Investment Policy
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Euro-Trough?

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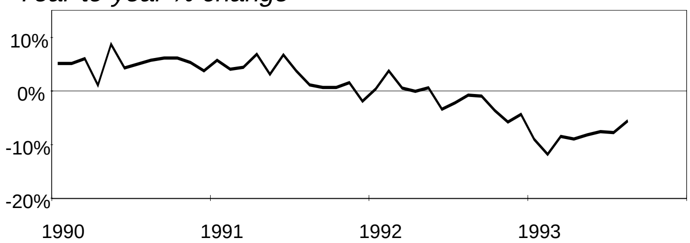
Having just returned from visiting Europe, we can report that sentiment among the investment community remains overwhelmingly skeptical, despite some faint signs that European economies are showing signs of bottoming. This is very much like the skepticism that persists among many investors in the U.S., although we are now almost three years into recovery.

The problem: The U.S. is in (and the Continent will likely soon enter) a very modest recovery. With real growth under 3% and inflation under 3%, *nominal* growth around 5% or less is hard to see on a day-by-day or even month-by-month basis. This is especially so for investors who grew up with *nominal* growth that was often twice that amount — even if the bulk of that growth was due to higher inflation. The industrial world's recoveries are turning out to be like the images created by the fans in the stands at a sporting event, each one holds up a colored placard. From a distance the image is clear, but sitting in the midst of a sea of multi-colored cards, it all just seems confusing. Soft recoveries are most visible after the fact.

The faint signs

While there are few signs that Continental Europe has begun to rebound, there are some faint signs that a trough is at hand and that recovery, albeit modest, sometime in 1994 is reasonable. Year-over-year comparisons are becoming easier for countries as well as companies. Thus, the graph of German industrial production below shows a rising trend even though the absolute figures are still in decline (industrial production fell 6.7% year on year in August, but was still up 2.1% from the prior month). On Monday, the German Federal Statistics Office reported that seasonal and calendar adjusted August retail sales rose 1% on the month and were down only 0.4% year over year, much smaller than the 3.6% drop expected. And Germany's Ifo Institute reported that its latest survey of industrial companies, while forecasting output to continue to fall this year, is forecasting output to stabilize in 1994. French GDP was flat in the second quarter after two consecutive quarters of decline, and French corporate failures fell 33% in August from July. And last week the European Community's statistical office reported that the Community's jobless rate remained stable in August, unchanged from June and July. On Thursday the U.K. reported that September unemployment fell to 10.3%, the first drop after four months of holding steady. So it is likely that more companies can be expected to report the kind of 6% increase in international orders (predominantly from Europe, particularly Italy and the U.K.) that Parker-Hannifin reported for September.

German Industrial Production
Year-to-year % change



As we have previously stated, it will likely be those economies that have devalued and cut interest rates aggressively that will be the first to show signs of life (see *More Cuts*, September 12, 1993). The U.K. has done both, and although Italy has so far only devalued, we believe that Italy is also the most likely of the Continental economies to reduce interest rates aggressively independent of the Bundesbank. Italy has abolished the mechanism by which Italian wages were indexed to inflation and is on the verge of passing a budget that constrains the budget deficit to 150 trillion lira ($94 billion or 7% of GDP).

GDP % Change

	1992	1993	1994
Germany	+1.5%	-2.0%	+0.5%
France	+1.3	-1.5	+1.0
U.K.	-0.4	+1.7	+2.7
Italy	+0.9	+0.0	+1.5
Spain	+1.0	-1.5	+1.3

Although this figure is high, as my colleague in London, Tony Baron, highlighted in *The Outlook for European Bond Markets*, October 4, 1993, the amount of interest payments on Italy's debt is 180 trillion lira per annum. Cuts in interest rates therefore would have an immediate positive impact on the level of Italy's deficit. We look for the best GDP growth in 1994 to come from the U.K. and Italy.

"Euro-angst" bears

Although Europe will see only moderate economic growth in 1994 (and while economists debate the exact level of economic activity in Europe), the key statistic is that 1994 will be the first year since 1989 that all of the major economies in the world will show positive GDP growth as the Continental European economies join the U.S., U.K., Japan and Canada in the plus column.

However, spending a few days in Europe can quickly lead to you to the view that 1994 is likely to be the *worst* year for growth since 1988. A high level of anxiety about the future is seen in the front page stories from the *Wall Street Journal* at the right.

THE WALL STREET JOURNAL December 2, 1982

Persistent Gloom

Europe Is Adjusting to a Long Recession
That Some Economists See as 'Permanent'

THE WALL STREET JOURNAL December 3, 1982

Bonn Time Bomb

In a Deepening Slump,
West Germany Droops
From Big Welfare Load

'Detroit Made Into a Country'

THE WALL STREET JOURNAL September 21, 1993

Over Half of Europe's Big Firms
Are Planning Work Force Cuts

Downsizing in Next 2 Years Is Expected to
Surpass Rate of Moves in U.S.

What is notable, however, is that two of these headlines appeared in December *1982*, after the bottom in that cycle. Back then the worries were that the welfare state in Europe, and particularly in Germany, would weigh down the economies preventing a recovery.

Today, the primary worry is that with unemployment already at 10.6% in the European Community, the likely wave of restructuring by European companies will threaten the social fabric of Europe. The Italian Interior Minister warned of jobless riots in Italy this autumn. French Prime Minister Balladur has instructed French nationalized companies not to lay off workers.

Bull markets

At the same time, financial markets in Europe are making new highs. On October 5, the German DAX index finally overcame its March 1990 all-time high, joining France, Britain and Switzerland as European markets that have new all-time highs in 1993. European bond markets have afforded excellent returns, as 10-year bond yields have declined 120 basis points in Germany, 220 bp in France and 430 bp in Italy. French government privatizations are the financial market equivalent of Madonna concert tickets. The French government ceased marketing the privatization of Banque National de Paris to French institutions after just two days, when the deal was already 12 times oversubscribed.

The markets appear to be comfortable with the idea that instead of leading to social turbulence and riots, the economic conditions in Europe will lead to increased prosperity in a disinflationary environment of accommodative monetary policy and improving real earnings. The same kind of modest and unspectacular growth seen in the U.S. recovery from the recession of 1990 is likely to be seen in Europe's recovery from the 1992/93 recession. And like the U.S. recovery, this is one in which restructuring will play a prominent role in producing a corporate profit rebound that outstrips GDP.

Alice through the looking glass

One wild card is recovery in Eastern Europe. Some secondary indicators suggest that the success governments in Poland, Hungary and Czechoslovakia have had in making progress on economic reform is beginning to result in meaningful increases in economic activity. Poland is likely to be Europe's fastest growing economy in 1993 with a growth rate of 5-6%. Six U.S. firms are among the top ten investors in Poland, according to the Commerce Department — including publicly traded companies International Paper, Procter & Gamble and Ameritech. Although U.S. corporate investment in Poland is only $829 million and only 11% of registered joint ventures are with U.S. companies, many of them have been spectacularly successful. In the consumer sector, for example, PepsiCo's first three-in-one restaurant incorporating Pizza Hut, Kentucky Fried Chicken and Taco Bell outside the U.S. has been opened in Poland; it has been a huge success with 25,000 transactions a week, 66% above the company's pre-opening estimate. This is not to suggest that PepsiCo is the company to benefit from Polish prosperity, merely that Poland is prospering. And given the lackluster domestic German economy, it is both interesting and ironic that German companies have the lion's share of investment in Eastern Europe. A turnaround in these economies could well give an important boost to German companies in this cycle.

GDP % Change

	1992	1993	1994
Czech Republic	-7.1%	-1.6%	+6.0%
Hungary	-5.0	+1.7	+4.6
Poland	+1.2	+5.0	+6.0

Source: Financial Times, PlanEcon Europe Ltd.

Euro-restructuring

As we discussed a few months ago (see *Euro-Destructuring*, June 27, 1993) after meeting with the German Bundesbank and I.G. Metall, the largest German Union, "clearly, destructuring is one American export that is headed for Europe. Just as the 'soft' recovery in the U.S. has not benefited all cyclical companies, so, too, it seems that the European economic recovery may not give a cyclical boost to all businesses there either."

European companies have been slow to restructure

While the headlines in the European newspapers are now just beginning to be filled with stories of European companies starting to restructure, restructuring has been going on for some time at U.S. corporations, as they reacted to the slow growth, disinflationary U.S. environment. And U.S. companies have for the most part viewed their European operations as part of an overall global restructuring program. Indeed many of America's Euro-industrials, such as Allied-Signal, Ford, and Owens-Corning have *already* gone through some high profile Euro-restructuring over the past few months.

European companies have, in general, been slow to follow for a number of reasons. First, while most Americans will change jobs several times in a lifetime, many Europeans spend their careers with one company. Thus, for social and cultural reasons many European companies are reluctant to let workers go. Second, there was no great takeover and merger mania in Europe in the 1980s, and consequently, there are few of the excesses which many U.S. companies are now trying to correct by restructuring. A third point is that European governments have used the cause of "national interests" to pressure companies not to close an unprofitable plant if that closure would lead to the country in question having to import from another country. Fourth, it is only recently that many previously state-owned industries in Europe have been privatized and thereby exposed to the rigors of the market place. Finally, high tariffs and other import duties had insulated many European companies, but following EC '92 a lot of these protectionist barriers are being removed. Therefore, we suggested that it was arguable that it will be America's Euro-industrials — which already have a domestic destructuring culture — that will lead the way in terms of Euro-destructuring.

When we presented this thesis to European investors last week — that American companies would lead local companies in restructuring European operations, and, therefore, it might be preferable to "play" any forthcoming modest European recovery by focusing on U.S. companies, rather than their domestic market competition — it was not met with the outright rejection that traditional parochial attitudes would have suggested. If anything, the skepticism was not about the validity of the American Euro-industrial as the vehicle but, rather, about the timing of the recovery.

Evidence supporting the impact of American Euro-Industrials' restructuring their European operations can be seen in Whirlpool's latest earnings release. The world's largest maker of home appliances reported a 27% rise in third quarter earnings, helped by strong results from their European business. In Europe the company had record operating earnings despite the sluggish environment. The company reported that their European unit shipments were higher and costs were significantly lower. These unit gains came in an environment in which overall industry shipments are projected to be down 2% this year.

Euro-Industrials

With 40-45% of S&P 500 earnings coming from overseas and one-half to two-thirds of those foreign earnings coming from Europe, S&P earnings are especially sensitive to a rebound in Europe. Consequently, over the next few months, the stock prices of those companies that have significant European exposure should begin to reflect the likelihood of better earnings from European operations in 1994. Euro-Industrials that we have been highlighting include: **Allied-Signal, Elf Aquitaine, Ford, Goodyear Tire, ICI, Microsoft, Owens-Corning, PPG** and **Vodafone.** Along with Allied-Signal, Goodyear Tire and Owens-Corning, other U.S. companies with significant exposure to Europe that will be speaking at our America's Euro-Industrial conference in New York on October 26 include: **AT&T, Digital Equipment, DuPont, Honeywell** and **Whirlpool.**

Price of companies mentioned as of 10/13/93:

Allied-Signal Inc ALD ($71 1/8)
Amer Tel & Tel[2,3] T ($57 3/4)
Ameritech AIT ($83 3/4)
Digital Equipment[2] DEC ($36 3/4)
DuPont, EI[2] DD ($46)
Elf Aquitaine ELF ($37 1/2)
Ford Motor Co[2,3] F ($55 1/4)
Goodyear Tire & Rubber GT ($43 3/4)
Honeywell Inc HON ($36)
Imperial Chem Ind[2] ICI ($44 7/8)
Int'l Paper IP ($58 1/8)
Microsoft[1] MSFT ($83 1/4)
Owens-Corning[1] OCF ($45 5/8)
PPG Industries PPG ($65)
Parker-Hannifin PH ($36 1/8)
PepsiCo Inc[2] PEP ($39)
Procter & Gamble[2] PG ($50)
Vodafone Group[2] VOD ($84 1/8)
Whirlpool Corp[2] WHR ($60 3/4)

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