MARKET INSIGHTS

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Is a More Integrated Europe the Answer?

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At the time of publication, Germany has voted (overwhelmingly) in favor of an expanded EFSF to stabilize the European Sovereign debt crisis, an important step towards reducing near-term concerns. However, broader problems still loom.

In recent weeks, mounting skepticism surrounding the ability of European policymakers to contain the broadening debt crisis has exacerbated fears of recession in developed economies, sending risk assets plunging and volatility soaring. In the following update on the situation in Europe, we'll consider:

- The underlying issues plaguing Europe
- A summary of steps taken to address them thus far
- A look at possible next steps and solutions (including some worst-case scenarios)
- A few thoughts on investing in such difficult times

While the exact outcome for Europe is difficult to predict, our hope is that the following offers some bit of clarity and context, and in turn, helps investors make more informed investment decisions.

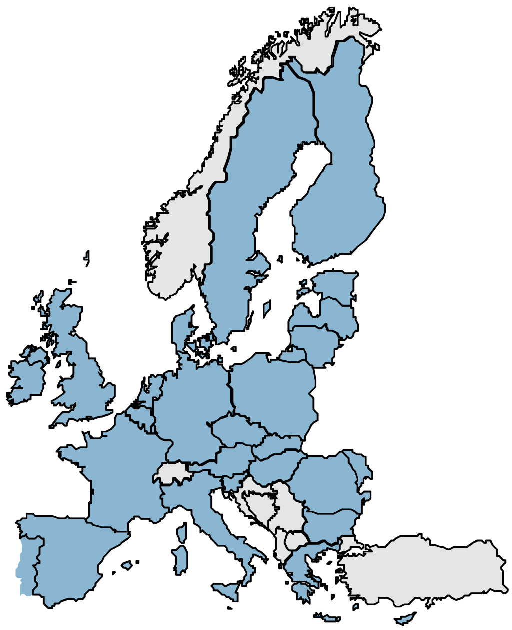
Early integration: Formation of the European Union

Despite today's various challenges, the European continent has come a long way in the last 60 years. In the aftermath of World Wars I and II, European policymakers sought stronger ties between countries as a means to foster both greater economic synergy and general peace in the region. In 1951, the Treaty of Paris was signed by France and West Germany, and later by Italy, Belgium, Luxembourg and the Netherlands, creating Europe's first supranational entity – the European Coal and Steel Community. The idea was that the creation of a common market for coal and steel could contribute to economic expansion, employment growth and an increase in living standards.

Six years later, the same countries signed the Treaties of Rome, establishing a broader European Economic Community (EEC), and over time, additional treaties brought greater integration. In 1993, the European Union (EU) was formed, and today the EU has 27 member nations. The European Monetary Union (EMU), a subset of the EU, has 17 members, all sharing a single currency (the euro) and monetary policy as administered by the European Central Bank (ECB).

Below is a map showing the EU in its current form. Taken together, the bloc represents the world's largest economy, accounting for roughly 25% of global GDP in 2010.

CHART 1: THE EUROPEAN UNION



Sources: J.P. Morgan Asset Management.

Shortcomings of the European Union

In many ways, the evolution of the European Union can be viewed as a significant success, measured in decades of peace and moderate prosperity. However, the introduction of a single currency to an otherwise loose confederation of nations exposed Europe to particular risks – some of which had been warned of years ago.

Lack of fiscal oversight and redistribution mechanisms

A 2009 study by Lars Jonung and Eoin Drea documented the views of U.S.-based economists on the prospects for the EMU during its formative years. They found that, among other things, economists had expressed concern around the lack of reliable fiscal oversight and redistribution mechanisms.

Quoting from their work:

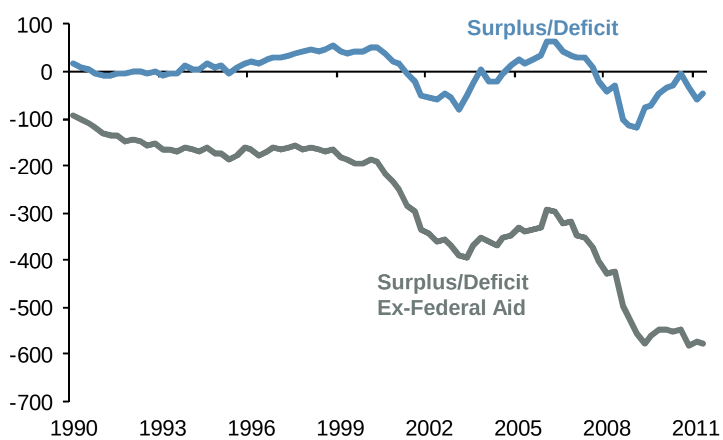
"Robert Inman and Daniel Rubinfeld (1992), comparing EMU with the US, found that 'with a centralised monetary policy, a substitute fiscal policy to ease the burdens of state specific economic shocks is needed.' These studies stressed that fiscal transfers, whatever the precise figure involved, partially offset regional asymmetric shocks in the United States."

Economists were, of course, referring to the fact that in the United States, the federal government can redistribute tax dollars as needed to offset regional economic weakness or shocks – a common occurrence in the United States. Much of this is automatic – a state hard-hit by recession will automatically generate less income tax or corporate tax revenue for the federal government, but this in no way slows the flow of federal Social Security, defense or transportation dollars into the state. In addition, the federal government routinely transfers money to state and local governments, as even in normal economic environments, some states spend more than they generate in tax revenue.

Recently, however, the most notable fiscal transfers have been those that came about in response to the financial crisis, when the U.S. government provided a sizable amount of funding to state and local governments in an effort to offset weaker tax revenues. As shown in the chart below, federal grants-in-aid have significantly contributed to state and local finances, particularly in the aftermath of the financial crisis.

CHART 2: STATE AND LOCAL GOVERNMENT SURPLUS/DEFICIT

Including and excluding federal aid, $bn



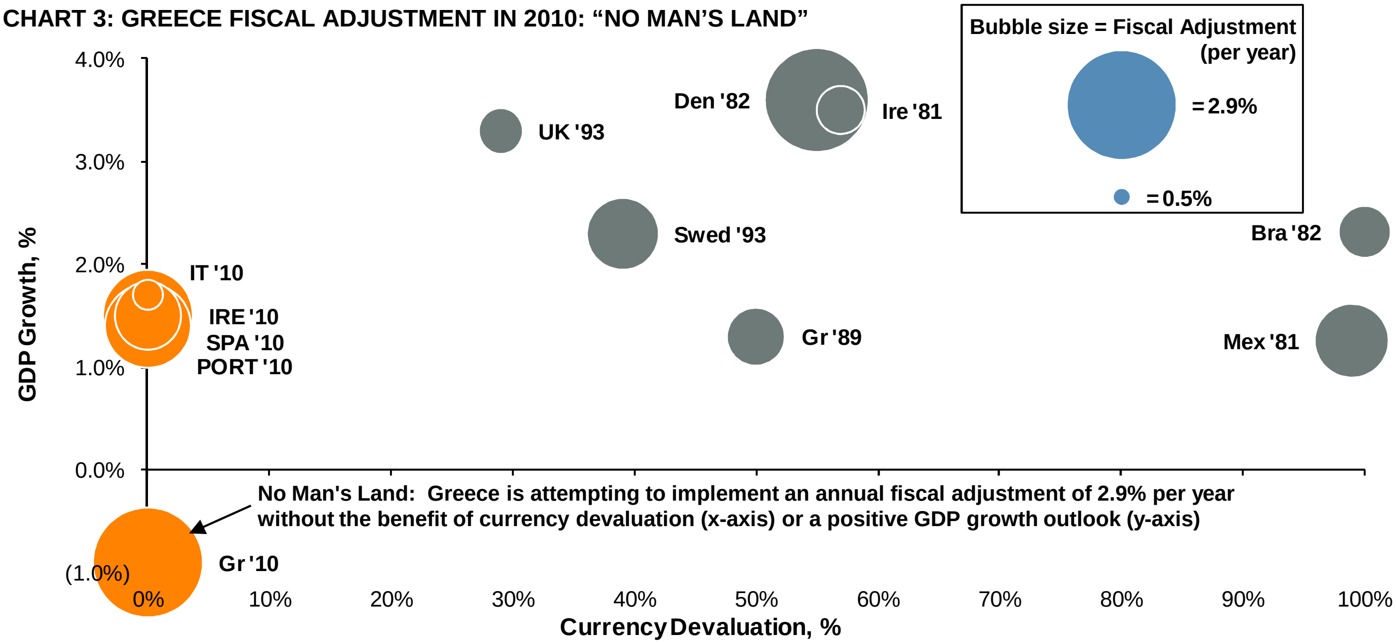
Sources: BEA, J.P. Morgan Asset Management.

While these transfers, coupled with balanced budget laws, have helped various state and local governments in the U.S., fiscal transfers of this scale do not occur within the EU. All this is not to suggest that the Europeans hadn't considered these risks; the 1997 Stability and Growth Pact provided fiscal guidelines for EMU members, setting budget deficit and overall debt limits of 3% and 60% of GDP, respectively. But without the means for proper enforcement, some countries – especially those in the European periphery – accumulated budget deficits and debt levels well in excess of these targets. Particularly, years of uncoordinated fiscal policy have left unsustainable strains on the euro, and if transfers had been possible, it seems that some of these strains could have been averted.

Lack of currency adjustment option

Being beholden to a shared currency in the post-2008/2009 crisis posed another serious challenge to heavily indebted countries: it deprived member states of the ability to devalue their currencies. The chart below is courtesy of J.P. Morgan Private Bank, and documents historical instances of fiscal and currency adjustment in response to recessions or other crises. For example, the Latin American debt crisis of the early 1980s saw a heavily indebted Brazil take steps to massively devalue its currency, which helped to boost exports, although at the cost of higher inflation. Of course, for the Greeks, this is not an option, as they remain locked into the euro. This lack of a devaluation "out" has added to the market's skepticism around the austerity promises in Greece and other periphery countries.

CHART 3: GREECE FISCAL ADJUSTMENT IN 2010: "NO MAN'S LAND"



Sources: IMF, OECD, Barclay's Capital, J.P. Morgan Private Bank, J.P. Morgan Asset Management. Data as of December 2010.

'Till Debt Do Us Part: The Roots of Europe's Woes

As discussed, some countries in the European periphery have accumulated significant debt burdens. The charts on the following page highlight projected debt-to-GDP levels, deficit-to-GDP levels, and 2011 real GDP growth rates for select countries, as well as the Euro area as a whole. Obviously, 3% deficit-to-GDP ratios and 60% debt-to-GDP ratios were surpassed long ago, and to complicate matters, many countries are currently experiencing little, if any, GDP growth.

CHART 4: 2011 GDP GROWTH
IMF estimate, percent

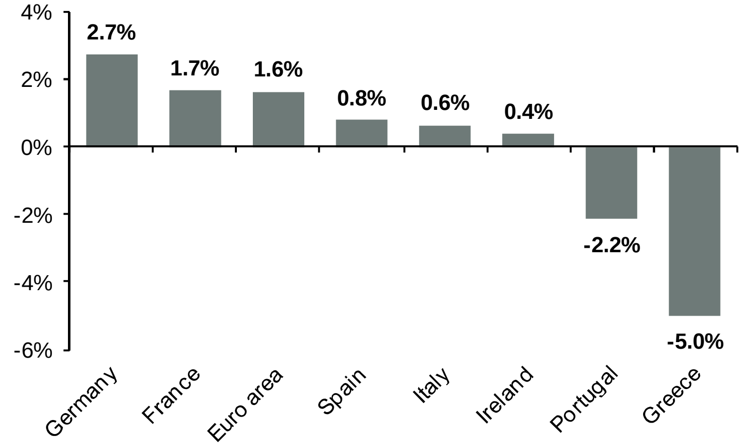


CHART 5: 2011 DEFICIT
IMF estimate, % GDP

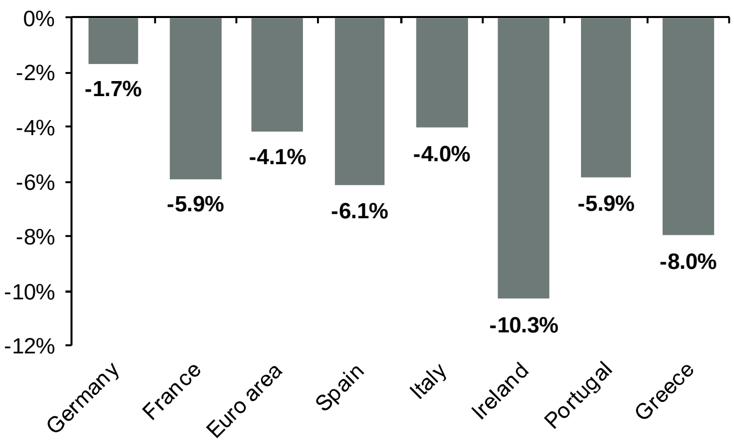
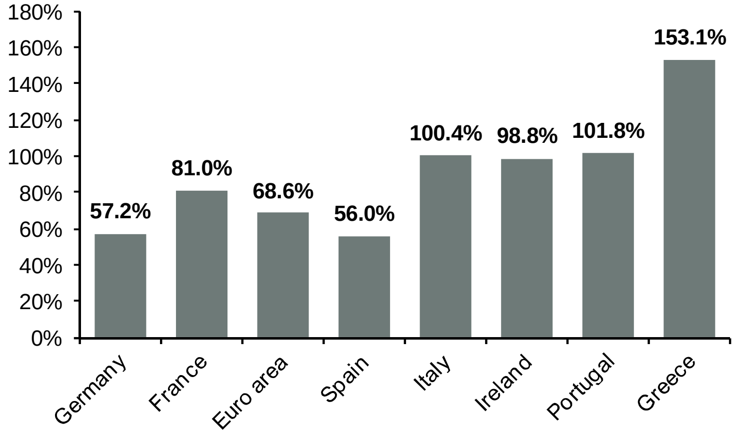


CHART 6: 2011 NET DEBT
IMF estimate, % GDP



Sources: IMF, J.P. Morgan Asset Management.

While the Euro area in aggregate does not look that bad, unsustainable finances in the European periphery have stoked market fears that some countries might be unable to make timely future principal and interest payments on their outstanding debt. This grim specter has sparked a vicious feedback loop, whereby nervous investors scramble to sell the threatened bonds, boosting borrowing costs for beleaguered countries. This, in turn, makes debt service even less manageable, further fanning the flames of investor anxiety. European policymakers have yet to find a way to extinguish these flames.

The political problem: Tax payer bailouts...of a different country?

During the U.S. financial crisis of 2008-2009, it was understandable that some U.S. taxpayers questioned the validity of so-called "bailouts" to companies in the financial and auto industries. But imagine if the government wanted to allocate trillions of U.S. taxpayer dollars to help another country pay its bills! This is part of the fundamental problem in Europe: *the political realities make it very difficult to take bolder action in response to the growing crisis.*

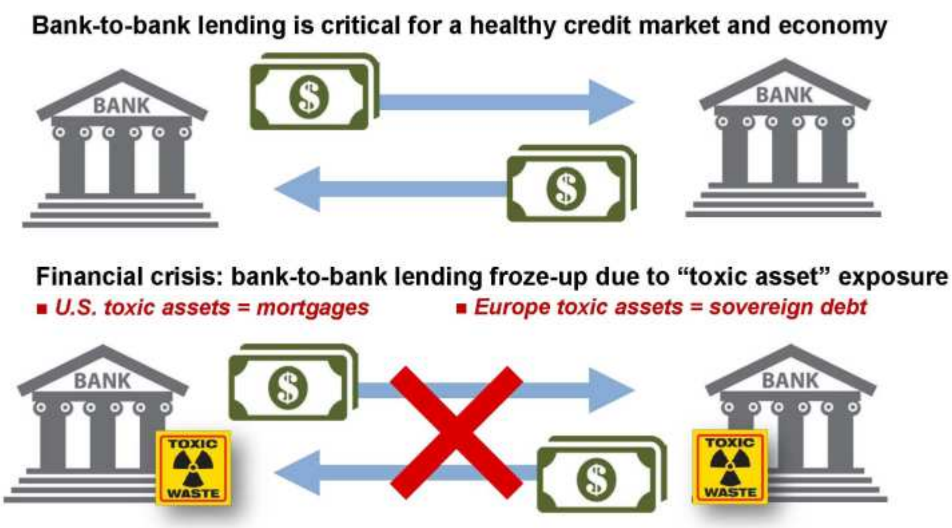
In the absence of a reliable, centralized mechanism for supporting "weak links" in the periphery, healthier countries (like Germany or France) are forced to contribute to rescue programs for weaker, more heavily indebted countries (like Greece). Accomplishing this has been difficult to say the least. Consider, for example, that the European Monetary Union includes 27 countries whose citizens speak 23 languages and boast a variety of proud and distinct cultures. For a German taxpayer, to "bail out" a Greek debt problem seems fundamentally wrong, making greater European integration a high hurdle.

The banking problem: Is that toxic asset contagious?

As if a sovereign debt crisis was not enough, a potential banking crisis looms as perhaps the biggest threat to global capital markets in the near-term. To understand this problem, the lessons of the U.S. financial crisis in 2008-2009 can provide a solid framework for comparison, and it all starts with interbank lending – as depicted in the diagram on the next page.

As shown below, bank to bank lending forms the foundation of credit markets. If one bank doesn't have adequate reserves on-hand to make a loan to a customer, it can readily borrow the funds from another bank to complete the transaction. Typically, banks lend to each other at very low interest rates, as they are reasonably confident they'll be repaid. However, in the years leading up to the financial crisis, many U.S. banks amassed large holdings in very complex securities that were tied to sub-prime mortgages. As the mortgages went bad, so too did the derivative assets; as the value of these assets plummeted, it eroded bank capital and called into question the very solvency of many banks – hence the term, "toxic assets." In short order, banks stopped lending to each other due to fears that they wouldn't be repaid, leading to total seizure of credit markets and a free-fall in economic activity. As a result, it became virtually impossible for a brief period to borrow money to buy a car or a home, or to build a factory.

CHART 7: BANK-TO-BANK LENDING



Sources: J.P. Morgan Asset Management.

European banks now find themselves in a similar situation, but with one key difference: instead of having exposure to toxic mortgage-related assets, the "toxic assets" are bonds issued by troubled sovereigns, like Greece. Fears regarding the solvency of some countries has resulted in panicky selling of these bonds, which has, in turn, eroded bank capital ratios and jeopardized the European banking system as a whole. As of the end of March 2011, data from the Bank of International Settlements suggests that European banks had approximately $490bn of exposure to the sovereign debt of Greece, Ireland, Italy, Portugal and Spain.

Is TARP possible in Europe?

In the U.S., the $700 billion Trouble Asset Relief Program (TARP) was used to recapitalize banks, in some cases removing the bad assets from bank balance sheets in exchange for cash, and in other cases, simply crediting banks' reserve accounts with funds from the Federal Reserve. Over time, the recapitalization effort reassured markets that not only were officials ready, willing and able to act aggressively to support the banking system, but also that the banks would survive. To some extent, confidence was restored and interbank lending markets began to thaw.

Can the same “success” be achieved in Europe? So far, programs similar in nature to TARP have been implemented, but none have matched the “shock and awe” of TARP in terms of size and scope. To date, Europe has only been able to muster piecemeal steps toward preventing a banking crisis.

What *has* been done so far?

Trying to keep up with the numerous policy steps taken in Europe can feel like swimming through a sea of acronyms. The European Commission and ECB have implemented a series of mechanisms to support sovereign governments and maintain liquidity in the financial system, and while the overall effectiveness of these programs is yet to be determined, it is important to understand their functionality and purpose.

- **European Financial Stability Mechanism (EFSM) –** The EFSM is designed to support financial stability in Europe by providing financial assistance to EU member states. The program relies on funds borrowed in the financial markets that are backed by the European Union. These funds are then lent to the beneficiary member state. The fund is backed by all 27 EU members and has the authority to raise up to **€60 billion.**
- **European Financial Stability Facility (EFSF)** – the EFSF is authorized to lend up to **€440bn** and has the power to issue bonds that are guaranteed by Euro area countries to preserve financial stability in Europe. It is a special purpose vehicle (SPV) that was set up to make loans to Euro area countries. The idea behind both the EFSM and the EFSF is to lower the borrowing costs of financially troubled countries; if the Euro area borrows as a collective unit, it can get better rates than an individual troubled country and can subsequently pass these more favorable rates on to the country in question.
- **European Stability Mechanism (ESM) –** On December 17, 2010, the European Council agreed on the need for a permanent stability mechanism. The European Stability Mechanism (ESM) will replace the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) in providing, where needed, financial assistance to Euro area member states after June 2013. The initial maximum lending volume of the ESM, after a complete rundown of the EFSF, is **€500bn**. The purpose of the ESM will be to generate funding and provide financial assistance, under strict economic policy conditionality, for EU countries that are experiencing or threatened by severe financing problems.
- **Covered Bond Purchase Program (CBPP) –** Covered bonds are bonds that are backed by public sector loans or mortgage loans. The covered bond market had essentially dried up in terms of liquidity, issuance and spreads in 2009 and 2010, and the aim of the purchase program was to revive this market, which has traditionally been a primary source of funding for European banks.
- **Securities Markets Program (SMP) –** The SMP was introduced in response to tensions in some segments of the financial market, specifically the Euro area sovereign debt market, in May 2010. Euro system interventions are meant to ensure depth and liquidity in dysfunctional areas of the market; however, purchases of government bonds are strictly limited to secondary markets, and to ensure that liquidity conditions are not affected, all purchases are fully neutralized through liquidity absorbing operations at the ECB.

Next steps and future challenges

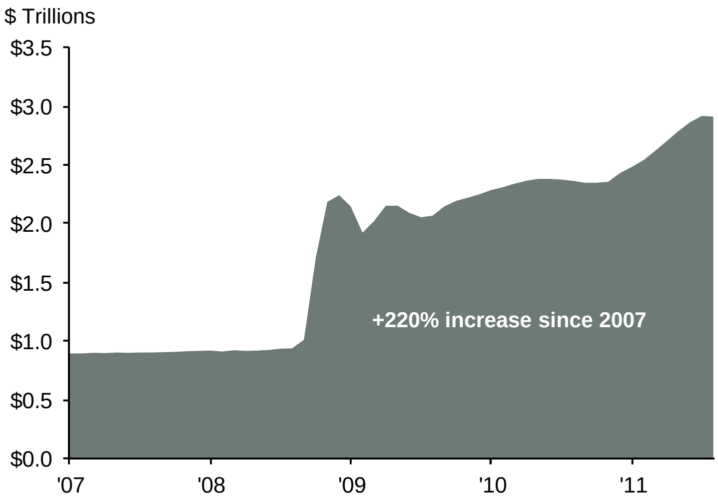
The ECB as a safety valve: Despite the possible benefits, Euro area governments remain reluctant to significantly enlarge the EFSF or introduce Eurobonds, as taxpayers in the core European countries view such measures as a bailout of bad behavior in the peripheral countries. For example, ECB data shows that Germany currently backs more than 25% of the EFSF, and thus far German taxpayers have not fully embraced the need for expanding the fund to provide additional support.

This has caused many to look to the ECB as the institution most capable of solving the region's sovereign crisis. While some suggest that the ECB should simply increase government bond purchases through the Securities Markets Program (SMP), this strategy comes with substantial risks, the largest of which is the prospect of rising inflation. Additionally, while the ECB is willing to act as a safety valve against short-term financial market stress, it is important to recognize that it cannot solve the longer-term problems of fiscal policy and solvency.

ECB balance sheet expansion

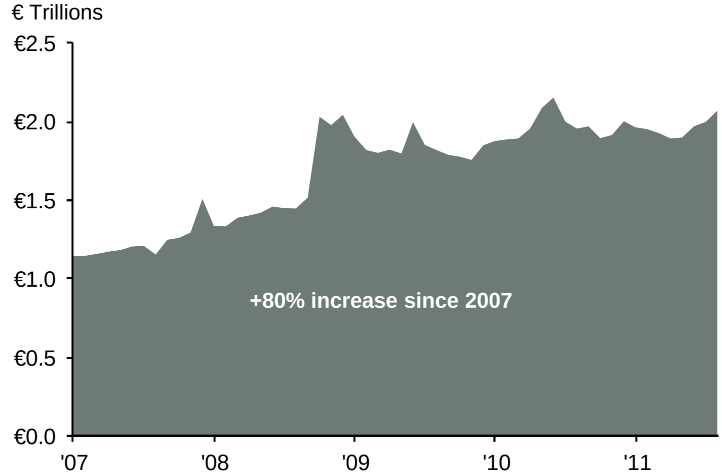
Some argue that, based on the response of the Federal Reserve during the financial crisis, the ECB should have been more aggressive with the expansion of their balance sheet, as the total size of the ECB's balance sheet has increased more than 80% since 2007, compared to the Fed's balance sheet increasing over 220%. However, the ECB has provided unlimited liquidity to the banks, purchased about €60bn of covered bonds to support the bank funding market and has bought approximately €157bn of peripheral sovereign debt in an effort to bring down yields to make the cost of capital for these sovereign entities more manageable.

CHART 8: FEDERAL RESERVE BALANCE SHEET



Sources: Federal Reserve, J.P. Morgan Asset Management.

CHART 9: EUROPEAN CENTRAL BANK BALANCE SHEET



Sources: ECB, J.P. Morgan Asset Management.

Why the ECB remains cautious

There are three major reasons why the ECB remains cautious. The first is **moral hazard**, as the ECB wants troubled banks to restructure their balance sheets and raise capital so that they are able to return to the private funding markets. Additionally, the ECB wants governments to make the appropriate fiscal adjustments and employ reforms that will allow them to regain access to market funding at sustainable rates. Thus, the concern is that the ECB's generous accommodations (supporting artificially low rates by expanding their balance sheet) may actually prevent governments from taking action to address budget woes.

The second reason has to do with the **ECB's single mandate for price stability**. The U.S. Federal Reserve, by contrast, has a dual mandate for both price stability and full employment. In other words, the Fed's policy is focused on steps that support economic growth, but also those that control inflation. In Europe, the ECB's single mandate for price stability neglects economic growth and focuses solely on inflation. As such (and even despite a lack of inflation following bond purchases in the U.S. and the U.K.), the ECB remains reluctant to act too aggressively over concerns of spiking inflation. Additionally, with markets questioning the solvency of some nations in the Euro area, ECB bond purchases may increasingly resemble the monetization of debt, which the EU treaty forbids and the Germans fear.

The third reason is **political legitimacy**; although the ECB has already purchased a tremendous amount of sovereign debt, they do not have the political legitimacy to purchase large quantities of this debt indefinitely. The SMP purchases and liquidity provisions already imply a huge socialization of liabilities across the Euro zone, and if this were to result in losses for the ECB, the bank would likely need to be recapitalized. With taxpayers already on the hook for the ECB's exposure, it seems unlikely that they would be willing to support this for an indefinite period. On the other hand, it seems that if it were deemed completely necessary, the ECB could very well provide liquidity and fiscal support as a backstop against a complete deterioration of the European political system and economy.

Greater European integration

Any long-term solution to Europe's problems may involve greater integration and a stronger ability to enforce fiscal rules across EU member states. However, investors would be wise to appreciate just how tough the road to further integration can be. Culturally, Europeans tend to identify more with their own country than with Europe as a whole, and some might fear that relinquishing sovereignty to "supranational" entities will entail the sacrifice of local cultures. Politically, today's era of 24/7 news coverage makes the kind of "closed door" meetings used during the formative process of our own constitution less possible, with jittery markets reacting (and over-reacting) to every word muttered by policymakers, with meetings playing out publicly, and in the ever-present eye of the news media.

Eurobonds

Some have proposed Eurobonds as the answer to the recent economic and financial conundrum. The challenge here is that a Eurobond would implicitly shift the burden of current problems to the members of the European Union who still enjoy capital market access at reasonable rates. Additionally, joint guarantees are tricky in the absence of a fiscal union, as there is no central authority policing taxation and spending, and as described earlier, fiscal unification is not something that can be engineered quickly or painlessly.

Our concern here is supported by the World Bank's database of "governance indicators," which compare countries on the quality of their government, as well as the extent to which the rule of law is adhered to. For example, despite serious efforts by the Greek government to implement austerity measures, their hard work has not been as successful as one might expect. This is reflected in each of the four metrics on the next page[1].

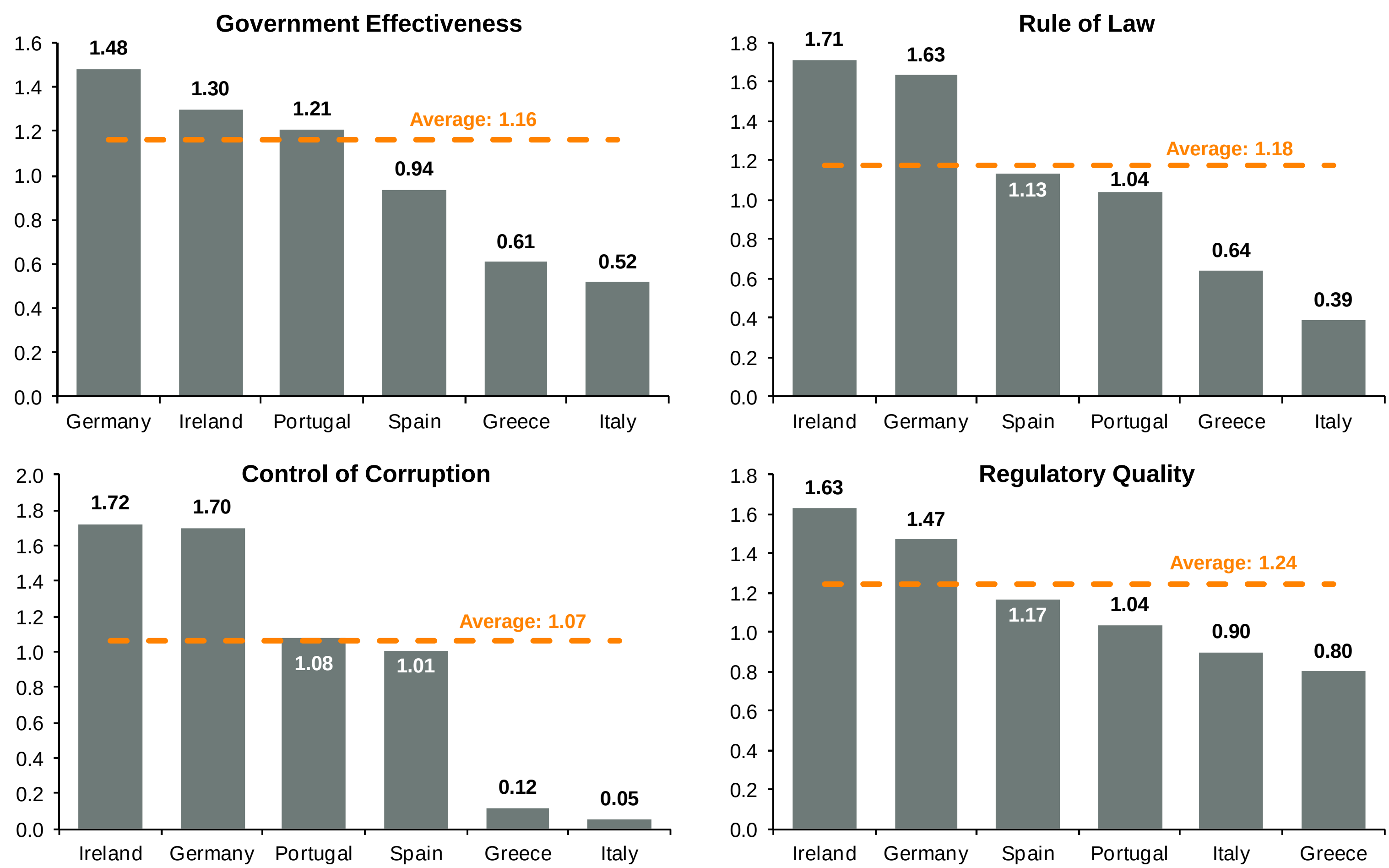
[1] **Control of corruption** captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

Government effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation and the credibility of the government's commitment to such policies.

Rule of law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular, the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

Regulatory quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

CHART 10: EUROPEAN GOVERNANCE INDICATORS



Sources: World Bank, J.P. Morgan Asset Management.

Based on this data, there are indeed stark differences in the quality of governance among the different members of the Euro zone, something that is likely contributing to the pessimism emanating from the stronger countries.

Why austerity hasn't worked

By May 2010, the Greek debt situation was dominating headlines. Fearful that a default might spark a broader financial crisis, the IMF and other Euro zone members came to the rescue with a €110 billion support package. However, this money had strings attached; in exchange for the funds, Greece would have to agree to harsh austerity measures – deep spending cuts designed to demonstrate the Greeks' commitment to reducing deficits, and to be measured via deficit-to-GDP targets.

Unfortunately, we believe this logic is fundamentally flawed. For example, if the Greek economy were growing at a rate of 4%, and they were to cut their deficit from 9% of GDP to 7% through austerity (e.g., a 2% fiscal drag), you might expect to see GDP growth fall to 2% (4% growth, less 2% fiscal drag from reduced spending). But the latest IMF estimate for Greek GDP growth in 2011 was for growth to contract by 5%. Thus, a 2% fiscal drag might cause the Greek economy to contract by 7% instead of 5%.

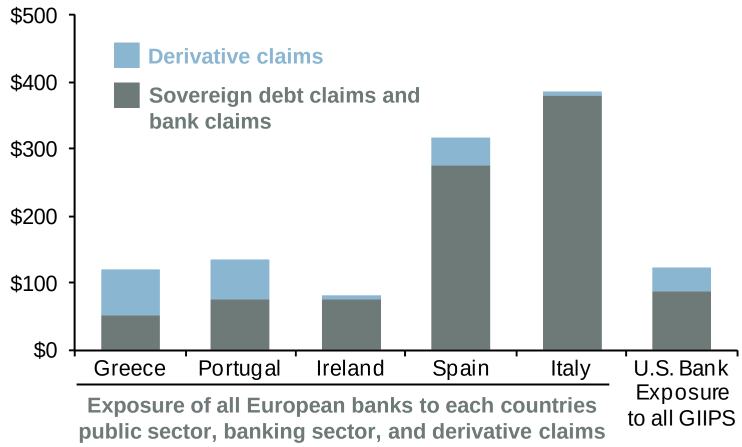
This will not only raise the debt-to-GDP ratio by cutting the denominator (GDP), but may also undermine any remaining political will to continue with austerity in Greece due to the significant hardship inflicted on the local population in the form of job cuts.

Expand EFSF and recapitalize banks

In its original form, the EFSF included total guarantees worth €440bn, but in order for it to maintain its AAA status, the fund can only lend a maximum of €225bn, or the amount of guarantees provided by a diminishing number of AAA-rated sovereigns. However, an expanded EFSF, which was approved by Euro area finance ministers in June but has not yet been ratified by the required parliaments, would increase total guarantees to €780bn, or €726bn after removing Greek, Irish, and Portuguese guarantees. AAA-rated countries are expected to contribute approximately €450bn, giving a revised EFSF the ability to lend up to €440bn without losing its AAA status. Importantly, however, this lending capacity is contingent on the sovereigns maintaining their current credit rating, as a downgrade would affect the fund's effective lending capacity.

Also discussed has been to use an expanded EFSF to recapitalize the banks, as many believe that it has been bank lending to debtor nations that is the primary source of Europe's problems. At the current juncture, it is essential that Europe's banks are capable of withstanding any further deterioration in the sovereign debt market, as well as muted economic growth. While the 2011 banking stress tests suggested they were broadly capable of doing so, these tests likely missed the broader issue, as they essentially ignored bank holdings of sovereign debt. However, as shown in the chart on the right, European banks have significant exposure to peripheral sovereign debt, highlighting why the current situation has become one of bank exposure to toxic assets.

CHART 11: European Bank Exposure to Peripheral Sovereign Debt
Billions USD



Sources: BIS, J.P. Morgan Asset Management.

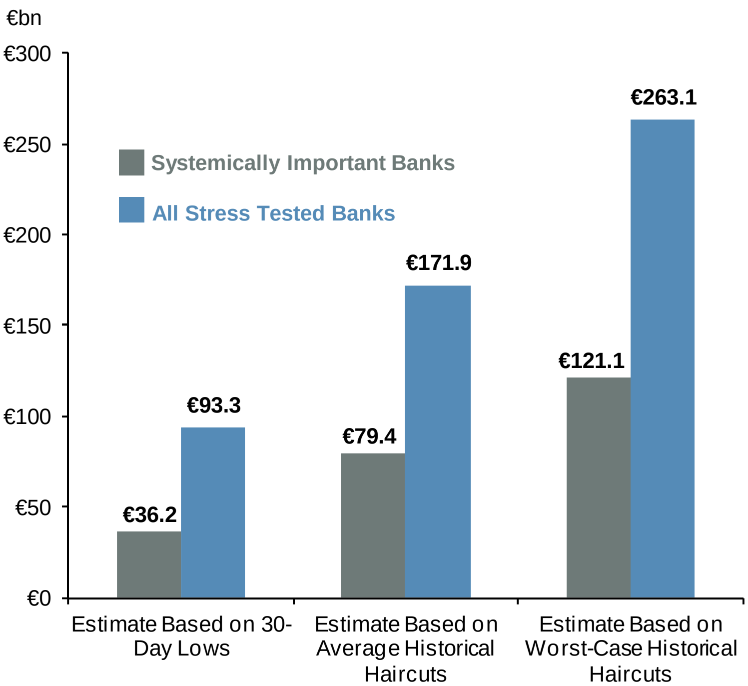
Given the exposures of European banks to peripheral sovereign debt, these banks currently face an issue of solvency; taking a write-down on these holdings could impair lending and possibly cause liquidity to dry up. In light of this, recapitalization (a la TARP in the U.S.) seems like an important option to consider. Additionally, it is important to remember the power of the private investor; during the financial crisis, private investors in the U.S., enticed by very attractive terms, provided cash infusions to help support large corporations.

Restructuring of debt and default

More and more each day it seems as though a restructuring of Greek debt will be unavoidable. In such an event, it will be important that policymakers consider ways to break the links of contagion and to foster as "orderly" a process as possible. For investors, this is a worrying prospect, and one that may already be somewhat reflected in securities prices. Consider, for example, a recent estimate by Credit Suisse, which suggests that a 30% write-off on Greek debt would be required to get debt-to-GDP back down to 100%; using 5-year CDS as a metric, roughly 80% of such a haircut was implied as of early September.

We also found Empirical Research Partners' estimates of potential bank losses to be very instructive. The estimates consider possible loss exposure resulting from a variety of scenarios whereby bond holders are forced to take a haircut. Based on worst-case historical haircuts (see footnote for details), systemically important banks could be on the hook for as much as €120 billion, while all 90 stress-tested banks could see losses of more than €250 billion. While this would cause dramatic write-downs for banks, the amounts are not outside the realm of manageable given appropriate action by policymakers. For perspective, European banks took write-offs of around €700 billion during the 2008-2009 crisis.

CHART 12: POTENTIAL SOVEREIGN DEBT LOSSES[1]



Sources: Empirical Research Partners, EBA, IMF, J.P. Morgan Asset Management.

Conclusion

A break-up of the Euro zone and a demise of the euro seem unlikely, especially given the enormous financial, social and political costs. That being said, the road to greater integration is fraught with obstacles that will likely continue to buffet markets in the near-term.

In the meantime, we believe it is essential for the ECB to maintain a presence in the Euro zone, as it is the only institution currently in place that has the operational and financial flexibility to prevent bank failures and sovereign defaults due to the loss of market access.

Longer term, Europe needs a common vision for its future, which may include steps toward greater integration. Unfortunately, political realities suggest that such steps can take time, and time is a luxury that markets are no longer willing to allow for. Nervous investors have become doubtful about policymakers' ability and willingness to respond swiftly and decisively in Europe, precipitating a groundswell of fear, which in turn (we hope) may prompt more aggressive action than originally thought possible.

Importantly, the underlying issue in the Euro zone is the lack of growth. Many European countries, especially those in the periphery, have seen slow or negative growth over the past few years, leaving them in an unsustainable fiscal position. As a result, any viable plan for addressing the European debt issue will need to involve catalysts for growth; if these countries aren't growing, it will be difficult to solve their debt problems. Austerity measures do not appear to be the answer, as they represent a drag on growth; rather, some form of fiscal transfer makes for a more practical solution. Furthermore, policymakers have been too sophisticated in their construction of various bailout mechanisms, as the current situation could be solved by simply providing Greece with a grant (as opposed to a loan). This would allow policymakers to focus on stabilizing the banks, as the consequences of a contraction in credit and lack of liquidity would be dire and affect the entire global financial system.

Along with a focus on growth, policymakers should also work to restore faith in Europe's remaining outstanding debt. As a first step, efforts to recapitalize banks could stabilize the banking system and restore some confidence, buying time to help struggling sovereigns craft long-term, credible, sustainable financial plans. As sovereign finances improve, investors would likely become more comfortable holding sovereign debt.

[1]Trading book adjusted for year-to-date change in bond price; sovereign holdings as of December 2010.

Investment implications

The global sell-off in risk assets has been driven by uncertainty surrounding European sovereign debt and fears of recession in developed economies. And while fear is indeed a major factor in these markets, it is important for investors to recognize that fear has also been factored in. As such, for investors with long-term time horizons (3-5 years), the market turmoil may represent an opportunity, as it is possible that some markets have been unfairly tainted by the situation in Europe.

But given that this crisis will take time to resolve, what should investors do?

In light of the uncertainty surrounding this issue and its potential global impact, it is more important than ever to stay balanced and diversified. If the issue is resolved through an expanded EFSF or bank recapitalization, investors could be well served by having some exposure to Europe. For example, some companies in Europe are less dependent on European economic success than others, but very high correlations within European stock markets suggest that investors have been rather indiscriminate in dumping assets. That said, investors should have appropriate expectations both in terms of volatility and timeframe, for Europe is likely to continue to experience volatility for some time.

Emerging markets and the United States, we believe, represent even more compelling long-term opportunities. In the U.S., many large multi-national U.S. corporations have exposure to both developed and emerging markets, allowing them to enjoy diversified revenue streams and strong balance sheets. In addition, some corporations offer sizeable dividend yields, which can help investors maintain and diversify their income stream in an environment of record low interest rates. Moreover, the recent sell-off has left valuations more attractive, suggesting investors should consider rebalancing to their strategic allocation levels.

With respect to emerging markets, lower debt levels and more robust economic growth make for attractive fundamentals, while current valuations are more appealing than earlier in the year.

Investors should also continue to maintain an allocation to fixed income. While the risk-return tradeoff in bonds is not what it was 20 years ago, a diversified mix of fixed income can cushion portfolios from market volatility when it spikes. Specifically, spreads on U.S. high yield bonds have moved wider on the back on negative headlines from Europe and disappointing economic data in the U.S. However, it continues to appear that default risk will remain low for the foreseeable future given heavy refinancing activity over the past few years and a focus by corporations on deleveraging versus releveraging. We are also seeing more attractive yields in the municipal space and believe that debt-service is manageable at the state and local level.

We also encourage investors to consider alternative strategies, such as long/short and market neutral approaches, to help dampen volatility and provide greater diversification. Of course, given the complexity of these strategies, it is important to understand the risks associated with them.

There is an enormous amount of uncertainty in the world, and volatile markets can drive investors to make emotional investment decisions. However, we believe that with a clear understanding of the state of the world, investors can make decisions that are appropriate for their specific situation, capitalizing on some opportunities while shunning others.