While there has been much discussion about the impact of the weak dollar on the U.S. economy, there has been much less attention paid to the impact of the strong European currencies on Europe's export-driven recovery. Over the last 12 months the Deutschmark has risen 21% against the dollar, the French franc is up 16% and the pound sterling is up 8%. Europe has lagged the U.S. in this cycle's economic recovery, but the risk now is that the global economies resynchronize sooner than most observers expect and at a much slower rate of growth.

Europe's economic recovery has been export-driven because domestic demand has been constrained by two factors: very sluggish employment growth that curbs consumer demand, and huge government deficits that constrain growth in Europe's large public sector. Unfortunately, in 1995 and 1996 growth in European exports will be slowed by the strength of major European currencies and by slowing demand in the U.S. Despite these factors constraining exports, most forecasters expect European growth to accelerate in 1996 from 1995. This seems unlikely. In fact, going forward, Europe is more likely to surprise on the downside than on the upside.

A surprising rebound. . .

That Europe's economic rebound was surprisingly strong should not really have been that amazing, given that most observers are typically most bearish about prospects at the economic trough, and most bullish about the outlook at the economic peak. For example, in mid-1993 when the European economies were in the process of bottoming, bearish sentiment was widespread. In August 1993 The New York Times ran a series of five articles about Europe's economic woes entitled "Western Europe's Dreams Turning to Nightmares; A Continent Adrift." This "Euro angst" was very much reminiscent of 1982 at the bottom of the last economic cycle when headlines then suggested that "Europe Is Adjusting to a Long Recession That Some Economists See as Permanent" (The Wall Street Journal, December 1982). Given this pervasive gloom, Europe's rebound in 1994 was much stronger than most observers expected, with the result that consensus estimates of European growth rates rose steadily throughout that year.

. . . but an equally surprising slowdown?

We now may have reached that point in the cycle where the outlook for the European economies is too optimistic. This widespread optimism is vividly illustrated by the changes over the last two years in the OECD's forecasts for European economic growth.

<table>
<thead>
<tr>
<th>OECD's forecasts of European growth rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>------------------</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>U.K.</td>
</tr>
</tbody>
</table>

At the end of 1993, the OECD, like most forecasters, acknowledged that the U.K. was leading the European recovery but predicted only about 1.0% growth for the continental economies in 1994. As 1994 came to a close and it became apparent that continental European growth was almost double these estimates, the OECD raised its forecasts for 1995 by an average of 20% and initiated estimates for 1996 that are significantly above those for 1995. Given such high expectations, the risk today is that forecasts for European growth are now too high and do not incorporate the impact of the European currencies’ appreciation or the economic slowdown that is already beginning in the U.S.
An export-driven recovery

Europe’s economic recovery has been largely export-driven. In 1993, of all the major components of economic activity, the only positive contributor to European GDP growth was net exports. Strong growth in exports to the U.S. and Asia subsequently led to a bout of inventory building, which in turn boosted intra-European trade. The OECD estimates that, after growing by 10.2% in 1994, European exports will grow by 7.7% in 1995 and a further 6.9% in 1996. By comparison, after expanding 1.6% in 1994, private consumption in Europe is forecast to rise by just 2.0% in 1995 and still only 2.9% in 1996.

One key factor driving increased European/German exports to Asia was the 30% drop in the value of the DM relative to the yen between August 1992 and August 1993. While German exports to Japan rose only 2% in 1993, German exports to Asia excluding Japan rose 19% as German companies won market share from Japanese companies in Asian markets. However, in the last 12 months, the currency trends have reversed and the DM has gained 7% against the yen since April 1994. These changes in relative cost advantage tend to have a somewhat lagged effect upon actual export levels, so that German machinery that was being pitched as having a pricing advantage versus Japanese competitors has recently lost some of that advantage. And remember that some of that German machinery being sold to Southeast Asia is to make consumer goods that in turn are sold to the U.S. (as well as the U.K., Canada, etc.), where consumption growth will be slowing.

Deutschmark not likely to weaken significantly

The Deutschmark remains the strongest of the major global currencies, a troubling fact for those bullish on Europe’s growth prospects, given that Germany’s export-driven growth has largely been the locomotive of the European economic recovery. Deutschmark strength relative to the dollar and the yen looks set to continue, both near term and longer term. In the near term, the “safe haven” status of the German currency has been enhanced by political anxieties in France, Italy, Spain and the U.K., as well as the Barings debacle. Longer-term trade trends also support the theories that the DM is likely to remain strong against the dollar and the Japanese yen. Chart 1 below shows the continuing growth in the German trade surplus, while Chart 2 shows that the Japanese trade surplus has actually been contracting in yen terms for sometime (as opposed to the Japanese trade balance in dollar terms which is most often referred to — this is due to the “J-curve” effect).

Chart 1: German Trade Surplus

<table>
<thead>
<tr>
<th>Year</th>
<th>Trade Balance in DM (left scale)</th>
<th>Trade Balance in US$ (right scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1986</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>1987</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>1988</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>1989</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>1990</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>1991</td>
<td>12</td>
<td>12</td>
</tr>
</tbody>
</table>

Chart 2: Japanese Trade Surplus

<table>
<thead>
<tr>
<th>Year</th>
<th>Trade Balance in Yen (right scale)</th>
<th>Trade Balance in US$ (left scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>1986</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>1987</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>1988</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>1989</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>1990</td>
<td>13</td>
<td>13</td>
</tr>
</tbody>
</table>

A temporary decline in the DM could be triggered by indications that the world’s central banks are unwilling to accept a significant decline in the U.S. dollar. Over the long term, however, currency intervention is generally viewed as being ineffective unless it is backed up by a willingness to change monetary policy. In this regard, it is highly unlikely that the Bundesbank would approve an easier monetary stance at this point in the economic cycle, especially when German unions are winning generous pay increases. (German metalworkers recently negotiated a two-year pay accord providing a 4.0% raise this year and another 3.6% increase in 1996.)

Similarly, while the Bank of Japan is expected to maintain a relatively accommodative monetary stance in the wake of the Kobe earthquake, it is unlikely to cut the official discount rate. As for the Fed, it seems unlikely that the U.S. central bank would be willing to subjugate domestic economic considerations for the sake of the currency. Indeed, fears that a further Fed tightening could actually increase the risk of a “hard landing” suggests that, while Friday’s strong employment data probably doesn’t entirely rule out some minor further Fed action, a very aggressive Fed response could well prove counterproductive.

The European consumer: Lagging the recovery
With consumption accounting for over 50% of European GDP, continued recovery in most economies depends largely on a stabilization in unemployment leading to an improvement in consumer confidence and spending. Unemployment should start a gentle descent from its current peak of more than 22 million to around 21 million during 1996, bringing the unemployment rate down from around 11.75% to below 11.00%. This will not, however, be enough to bring unemployment in Europe back down to the 10.2% level which prevailed as recently as 1992. Consequently, consumption is likely to continue to grow only slowly in response to gradual increases in real disposable incomes. In addition, savings ratios are already low by historical standards, which further argues for only a modest increase in consumer spending. The German savings rate is at its lowest level in over a decade.

Tax increases, public spending cuts and lower government transfer payments will also have a negative impact on consumer sentiment and disposable incomes. And note that consumer spending in some countries such as France and Spain had been stimulated by government programs designed to increase purchases of autos, but these incentives expire in July. European auto sales this year already look like they will fall well short of the 5% growth experienced in 1994; Ford anticipates an increase in sales of only 1.8% in 1995.

**Fiscal imbalances, Maastricht Treaty further constrain growth**

Another factor that continues to constrain Europe’s growth is the large fiscal imbalances that have lifted government debt in most countries. The total European budget deficit is projected to be 5.2% of GDP in 1995 (versus 1.8% in the U.S.) while gross government debt is projected at 76% of GDP (versus 65% in the U.S.). The steady rise in public indebtedness which most countries have experienced during the past 20 years has made fiscal positions increasingly vulnerable to rising interest rates and debt servicing costs. Economic recovery in 1994 delivered faster than expected revenue growth for European governments, but the accompanying higher than expected bond yields that accompanied the unsettled U.S. Treasury market pushed up debt servicing costs. European budget deficits as a percent of GDP should decline over the coming year, but short rates are forecast to move higher as inflation rises modestly from current levels (with the recent strength of the DM only delaying the Bundesbank from raising short term rates) so that debt servicing costs will continue to be a burden.

While budget deficits will likely decline, gross public debt as a percentage of GDP is likely to continue to rise in virtually all European countries. However, under the terms of the Maastricht Treaty on European Monetary Union, by 1997 a majority of European Union member states must meet the necessary criteria for the EU to move to a single currency. These criteria include a government budget deficit of less than 3% of GDP and a ratio of government debt to GDP of less than 60%. Clearly, in the years before 1997 economic growth across Europe will be constrained by these destimulative requirements. Germany, the U.K. and a number of smaller countries have implemented restrictive measures that are already reducing budget deficits. In most countries, these measures have included not only increases in taxes but expenditure restraints as well. Going forward, the main reduction effort will largely be on the expenditure side, as the overall level of taxation is already relatively high.

**Implications of a European slowdown for stock selection**

One of our investment themes over the past few years has been the opportunity in “Euro-industrials” — those U.S. industrials with exposure to the European recovery. Many prominent U.S. industrial companies derive a significant portion of their revenues from Europe, primarily companies in the technology, chemicals and auto-related sectors.

### S&P 500 industrial companies with 25+% European sales

<table>
<thead>
<tr>
<th>Company</th>
<th>Euro % Tot</th>
<th>Company</th>
<th>Euro % Tot</th>
<th>Company</th>
<th>Euro % Tot</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foster Wheeler</td>
<td>59.6%</td>
<td>Autodesk</td>
<td>36.7%</td>
<td>Trinova Corp</td>
<td>29.6%</td>
</tr>
<tr>
<td>Varity Corp</td>
<td>54.1%</td>
<td>Avery Dennison</td>
<td>36.6%</td>
<td>Amdahl Corp</td>
<td>29.1%</td>
</tr>
<tr>
<td>Great Lakes Chem</td>
<td>52.7%</td>
<td>Intergraph</td>
<td>35.4%</td>
<td>Intel Corp</td>
<td>28.2%</td>
</tr>
<tr>
<td>Digital Equip</td>
<td>48.5%</td>
<td>Hewlett-Packard</td>
<td>35.3%</td>
<td>Dow Chemical</td>
<td>26.8%</td>
</tr>
<tr>
<td>Raychem Corp</td>
<td>46.5%</td>
<td>Engelhard Corp</td>
<td>35.1%</td>
<td>Ingersoll Rand</td>
<td>26.6%</td>
</tr>
<tr>
<td>Oracle Systems</td>
<td>45.0%</td>
<td>Microsoft</td>
<td>34.3%</td>
<td>Polaroid Corp</td>
<td>26.6%</td>
</tr>
<tr>
<td>Pall Corp</td>
<td>42.1%</td>
<td>Whirlpool</td>
<td>32.0%</td>
<td>Tandem Computer</td>
<td>26.5%</td>
</tr>
<tr>
<td>Perkin-Elmer</td>
<td>41.6%</td>
<td>Data General</td>
<td>31.8%</td>
<td>Scott Paper</td>
<td>26.0%</td>
</tr>
<tr>
<td>DuPont</td>
<td>38.6%</td>
<td>Lotus Develop</td>
<td>31.5%</td>
<td>3M</td>
<td>25.0%</td>
</tr>
<tr>
<td>Compaq</td>
<td>37.8%</td>
<td>AMP Inc</td>
<td>30.5%</td>
<td>Sun Microsystems</td>
<td>25.5%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Apple Computer</td>
<td>25.1%</td>
</tr>
</tbody>
</table>

- 3 -
Note that PaineWebber's International Computer Spending Index — largely driven by European respondents— fell noticeably in February. The survey indicated that minicomputer, and especially mainframe demand, remained weak, while PC and workstation demand declined modestly. And, as noted above, European auto sales this year already look like they will fall well short of the 5% growth experienced in 1994; Ford anticipates an increase in sales of only 1.8% in 1995. In addition, PaineWebber appliance analyst, Jeffrey Sprague, reports that 1995 is shaping up to be a less than inspiring year for the European appliance market, with industry growth for 1995 likely to be in the 1.5-3.0% range.

The Euro-industrial theme had worked well, with our Euro-industrial index (of S&P 500 stocks with a large European exposure) gaining 80% from their trough in October 1990 to their apparent peak in October 1994. But given an increased focus on stocks with a record of consistent earnings growth and with low earnings volatility, it may already be time to look elsewhere.

Someplace to hide

Which companies can benefit from a weak dollar (i.e., the increased competitiveness of dollar-costed products and/or currency translation gains) yet have the earnings stability to not be materially penalized by any global economic slowdown? The five companies below have an earnings volatility less than that of the market and derive 30% or more of sales from abroad. These five would seem to be a good place to hide in a period of economic deceleration and dollar weakness, in that they will benefit from a weaker dollar owing to their foreign sales exposure, but they are not high volatility/economically sensitive stocks.

<table>
<thead>
<tr>
<th>Company</th>
<th>Ticker</th>
<th>Price 3/9/95</th>
<th>PW Rating</th>
<th>Standard Deviation of EPS Growth 1984-1994</th>
<th>Foreign sales as a % of total sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abbott Labs</td>
<td>ABT</td>
<td>34 7/8</td>
<td>1</td>
<td>3.2%</td>
<td>36%</td>
</tr>
<tr>
<td>Becton Dickinson</td>
<td>BDX</td>
<td>54 1/4</td>
<td>2</td>
<td>12.0</td>
<td>44</td>
</tr>
<tr>
<td>Coca-Cola Co</td>
<td>KO</td>
<td>55</td>
<td>1</td>
<td>3.5</td>
<td>67</td>
</tr>
<tr>
<td>Interpublic Group</td>
<td>IPG</td>
<td>33 3/4</td>
<td>2</td>
<td>3.8</td>
<td>67</td>
</tr>
<tr>
<td>McDonald’s Corp</td>
<td>MCD</td>
<td>33</td>
<td>1</td>
<td>5.4</td>
<td>47</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td></td>
<td>483.16</td>
<td></td>
<td>15.0%</td>
<td>30-35%</td>
</tr>
</tbody>
</table>

Prices of other companies mentioned as of 3/9/95:
Abbott Labs ABT $34 7/8
Amdahl Corp AMH $10 3/4
AMP Inc AMP $38
Apple Computer AAPL $93 3/4
AutoSed, Inc ACO $38 1/4
Avery Dennison AVY $37 1/2
Becton, Dickson BDX $54 1/4
Black & Decker BDK $26 5/8
Coca-Cola Co KO $55
Compaq Computer CPQ $33 1/2
Data General DGN $7 7/8
Digital Equip DEC $32 1/2

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2 PaineWebber Incorporated makes a market in this security.

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