to MSCI World ex U.K.

31 January 1990 – 30 November 2011

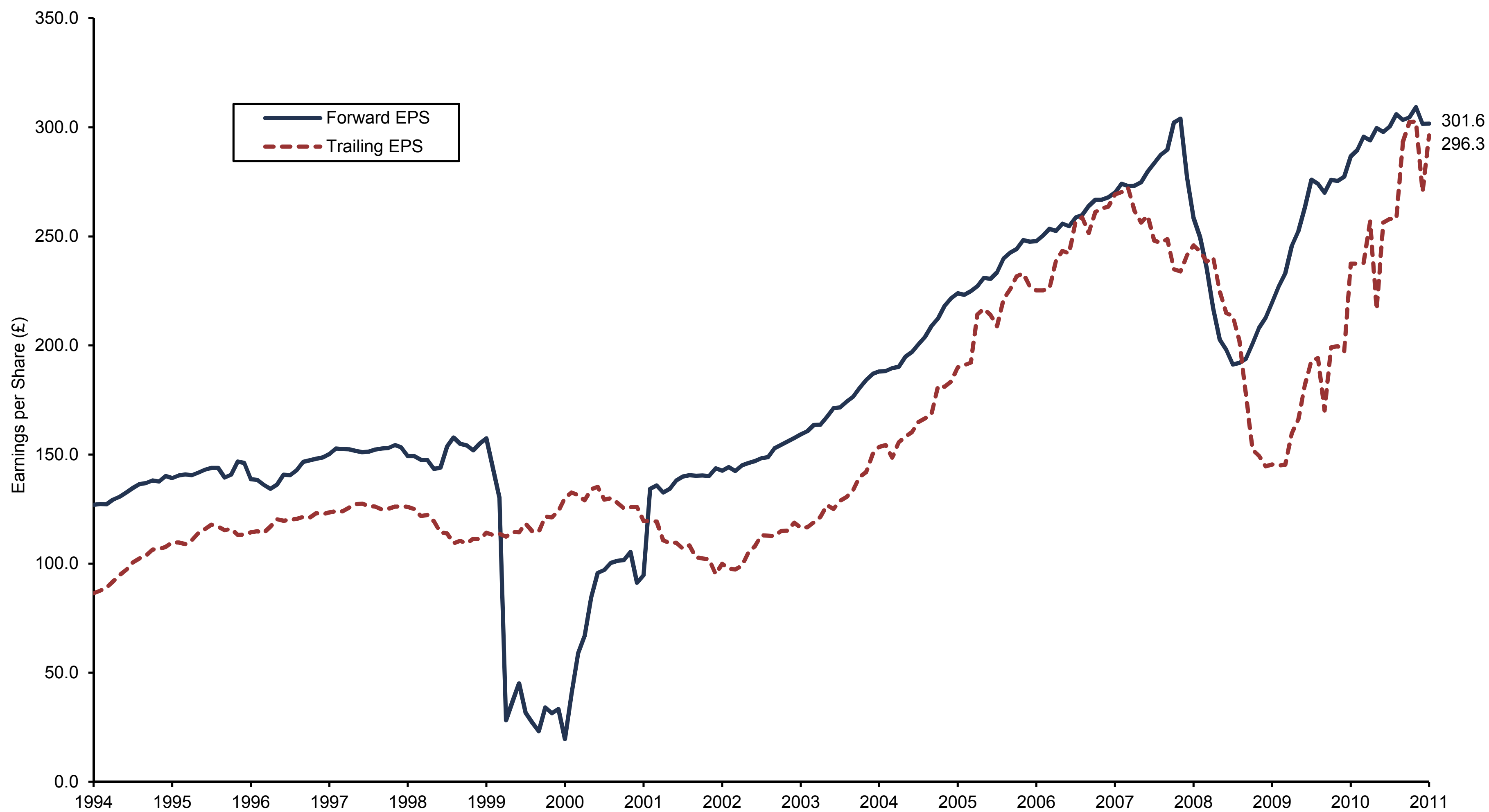


Sources: FactSet Research Systems, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE.

Exhibit 8

FTSE® All-Share Forward Earnings

30 November 1994 – 30 November 2011

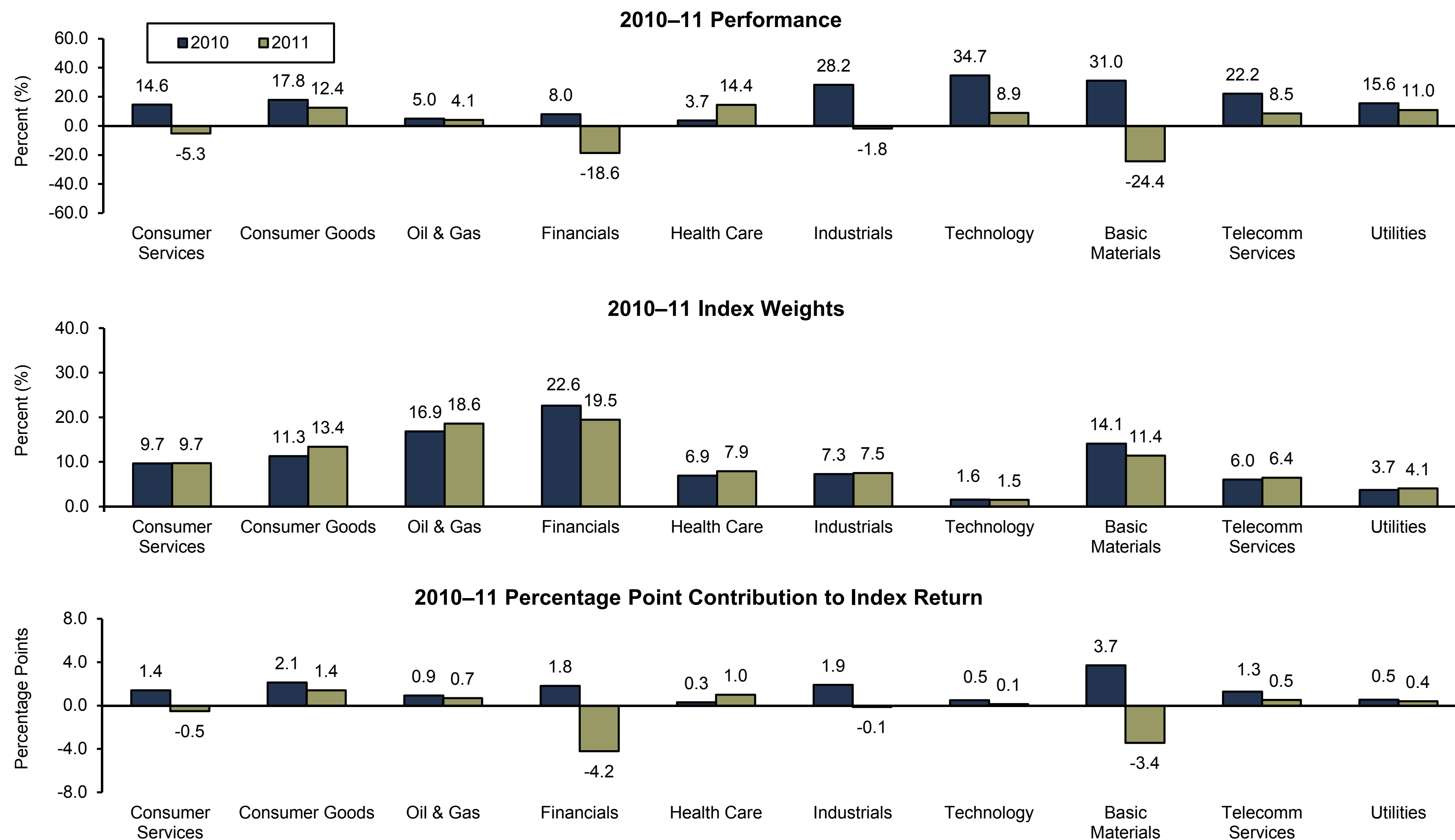


Sources: FactSet Research Systems, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Exhibit 9

FTSE® All-Share Economic Sector Weights and Contribution to Return

2010–11 • Pound Sterling

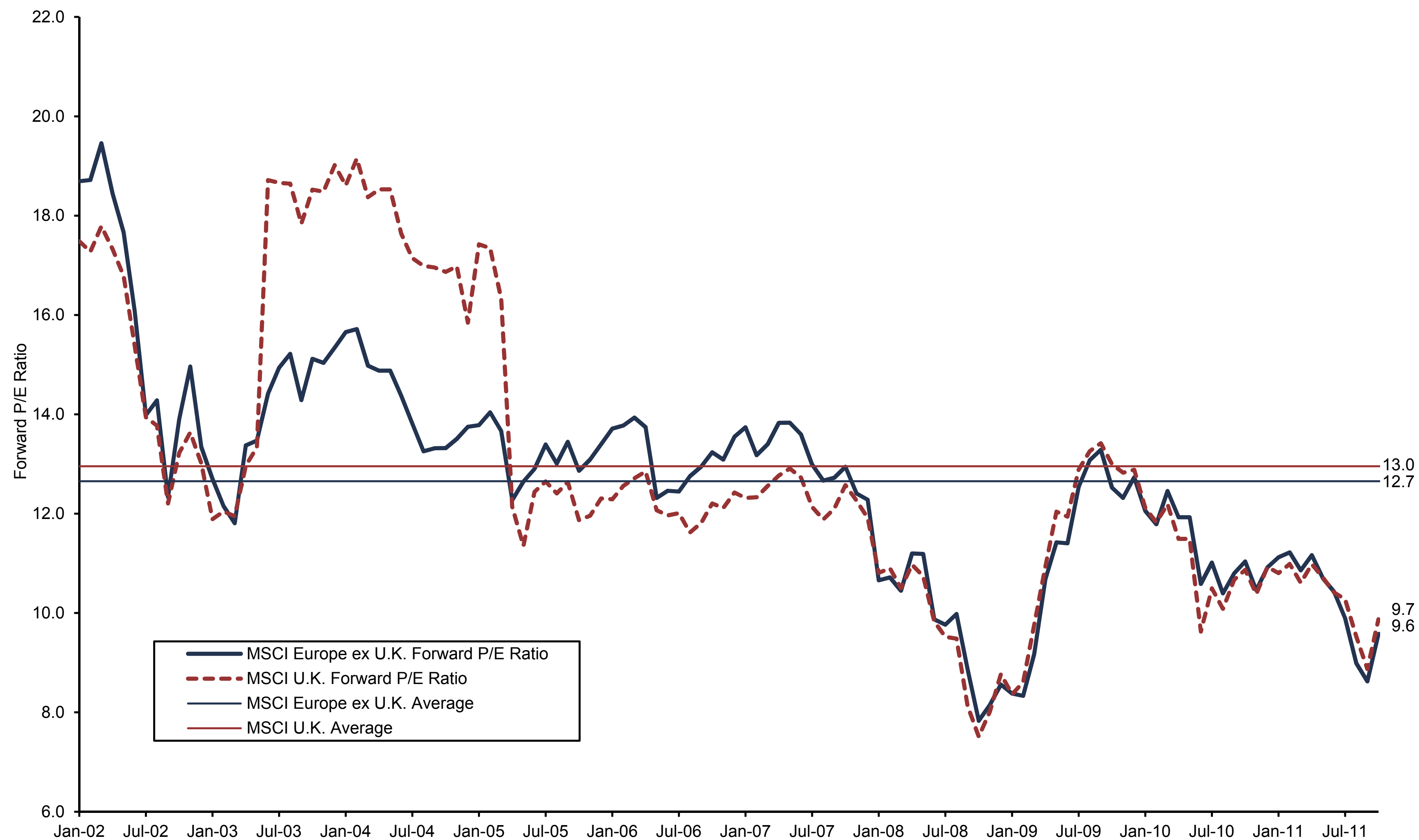


Sources: FTSE International Limited and Thomson Datastream.
Notes: Weights may not total to 100% due to rounding. ICB sectors shown for FTSE® All-Share Index. Data for 2010 are calendar year and for 2011 are year-to-date through November 30.

Exhibit 10

MSCI Europe ex U.K. and MSCI U.K. Historical Forward P/E Ratio

31 January 2002 – 30 November 2011



Sources: FactSet Research Systems, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Exhibit 11

MSCI Europe ex U.K. Country and Economic Sector Weights and Contribution to Return

As of 30 November 2011 • Euro

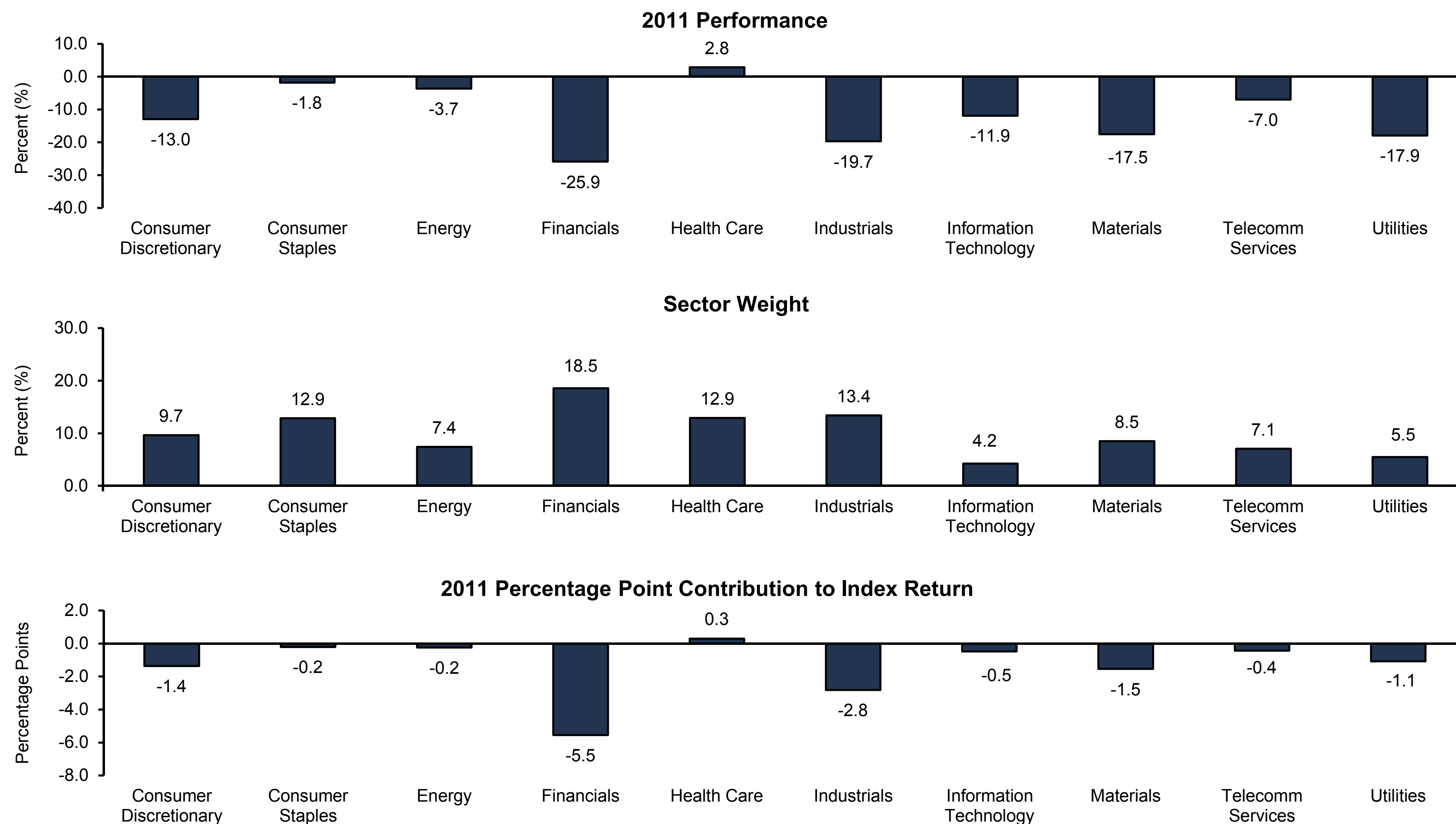
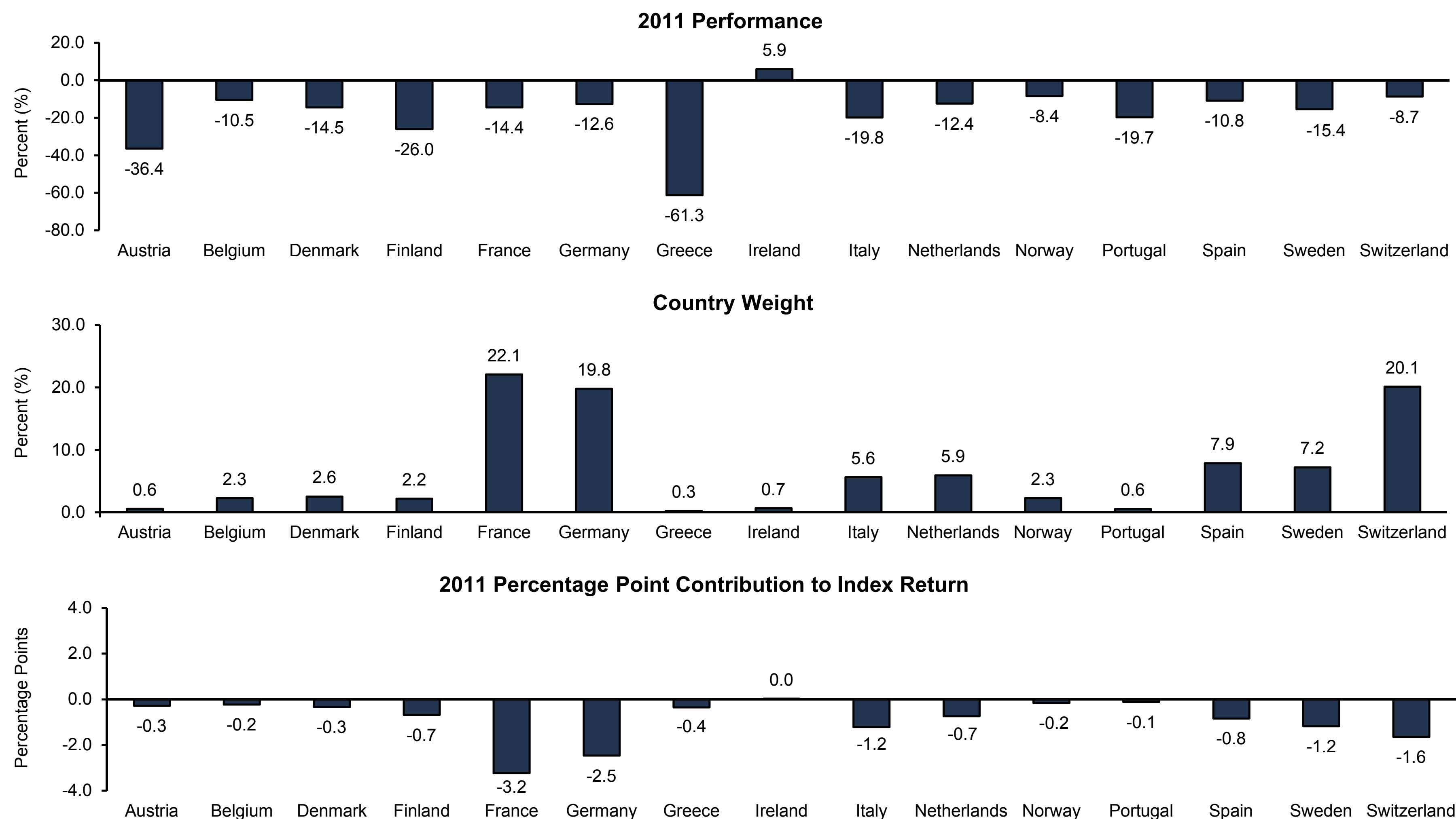


Exhibit 11 (continued)

MSCI Europe ex U.K. Country and Economic Sector Weights and Contribution to Return

As of 30 November 2011 • Euro

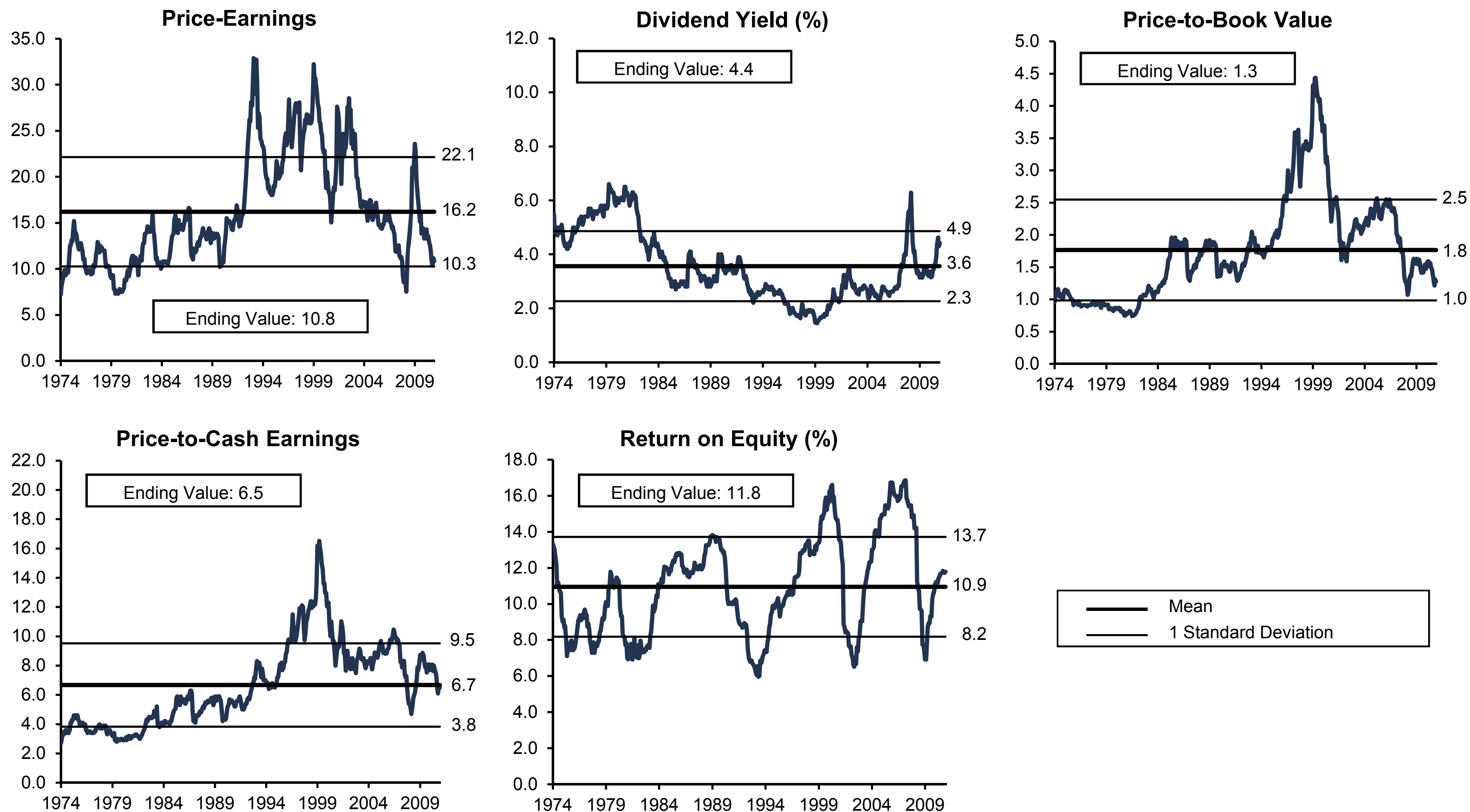


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: GICS sector classifications used for MSCI Europe ex U.K. Weights may not total to 100% due to rounding.

Exhibit 12

MSCI Europe ex U.K. Index Valuations

31 December 1974 – 30 November 2011



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.
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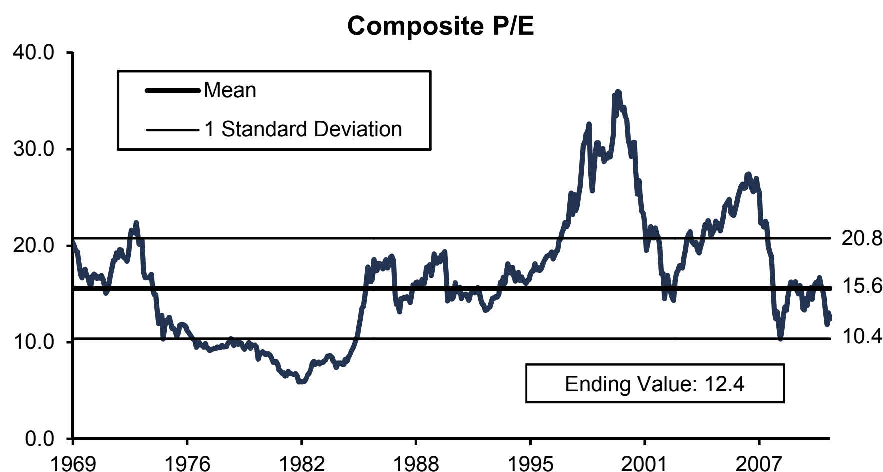
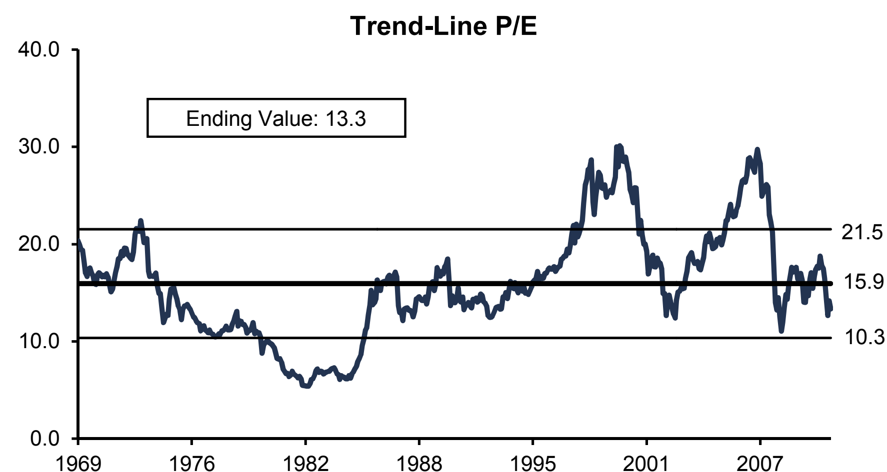
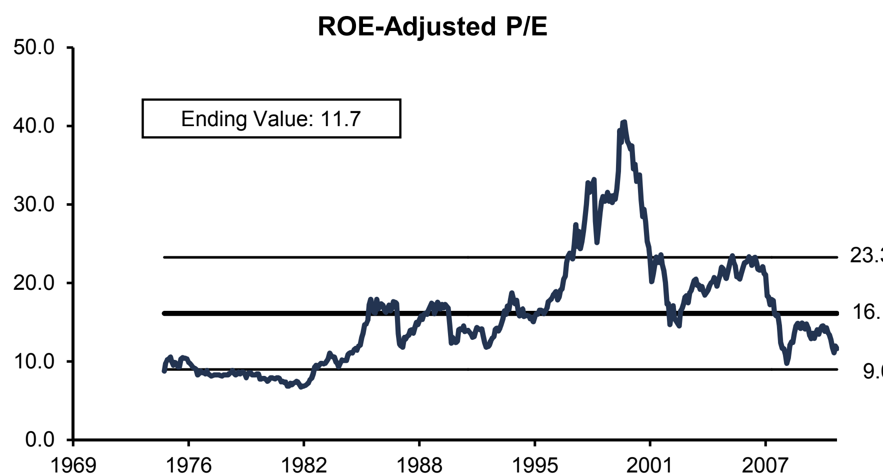
Exhibit 13

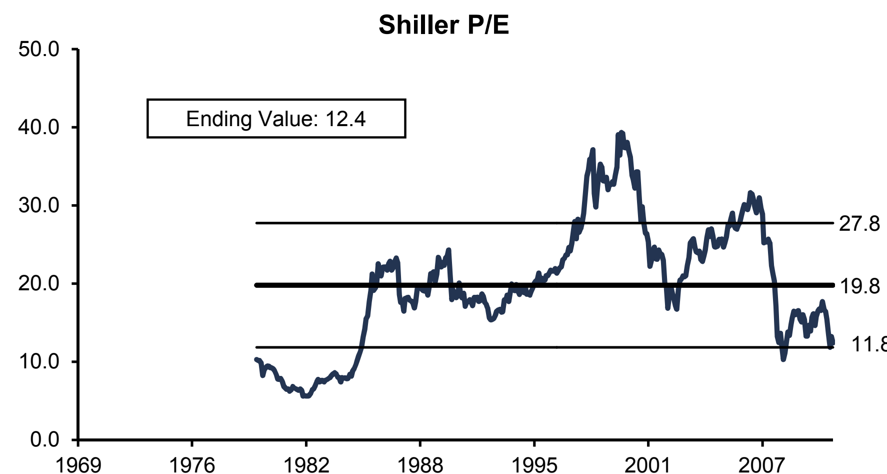
MSCI Europe ex U.K. Price-Earnings Valuations

31 December 1969 – 30 November 2011







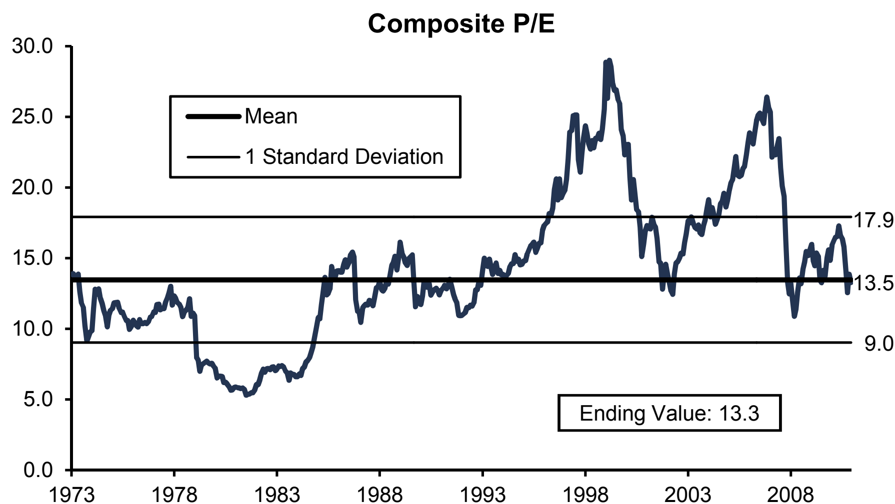


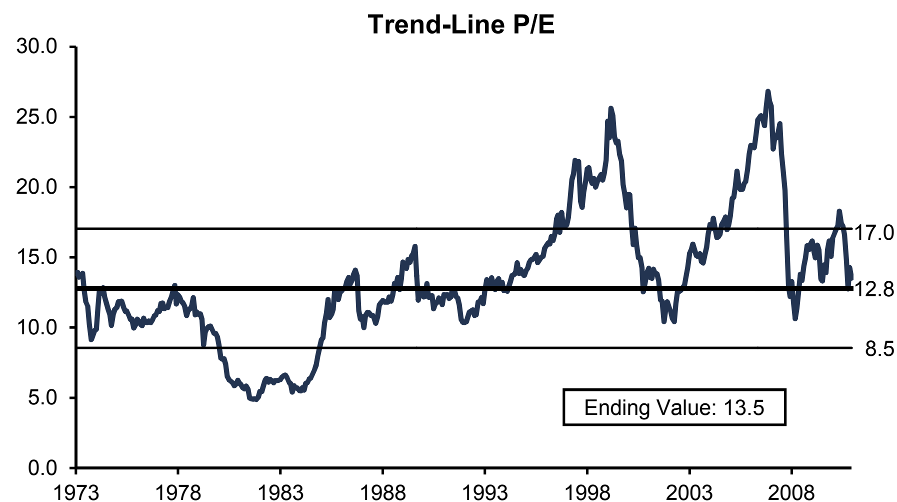
Sources: MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite price-earnings (P/E) ratio is a simple average of the trend-line P/E, return on equity (ROE)–adjusted P/E, and Shiller P/E. Earnings deflated by CPI-U. ROE is calculated by dividing the index's price-to-book ratio by its P/E ratio. The ROE-adjusted P/E data start on 31 December 1974. The Shiller P/E data start on 30 November 1979. To minimize the impact of bubble periods on valuations, we have excluded the years 1998–2000 from our historical average and standard deviation calculations for the composite trailing P/E and ROE-adjusted P/E.

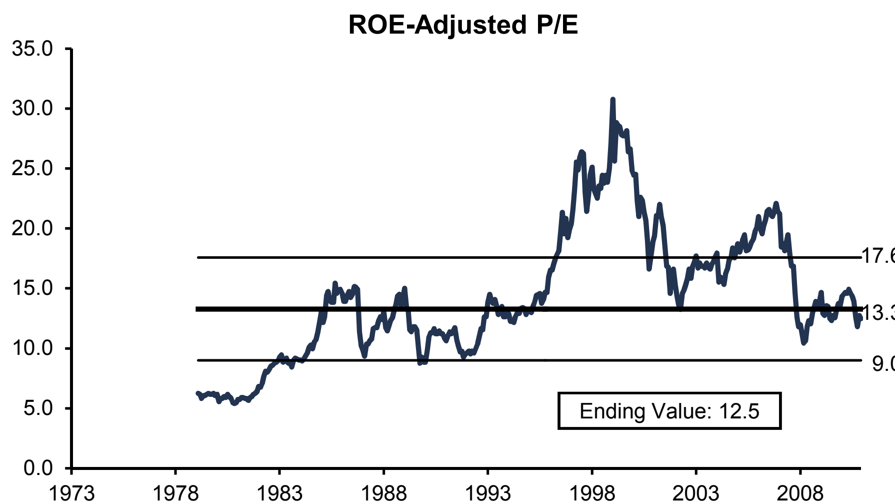
Exhibit 14

Datastream Europe ex U.K. Non-Financials Normalized P/E Valuations

31 December 1973 – 30 November 2011







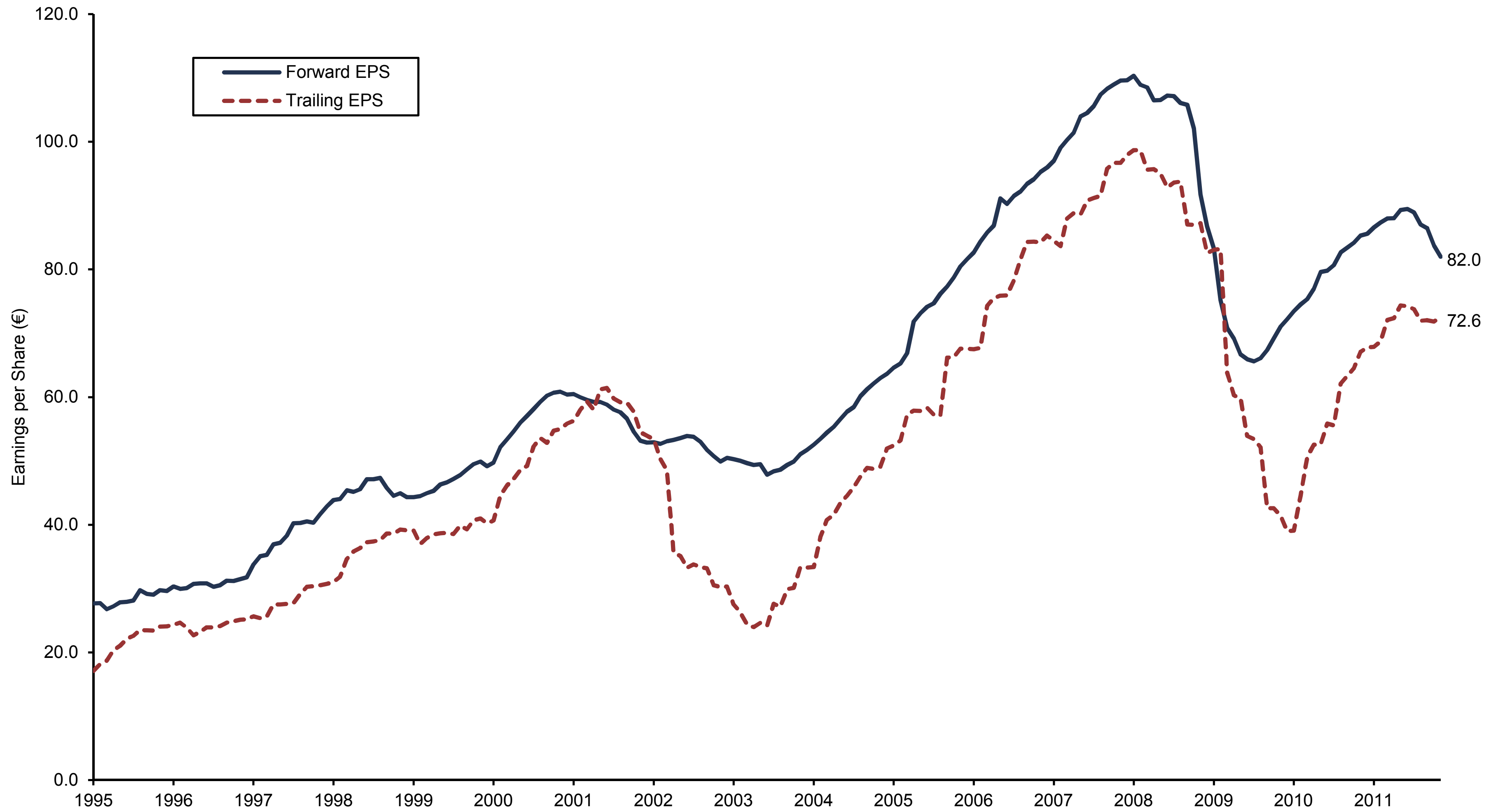
Source: Thomson Datastream.

Notes: The composite price-earnings (P/E) ratio is a simple average of the trend-line P/E, return on equity (ROE)–adjusted P/E and Shiller P/E. Earnings deflated by CPI-U. ROE is calculated by dividing the index's price-to-book value ratio by its P/E ratio. Mean and standard deviations exclude years 1998–2000.

Exhibit 15

MSCI Europe ex U.K. Forward Earnings

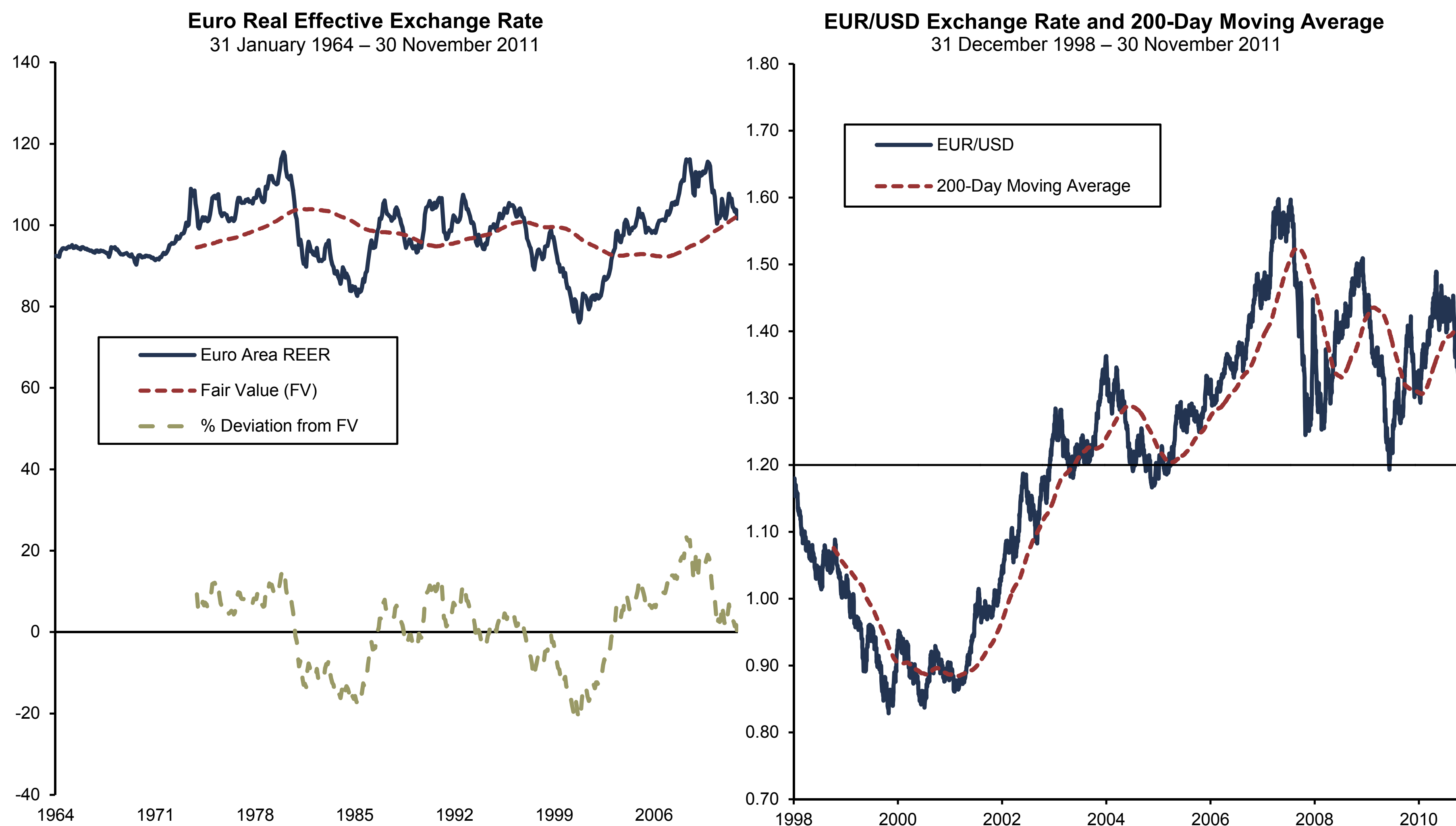
31 January 1995 – 30 November 2012



Sources: FactSet Research Systems, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Exhibit 16

Euro Exchange Rates

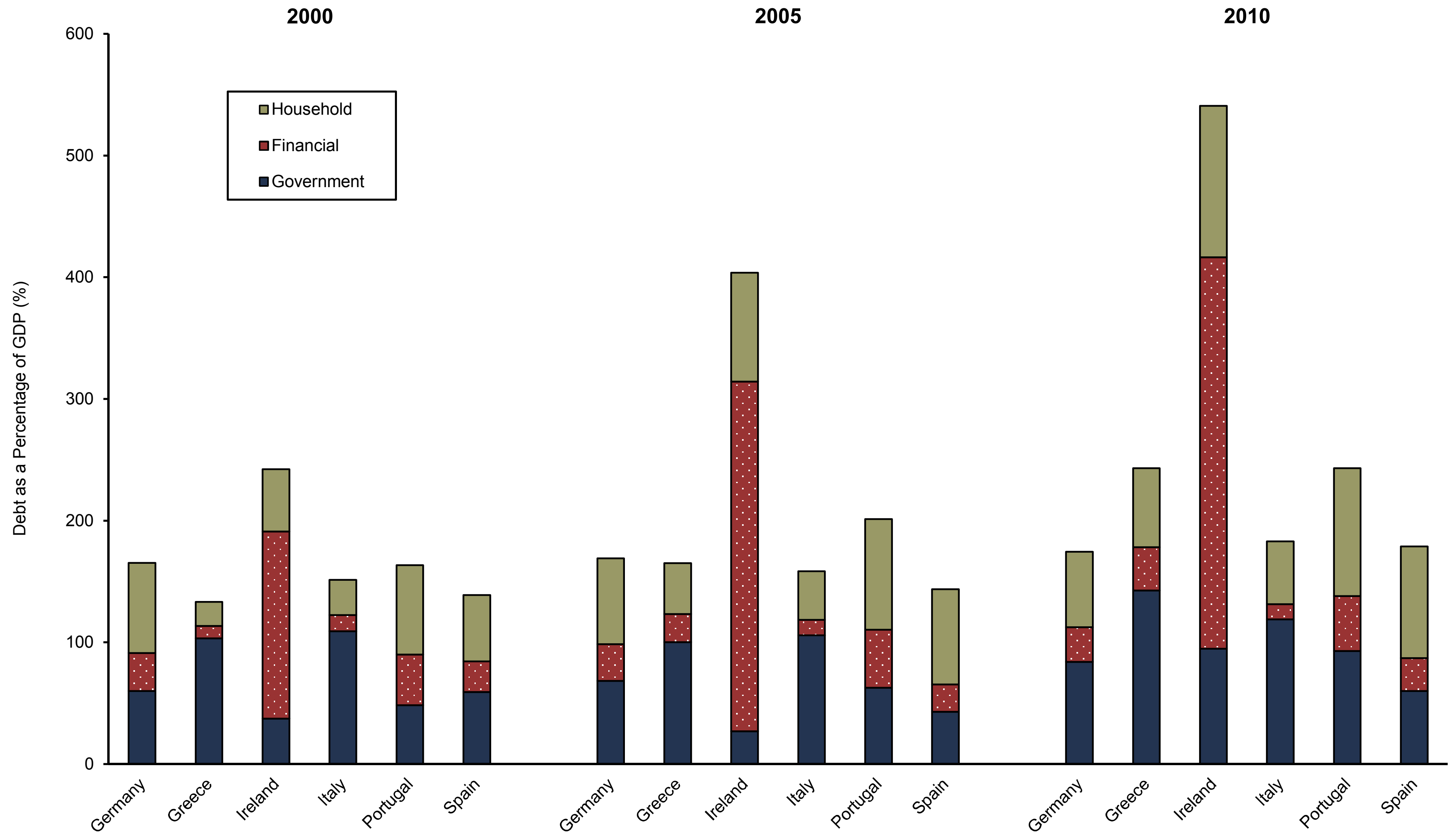


Sources: Bank for International Settlements and Thomson Datastream.

Notes: Real effective exchange rate (REER) graph uses monthly data. The REER is calculated as geometric weighted averages of bilateral exchange rates for 27 economies adjusted by relative consumer prices. Fair value represents the REER ten-year moving average. November data point is estimated using J.P. Morgan's Nominal Narrow Trade Weighted Euro. Data for the euro to U.S. dollar graph are daily.

Exhibit 17

Economy's Debt Level by Sector as a Percentage of GDP



Source: Thomson Datastream.
Notes: All data are annual. Irish household debt data shown in 2000 graph are as of 2001.

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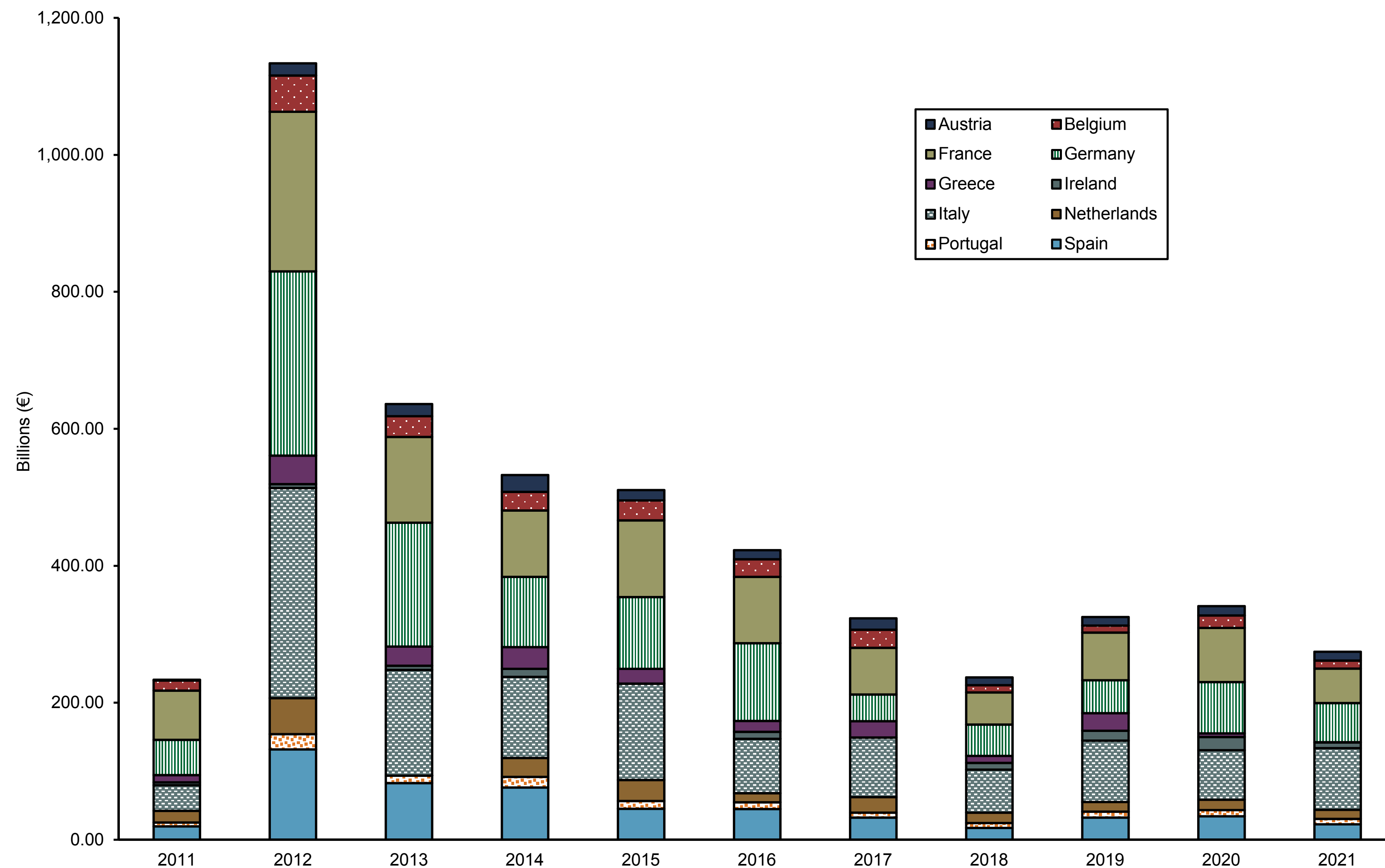
Exhibit 18

Expected European Sovereign Bond Redemptions

As of 31 October 2011



Source: Bloomberg L.P.