Chandler Asset Management

Europe's Nascent Economic Recovery

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Since 1988, Chandler Asset Management has specialized in the management of fixed income portfolios.

Chandler's mission is to provide fully customizable, client-centered portfolio management, which preserves principal, manages risk, and generates income in our clients' portfolios.

After six quarters of declining gross domestic product in the euro zone, economic growth finally turned positive in the second quarter of 2013, marking the end of a long recession in the region. Several recent economic data points have also been indicative of improving economic conditions in Europe. Meanwhile, fears of a potential breakup in the euro zone which rattled the financial markets over the past few years have diminished significantly, due in large part to accommodation from the European Central Bank and stabilization in demand. It appears that market participants have become more complacent about Europe as tail risks from a European breakup have dissipated. Many investors are now looking to Europe for undervalued investment opportunities. However, Europe is not completely out of the woods in our view, as core structural economic issues have not been completely resolved and many of the peripheral countries continue to struggle.

While economic data in the euro zone has improved, GDP growth in the region is still lagging behind growth in other parts of the world such as the United States and China. Moreover, improving economic data in the euro zone has also largely been fueled by gains in core nations such as Germany and France. Meanwhile, economic growth in many of the southern peripheral countries such as Cyprus, Greece, Italy, and Spain, has continued to contract and unemployment levels remain unfavorably high. The unemployment rates in Greece and Spain remain well over 20%. Many of the peripheral countries also continue to contend with very high government debt to

RECENT EURO ZONE ECONOMIC DATA (Aggregate data for euro zone member states)
Positive
Industrial output rose 1.1% in 2Q13 (the fastest pace since 4Q10).
2Q13 GDP rose 0.3% (following 6 quarters of declines).
Construction output rose 1% in 2Q13 (the strongest rise since1Q11).
Manufacturing PMI rose to 51.4 in August from 50.3 in July (above 50 indicates growth).
Consumer confidence rose to -15.6 in August from -17.4 in July (better than expected).
Business Climate Indicator rose to -0.21 in August from -0.52 in July (the 4th monthly increase).
Gross fixed capital formation rose 0.3% in 2Q13 from 1Q13.
Exports rose 3% in June from May (seasonally adjusted basis), while imports rose 2.5%.
Government spending rose 0.4% in 2Q13 from 1Q13 (a sign that austerity is easing).
Neutral
CPI remained unchanged at 1.6% year-over-year in July. Core CPI also remained unchanged at 1.1%.
Unemployment remained steady at 12.1% in July (highest in Greece and Spain, lowest in Austria and Germany).
PPI rose to 0.2% year-over-year in July, after rising at a rate of 0.3% in June (slightly higher than expected).
Retail sales declined 1.3% year-over-year in July, but rose 0.1% from June.
Negative
M3 money supply slowed in July to 2.2% year-over-year from 2.4% in June (lower than expected).
Private sector loans declined 1.9% year-over-year in July, faster than the 1.6% decline in June.

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CELEBRATING 25 YEARS OF SERVICE

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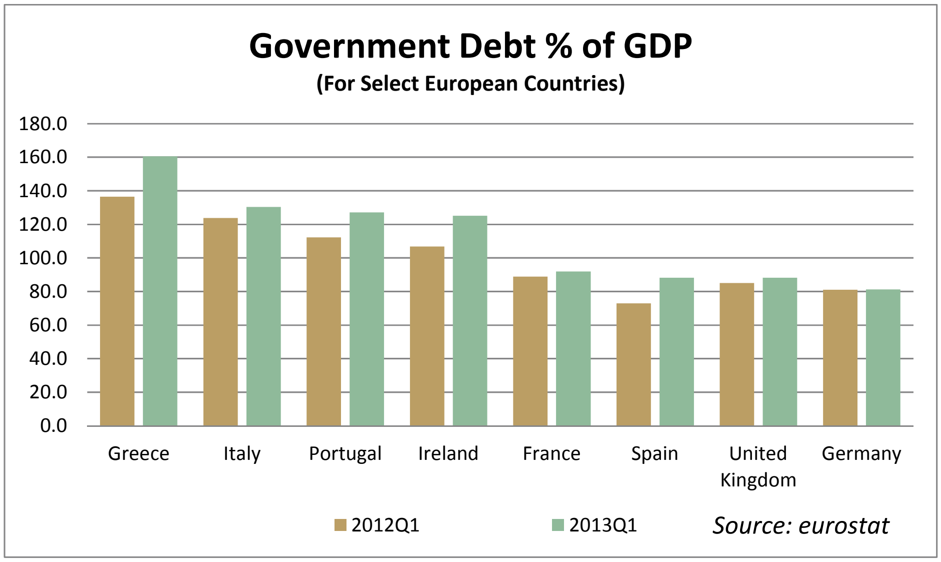
GDP ratios. At the end of the first quarter, the sovereign debt to GDP ratios in Greece, Italy, Portugal and Ireland were each above 100%.

European Central Bank (ECB) policymakers have made strides toward stabilizing the European economy and tackling the region's debt crisis. They have lowered interest rates (the ECB's benchmark interest rate currently stands at a record low of 0.5%, down from 4.25% in 2008) and provided cheap financing to euro zone banks through the Long-Term Refinancing Operations (LTRO), which launched in December 2011. However, governments are largely expected to maintain their austerity policies, in an effort to curtail their heavy sovereign debt loads. In our view, this means the euro zone is unlikely to see a significant jump in economic growth anytime soon. In addition, the ECB is unlikely to keep its key interest rate low for long, given that its primary mandate is to protect price stability (unlike the Federal Reserve's dual mandate of maximizing employment and price stability). As such, we believe investment downside risks still remain and investors should be selective about their exposure to Europe.



We remain particularly cautious about many European banks, which are still working to implement stricter capital requirements. The euro zone is also still in the early stages of developing a banking union in which the ECB and national supervisory authorities will jointly assess the health of systemically important banks. European leaders are taking steps in the right direction, but structural reforms take time to implement.

Nevertheless, we believe improving economic conditions in Europe could be a tailwind for corporate earnings in the second half of 2013. Economists at BCA Research estimate that corporate operating earnings in the euro zone could rebound meaningfully by the end of this year. They believe the catalysts for improvement in corporate profits will be a decline in borrowing and labor costs, as well as a reduction in government fiscal austerity.

We believe earnings upside exists not only for European-based corporations, but also for U.S.-based multinationals. Whereas Europe has been a weak spot for many corporations (such as Ford, Staples, and Coca-Cola) over the past year, we believe improving economic fundamentals in Europe could contribute to positive earnings surprises for these companies in coming quarters.

Shelly Henbest
VP, Credit Analyst

Shelly Henbest joined Chandler Asset Management as a credit analyst in 2009. She is actively involved in analyzing and assessing the credit suitability of debt issuers and assisting portfolio managers in the portfolio management process. Shelly is a member of the firm's Credit Committee, the Economic and Market Analysis Committee, and is responsible for monitoring developments in the financial markets and providing fundamental economic and investment research. Shelly has more than 12 years of experience in financial research and analysis.