October 8, 2010

Dear clients and colleagues,

European macro picture:

European countries are still digesting the implementation of tough austerity measures proposed by their respective governments. Common budget proposals include: increased taxes, public wage cuts, reducing the subsidies to public companies and a special tax rate on bank activities. Consumer-related companies and the banking sectors should be the most impacted by these major government-spending cuts.

Recently, it seems like the momentum has shifted to a slightly more negative picture: Spanish unemployment numbers soared for the first time in five months in August; Eurozone household consumption for Q2 was lower than expected; September UK home prices are still plunging…

Many argue that the expected economic growth for countries such as Greece, Ireland, Portugal and Spain should be minimal in the near future. Some of these governments have come out with very optimist assumptions for their GDP, retail consumption and export figures for next year. We think that down the road, further spending cuts will be needed in order to re-balance budget numbers. Considering the massive unemployment rate in Spain, we find that 1.8% expected growth in consumption for 2011 could be hard to achieve.

Another area of concern could be the euro appreciation against the dollar. Not that it's a real concern at the present time but if the euro continues to strengthen, it could definitely impact Eurozone economic growth for 2011.

Observations from our European tour:

We were very surprised by businesses' optimism levels, especially in a context where revenue visibility has been reduced so much following the 2008 financial debacle. The consensus is that a new recession threat is a very unlikely scenario. Although order backlogs are at good levels, it's the dynamics of the new order intakes for the upcoming quarters that we fear. We saw during Q4-2008 how easy it is for companies to delay investment.

We also noticed that price increases are underway across all industries, despite the fact that end demand is far from robust. Whether it's a food manufacturer or an industrial company, price inflation is there. There seems to be a huge disparity in CPI numbers, first between what authorities are publishing and what businesses are saying and then, between different markets. For instance, the UK published 3.1% consumer price inflation as opposed to only 1.1% in the U.S. We understand the methodology is different, but the component weights of the CPI of these markets aren't extremely different. Keep in mind that the recent asset price inflation experienced during the past decade was barely reflected in CPI numbers.

While most companies are done with their cost-cutting programs, others are still committed to improving their cost structure. One motivation behind further cost cutting comes probably from the fact that corporate tax rates are now increasing. Generally speaking, we feel like margin expansions will be very limited going forward. In that perspective, we expect that the labour market will continue to be under great pressure in the near term.

Businesses are continuing to build an impressive amount of cash. Balance sheets have never been so clean. Cash will mainly be redeployed to finance acquisitions and expansion into other geographies. In some cases, cash may also be redistributed to shareholders via dividend-payout increases and share buybacks.

Company specific

We had a very positive meeting with the management of Portucel, the Portuguese producer of pulp and paper in our portfolios. In a nutshell, we like the fact that the company is able to run at very high capacity in an industry that is shrinking. When taking into consideration its high margins and low debt level, it is the most compelling name in the pulp and paper universe. Management believes pulp prices will remain strong and that paper-price increases will be possible to a certain extent, which is positive for them. Finally, the company has ended its high Capex program, and it should generate very healthy free cash flow levels going forward.

Regards,

The Global Alpha Team