



# Bradley, Foster & Sargent, Inc.

## Quarterly Market Commentary

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### Can Europe Get Its Mojo Back?

Within our mandate, the ECB is ready to do whatever it takes to preserve the euro.  
And believe me, it will be enough.

European Central Bank President Mario Draghi, July 26, 2012

Over the past half dozen years, we have written in our investment commentaries about the BRIC countries – Brazil, Russia, India, and China – as well as the economic success story of Singapore. But we have never written about Europe. At BFS, we follow political and economic events in Europe on a daily basis, as the 28 countries that make up the European Union (EU) are key U.S. trading partners. Many American companies have substantial operations in Europe, and approximately 10% of the revenues of companies in the S&P 500 come from Europe. We also keep an eye out for good investment opportunities in Europe and hold the shares of some leading European companies in many of the portfolios that we manage for our clients. Recently one of our partners was in Germany and the U.K., and some of the observations in this commentary reflect his views.

Currently we are paying close attention to Europe, because the state of affairs in the EU is not promising. Some of the major challenges that the EU faces include the following: a weak economy, the specter of deflation, sky-high unemployment in some member nations, worrisome demographic issues, political and military challenges in Eastern Europe, and the EU's dependence on Russia for much of its energy. Our purpose in this commentary is to sketch a full and realistic picture of the EU with its strengths and weaknesses and think through whether it is an opportune moment to commit incremental capital to shares of EU companies at this time.

The EU's total population is slightly over 500 million – 58% more populous than the U.S. Eighteen of the 28 nations in the EU are bound together by one common currency – the euro. The most populous EU nations are Germany (81 million), France (64 million), the U.K. (64 million), and Italy (60 million). The U.K. has retained its own currency, and Switzerland has chosen neither to be a member of the EU nor to use the euro. Perhaps the most pernicious challenge facing the EU is the dramatic economic extremes between some of the Northern and Southern European nations. Before the global financial crisis, a number of nations with weak economic characteristics were able to command very low interest rates on sovereign debt, due to their association with economic powerhouse, Germany, through their common use of the euro as their currency. This situation contributed to the ability of the so-called PIIGS – Portugal, Italy, Ireland, Greece, and Spain – to borrow substantial amounts at relatively low interest rates to fund budget deficits and to seek to accelerate their economic growth. This behavior caused a significant increase in the national debt of the PIIGS and worsened their Debt/GDP ratios. The global economic recession of 2007-2009 brought this behavior to a halt, but in the years following the Great Recession, many observers

predicted that the 18 nations using the euro as their currency might be forced to split into two groups largely along regional lines. However, the underlying causes of this dichotomy were not geographic but rather the broad differences in national economic growth, income, wealth, debt levels, work habits, and culture. Worsening the situation was the recession that the EU experienced in 2012 with the EU economy contracting during all four quarters. Enter Mario Draghi in July 2012!

### Mario Draghi

Mario Draghi is the President of the European Central Bank (ECB). His nomination to that position was approved by the European Parliament and the ECB board in June, 2011, and the EU leaders confirmed him the same month. His term of office commenced in November, 2011 and expires in October, 2019. He had excellent qualifications for the job. Having graduated from the University of Rome, he earned a PhD in economics from MIT in 1976. After serving on the faculty of the University of Florence, he worked for the World Bank and later for the Italian Treasury. From 2002-2005, he was a senior officer at Goldman Sachs. Following his service there, he became Head of Italy's Central Bank and then, in 2011, President of the ECB.

Shortly after assuming the reins, Draghi oversaw an ECB 489 billion euro loan program to European banks (some of which were encountering liquidity issues), which was similar to TARP in the U.S. He followed this up in early 2012 with a bond purchasing program to assist European nations dealing with sovereign debt issues. And then, in July, 2012, in the midst of renewed fears about sovereign debt default by some nations and predictions of the dissolution of the euro currency union, he made his now famous statement at a dramatic press conference: ***“Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.”*** This forceful statement by Draghi led to a steady decrease in bond yields (and borrowing costs) for most EU countries. The decline in yields on EU government bonds has continued for the past two years so that the yields on 10-year debt for many nations is lower than the yield on the 10-year U.S. Treasury note (see page 7). Most observers view Draghi's statement at the July, 2012 press conference as the key turning point in the fortunes of the Eurozone. In April 2013, Draghi answered a question in regard to membership in the Eurozone: “These questions are formulated by people who vastly underestimate what the euro means for the Europeans, for the euro area. They vastly underestimate the amount of political capital that has been invested in the euro.” In parsing Draghi's answer, many analysts believe that Draghi was referring to the vital importance that Germany ascribes to the viability of the Eurozone, as it is its most important exports market.

### The EU's Anemic Economy

With 28 nations in the EU, any pronouncement about the EU's economy is bound to be a generalization. For example, between 2008 and 2013, Greece's real GDP declined 23%. The GDP of Italy, Spain, and Portugal declined 7%, 6%, and 6% respectively during this period. Meanwhile Germany's GDP during the same period was 4% above its pre-recession high. In 2014, real GDP in Ireland, Poland, and Sweden is forecast by some observers to exceed 3%, while the governments of larger nations such as France and Italy currently forecast GDP growth of less than 1%. It is likely that Portugal's economy will contract in 2014. The table on the following page contrasts GDP growth in the EU with the U.S., starting near the pre-recession peak:

### EU and U.S. Real GDP Growth 2008-2013

	2008	2009	2010	2011	2012	2013	Cumulative
EU	0.6%	-4.4%	2.0%	1.7%	-0.3%	0.2%	-0.4 %
U.S.	-0.3%	-2.8%	2.5%	1.8%	2.8%	1.9%	+5.9%

Source: International Monetary Fund

The U.S. has seen the slowest economic recovery since World War II, but at least real GDP is modestly higher than it was at the pre-recession peak in 2007. GDP growth in the U.S. during this six-year period averaged less than 1% annually. The EU has fared even worse, as economic activity was less at the end of 2013 than it was six years earlier – a contraction of -.4%. There are many causes for this weak economic performance. One of the most important causes is the high ratio of government debt to GDP in some of the largest EU nations. The U.K. and France had Debt/GDP ratios larger than 90% at the end of 2013. Italy's Debt/GDP ratio was 133%. Most economists opine that as a nation's Debt/GDP ratio nears 100%, robust GDP growth becomes more difficult. Another key reason for the EU's weak economy has been the lack of political will in many countries to make the necessary structural changes in the job market and welfare system to encourage greater investment, more start-up companies, and greater job mobility. The heavy lifting has been left to the monetary initiatives of the ECB, which have been successful thus far in preventing a crisis, but not able to create faster economic growth. The lack of economic growth over the past six years has resulted in high levels of unemployment in many EU countries and sky-high levels of youth unemployment as the table below shows:

### Unemployment Rate – May, 2014

	Total	Youth
EU	10.3%	22.2%
France	10.1%	22.5%
Italy	12.6%	43.0%
Spain	25.1%	54.0%
Greece (as of 3/31/14)	26.8%	57.7%

Source: Eurostat

An additional concern for the EU is that the lowest fertility rates in the world (except Japan) are found in nations on the European continent. To maintain a stable population (without immigration), a nation in the developed world needs a total fertility rate of approximately 2.1 births per woman. The rates for Germany, Italy, and Spain are below 1.5. The substantial Muslim immigration into many EU countries has helped to offset the decline in the population but has contributed to some of the cultural and ethnic issues which have afflicted Europe recently.

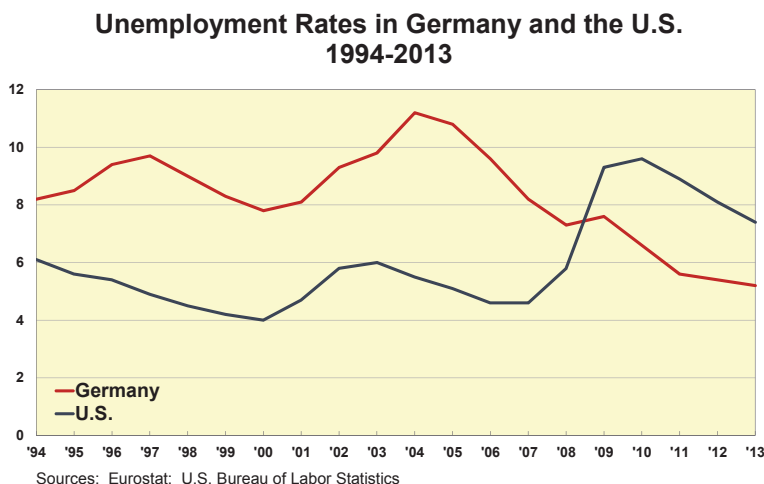
### Negative Interest Rates in the EU

In 1848, Karl Marx promulgated his Communist Manifesto. It began: “A specter is haunting Europe – the specter of communism!” 166 years later, there is a new specter haunting Europe. But it is not communism; it is deflation. As we have shown above, economic growth in Europe is almost non-existent. Unemployment is a scourge in most European nations. Prices are not rising; in some sectors, they are declining. The politicians and monetary authorities in the EU do not fear inflation, which, in classical economic theory, occurs following the dramatic expansion of the money supply, which has already taken place in the EU. Instead European leaders fear deflation and the damage

that deflation can do to a nation's economy and its social fabric. To counter this threat, ECB President Mario Draghi announced on June 5, 2014 the Bank's decision to reduce interest rates on key refinancing operations in Europe from 25 basis points to 15 points. More importantly, banks which hold excessive reserves at the ECB or other central banks will incur a negative interest rate of -10 basis points (-.1% p.a.) on these deposits. In taking this step, the ECB is giving European banks a financial disincentive to park their liquidity with central banks, thereby encouraging banks to seek out borrowers to help grow the economy. In the past, central banks have occasionally resorted to negative interest rates to stem unwanted inflows of foreign funds which often cause their currency to appreciate excessively, but it is rare to see a supranational authority impose negative interest rates on the banking system. Draghi is attempting to use monetary measures to avoid the type of deflationary spiral which Japan has suffered for the past twenty years. But the very fact that this step has been implemented is a clear signal that all is not well within the economies of many EU countries.

### Germany: A Nation that Has its Act Together

Unlike many countries in the EU, Germany showed modest but positive cumulative growth of 4% in real GDP since 2008 – slightly below the U.S.'s GDP growth of 5.9% for the same period. And, unlike the U.S., Germany undertook a series of far-reaching reforms dealing with unemployment benefits and welfare payments between 2003 and 2005. These reforms were pushed through the German Bundestag and Bundesrat by then German Chancellor Gerhard Schröder, leader of the Social Democratic Party. This remarkable set of reforms to the German labor market, known as the Hartz plan, is an exemplary model of reform that other European social welfare states, as well as the U.S., should emulate. In brief, unemployment benefits were reduced from 36 months (or longer) to 12-24 months, depending on the age of the person out of work. Moreover, eligibility for unemployment benefits depended on the unemployed person's savings, life insurance, and the income of a spouse or partner. There was also a contractual obligation between a claimant of unemployment benefits and the state, which defined what the claimant was obliged to do to improve his or her job situation. The net result was a sea change in the level of German unemployment. Germany, which perennially had significantly higher levels of unemployment than the U.S., saw its unemployment rate drop below that of the U.S., which since 2008 took the opposite tack and increased unemployment benefits from 26 weeks to as much as two years. The chart below shows how financial incentives affect behavior in the workplace:



Germany has also managed its fiscal situation in a highly responsible manner. Its Debt/GDP level at the end of 2013 was below 80% – the only major EU country to have maintained this fiscal discipline. In 2013, Germany ended the year with a *modest budget surplus*. Moreover, Chancellor Angela Merkel, who recently put together a coalition of the CDU/CSU and the SPD to govern the country, announced that it is projecting a budget surplus in 2014 and planning for surpluses each year through 2017 in order to bring Germany's Debt/GDP ratio below 70%. The goal of this fiscal discipline is to comply with the EU's Stability and Growth Pact, which mandates that a country's fiscal deficit annually be less than 3% of GDP and its Debt/GDP ratio held below 60%. If it is over 60%, the Pact mandates that a non-conforming country implement fiscal policies which will ultimately bring its Debt/GDP below 60%. Also, Germany has reduced its corporate income tax rate from 60% in 1989 to 30% currently – well below the U.S. corporate income rate tax. In brief, the German economy is in good shape, as the pictures below of recent construction activity in Berlin illustrate:

#### Cranes in Berlin June 2014



#### Germany's Energy Challenges

While Germany is the strongman of Europe, it does face challenges, and none is more problematic than its energy dependence on Russia. Gazprom, the giant Russian natural gas company, accounts for approximately 38% of Germany's consumption of natural gas (and more than 25% of Europe's natural gas consumption). Moreover, Gerhard Schröder, Germany's Chancellor from 1998 through 2005, accepted a position as Chairman of the Board of the Russian-German pipeline company, Nord Stream AG, which supplies Gazprom natural gas to Germany. Schröder still holds his position in Nord Stream AG, which is owned 51% by Gazprom. Thus, while U.S. and European leaders were seeking to impose sanctions on Russia for her annexation of Crimea, Russian President Vladimir Putin was hugging Schröder at his 70th birthday party several months ago. Although German Chancellor Merkel was reported to be furious with Schröder, it is not hard to see why Germany has been reluctant to ratchet up the political pressure and apply tough sanctions on Russia during the past six months. One possible solution to Germany's energy dependence on Russia for natural gas is hydraulic fracturing. According to *The Wall Street Journal*, Germany has 2.3 trillion cubic meters of domestic shale gas, and Germans are fracking pioneers, having used this technology to extract tight gas since the 1960s. But German Environment Minister Barbara Hendricks recently announced that most forms of hydraulic fracturing will be prohibited until 2021. So it appears as if Germany will continue to play a weak hand against Russia in her military initiatives in Eastern Europe.

## The Russian Bear

On the last day of the previous century, Vladimir Putin was appointed Acting President of Russia by Boris Yeltsin. In May, 2000, Putin was elected President by the Russian people. Since then, he has never relinquished his political power and his position as the key and sole decision maker in Russia. His power and popularity in Russia did not diminish when his hand-picked protégé, Dmitry Medvedev, served as Putin's stand-in as President (or some would say puppet) in 2008-2012. In 2008, Russia orchestrated a military invasion of the Republic of Georgia, occupying and annexing two Georgian territories – Abkhazia and South Ossetia. In doing so, Putin put the world on notice that Russia would resist challenges to its self-interest in countries which she considers to be in her own “privileged zone of influence.” This year, Putin has used the same playbook in Ukraine, provoking a conflict by encouraging protests by pro-Russian denizens of a neighboring land and then using military force to conquer and annex the region. In this case, the uprising and removal of pro-Moscow Ukrainian President Viktor Yanukovich, who decided to abandon in November, 2013 a far-reaching EU partnership deal, was the proximate cause of the annexation of Crimea – a landmass the size of Belgium. Subsequent separatist activities by pro-Russia citizens, supported by Russian special forces, have threatened the dismemberment of key eastern and southern territories of Ukraine.

President Putin appears to have calculated that this aggressive and provocative strategy, which mirrors in many respects the methods that Hitler used in Austria, Czechoslovakia, and Poland in the late 1930s, would not be strongly challenged by the EU and the U.S. And he has been right. EU nations, with the exception of the U.K. and France, have very limited military capabilities, and most European leaders do not have the stomach to challenge Russia's military adventures – especially in view of Europe's energy dependence on Russia. Those looking to the U.S. for leadership in the crisis in Ukraine have been disappointed by the current administration's policy of “leading from behind.” There has been much jawboning of Putin by European leaders and President Obama as well as attempts to impose meaningful sanctions on Russia, but little has been accomplished – other than demonstrating the EU's impotence on further Russian military forays in Eastern Europe.

## Investing in Europe

Generally, yields on bonds are determined by several factors including the maturity of the bond, the size and the liquidity of the bond issue, and most importantly, the creditworthiness of the borrower. Normally, the stronger the creditworthiness of the borrower, the lower the yield. However, in the world of sovereign debt, the rules have changed, as can be seen from the table below:

### Yields on 10-Year Government Bonds June 30, 2014

Japan	0.56%	U.S.	2.53%
Switzerland	0.65%	Spain	2.66%
Germany	1.24%	U.K.	2.67%
Netherlands	1.48%	Italy	2.85%
France	1.70%	Portugal	3.64%
Ireland	2.35%	Greece	5.91%

Source: Bloomberg

How can Ireland borrow at lower rates than the U.S.? How can Spain, with a weak economy and an unemployment rate over 25%, borrow at almost the same cost as the U.S.? There are two important observations to make on the current yields of sovereign debt. The first is that yields have rarely, if ever, been so low. Many believe that we are in a “bond bubble.” Secondly, the creditworthiness of the borrower is less important if central banks, backed by their governments, are prepared to flood the market with liquidity and bail out smaller countries in fiscal crises. And the ECB, led by Mario Draghi, has shown that it is willing to use every monetary weapon at its disposal to counter deflation and shore up weak banks and nations struggling in fiscal crisis. With interest rates at such low levels, it is hard to see how investors can make much money in this asset class. And it is not clear how this experiment in monetary engineering will end, but it could well end up badly for investors.

### European Stock Markets

The major European stock markets have bounced back nicely over the past 2½ years. Although there are many challenges still facing the EU, things were much worse two years ago. Greece was near collapse, and fears of financial contagion throughout Europe were rife. Interest rates on Spanish 10-year bonds were near 8%. However, Mario Draghi’s actions worked wonders, and select European stock markets have climbed 30-45% over the past 3½ years compared with the S&P 500, which has had a total return of nearly 68% in this period. U.S. investors have poured over \$38 billion into European region mutual funds and ETFs over the past 18 months, according to Lipper, a leading mutual fund research firm. Many global international managers have also increased their allocation to Europe. The table below tracks the various key indices from each country against the S&P 500 from the end of the 3rd quarter, 2007 (near the peak of the previous bull market) through June 30, 2014. The two best performing European markets – the U.K. and Germany – reflect the superior fiscal discipline employed by these two countries and the correspondingly better performance of their economies. The two worst performers – Italy and France – mirror the structural difficulties in their labor market as well as the weaker economies:

**U.S. vs. European Stock Market Total Returns  
10/1/2007 - 6/30/2014**

	<b>4Q 2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>1H 2014</b>	<b>Cumulative</b>
<b>S&amp;P 500 (U.S.)</b>	-3.3%	-37.0%	26.5%	15.1%	2.1%	16.0%	32.4%	7.1%	48.9%
<b>FTSE 1000 (U.K.)</b>	0.5%	-28.3%	27.9%	13.0%	-1.8%	10.4%	19.1%	2.1%	37.8%
<b>DAX Index (Germany)</b>	2.6%	-40.4%	23.8%	16.1%	-14.7%	29.1%	25.5%	2.9%	25.1%
<b>SMI Index (Switzerland)</b>	-5.0%	-33.2%	21.8%	1.1%	-5.6%	18.0%	22.9%	6.5%	13.9%
<b>IBEX (Spain)</b>	4.9%	-36.5%	38.0%	-12.7%	-7.3%	2.9%	27.6%	12.8%	10.2%
<b>CAC (France)</b>	-1.5%	-40.3%	27.7%	0.6%	-13.4%	20.4%	22.2%	5.5%	1.5%
<b>FTSE MIB (Italy)</b>	-2.7%	-46.6%	24.0%	-9.8%	-22.1%	12.1%	20.4%	14.4%	-30.0%

Source: Bloomberg

How do the market valuations compare? At the moment, the S&P 500 trades at a 16.6 P/E ratio on estimated 2014 operating earnings and at a 14.9 P/E ratio on 2015 operating earnings. The DAX Index in Germany trades at a lower multiple than the S&P 500 – 13.8 times 2014 estimated earnings and 12.1 times 2015 estimates. The FTSE in the U.K. is also cheaper than the S&P 500, trading at 14.2 times 2014 estimates and a P/E of 13.0 on estimated 2015 earnings. The Swiss market (the SMI Index) trades at a very similar P/E multiple to the S&P 500 for both 2014 and 2015. Thus, the valuations on several European markets are lower, but the discounts appear to reflect some of the challenges facing the EU countries.

### Summary

During the last several years, Europe has come back from the brink. The news flow has been incrementally better, and when that happens, stock prices usually move higher. That being said, key countries in the EU struggle with high Debt/GDP ratios, inefficient labor markets, fiercely protective unions, and demographic issues, all of which foreshadow continuing weak economic growth and high unemployment. Russia's stranglehold on Europe's natural gas markets may well lead to greater political instability in Europe. In general, stock prices reflect corporate earnings growth, and it is difficult for most companies to grow earnings faster than the nominal GDP of a country over the long term. If GDP growth is weak, most stocks (and therefore the market) will also produce weak returns. There are, however, some very well-managed European companies with global brands, strong balance sheets, and excellent cash flow, and it is possible to cherry pick these stocks, which is the approach that we at BFS employ. Our mutual fund, BFS Equity Fund (BFSAX), currently owns 50 stocks, and four of the holdings are European companies – two based in Switzerland, one in Holland, and one in Italy. Yet, even as we seek good investment opportunities in the EU, we believe that, in general, the U.S. – despite the many challenges and difficulties it is facing at this time – represents a better place to deploy significant capital than in Europe, which shows few signs that it is getting its mojo back.

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