Keeping European Woes at Bay

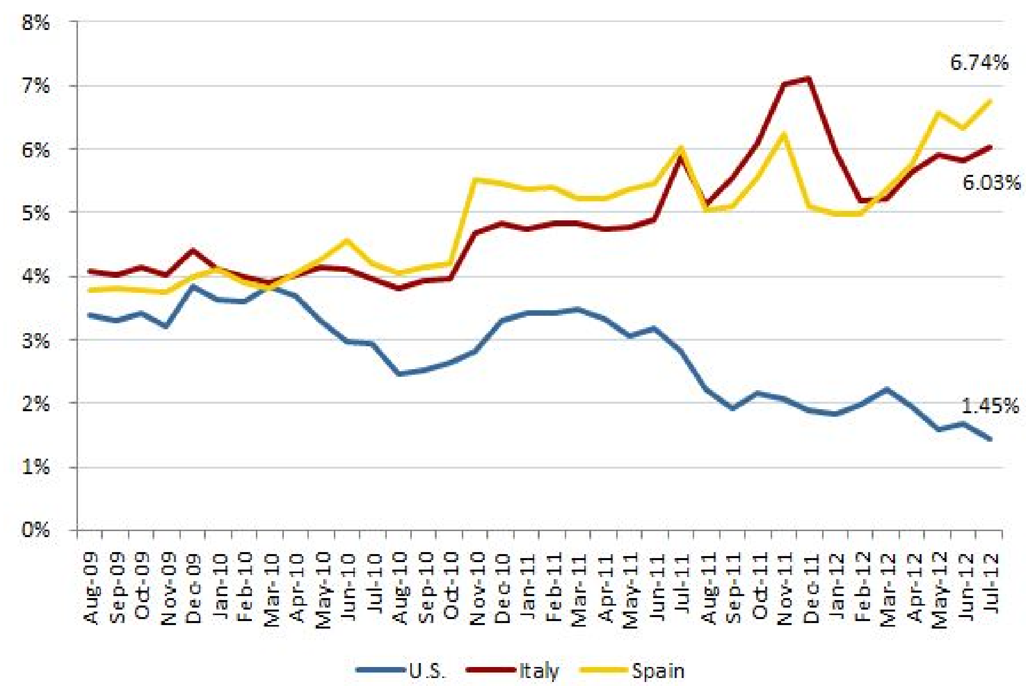
Stresses affecting the European Monetary Union could tarnish the outlook for U.S.-based assets.

The euro zone banking and sovereign-debt crisis could still worsen if economic growth remains weak.

Although the stalled U.S. economic engine frustrates many investors, conditions in the United States look almost rosy compared with the situation across the pond. Tight lending conditions, contractions in business activity, and economic recession in select countries are challenging the European Monetary Union in the wake of the 2007-2008 global economic crisis.[1]

There is considerable debate whether Europe's woes could undermine the performance of U.S. assets. A flight to safety appears to be playing out in the arena for U.S. Treasury securities. Yields of 10-year U.S. Treasury securities recently declined to a record low as the yield of Spanish sovereign debt escalated to 6.74%.[2] In the bond market, yields and prices move in opposite directions, with yields falling as prices rise. Some observers believe that investors are bidding up the value of U.S. Treasuries to avoid the risk associated with European government bonds.[3]

Higher Yields for Greater Risk



Investors are demanding significantly higher yields on Italian and Spanish sovereign debt compared with U.S. Treasury securities.

Sources: S&P Capital IQ Financial Communications; Bloomberg. United States is represented by the yield of 10-year U.S. Treasury securities, Spain by the yield of the Spanish Government Generic 10-Year Note, and Italy by the average 10-year yield of Italian government bonds. Past performance does not guarantee future results.

Portfolio Planning

In light of uncertainty that is likely to persist, consider the following when creating portfolio allocations:

- **Anticipate volatility in U.S. stocks.** Challenges in Europe are coming at a time when the United States faces its own questionable circumstances. Unless Congress takes action, a combination of higher tax rates and federal spending cuts scheduled to take effect in 2013 could hinder future economic growth. S&P Capital IQ has increased the probability of a U.S. recession during the next 12 months from 20% to 25%.[4]
- **Consider overweighting U.S. stocks in the Consumer Staples, Energy, and Information Technology sectors**. S&P Capital IQ believes that these sectors have the potential to outperform the S&P 500 during 2012 due to inelastic demand within Consumer Staples, pent up demand within Information Technology, and a low earnings per share (EPS) hurdle within Energy.[5]
- **Look for lower yields of European sovereign debt.**[6] Current Spanish and Italian bond yields may not be sustainable given the high interest payments that these countries are forced to pay. Lower yields on sovereign debt would demonstrate that investor confidence is on the upswing.
- **Be cautious about banks with a strong presence in Europe.** Multinational banks currently dominate the European banking scene, and these banks historically have used lower-yielding deposits within stronger economies to finance higher-yielding loans in countries where borrowing rates are higher. If the European Monetary Union collapses, the liabilities of these banks could swell while their assets decline in value.

The European Monetary Union's challenges may take years to resolve, and investors may be forced to interpret mixed signals along the way. In the meantime, overweighting U.S. sectors with the potential to outperform the S&P 500, waiting for more sustainable yields before investing in European sovereign debt, and being cautious about banks with a strong European presence may be to your benefit.

[1]Sources: *The Wall Street Journal*, "Euro-Zone Business Output Falls," July 24, 2012," "ECB Survey, Ifo Point to Deepening Gloom," July 25, 2012; *The Economist*, "A Very Short History of the Crisis," November 12, 2011. The Ifo Business Climate Index gauges the confidence level of business executives.

[2]Sources: Bloomberg; The Federal Reserve. Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value.

[3]Source: *The Wall Street Journal*, "U.S. Scores Another Record Low Auction Yield," July 24, 2012.

[4]Source: S&P Capital IQ *Trends & Projections*, "Ain't No Cure for the Summertime Blues," July 2012.

[5]Source: S&P Capital IQ *Trends & Projections,* "Sell in May, Buy in July?" July 2012. Investments in specialized industry sectors have additional risks.

[6]Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. Foreign investments involve greater risk than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors.