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Crossing The Pond

At some point in an investor's development, it should become intuitive that capital will go where capital is treated best. Repeat this at a weekend cocktail party and you might receive a wide range of responses -- from furrowed brows, to nods of agreement, to the ever-popular shit-eating grin. Pardon our French, this last one seems especially common. It means the listener has no idea what you are saying, but the wine is splendid. One guest will seek clarification. What exactly does this mean, that capital will go where capital is treated best?

Thanks for asking.

Rule of law is paramount. So Canada will score much higher than Argentina, which on a whim decided to default on its debt obligations with regard for neither its ability to pay, nor the legal covenants known as a bond indenture. Fool us once, shame on you. Fool us twice.. well, second chances come at a steep price.

Next, the market in question should have a reasonable tax and regulatory structure, with a commitment to free markets and ownership rights. The adjective 'byzantine' is a real no-no. On this score, Hong Kong prevails over the US. Sorry Washington, it's your own doing.

There should be an expectation of real growth, with low or moderate inflation, and a secure currency. When we talk about growth, starting anywhere but China seems foolish.

If we have trouble keeping score, the Heritage Foundation is here to help. It compiles an Economic Freedom ranking of 177 nations, describing the extremes from 'Free' to 'Repressed'. It takes into account measures including Trade Freedom, Property Rights, Corruption, and Government Spending. The top three include Hong Kong, Singapore, and Australia. The US ranks tenth on the list, a reminder that, no matter how bad it seems here, it is probably worse elsewhere.

Western Europe rates fairly well. Switzerland is ranked fifth, Denmark ninth. The top 20 rankings also include Germany, Holland, Ireland, Finland, Sweden and the UK. 'Club Med' members, also known as the 'PIGS' are in the middle of the pack, generally described as 'Moderately Free'.

To be clear, this is not an investment grade. The Heritage Foundation is neither a market

prognosticator nor a money manager. And for an investor, one key variable is missing in this qualitative scorecard: Price.

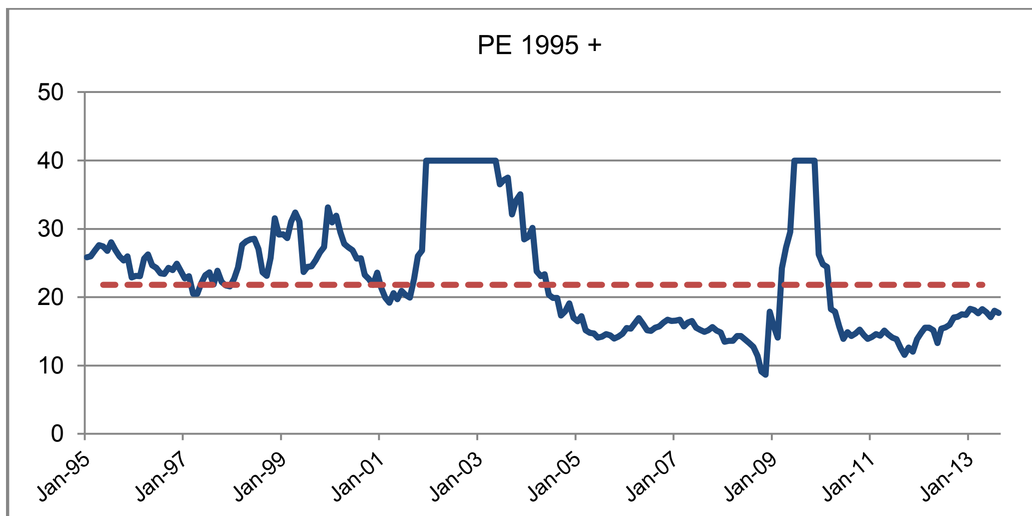
Imagine a US bond market where Treasury notes yield not three percent, but six percent. Would we feel differently about investing in Treasurys? Now consider a US stock market with a dividend yield not at two percent, but at four percent; with a PE multiple at 10 times instead of 16 times. Would this be more attractive? Of course it would. Price is not the only consideration when owning as asset, but it typically is the most important.

So where does today's pricing take us? Across the pond, to Western Europe.

Go ahead, scream. We know. Europe, the land of collectivism, failed currency union, stagnant growth and a desire for everyone to live in an equal state of misery. But not so fast. While we have been long-term skeptics on Europe, the land of a lost generation, every dog has its day. Yes, we did just call Europe a dog; but as the Heritage Foundation rankings imply, at least it is a well-bred dog.

Our investment premise is NOT that Europe is a sleeping giant, that it will awaken to a low-cost model capable of competing with China, or an innovative gene on par with the US. No, Europe as a whole will enjoy no economic renaissance. But it will make a bottom, or already has. In the depths of that bottom sit real companies selling at cheap prices; companies including Nestle and Unilever, Vodaphone and Glaxo, Siemens and SAP. They cannot all be losers, but many are valued as such. This is the appeal of Europe: real companies at cheap prices.

By our work, Europe is 20 to 25 percent undervalued versus its norm, and its norm was with much higher interest rates. The chart below shows a historic price-to-earnings ratio for an index that serves as a proxy for Western Europe. The dotted line across the chart represents the median value in the data series.



On this price-to-earnings basis, valuations are 20 percent below the historic median. But it gets better. Unlike in the US, where corporate profits have rebounded to record levels, earnings in Europe remain depressed. Profits sit one-third below their 2007 peak, yet are expected to accelerate as Europe's recession gives way to recovery. In short, we are paying below average prices on below normal earnings, in a low-interest rate environment, with profits expected to accelerate.

Not convinced? There's more. Valuation does not begin and end at earnings multiples. If we look at price-to-book ratios, and dividend yield levels, we also find values 20 to 25 percent below normal.

In the past few months we have invested in two vehicles giving us diversified exposure to European equities. First is the EAFE index, a broadly-based index that includes companies in Continental Europe, the UK, as well as Japan, Australia and other locales. As an interesting sidelight, two decades ago this index provided investors new and easy entrée into developed foreign markets. The notion, and the index, gained a bit of cachet as an appealing alternative for US-based investors. And it performed miserably. Timing is everything.

The second investment vehicle we recently bought is based on the Euro STOXX 50 index. This is a more-concentrated position, limited to the 50 largest public companies within the Euro Zone. German and French companies account for 70 percent of the index.

Investing never offers a sure thing. The economic recovery in Western Europe could stall. Corporate profit growth may disappoint. Another Euro crisis is always a threat. Valuations may remain depressed. These are all plausible risks, yet they are risks worth taking.

For a generation, Western Europe has acted not as a sleeping, but as a clumsy, lumbering giant. Its economy is large, its populace wealthy. Its financial system is well-developed. Yet it is continually plodding along, offering minimal innovation and growing much slower than its global competitors. With a penchant for collectivism, taxes and regulation, its economics will always be second-rate. Still, Europe has probably hit bottom. There are quality companies based in Europe, they are selling at cheap prices, and the headwinds of recent years are subsiding.

For any investor, that's a nice place to start.

American Exodus

Imagine a benevolent government. Sorry, bad joke. That idea is too far-fetched, but try this one instead: Imagine a government that cuts taxes, encourages business investment, reduces regulatory burdens; that welcomes innovation and risk-taking and success.

Imagine all that. What should we expect? More jobs, higher wages, rising productivity, strong growth? Is this a reasonable goal?

Indeed. Beginning in late-1982, the US economy produced one of the great booms in history. Over the next 25 years the economy suffered a grand total of 16 months of recession. Real GDP grew at an average rate over three percent. Unemployment, peak to trough, fell from nearly 11 percent to under four percent. Nominal personal incomes grew four-fold, while inflation-adjusted incomes more than doubled. At one point, the US represented just over four percent of the world's population, and nearly 30 percent of its economic output. That is an economic superpower. It wasn't perfect, but all in all it was pretty good.

Now fast-forward to present day. It isn't hard to do, but you might not like what you find. Our government no longer believes in lower taxes, business formation, innovation, or capitalism itself. It believes in regulatory hurdles, higher costs, and higher taxes. The primary goal of the federal government is to become larger. Feed the beast.

What should we expect? Nothing good. In fact, what we have is the worst economic recovery since the great depression. Job creation is tepid, and much of it is part-time. Real GDP growth can hardly sustain a two-percent pace. Nominal incomes are barely growing and real incomes are flat-lining. Companies are reporting record profits, but increasingly from overseas markets. Cash builds up on corporate balance sheets, measuring in the trillions of dollars, yet remains offshore indefinitely. Considering that we are four years into recovery, the results are pathetic.

Mondays dawn early on Wall Street, weekend deal-making announcements typically setting the headlines. Late July was no different, with three notable mergers announced. In the largest deal, advertising agency Omnicom agreed to combine with Publicis, creating a global ad giant in a 35 billion dollar merger-of-equals.

Next up was drug and nutritional company Perrigo, which agreed to purchase drug-delivery firm Elan, for eight billion dollars. Then came retailer Hudson's Bay, with a three billion dollar deal to acquire New York department store icon Saks.

Just another Monday? Well, maybe not. Follow the bouncing ball.
Omnicom, of New York, is merging with Publicis, of Paris. The combined company will be based in the Netherlands. Perrigo is a Michigan-based company which has decided to re-locate its headquarters to Elan's home of Ireland, more for the low tax rates than for the pleasant weather. Hudson's Bay is based in Toronto, where it presumably will remain, Saks Fifth Avenue or not.

In the matter of one weekend, three US-based businesses were lost to foreign domiciles. Each of these deals might make sense on their own merits, but a larger issue comes into play, framed by three questions:

Is US policy -- taxes, regulation, and health care -- driving business away?
For every business that leaves the US, how many jobs have already been lost?
Can we create a healthy economy without a healthy business climate?

Three deals in one weekend does not a trend make. Yet something tells us these questions, unanswered for now, will be revisited in the future.

Sources:
Bloomberg
National Bureau of Economic Research
The Heritage Foundation
Wall Street Journal

Tidbits..

UK's Vodaphone to sell Verizon Wireless stake to Verizon for 130 billion dollars.

Microsoft to purchase Nokia handset business, move into smartphone hardware market.

Bond funds suffer losses, record withdrawals of 60 billion dollars over four week span, as investors rush for the exits.

Bonds are not risk free? Who knew?

Apple's e-books strategy included illegal price fixing, district court rules.

Justice Department sues to block American-US Airways merger.

Activist investor Bill Ackman departs JC Penney board, sells stock, leaves company in shambles.

White House delays by one year employer mandate section of Obama Care, still not ready for prime time.
UPS to slash health care benefits for employee spouses, blames cost of Obamacare.

Surprise, surprise, surprise.

Time Warner Cable temporarily shuts down CBS broadcast in spat over retransmission fees.

Biggest network fear: off the air, and nobody cares.

New Glass-Steagall banking law proposed by US senators in quest for supreme regulation.

Always fighting the last battle.

Hedge fund giant SAC Capital faces civil, criminal charges on insider trading.

Boston Globe newspaper, once valued at 1.1 billion dollars, to be sold to Red Sox owner John Henry for 70 million dollars.
Washington Post newspaper to be sold to Amazon founder Jeff Bezos for 250 million dollars.

Newspaper business becomes token play toy for billionaire class.

NASDAQ equity trading halts for hours due to computer glitch.

Complex systems built for speed and volume, not stability.

Whopper of the Year
-- New York Times columnist Paul Krugman, on Detroit's bankruptcy:
"There are influential people out there who would like you to believe that Detroit's demise is fundamentally a tale of fiscal irresponsibility and/or greedy public employees. It isn't. For the most part, it's just one of those things that happens now and then in an ever-changing economy."

You mean it isn't Bush's fault?