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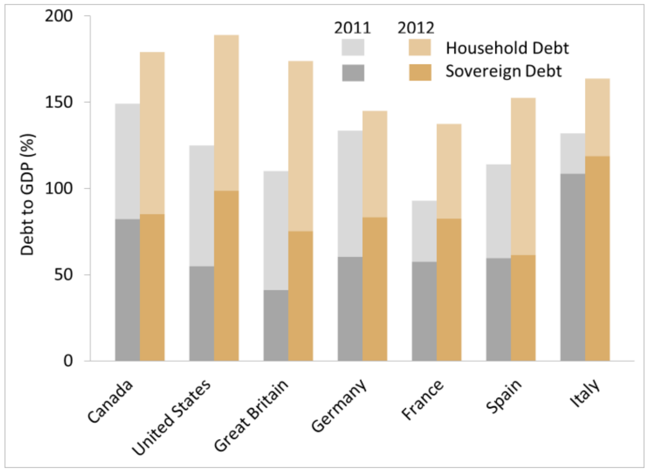
What We Think……

Figuring out the Eurozone

Stimulus/austerity, default/bail-out, risk-on/risk-off… These are the dichotomies that continue to plague the Eurozone, no matter how much hope there is that the latest resolution will be the last. By now most investors have learned to take every summit, every agreement and every compact with a dose of skepticism. Yes the markets are volatile, but generally speaking volumes are low, indicating that many investors have decided to stay on the side-lines. There have been episodes where analysts and commentators, not to mention markets, have gotten carried away with optimism, but since the beginning of the Greek crisis, not much has really changed. The crisis has moved on from its original protagonist to a new, more menacing one (Greece to Spain), but the doomed-to-fail *monetary union without fiscal union* continues to muddle along, anticipating the day that politicians are no longer able to delay the inevitable crisis.

We have no doubt that most actors central to this story are hopeful that, delayed long enough, a real crisis will be avoided. After all, Spain, Italy and even France would rather not have to contemplate further bailouts and defaults, and Germany does not want to have to tell its southern neighbours that no more money is forthcoming. However, the lessons we have learned from other financial crises, suggest we are still in relatively early days of the global debt deleveraging process, and that delaying until economies and balance sheets turn-around is ultimately not a reasonable solution. As such we believe that it is highly unlikely that we will be able to escape the Eurozone sovereign debt crisis without having to deal with the fundamental issues of too much debt and not enough growth. Figure 1 shows the debt burdens of the key Eurozone players alongside North American comparisons. Today's economic fundamentals are not tenable, especially when one accepts that substantial fiscal stimulus is impossible.

Figure 1 — G7 Household and Sovereign Debt to GDP



Source: StatsCan, IMF, Eurostat & Lorica Investment Counsel Inc.

The recent French election was a pivotal one, perhaps more so outside of France than within (unless of course you are on a millionaire's income). For it ended the Merkozy power base and ideology that had dominated the Eurozone for the past couple of years, leaving Angela Merkel with only the support of smaller allies, principally the Netherlands and Finland. Ultimately, the shift of power towards the triumvirate of Spain, Italy and France, will only shift the discussion, but will not materially shift the probability of resolution. We are still very much of the belief that containing the Eurozone problem rests with German acquiescence to fiscal union or at least Eurobonds (as union is often disguised) – a scenario that we feel is highly unlikely. The window for creating fiscal union in the Eurozone was when there was, at least the semblance of, more common footing amongst Germany and the other dominant Eurozone countries. Today, German finances are sufficiently out of sync with those of its neighbours statistically and more importantly philosophically. Recent German polls suggest that the electorate is not in favour of fiscal union, and from a practical standpoint, Merkel's Christian Democrats coalition partners have indicated waning support for further concessions to struggling Eurozone members.

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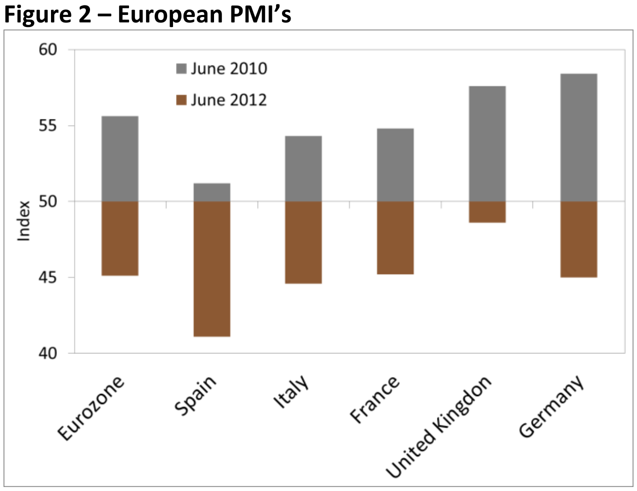
Can the Eurozone turn around?

Growth projections for Europe are not pretty. According to the Bloomberg poll of professional economists, GDP growth in 2012 will average -0.4% and 0.8% in 2013. Excluding Germany from the mix, lowers the forecast to -1.0% and 0.5% for 2012 and 2013 respectively. There are so many problems affecting Europe, it is difficult to find somewhere to turn to look for optimism. Following Mario Draghi's appointment as president of the ECB, the ECB has taken on a decidedly more interventionist and arguably pro-growth stance. The benefits of the LTRO has proven to be invaluable to embattled Eurozone governments, by providing relief to the banking sector, indirectly supporting further sovereign debt issuance and generally forestalling spiralling contagion. Unfortunately, the LTRO's and rate reductions have only produced fleeting benefits to Eurozone economies. Note the similar problems facing the Bank of England and its aggressive quantitative easing program.

Figure 2 – European PMI's



Source: Markit; Lorica Investment Counsel Inc.

In January of this year European Union members (except the Czech Republic and the U.K) broadly supported, albeit through much coercion, the Merkozy-led *fiscal compact*; see http://european-council.europa.eu/eurozone-governance/treaty-on-stability for details on the *Treaty* on Stability, Coordinationand Governance in The Economic and Monetary Union. The compact targets compliance by signatories one-year after a minimum 12-member ratification by January 1, 2013. Although the compact has yet to be implemented, Eurozone members have been in tightening fiscal environments, or at the very least not in stimulating ones, given the the current state of government finances; this has not helped struggling Eurozone economies. PMI indicators across Europe are now indicating contraction, even in the healthiest economies such as Germany; see Figure 2. Led by the triumvirate, there is now a move to not just delay austerity measures, but opt for pro-growth ones – a move that has been supported by the U.S., Britain and other non-Eurozone countries.

This all sounds pretty philosophical until you examine the finances of the Eurozone countries and consider the U.S. and U.K. experiences. The majority of Eurozone countries do not have the capacity to take on more debt, especially with little confidence that growth will sustainably pick-up. Of course, there is the view held by some that we are in a vicious circle, whereby political uncertainty and fiscal probity are preventing any chance of a virtuous one, with implications beyond Europe. We are more circumspect, and relate the prospects for a global recovery to the deleveraging process and other secular themes of employment, globalization and technological change.

Breaking at the seams

While European leaders continue with their full menu of meetings and summits, electorates in the troubled Eurozone economies are becoming more restless. On the one hand, youth, who have been affected by high levels of unemployment, are expressing their frustrations through migration and public demonstration; see Figure 3.

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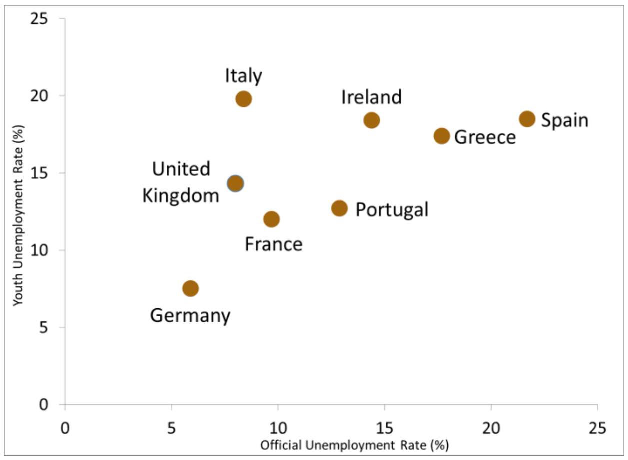
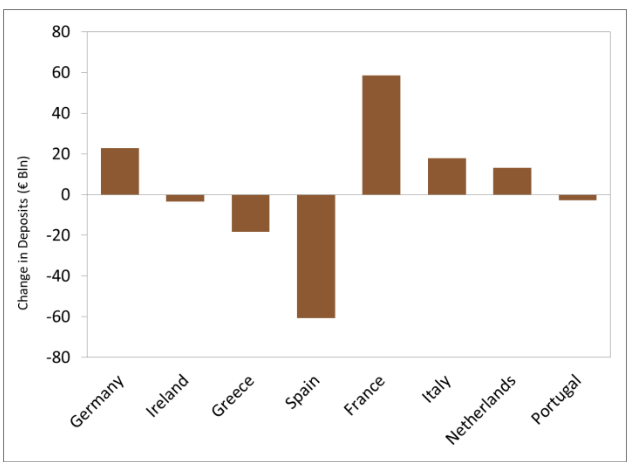
Figure 3 – European Unemployment – Overall & Youth



Source: Eurostat; Lorica Investment Counsel Inc.

Figure 4 – 24 Month Change in Eurozone Bank Deposits

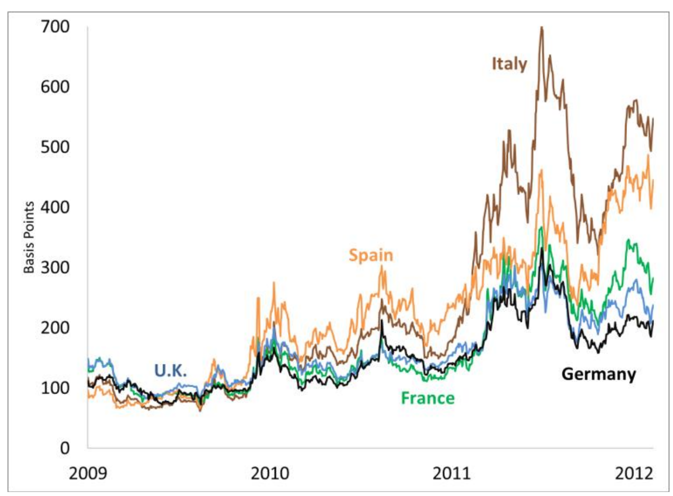


Source: ECB; Lorica Investment Counsel Inc.

On the other hand, adults concerned about the prospects of the Euro and their savings, are expressing their frustrations through their bank accounts, moving capital out of troubled countries and into safe havens. See Figure 4 for the recent changes in Eurozone bank deposits. And still, all is not copacetic in the more economically sound Germany. While Merkel's approval ratings are at the highest since 2009, they have not come without having to take on a fairly hawkish response to Eurobonds as her no to Eurobonds "as long as I live" comments following July's summit attest.

The European bank sector continues to be under pressure from capital markets, credit rating agencies, and regulators. For banks domiciled in the weakest Eurozone countries, yield spreads are hovering around their widest levels of the last three years; see Figure 5 for European bank CDS spreads. Credit ratings are also under pressure, having already fallen, and in many cases now on credit watch with negative outlook; see Figure 6 for average bank credit ratings. And finally, regulators are not happy with the capital cushions of many European banks, and politicians are not happy with the regulators. At the "arm twisting" summit, Eurozone politicians agreed to create a unified bank regulator likely to reside in Frankfurt or Brussels. As an aside, Britain finds itself exposed to further Eurozone alienation, facing the prospects of another European city encroaching on its status as Europe's banking centre.

Figure 5 – Representative European Bank CDS Spreads



Source: Bloomberg; Lorica Investment Counsel Inc.

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Figure 6 – Representative European Bank Credit Ratings

Country	Average Rating
France	A+
Germany	A+
Great Britain	A+
Ireland	BBB
Italy	BBB+
Netherlands	A+
Portugal	BB
Spain	BBB
Switzerland	A

Source: Fitch; S&P; Lorica Investment Counsel Inc.

The Prospects

We expect the Eurozone problems to continue for a while yet, ebbing and flowing with each new policy initiative, taking risky-assets along for the ride. Two thousand and twelve will likely be another lost year for European economic renewal, as politicians struggle to find a solution that solves both Europe's sovereign debt and economic growth problems. Unfortunately, there is no quick fix, and as we have already expressed, we believe that Germans will ultimately resist fiscal union. Although, it will likely be a few years before this comes to a head.

As far as capital markets are concerned, Europe's policy rollercoaster has taken over as the main driver of the risk-on/risk-off trade. There is still the contingent of investors who pay a lot of attention to the Fed, but so far in 2012, Fed participation has been mostly speculative. The extension of Operation Twist only satisfied what was already priced into the market and provided no real additional catalyst for investors. Europe, however, has had several significant elections, summits and central bank meetings that have transfixed investors. While Europe's actions haven't amounted to any real change, they have contributed significantly to market-moving news and hence market volatility. We expect Eurozone events to continue their impact on the markets for the remainder of the year.

The uncertainty coming out of Europe and the lack of countercyclical European economic policies has also had ramifications globally – the Eurozone represents 25% of global GDP and accounts for 17% of Chinese exports. To make matters worse, the weakened state of the U.S. economy has left the U.S. vulnerable to weak European imports while leaving little hope for a U.S.-centric catalyst for the global economy. We are not optimistic that a recession can be avoided across much of Europe. The challenge will be to avoid a recession beyond Europe. China has shown a willingness to stimulate its economy through monetary policy, and we expect the Fed to also enter the fray. However, we discount the success of current U.S. monetary policy given the low-level of interest rates and the questionable effectiveness of non-traditional actions. It remains to be seen whether governments globally have the mandate, resolve or means to enact stimulative fiscal policies to avoid a broader and deeper global recession.

Global bond markets are now pricing in low growth, if not recession. Yields on the highest rated sovereign bonds have fallen to all-time lows and show little risk of rising. The ECB is lowering interest rates and the Fed has extended its forward commitment to keep rates low. While implied returns on high quality government bonds are low, at present we see relatively little risk of capital losses. As for the bonds of the troubled Eurozone governments, we expect yield spreads to remain relatively wide and volatile.

Gary Morris, CFA
President

T. 647.776.8111 E. info@loricaic.com www.loricaic.com