AUREUS ASSET MANAGEMENT

Aureus Asset Management
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Europe: Measurable Progress towards a Brighter Future

We believe that 2012 was a watershed year for Europe. New leadership at the European Central Bank (ECB), new political leaders in Italy, Spain, and Greece, and a new and constructive attitude towards Greek debt were signal events.

From 2007 through much of 2011, headlines from Europe were grim. A wide gap opened between the north, led by Germany, and the south, led by Italy and Spain, in productivity, competitiveness and general economic health. Many observers questioned whether the euro zone could hold together.

The headlines slowly shifted in 2012. New leadership produced painful but necessary changes in economic policies. These changes promise a return to better times ahead, once they have been implemented throughout the European Union.

We argue that Europe is slowly but definitively moving forward. While high unemployment might derail progress, through a major political upheaval, we remain hopeful that today's policies will attract increasing support. Barring a political return to the outmoded past, investors may have interesting opportunities in both the stock and bond markets of Europe.

I. The European crisis began in Ireland in 2008, spread to Greece in late 2009, and from there to Portugal, Spain and Italy. The hallmarks of the crisis were enormous bailouts, bank recapitalizations, forced write-offs of debts both private and public, recessions in southern Europe and changes in political governments. The crisis took its toll on the securities markets, with yields of sovereign debts of southern countries rising rapidly to a peak last July. By last summer, the Greek stock market had shed 90% of its peak 2007 valuation, with other southern European markets down between 35-60% from their peaks.

Then, positive things began to happen. The most significant change was in the leadership of the ECB. The ECB had maintained its conservative, anti-inflation, tight money stance throughout 2009 and 2010. However, when Mario Draghi took the helm of the ECB in 2011, he moved swiftly to try to rescue Europe from stagnation. Initially, he instituted a lending facility of several hundred billion euros at 1% for three years, which European banks took advantage of early last year, to restore their stretched balance sheets. Then, last August he declared that the ECB would do everything in its power to prevent the euro zone from splitting apart, and he assured investors "that it will be enough". Central bankers almost never make sweeping statements like this. Because of its rarity, Mr. Draghi's assertion immediately restored calm to financial markets.

Other positive changes occurred in Italy, Spain and Greece. New and different political leaders eased stifling labor regulations, modified far too generous pension policies, cut business taxes and improved collection procedures, and started to reduce budget deficits. These changes were painful for many segments of society which had become used to large and generous government benefits, and there were a number of protests.

To date, demonstrations have not forced governments to abandon their new, tougher economic policies. The Italian election in late February will be another important touchstone in this pathway. Assuming that the new government backs the reforms instituted by Mario Monti, prime minister for the past 15 months, Italy will join Spain and Greece in electing governments committed to long-term substantive improvement in their competitiveness.

In addition, governmental bodies which had lent large sums to Greece offered to delay principal payments and slash interest rates. This action means that Greece has averted debt crises for several years. While the total principal amount of public sector debt remains the same, the terms have been generously altered in a way that seemed inconceivable a year ago.

Reversing those outmoded policies, which had led Europe almost to the point of collapse, is both arduous and time-consuming. However, from the ECB to the various governments of the Continent, 2012 became a year of crucial and positive change. The ECB as well as all major governments either explicitly or implicitly endorsed new monetary and fiscal policies, which should lead Europe along the right path.

II. The investment implications of the political and economic actions of 2012 are positive. Initially, the sovereign bond markets of southern Europe showed the greatest improvement, with yields in Spain and Italy down from over 7% to a 4-5% range. Even Greek debt doubled in value from its lowest point of last July.

European stock markets also showed strength in the third and fourth quarters of last year, with Germany leading the way, up over 27% for the year. Valuations, despite upward market moves in the past few months, still appear attractive. Price earnings multiples are about 10-11x, vs. 13-14x in the US. There are many world class companies in Europe, with strong balance sheets, high quality products, and good growth prospects.

Conclusion

Aureus believes that last year proved to be a key turning point for Europe. Assuming that European governments continue to follow today's policies, there should be many exciting investment market opportunities, in both European equity and debt markets.

Aureus will discuss with its clients these opportunities and how the firm is trying to participate in them.