# Why We Remain Underweight Europe

*From right to left:*

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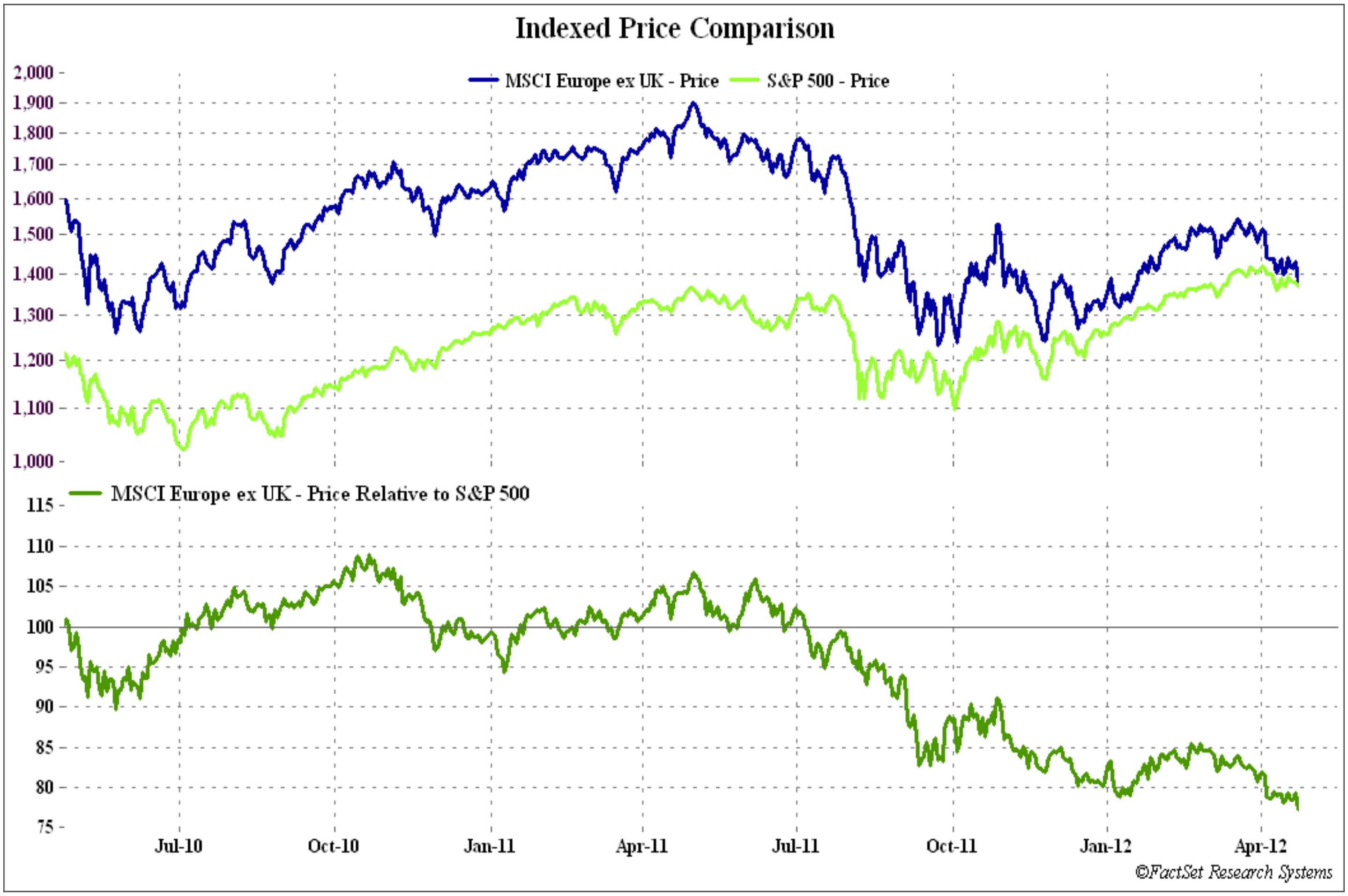
- We are highly selective in our willingness to invest in Continental Europe. While we recognize that Europe appears cheap relative to global equity markets, the potential for continued economic and banking problems, coupled with the absence of a plan for growth, makes us worried that Europe may be a 'value trap.' By this we mean that earnings, especially in the banking sector, may not reflect the risks. If efforts at stemming Europe's sovereign debt crises fail, the International Monetary Fund (IMF) estimates European banks' balance sheets could shrink by $2.6 trillion, which "could do serious damage to asset prices, credit supply, and economic activity in Europe and beyond," according to the IMF's Global Financial Stability Report released last week. Complicating Europe's problems and adding to uncertainty globally are upcoming elections in France and Greece, which could undo recent policies put in place to regain investor confidence. French polls indicate that the Socialist Party is favored to win, while smaller (and more radical) Greek parties are also anticipated to make gains. Although Greece has garnered most of the attention over the last two years, we think the bigger issues are the sovereign debt challenges in Spain, Italy (among peripheral Europe) and now increasingly France and the huge amount of that debt held by Europe's banks. **We are underweight Europe as a whole but we have a position in Germany, given its proven corporate competitiveness and comparatively robust labor markets.**
- Comparing 10-year government bonds, Spanish yields are currently at 6% and Italian yields are 5.7%, while French yields recently just broke out above 3%. All are well below last November's highs — 6.7%, 7.3%, and 3.7%, respectively — but have risen significantly from their March lows of 4.9%, 4.8% and 2.8%. By comparison, yields in the US are currently 2%, Germany 1.7% and Japan 0.9%. Rising yields can be regarded as useful catalysts to force necessary, but unpopular, structural adjustments; however, they also reflect growing signs of financial distress. The ECB (European Central Bank) has bought time with its trillion euro balance sheet expansions and liquidity operations, while the IMF and various European stability funds have provided a bulwark to help shield banks, similar in size to the US' TARP program. Unfortunately, this has been insufficient to restore confidence in a banking system that holds substantial amounts of risky sovereign debt, while credit contraction and austerity measures have tipped Europe into recession. In our view only debt reductions and resolving fundamental competitiveness issues, e.g. labor market reforms, could lead to growth, which is key to government solvency and maintaining the common currency's integrity.
- Ultimately, for the Eurozone to survive, which we think is in the longer-term interests of its members, there must be further support from countries and institutions with adequate balance sheets. As the Financial Times' Martin Wolf writes: "The most likely outcome — though far from a certainty — is compromise between Germanic ideas and a messy European reality. The support for countries in difficulty will grow. German inflation will rise and its external surpluses fall. Adjustment will occur. The marriage will be far too miserable. But it can endure." We agree that the situation is messy and

will involve significant compromise by all. **We do not doubt the current leaders' desire to preserve the euro or the huge challenges involved for any country that exits, but we expect more political fallout from the 'miserable' economic conditions that German demands for austerity put on the rest of Europe.**

- **Short term, we think the return of rising credit spreads, political polarization and further economic weakness is a good reason to remain underweight. Longer term, if Europe becomes willing to embrace labor market reforms then some of the value might be unlocked.**

## THE WEEKLY CHART: EUROZONE RELATIVE PERFORMANCE MAKES NEW LOW




Our chart compares the performance of Europe excluding the United Kingdom with the S&P 500. The top panel shows each equity index; the bottom panel shows the relative performance of Europe to the US. Europe is underperforming when the line in the bottom panel is falling. Europe excluding the UK has been underperforming the S&P 500 since the summer of 2007. After outperforming this January and February, Europe's longer-term trend of relative under-performance has resumed, making new lows. Also noteworthy, the S&P 500 (top panel, grey line) has risen above its April 2011 high while Europe remains well below its year ago peak. Thus Europe's technical picture supports our negative fundamental view and keeps us underweight.