CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

An Update on Europe: Not Quite Time to Sound the All Clear

June 2010

Wade O'Brien
Eric Winig
Eric Schaaf

Copyright © 2010 by Cambridge Associates LLC. All rights reserved. Confidential.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of U.S. and international copyright laws (17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. Therefore, clients may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. An authorized client may download this report and make one archival print copy. The information or material contained in this report may only be shared with those directors, officers, staff, and investment committee members or trustees having a need to know and with the understanding that these individuals will treat it confidentially. Violators of these confidentiality provisions may be subject to liability for substantial monetary damages, injunctive action, and all other remedies available at law or equity. Additionally, information from this report may be disclosed if disclosure is required by law or court order, but clients are required to provide notice to CA reasonably in advance of such disclosure.

This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that may be described in the report. This report is provided only to persons that CA believes are: (i) "Accredited Investors" as that term is defined in Regulation D under the U.S. Securities Act of 1933; (ii) "Qualified Purchasers," as defined in Section 2(a)(51) of the U.S. Investment Company Act of 1940; (iii) of a kind described in Article 19 or Article 49 of the Financial Services and Markets Act 2000; and (iv) able to meet the requirements for investors as defined in the offering documents. Potential investors should completely review all Fund offering materials before considering an investment. No part of this report is intended as a recommendation of any firm or any security. Nothing contained in this report should be construed as the provision of tax or legal advice. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results made by a manager that are delivered to CA electronically, by wire or through the mail. Managers may report returns to CA gross (before the deduction of management fees), net (after the deduction of management fees) or both. Past performance is not indicative of future performance. Any information or opinions provided in this report are as of the date of the report and CA is under no obligation to update the information or communicate that any updates have been made.

Where referenced, the CA manager universe statistics, including medians, are derived from CA's proprietary database covering investment managers. These universe statistics and rankings exclude managers that exclude cash from their reported total returns, and for calculations including any years from 1998 to the present, those managers with less than US$50 million in product assets. Returns for inactive (discontinued) managers are included if performance is available for the entire period measured. CA does not necessarily endorse or recommend the managers in this universe.

Cambridge Associates, LLC is a Massachusetts limited liability company with offices in Arlington, VA; Boston, MA; Dallas, TX; and Menlo Park, CA. Cambridge Associates Limited is registered as a limited company in England and Wales No. 06135829 and is authorised and regulated by the Financial Services Authority in the conduct of Investment Business. Cambridge Associates Limited, LLC is a Massachusetts limited liability company with a branch office in Sydney, Australia (ARBN 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G).

June 2010 European Market Commentary

An Update on Europe: Not Quite Time to Sound the All Clear

Wade O'Brien, Eric Winig, & Eric Schaaf

Authorities have taken decisive steps recently to quell concerns about sovereign debts. However, the underlying problems will take a long time to work through and thus volatility is likely to be a recurring theme in European markets for some time.

The impact of the sovereign debt crisis raging across the Eurozone continues to reverberate through global risk markets.[1] There are numerous reasons to expect ongoing volatility, perhaps most notably the fact that the effect of austerity plans is yet to be seen. Furthermore, the various bailout packages announced to date have done little, if anything, to resolve the issue of too much debt. Refinancing risk will be an ongoing theme given heavily indebted sovereigns and banks.

This commentary provides an update on the investment landscape in Europe, including developments to watch in monitoring the health of peripheral sovereigns and European banks. We provide an overview of the impact of the crisis on the euro and European capital markets and conclude with our investment outlook.

Recent Events in Europe

There has been an almost daily barrage of headlines on the sovereign debt crisis in Europe, most significantly the €750 billion "relief package" announced in early May for Greece and other peripheral, over-indebted countries such as Spain and Portugal. Almost immediately, however, it became clear that this package had large, perhaps intractable issues. For example, the European Financial Stability Facility is designed so that any country that requests aid from the facility is no longer eligible to contribute toward it. In other words, if Spain used the facility, it would then be ineligible to help guarantee loans to other Eurozone members, reducing the potential size of the loan facility. Such restrictions also illuminate the almost existential issues with the package, which involve debtors pledging money they do not have to bail out other debtors.

While a backstop facility could reduce liquidity concerns, countries may ultimately fail to implement necessary fiscal reforms and meet austerity targets. No country with problems as severe as Greece's has *ever* successfully implemented an International Monetary Fund (IMF) austerity program, largely because doing so would cause considerable *short-term* pain. Given that such programs are likely to cause debt levels to *increase* (again, in the short term), the political and social resolve to continue down this road may be short-lived.

Consider the Baltic countries, which enacted severe austerity programs late in 2008, cutting spending by between 6% and 9% of GDP, only to see economic growth plunge and unemployment soar; for example, Latvian GDP plunged 18% in 2009. Importantly, these programs were supported by local populations eager to join the Eurozone; how existing southern European members will respond is highly uncertain.

[1] See our February 2010 Market Commentary *A Note on the Greek Drama.*

©2010 Cambridge Associates LLC

A Bailout by Any Other Name …

In our opinion, the bailout package was never intended to address the sovereign debtors; instead, it was a thinly veiled bailout for European banks, which are by far the largest holders of sovereign and financial debt from the peripheral countries. The Bank for International Settlements estimates that European banks hold $1.9 trillion of public and private debt from Greece, Ireland, Portugal, and Spain,[2] with French and German banks alone holding $400 billion and $514 billion, respectively (Exhibit 1). In recent months, the value of these holdings had plummeted, creating mark-to-market problems for banks, while longer term, a large-scale default or restructuring could trigger massive write-downs and solvency issues.

The fact that European banks were not only weakened by the global credit crisis but slower to recognize bad debts than U.S. banks also increased the likelihood of such a bailout. Many European banks continue to struggle with loans originating from the peak of the property boom and are suspected of understating the extent of their bad debts.[3] This led investors to demand the recently announced pan-European stress tests on its banks, and clamor for the results to be made publicly available. In the interim, given the uncertainty about both the value of assets (sovereign bonds) and capital strength, some investors have become unwilling to lend to these banks, effectively shutting them out of the wholesale and interbank lending markets. As a result, the European Central Bank's (ECB) balance sheet has ballooned, with loans to European banks soaring from €483 billion in June 2008 to €815 billion as of May 30.

[2] These numbers would soar further if Italian obligations were included; French banks hold $911 billion of debt from the five countries.

[3] The IMF, for example, has cautioned that European banks have not gone nearly as far as their U.S. and U.K. peers in writing down bad debts.

Things to Watch

The ability of sovereigns to service and refinance their growing debt burdens is essential. It is not inconceivable that one of the peripheral countries will be forced to restructure its debt obligations before the crisis is fully resolved, although the recent rescue package makes this unlikely in the near term. Spain, for example, has more than €75 billion of debt maturing over the course of 2010, and a similar amount in 2011. These figures do not reflect expected budget deficits, which will require further borrowing (Exhibit 2).While bond markets have been open in recent weeks, it is an open question as to who is ultimately behind such buying (e.g., domestic banks, the ECB).

European banks also have significant ongoing funding needs, and face over $1 trillion of senior debt maturing before the end of 2011. Recent issuance has been hit or miss, with many peripheral banks unable to complete deals, while some northern European banks have been able to bring transactions. Although recent measures help guarantee continued access to liquidity and reduce some of the mark-to-market issues, critics point to the limited progress banks have made in replacing the wholesale-focused funding models that made them so vulnerable to market stresses in the first place. The true test is likely to come after the summer recess, as autumn is historically a busy time in the new issue market. Another metric of the health of bank lending is the Libor/OIS (Overnight Index Swaps) spread, a metric that essentially shows the level of trust between banks by measuring how much they charge each other to borrow short-term funds. As of June 30, the spread was 33 basis points (bps), up from 9 bps at the start of the year, but well below the 364 bps reached in late 2008 (Exhibit 3).

Finally, the health of the non-financial corporate bond market should also be monitored, as widening sovereign bond yields and contagion

concerns could threaten the health of even globally diversified blue-chip corporates based in peripheral nations. In general, however, many corporate balance sheets are in reasonably good shape, and treasurers may be able to wait an extended period before needing to tap the markets again.

Impact on Asset Classes

The euro has been the largest casualty of the European fiscal crisis, tumbling 21% against the U.S. dollar between early December and early June. Such a fall reflects not only fundamental factors, but also that shorting the euro has been the most liquid and direct way to express a negative view on Europe, given the size of the foreign exchange market.

The initial driver of euro weakness was a reassessment of Eurozone growth and monetary tightening prospects. By late 2009, a consensus view had developed that the ECB would begin tightening well ahead of the Federal Reserve and the Bank of England, as the Eurozone economy would enjoy a cyclical rebound before the United States and the United Kingdom. The stresses in Greece caused investors to realize that peripheral Europe would be a drag on Eurozone growth and that the ECB was in no position to begin draining liquidity.

The initial euro weakness was greeted with relief, as by late 2009 the currency had again risen to levels that threatened exports and economic recovery. Some have even argued that the unwillingness of the ECB and Germany in early 2010 to intervene in the crisis was intentional and designed to encourage an orderly currency depreciation. However, the escalating uncertainty and the inability of Europe's political leadership to coalesce around a solution eventually turned the euro's decline into a rout. The intensifying Greek crisis had exposed a fundamental flaw in the structure of the European Monetary Union (EMU)—a monetary union without political union.

After a relentless slide over May and early June, with the EUR/USD exchange rate reaching $1.19, its lowest level since 2006, the euro has stabilized in recent weeks. While the recent turnaround in the euro was partly a natural bounce following such a vicious decline, it also reflected investors shifting their concern from Europe to the global recovery.

Still, the tumble in the euro needs to be viewed in the context of a fundamentally overvalued currency. Exhibit 4 shows the real effective exchange rate for the euro, highlighting how uncompetitive the euro had become against its trading partners. The decline in the EUR/USD exchange rate from $1.50 to $1.19 has set markets on edge; however, the euro traded at $1.20 as recently as 2006, and traded below parity with the U.S. dollar from 1999 to 2002. In other words, the past ten years have seen wide swings in the euro. Indeed, one could argue that the upward pressure on the euro over the past few years was largely related to central bank reserve diversification away from the U.S. dollar and into euros—a process that recent events have, at best, put on hold, if not into reverse, as the fiscal crisis has shaken investor perceptions of the euro as a "dollar substitute."

European Equities

European equities held up well until early May, when indices across Europe sold off heavily as the cost and implications of the crisis became better understood. As of June 30, the MSCI Europe ex U.K. Index had returned -6.2% year-to-date, though performance has varied greatly by country. For example, Greek and Spanish indices returned -39.5% and -21.4%, respectively (Exhibit 5), while German markets have been roughly flat. It is interesting to note that European equities

moved into the red for the year only *after* the €750 billion relief package was announced.

From a valuations perspective, European equities remain at a modest discount to other global equity indices (Exhibit 6). European equities trade at a return on equity–adjusted price-earnings ratio of 12.2 (Exhibit 7), modestly below their post-1974 adjusted average of 13.7, and at 12.5 times normalized earnings, down from 13.8 at the end of December, and about 0.5 standard deviation below their long-term average of 16.2. In our opinion, this discount is reasonable given the uncertainties surrounding the European outlook. While we would not load up on European equities at current prices, neither would we shun them.

European Sovereign Bonds

The Barclays Capital Euro Government Bond Index had returned 2.7% as of June 30, as positive returns from heavily weighted German and French treasuries offset losses from peripheral sovereigns (Exhibit 8). Indeed, the crisis in peripheral debt had the ironic effect of driving up demand for core sovereigns, thus pushing yields down. The yield on the benchmark German ten-year bond fell from 3.4% to 2.6% in the first half of 2010, while the spreads of comparable peripheral government bonds reached in May or June the widest levels since the creation of the euro (Exhibit 9), and remain extremely elevated. Looking forward, countries such as Spain (€480 billion of outstanding sovereign debt) and Italy (€1.4 trillion) will have a larger impact on fund performance than Greece, which has less than €300 billion in outstanding debt.

European Credit

European credit has been fairly resilient year-to-date, with the Bank of America Merrill Lynch EMU Corporate Index returning 3.8% year-to-date, as the drop in yields has more than offset the widening of credit spreads (from an option-adjusted spread of 168 bps at the start of the year to 201 as of June 30). What is perhaps most surprising is that financials have managed to generate positive returns. The Bank of America Merrill Lynch EMU Financial Corporate Index has returned 3.4% year-to-date, in line with the main credit index, perhaps due to feelings that there is limited political appetite for a large bank failure in the post-Lehman world.

Implications for Investors

The one near-certainty is that *un*certainty will persist in the market for some time. Austerity plans are just beginning to be implemented, bailout mechanisms are untested, and debt loads remain untenable, while banks remain dependent on the ECB for survival. There are also signs that global growth is slowing, and thus any boost from exports may be limited. Investors have also been clearly skittish about the lack of transparency on topics such as bank stress tests and ECB operations. Although more disclosure on these topics *may* help calm nerves, it could also reveal unpleasant facts. On balance, given the various unknowns, as well as the time and pain required to heal some of the problems, it seems unlikely that risk assets will resume a steady ascent in the near future. That said, European governments, as in the rest of the world, seem primed to intervene if further sell-offs occur, which, while obviously increasing moral hazard still further, could put some sort of floor under *nominal* asset prices.

The euro seems the most likely candidate to resume its recent sell-off if sentiment again turns negative. Despite its recent stabilization, renewed weakness could be justified on any number of grounds, including deflationary pressures stemming from austerity programs and the potential for further political/social stress, not to mention fundamental valuation issues. Given the economic benefits of a weaker currency, which

could help make the economic adjustments in peripheral Europe less painful, we expect the goal of politicians will be to manage, rather than prevent, this decline. Currency depreciation may be less of an issue for euro-based investors, but investors with other base currencies might consider currency-hedging strategies.

European equities currently trade at a slight discount to international peers, although some peripheral markets now trade at much cheaper valuations. Investors must differentiate between discounts that can be justified by fundamentals and discounts that may have been created by indiscriminate selling, thus creating an opportunity. For example, the European banking sector may deserve to trade at a discount given uncertainties about access to liquidity and the need for future capital raisings. However, strong exporters in the periphery may struggle for no other reason than their domicile. This suggests investors might be best served to allocate funds to active managers, assuming, of course, that they have demonstrated the ability to identify value and have the courage to add risk during sell-offs. In any event, given the likelihood for future volatility, investors may wish to keep dry powder on hand.

In the fixed income markets, yields are likely to be pulled lower by slower growth, but also remain vulnerable to central bank actions and/or default worries. Investors holding European sovereign bonds in deflation-hedging portfolios should stick to core countries, as peripheral bonds now encompass liquidity and default premiums that we have no ability to price. Further, such bonds seem poor candidates to benefit from a flight to quality or fears of deflation. Given the low level of sovereign bonds globally, investors have limited opportunity to benefit from further yield declines, but are subject to significant interest rate risk should yields rise. While we make no prediction about the future direction of interest rates, holding some cash or shortening bond duration may make sense in an effort to maintain adequate liquid resources to meet spending needs in the event of further economic stagnation without taking undue interest rate risk for the potential limited reward.

At current spreads, we consider European credit fairly valued, though risks may be to the downside for several reasons. One is that increasing sovereign debt issuance has the potential to crowd out demand for new corporate bonds. Another is that refinancing needs are high, especially for banks, and thus borrowers need markets to be continuously open. The likelihood of this occurring is, to be charitable, far from certain. ■

Exhibit 1

Cross-Border Banking Claims

31 December 2009 • U.S. Dollar (millions)

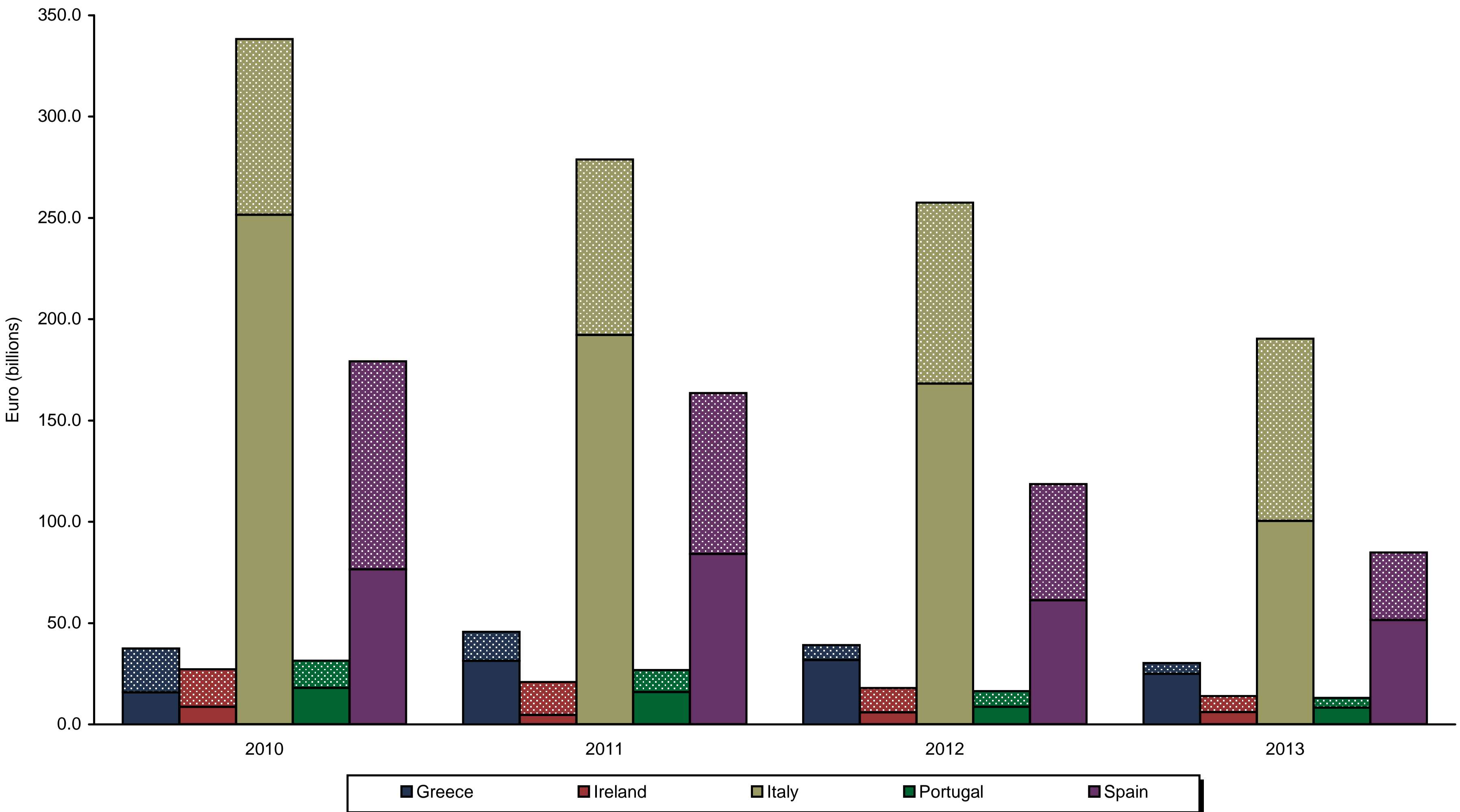
Lender Domicile	Borrower Domicile						
	Portugal	Ireland	Greece	Spain	**Subtotal**	Italy	**Total**
Germany	47,377	183,757	45,003	237,983	**514,120**	189,675	**703,795**
France	44,739	60,326	75,172	219,636	**399,873**	511,449	**911,322**
Belgium	3,139	64,503	3,806	26,562	**98,010**	26,438	**124,448**
Netherlands	12,414	30,824	11,892	119,730	**174,860**	68,731	**243,591**
Portugal	---	21,516	9,746	28,075	**59,337**	5,203	**64,540**
Ireland	5,431	---	8,464	30,225	**44,120**	46,258	**90,378**
Italy	6,740	18,357	6,924	31,101	**63,122**	---	**63,122**
Greece	105	804	---	434	**1,343**	710	**2,053**
Spain	86,083	15,664	1,273	---	**103,020**	46,786	**149,806**
Austria	2,791	8,498	4,649	8,819	**24,757**	25,392	**50,149**
Switzerland	3,860	16,526	3,642	18,263	**42,291**	16,396	**58,687**
United Kingdom	24,259	187,506	15,089	114,139	**340,993**	76,868	**417,861**
Europe	240,639	638,294	188,780	856,107	**1,923,820**	1,029,381	**2,953,201**
United States	4,955	58,553	16,647	52,696	**127,896**	53,794	**181,690**

Source: Bank for International Settlements.

Exhibit 2

Financing Needs of Peripheral Countries

2010–13

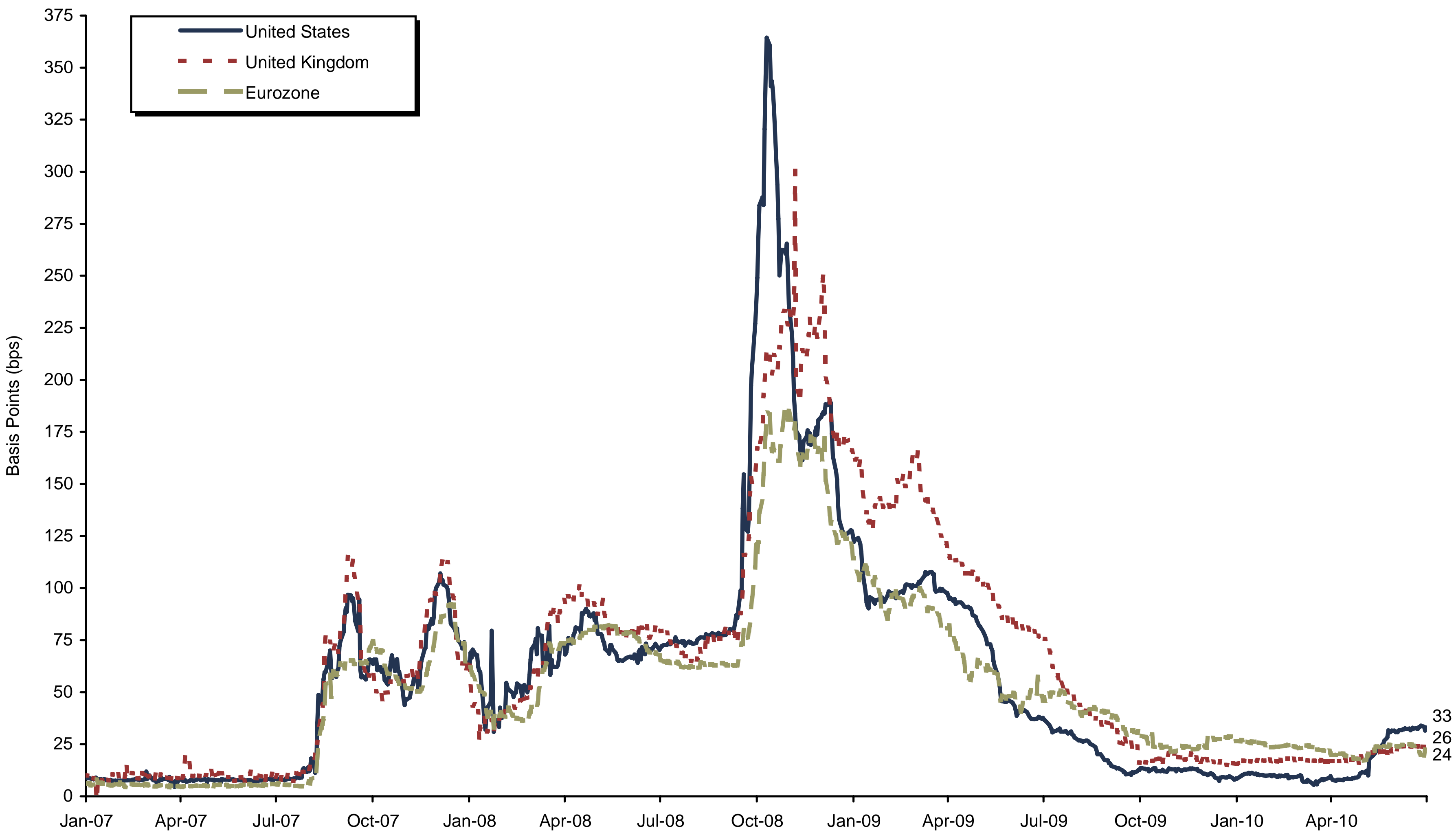


Source: BofA Merrill Lynch.
Notes: Solid bars represent debt maturing. Shaded bars represent fiscal deficits.

Exhibit 3

Spread of Libor to Overnight Index Swaps

1 January 2007 – 30 June 2010

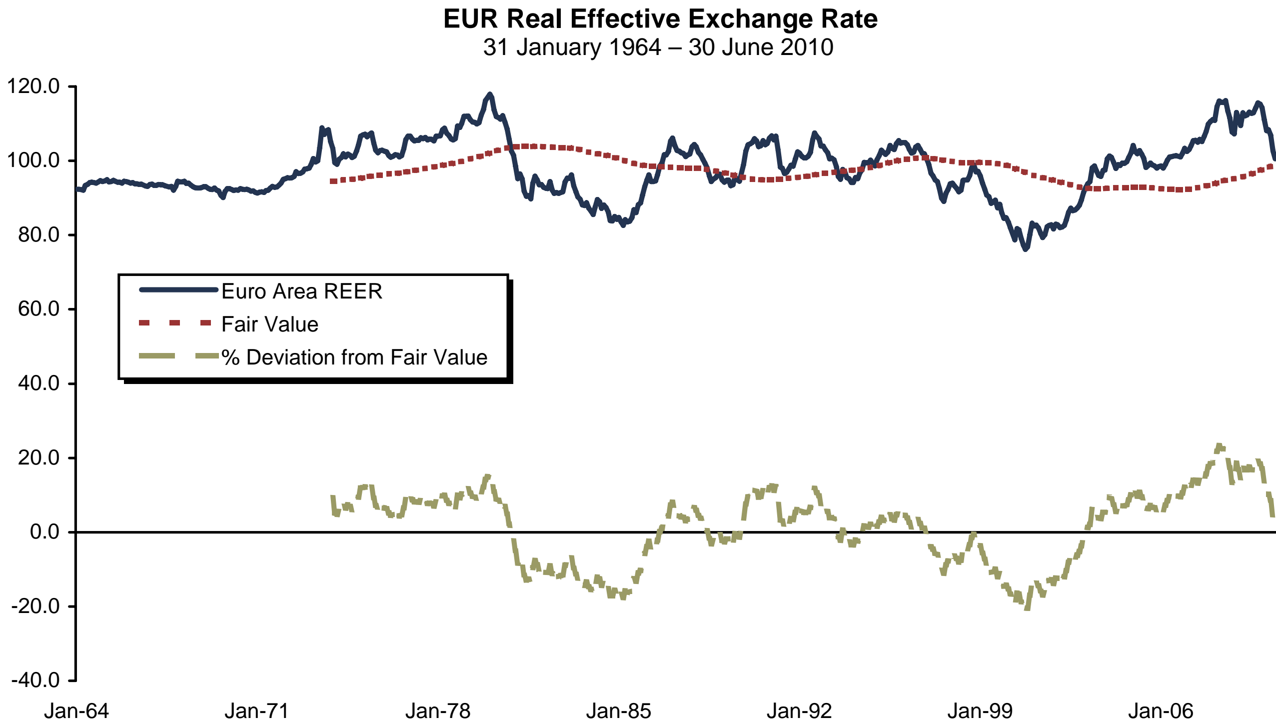


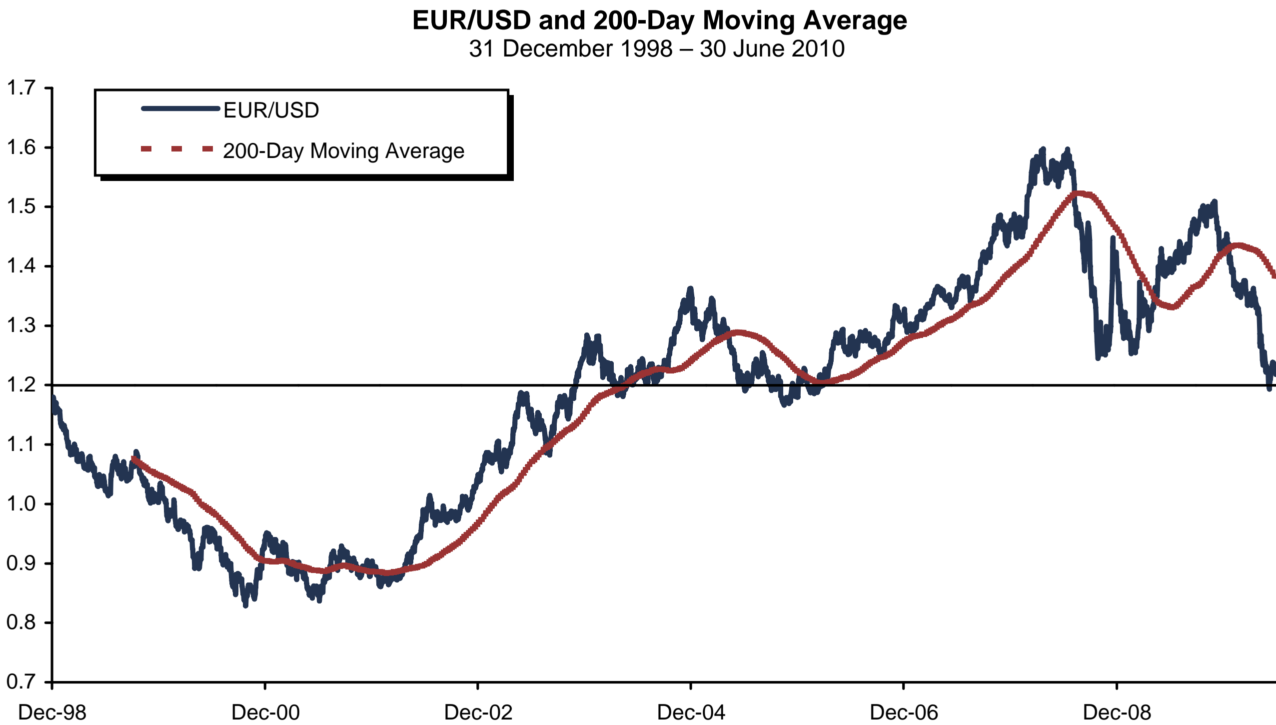
Sources: Bloomberg L.P. and Thomson Datastream.

918m

Exhibit 4

Euro Exchange Rates





Sources: Bank for International Settlements and Thomson Datastream.
Notes: EUR Real Effective Exchange Rate (REER) graph uses monthly data. EUR/USD graph uses daily data. 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. The June data point is estimated using J.P. Morgan's Nominal Narrow Trade Weighted Euro.

Exhibit 5

Cumulative Wealth of Various European Equity Indices

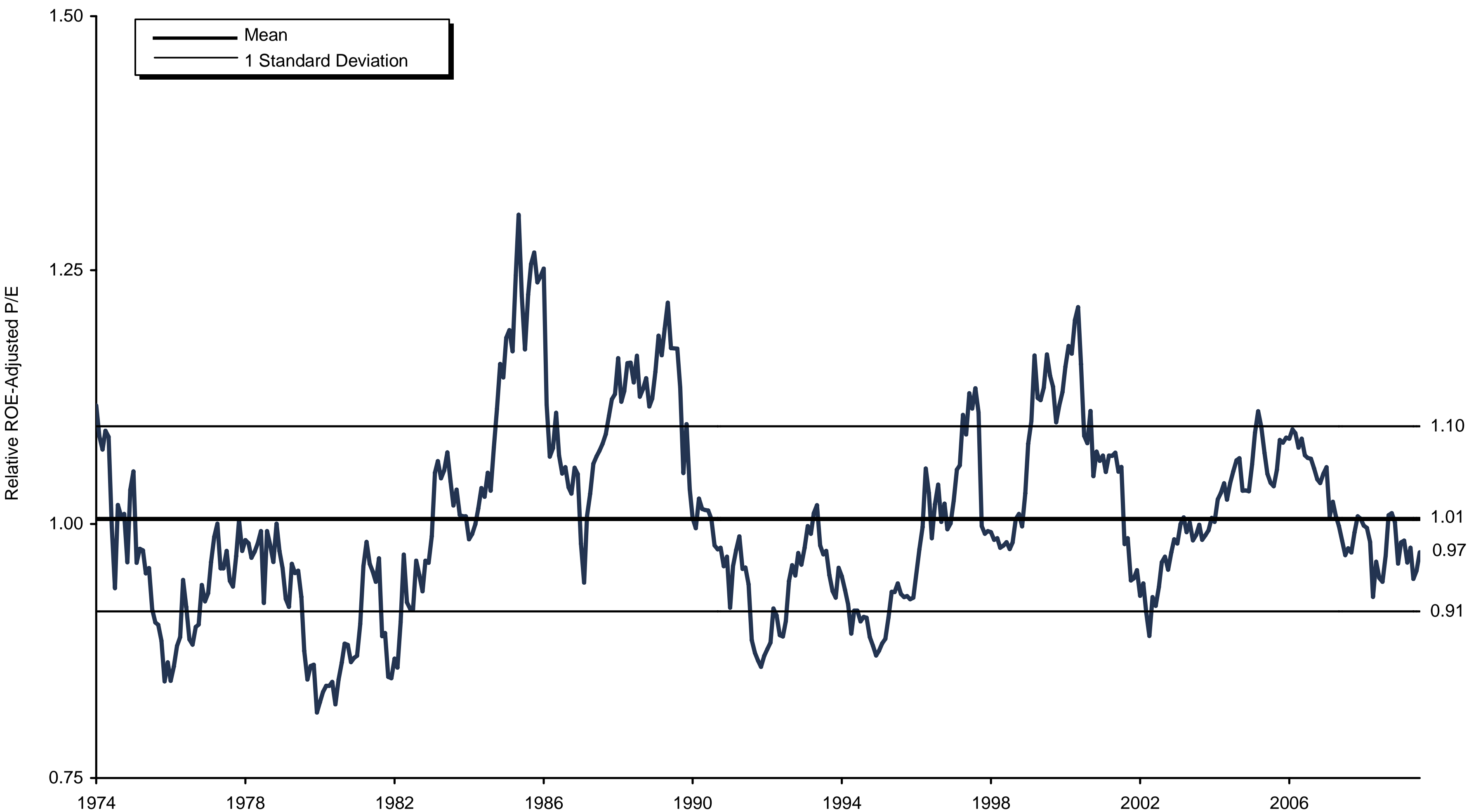
31 December 2009 – 30 June 2010

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

Exhibit 6

Relative Valuations: MSCI Europe ex U.K. Versus MSCI World ex Japan

31 December 1974 – 30 June 2010



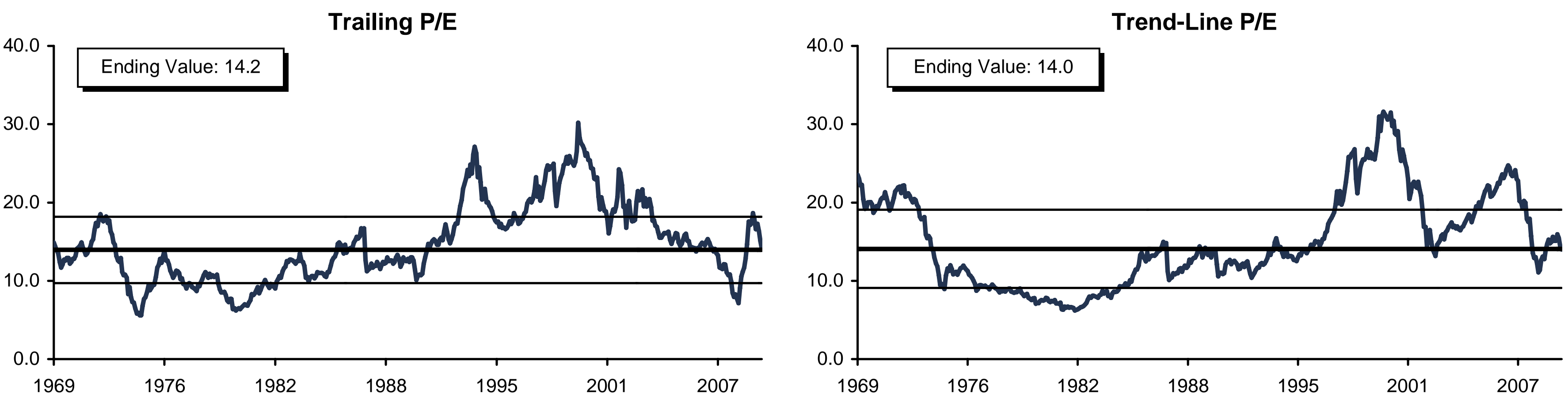
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

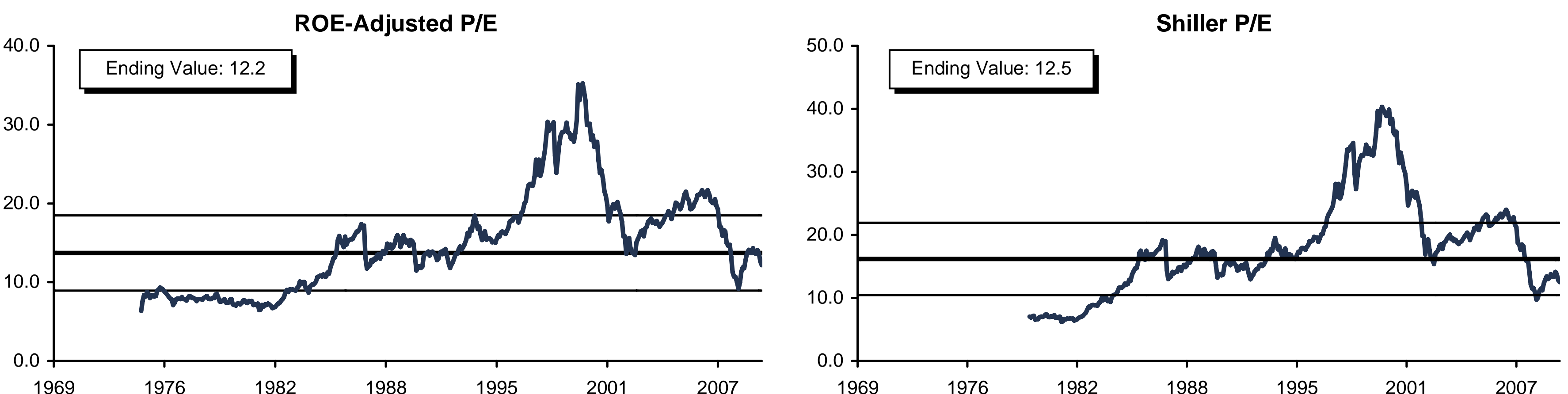
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE. We have removed the bubble years 1998–2000 from our mean and standard deviation calculations.

Exhibit 7

MSCI Europe Price-Earnings Valuations

31 December 1969 – 30 June 2010



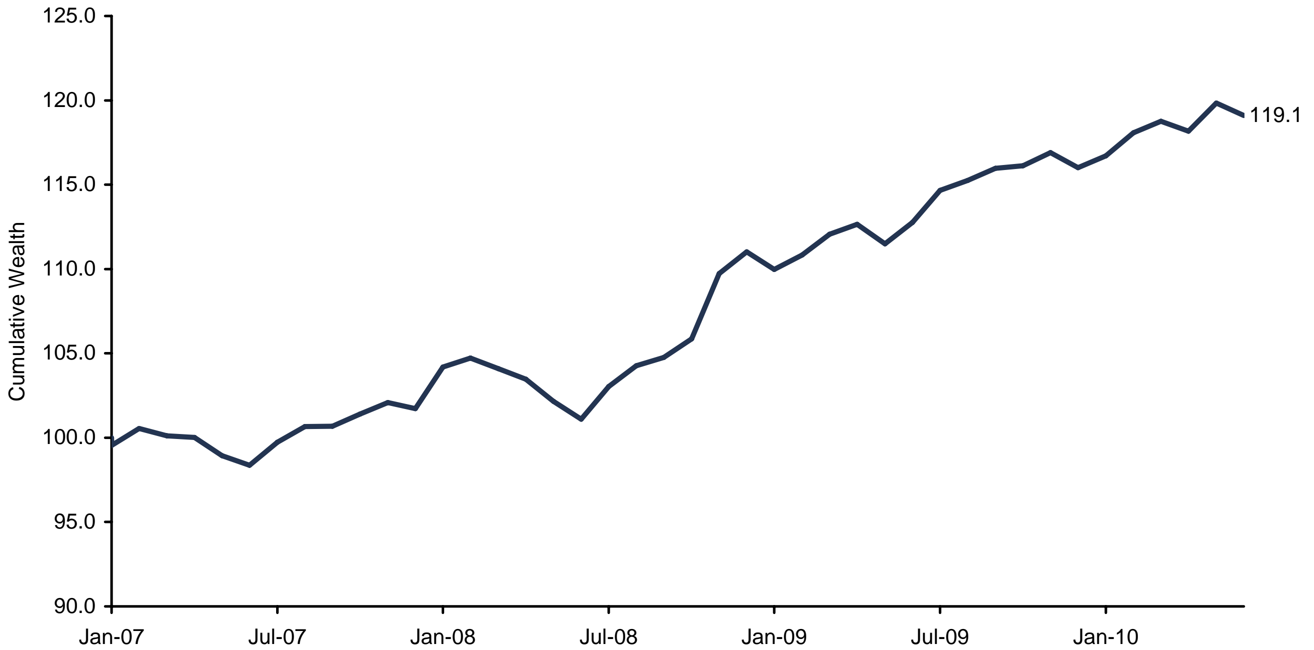


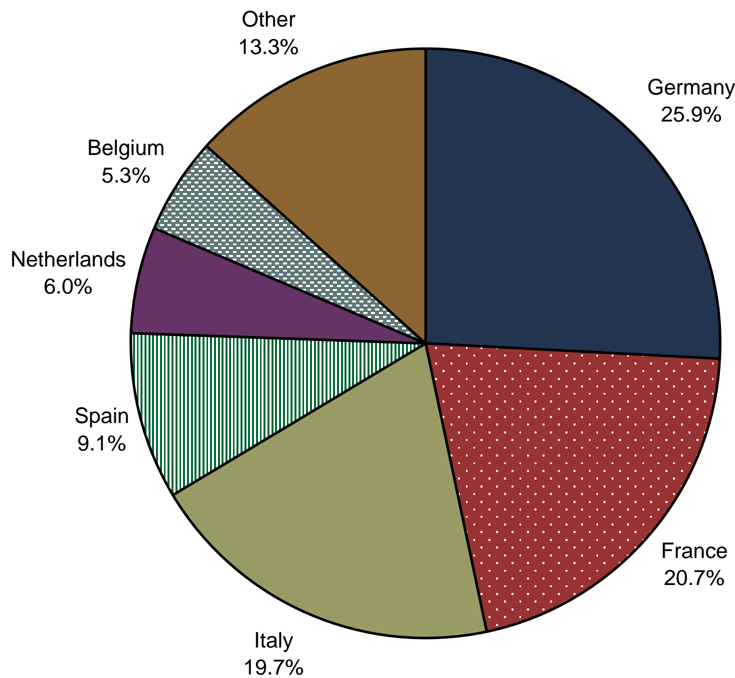
Sources: Global Financial Data, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Earnings deflated by CPI-Eurozone with data before 1996 based on a historical composite calculated by Global Financial Data, Inc. The return on equity–adjusted price-earnings (P/E) data start on 31 December 1974. The Shiller P/E data start on 30 November 1979. The bubble years 1998–2000 have been removed from the mean and standard deviation calculations. CPI-Eurozone data are as of 30 June 2010.

Exhibit 8

Euro Government Bond Index Cumulative Wealth and Country Allocations



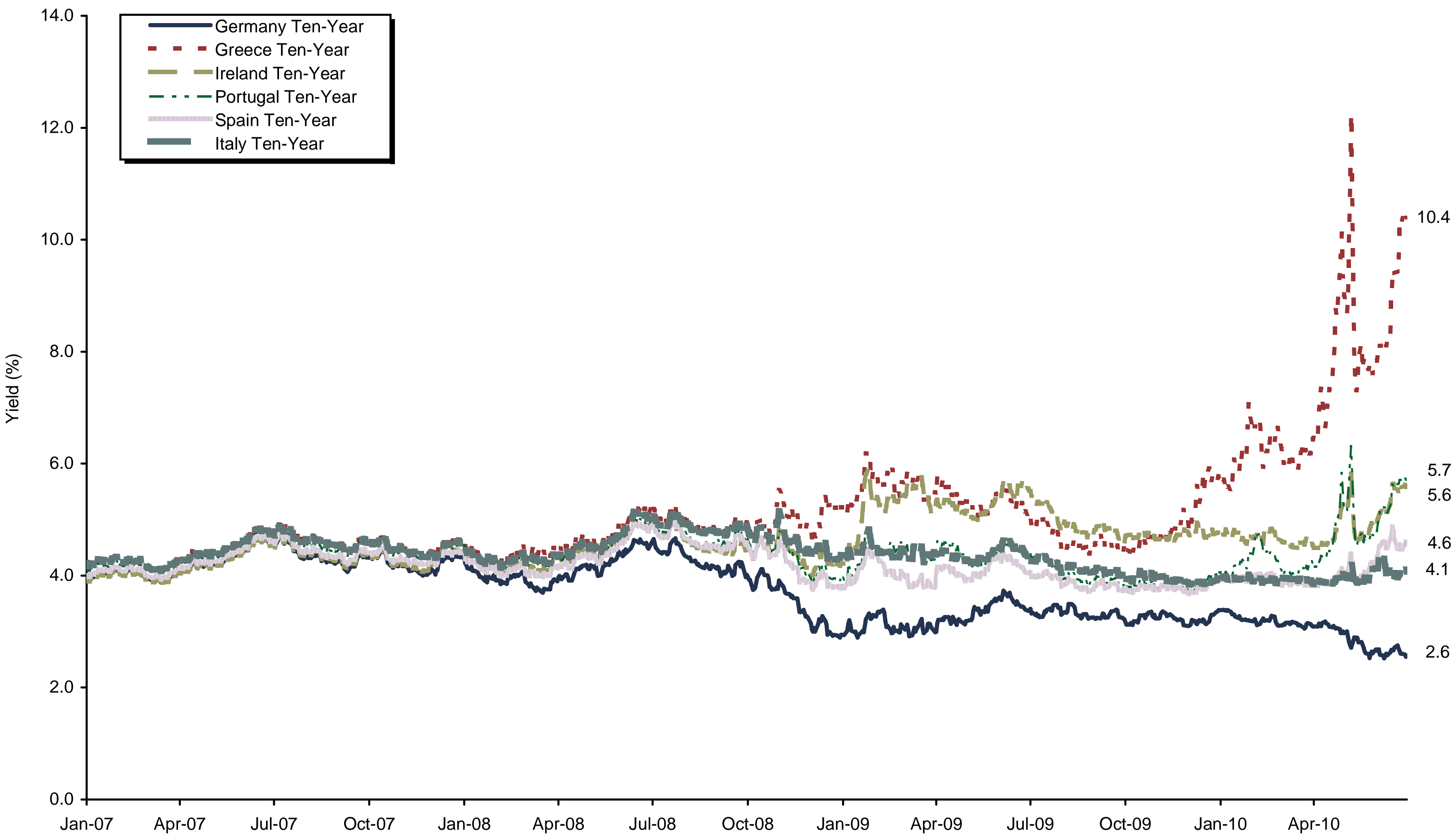


Source: Barclays Capital.

Exhibit 9

Sovereign Ten-Year Yields

1 January 2007 – 30 June 2010



Source: Thomson Datastream.