



EUROPE LEADS FLIGHT TO QUALITY

Our cautious stance has paid off this quarter as many of the risks we were concerned about have begun to play out. This has led to a flight to quality, which is where we are positioned, and has helped us to outperform.

Our present situation feels like *déjà vu* from last year. In Q2 of last year we were introduced to the Greece and Ireland debt problems. A European short-term bailout and a Federal Reserve QE2 later, and all trouble was forgotten.

However, one year later, we are back where we started. Greece is in trouble again and Portugal, Spain and Italy have been added to the mix. European banks are struggling and will need more capital due to these problems and more. In the US, QE2 has run its course and the sluggish economy is back to where it was prior to QE2. The Fed's recently announced Operation Twist seems unlikely to boost the economy out of its softness.

Is this merely a pause that refreshes or should we be concerned about a 2008 redux? We look at the global landscape to gauge where earnings and stock markets may be headed.

EUROPE

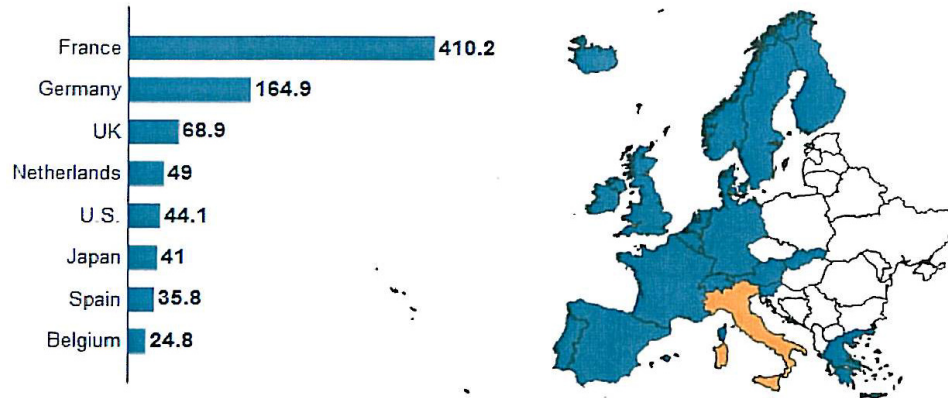
All roads lead to Rome. Italy is too big to bailout and if the Greek crisis makes its way to Italy, we may see a 2008 redux. French banks have large exposures to Italy sovereign debt and if France is forced to step in and nationalize/recap its banks, it will lose its AAA credit rating. If that happens, then Germany will be the only sovereign of size left in Europe to bail anyone else out. If Germany were to take on a European rescue, its Debt/GDP ratio would rise to 130% and they would lose their AAA credit rating and they would lose the ability to bail anyone out.

So the reason that Greece matters is its impact on contagion. That is, if Greece defaults, then investors could bid up Portugese bond yields due to worries that it defaults too. Those higher yields add to their fiscal deficit due to increased financing costs and make it more likely that Portugal will default. It can become a self fulfilling prophecy if investors are not convinced that the authorities will do something to protect investors from such losses. If Portugal defaults, then maybe Spain will. If Spain does, then maybe Italy will. The dominoes keep falling until we reach a new equilibrium. The problem is that that new equilibrium will be at much higher yields for sovereigns and banks and will mean much slower global growth if not outright contraction.

European bank exposure

Italy

Bank exposure to Italy - \$ billions



[For breakdown by debt type for selected countries click here](#)

Source: Bank for International Settlements - data as at end March 2011



Reuters graphic/Scott Barber

10/08/11

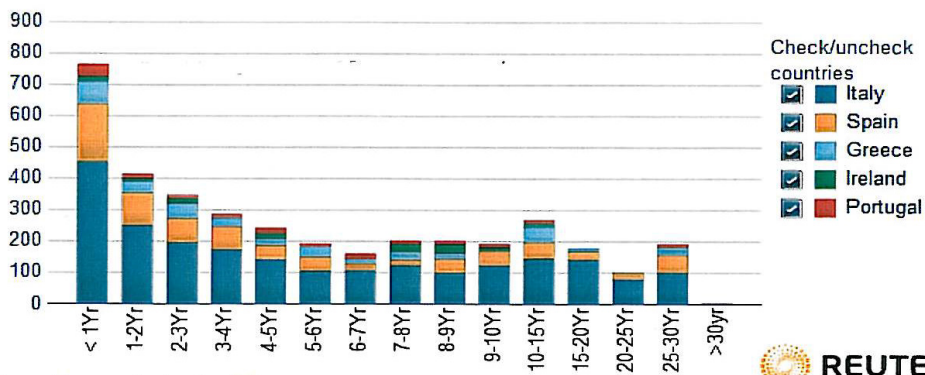
Peripheral government debt maturity

Government debt by maturity

\$ billions

Choose display Value

Proportion



Source: Thomson Reuters CreditViews

Reuters graphic/Scott Barber



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Also, this is not an issue that might arise in the distant future. Italy, Spain and Greece have significant debt that matures over the next year and will need to be rolled over.

So that is why the lights are on at all hours of the night in European capitals. It is also why the IMF and EU institutions are getting creative to come up with ways to increase bailout funds. The idea being that if investors are convinced that the authorities have the firepower to rescue them, then said investors will continue to invest and keep yields low and perhaps a bailout will not be needed or at least will be minimized. It is the Hank Paulson “bazooka” approach from 2008.

Will those worries come to fruition? That probably is not the most important question for us. Rather it is will the earnings environment for the next couple of years be better or worse than it is right now. Even if contagion does not take hold, the increase in interest rates and cuts in spending could make earnings growth slow and stocks worth less. If there is a better than even chance that the earnings environment deteriorates, then we should be cautious. We currently believe that the risk is better than even and thus we are in a cautious stance presently.

BANK CAPITAL

Banks are instruments of a country’s monetary policy and can impact the growth of a country’s economy and the earnings of companies that do business in that country. As such, the health of banks, or lack thereof, have a large impact on economic and earnings growth. Bank capital growth or shrinkage impacts the ability of these banks to make new loans and grow an economy. This is why the US recapitalized its banks with TARP in 2008 because principal losses reduced bank capital and threatened to shrink loans (and therefore the economy) in the US without a capital infusion.

Banks are the most leveraged sector in the market. As such they try to minimize risk by taking senior credit positions in loans with the goal that they minimize principal losses to acceptable levels. The total amount of bank assets is limited by the type of assets it has and the capital that it has. In normal times a bank has few losses so it levers up its capital to the limit to maximize earnings.

Regulators set minimum capital ratios to limit the maximum leverage in the banking system. In simplistic terms a 10% capital ratio implies 10:1 leverage while a 2% capital ratio implies 50:1 leverage.

So how much capital do banks have? Well it turns out that the answer is a moving target. In theory, capital is what is left over when you subtract liabilities from assets. That sounds straightforward but the trouble comes when trying to value the assets. That is why there is a footnote to balance sheets that divides assets into three levels. This tries to give the reader an insight into what portion of assets are valued based on liquid markets or a more subjective value from the company.

A more subtle notion is Risk Weighted Assets (RWA). This notion tries to level the playing field for banks with different risk profiles. The idea is banks that only make nearly riskless loans need less capital than banks that make more risky loans. In theory this makes sense and is a shorthand way of using a single metric to measure the relative safety of a bank regardless of the underlying asset profile.

RWA implicitly assumes that the relative risk of the asset class remains the same and that credit ratings are timely. In the old regime where all assets were treated the same, a bank may need 10 cents of capital for every dollar of AAA US Treasuries or AAA French Euro bonds that it held as assets (note that the numbers are merely illustrative). Under a RWA regime, the bank may need only 2 cents, or less, of capital for every dollar of such bonds. Under RWA, the bank could hold 5 times as much AAA debt as before and still be considered adequately capitalized. (Technically RWA lowers the value of the asset, but conceptually lowering capital required seems easier to understand).

The problem arises that over time AAA credits take on more debt and the rating agencies are slow to lower ratings. So the banks are still following the rules but the underlying assumptions have changed and the banks are really more risky than its capital ratio would imply.

That is the world that we are now in. The RWA regime does not adequately reflect the true risk of underlying assets, thus leaving banks undercapitalized. The IMF was criticized for suggesting that European banks needed at least \$300 billion in additional capital. That was when people were assuming a 22% haircut to Greek debt and perhaps other sovereign debt. Now a 50% number is being rumored and \$1 trillion additional capital numbers are being mentioned.

We met with the CEO of BNP, a large French bank, who said that they were going to be shrinking their balance sheet to help deal with their reduced capital. This will in turn reduce the credit available to BNP clients and probably the French economy as well. Some of this credit will be picked up by other banks but at the margin it makes credit harder to get and probably raises rates as there is less supply of credit.

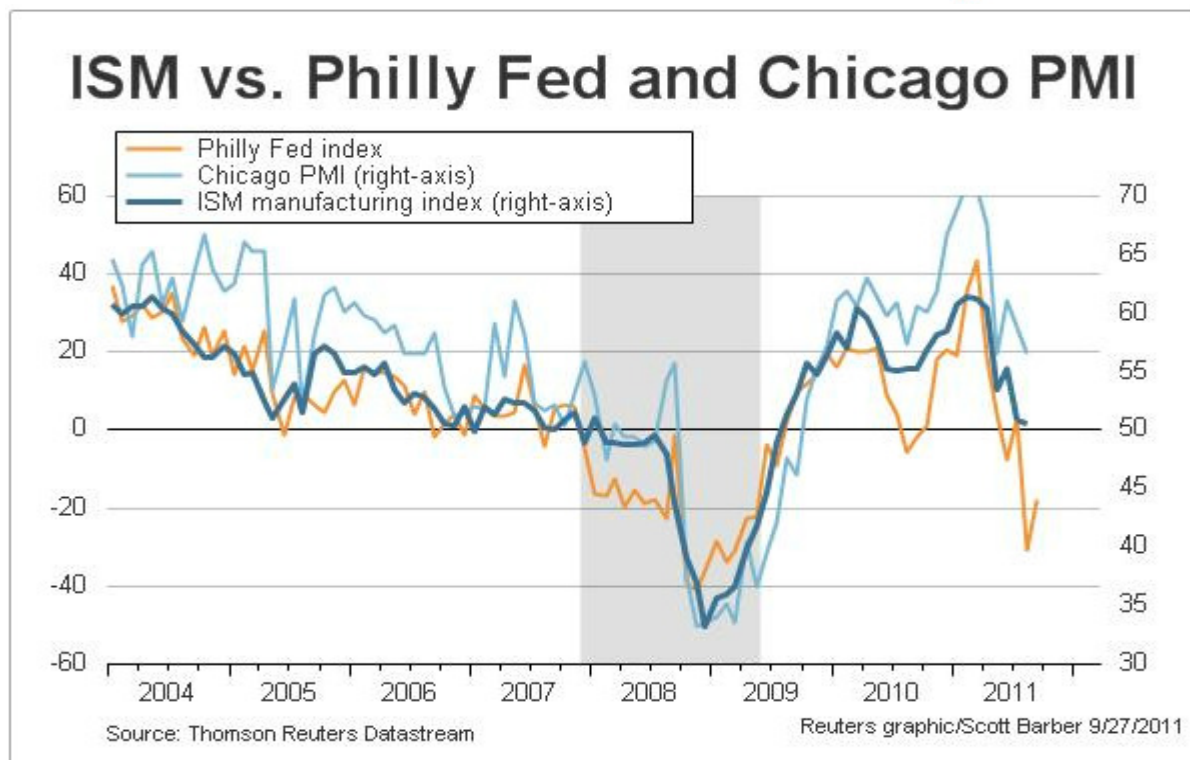
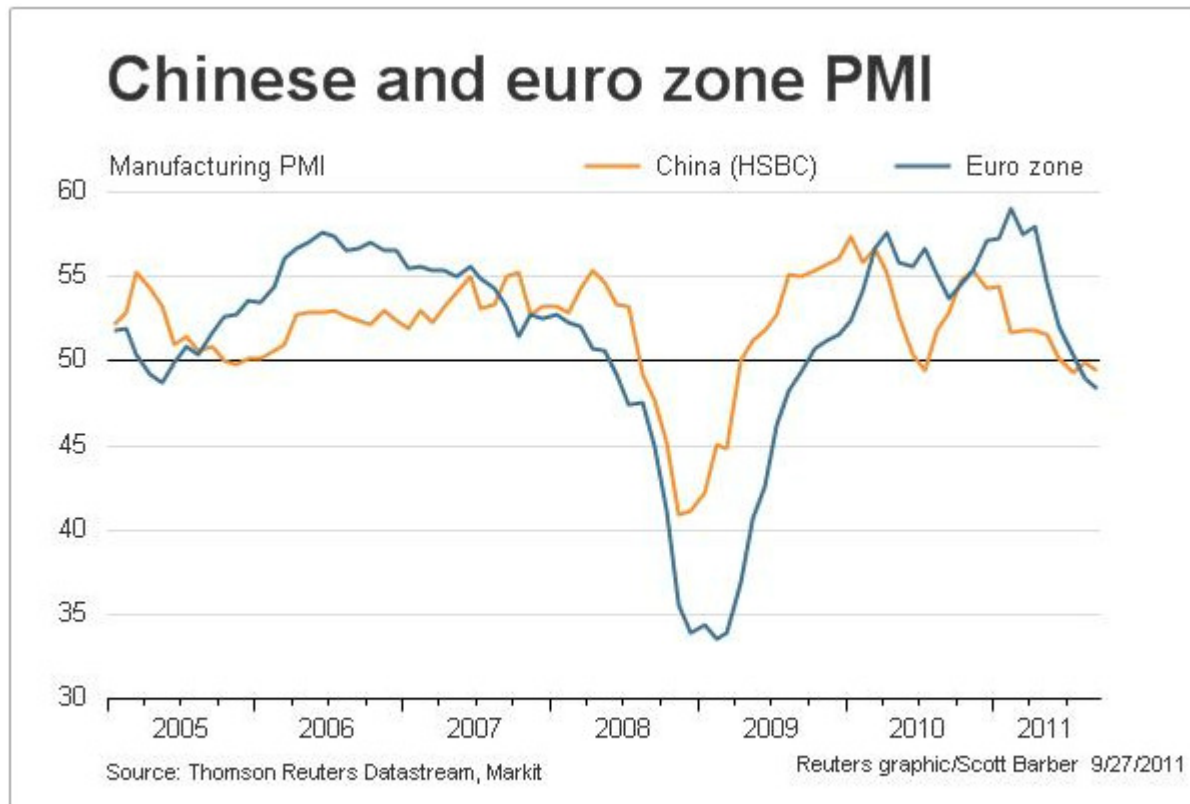
The more the contagion spreads from Greece, the more losses are incurred and the more capital is required or balance sheet shrinkage is required. If the contagion spreads to Italy, then the problem is probably too big for Europe to handle and the only recourse is a global bailout or economic shrinkage. That is why the Europeans are willing to throw so much time and resources at a seemingly insignificant Greek problem.

Perhaps there will be a large enough bailout that will solve the problem and markets will soar from here. We do not assign that a high probability but it is something that we keep a close eye on.

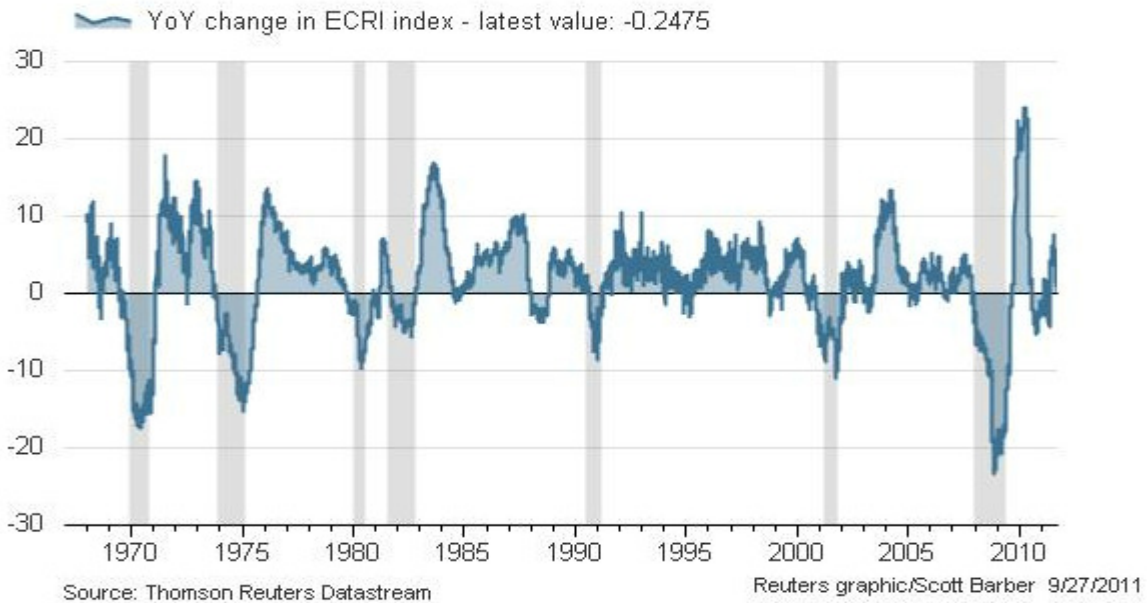
ECONOMIC HEALTH

Given the issues in Europe, one would expect that their economy would be softening, and indeed it is. But what about the other global growth engines?

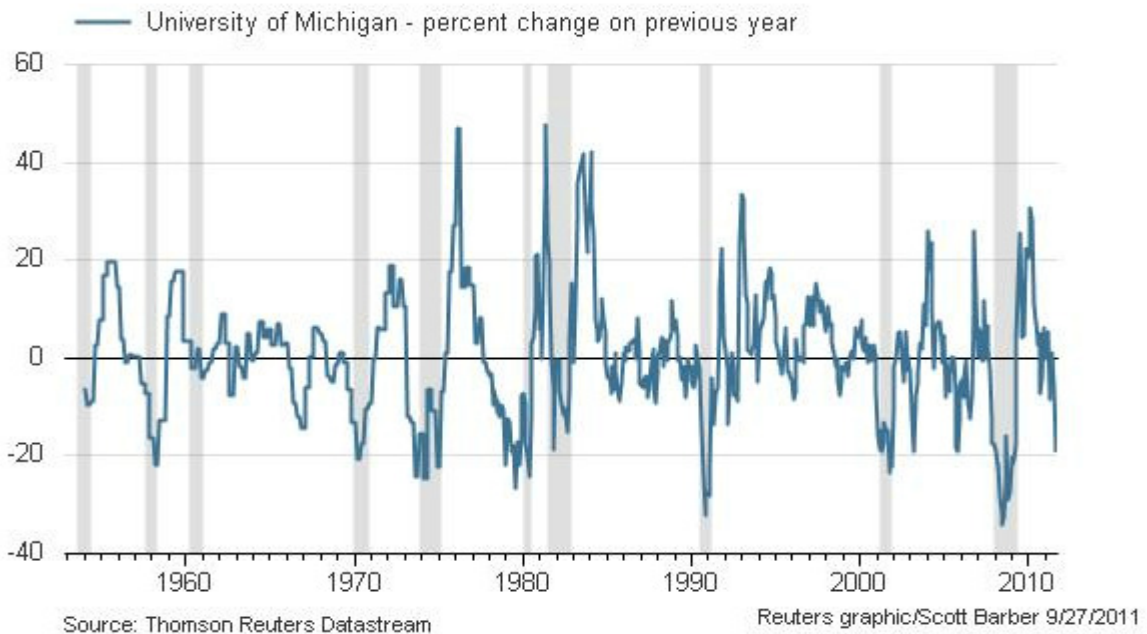
Interestingly the Chinese Manufacturing PMI is now below 50. It last started down in mid-2008. China did an almost 30% of GDP stimulus plan back in 2009 through bank lending. This originally led to strong growth but has now morphed into inflation and bad loans which they are trying to contain. It is doubtful that China will be a strong growth engine in the near term.



ECRI weekly leading index



Consumer sentiment and recessions



In the US, the Philly Fed Index is now negative, while the ISM manufacturing index is right about 50 suggesting softness in the US economy as well. The ECRI weekly leading index is also negative. The University of Michigan Consumer sentiment index is quite negative again.

While all of these indices are a bit noisy and could turn around, they confirm our cautious stance.

PORTFOLIO

High quality performed almost twice as well this quarter as low quality. This helped our stock selection and sector selection. This quarter we took some risk off as we sold more volatile stocks and replaced them with less volatile stocks. One example is that we bought Autozone (up 8% for Q3) which is expanding into supplying local mechanics and garages. We sold Newell (down -24% for Q3) to make room for AZO.

We also added to cash and puts. Cash is now up to 23%.

Our stocks worked quite well this quarter as did our sector weights. Consumer staples (large overweight, -4.9% return Q3 vs S&P 500 -13.8%) and utilities (overweight, 0.4% return Q3) were the top performing sectors. Financials (large underweight, -23.1% return Q3) lagged badly. So we were overweight the strong sectors and underweight the weak sector which added to outperformance.

HIGH QUALITY STOCKS OUTPERFORM SINCE EARLY 2011 (Going up is quality outperf.)



LOOKING FORWARD

We see Europe as a possible game changer. Estimates are all over the place as to how much additional capital the banks in Europe need. The IMF suggested around EU300 billion. Some brokerage firms suggested over EU1 trillion. This is uncharted territory. If Europe gets it right, we could see improved global GDP growth. If they get it wrong, slow global GDP growth could be with us for some time.

We try to produce the best risk-adjusted returns available. As risks have increased, we have increased our protection. If risks subside or are priced in, we will gladly reduce our protection.

One possible piece of good news is that the price of gasoline is finally dropping. This will help many consumer stocks as consumers spend their gas savings on other things.

Best regards,



Thomas H. Forester
Portfolio Manager

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