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Restoring Europe to a Neutral Weighting

Last week we completed a process (begun two weeks ago) of restoring our weighting to European markets to bring them in line with our Price Matters® strategic weightings in our portfolios. Our rationale is simple -- all three of our investment rules suggest that being underweight is no longer appropriate.

1. **Don't fight the Fed:** The immediate catalyst is our rule of not fighting the Central Bank, in Europe's case the ECB. Talk is cheap, but when ECB Chairman Draghi said in late July that he would do "whatever it takes" to keep the Eurozone together, the euro bottomed as did the relative performance of European stocks. Draghi has backed up his words with aggressive diplomacy and, more recently, the framework of potentially "unlimited" purchases of short-term European debt. We see this as a possible game changer only in that it buys time for Europe to tackle its longer term issues. We believe the US household and business sectors have used similar Federal Reserve support over the last three years to greatly improve their balance sheets and competitive positions. We remain skeptical as to whether Europe will do as well, but we see a stable source of low-cost financing as an essential first step.

Short-term interest rates in Italy and Spain have fallen significantly since late July, confirming that investors are placing some credence in ECB Chairman Draghi

2. **Don't fight the Trend:** Europe's primary down-trend, as measured by its 200-day moving average, has stabilized and the price is now above it, as illustrated in our Weekly Chart. Furthermore the relative downtrend appears to be stabilizing, so we no longer want to be underweight.

3. **Beware the Crowd at Extremes:** Pessimism about Europe has been fairly extreme for some time, justifiably so in our view. Europe has underperformed significantly in terms of economics, the stock market, and earnings. As a result, Europe has been selling at a significant valuation discount (we estimate 20 to 30%). If the ECB now has the tools and the desire to 'buy time,' then we think Europe's underperformance can begin to reverse. The sustainability of any recovery will be dependent on the performance of businesses and households, but the case for being underweight has become less compelling to us.

Whether the Fed acts with Quantitative Easing 3 this week, their belief in, and commitment to current policies was re-enforced by Bernanke at the Jackson Hole Summit

Economic Data Mixed: The case for easy money remains. The August employment report was disappointing, with an increase of just 96,000 new jobs and the previous two months revised down by 41,000, bringing the three-month average of monthly job gains to a lackluster 94,000. Goods-producing industries shed 16,000 jobs, service providers added 119,000, and government lost 7,000. The unemployment rate fell to 8.1% from 8.3% but this was due to 368,000 people leaving the labor force, which took the labor force participation rate to 63.5%, a three-decade low.

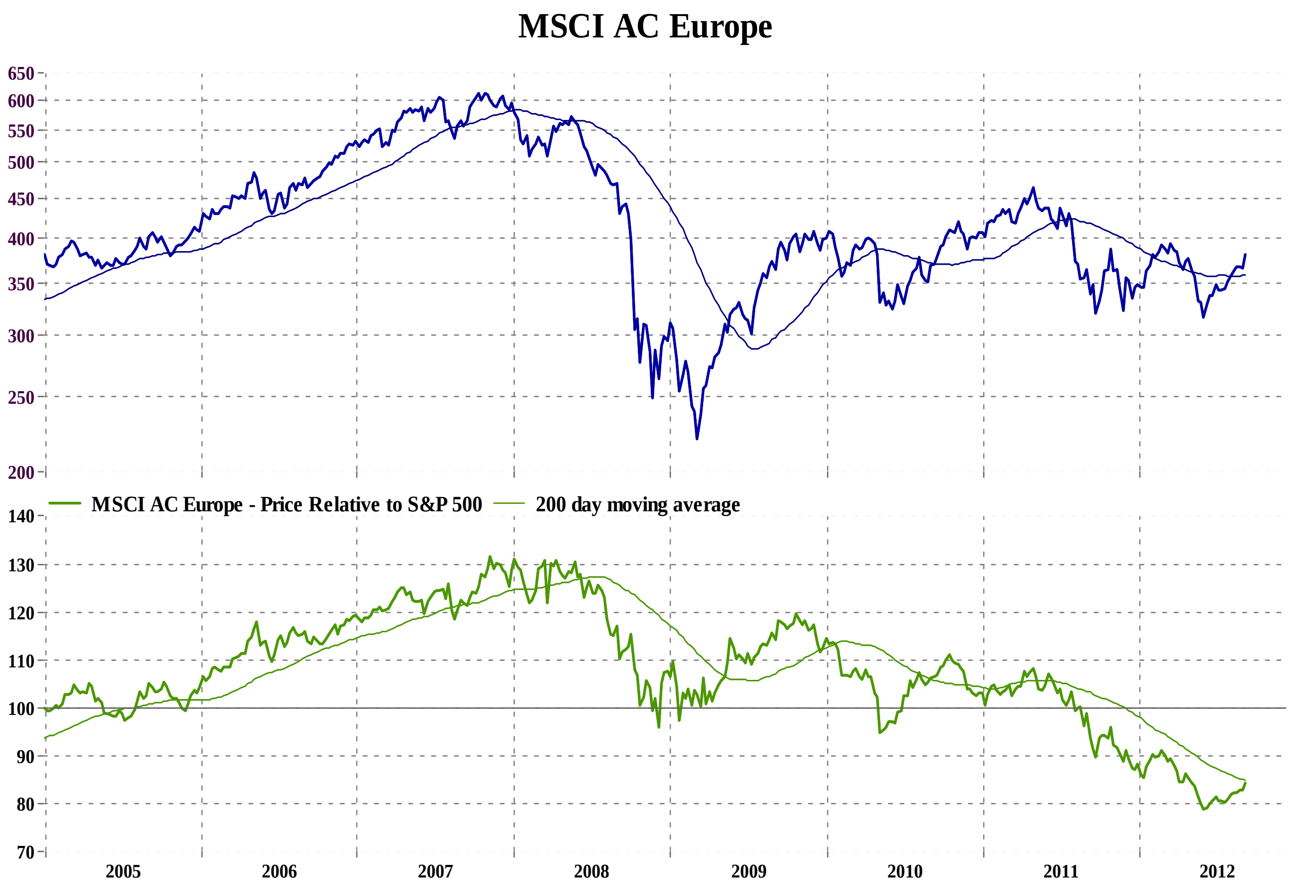
The weak jobs picture was reflected in the ISM manufacturing index, which stayed just below 50 (indicating contraction) for the third month in August. The leading new orders component fell almost a point to 47.1, implying further weakness ahead, especially with the global economy decelerating as China slows and much of Europe is in recession.

August's ISM non-manufacturing report on business was an important bright spot last week, since services reflect about 80% of US economic activity. The non-manufacturing index rose more than a point to 53.7 in August, while its employment component increased

4.5 points to 53.8, suggesting ongoing economic and jobs growth. So while US industrial production is starting to sag, consumer spending is holding up along with the housing market; two sectors that should keep the US out of recession if most of the 'fiscal cliff' is avoided next year as we expect.

Another bright spot is a growing consensus that the Fed is likely to implement a third round of quantitative easing on Thursday, given Chairman Bernanke's concerns about the pace of job creation and the effects of long-term unemployment. This expectation has helped risk assets like stocks and inflation hedges like gold rally. If the ECB and Fed follow through with bond purchases, we think these rallies can be sustained.

THE WEEKLY CHART: EUROPEAN STOCKS – TRYING TO TURN THE CORNER



Source: FactSet Research Systems; Past performance is no guarantee of future results.

The top panel of our chart shows the price performance of MSCI's All Country Europe Index (which includes developed and emerging markets) and its 200-day moving average, which we regard as the primary trend. The index broke out above its primary trend early this past August, and the trend has now begun to rise. The bottom panel shows the price performance relative to US stocks, as represented by the S&P 500. Relative performance bottomed early in June and has risen up to its 200-day moving average, reflecting Europe's outperformance of US stocks for the past three months. However, our enthusiasm for this recent period of relative outperformance is tempered with the recognition that there have been several episodes of such outperformance during Europe's four-year period of relative underperformance. If Europe has indeed 'turned the corner' we would expect to see the upturn of the primary trend in the top panel become more pronounced and the relative primary trend begin to flatten out, but from a 'don't fight the trend' technical perspective, we no longer want to be underweight Europe.