



# Brandes

# analyzes:

THE BRANDES PERSPECTIVE  
NOVEMBER 17, 2011

## Continuing Uncertainty in Global Equity Markets

### **Long-Term Investors Could Benefit from Holding Undervalued Equities Today**

Macroeconomic concerns have remained top of mind among global investors, sending key stock market indices into a volatile trading pattern.

In Brandes' view there are two core issues driving markets:

- the potential for a global economic recession, and
- concerns regarding systemic instability in Europe

Our overall assessment is that there are significant risks to be accounted for and the path to worldwide economic recovery will not be swift or without hardship for many countries and companies — nevertheless, we believe the recent correction is overdone and that investors could potentially benefit from holding undervalued equities today. We provide some perspective on each of these topics below.

### **Global Economic Recession Risk**

Our view has been, and continues to be, that large government fiscal deficits, relatively high debt-to-Gross Domestic Product (GDP) ratios, and protracted deleveraging of households, will likely inhibit growth for many developed nations in the decade ahead. We also incorporate a rising risk of a global recession, or at the very least low nominal growth, within the next two years. However, this scenario appears to be more than built into the price of many businesses today. In fact, we see established businesses that are priced as if they will have flat or negative growth for the foreseeable future when their operations and industry dynamics suggest otherwise. Put another way, we believe the intense focus on the question of whether we are about to slip into a recession has caused prices of many attractive businesses – including those that we believe are likely to maintain or grow profits even during a recession – to fall too far.

Overall, we are underweight cyclical businesses – specifically the materials and industrials sectors – out of concern that prices of many companies did not reflect the potential for a downshift in the business cycle. Now that expectations in the market appear to be adjusting, we may see more opportunities present themselves in these areas.

### **Systemic Instability in Europe**

Market participants are becoming increasingly worried that European countries may not be able to achieve the right balance of fiscal austerity and economic growth to allow their debt-to-GDP levels to be lowered to more sustainable levels. Concerns that had previously been confined to economically smaller countries such as Portugal, Ireland, Greece, and Spain, have now spread to Italy and France. As a consequence,

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investors are requiring higher rates of interest for loans to these countries and are factoring in a greater potential for debt defaults, potential decomposition of the Euro, and a widespread loss of confidence in the banking system.

### **How is Brandes positioned in Europe?**

We share many of these concerns and have been incorporating in our analysis the potential of an escalating sovereign debt crisis in Europe and the ripple effects resulting from that.

Based on our bottom-up investment approach, we have implemented the following:

- For the last few years we have limited our exposure to European banks given our concerns over their capitalization levels and more recently the potential for a restructuring to the government debt they hold on their books.
- In light of the rising risks we are continually re-assessing our remaining positions in European financials.
- Our base view is that Italy and France will manage through the current environment and it is our expectation that they will not default on any debt.
- We expect the euro to remain intact, but continue to see low growth in the Euro area for an extended time period.

In trying to find companies trading at undeserved bargains, we consider each company's sensitivity to systemic risk in Europe. Rather than focus primarily on situations most directly affected by such risk, we currently prefer companies which have cheapened despite appearing to us to be less directly exposed to systemic risk.

A meaningful portion of our European investments are currently held in more defensive sectors such as pharmaceuticals, telcos, and food retailers and we continue to believe these businesses offer compelling risk/return tradeoffs. We have not yet made any material adjustments to our European holdings in light of the recent sell-off, but continue to monitor events and company valuations closely so that we can position the portfolio appropriately.

### **Conclusion**

Overall, we see the recent correction in global equity markets as providing an appealing opportunity for selective equity investments. We do see a rising risk of a global recession, but believe a moderate recession is more than adequately reflected in the prices an investor must pay to own many great businesses. Our biggest concern – and key area of focus – is the potential for greater instability in Europe. We see Europe managing through the current situation, but acknowledge the significant downside risk given the worst case outcomes. Concerns about systemic instability are currently swamping company fundamentals and may do so for some time. We will continue to monitor events closely and will take actions that we believe benefit the long-term potential of client portfolios.

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We have limited exposure  
to European banks

A meaningful portion  
of our European  
investments are held in  
pharmaceuticals, telcos,  
and food retailers

We continue to monitor  
events and company  
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