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EUROPEAN EQUITIES – IT'S DEJA VU ALL OVER AGAIN JANUARY 2012

Friday evening saw the widely anticipated downgrade of France's sovereign debt rating by Standard and Poor's from triple A to double A plus (with a negative outlook). Austria was also downgraded by the same amount (due to fears of Austrian exposure to Eastern Europe), which leaves only four eurozone countries with triple A ratings: Germany, the Netherlands, Finland and Luxembourg.

This past week also saw the deterioration of negotiations between international creditors and the Greek government on the prospect of taking voluntary haircuts on outstanding Greek sovereign debt.

What are the implications of the ratings downgrades?

It is easy to say that these downgrades were already "priced" by the bond markets. That doesn't stop the embarrassment factor for, in particular, the French and Austrian administrations. Could this mean the end of the "Merkozy" love-in we have seen over the past few months? This is more likely now than before. Sarkozy has an election to fight in May, and it is difficult to argue that France and Germany are equal at this stage of the crisis (if they ever were).

This downgrade drives a wedge into the inner core of the eurozone, with France moving ever closer to becoming a "problem country" rather than a "solution country". Clearly the loss of triple A by France also has significant negative implications for the creditworthiness of bailout vehicles such as the European Financial Stability Fund, or EFSF – of its €440 billion firepower France accounts for €158.5 billion and Austria €21.6 billion. The proposed €500 billion permanent rescue, known as the European Stability Mechanism (ESM) also relies on direct capital contributions from its members.

We have argued consistently that a lasting solution can only be found if the Germans allow the ECB to print money and become the lender of last resort for Europe. Estimates suggest that the deleveraging required by the European Banking Authority (EBA) to achieve target capital ratios in the banking sector will result in a credit contraction of around €4 trillion from the European banking system, unless capital can be raised by other means. The dismal performance of Unicredit since the announcement of its deeply discounted rights issue shows that this route is not attractive for most entities.

We still consider it very likely that there will be government involvement in this process, à la the UK in 2008/9. In the UK and the US QE has been successfully deployed to plug this deleveraging deficit – without which these economies would have seen significantly more contraction since the 2008 banking crisis. Our belief is that the ECB needs to do the same for Europe, in a decisive and direct manner.

The announcement of the Long-Term Refinancing Operation (LTRO) in December has been hailed by many as QE by the back door. So far we have only seen a very small amount of the approximately €480 billion borrowed at the ECB LTRO window in December deployed by the banks that borrowed it. If this money is used to buy back sovereign and bank debt below par values,

then there is a positive effect from both deleveraging and effectively raising bank capital through the capital gain. The danger is that the European banking system, fearing a banking crisis, hoards that capital in order to maintain liquidity and does not do the quasi QE. The downgrades make this scenario more likely.

Ultimately we are still waiting for a package which, as well as promoting austerity, also stimulates growth. This would include unlimited and unsterilised QE from the ECB. Without this we fear a severe and potentially prolonged recession for the eurozone.

What about the Greek situation?

Greece looks like it will now default – the only question is whether this is done in an orderly or disorderly way. Ironically a Greek exit is likely to strengthen the euro, at least temporarily. There has been a well flagged deposit flight from Greece of roughly €65 billion – one third of total deposits – which suggests that Athens requires a further €10 billion to recapitalise its banking sector. As the situation in Greece worsens, October's €130 billion rescue package looks increasingly insufficient. A disorderly default, which would trigger instruments such as CDS, could lead to a run on the global financial system with potentially serious unforeseen consequences. Furthermore with Portuguese debt now rated as junk, how long will it take before markets start to apply the same degree of pressure to Portugal as they have done to Greece?

What is happening in European stock markets?

We have been advocating avoiding exposure to domestically focused businesses, regardless of their defensive or cyclical qualities. The importance of this theme was amply demonstrated last week through results announced by Tesco and SAP.

Tesco's results were disappointing and were harshly punished by the market. The UK franchise has begun to under-deliver, and it seems that management has under-invested over the past few years in order to maintain historic levels of profitability. These results indicate a resetting of expectations for domestic profitability to a lower level in the future, leading to downgrades of around 10% as well as a de-rating of the stock. The stock is likely to trade lower so long as the market remains sceptical about the management's plans to regain previous margin levels.

Conversely SAP, the German software company, has a global franchise selling to mainly large business customers (B2B). It also has a strong product cycle which is driving its substantial existing client base to upgrade. Despite warnings elsewhere in the sector from the likes of Oracle and Software AG, the company posted record results which saw double-digit growth across all regions. SAP is one of our largest holdings in the funds.

We feel that markets are likely to be increasingly discriminating between domestic and global businesses over the coming months. This does not lead us to any significant sector conclusions; rather, the source and sustainability of earnings will be scrutinised at a stock-by-stock basis. The Q4 earnings season will provide an opportunity to hear how companies are seeing the outlook for profits in the coming quarters.

As expected, results so far have been mixed, with a bias towards the negative. The results season doesn't really start until next week but our expectation is that companies will be cautious with their outlook for 2012 – there are unlikely to be many positive revisions to companies' forecasts.

How are our funds currently positioned?

In simple terms our positioning and strategy can be summarised as follows: we are avoiding domestic exposure, avoiding value traps and selectively favouring income where that income is stable and growing. Most of all we continue to

prefer high quality companies which can continue to grow in the current environment. Typically these are companies with higher than average margins, returns on capital and cash flow where we believe there is a sustainable competitive advantage. We continue to be underweight financials. This overall positioning is unlikely to change until the policy responses we expect (above) are more likely. When it does change, however, it may change quickly. We therefore need to maintain a nimble approach.

We continue to believe that selectively the opportunities in Europe are very attractive. The good companies continue to be dragged down by the macro situation and are typically priced at a discount to their global peers. We are not universally defensive in our portfolios, as we believe that a business's geographic and end market is currently more important than its underlying cyclicality.

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