TODD ASSET MANAGEMENT LLC

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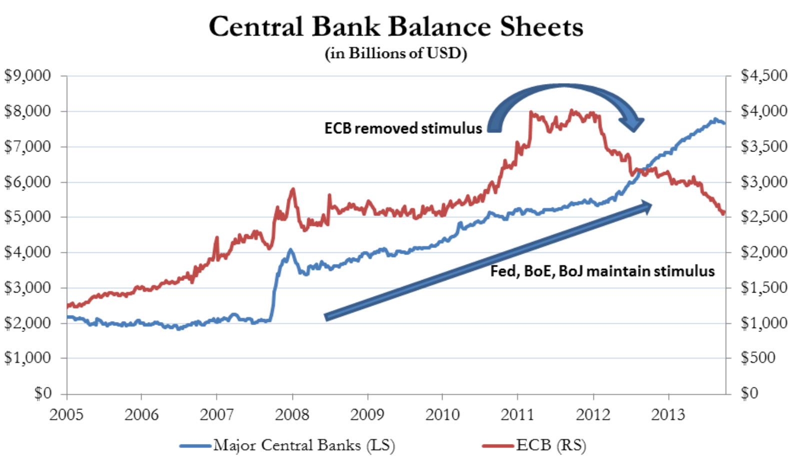
Show Me the Money!

"Within our Mandate, the European Central Bank is ready to do whatever it takes to preserve the Euro. And believe me… it will be enough"

-Mario Draghi, President of the ECB, July 2012

Two years after this pledge, most investors are skeptically watching the ECB to see if they back that promise up with actions. Like we heard in the movie *Jerry Maguire*, investors are saying; "Show Me the Money!" And they seem to be following up with "And it better be enough." While a lot went on in the quarter, we think this is what you should probably focus on the most. Mr. Draghi recently previewed more activity on the Quantitative Easing front, promising targeted financing for banks and bond purchases. Now the market wants to see it. Central bankers regulate and backstop commercial banks. Without healthy commercial banks, commerce stops. We believe the ECB is probably going to double the size of their balance sheet in the coming years, and pursue QE policies as aggressive as other world central banks to support their commercial banks.

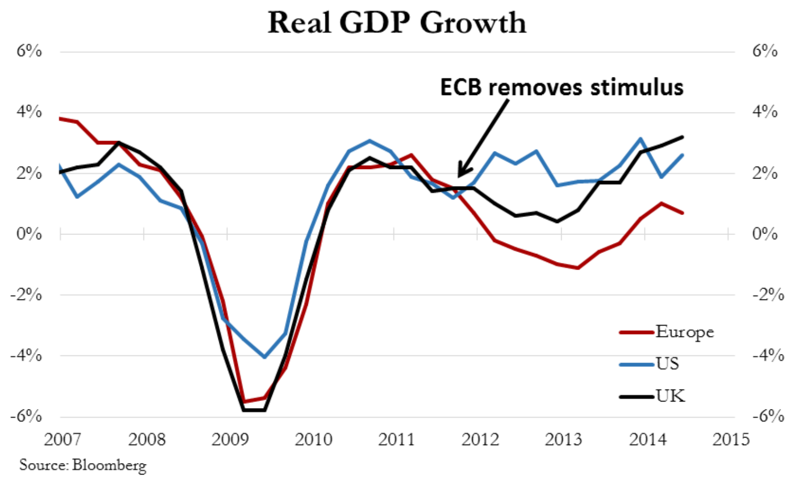
Some history might help; during the US sponsored financial crisis (brought on by too much debt) in 2008, Ben Bernanke got it right. He had studied economic depressions and realized if swift decisive action was not taken, then paralysis could set into the financial markets and economy, leading to a prolonged depression. You may recall the result, Chairman Bernanke dropped short term rates to near zero and set up a host of programs designed to liquefy the financial system, and get commercial banks healthy again. Congress pitched in with some fiscal stimulus and "Voila!" we began a durable (albeit sluggish) recovery. To achieve this, the Fed bought a lot of debt from the market and held it on their balance sheet. This included government and mortgage debt. Private sector de-levering was accomplished, and the problem was solved (or at least delayed).

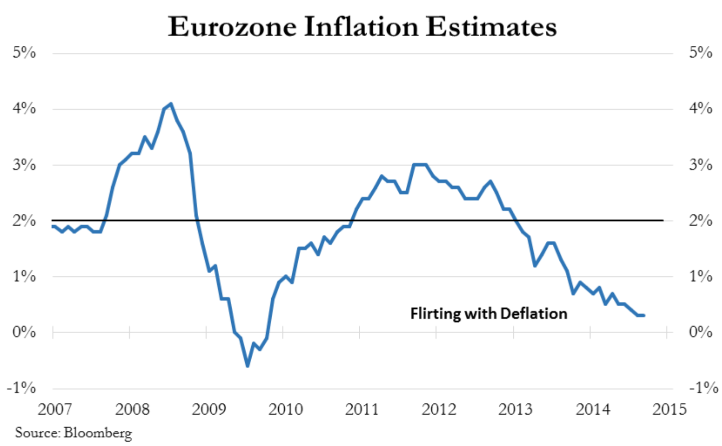


*Major Central Banks include US Fed, Bank of England and Bank of Japan
Source: Bloomberg and Todd Asset Management

Worldwide, central bankers also adopted Bernanke's playbook by lowering rates and adding capital to their commercial bank balance sheets. They accomplished this by taking bonds from them in exchange for cash via programs of various names like TARP in the US or Long Term Refinancing Operations (LTROs) elsewhere. This was the first of several rounds of central bank purchases of bonds, and was successful in "righting the ship" for the commercial banks. Following this, at various times over the past five years, the Federal Reserve, the Bank of England and more recently the Bank of Japan have been very busy buying their own bonds and holding them on their enlarged balance sheets. This accomplishes some good things, notably allowing commercial banks to become more stable and start lending to consumers and businesses again.

The ECB is designed to support the 18 countries that use the Euro for their currency. In 2011-2012 the European financial system had a second crisis, spawned by excessive debt and spending by Greece, Spain, Portugal, Italy, Ireland and later Cyprus. Defaults loomed and fear took hold. Northern European leaders initially treated it like a regional problem, but ultimately had to prepare bailouts for these countries, which included stern austerity measures. The ECB established LTROs lasting through 2012, but made the mistake of sitting idly by while their banks repaid them and their balance sheet shrank. Fewer loans were given, governments pursued austerity and their economy drifted into recession in 2012. It sent a chilling message to consumers and investors.





Currently, investors expect the Euro to hold together, but don't expect its economy to recover anytime soon. After Mr. Draghi's famous quote, the European sovereign bond markets recovered because the ECB said they should, but the ECB never bought a single bond. Markets are now forcing Mr. Draghi's hand and saying "Show Me the Money!" Europe's central problem is that deflation is a risk. The ECB president realizes this, and has pledged to offer LTROs to the banks again, and buy bonds. Initial results on the LTROs were disappointing, so now investors want to see huge bond purchases. Markets are telling you they don't believe it will happen. Long term rates in Germany are less than 1%, inflation is well below the 2% target and declining towards deflation, and growth estimates are being revised downward. Well, it's "go time" for the ECB. When they show us the money, it will be the first step on the road to recovery for their economies. ***Where we differ from the consensus is WE THINK IT WILL HAPPEN!*** That's probably good for markets worldwide, and why we are overweight European equities in our International Intrinsic Value strategy.

As always, we are here to assist you. If you need any additional information, please feel free to contact any of us.

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