August 7, 2013

Europe, One Year Later
Our Conviction Remains

Since 2010, each summer has come with a different shade of panic. In 2010, we had the Greek crisis and riots sparking the Flash Crash. The summer of 2011 was scarred by the “Debt Ceiling Crisis” and S&P’s downgrade of the U.S. Government’s credit rating alongside continued European woes[1]. 2012 saw an escalating round of fears in the E.U. shake markets until Mario Draghi declared he will do “whatever it takes” to ensure the Euro lasts as a common currency[2].

After the fixed income torrent in June, many pundits warned a spike in interest rates would cause this summer’s sock. Meanwhile, markets calmed substantially during July. Interest rates rose moderately on the month, while the Russell 2000 led stocks forward with a 6.86% gain, and the S&P tacked on 5.16%. The major headline economic data continued its positive momentum, with continuing unemployment claim registering new recovery lows, indices of manufacturing production (the ISM and PMI both) accelerating to levels not seen since the initial bounce-back from recession, and consumer confidence recording a post-recovery high. This sits in stark contrast to the path of the last three summers to the point where the calm warrants our acknowledgment.

Just last summer, we made clear our contrarian stance towards the EU crisis in our commentaries, and by buying cheap, multinational European businesses, including two financial firms (one bank, and one bank/insurer)[3]. Our conviction level in these businesses continues to increase as time marches on, and only now are many catching on to the attractive opportunities out of Europe. The move upward in these markets since last year was reflective of Europe taking a step back from its abyss, while the economies themselves continued to contract and/or deteriorate.

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[1] http://online.wsj.com/article/SB10001424053111903366504576490841235575386.html

[2] http://blogs.wsj.com/marketbeat/2012/07/26/stocks-jump-on-draghis-whatever-it-takes-comment/

[3] http://www.rgaia.com/july-2012-commentary-bulls-and-bears/

Today, we can finally say that economies are improving in Europe. In July, the Eurozone Purchasing Managers' Index (PMI) came in at 50.5, improving upon June's 48.7 number[4].

This is important, because a PMI greater than 50 is associated with economic expansion, while a number below 50 is contractionary. Significantly, this is the first positive PMI for Europe in two full years and it was drive by tangible improvements in some of Europe's weakest economies.

Just this month, Barron's featured its call for European economies to "rebound" on its front pages, arguing that the ECBs actions have helped stabilize the financial sector and the rally in U.S. equities has left Europe particularly attractive in relative terms[5]. The positive

[4] http://www.cnbc.com/id/100938465

[5] http://online.barrons.com/article/SB50001424052748704093404578613863100842212.html#articleTabs_article%3D0

feedback loop driven by the US economy's consistent improvements is but one of the key drivers for Europe. We remain positioned accordingly.

Feedback Loops:

Feedback loops play important roles in markets, and only recently has the negative cycle broken in Europe. We are at a possible positive inflection point, though by no means is that a certainty. Last July, we observed the following about the negative feedback loop out of Europe:

> The second substantial factor is Europe's role in emerging markets. Europe is a major end market for China in particular, and further, European banks are some of the primary financiers to the emerging world. European banks are far more global than our American institutions and with market dislocations plaguing the Eurozone, banks are reigning in on their activities outside of their home domiciles. Some of this is pure risk management, while some is mandated action at the hand of concerned regulators. With Europe slumping, many of these emerging markets have stagnated in growth due to the drop in demand.

This was an important observation at the time, and many still take for granted Europe's role as lifeblood for global finance. As of July, Emerging Markets (as represented by the EEM) are down 10.73% year to date. These economies are slowing for various reasons, including the managed transition from an investment to consumer-driven economy in China, though rarely will one hear about the role Europe's own travails play in the emerging market woes.

Latin America is one region in particular where European institutions have been selling assets and pulling out capital. In our opinion, this is starting to create some very interesting opportunities, with emerging markets as attractively valued on a relative basis to the U.S. as they have been in over a decade. With the break in Europe's negative feedback loop, we can see a path to Emerging Markets regaining favor, though we approach this part of the globe with far more suspicion and uncertainty than we did Europe.

There are several unquantifiable risks, including serious questions about the rule of law in some domains. As such, we pursue exposure to these areas primarily through U.S.-based multinational firms that enjoy earnings leverage to Emerging Markets, without risking permanent impairments to earnings should Emerging Market growth not play out as planned.

A Global Portfolio

We are not purposely neglecting the U.S., but rather, we are simply seeing far more attractive opportunities globally on both an absolute and relative basis. As U.S. markets have continued their strong 2013 through July, the cheap values at home are fewer and farther between. This is a good thing! Our economy here continues to improve, and just might reach "escape velocity" from the financial-crises doldrums in the not-to-distant future. U.S. equity markets are certainly starting to anticipate such an improvement.

In this day and age, with tightly integrated global economies, a global portfolio is no panacea against economic troubles in one region; however, it is a way to diversify some of the correlations and risks to which our portfolio is exposed, and is a means through which we can allocate towards only the most sensible of value-based opportunities.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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