

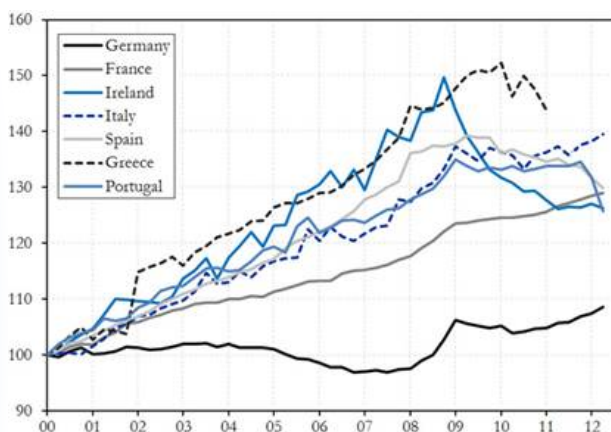
October 4, 2013

Dear clients and colleagues,

Germany's latest confidence readings suggest that the overall sentiment has become more positive. Germany's consumer confidence survey reached a six year high in September while the IFO business confidence survey also gained momentum for a fifth consecutive month. Thanks to a stable job market and a low interest rate environment, private consumption is expected to outpace Germany's GDP growth.

Eurozone outlook

We feel like euro recovery is under way. We expect fiscal consolidation and price adjustments in the Eurozone will continue.



Source: Eurostat

The unit labour cost convergence between southern Europe and Germany is under way. Wage increases in Germany should support private consumption while reforms in the South should stimulate their core industries.

On the other hand, there are still major challenges ahead. Price adjustments are evolving in the right direction however France and Italy are not converging.

With an absence of pressure from the financial markets, it seems as though some Governments may take longer to implement fiscal reforms. This lack of fiscal consolidation can pose a serious threat to the overall financial stability of the Eurozone.

Rising non-performing loans and the ongoing tensions between creditor and debtor countries are also important factors that could impact the region's recovery.

Finally the German Court ruling on ECB mandate will determine if the ECB bond purchasing program is constitutional under German law. A negative outcome could revive volatility in the region.

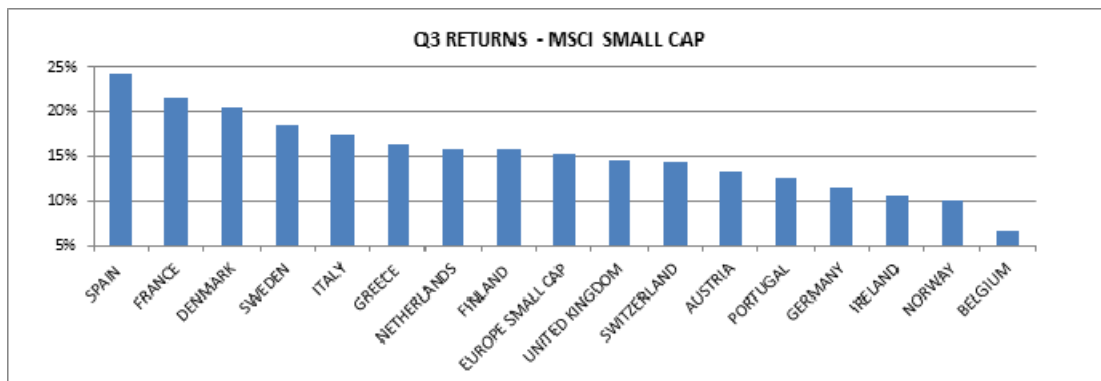
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German companies

We recently had the opportunity to meet with more than 25 German companies. Here is an overview of our observations:

- The majority of companies reconfirmed their neutral business outlook for the rest of 2013 whereas 25% have upgraded their outlook. Following some profit warnings in the first half of 2013, we feel that there could be some positive earnings surprises for the second half.
- Cost control, restructuring and efficiency gains remain a particular focus. Like Siemens's announcement to lay off 4% of its workforce, many other companies are still restructuring some of their business units. We noticed that capacity is being reduced, mainly in the Materials sector and in the Semis industry.
- Most companies remain cautious on their capital expenditure programs and very few are chasing takeovers. Cash levels and dividends are expected to rise while debt is decreasing. Their core strategy continues to be focused on organic growth in their niche markets and on improving their revenue mix.
- We remain bullish on German small caps even though they underperformed most of their European peers during Q3. While US profits are already at 20% above their last peak, German profits remain 5% to 10% below their peak levels of 2007. As German profits close the gap, valuations will become more compelling.



Source: MSCI, GACM

Have a nice weekend.

The Global Alpha Team

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