October 27, 2011

Dear clients and colleagues,

October is turning out to be the best month for the stock market since 1974. We had upgraded our view for the market at the end of last quarter, mainly due to valuations reflecting worst outcomes; i.e. no resolution in the European debt crisis, a recession in the developed World and a significant slowdown in China.

The last few weeks have seen an agreement on the European debt crisis and better than expected economic number out of the US and China. In addition, the current earnings season is still showing good growth and positive, although cautious, guidance. As a result, the S&P 500 is up 15% since its low on October 4th and small cap indices are doing better than that.

What do we think today?

We are still of the opinion that macroeconomic risks won't go away anytime soon. Economies in the developed world are facing a prolonged period of adjustment. Both governments and individuals need to spend less and growth will be low as a result. We believe central bankers in the developed world are maintaining artificially low rates, maybe hoping to partially solve their debt problems by creating inflation. The jury is out on this one. The GSCI index of commodity prices is up 11% since October 4th, and that again, could derail growth.

So again we repeat that we'd better get ready for slower growth and higher inflation; in other words, stagflation.

We are still in the midst of earnings season. Earnings are generally strong; however, guidance for next year is cautious due to several factors: macroeconomic uncertainty, input cost inflation and the ability to increase prices, and the need to increase spending to continue growth.

Many companies in our portfolio reported results in the last weeks.

We had 14 companies report results in the last 10 days. Median sales growth was 9.3% with a range between 1.8% and 176.6%. Median EPS growth was 9.2% with a range between -29% and 236%. Guidance for next year calls for low double digit growth in sales and earnings.

One company that reported results today and worth highlighting is Prosegur SA, Spain's largest physical security company. Before today, the stock price was down 17.2% in Euro terms. This was mostly attributable to the deteriorating economic situation in Spain, the company's largest market. The company reported that its sales grew 9.3%; however, it is a tale of two stories. In Spain, the company is facing a very difficult market. Its sales were down 2% in a market down 10%, so the company is winning share. However, there was a mandatory wage increase of 5% agreed with the unions and the company is not able to pass that increase to its customers, leading to decreased margins and profits.

However, and this is one of the main reasons why we invested in Prosegur, sales in Latin America have now surpassed sales in Europe for the very first time and now represent 53% of total sales, thanks to growth of over 20% in the region (Argentina, Brazil, Chile). Prosegur is a good example of a company using strong cash flows in its mature markets to invest in faster growing markets. It is a good illustration of benefiting from emerging market growth while having the comfort of buying a security on a developed exchange with the liquidity, currency convertibility, accounting standards and compliance that come with it.

The next few weeks will continue to see a lot of earnings releases as well as updated guidance for 2012.

Our portfolio strategy does not change. We continue to have a well diversified portfolio minimizing industry and currency risk and adding value through security selection.

Have a good week.

The Global Alpha Team