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2010 OUTLOOK
EUROPEAN MARKET COMMENTARY

European Equities: Average Valuations in Abnormal Times

Wade O'Brien
Kyle Anderson

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European Equities: Average Valuations in Abnormal Times

Wade O'Brien & Kyle Anderson

While European equity valuations are reasonable from a historical perspective, market pricing doesn't provide much cover for risks stemming from sovereign finances and the halting economic recovery.

"As output in the developed world continued to decline throughout 2009—despite the best efforts of central banks and finance ministries—the tag 'Great Repression' seemed more and more apt: although this was the worst economic crisis in 70 years, many people remained in deep denial about it." —Niall Ferguson, writing of the coming year in the *Financial Times*, December 27, 2008.

"Many European economists discount (sovereign default) as a remote possibility. But that does not mean Europe has safely emerged from crisis." —Landon Thomas Jr., *New York Times*, December 31, 2009.

It is hard to believe that just last March, the world's financial system seemed on the edge of collapse. Despite the stabilization of the global economy since that time and the remarkable recovery of markets, the causes of the sell-off remain largely unaddressed (and obscured by government interventions), making the foundations of the equity market rally look shaky at best. The much-touted economic "recovery" has been aided to a huge degree by government stimulus and central banks' provision of abundant liquidity; as a result, there is considerable risk that this stabilization will not morph into a fundamentals-based recovery in 2010. While this is the case for many western developed economies, most notably the United States, expectations for earnings growth of European shares are more subdued, perhaps reflecting skepticism regarding the sustainability of prior peak earnings in the United Kingdom and on the Continent. On a global basis, we regard equities as vulnerable to risks that include the impact of a pullback in fiscal and monetary stimulus and continued deleveraging, particularly by dangerously indebted sovereigns. Although European equities certainly face these risks, valuations for European equities are somewhat more attractive relative to those of most other developed markets (with Japan a notable exception) and emerging markets, and may provide a bit of a buffer, at least in relative terms.

The 2009 Rally—Sizzle or Steak?

At the end of 2008, equity investors were nursing serious losses but hoped the worst had passed. From our perspective, the dramatic sell-off had restored a semblance of normalcy to pan-European valuations, and we recommended investors hold neutral weights of the region's equity markets, although we also said we did not expect a sustained rally given the prevailing uncertainties. However, much as the 2008 sell-off surprised nearly everyone with its ferocity, the strength and duration of the 2009 rally similarly caught the vast majority of investors off guard.

Indeed, as 2010 begins, we find a very different investment climate. Much of the negative sentiment and forced deleveraging has eased, and credit and interest rate markets (thanks to significant intervention) are functioning more or less normally. Economic data have improved, but only from a very low base, and subdued economic forecasts for 2010 point to lackluster growth, higher unemployment, and overindebted households likely to reduce spending. In short, it appears *expectations* for recovery, rather than recovery itself, have driven the recent rally. While consensus expectations for earnings growth in 2010 seem to suggest that consumer deleveraging and further financial sector deleveraging will not weigh on corporate earnings, at least in the near term, we wonder if the markets will be so forgiving should earnings come in below expectations or stresses of deleveraging reignite.

Along similar lines, investors have been slow to acknowledge concerns regarding sovereign finances—most notably, but by no means limited to, Greece and Spain—yet the need for overlevered governments to get their fiscal affairs in order is crucial to the European investment outlook for 2010 (and beyond). Although expectations for GDP growth and employment are already tempered, what will happen when government spending is curtailed, quantitative easing pulled back, and interest rates hiked?

The United Kingdom

Sector and Strategy Performance

The FTSE® All-Share Index returned 30.1% in 2009, its best performance since 1993, after falling 29.9% in 2008. The rally off the March trough was even more impressive (60.1%), as markets essentially climbed for the remainder of the year, with small caps and growth leading the way. The FTSE® SmallCap Index returned 26.5% in April alone, and 54.3% for the year—nearly double the 27.3% return of the FTSE® 100. This helped offset 2008 losses, when small caps returned -43.9%, versus -28.3% for the FTSE® 100. Growth, meanwhile, bested value for the second straight year (25.2% to 19.9%).

Materials was the best-performing sector in 2009 (107.1%), contributing 9.2 points to the FTSE® All-Share return (Exhibit 1), after being the *worst* performer in 2008 (-54%). Mining stocks rallied strongly, particularly those with exposure to emerging markets and/or precious metals. Information technology was the second-best performer (61.9%), following a -31% return in 2008. The financial sector, after plummeting 48.9% in 2008, returned 28.4% and reclaimed its place as the index's largest component after being displaced by energy in 2008. Utilities was the worst-performing sector (5.5%) as investors shunned the defensive sector and its limited exposure to offshore growth.

The pound sterling staged something of a comeback in 2009, after falling to its lowest level *ever* on a trade-weighted nominal basis in 2008. This boosted returns for unhedged US$ investors—the FTSE® All-Share, for example, returned 30.1% to local investors but 46.1% in U.S. dollars, as sterling rose 12% for the year versus the greenback. Unhedged euro-based investors also benefited thanks to sterling's 9% rise versus the common currency.

Valuations Are Nearing "Normal," Conditions Are Not

The trailing 12-month price-earnings (P/E) multiple for U.K. equities nearly halved in 2008, as the sell-off in equity markets rapidly outpaced the deterioration in earnings. By the beginning of January 2009, U.K. shares[1] traded at 6.9 times trailing 12-month earnings (Exhibit 2), more than 1 full standard deviation below their long-term average. However, the year-end 2009 multiple of 13.0 was nearly identical to the long-term mean of 13.3.

P/E multiples based upon normalized earnings, such as ten-year average real earnings and return on equity (ROE)–adjusted earnings,[2] also richened during the

[1] P/E estimates and ratios referred to here and elsewhere in the text refer to the MSCI U.K. Index rather than the FTSE® All-Share Index.

[2] Normalized P/E ratios attempt to adjust valuations for earnings cyclicality, by comparing both earnings and profitability (ROE) to some sort of normative measure over the earnings cycle. Real normalized P/E ratios (also known as Shiller P/E ratios) compare price levels to the ten-year average of real (inflation-adjusted) earnings per share (EPS), while ROE-adjusted P/Es adjust the current P/E multiple by the ratio of the current level of ROE compared to its historical norm.

year, but by a lesser extent. The trailing ten-year P/E multiple is now 13.0, up from 11.3 at 2008 year-end, and still 0.5 standard deviation below its long-term average of 15.4. The ROE-adjusted multiple is now 13.8, up from 9.2 at 2008 year-end and now 0.1 standard deviation above its long-term average of 13.3. These are our preferred valuation metrics, as they tend to give a better picture of *sustainable* earnings than do 12-month measures (and have tended to be more predictive than other measures); however, it is worth noting that the massive credit bubble from 2003 to 2007 distorted earnings for companies across the board, and we thus view these measures as somewhat less reliable than normal. Still, such measures indicate that valuations have increased meaningfully over the last year, but do not appear particularly stretched, especially when compared to those of other equity markets.

Other valuation metrics such as price-to-book (P/B) and price-to-cash earnings (P/CE) also suggest U.K. equities are roughly fairly valued (Exhibit 3). At year-end, U.K. equities traded at 2.0 times book value, up from 1.3 12 months prior, and in line with their long-term average of 1.9. Dividend yields (DYs), meanwhile, fell to 3.5% from 5.1%, below their long-term average of 4.4%. ROEs have only fallen from 19.3% to 15.4%, slightly above their long-term average of 14.5%, but ended 2009 well above the long-term global average of 12. If history serves as a useful guide, some further decline in profits may be likely before this cycle is over, as ROEs tend to be mean reverting, but overshoots both on the upside and downside. However, ROEs may be lower than what has actually been recorded, as reporting of such data tends to lag, so some of this adjustment has likely already occurred.

In relative terms (compared to Europe ex U.K.), U.K. equities look somewhat expensive on a P/B, DY, or normalized P/E basis (Exhibit 4). Speaking more broadly, U.K. equities trade at just 0.4 times the P/E multiple of the MSCI World ex U.K. (Exhibit 5), 2 standard deviations below their long-term average. DYs in the United Kingdom of 3.5%, meanwhile, remain among the world's highest.

The outlook for earnings, which were expected to decline by 31% in 2009, is key for U.K. equity valuations. Consensus analyst estimates call for a 23% increase in 2010 EPS, with almost every sector expected to post gains. While seemingly impressive, this recovery in U.K. earnings is occurring at a slower pace than in other markets. The consensus expects U.K. earnings to return to 67% of their peak in 2010, versus 88% for the United States and nearly 100% for emerging markets (Exhibit 6). Financials and energy (expected EPS increases of 66% and 39%, respectively) are expected to show the largest gains, after experiencing among the largest profit drops in 2009; financials, for example, saw EPS drop by 49% in 2008 and 58% in 2009. On a historical basis, a 23% increase would not be unprecedented this decade, and would help return earnings close to their post-1970 trend-line growth rate of 1.8 % (Exhibit 7).

The Investment Outlook

The question for investors is whether the outlook for earnings growth is consistent with current valuations. While earnings growth rates are expected to be strong, they are building off a low base relative to other equity markets. Even as valuations may be reasonable, they leave little room for disappointment, which seems likely given the high degree of uncertainty related to the sustainability of economic improvement and earnings growth, the vulnerability of the market to a pullback in stimulus, and sovereign debt concerns. Somewhat mitigating these risks is the fact that bullish earnings forecasts appear to be based on expectations for strong offshore earnings, rather than exposure to the weak domestic economy. Indeed, Morgan Stanley notes that just 35% of U.K.-listed company revenue comes from the United Kingdom, with 43% derived from other developed regions and 22% from emerging markets, including 13.5% from fast-growing emerging Asia and Latin America. This is even more so for the largest companies and sectors. For example, only 20% of revenues for the largest U.K.-listed stocks come from the United Kingdom, while more than 50% of small-cap revenues are domestic; the heavyweight financial, energy, and consumer staples sectors all include strong international competitors. However, investors should temper expectations for non-U.K. growth, given the degree to which it has been driven by temporary, debt-financed government programs. Despite their awareness of the poor prospects for the U.K. economy, investors betting on an economic/profit resurgence outside the United Kingdom may be setting themselves up for disappointment.

On the economic front, the government was forecast to run a 2009 deficit of 12.6% of GDP, and is expected to borrow a similar amount in 2010. The European Commission estimates that U.K. government gross indebtedness will increase from 69% of GDP at year-end 2009 to more than 80% at the end of 2010. While the United Kingdom is not alone in facing looming debt problems—the average 2010 gross debt to GDP ratio for members of the European Union is expected to reach 79.3%—the United Kingdom is unique in its currency. If the market begins to punish currencies and sovereign debt of countries with severe fiscal imbalances, the United Kingdom could be more badly affected than its peers. In contrast, the U.S. dollar could benefit from its status as the global reserve currency, and the euro could benefit from the ability of stronger Eurozone members such as Germany to help shore up weaker members. Some central banks such as Russia's also now hold significant amounts of their foreign reserves in euro, which will also help support that currency. The United Kingdom is also distinguished by its overlevered households that in recent years have had much lower savings rates than their continental peers. Any attempt to close the deficit will (absent a massive and sustained economic recovery) require sharp spending cuts and/or higher taxes that are likely to weigh on the economy.

Europe ex U.K.

Sector and Strategy Performance[3]

The MSCI Europe ex U.K. Index returned 28.4% in 2009, following a disastrous 2008 during which the index returned a record -42.7%. Norway was the best-performing market overall, up 81.2% in 2009 on the back of strong performance from energy, materials, and financial firms. Sweden and Belgium each returned over 50%, while heavyweights France and Germany returned 27.7% and 21.3%, respectively. In contrast to the United Kingdom, value stocks outperformed growth shares, returning more than 20% in April alone and 34.0% for the year—over 1,000 basis points (bps) more than growth. Continental small caps also outperformed, returning 21.1% in April and 55.9% for the year, trouncing large caps by more than 2,800 bps.

In a complete turnaround from 2008, when no part of the market was spared, every sector in the MSCI Europe ex U.K. was in the black in 2009 (Exhibit 8). Materials led the way with a 49.7% return, with industrials and financials also returning more than 35%.[4] Financials account for more than 25% of the index, and contributed 8.5 points of the overall 28.4% return.

Valuations Have Risen

Last year we suggested the 2009 consensus estimate for a Eurozone EPS increase of 1% might be too optimistic. In fact, this was wildly optimistic, as EPS for the Eurozone declined 24% after a similar drop in 2008. The contrasting price appreciation has left

[3] Returns in this section are in euro terms.
[4] It is worth noting that the MSCI Europe ex U.K. materials sector is very different than that of the FTSE, featuring many smaller chemical and materials firms as opposed to some of the global mega-cap miners in the FTSE.

equities more richly valued, yet still below historical averages on several measures.

Our preferred valuation metrics, including trailing ten-year real P/E ratios and ROE-adjusted P/E ratios, suggest European equities are reasonably priced. The trailing ten-year P/E multiple is now 14.2, 0.6 standard deviation below its long-term average of 19.6, while the ROE-adjusted P/E multiple is 14.9, 0.4 standard deviation below its long-term average of 16.2 (Exhibit 9). It is worth noting that valuations in our post-1970 dataset have been elevated relative to longer-term equity data; in our opinion, a multiple of 15 is a more reasonable "bogey."

The market's P/B ratio of 1.6 is slightly below the long-term average of 1.8 (Exhibit 10); however, this measure offers limited utility given recent accounting restatements and the vagaries of valuing intangible assets for non-manufacturing businesses. Unlike U.K. equities, the ROE for the MSCI Europe ex U.K. Index is now over 1 standard deviation *below* its historical average, versus 1 standard deviation *above* 12 months ago, suggesting that much of the cyclical adjustment in ROE may have already transpired.

Given the plunge in earnings over the last year and the potential for a swift recovery in 2010, it is tempting to examine forward-looking multiples for valuations guidance. Stocks based on forward-looking valuations are attractive, *assuming the consensus EPS estimate of 29% growth in 2010 is accurate*. However, investors should always view estimates with a large grain of salt, as such estimates always tend to be overstated, both on the downside and the upside. The likelihood that such estimates are overstated today is arguably even higher given the scope of government intervention in the economy, and the degree to which it has obscured price signals typically used by businesses to forecast demand. Yet, given the hit to earnings in the last two years, such estimates seem more reasonable than the consensus view for other countries/regions. Earnings in Europe ex U.K. are expected to reach about two-thirds of their pre-crisis peaks at the end of 2010, compared to about 90% for U.S. equities and 100% for emerging markets.

The Investment Outlook

As 2009 drew to a close, investors struggled to reconcile the strong performance of equity markets with a lackluster economic recovery. While government stimulus packages (Exhibit 11) certainly provided a boost to short-term numbers, their long-term effect is far less certain, and concerns over the deficits incurred to pay for such spending have gone from a simmer to a boil. Countries such as Spain that previously had relatively low debt levels saw deficits balloon to levels much closer to other European peers (Exhibit 12), and the average Eurozone member is expected to see its debt/GDP ratio rise to 84% by the end of 2010.

Unemployment is expected to rise above 10% in early 2010, while banks continue to face concerns over further write-downs. The International Monetary Fund recently estimated that Eurozone banks have only recognized around 40% of their expected writedowns from the crisis; the comparable figure for American banks was closer to 60% (Exhibit 13).

The consensus earnings forecast is for Eurozone EPS to increase by 29% in 2010. This follows declines of 27% and 24% in 2008 and 2009, respectively. As in the United Kingdom, European equities offer significant exposure to international markets. European companies receive almost a quarter of their revenues from emerging markets (15% from emerging Asia and Latin America), but still rely on European and North American customers for the remaining 75%. Materials, consumer discretionary, and information technology are expected to see the biggest profit growth, due in large part to strong export revenues. Export-driven Germany, for example, is expected to see earnings increase by 45%.

While current European equity multiples are below or near long-term averages by most measures, we believe risks are above average given fiscal imbalances. Even if earnings meet analysts' bullish estimates for 2010, the structural problems created by greater leverage and weaker employment remain unaddressed. We concede equities may move higher in the short term as governments are unable or unwilling to withdraw stimulus, but longer-term risk remains. At some point governments will have to cut record deficits through higher taxes and/or lower spending, and overlevered consumers will need to address their own balance sheet issues. Geographic exposure is likely to cushion the blow for some, but the ensuing market correction may be indiscriminate. In the meantime, sovereigns may have their hands forced by bond investors, a dynamic already starting to play out in the some peripheral bond markets (Exhibit 14). Some domestic equity markets had been spared, but over the past couple of months, markets have increasingly incorporated market skepticism, with Greece underperforming in late 2009, joined by Spain and Portugal in January.

For investors that maintain target allocations to European equities, ensuring that positions have a desirable mix of domestic and offshore earnings is important. With expectations of 1.2% Eurozone GDP growth in 2010, local drivers for multiple expansion are limited. However, these concerns are not limited to Europe. In fact, U.S. equities face similar, if not more acute risks than the Eurozone, as the United States has also been running a high deficit and using expansionary monetary policy to support the economy, and debt as a percentage of GDP is also increasing rapidly. The main difference in Europe is that slower growth is priced in. As a result, although markets may be vulnerable, they are less vulnerable than U.S. equities and even emerging markets equities, which have more upbeat long-term prospects but are more vulnerable in the near-term due to relatively high valuations and overbought conditions.

Conclusion

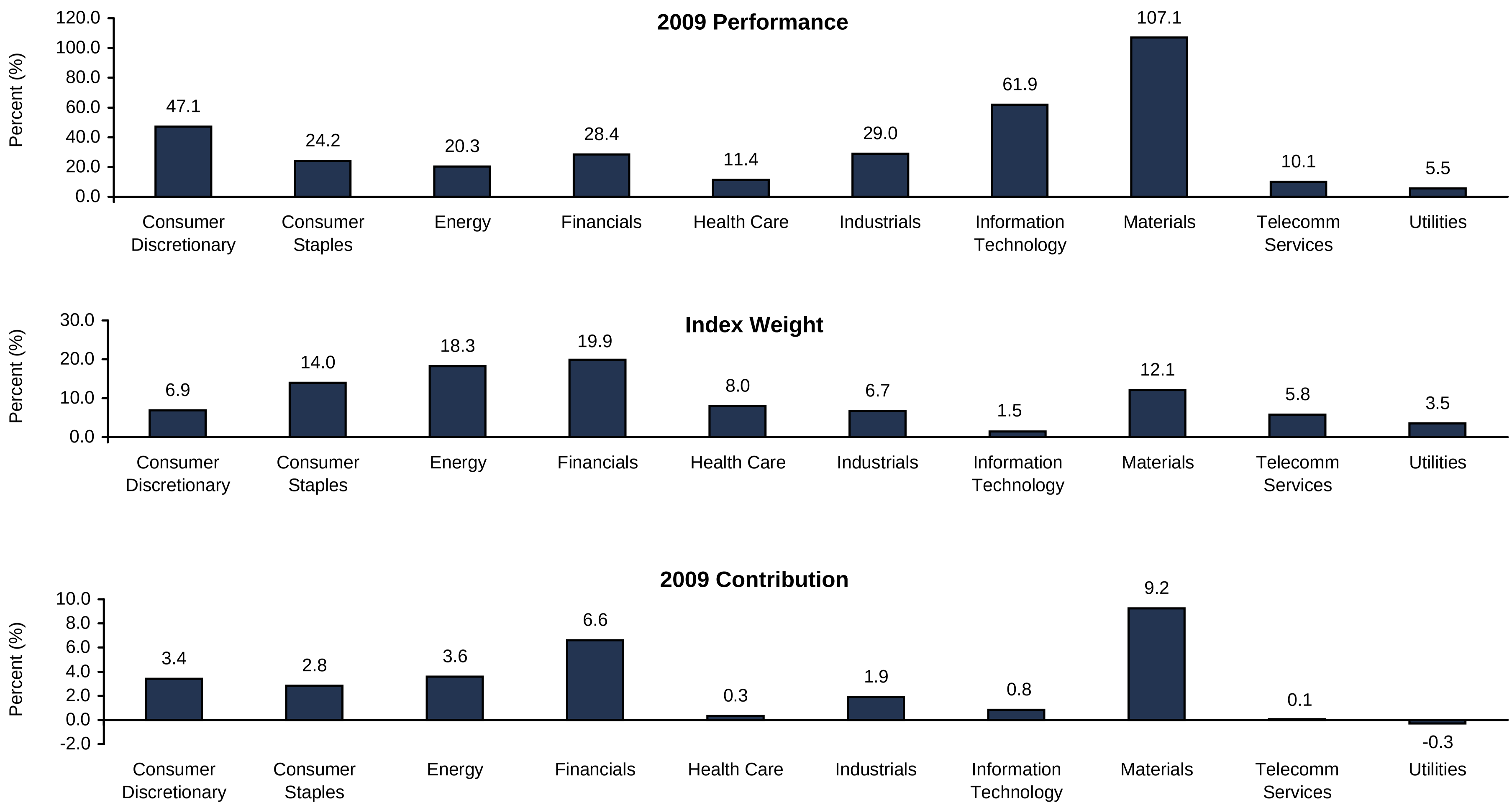
U.K. and European equities are more fully valued than they were at the end of 2008. Equities are not overvalued by most measures, nor are they inexpensive, particularly given prevailing macroeconomic uncertainties, including the largely unprecedented level of government involvement in economies. Although GDP growth has turned positive for most countries, this statistic obscures the risks (and leverage) that have been transferred to government balance sheets. Further, central banks cannot keep short-term rates at or close to 0% indefinitely, much as governments must at some point cut deficits and withdraw stimulus.

The broad market rally in 2009 largely ignored such macro concerns, and recent signs of stress in peripheral countries caused only isolated equity market sell-offs. In recent weeks this has changed, and a January equity market correction that acutely impacted Portugal, Spain, and Greece has morphed into a deeper and broader market sell-off in early February. The problem that led to the 2008 crisis (i.e., too much debt) has not been "solved"; indeed, government actions may have actually exacerbated stresses by increasing public debt burdens faster than the private sector can deleverage. Given valuations that are in line with historical averages, coupled with large (and in many cases unprecedented) macroeconomic risks, we believe European and U.K. equities on balance are fairly valued, although the risk of a sharp drawdown seems higher than normal, particularly considering the parabolic run-up for much of 2009. We see no particular reason to underweight U.K. and European equities, but would not overweight them either. Attractive relative valuation and broad-reaching geographic exposure provide some defensive characteristics, but the risks of overleveraged private and public sectors remain.

Exhibit 1

FTSE® All-Share Economic Sector Weights and Contribution

As of 31 December 2009 • Pound Sterling



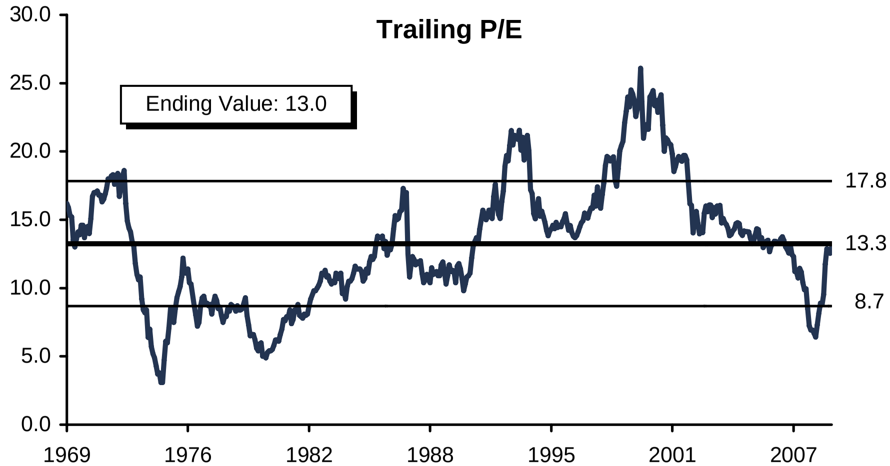
Sources: FactSet Research Systems and FTSE International Limited.

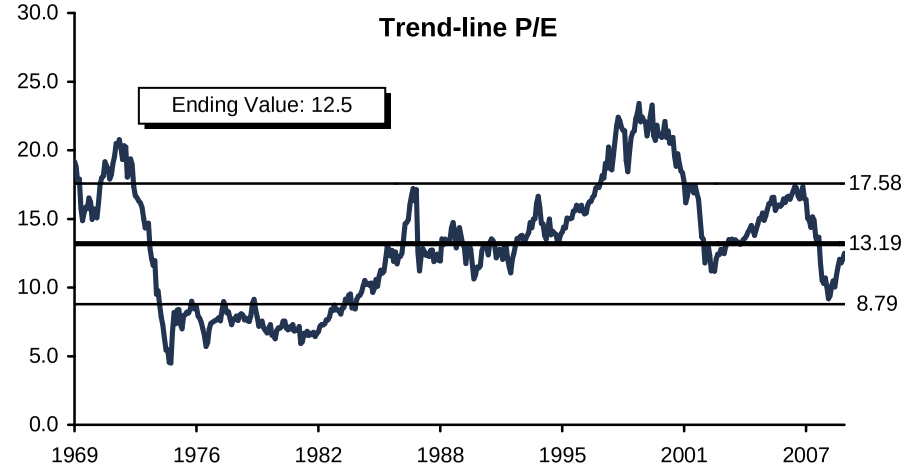
Notes: Weights may not total to 100% due to rounding. Approximately 3.5% of the index (accounting for 159 basis points of the index's return contribution) is not assigned to any sector and is therefore not shown in this exhibit.

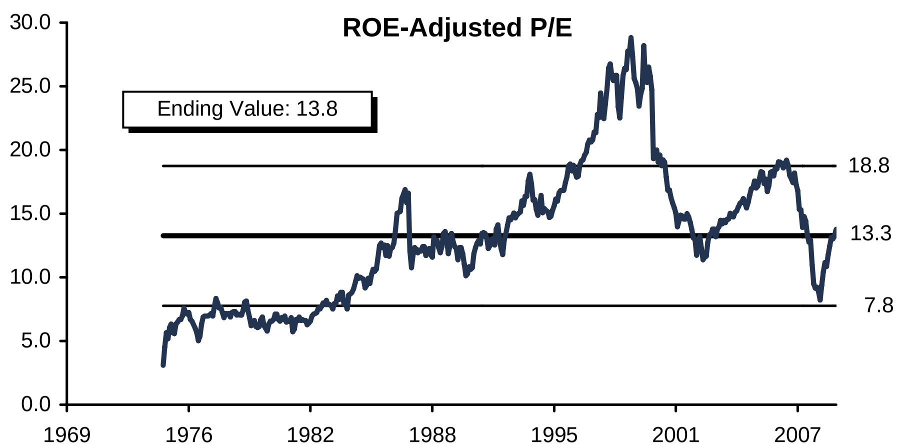
Exhibit 2

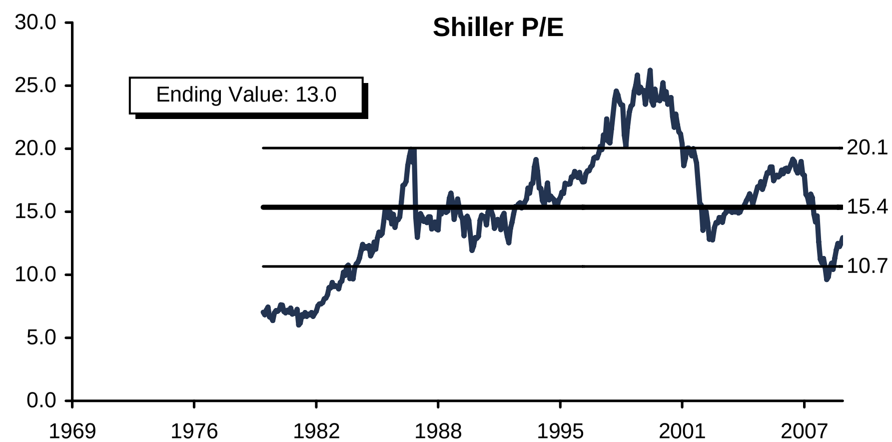
MSCI U.K. Price-Earnings Valuations

31 December 1969 – 31 December 2009









Sources: Global Financial Data, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: U.K. earnings are deflated by the U.K. RPI from 1969 to November 2003 and the U.K. CPI from December 2003 to present. Return on equity–adjusted price-earnings (P/E) data start on 31 December 1974. Shiller P/E data start on 30 November 1979. U.K.

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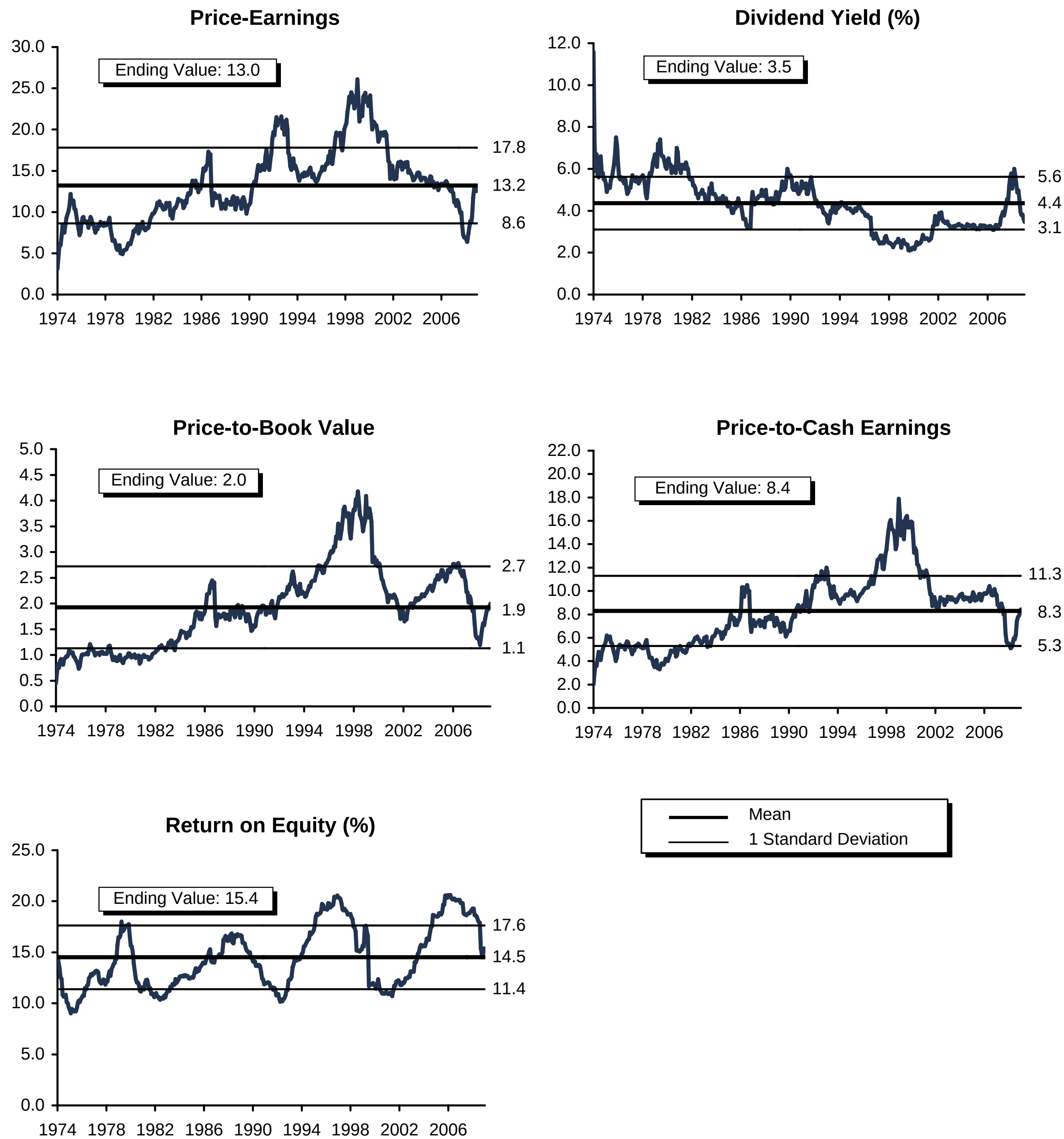
Exhibit 3

MSCI United Kingdom Index

31 December 1974 – 31 December 2009



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.
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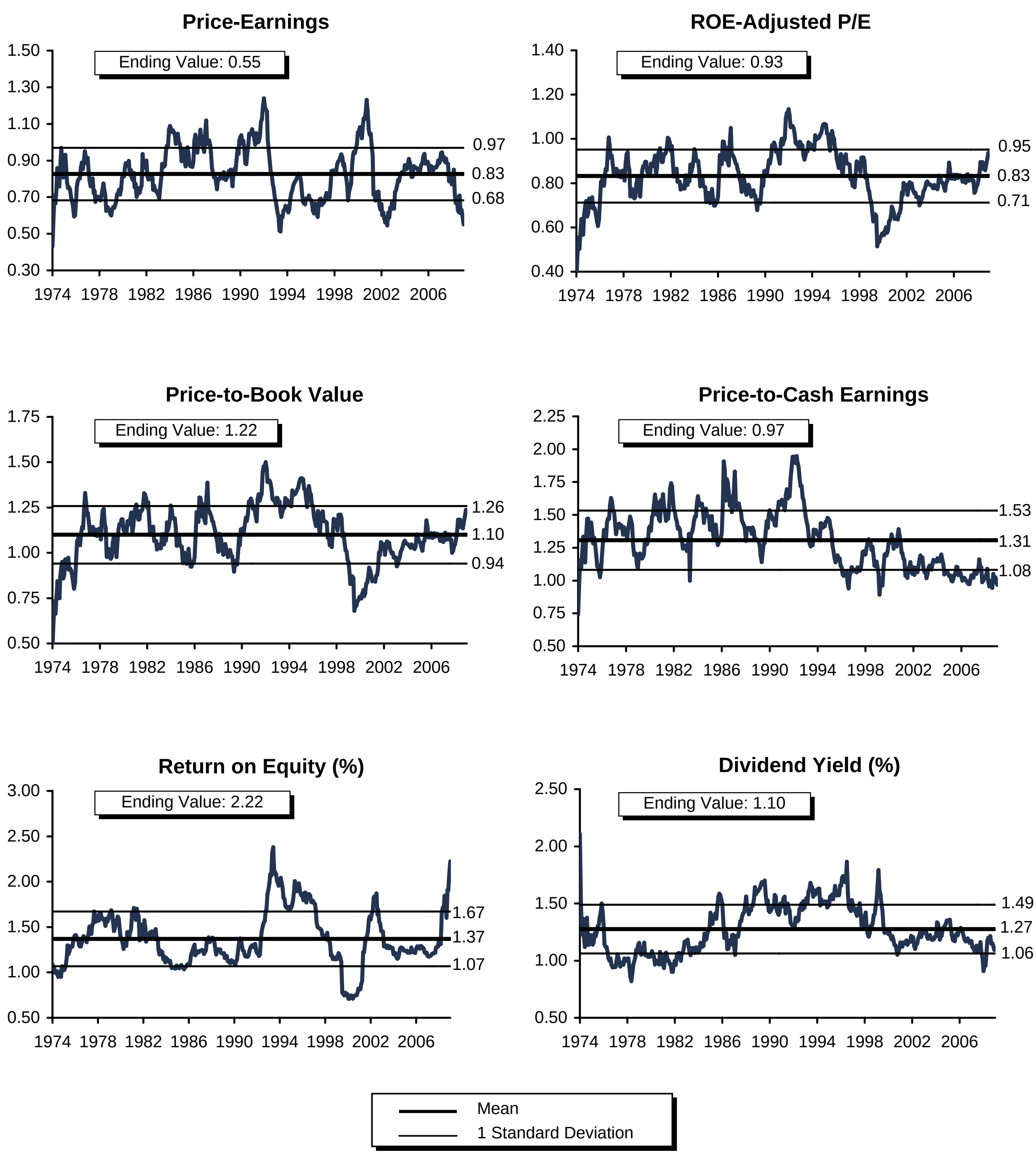
Exhibit 4

MSCI U.K. Relative to MSCI Europe ex U.K.

31 December 1974 – 31 December 2009

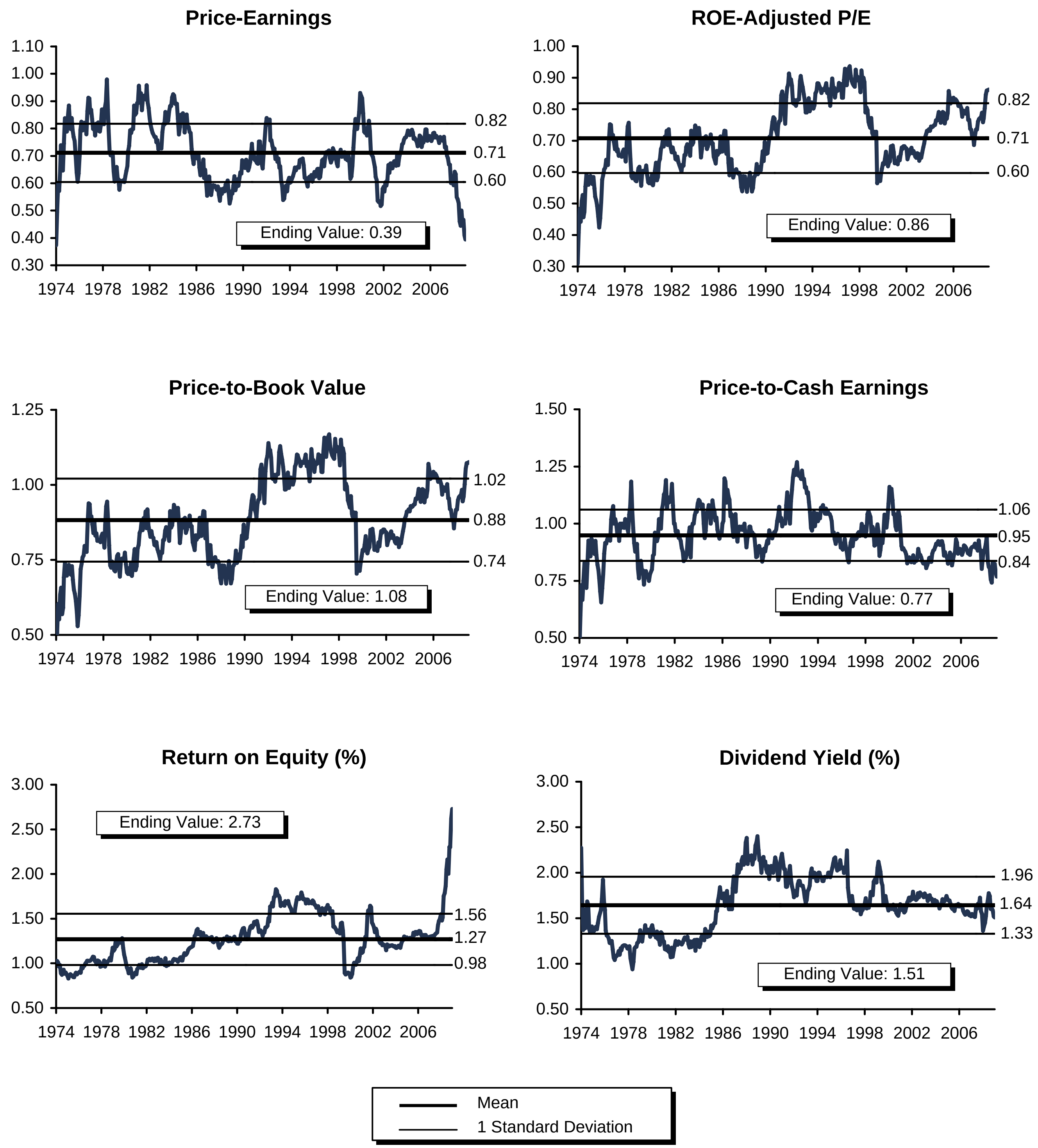


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE.

Exhibit 5

MSCI U.K. Relative to MSCI World ex U.K.

31 December 1974 – 31 December 2009

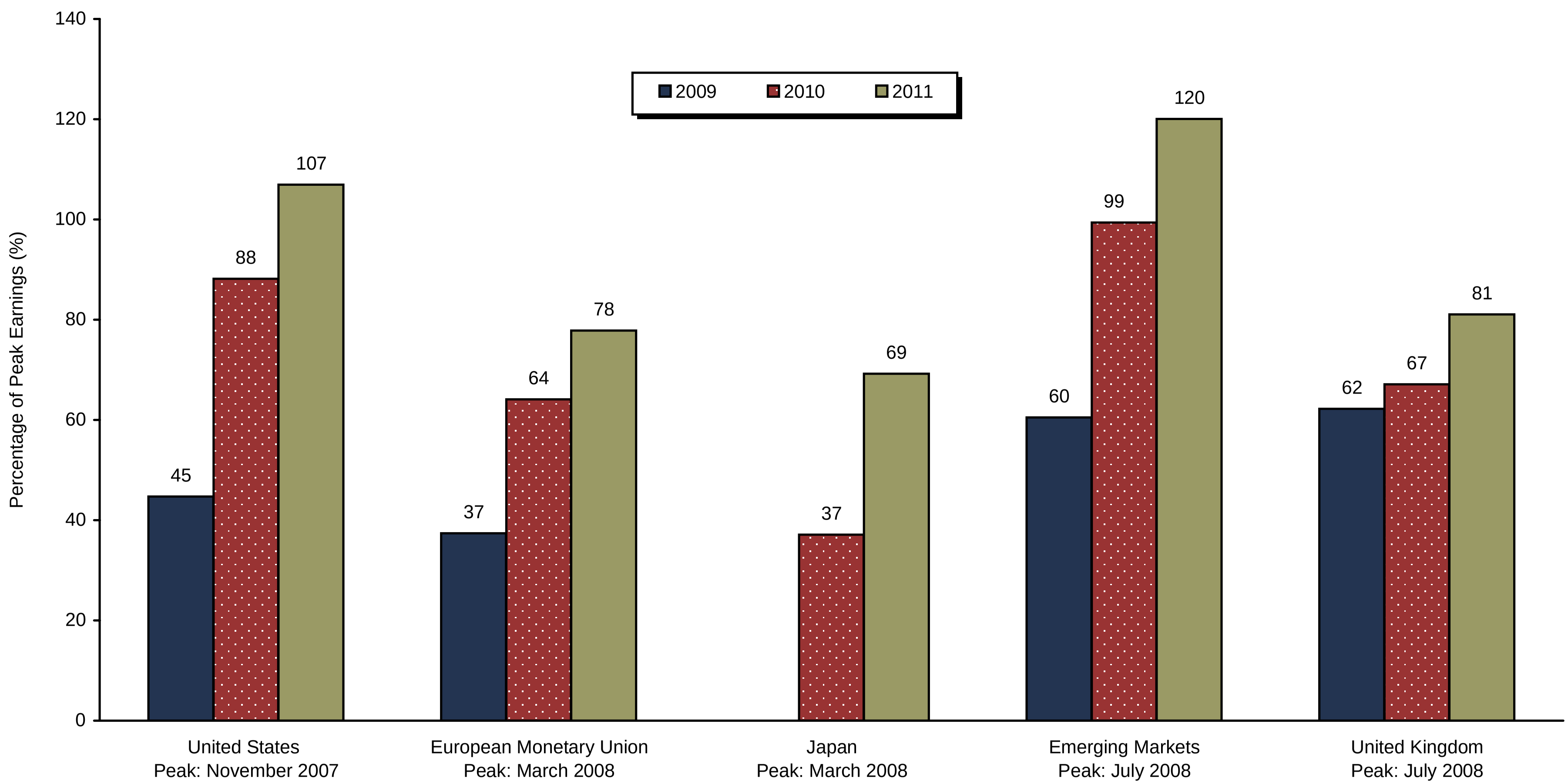


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE.

Exhibit 6

Forward EPS Expectations as a Percentage of Peak EPS

As of 18 January 2010



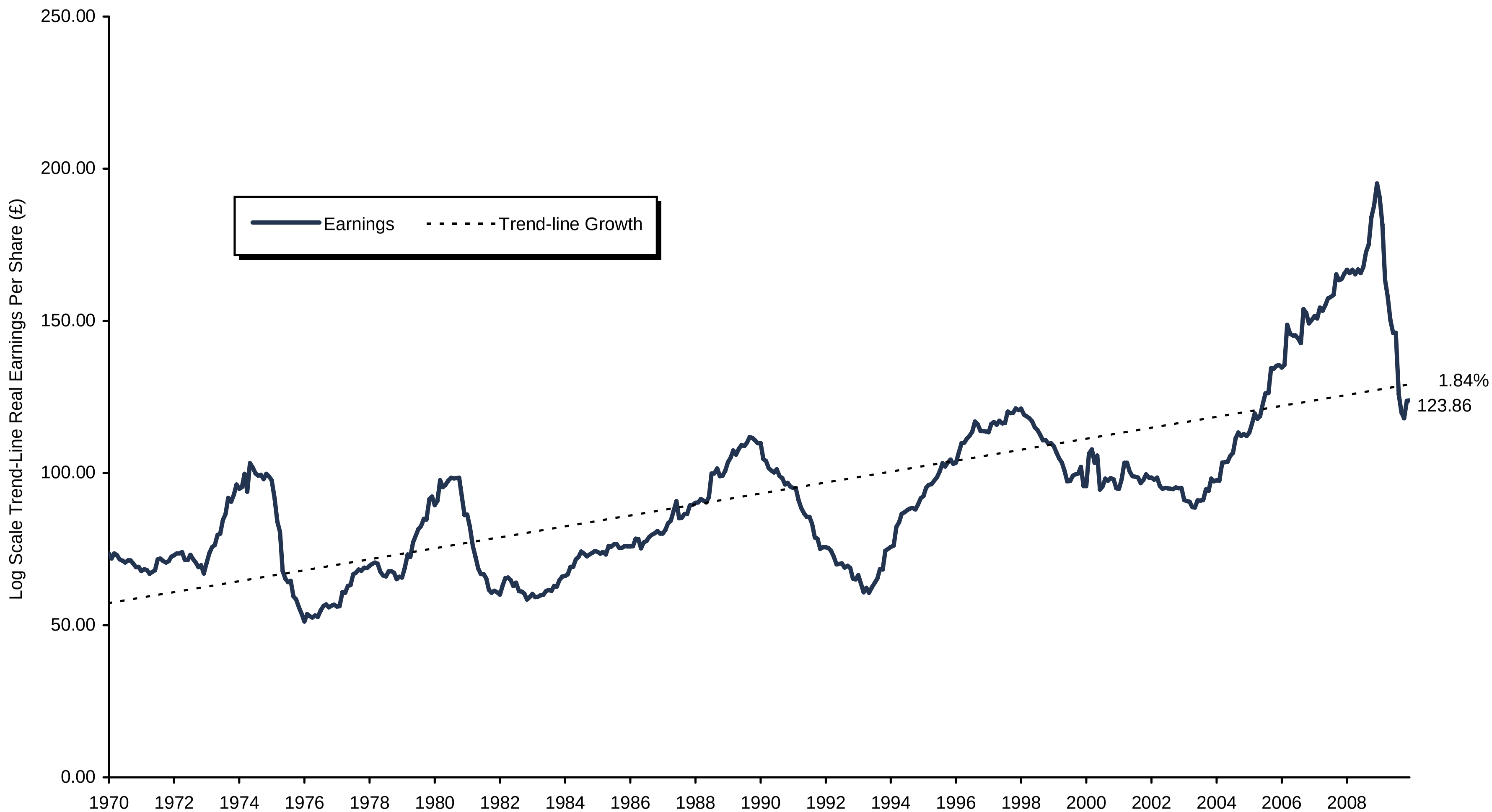
Sources: I/B/E/S, J.P. Morgan, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Consensus forward EPS estimates for 2010 and 2011 provided by J.P. Morgan. Historical EPS provided by MSCI Inc. Japanese 2009 data are left blank due to negative EPS.

Exhibit 7

MSCI U.K. Real Reported Earnings

1 January 1970 – 31 December 2009



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The average year-over-year real earnings growth rate of 3.2% is calculated arithmetically. U.K. inflation data represent the Retail Price Index from 1974 through November 2003 and the U.K. CPI from December 2003 onward. Real earnings are based on trailing 12-month earnings as reported by MSCI.

Exhibit 8

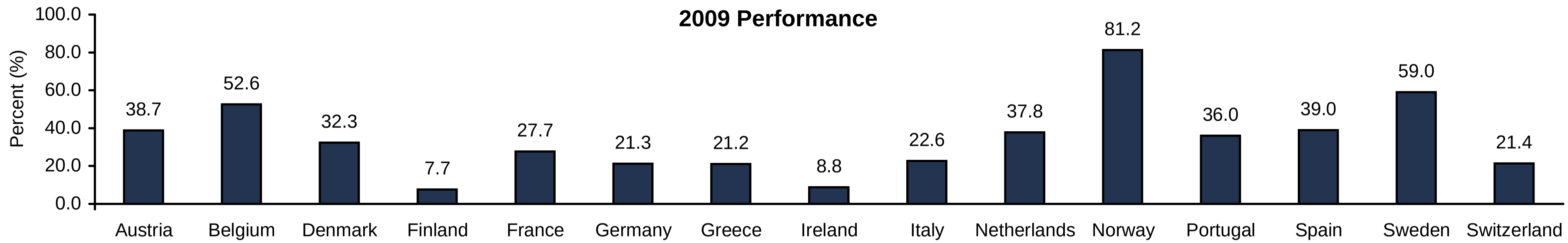
MSCI Europe ex U.K. Country and Economic Sector Weights and Contribution

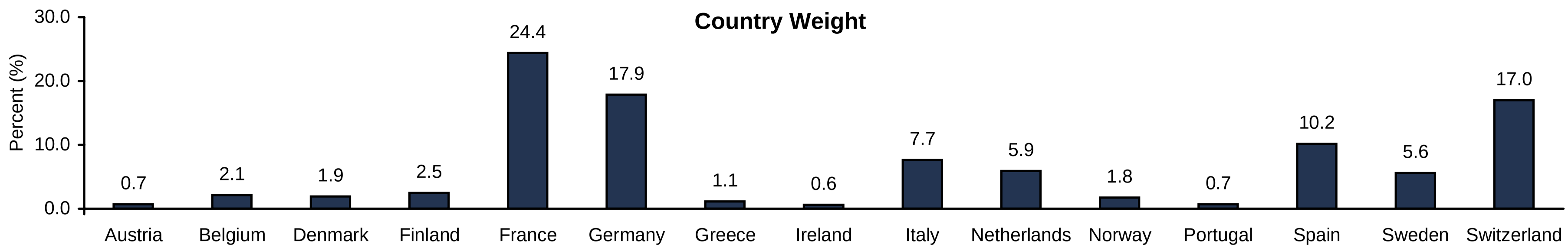
As of 31 December 2009 • Euro

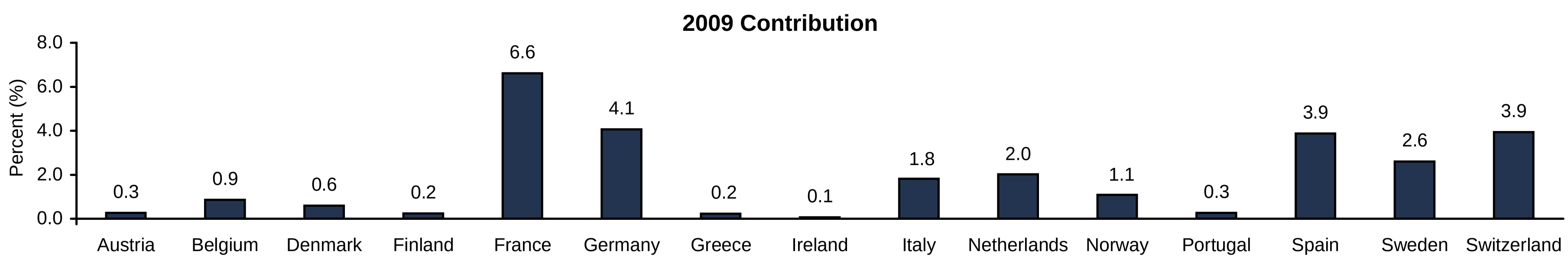
Exhibit 8 (continued)

MSCI Europe ex U.K. Country and Economic Sector Weights and Contribution

As of 31 December 2009 • Euro





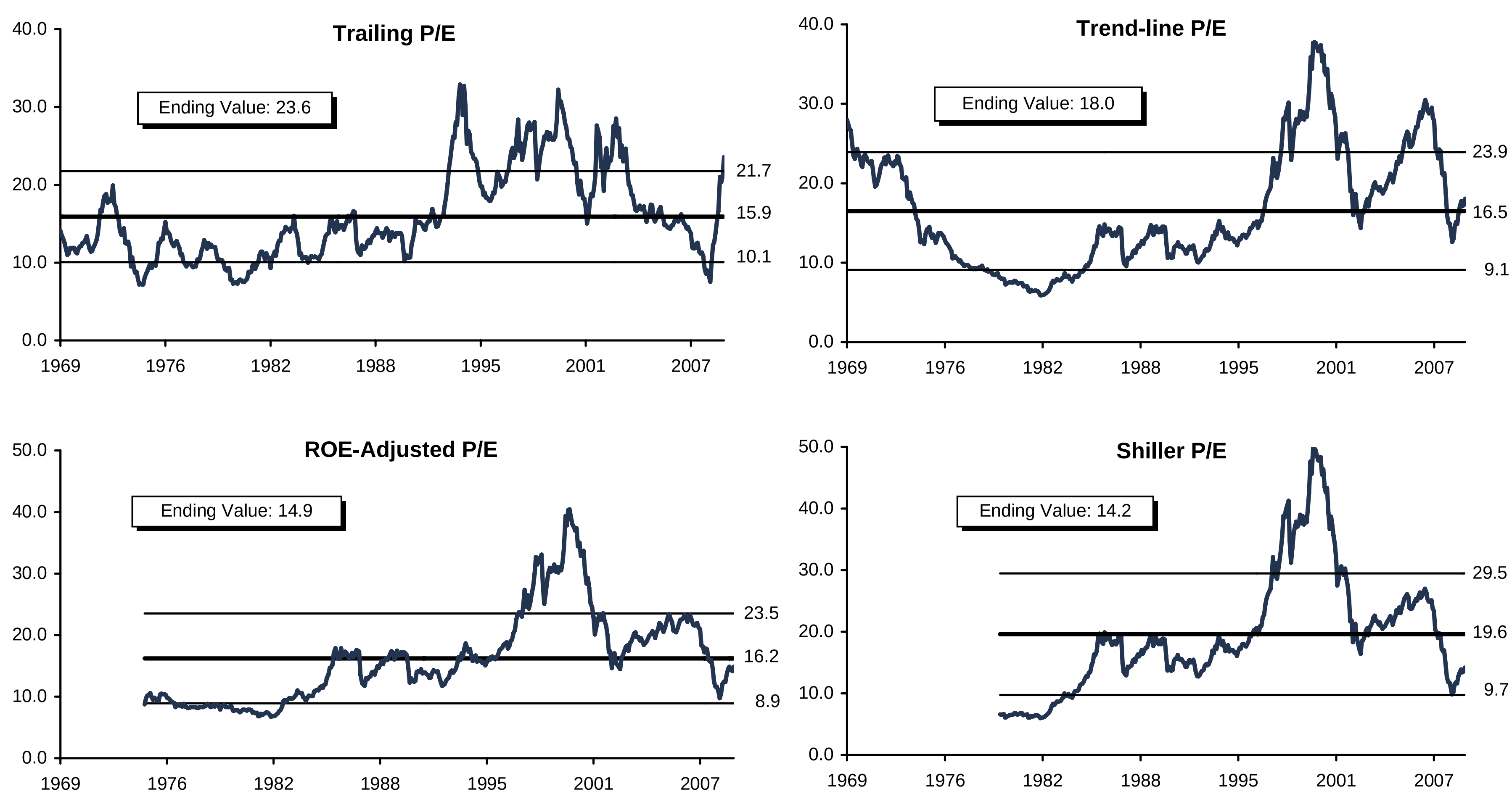


Sources: FactSet Research Systems, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Weights may not total to 100% due to rounding.

Exhibit 9

MSCI Europe ex U.K. Price-Earnings Valuations

31 December 1969 – 31 December 2009

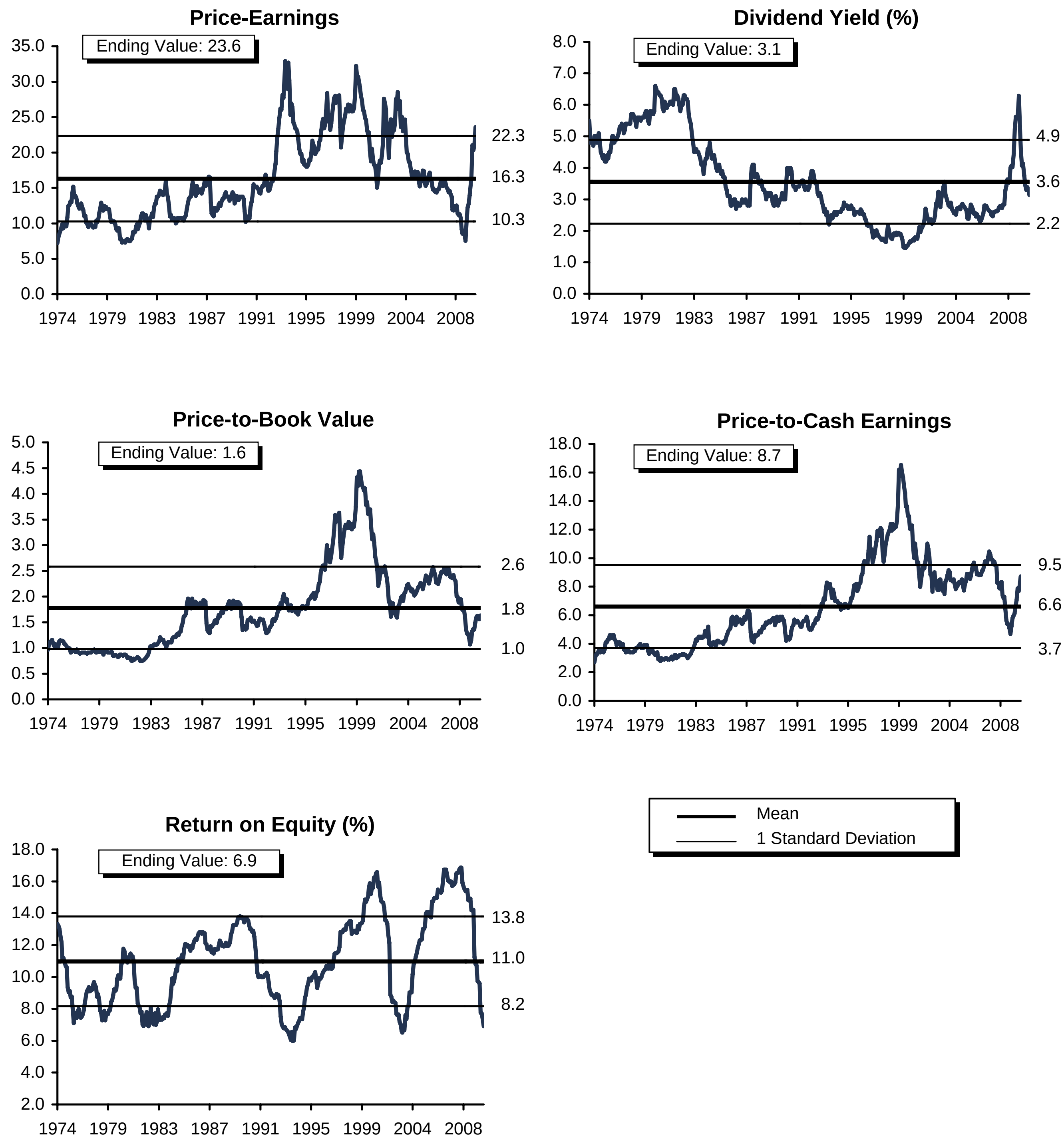


Sources: Global Financial Data, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Earnings deflated by CPI-Eurozone with data before 1996 are based on a historical composite calculated by Global Financial Data, Inc. Return on equity–adjusted price-earnings (P/E) data start on 31 December 1974. Shiller P/E data start on 30 November 1979.
uk_259m

Exhibit 10

MSCI Europe ex U.K. Index

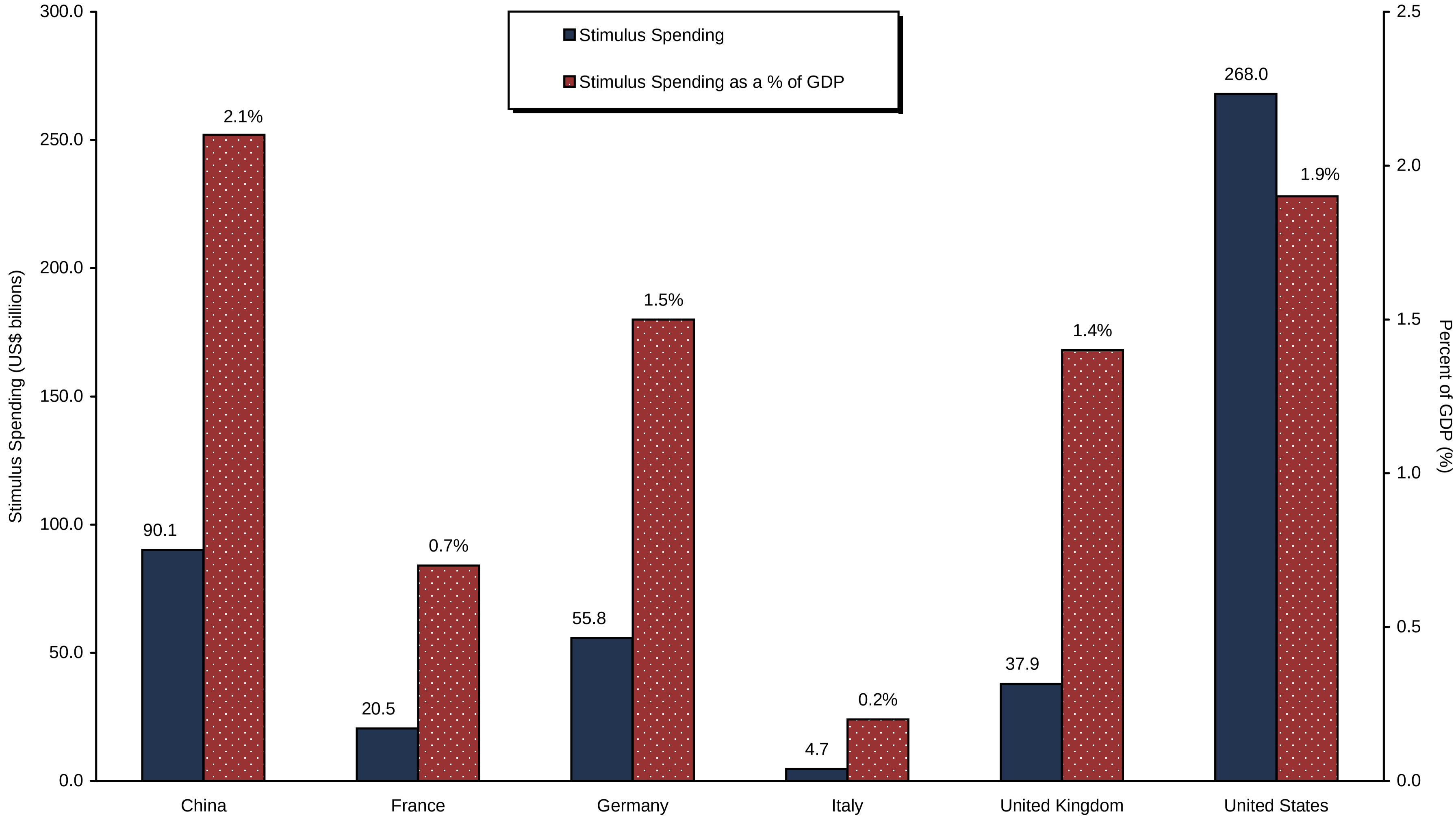
31 December 1974 – 31 December 2009



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.
398q

Exhibit 11

2009 Fiscal Stimulus

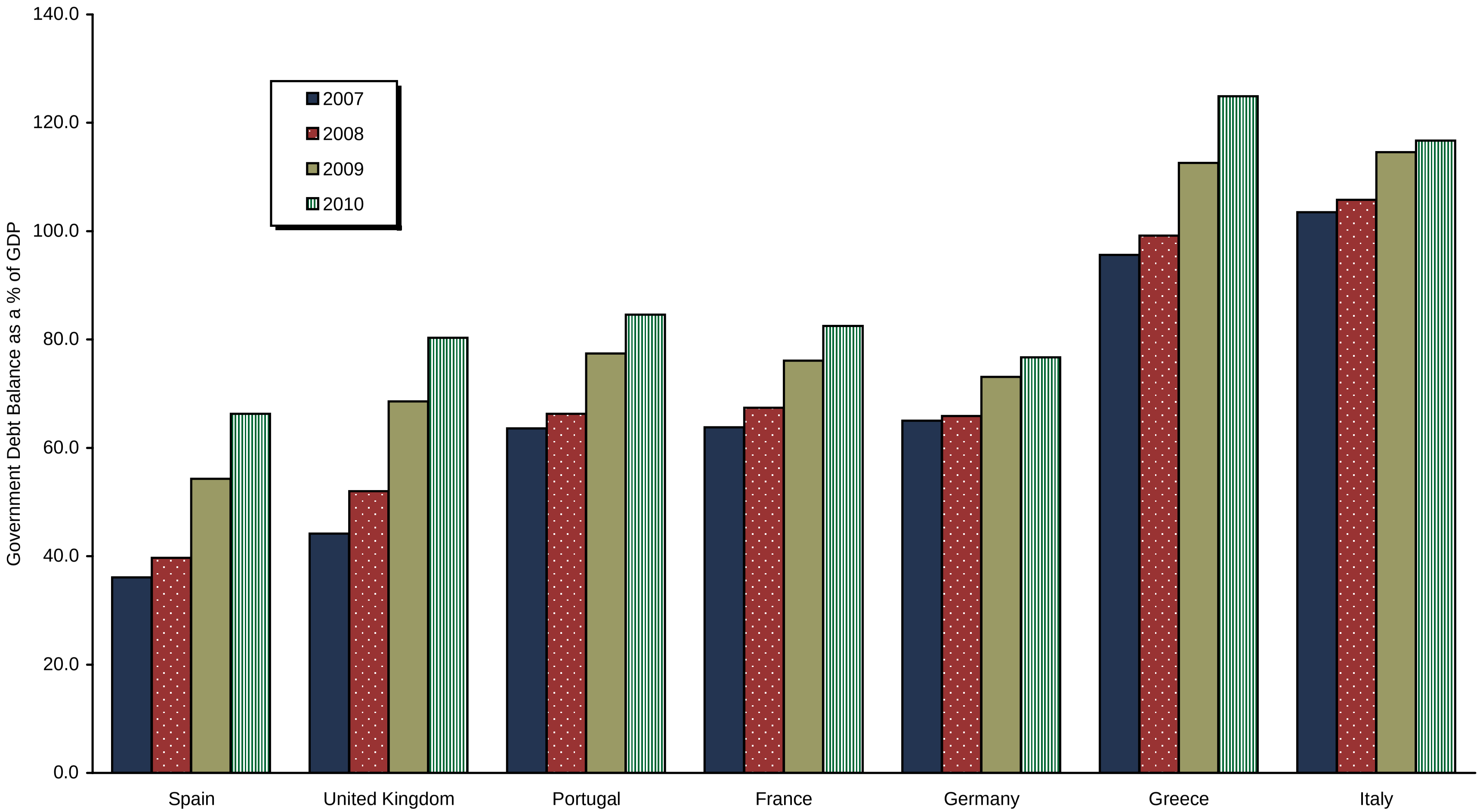


Sources: The Brookings Institution, CIA World Factbook, and International Monetary Fund.
Note: Percentages are based on 2008 GDP.

Exhibit 12

Debt as a Percentage of GDP

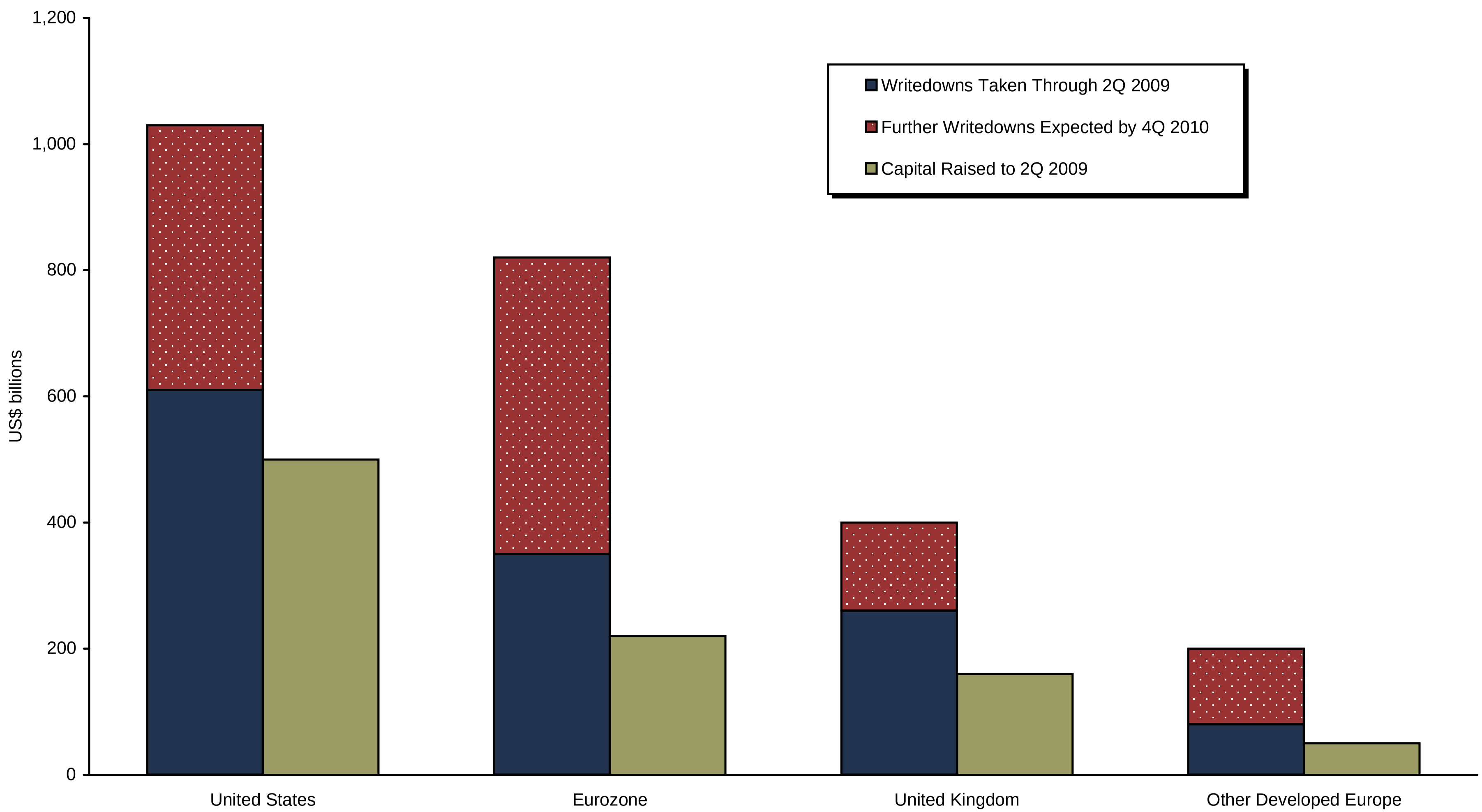
2007–10



Source: European Commission.
Note: Data are as of October 2009.

Exhibit 13

Estimated Bank Writedowns and Capital Raised

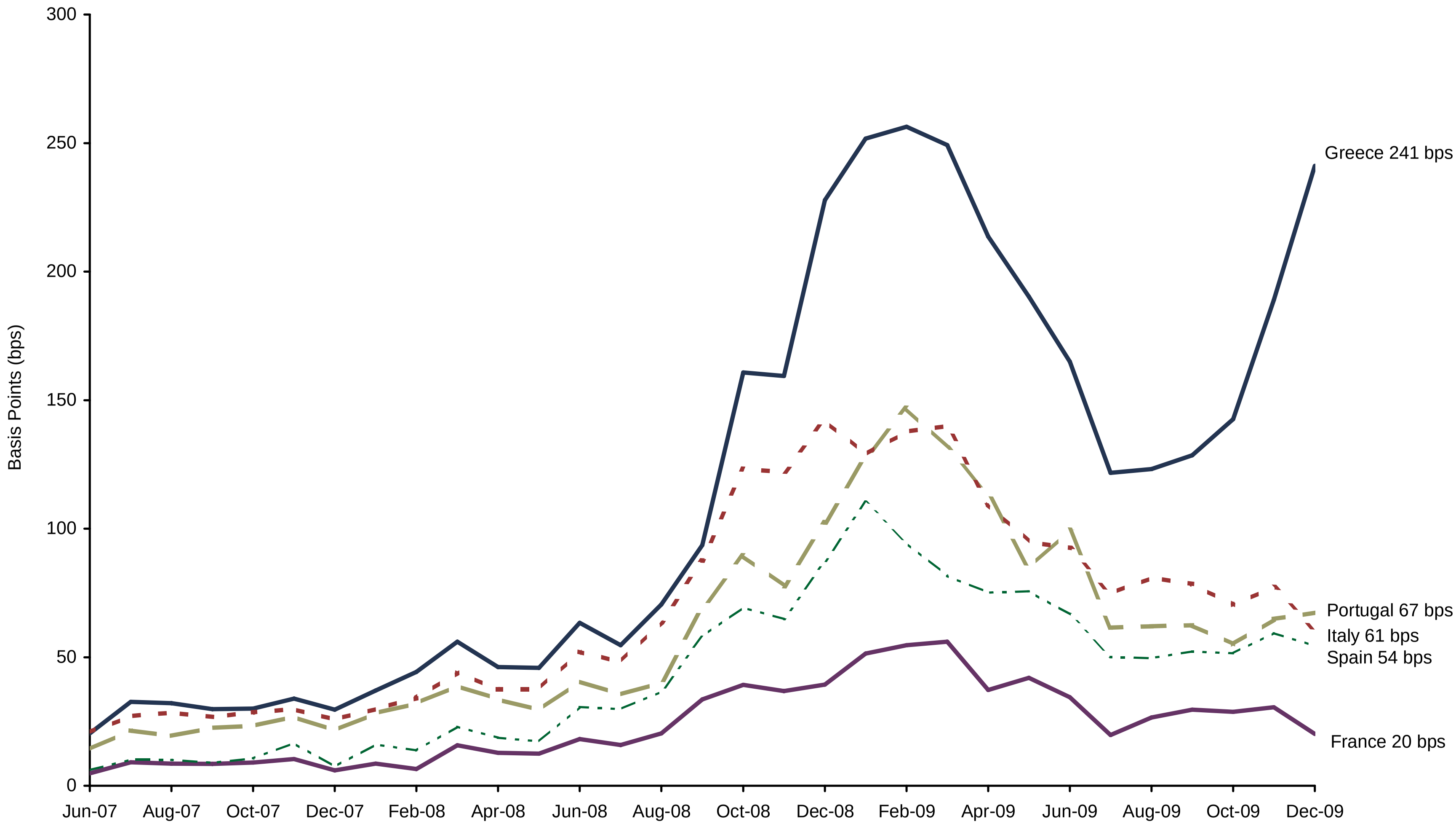


Source: International Monetary Fund.
Notes: Data are based on IMF staff estimates. U.S. data exclude government-sponsored enterprises. U.K. data are estimates based on an assumption of implementation of Asset Protection Schemes. Other developed Europe includes Denmark, Iceland, Norway, Sweden, and Switzerland.

Exhibit 14

European Government Bond Yield Spreads Over Bunds

30 June 2007 – 31 December 2009



Source: Thomson Datastream.