



Causeway Capital Management LLC  
**Market and Economic Commentary**  
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An ignominious year for international stocks, 2011 brought a variety of economic shocks and a string of natural disasters. Every major non-US global equity market finished the year in the red. Emerging markets produced the greatest losses, heralding deceleration in global growth. Inflation concerns and subsequent interest rate increases dampened demand for emerging market equities. The negative returns were substantial: India - 37%, Russia -19%, and China -18%. Brazil had both a 12% market decline, and also a 12% depreciation of the real, leaving investors with a loss of 22%. In the developed economies, the US market stood apart, representing an investment haven from the European financial crisis and its secondary effects. The S&P500 was flat, while the Dow rose 6%. This compares with -20% for the Euro Stoxx 50, a polarized benchmark of well-behaved consumer staples and energy-related stocks dragged down by the weight of European financials and cyclicals. Why did US equities dominate all other regions? The US economy has several bright spots in manufacturing and services activity, whereas Europe (especially peripheral euro zone) has the potential for a severe recession in 2012. A major engine of global demand, China must engineer a slowing of property prices and endure a loss in export competitiveness. We believe that global equities have discounted much of the economic malaise facing Europe near term, excluding the nightmare scenario of euro zone disintegration (a scenario we currently consider unlikely). Post 2012, we expect a more competitive European Union, and the implementation of labor reforms with lasting positive implications for employment and economic expansion. We expect the US economy to recover, supported by accommodative monetary policy, improved consumer spending, and another year of postponing the inevitable fiscal restructuring. With a dwindling current account surplus, Japan may have only a few more years before it must also confront its staggering fiscal debt. Equity markets are likely to applaud any signs of rational, pragmatic political decisions in all geographies, especially Europe. Emerging markets should rally the most, as money flows from zero-yielding money market funds to risk assets.

At the end of November 2011, the Organisation for Economic Co-operation and Development (OECD) issued its latest economic projections for its 34 member countries. The OECD economists forecast a mild recession in greater Europe and a slowdown across the rest of the developed/rich world. They expect euro zone growth to fall from 1.6% in 2011 to 0.2% in 2012, while the US should produce real GDP of 2.0%. Although the 34-nation constituents comprise about two-thirds of global GDP, this group should contribute only 28% to world GDP growth, on average, between 2012 and 2013. We do not currently expect any rich world inflationary pressures in 2012, with sluggish growth, capped wages – especially European – and tight credit conditions as banks respond to strict capital requirements.

What explains our sanguine view of the euro area fiscal crisis, with a low probability of a breakup of the euro zone? We give several reasons, including the prohibitive cost per person of leaving the common

currency, a prospective collapse in banking systems, capital flight, etc. However, our most powerful argument rests with the actions of the European Central Bank (ECB). Although criticized for not buying Italian and Spanish sovereign debt in unlimited quantities, the ECB has singlehandedly saved the European banking system. The ECB is engaging in unlimited lending to the region's troubled banks. While European politicians struggle to ratify a plan for fiscal union, the ECB must be the lender of last resort. This crucial bank liquidity keeps sovereign insolvency from becoming a self-fulfilling prophecy. We believe that the ECB has no alternative. Imagine a situation where the ECB allowed lack of confidence in the banks to precipitate depositor panic and bank runs. With depleted funding, the banks would impose a straightjacket of deleveraging and a lending ban that would send European economies into a tailspin. Technocratic and other disciplined governments in southern Europe need time – probably a few years – to regain investor confidence in their sovereign bonds and hammer out a sustainable fiscal solution. The ECB can fund the region's banks for as long as necessary. This sounds like a major dose of quantitative easing (“QE”). Yes, indeed, total ECB lending is now about equivalent to the Fed's largest round of QE. Liquidity-recipient banks earn the spread between the cheap (1%) ECB funding and buying their own (or other) high-yielding corporate and/or government debt. We currently believe the ECB's Mario Draghi and team will ultimately do whatever it takes to replenish confidence while banks continue to bolster capital. The ultimate solution to the fiscal crisis in the euro zone rests with policy makers and politicians. No monetary union can sustain itself without fiscal coordination. We currently believe euro member states will eventually reach a unified decision on shared fiscal monitoring and coordination, and will gradually implement growth-oriented policies. The bond market – the source of external discipline – will respond negatively to any poorly constructed deals for euro-backed bonds. The EU must become more intrusive in the proper monitoring of budgets and will probably implement pre-emptive mechanisms to identify imbalances. The EU will also likely have enforcement powers and sanctions (e.g., financial penalties) for countries which fail to meet targets. Fiscal policy will remain the task of local governments, but room for maneuver will be strictly limited.

What are the implications for corporate earnings? Our interviews with management generally indicate limited impact thus far on growth and profitability. Companies expect affordable and abundant labor in many industries, price relief in an array of raw materials, and (for the healthy businesses) low financing costs. Barring a politically-induced crisis, this implies resilient corporate earnings. The majority of companies we research have taken steps to avoid another 2008-style collapse. They have extracted greater efficiency from their operations and capital structures, and have boosted productivity and slashed fixed costs to the bone. Even financial sector balance sheets have considerably more cushion than they did in 2008/9. Moderate earnings growth will likely boost equity returns above those from government bonds and cash. Some of the most promising global sectors and industries for investment in 2012 include capital goods, especially large, European and Asian multinational companies positioned to benefit from a more competitive local currency and with no need for bank financing. We also find energy-related business very attractive such as petrochemical engineering and oil and gas services. We will continue to look for stocks benefiting from aging populations and increased demand for healthcare



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through pharmaceuticals and healthcare services. As for the most deeply discounted stocks, we point to the European small/mid-capitalization cyclical companies. Abandoned in a mass exodus from Europe, many of the better small-mid-size companies trade miles from fair value, making them candidates for a multifold recovery in share prices. We also remain confident in emerging markets, where earnings growth will likely (again) surpass the developed world. We track the geographic split of revenues of the companies in our clients' portfolios and the international and global indices. Each quarter, the percent of revenues generated from emerging countries increases. In 2012, Causeway's fundamental value portfolios should be well positioned to capture any relief rally in European markets, and will give our clients both direct (if permitted by client guidelines) and indirect emerging markets exposure. We want the exposure to economic growth – without the risk of paying a premium price.



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