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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

ENCORE! OR EXIT?

December 2006

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Encore! Or Exit?

With the FTSE All-Share and MSCI Europe ex U.K. Index returning 16.7% and 21.6%, respectively in 2006,[1] we are compelled to step back and say "*Bravo!*" As the curtain falls on another outstanding performance, and investors applaud the fourth straight year of double-digit returns, we are increasingly beginning to wonder whether there will be a fifth act to this stirring drama, or whether European equities will take a bow in 2007 as the cyclical bull market exits (stage left) amid growing headwinds and a demanding audience with expectations of a perfect performance and a fairy tale ending.

The strong performance of European equities in 2006 partly reflects the acceleration of economic growth in both the United Kingdom and the Eurozone over the past year and the increasingly feverish level of merger and acquisition (M&A) and buyout activity (and the related market speculation) taking place throughout the region. Stronger-than-expected earnings growth and steady corporate share buybacks certainly did not hurt performance either. While at this time last year we viewed European equities as fairly valued, the strength of the rally and the determination that the markets are priced on what are likely to be peak levels of earnings and return on equity (ROE) has changed our opinion. Since mid-year we have viewed both U.K. and Europe ex U.K. equities as slightly overvalued, although still modestly attractive relative to U.S. equities.[2] Still, as we head into 2007 we would advise a cautious stance toward European shares as the markets, in our opinion, are priced for what seems to be an overly optimistic scenario and unprepared for even a modest level of disappointment.

"Decoupling" is the theme *du jour*, especially among those investors expecting double-digit returns from European (and Asian) stock markets. The current bullishness regarding the prospects for European equities derives from the belief that the global economy is well poised to withstand any weakness in U.S. economic growth and that consumers across Europe, Asia, and the emerging world are finally ready to spend and will thus become the engine of global growth going forward. In other words, current earnings growth expectations and high levels of ROE will prove sustainable as the global economy at worst undergoes a "mid-cycle slowdown" and achieves a "soft landing." In such a benign environment, price-to-earnings (P/E) multiples are expected to expand, helping to drive the markets higher, a factor that has been absent over the past four years as earnings have surged ahead of share prices, causing multiples to contract. While such an outcome is feasible, it is far from guaranteed, and we consider the possibility that the markets may be forced to reprice an outlook that better reflects the headwinds facing earnings growth across Europe, similar to what occurred last May and June when concerns of a U.S.-led global slowdown ignited a brief, but significant, sell-off among global equity markets.

[1] All returns are total returns in local currency, unless otherwise noted.
[2] Please see our March 2006 European Market Commentary: *European Equities Getting Pricey* and our monthly *Notes on Current Valuations*.

The United Kingdom

U.K. equities finished 2006 at five-and-a-half year highs, with the FTSE All-Share only 1.4% below its all-time peak in September 2000. Performance was stratified by capitalization size, as the large-cap FTSE 100 (14.4%) and the FTSE SmallCap (20.6%) fell behind the mid-cap FTSE 250, which returned 30.2%, driven largely by strong M&A activity. Sector performance was also skewed, with utilities (40.3%) and materials (27.5%) the best performers, while energy (1.5%), technology (1.6%), and health care (-2.0%) were laggards. Overall, seven out of ten economic sectors posted returns in excess of 20%, yet the oil and gas sector's vast underperformance weighed on the market's overall return[3] (Table A). In short, the key to 2006 was to be exposed to mid caps and to those sectors with the most M&A activity.

The U.K. economy rebounded in 2006 as the housing market sprung back to life, consumption perked up, and exports benefited from the economic revival in continental Europe (the Eurozone is the United Kingdom's largest trading partner). Real GDP is expected to grow 2.6% in 2006 and 2.4% in 2007, yet the return to trend growth has heightened the Bank of England's (BOE) concerns over inflation. The BOE hiked policy rates 50 basis points (bps) in 2006 to 5.00%, reversing an August 2005 25-bp rate cut and taking U.K. rates within 25 bps of U.S. policy rates. With headline CPI running at 2.7% year-over-year in November—its highest level since 1997 and above the central bank's 2.0% target rate—the prospect of further monetary tightening cannot be ruled out. While the markets expect only 50 bps of additional tightening in 2007, nervousness over inflation expectations and possible pass-through effects from rising labor costs increases the risk that the BOE may tighten more than is currently discounted. This may impact growth adversely, as higher interest rates not only pressure the housing market and consumer spending, but to the extent that higher rates result in an even stronger pound, the export sector may be hampered as well.

Europe ex U.K.

Continental equities were a top performer in 2006, outperforming U.K., U.S., and Japanese equities, while only emerging markets and developed Asia generated higher returns. The MSCI Europe ex U.K. Index also ended the year near record highs, standing only 9.8% below its peak in March 2000. As seen across most global markets, continental small caps outperformed large caps. Unlike last year, when equity performance was broad based with every sector posting returns in excess of 20%, sector performance this year was less homogeneous. Materials (35.0%) and industrials (28.7%) did particularly well, while an M&A free-for-all helped the usually sleepy utilities sector post a 39.4% return. While every sector finished the year in the black, technology (5.2%), health care (8.6%), and energy (11.5%) were notable laggards (Table B). Yet, financials continue to be the driving force, accounting for 34.3% (or 7.4 percentage points) of the benchmark's return, and now accounts for a record 31.8% of market capitalization. As we have noted in the past, the financial sector has been a critical source of earnings growth for European equities over this cycle

[3] This is a theme we have addressed in the past; namely that the performance (and valuation) of the U.K. equity market is highly dependent upon the fortunes of the "mega-cap" companies, which account for an outsized 42% of the market, and are in turn dominated by energy and financial companies. Please see our May 2006 European Market Commentary: *U.K. Equity Valuations: A Cross-Sectional Peek.*

and in some sense may be the "weakest link" given the market's current dependence on the sector amid a time of rising policy rates and flat/inverted yield curves.[4]

While European equities have performed quite well over the past four years, 2006 was the first year in which anemic economic growth in Europe was *not* a headwind for equities. Eurozone real GDP accelerated from a 1.4% pace in 2005 to 2.6% in 2006, on the back of strong exports, a housing boom in many countries, and budding signs of growing consumer spending as unemployment rates have fallen across the region. Heading into 2007, consensus forecasts see Eurozone economic growth moderating to 1.9%. Indeed, while sentiment surveys point to excellent *current* conditions in Europe, expectations of *future* economic conditions are not so cheery. Both the IFO and ZEW surveys point to weaker conditions going forward (Table C). Concerns over the direction of the U.S. economy aside, much of the trepidation over European growth next year revolves around fiscal tightening measures in Germany and Italy, most notably Germany's 3.0% hike in the VAT sales tax. Some observers argue that the recent uptick in consumer activity is largely the pulling forward of expenditures by households to avoid paying higher prices, and therefore consumption should moderate in early 2007. The acceleration in economic growth in 2006 also prompted the European Central Bank (ECB) to embark on a tightening campaign. Citing concerns over inflation and rapid credit growth, the ECB has hiked policy rates by 150 bps since December 2005, bringing policy rates to 3.50%. Continued hawkish rhetoric by the central bank has the markets expecting roughly 50 bps of further tightening in 2007. Continued monetary and fiscal tightening combined with a cool down in consumer spending would leave the Eurozone economy even more reliant on the export sector, which is in turn threatened by a rising euro. A slowdown in global growth, coupled with continued euro strength could very well weaken this engine of European growth.

Earnings Growth and Valuation

Central to our thinking regarding European equities is that the earnings cycle is quite advanced, with the markets approaching peak levels of earnings and profitability (ROE). Tables D through G help put this into perspective. As derived from the MSCI U.K. and Europe ex U.K. indices, real earnings per share are at an all-time high (and possibly inflated by share buybacks), while ROE is running 2 standard deviations above historical averages and is also at record highs in both markets. While earnings and ROE may very well continue to climb higher, this would be unprecedented from an historical perspective, as earnings and ROE tend to be highly cyclical. Indeed, real earnings growth has peaked in both U.K. and Europe ex U.K. equities and is slowing sharply, although both regions currently show year-over-year growth rates well above historical norms.

In line with our belief in reversion to the mean, analysts have been revising down expectations for 2007 earnings growth from their lofty initial estimates at the beginning of the year. Consensus expectations now call for single-digit growth in 2007 of 7.2% for U.K. equities and 8.8% for Europe ex U.K. equities, which is roughly in line with historical *nominal* earnings growth of 9% to 10%. However, adjusting the Europe ex U.K. 2007 earnings growth estimate for inflation expectations of 2.1% priced into inflation-

[4] Please see our September 2006 European Market Commentary: *European Equity Leadership Still Concentrated*.

indexed bonds results in 2007 *real* earnings growth of 6.7% compared to the long-term average of 4.7%. For the United Kingdom, adjusting for implied inflation of 3.1% results in 2007 *real* earnings growth of 4.1% compared to the historical average of 3.3%. Given where we stand in the cycle and the headwinds facing earnings, we find such expectations of a benign return to historical average growth, or slightly above historical average growth in real terms, to be somewhat optimistic. Said differently, we expect earnings to disappoint after four years of surprising on the upside, should expectations of rising policy rates, strengthening currencies, decelerating (if not contracting) economic growth, and rising labor costs transpire, and thus weigh on corporate profitability.

While most observers argue that European equities are currently "cheap" we beg to differ, as the "P" is too high relative to an "E," which will likely prove fleeting going forward. Tables H and I show our preferred valuation metrics (real normalized P/Es and ROE-adjusted P/Es) relative to traditional trailing reported P/Es. The divergence between our cyclically adjusted, normalized measures and headline P/Es since 2003 is striking. European equities are only cheap if you assume the current high level of earnings will be maintained going forward.

Historically, U.K. and U.S. equities have generated similar levels of ROE (roughly 14%) while continental equities have produced a much lower level of profitability, due to structural economic impediments in Europe. Currently however, U.K. ROE is running 25% above the U.S. level while Europe ex U.K. ROE is now on par with that of the United States, although historically continental ROE has been 25% lower than U.S. ROE on average. The current high level of U.K. ROE (20% versus a historical average of 14%) seems plainly unsustainable, while much of the rise in continental ROE represents a structural rise in corporate profitability. In other words, Europe ex U.K. companies should now be achieving ROE closer to U.S. and U.K. levels rather than its historical average of 11%. Still, the current level of European ROE of 16% is likely to prove too high going forward.

M&A and Buyouts

While the strong recovery in earnings since 2003 has been the main driver of the current equity rally, M&A activity and leveraged buyouts (LBOs) by private equity firms have been driving share prices at the margin, especially over the past year. While traditionally investors have rewarded takeover targets with higher share prices and slightly punished acquirers who generally overpay, so far in this cycle both parties have seen their shares jump. Indeed, speculation is running wild as any hint/rumor of deal activity seems to move the markets. Furthermore, takeover activity has been increasingly cross-border and pan-European. M&A volumes—both globally and in Europe—set a new record in 2006, while new records in the LBO space seem to be broken regularly. European deal activity has continued at a frenzied pace even late into the year, with many investment banks arguing that 2007 will see even more activity, judging from their deal pipelines. Standard & Poor's (S&P) estimates that private equity firms have raised close to €90 billion for European buyouts in 2006, double last year's fund raising. S&P warns that the average price for LBOs in Europe is approaching a record 9.4 times EBITDA and that this combined with record high-yield bond and leveraged-loan issuance represents an "extreme credit risk." Yet, so long as liquidity remains ample and risk aversion low, deal activity will likely remain strong. However, credit spreads and corporate defaults are at record lows, a situation that cannot be expected to exist in perpetuity.[5] Buyouts, therefore, provide another example of how the markets are pricing in an ongoing benign investment climate. Possible spoilers to such a rosy outlook include slower economic growth than currently expected, and/or continued tightening by the ECB and other central banks leading to a spike in debt servicing costs, or a "financial accident" of some sort that triggers a general rise in risk aversion.

What if we are Wrong?

We are confident that *at some point* profit margins, earnings, and ROE will fall from their current levels, and share prices along with them, while some semblance of a risk premium will return to the credit markets; the business cycle is not dead. With that said, we could be terribly early in our concern over the outlook for European equities.

The bulls argue that the "mean" to which profits will revert has risen substantially given the powerful effects of globalization, information technology, and the deep restructuring that European (specifically German) companies have undergone. We would not argue with any of the above! We agree that European equities should trade at a lower discount to U.S. equities than they have in the past, as corporate restructuring has improved European corporations' competitive position and profit margins.

We would point out, however, that the scope for future improvements is somewhat limited; the United Kingdom long ago completed its restructuring, and while continental European companies continue to move production to lower cost markets and resist wage demands at home, deeper structural reform cannot occur without supporting economic reforms from politicians to address serious labor market and service sector inefficiencies and rising social tensions. We would note that growing "euro skepticism" and the rising backlash against both EU expansion and globalization in general in Europe are not encouraging signs. Still, the long-term prospects for European equities have improved relative to the past, especially if politicians become serious about reform.

As the *Bank Credit Analyst* recently commented: "If you are bullish on global growth, overweight European equities." If global growth holds up (or even accelerates) and earnings grow despite the headwinds from monetary tightening and a potential U.S. slowdown, global markets could very well soar on the back of multiple expansions. Furthermore, should M&A and LBO activity move into the large- and "mega-cap" space, European markets (and especially U.K. equities) have scope to rerate substantially. While we are leery of placing too much confidence in such prospects, we fully recognize the potential upside and advise investors to maintain their policy allocations to European equities, rebalancing back to policy targets on an ongoing basis. Those building allocations should do so gradually over time, taking advantage of any sharp sell-offs to increase exposure. While market expectations for 2007 remain high, the stage may be set for only a brief encore.

[5] Please see our October 2006 European Market Commentary: *European Credit: An Accident Waiting to Happen?*

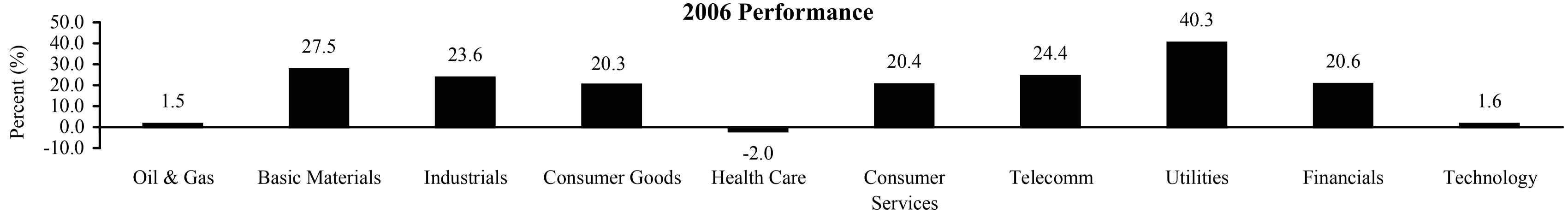
Table A

FTSE ALL-SHARE ECONOMIC GROUP WEIGHTS AND CONTRIBUTION

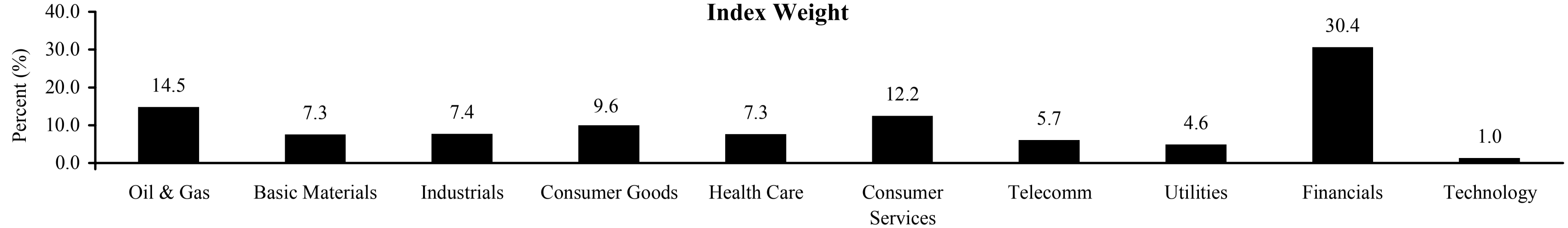
As of 31 December 2006

Sterling (£)

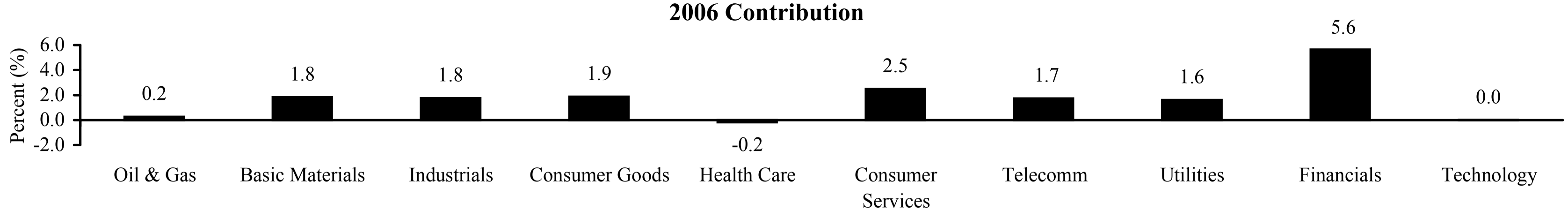
2006 Performance



Index Weight



2006 Contribution



Sources: Factset Research Systems and FTSE International Limited.

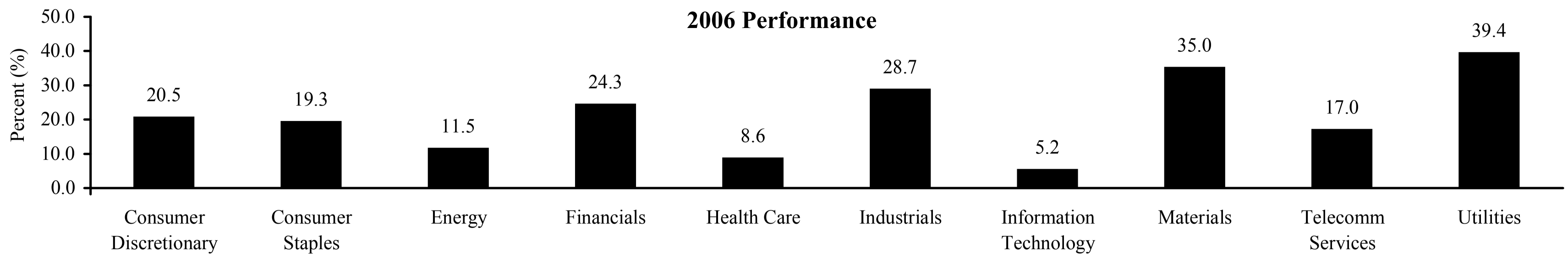
Note: Weights may not total to 100% due to rounding.

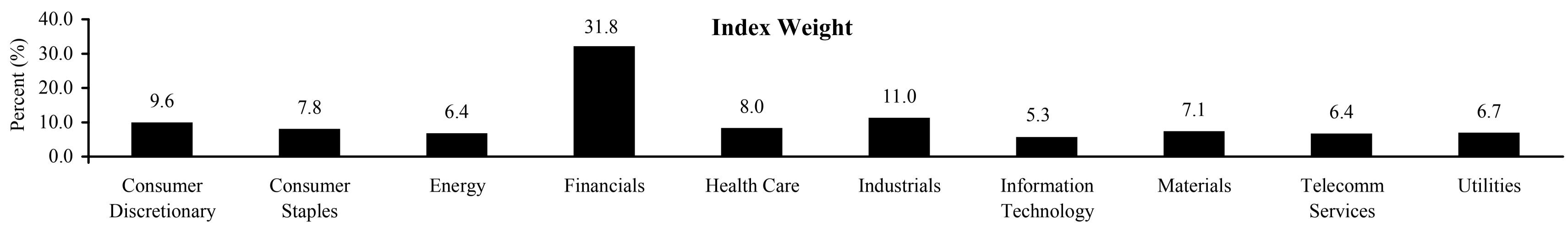
Table B

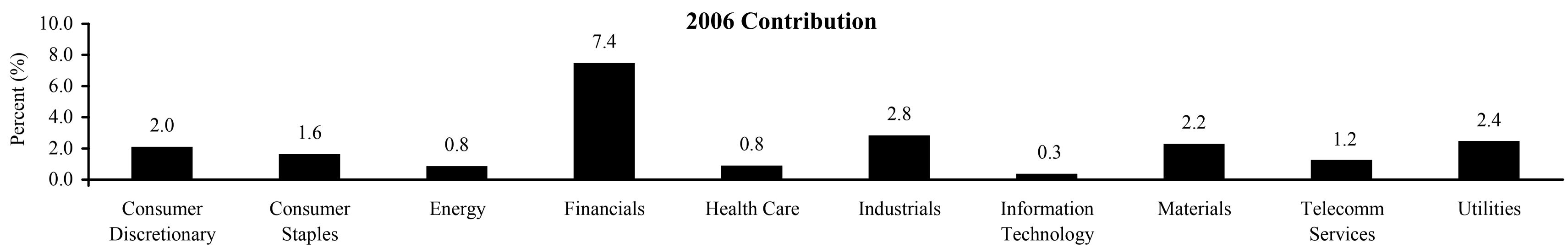
MSCI EUROPE EX U.K. ECONOMIC GROUP WEIGHTS AND CONTRIBUTION

As of 31 December 2006

Local Currency







Sources: Factset Research Systems, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

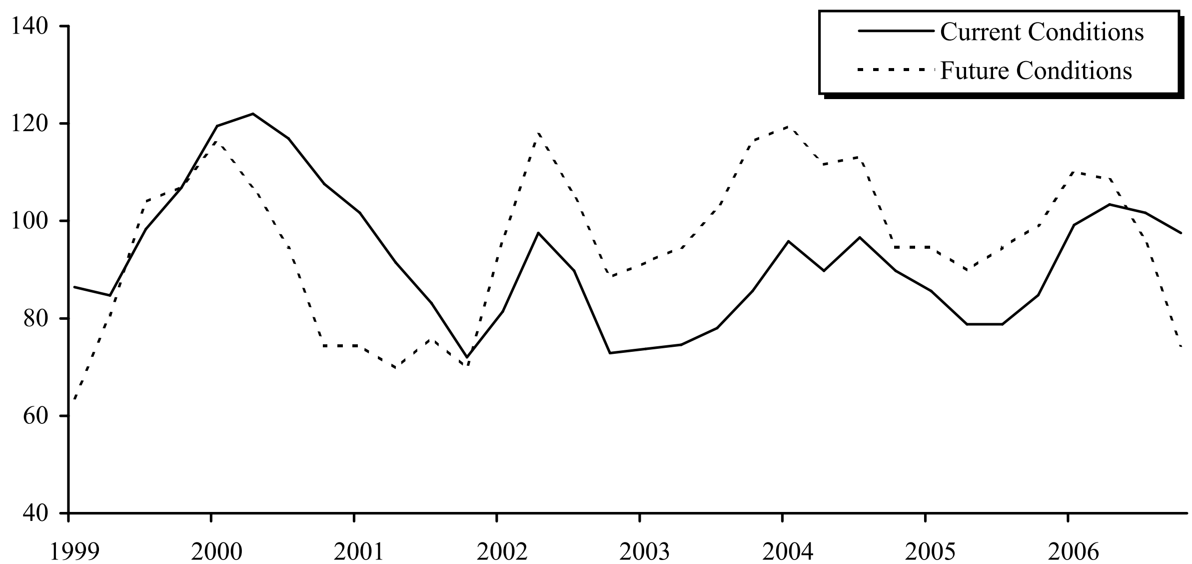
Note: Weights may not total to 100% due to rounding.

Table C

EUROPEAN SENTIMENT INDICATORS

1999-2006

IFO Eurozone Survey



ZEW Survey

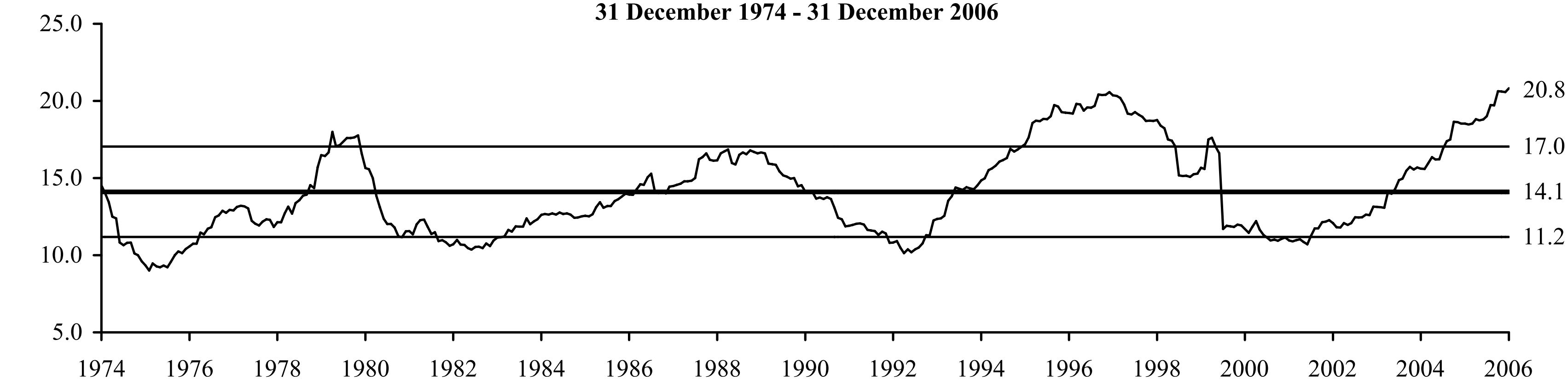
Sources: IFO World Economic Survey, Thomson Datastream, and ZEW.

Note: IFO data are as of November 2006 and ZEW data are as of December 2006.

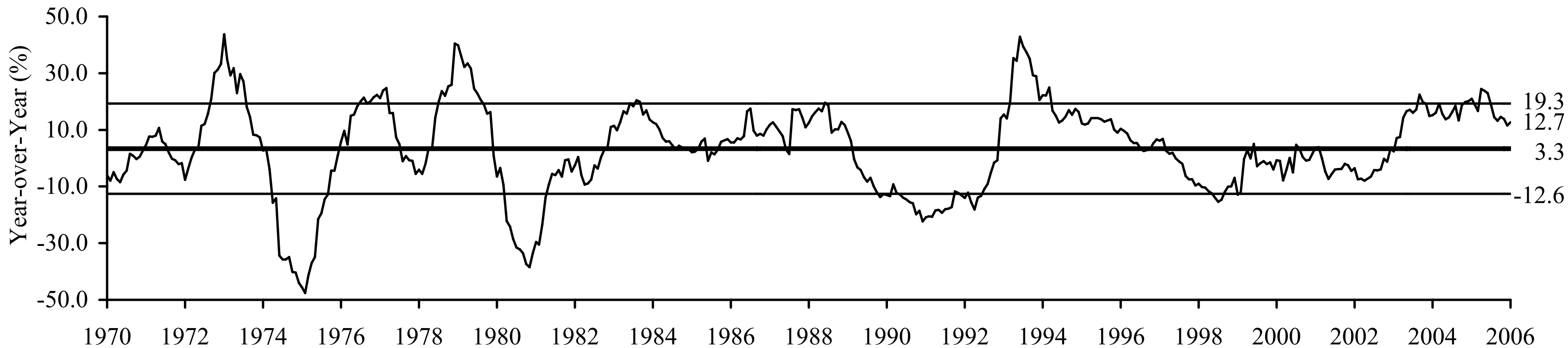
Table D

MSCI U.K. RETURN ON EQUITY AND REAL EARNINGS GROWTH

Return on Equity
31 December 1974 - 31 December 2006



Real Earnings Growth
31 December 1970 - 31 December 2006



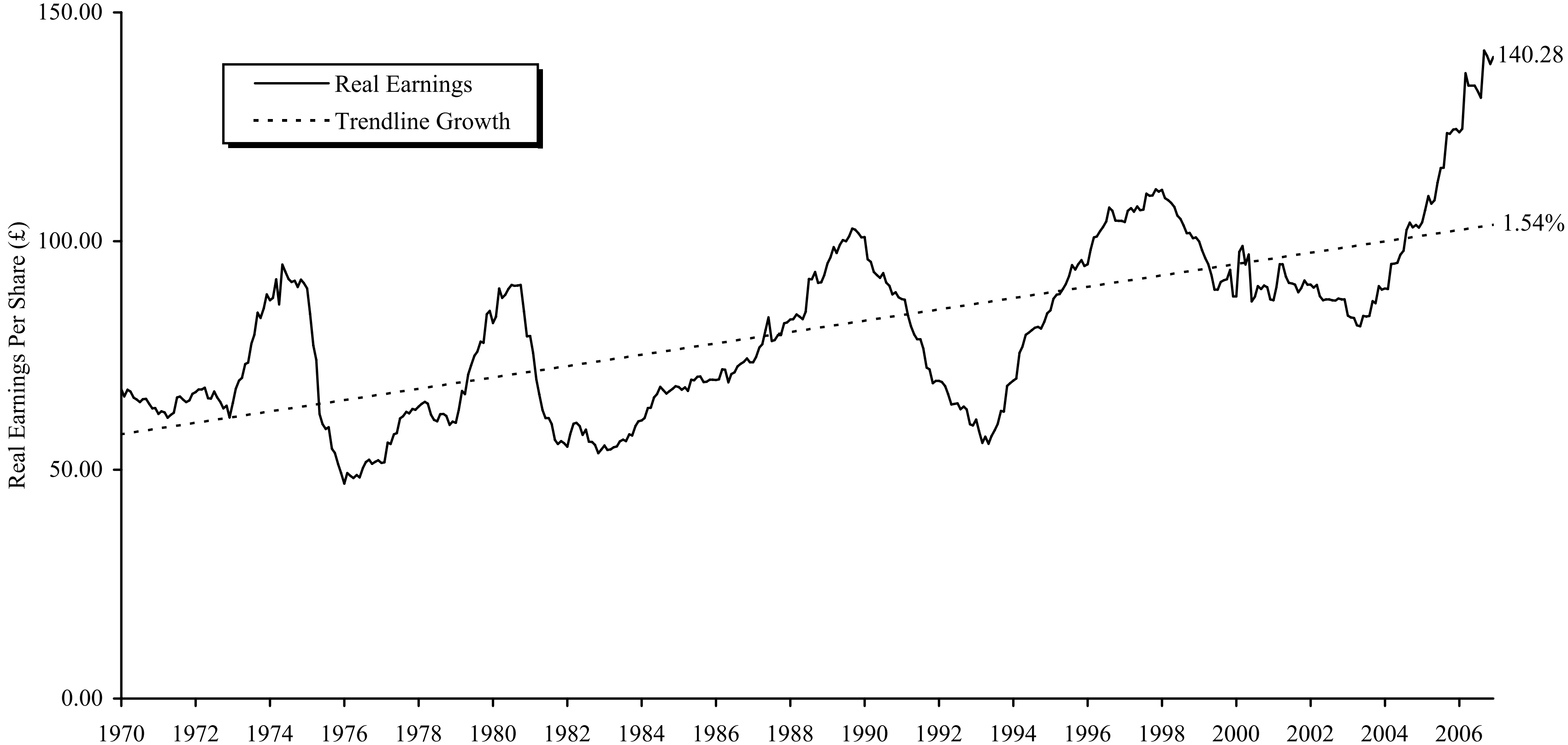
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: U.K. CPI inflation data as of 30 November 2006. U.K. inflation data are represented by the U.K. RPI until November 2003 and the U.K. CPI from December 2003 to the present.

Table E

MSCI U.K. REAL REPORTED EARNINGS

31 January 1970 - 31 December 2006



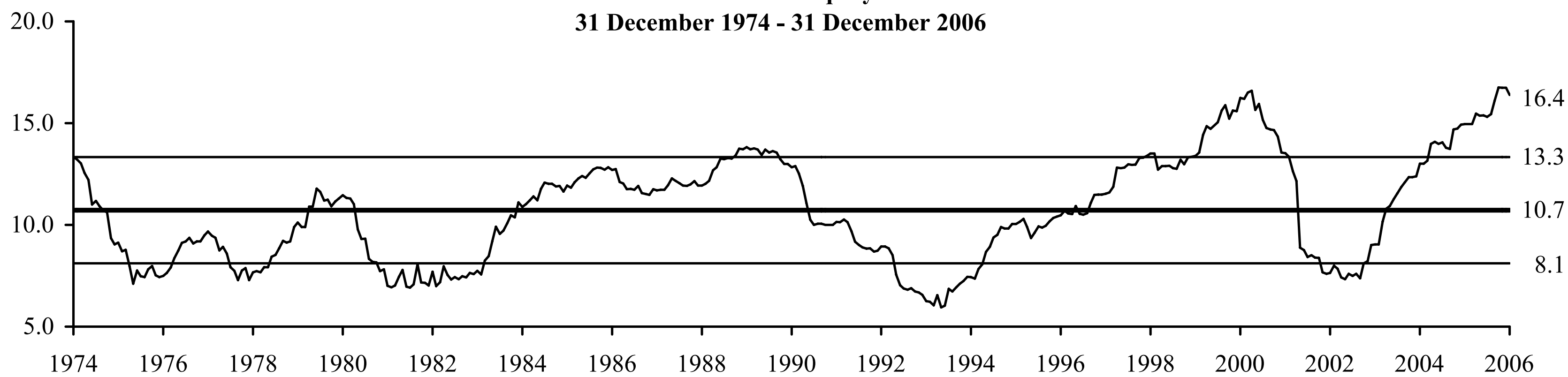
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: The average year-over-year real earnings growth rate of 3.3% is calculated arithmetically. U.K. CPI inflation data as of 30 November 2006. U.K. inflation data are represented by the U.K. RPI until November 2003 and the U.K. CPI from December 2003 to the present.

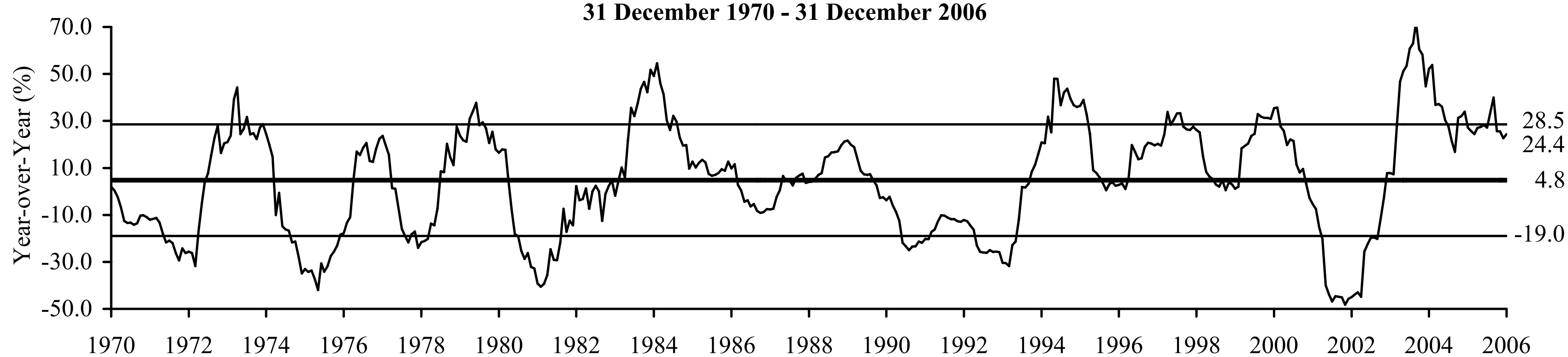
Table F

MSCI EUROPE EX U.K. RETURN ON EQUITY AND REAL EARNINGS GROWTH

Return on Equity
31 December 1974 - 31 December 2006



Real Earnings Growth
31 December 1970 - 31 December 2006



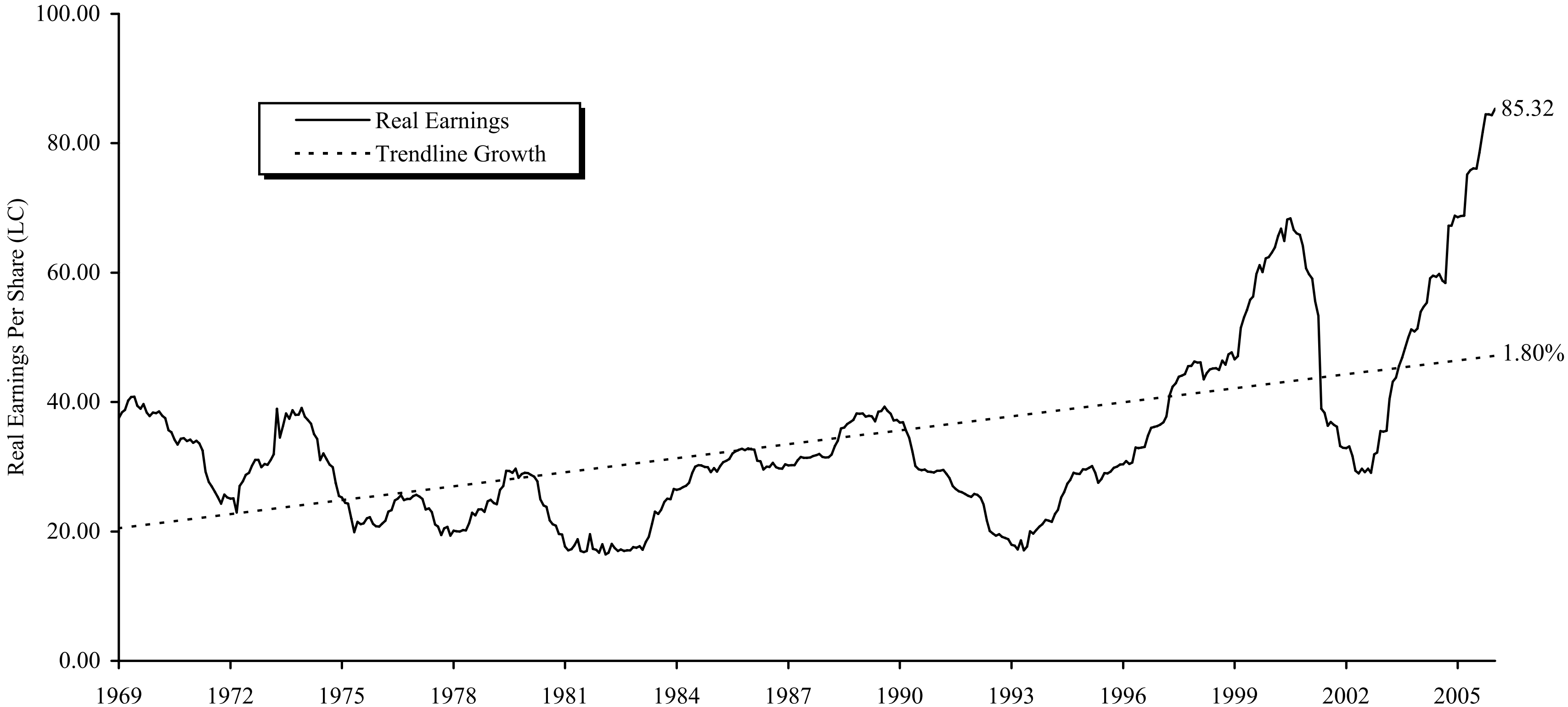
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Note: Earnings are in local terms and deflated by Eurozone CPI.

Table G

MSCI EUROPE EX U.K. REAL REPORTED EARNINGS

31 December 1969 - 31 December 2006



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

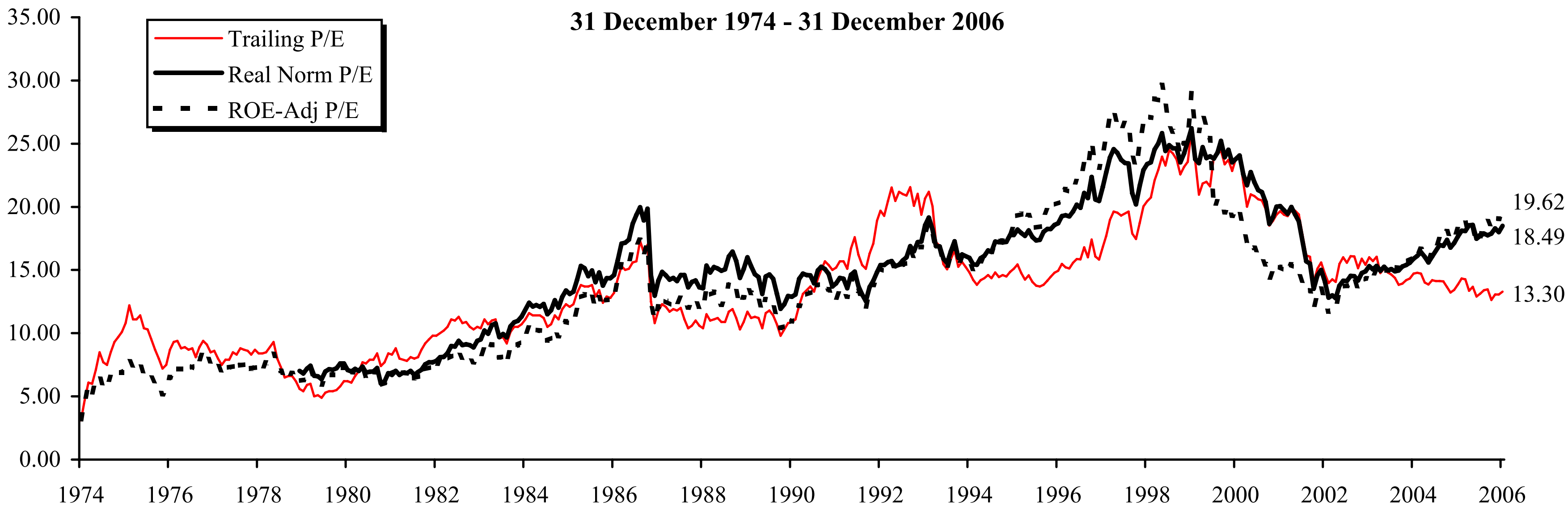
Notes: Data are in local currency. Reported earnings include goodwill amortization. Real earnings are based on Eurozone CPI as of 30 November 2006. The average year-over-year real earnings growth rate of 4.8% is calculated arithmetically.

Table H

PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

MSCI United Kingdom

31 December 1974 - 31 December 2006



P/E Ratios - By Types of Earnings

	Trailing 12 Months Reported	Trailing 10 Years Real Normalized	ROE-Adjusted
December 31, 2006	13.30	18.49	19.62
Common Period Mean	14.35	15.43	14.76
Std Dev Above/Below Mean	-0.23	0.63	0.89

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

Notes: Normalized real price-earnings (P/E) ratios are calculated by dividing the current real index value by the annualized average real earnings for the trailing ten years. U.K. inflation data represent the Retail Price Index from 1974 through November 2003 and the U.K. CPI from December 2003 onward. Inflation data are through November 30, 2006. Return on equity (ROE) is calculated by dividing the index's price-book ratio by its P/E ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to its post-1974 average. Common period represents data from November 1979 onward.

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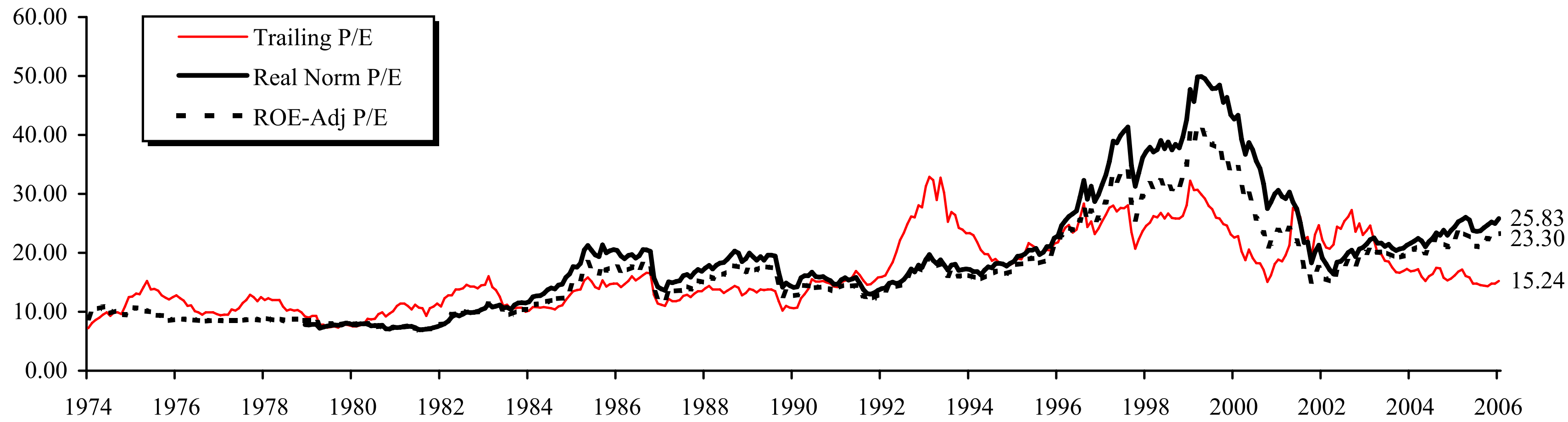
Table I

PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

MSCI Europe ex U.K.

31 December 1974 - 31 December 2006



P/E Ratios - By Types of Earnings

	Trailing 12 Months Reported	Trailing 10 Years Real Normalized	ROE-Adjusted
31 December 2006	15.24	25.83	23.30
Common Period Mean	17.46	20.27	17.89
Std Dev Above/Below Mean	-0.36	0.56	0.71

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

Notes: Normalized real price-earnings (P/E) ratios are calculated by dividing the current real index value by the annualized average real earnings for the trailing ten years. Inflation data are through 30 November 2006. Return on equity (ROE) is calculated by dividing the index's price-book ratio by its P/E ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to its post-1974 average. Common period represents data from 30 November 1979 onward.
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