Diversifying Beyond the US" Equity Plays in Europe & China

Senior Bank Loans offer a very good alternative to diversify High Yield holdings within an investment portfolio.

The US equity market has had a very strong 2013, with the S&P 500 up +17.8% YTD[1]. The market is looking closer to fairly valued from many different valuation metrics, and the extended rally could very well take a pause. Within our client's equity allocation, we have been heavily overweight the US over the past few years- a position which has paid off nicely. While we maintain an overweight to the US- we are looking for selective opportunities in other regions.. We believe that we can find such opportunities in Europe- where both the economic and fiscal backdrop are set to improve. Another play we like – albeit with a much smaller allocation- is the Chinese consumption theme. The equity markets in China have been largely underperforming due to slowing macro data and expectations of a "hard landing" – and we believe there is an opportunity to play off a strengthening Chinese consumer.

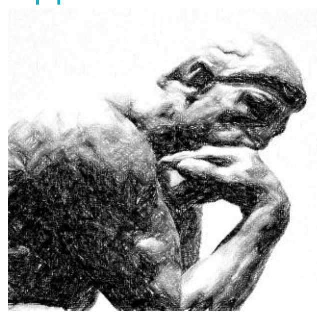
The below chart illustrates the outperformance of the US equity markets this year. Since the last week of June, when the Fed discussed the potential start of the "tapering" program to scale back quantitative easing – we have seen a reversal in trend: Europe and China are playing catch up and outperforming US equities markets. We believe that this catch up trend will continue, as fears of ending easy monetary policy continue in the US; Europe enters an environment of growth out of recession and select companies in China benefit from its powerful consumers.

Total Return of Global Equity Indexes (in USD)	YTD (As of 8/22/13)	Post Taper Talk (6/24/13-8/22/13)
S&P 500	17.8%	5.7%
MSCI Europe	12.5%	12.5%
FTSE China 25	-7.2%	14.3%

Source: Bloomberg

[1] S&P 500 Index performance as of 8/22/13

The Thinking Man's Approach



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Ignacio Pakciarz | CEO

We have benefitted from our overweight position to the US within our equity allocation over the past few years. Given the strong outperformance of the US markets- we are looking to add exposure outside given the opportunity for attractive entry points. We like opportunities in Europe, and also adding a small allocation to companies set to benefit from a strong Chinese consumer.

For more information and details on the list of stocks we like to play these themes, please inquire: ideas@bigsurpartners.com
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Strengthening Macro and Fiscal Situation Can Boost European Companies Earnings

There are two forces at work which make the picture for Europe more attractive: economies are bottoming from the 2011 crisis and Europe will be the beneficiary of more expansive monetary policy

- In July, the Eurozone purchasing manager's index (PMI) data came in at 50.4.[1] 50 is the magic number- anything above 50 generally indicate that the manufacturing industry (and the economy) is growing. Europe has not had a PMI reading above 50 since January 2012. Additionally, consensus estimates on 2014 GDP in Europe are forecasting growth to turn positive to 1.24% next year.[2] Part of this can be explained by the reduced impact of fiscal adjustments on GDP. The required deficit reductions as a result of the 2011 crisis have been largely carried out by many countries- and their drag effects on GDP will significantly lessen in 2014.

- As the below chart demonstrates, a stronger economic backdrop is supportive of stronger earnings. JPMorgan estimates earnings to change from negative in 2013 to positive double digit growth in 2014.[3] The divergence between US and European companies earnings since 2009 has been significant- helping support the outperformance of US equities. Strong earnings growth in Eurozone companies should be supportive of strong equity market performance.

Table 4: Eurozone Real GDP and EPS, %y/y

Year	Eurozone Real GDP, %y/y	MSCI Eurozone reported EPS, %y/y
'92	1.4%	-29%
'93	-0.8%	-7%
'94	2.5%	63%
'95	2.7%	0%
'96	1.5%	17%
'97	2.6%	23%
'98	2.7%	-7%
'99	2.8%	13%
'00	3.9%	19%
'01	2.0%	-23%
'02	0.9%	-10%
'03	0.7%	48%
'04	2.0%	52%
'05	1.8%	28%
'06	3.4%	29%
'07	3.0%	-1%
'08	0.3%	-20%
'09	-4.3%	-30%
'10	1.9%	33%
'11	1.5%	-3%
'12	-0.5%	-4%
'13e	-0.6%	-1%
'14e	1.2%	14%

Source: Datastream, IBES, J.P. Morgan Economics

- Europe will be the beneficiary of a relative easy monetary policy versus the US. The Fed is likely start its tapering of quantitative easing in the next few months, scaling back it's expansive monetary policy- while Europe will continue or even increase its expansive monetary policy. The US's relatively easy monetary policy versus the rest of the world helped support the relative outperformance of US equities- and a shift to a relative easy monetary to Europe versus US should help support European stocks.

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[1] Bloomberg
[2] Bloomberg
[3] JPMorgan, "Europe Equity Research," August 12, 2013

Within Europe, we are looking for select opportunities which are well positioned. For example, we like Germany- in particular, companies which relate to the consumer- as they are set to benefit from wage inflation. German wages have been depressed versus other European nations and it is believed that policy makers are likely to help set Germany wages higher by 5-6%.[1] We are looking to avoid Southern Europe- where problems with the labor markets are still posing structural issues around competitiveness still exist

Power of Chinese Consumer

Some are questioning whether the "Golden Decade" that was experienced by Emerging Markets is coming to an end- as they are facing headwinds related to commodity prices, potential tightening monetary policy and slowing growth. Whether China will hit a "hard landing" has been a debated issue for many investors- and it seems as though the negative case has been priced in to the Chinese equity markets, down 5% this year. Given the weakness the Chinese equity markets have experienced, we are looking to see if there are any opportunities for attractive entry points. While we do not favor Emerging Markets equity as an asset class- we see some select opportunities- mostly focused on the Chinese consumer. China is changing into a consumption economy- McKinsey estimates that in 10 years, urban private consumption will have doubled- from 10,048 billion CNY to 26,804 billion CNY.[2] Additionally, sources close to the National Population and Planning Commission in China say that the one-child policy could be changed to a two children, as early as the end of 2013 or early 2014. Bank of America Merrill Lynch's China economist, Ting Lu, expects 9.5 million babies will be born over the first five years, and benefitting certain businesses in the consumer sector.[3]

Conclusion

Given the strong performance of the US equity markets this year, we are looking for some added value plays beyond US borders. With the situation improving in Europe, and companies' earnings set to rebound nicely, we believe there is value in adding exposure to select high quality companies. We also believe that the sell-off in Chinese equities has created some attractive entry points for companies which will benefit from increasing private consumption and population dynamics.

We selected a list of companies that we believe are well positioned to benefit from these themes, and also fit with our investment philosophies for selecting individual equities global and high quality brands, strong dividends and market leaders in their industry. For a list of equities that we like to execute the ideas in this note, please contact us.

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[1] BCA Europe Investment Strategy, "German Assets to Sell….And to Buy," July 25, 2013
[2] McKinsey & Company, "Mapping China's Middle Class," June 2013
[3] Bank of America Merrill Lynch, "A two-child policy on its way," August 3, 2013

Important Disclosures

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