

Bullish Europe Risk Assets

We began to be bullish US equities 14 Oct 2011. On 13 Jan 2012, we called a buy on Europe across all risk assets on the back of the ECB's unprecedented 3 year repo facility. This was a bit early and required the investor to sit through quite a lot of volatility. Some would have folded in May 2012 on the adverse price movements, but it turned out to be a profitable trade after all.

We continue to like the **US** and **Europe**. **US** equities, while still attractive on the back of a recovery are no longer as cheap as they were a couple of years ago, and are also more advanced in the profit cycle. While we continue to maintain exposure to the **US**, we now turn our attention to **Europe**, an under-represented exposure in many investors' portfolios.

First of all, **Europe** is a high risk investment. The Euro as a single currency clearly doesn't work. Its financial symptoms have been clear enough with mini crises precipitating in the periphery of the Eurozone every so often. **Greece, Italy, Spain and Portugal** continue to look flimsy. The banks continue to periodically wobble. But the true cost of the Euro is yet more insidious, it is that factor markets, particularly the labour market, fails to clear. A host of issues remain unresolved and await the German election where incumbent Angela Merkel is expected to win. After that the hard work begins.

Yet for all its risks and flaws, **Europe** remains an attractive hunting ground for investment opportunities. A number of features make **Europe** stand out as a region where detailed analysis can be rewarded by the discovery of mispriced assets.

1. The global nature of its companies.
2. The heterogeneity of its economies and businesses.
3. The complexity of its financial system.
4. The complexity of its political system.
5. The length and traction of its history.

The current opportunity consists of a number of things. Europe is currently in the

early stages of a recovery, much like the **US** was nearly two years ago. Europe had a different crisis than the **US**. Whereas the **US** leant on and broke the pole of residential housing, **Europe** had an unsustainable financial model and monetary system which was laid bare by sudden contraction of credit in 2008. Europe's economic woes were and continue to be much more serious than in the **US**. As a result, compared with the **US**, **Europe** is still in the very early stages of recovery. Now an inspection of the broad European stock indices might make it appear as if Europe had already recovered, but these are the consequence of global companies listed in **Europe** pulling up the aggregate indices.

Whereas profit margins in the **US** are at cyclical highs, in **Europe**, corporate profitability remains weak. Yet investors are happy to assign multiples of 15X to US earnings and only 12 X to European earnings. **Europe** is facing discounted valuations on trough earnings making the market quite attractive. With a nascent recovery, profitability and earnings have a higher probability of recovering to trend levels. Markets tend to also reward such recoveries with higher multiples. The upside potential is significant.

In the **US** recovery, companies with high operating leverage prospered. A similar scenario is likely to occur, if the European recovery gains traction. As political systems more Socialist and labor markets less efficient, European companies on average have higher operating leverage. Even the much vaunted German companies have codetermination and labor representation on boards. Excess capacity abounds in **Europe**, a delaying factor in a recovery, but a boost to profits when a recovery gets underway.

While the **US** contemplates moderating its central bank asset purchases (QE Tapering), the ECB is expected to remain accommodative. Tightening will not be on the ECB's agenda for some time to come. Cost of debt will remain low, especially for companies with access to the debt capital markets, while global operations provide diversified sources of revenues, making for attractive economics.

In many ways, the conditions that favor European equities may favor European high yield bonds even. Low interest rates, weak positive growth, international companies, bode well for high yield credit.

No investment is without its risks. The risks of investing in Europe, we have already highlighted. The fundamental flaw of the single currency, the Euro, will

create periodic mini-crises, as markets, for goods and services as well as financial assets struggle to clear. This can be a risk as well as an opportunity. Sometimes, the best assets are found in the scrapheap.