CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

ARE EARNINGS POISED TO DISAPPOINT?

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Are Earnings Poised to Disappoint?

Last month we changed our valuation rating for European equities from fairly valued to overvalued, primarily because price-earnings ratios (P/Es) adjusted for earnings cyclicality indicate both U.K. and Europe ex U.K. shares are expensive, even though standard trailing 12-month P/Es are near their long-term averages. Use of P/Es based on normalized earnings is preferable because earnings are cyclical, such that P/Es based on trailing 12-month earnings should be higher when earnings are at or near peaks, and lower when earnings are at or near troughs. While historical trends suggest that earnings and returns on equity (ROE) may be at or near cyclical highs, it is certainly possible that strong earnings growth could persist for some time. European economies, while weak, have shown improvements, mergers and acquisitions (M&A) and structural reforms have fueled corporate restructuring, financials have been supported by continued credit creation, and oil shares have benefited from continued strength in oil prices.

The Economy

Economic prospects appear to be slow, but improving on the Continent. Since year-end, consensus GDP expectations have increased modestly to 2.1% for 2006 and 1.8% for 2007. European business sentiment has improved across much of Europe, including Germany, where the IFO survey reached a 15-year high. Real yields have also picked up this year, reflecting improved economic prospects. Inflation remains low and unit labor costs are flat. While Euribor futures are pricing in a full 75 basis points (bps) of tightening by early next year, the European Central Bank (ECB) has made it clear that they will raise rates slowly unless inflation picks up. The biggest risks are a slowdown in global economic growth accompanied by strength in the euro, as exports have been an important driver of economic growth (as well as corporate earnings growth). However, strength in the euro could also cushion consumers from further increases in energy prices.

The biggest potential positive surprise may come from consumer spending, as European consumers have tightened their belts, decreased their leverage, and saved heavily—at over 10% of disposable income across much of the region. The Bank Credit Analyst (BCA) believes that upside surprise from improved consumer spending is likely, particularly in Germany where savings is above average, net household wealth has been slower to increase, and housing prices have just started to rise. According to a study by the OECD, Germany is one of the few markets in the world in which housing is undervalued. BCA believes the catalyst for increased consumer spending will be an increase in income growth, which has yet to develop, though unemployment is falling and the German PMI survey shows improved employment prospects.

In the United Kingdom, the economy stabilized toward the end of last year, following a rout in consumer spending as house prices fell, but economic growth expectations remain relatively weak. House prices have turned around, increasing for five straight months, though consumer confidence remains low. The strongest economic headwinds for equities are the pressure on consumers from high debt levels, high energy prices (energy costs account for 10% of discretionary income), rising unemployment, and taxes as a percentage of wages at a 20-year high. The only positive with regard to consumer spending is that the

housing market has picked up, which has reignited mortgage equity withdrawals. The Bank of England is unlikely to ease this year given the renewed strength in house prices, and futures markets are pricing in no easing for the next 12 months.

Mergers and Acquisitions

M&A volume continues to be strong across Europe, growing from $181 billion in the first quarter of 2005 to $337 billion in the fourth quarter of last year and $437 billion last quarter. The boom has been supported by the improvement in corporate finances, as corporations have been holding significant cash that shareholders have been pressuring them to spend on increased dividend payouts or investments. European ROE is its highest level ever, the spread between financing costs and ROE is wide, and according to Alliance Bernstein, operating cash flow (after capital expenditures, taxation, and interest payments) is at its highest level since their data begin in 2000. Should M&A continue to rise, this would be positive for profits as it would likely set off another wave of corporate restructuring.

However, the rise in M&A has stirred some nationalistic backlash. Two prominent examples have been France's attempt to stop Italy's Enel from acquiring Suez, and the Polish government's attempts to prevent Italy's UniCredito from merging its Polish units. Despite setbacks of this sort, we expect M&A activity to remain strong.

Structural Progress

As structural improvements continue across Europe, we would expect a secular improvement in trendline real earnings growth, which has lagged that of the United States. To date, European nations, particularly Germany and France, have made gradual improvements in easing labor market rigidities. Europe ex U.K. equities have significant upside potential given the degree to which corporations can still benefit from improving labor flexibility, restructuring, and deepening and broadening capital markets. Progress has historically been slow and periodically faces setbacks, most recently through the spectacular failure in France to pass reforms intended to improve labor conditions among youths, but this is to be expected when any region undergoes significant reform.

Financials and Energy Shares

Both United Kingdom and continental European shares have a high concentration in financials, and the U.K. market has a relatively heavy weight in energy. The outlook for financials is reasonably positive, but risks weakening as the ECB raises rates, particularly if yield curves in Europe were to flatten or invert. However, the ECB has indicated that it would regard rates in the 3.0% to 3.25% range as neutral, so with rates at only 2.5%, credit conditions remain accommodative in the short term, and the BOE is more likely to ease than tighten, though the Bank is expected to sit tight as long as house prices continue to accelerate. The

strongest positive factors influencing the financial sector are tied to the M&A wave, as banks continue to consolidate. Despite political opposition, potential remains for profitable large banks to acquire and consolidate small banks with low ROEs.

The outlook for oil stocks continues to look modestly positive, as global growth remains strong, and energy infrastructure developments have been slow, suggesting refining bottlenecks will continue to support oil prices. However, oil prices have broken out over $70/bbl and are cyclically extended. Furthermore, at some point, and no one knows when this would occur, rising oil prices themselves could be the catalyst to slow global economic growth, which would ultimately drive down oil prices. At present, global growth remains strong and oil company profits, which began to deteriorate in 2005, have improved this year. Consensus expectations for energy stocks have also declined, as analysts expect U.K. energy share earnings to decline 1.4% over the next 12 months. Expectations are substantially higher in the Eurozone, with the consensus calling for a 7.2% profit expansion.

The Bottom Line

While there is some cause for cautious optimism on earnings growth given recent improvements in economic growth, the potential for consumer spending to exceed expectations, continued corporate restructuring from M&A and marginal structural improvements, and continued credit expansion, the risk of falling short of high market expectations is significant. Earnings strength could be thwarted by any number of risks including a strengthening euro (which occurred during the first quarter against every major currency), rising oil prices, and slowing credit expansion. Given the strength of the earnings run since early 2003, as well as the high levels of ROE, we believe that earnings growth is cyclically stretched and more likely to decrease than continue to rise. Consensus expectations for profit margins and earnings set a high bar.

According to analysis by Morgan Stanley, consensus expectations for EBIT profit margins expansion are excessively bullish. The consensus expects 75% of companies in the MSCI Europe Index to improve their margins in 2006 and 83% of companies to do the same in 2007, even though 2005 EBIT margins were at historical high of 11%. Since their data begins in 1985, this broad an increase in profit margins has never occurred, as the highest number of companies improving their profit margins in one year was 65% in 1986. Consensus expectations are similarly optimistic in the United Kingdom, with 70% of companies in the MSCI U.K. Index expected to expand margins in 2006 and 2007. Since 1982, 53% of companies have expanded their margins on average annually, and only once (1986) did more than 70% of companies achieve this feat.

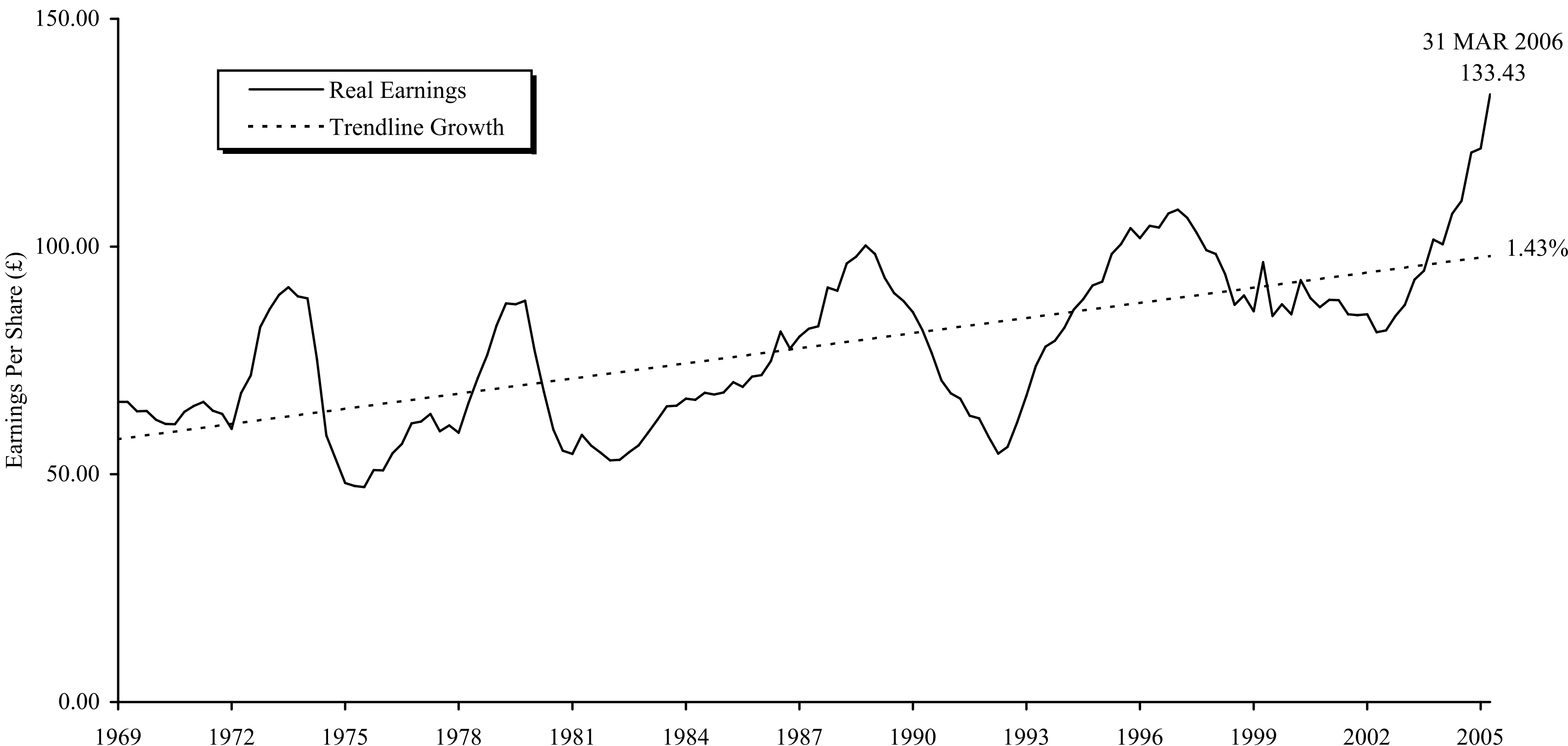
Earnings expectations are somewhat more conservative, but are still frothy, particularly for this stage in the earnings cycle. Earnings crossed above their long-term trendline during third quarter 2004 in the United Kingdom, and in February 2004 in Europe ex U.K., and the magnitude of this divergence has reached historical highs (Tables A and B). However, as of the end of March, IBES earnings growth expectations for the next 12 months remain relatively high, at 6.9% for the United Kingdom, and 8.1% for the Eurozone, based on MSCI indices. Since 1970, when the MSCI index data begin, U.K. earnings have grown an average

of 10.2% a year, but only 3.2% a year adjusted for inflation, while Europe ex U.K. earnings have growth 9.4% and 3.5% respectively. Given ten-year inflation expectations priced into the bond market of roughly 2.75% for the United Kingdom and 2.0% for the Eurozone, earnings growth expectations appear too aggressive.

Table A

MSCI UNITED KINGDOM REAL REPORTED EARNINGS

31 December 1969 - 31 March 2006



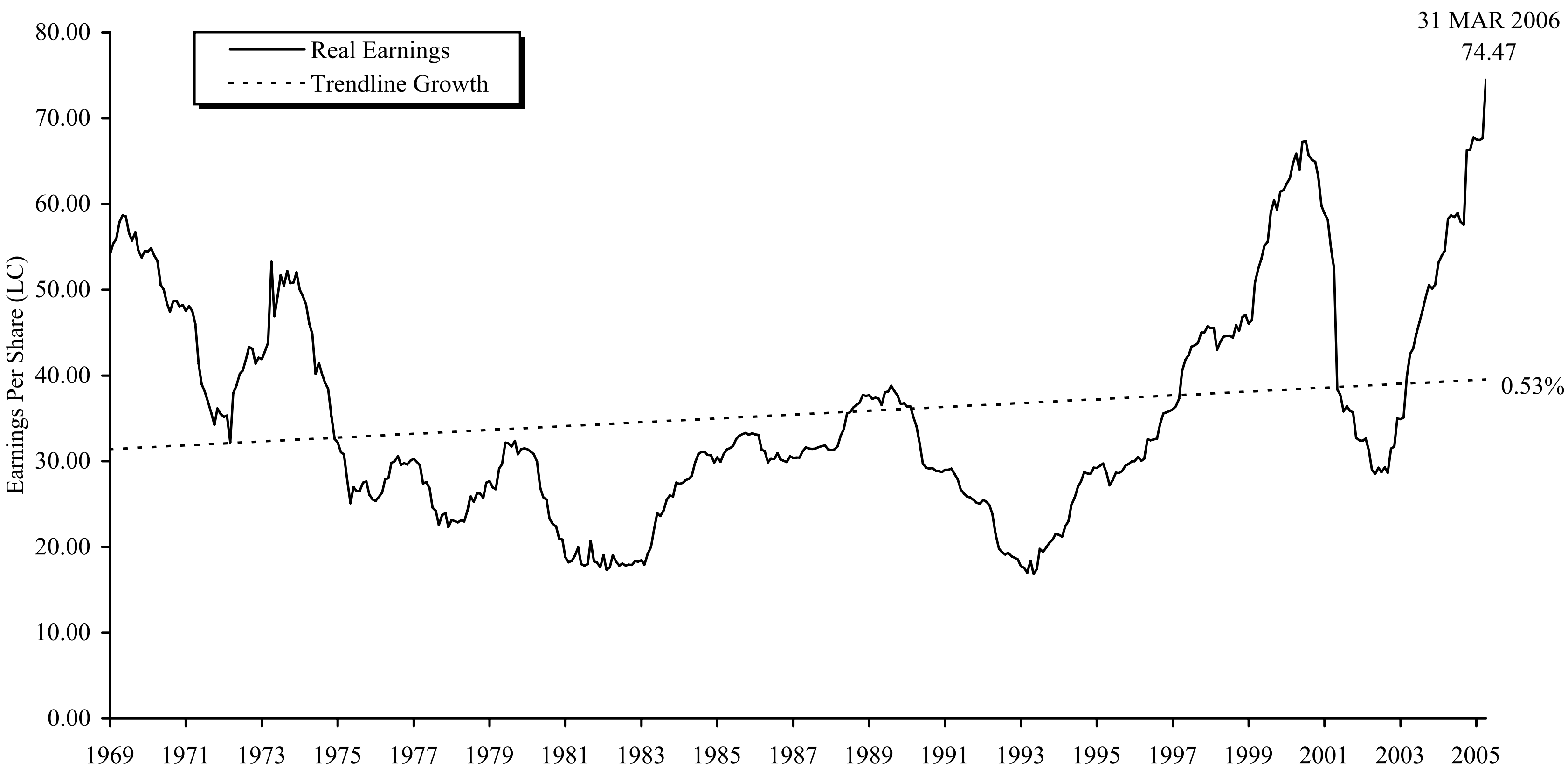
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: U.K. inflation data are represented by the U.K. RPI for the period 1969 to third quarter 2003 and the U.K. CPI for the period fourth quarter 2003 to the present, as the official U.K. measure of inflation changed to the CPI data series in December 2003. Inflation data are as of February 2006.

Table B

MSCI EUROPE EX U.K. REAL REPORTED EARNINGS

31 December 1969 - 31 March 2006



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

Notes: Reported earnings include goodwill amortization. Real earnings are based as of 31 December 2005 on an euro basis. Data for Europe CPI are taken from the Swiss National Bank from 1960 through 1975, from the OECD from 1975 through 1980, from Eurostat beginning in 1980, and from the European Central Bank (ECB) beginning in 1995. Data are calculated for all of Europe (Europe 15) through 1980, for the EEC countries by Eurostat, and for the Eurozone countries by the ECB.