

Equities

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Equity Strategy

European Economic Woes Should Worry Exposed Investors

■ Equities

- **Some US companies could experience sales and earnings weakness from Europe as GDP forecasts get trimmed overseas.** Given austerity programs and signs of economic slowing, there is a good probability that business could dip for corporations that have more meaningful sales and earnings coming from the continent. More cyclical end markets are likely to see the softness and that may not be fully priced into their share prices.
- **Europe represents less than 10% of S&P 500 constituent sales.** While international sales account for almost 30% of overall S&P 500 revenues, only about a third of that exposure is to Europe though certain industries generate a higher proportion of their incoming business from that region. As a result of limited disclosure and tax sourcing decisions, it is nearly impossible to accurately determine the exact earnings coming from European locales, leaving sales as the best proxy especially due to typically lower overseas margins.
- **Some deeply cyclical industries can be hurt by any European slowdown.** The five groups with the most substantial exposure to Europe are Materials, Autos & Components, Consumer Durables & Apparel and Consumer Services, as well as Capital Goods. In light of cutbacks in government spending, tax increases and waning business confidence, there already has been some commentary on slipping appliances, bearings and heavy-duty trucks demand. In many respects, these early remarks are a worrisome sign.
- **Traditional defensive groups also have large sales compositions from across the pond.** Investors may be surprised to notice that some typically defensive areas of the market garner meaningful business in Europe, specifically the Food, Beverage & Tobacco, Pharmaceuticals & Biotechnology as well as Household & Personal Products groups. Thus, one cannot be assured that non-cyclical positioning abroad provides much protection.
- **A screen looking for large sales exposure and weaker balance sheets yield a list of names that could experience some of the most difficulty from Europe's challenges.** Companies such as Owens Illinois, Ford Motor and DuPont, among others, may face the greatest risk from economic troubles from both periphery and core Europe with even Germany recently experiencing new business softness. Thus, political uncertainty and fiscal pressures can manifest themselves in terms of business trends.

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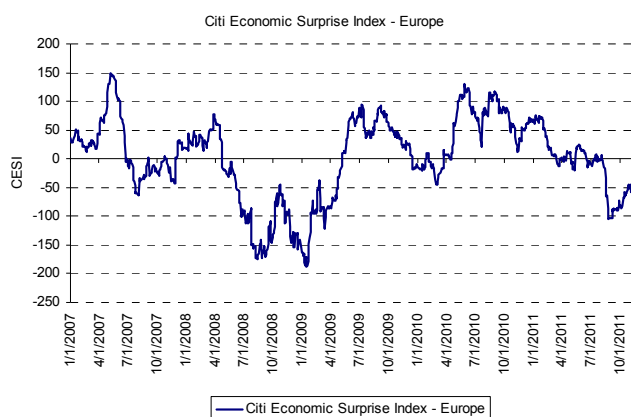
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A Continental Divide

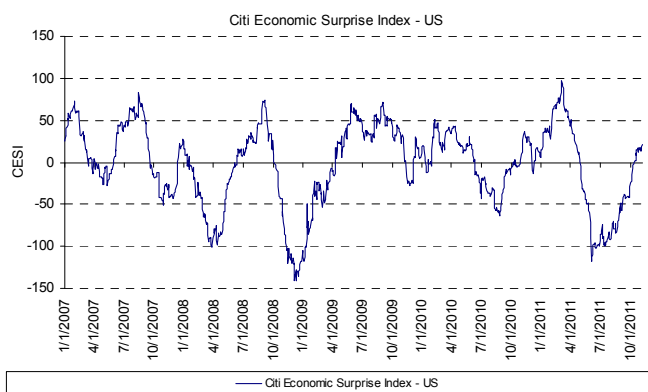
Investors have been looking at macro headwinds from sovereign credit woes across the pond while some of the data in the US has improved. Indeed, the Citi Economic Surprise Index in the US and Europe both plummeted and while the US has bounced back, Europe remain lows (see Figures 1 and 2). Moreover, the important IFO Institute survey has been slipping abroad with German industrial production sliding back (see Figure 3) while Citi's economists now are forecasting a 2012 European recession as the GDP estimates in Europe have been slipping for some time (see Figure 4).

Figure 1.



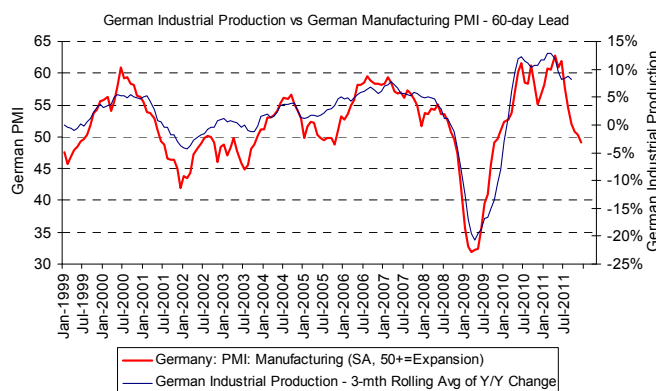
Source: Bloomberg and CIRA – US Equity Strategy

Figure 2.



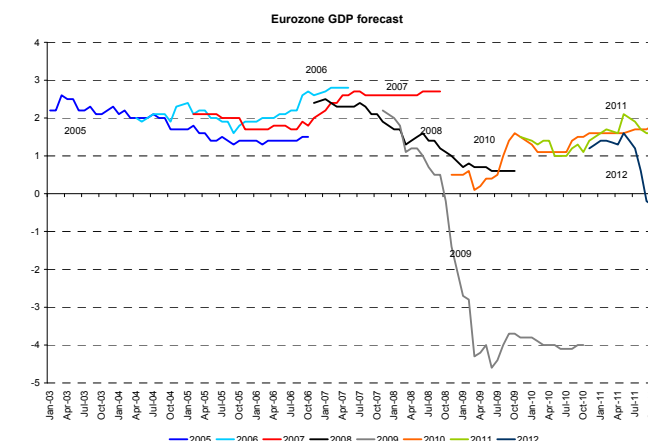
Source: Bloomberg and CIRA – US Equity Strategy

Figure 3.



Source: Haver Analytics and CIRA – US Equity Strategy

Figure 4.



Source: CIRA - Global Economics and Global Equity Strategy

Even as progress is made on sovereign debt challenges and bank capital requirements, it should be obvious to almost anyone that the tight fiscal programs needed to address large deficits will cause drags on European economic trends. Even the powerhouse of Germany is seeing a modest uptick in unemployment. Thus, revisiting regional sales exposures seems appropriate and Figure 5 provides the best data we are able to garner from corporate disclosure statements and input from Citi's equity research analysts. Moreover, Figure 6 provides a list of the top 50 company exposures to Europe. To be fair, the limitations of corporate sales disclosures and even areas like Semiconductor industry reported sales to Asian contract manufacturers that then gets exported out of Asia makes the regional results somewhat less than accurate. Nonetheless, fund managers do need to

understand where they may be at risk with their investments. Keep in mind that typically defensive groups can have very substantive European sales and that may not be well understood by investors, though admittedly they are not that cyclical. In addition, the Automotive arena is the most exposed industry though Materials and Capital Goods may also be impacted by regional weakness as pricing can be affected by inventory builds. In addition, some areas of consumer cyclicals can be seen at risk.

Figure 5.

	Geographic Revenue Breakouts For Latest Fiscal Year (2010 or 2011)					
	% of Total Revenues					
	North America (includes Canada & Caribbean)	Europe, Middle East, Africa	Asia-Pacific	Lat Am	Global/Rest of World/Other	Total Foreign (Non NA)
S&P 500	69.58%	8.51%	4.56%	1.60%	15.75%	30.42%
Consumer Discretionary	77.28%	9.45%	2.08%	0.93%	10.27%	22.73%
Automobiles & Components	52.34%	27.59%	0.20%	0.00%	19.86%	47.66%
Consumer Durables & Apparel	61.46%	16.16%	6.53%	6.08%	9.76%	38.54%
Consumer Services	57.43%	16.69%	8.46%	0.06%	17.36%	42.57%
Media	80.29%	8.98%	3.64%	1.90%	5.19%	19.71%
Retailing	90.80%	1.00%	0.10%	0.02%	8.08%	9.20%
Consumer Staples	74.64%	8.02%	2.68%	2.44%	12.22%	25.36%
Food & Staples Retailing	86.66%	0.00%	0.00%	0.00%	13.34%	13.34%
Food Beverage & Tobacco	59.60%	22.05%	6.11%	4.51%	7.73%	40.40%
Household & Personal Products	41.76%	17.45%	9.81%	12.21%	18.75%	58.24%
Energy	58.16%	10.87%	3.92%	0.77%	26.27%	41.84%
Financials	66.73%	3.78%	5.29%	1.60%	22.60%	33.27%
Banks	100.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Diversified Financials	69.07%	8.32%	5.65%	4.08%	12.88%	30.93%
Insurance	52.93%	1.39%	6.83%	0.18%	38.68%	47.07%
Real Estate	88.32%	2.71%	2.97%	0.36%	5.64%	11.68%
Health Care	80.42%	6.45%	1.55%	0.28%	11.31%	19.58%
Health Care Equipment & Services	93.48%	2.47%	0.97%	0.22%	2.85%	6.52%
Pharmaceuticals, Biotechnology	50.41%	15.57%	2.89%	0.41%	30.72%	49.59%
Industrials	63.81%	13.56%	8.40%	2.77%	11.46%	36.19%
Capital Goods	59.34%	16.40%	9.85%	3.38%	11.03%	40.66%
Commercial & Professional Serv	80.71%	6.26%	3.68%	0.99%	8.36%	19.29%
Transportation	81.62%	0.90%	2.34%	0.15%	14.99%	18.38%
Information Technology	46.44%	10.25%	12.86%	0.98%	29.47%	53.56%
Semiconductors & Semiconductor	15.25%	13.17%	66.45%	0.50%	4.63%	84.75%
Software & Services	60.05%	8.92%	1.41%	0.03%	29.58%	39.95%
Technology Hardware & Equipmen	43.74%	10.54%	11.28%	1.54%	32.91%	56.26%
Materials	52.10%	19.77%	10.54%	5.04%	12.55%	47.90%
Telecommunication Services	99.87%	0.00%	0.03%	0.09%	0.00%	0.13%
Utilities	95.08%	0.63%	0.18%	4.05%	0.05%	4.92%

Source: Bloomberg, Company Reports and CIRA – US Equity Strategy

Figure 6. Top 50 S&P 500 Names with EMEA Sales Exposure

Ticker	Company Name	Sector	Industry Group
CCE	COCA-COLA ENTERPRISES INC	Consumer Staples	Food Beverage & Tobacco
NEM	NEWMONT MINING CORP	Materials	Materials
PM	PHILIP MORRIS INTERNATIONAL	Consumer Staples	Food Beverage & Tobacco
FSLR	FIRST SOLAR INC	Information Technology	Semiconductors & Semiconductor I
HAR	HARMAN INTERNATIONAL INDS	Consumer Discretionary	Consumer Durables & Apparel
FLS	FLOWERVE CORP	Industrials	Capital Goods
PCLN	PRICELINE.COM INC	Consumer Discretionary	Retailing
OI	OWENS-ILLINOIS INC	Materials	Materials
APA	APACHE CORP	Energy	Energy
MCD	MCDONALD'S CORP	Consumer Discretionary	Consumer Services
AON	AON CORP	Financials	Insurance
ERTS	ELECTRONIC ARTS INC	Information Technology	Software & Services
CCL	CARNIVAL CORP/PLC (USA)	Consumer Discretionary	Consumer Services
TAP	MOLSON COORS BREWING CO	Consumer Staples	Food Beverage & Tobacco
IVZ	INVESCO LTD	Financials	Diversified Financials
LXK	LEXMARK INTL INC -CL A	Information Technology	Technology Hardware & Equipmen
NOVL	NOVELL INC	Information Technology	Software & Services
NE	NOBLE CORP	Energy	Energy
BF.B	BROWN-FORMAN -CL B	Consumer Staples	Food Beverage & Tobacco
CELG	CELGENE CORP	Health Care	Pharmaceuticals Biotechnology & L
JCI	JOHNSON CONTROLS INC	Consumer Discretionary	Automobiles & Components
DOW	DOW CHEMICAL	Materials	Materials
IFF	INTL FLAVORS & FRAGRANCES	Materials	Materials
PCAR	PACCAR INC	Industrials	Capital Goods
BIIB	BIOGEN IDEC INC	Health Care	Pharmaceuticals Biotechnology & L
MMC	MARSH & MCLENNAN COS	Financials	Insurance
GR	GOODRICH CORP	Industrials	Capital Goods
RDC	ROWAN COS INC	Energy	Energy
MYL	MYLAN INC	Health Care	Pharmaceuticals Biotechnology & L
BAX	BAXTER INTERNATIONAL INC	Health Care	Health Care Equipment & Services
BDX	BECTON DICKINSON & CO	Health Care	Health Care Equipment & Services
NBL	NOBLE ENERGY INC	Energy	Energy
EW	EDWARDS LIFESCIENCES CORP	Health Care	Health Care Equipment & Services
HNZ	HEINZ (H J) CO	Consumer Staples	Food Beverage & Tobacco
APD	AIR PRODUCTS & CHEMICALS INC	Materials	Materials
ITW	ILLINOIS TOOL WORKS	Industrials	Capital Goods
AVY	AVERY DENNISON CORP	Industrials	Commercial & Professional Service
MCO	MOODY'S CORP	Financials	Diversified Financials
GENZ	GENZYME CORP	Health Care	Pharmaceuticals Biotechnology & L
WAT	WATERS CORP	Health Care	Pharmaceuticals Biotechnology & L
CAM	CAMERON INTERNATIONAL CORP	Energy	Energy
NWSA	NEWS CORP	Consumer Discretionary	Media
MRK	MERCK & CO	Health Care	Pharmaceuticals Biotechnology & L
EMC	EMC CORP/IMA	Information Technology	Technology Hardware & Equipmen
AAPL	APPLE INC	Information Technology	Technology Hardware & Equipmen
F	FORD MOTOR CO	Consumer Discretionary	Automobiles & Components
AVP	AVON PRODUCTS	Consumer Staples	Household & Personal Products
FLR	FLUOR CORP	Industrials	Capital Goods
CA	CA INC	Information Technology	Software & Services
CSC	COMPUTER SCIENCES CORP	Information Technology	Software & Services

Source: Bloomberg, Company Reports and CIRA – US Equity Strategy

One metric worth considering is large sales exposure mixed with a more leveraged balance sheet. In this context, Figure 7 reflects a screen that we conducted (looking for companies with more than 20% EMEA sales exposure and more than 35% debt/capital) and it shows greater than 30 companies potentially looking risky should proposed economic weakness be borne out. Not surprisingly, primarily US-oriented companies may be the most intriguing opportunities as opposed to a general focus on international growth that has been a dominant theme for the investment community. One note of caution might be the value of the Euro. A weaker Euro would translate into added dollar sales so one will have to benchmark unit demand against foreign exchange swings.

Figure 7. S&P 500 Companies with 20%+ Exposure to EMEA and Leveraged Balance Sheet

Ticker	Company Name	Sector	Industry Group	2010 EMEA	
				Revenues as % of Total Revenues	Total Debt to Capital
CCE	COCA-COLA ENTERPRISES INC	Consumer Staples	Food Beverage & Tobacco	100.0%	49.28%
PM	PHILIP MORRIS INTERNATIONAL	Consumer Staples	Food Beverage & Tobacco	64.9%	89.29%
OI	OWENS-ILLINOIS INC	Materials	Materials	41.4%	67.82%
MCD	MCDONALD'S CORP	Consumer Discretionary	Consumer Services	39.7%	45.10%
AON	AON CORP	Financials	Insurance	39.4%	35.05%
IVZ	INVESCO LTD	Financials	Diversified Financials	36.6%	49.03%
DOW	DOW CHEMICAL	Materials	Materials	34.4%	44.80%
IFF	INTL FLAVORS & FRAGRANCES	Materials	Materials	34.2%	45.37%
PCAR	PACCAR INC	Industrials	Capital Goods	33.7%	49.87%
GR	GOODRICH CORP	Industrials	Capital Goods	33.4%	38.80%
MYL	MYLAN INC	Health Care	Pharmaceuticals Biotechnology & L	32.9%	60.53%
BAX	BAXTER INTERNATIONAL INC	Health Care	Health Care Equipment & Services	32.6%	38.61%
HNZ	HEINZ (H J) CO	Consumer Staples	Food Beverage & Tobacco	31.8%	59.83%
APD	AIR PRODUCTS & CHEMICALS INC	Materials	Materials	31.2%	41.92%
AVY	AVERY DENNISON CORP	Industrials	Commercial & Professional Service	31.0%	46.47%
MCO	MOODY'S CORP	Financials	Diversified Financials	30.9%	102.14%
WAT	WATERS CORP	Health Care	Pharmaceuticals Biotechnology & L	30.1%	40.56%
NWSA	NEWS CORP	Consumer Discretionary	Media	29.4%	36.08%
F	FORD MOTOR CO	Consumer Discretionary	Automobiles & Components	28.5%	94.08%
AVP	AVON PRODUCTS	Consumer Staples	Household & Personal Products	28.1%	63.99%
GE	GENERAL ELECTRIC CO	Industrials	Capital Goods	27.2%	75.81%
SEE	SEALED AIR CORP	Materials	Materials	26.9%	35.42%
MDT	MEDTRONIC INC	Health Care	Health Care Equipment & Services	25.4%	38.09%
HON	HONEYWELL INTERNATIONAL INC	Industrials	Capital Goods	25.2%	41.15%
BK	BANK OF NEW YORK MELLON CORP	Financials	Diversified Financials	25.2%	44.32%
DD	DU PONT (E I) DE NEMOURS	Materials	Materials	24.8%	57.32%
XRX	XEROX CORP	Information Technology	Technology Hardware & Equipment	24.6%	41.24%
AA	ALCOA INC	Materials	Materials	24.4%	38.43%
KFT	KRAFT FOODS INC	Consumer Staples	Food Beverage & Tobacco	23.6%	43.14%
ABT	ABBOTT LABORATORIES	Health Care	Pharmaceuticals Biotechnology & L	23.2%	40.85%
X	UNITED STATES STEEL CORP	Materials	Materials	23.0%	48.40%
NSM	NATIONAL SEMICONDUCTOR CORP	Information Technology	Semiconductors & Semiconductor I	22.4%	55.08%
KO	COCA-COLA CO	Consumer Staples	Food Beverage & Tobacco	22.2%	46.78%
MKC	MCCORMICK & CO INC	Consumer Staples	Food Beverage & Tobacco	20.4%	37.62%

Source: Bloomberg, FactSet, Company Reports and CIRA – US Equity Strategy

Appendix A-1

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