

The Worst Movie Ever

Dear Clients and Friends,

The worst movie ever? A tough choice and the list is long, but my personal (dis)favorite would have to be *Americathon*, a 1979 comedy starring John Ritter as US President Chet Roosevelt. Even as a teenager, I felt disgusted for paying \$2.50 to sit through the ridiculous and improbable film. Fortunately, such box office bombs usually don't result in a sequel and I have long assumed I was safe from having to witness such a farce again.



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For those luckily unfamiliar with the movie, it was set in an America 20 years in the future. The writers of the film believed in the crazy notion that China would embrace capitalism and become a global economic superpower, that the USSR would collapse and that people would buy expensive, specialty coffee drinks. But craziest of all, America would run out of oil and be deeply indebted to foreign investors and on the verge of bankruptcy. Ridiculous!

In order to bailout the country, a Jerry Lewis-style telethon, to be hosted by Monty Rushmore (Harvey Korman), was held and various assets (such as national parks) sold to raise money. What led me to recall the movie for the first time in 30 years, was the recent Greek government initiative to sell or lease some of the country's 2,000 plus islands to help deal with their financial crisis. Maybe not exactly an *Americathon* sequel, but certainly a Greek version – and we can only hope it does not precede an American sequel. (For those who applaud the economic and political foresight of the screenwriters, while they also saw the United Kingdom as an economic basket case, they believed London would be turned into a theme park named "Limeyland" and 10 Downing Street into a discothèque – not quite 100% clairvoyance, at least not yet).

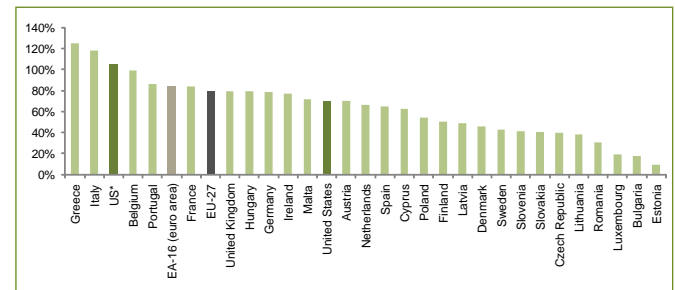
With the concern over European economic health, I thought it might be useful to lay out some key balance sheet and income metrics for various member states, Europe in the aggregate and the United States (all data includes federal, state and local governments). While the US might have been a near-term beneficiary of the European turmoil, in many instances the US looks to be in an uncomfortably similar situation as Europe.

When asking who has the most debt today, the United States stacks up slightly better on the surface. Of the sixteen eurozone countries, just half – Luxembourg, Slovakia, Slovenia, Finland, Cyprus, Spain, the Netherlands and Austria – have less debt (as a percentage of

their gross domestic product [GDP]). Nine of the eleven European Union (EU) countries who have not adopted the euro fare better than the US. Only Hungary and the UK are in worse shape. In aggregate, however, the US's debt/GDP ratio of 70.3% is better than the eurozone (85%) and EU (80%) aggregates. However, if we were to include the roughly \$5 trillion in debt issued by Fannie Mae, Freddie Mac and the FHA (Federal Housing Administration), which many believe should rightfully be considered debt of the US government, only Greece and Italy look worse. (See Exhibit 1.)

Exhibit 1

Debt as % of GDP 2010



US* represents Gross Debt inclusive of Fannie Mae and Freddie Mac.
 Source: European Commission, Economic and Financial Affairs

The next question is how fast new obligations are being added to old ones. By this measure, only Ireland, the UK and Greece are more profligate. The US has a 1.4% of GDP deficit disadvantage versus the EU in aggregate. This comparison is likely to continue to move against the US given the recent, and universal, intentions of the Europeans to tighten their fiscal belts and the stated desire of the US government to push for near-term growth and worry about the bill later. (See Exhibit 2.)

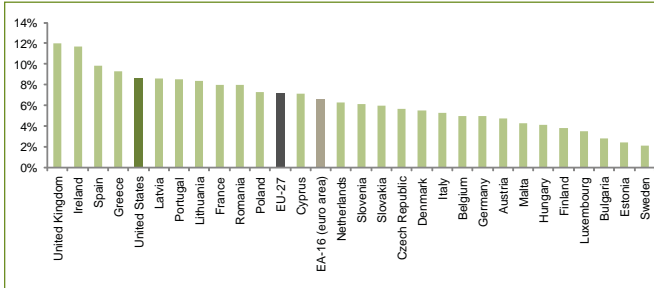
The next key metric to consider is the level of debt service relative to each country's GDP (see Exhibit 3). On this measure, there is little to differentiate between the US and Europe. While the eurozone countries have a slightly higher level of debt service costs (3.0% of GDP), the EU in its entirety is only slightly higher than the US (2.8% versus 2.6%). This metric should not be underestimated as it is the debt service costs that divert monies that could otherwise

be spent for investment (and growth creation) purposes. As debt service creeps higher, growth is likely to inch lower. Once debt service levels approach GDP growth levels, it becomes very hard to sustain any future growth as newly created wealth is diverted for paying old debts.

Exhibit 2

Deficit as % of GDP

2010

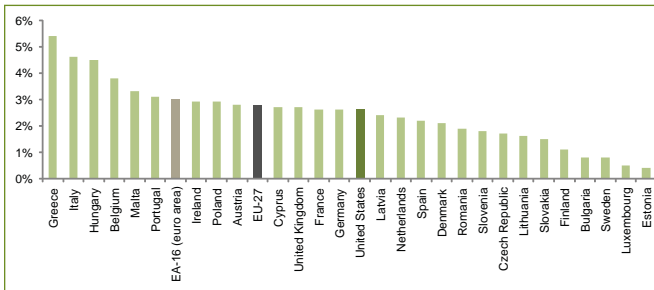


Source: European Commission, Economic and Financial Affairs

Exhibit 3

Interest Payments as % of GDP

2010



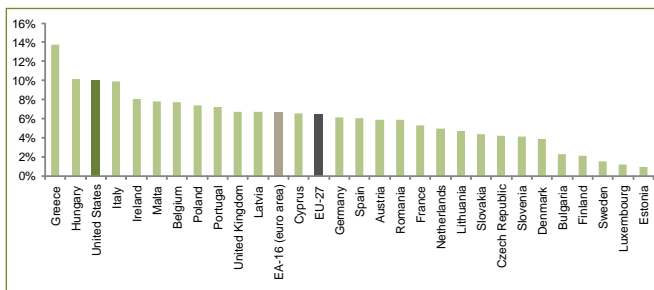
Source: European Commission, Economic and Financial Affairs

Another way to put debt service into context is to ask how much of a government’s revenues are being diverted to this non-productive use. By this measure, the US has the third highest percentage, just 1.0% of GDP, behind Greece and on par with Hungary (see Exhibit 4). With debt service absorbing over 10% of revenues, the US clearly faces a dilemma. The bond ratings agency Moody’s Investors Service notes that one of the key metrics for a country to maintain its “AAA”-rating is for debt service to be less than 10% of revenue

Exhibit 4

Debt Service as % of Total Revenue

2010



Source: European Commission, Economic and Financial Affairs

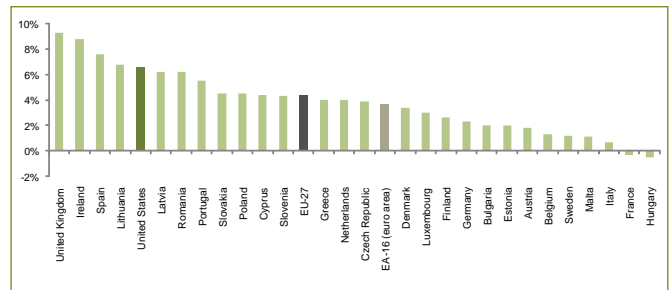
collections. Either revenues must go up (through greater growth or higher taxes – conflicting options to be sure), or the US will remain vulnerable to debt downgrades (note that a Chinese bond rating agency has already downgraded the US to “AA”).

To get an idea of the structural nature of the deficit in each country/region, the primary deficit (the annual deficit less debt service costs) is the metric most often turned to (see Exhibit 5). In this instance, both the US and the UK are among the countries with the most pressing spending vs. taxing decisions to make, lest control over their budgets slips away for good.

Exhibit 5

Primary Deficit as % of GDP

2010



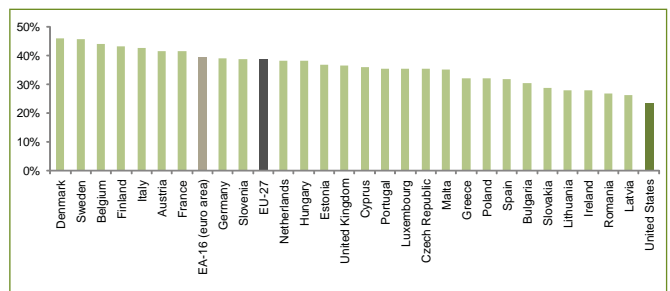
Source: European Commission, Economic and Financial Affairs

As to whether there is scope for US taxes to increase, it appears that while high by historical measures at 23.3% of GDP, the US carries the lowest tax burden of the group (see Exhibit 6).

Exhibit 6

Tax Burden as % of GDP

2010



Source: European Commission, Economic and Financial Affairs

It would seem that in many instances the US is already at European levels in terms of balance sheet and income statement strength. Yet, while investors have attacked European stocks and bonds, US assets have come through in relatively better shape. If, however, fundamentals matter, this may only be a temporary respite. The likely reason Europe was more susceptible to attack is they are not a fiscal union, only a (partial) monetary one. Thus, weaker members were able to be challenged one by one as the region’s resolve was tested (would the whole come to the rescue of the fringe). In the US, there are no weak links to easily test – you either attack the core or you don’t attack at all.

Just When You've Got a Sure Thing

Who would have thought? Coming into the second quarter, the stock versus bond question looked like an easy one for investors. With all G-7 country government bonds yielding less than 4% dividend yields were higher than or just below the corresponding 10-year government bond in all of the G-7 countries with the exception of the US and Canada. The relative performance of the two assets seemed decidedly tilted in favor of equities (see Exhibit 7).

Exhibit 7

G-7 Country	Equity Index	Index Div Yield (3/31/10)	Index Div Yield (6/30/10)	10 Yr. Gov't. Bond Yield (3/31/10)	10 Yr. Gov't. Bond Yield (6/30/10)
US	S&P 500	1.85%	2.12%	3.83%	2.93%
Canada	TSX	2.63%	2.83%	3.57%	3.08%
UK	FTSE 100	3.31%	3.71%	3.94%	3.36%
Germany	DAX	3.35%	3.23%	3.09%	2.58%
France	CAC 40	3.59%	4.06%	3.42%	3.05%
Italy	FTSE MIB	3.20%	3.92%	3.98%	4.09%
Japan	Topix	1.70%	1.94%	1.40%	1.09%

Source: Bloomberg

As long as dividends were maintained, long-term relative performance seemed assured. So, of course, the opposite occurred. Fixed income securities turned in one of their best quarters in 25 years, while equities turned in one of their worst – the pleasures of short-term investing. By the end of the quarter, the dividend vs. bond yield comparison would seem to be even more skewed toward equities. Will fundamentals take over or will we again be confounded by short term experience?

European Dividends

The dividend yield angle is an interesting one and on this we would advise to do what Wall Street does, not what it says. The financial seers are a consistently bullish lot, a characteristic we have talked about in the past. It is interesting to note that currently, the divergence between what they say and what they do is about as wide as it has ever been.

Year-to-date through June 30, dividends on the EuroStoxx 50 Index (50 European blue chip companies) are forecast to come in around €112. On this there is only marginal disagreement. However, whereas Wall Street analysts see the dividends growing to over €150 by the year 2013 (based on a bottom-up stock-by-stock analysis), the EuroStoxx 50 dividend futures expect 2013 dividends closer to €82! (See Exhibit 8.) Based on today's price, the yield on the EuroStoxx would be over 6% by the year 2013 if the analysts are correct – back up the truck and buy stocks! However, we think the investors may be on to something.

Exhibit 8

	Analyst Dividend Estimates (€)	EuroStoxx Futures Estimates (€)
2010	113.24	111.00
2011	122.22	95.30
2012	136.99	84.50
2013	152.28	81.20

Source: Bloomberg, IBES, Artio Global Management as of July 1, 2010

Clearly, bank dividends are at risk. But so are the dividends of many of the more levered firms in industries such as utilities and telecommunications. The recent displacement in Europe and the higher government yield spreads in countries such as Greece, Spain and Portugal, have caused the cost of refinancing corporate debt to rise, impinging, we think, on companies ability to divert cash for dividends.

We feel a more prudent course would be to focus on companies that appear to be a little more "expensive" but where balance sheet strength and refinancing issues are not a question. In other words, maybe it is time for the "quality" trade to actually work. Since the market's bottom on March 9, 2009, this trade has not been rewarded. Investors who dared buy the more levered, less earnings stable companies have come out in front by a large margin.

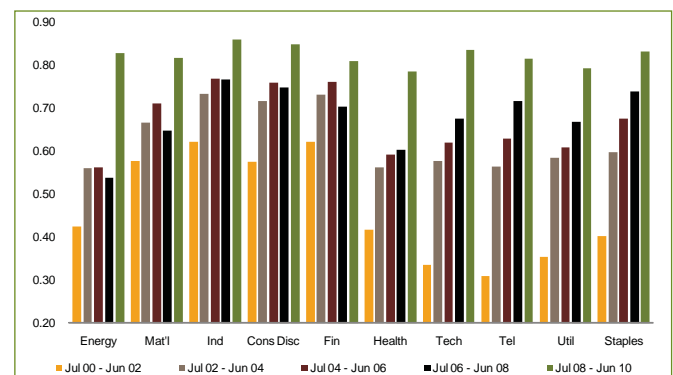
Stock and Sector Correlations

Another interesting relationship that has developed in the post-Lehman environment has been the dramatic synchronization of correlations among market sectors. Exhibit 9 breaks the market into discreet two-year periods for the past decade. If we look at the post-June 2008 intra-sector correlations for the MSCI World Index (GIC Level 1) and compare them with earlier periods, we see a tremendous convergence in the weekly returns with eight of ten sectors showing a greater than 0.80 correlation (the other two sectors fall just short). In many cases these correlations have more than doubled from early levels this decade.

Exhibit 9

MSCI World Sectors

Average Weekly Return Correlations with Other Sectors



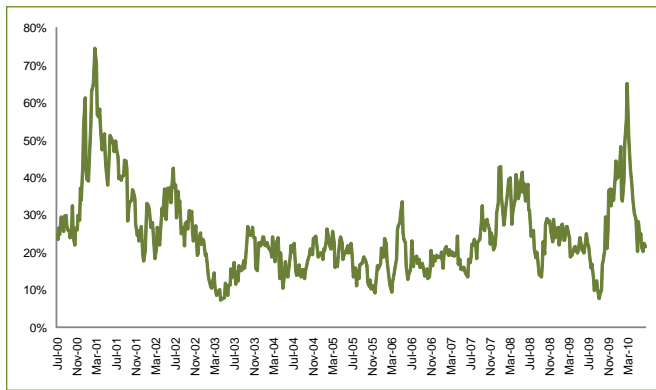
Source: MSCI Barra, Artio Global Management

One conclusion investors should not jump to from this data is to interpret the observations of high correlations as direct evidence of return convergence between the sectors. Rather, correlation tends to be more often driven by direction than by the dispersion between returns. While rising correlations from 2000 to mid-2007 coincided with smaller return differentials between sectors, the dramatic jump in correlations in the post-Lehman period has coincided with greater return differentials. In plain English, while sectors are tending to move more often in the same direction (diminishing some of the benefits of diversification), the spreads between the returns of the best/worst performers have not necessarily narrowed. This can be seen in Exhibit 10 which looks at the performance differential (rolling 52-week periods) between the second and ninth best performing sectors (chosen to eliminate the potential for outliers caused by the best/worst performing sectors).

Exhibit 10

MSCI World Sectors Rolling 52-Week Performance Differential

Second vs. Ninth Best Performing Sectors



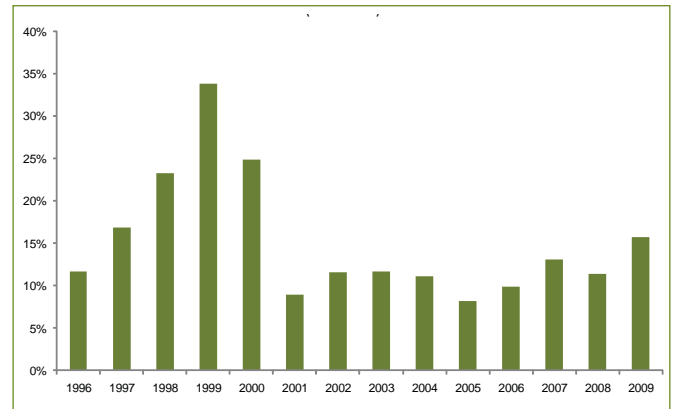
Source: MSCI Barra, Artio Global Management

Another traditional source of potential value-add is stock selection. Exhibit 11 shows the standard deviation of returns among companies in each of the 24 SIC GICS (Standard Industry Classification Global Industry Classification Standard) Level 2 groups. The greater the standard deviation, the greater the observed difference in returns between the best and worst performers in each industry.

While nowhere near the levels of the late 1990's and 2000, return dispersions have been greater than normal over the past three years signaling that getting the "right" stocks has been increasingly important and that the penalty for getting it wrong has been more severe than usual. Unfortunately, it was many of the more levered, lower quality names that led the performance derby and the more fundamentally "sound" names that lagged.

Exhibit 11

MSCI World Standard Deviation of Industry Returns (GIC Level 2)



Source: MSCI Barra, Artio Global Management

Speculation on What It Might All Mean?

It is possible, though likely improbable for industry and sector correlations to move higher, given the historically high absolute levels seen today. Should correlations decline going forward, this may mean more benefit from industry diversification in the years ahead than there has been so far this decade. It may also create an opportunity for greater alpha to be added by industry/sector rotation should these lower correlations be accompanied by greater performance differentials (as is normally, but not always the case). At the stock level, dispersions have been high, though short of the late 1990's bubble level. As such they are more likely to remain stable or move lower. Thus, stock selection should be a similar source of alpha in the years ahead as it has been of late. Any return to a higher quality bias should be positive for fundamental stock pickers as the 2009 dispersion was decidedly in favor of lower quality holdings. ▲

Best Regards,

Brett Gallagher
Deputy Chief Investment Officer

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