European Uncommon Market

Unless you've been exiled to Elba, you've probably heard that all is not well in Europe. The common thread is that places in which the climate is nice and sunshine is abundant seem to be those with the biggest fiscal problems and thus the deepest crisis of confidence. All places that beat the heck out of a Seattle winter: Spain, Greece, Portugal and Italy. Interestingly, a less temperate Ireland is on the rocks but seems to be getting its act together.

The reality is the EU had structural contradictions and conflicts from the very start. Being able to cross the borders of countries the size of New England states without having to swap currencies or clear customs sure sounds convenient. But a monetary union of disparate Eurostates is the typical politician's fallacy: known, obvious benefits and hidden (or ignored) costs. With the situation at a head, the costs are now in plain view.

Is it wise to have the same monetary policy for both Germany and Italy? One currency necessarily means only one central bank. There's a reason a dollar bought 2,200 Italian lira yet only 2.3 German mark when the euro took over. Italy had a long history of printing money shortly before elections with the ill side effects not revealed until after Signore Incumbent had been re-elected.

When free-spending nations handed the central bank mantle over to Brussels, they lost their unilateral ability to inflate away their growing debts. Part of joining the EU was a mandate that any member get its budget deficit down to specified, low levels, around 2% of GDP. However, the EU for all its bluster has no serious enforcement options for fiscally profligate members.

And getting a fiscal house in order is easier said than done, as we Americans have recently observed at home. While European countries may be physically close, their internal mechanics are far apart. It's tough to cut the fat when civil servants (Greece), farmers (France) or pensioners (Spain) have grown accustomed to decades of "freebies" sponsored by taxpayers or sovereign lenders.

There are no easy solutions to this mess. And it is a precautionary tale for the U.S., as we are presently running a budget deficit higher (as a percentage of GDP) than Greece.

As with all crises, this one has produced both casualties and opportunities in the form of undervalued stocks. These include a French-based utility priced at more than half off, a bargain Spanish-based media business with major operations in fast-growing Latin America, and the preferred of a too-big-to-fail UK bank, which follows the U.S. playbook of three years ago. We discuss the former and the latter later in the letter.

Equities

Stocks have remained volatile as government debt concerns have weighed on equity prices. U.S. stocks have held up better than the rest of the world, with the S&P 500 up 1.3% through November versus a 6.9% decline for the All Cap World Index.

Overall stocks appear reasonable. The S&P 500, at 1,253, is selling for 14.4 times trailing earnings and 13 times forward estimates.

One of the most interesting paradoxes in the market is the difference between borrowing rates on high-quality, large companies and the earnings yields on their stocks. Below are a few examples, the debt of each is rated at least AA:

Company	Earnings Yield	25+yr Bond Yield
Johnson & Johnson	6.4%	4.1%
Wal Mart	8.1%	4.5%
Microsoft	10.9%	4.1%
Disney	6.9%	4.3%

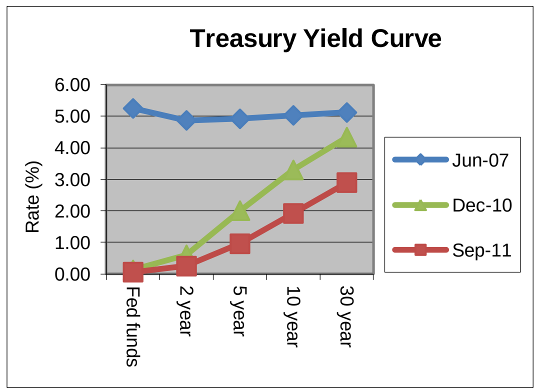
Historically the stock/bond yields have tended to be more comparable, as the expected growth in earnings on the stock was considered to be the reward for taking on more risk than the bonds. Bond yields are indeed artificially low because of central bank efforts. But a name like Microsoft just leaps off the page. Indeed big tech is statistically cheap across the board, and we have a major allocation to the sector.

	2011 P/E	Div Yield	2001 P/E
Microsoft	9.2	3.1%	31.1
IBM	15.0	1.6%	24.0
Cisco	16.2	1.3%	108.0
Hewlett-Packard	8.4	1.7%	28.1
Intel	10.7	3.4%	53.8
Dell	8.2	0.0%	36.2
AVERAGE	**11.3**	**1.9%**	**47.9**

On average the bellwethers above are 77% cheaper per dollar of earnings than they were 10 years ago, and they are cheap on an absolute basis.

Bonds

Long-term treasury bonds rallied as European periphery yields spiked. In September the Federal Reserve announced “operation twist,” in which it would use the proceeds from maturing medium-term, 3- to 5-year bonds to buy longer-term bonds and attempt to bring long-term interest rates lower. The result can be seen in the yield curve below. The September curve appears to be swinging lower from where it is attached at the Federal funds point (which is 0.06% and can’t go any lower).



We continue to find value in large bank trust preferreds. The dividends on these “senior to preferred” issues were never suspended during the financial crisis. This represents a stress test whose severity is unlikely to be matched.

Non-investment-grade issues continue to selectively be an area of relative value after selling off this summer. We were early in purchasing Sears Holding debt in August, so we purchased more. Sears did the same, buying back 20% of the notes in the first three quarters of the year, which were just issued in 2010. The notes are secured and well covered by asset value. RR Donnelly senior notes were another recent addition, yielding nearly 9% to maturity.

We added RBS preferred to fixed income oriented accounts. RBS is a UK-based bank that ran into problems during the ’07/’08 fiscal crisis. It was bailed out by the UK government, who became majority owners. Dividends on the preferred were suspended in 2009 but are tentatively set to resume in April 2012. We emphasize *tentative*, as it depends on the whims of the board and capricious regulators. Importantly, RBS has boosted capital levels, is profitable and has low exposure to European sovereign debt. The preferred is senior to the UK government’s stake. There were multiple ways we played this thesis here in the states during the downturn: GMAC debt, large bank trust preferreds, and Citi preferred stock prior to a forced conversion. Shaking hands with the government is a good deal, particularly when you stand a step above the government.

Stock Updates

We sold **American Express** in the 4th quarter due to valuation and concerns about the company’s rising cost of benefits and eroding merchant fees. We disposed of shares at a 17 times multiple to its average five-year earnings. Amex was one of our better investments as it was funded with proceeds from the sale of Kodak, which has since plunged from our sale price of $13 to just over $1.

The valuation of **Hewlett Packard** became too irresistible and we added shares in the 3rd quarter. This is our second go-round with HP, having bought shares 10 years ago amidst the contentious merger with Compaq. Shares are cheaper this time around; the company is more diversified, and the dividend yield is higher. And it worked out well last time.

Cemex is one of our cheaper names and we averaged down in October at less than $4 a share. Cemex has grown via acquisition from merely dominating the Mexican cement market to being a global operator. A large U.S.-centric acquisition at the top of the market in 2007 brought a huge debt load, which Cemex has been slow to pay down due to depressed cement demand.

We added **Whirlpool** at the end of November to income-oriented accounts. Whirlpool is the largest appliance maker in the world, with highly profitable operations in Latin America and growing business in Southeast Asia. Whirlpool earnings are relatively stable over the cycle and shares yield 4.1%.

Veolia Environment is a utility company diversified by geography and industry. They offer water, wastewater treatment, trash and recycling collection and sorting, public transit management, and other services. We added shares in October, as the company is defensive and undervalued due to European concerns.

Harper Asset Management specializes in managing capital for private clients according to a long-term, value-oriented process. We also assist clients with financial and life planning.

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