

C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT

EQUITY INVESTORS SHRUG OFF ECONOMIC CONCERNS

August 2005

Robert Lang
Ann-Marie Hofer

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Equity Investors Shrug Off Economic Concerns

Reflecting rising optimism about future earnings growth, European equities have been climbing this year despite widespread economic weakness. Even as economic growth in the United Kingdom has decelerated to its lowest level in 12 years and the Continent struggles to register any amount of growth, equity markets have hit three-year highs. Given that equity valuations remain attractive, though not stellar, it seems reasonable to expect the discrepancy between economic growth and equity performance to persist.

In the United Kingdom, the Heavyweight Trio

In the United Kingdom, real GDP growth this year has slowed sharply to 1.8% for the year ended in the second quarter, far below the 3.1% consensus 2005 forecast at the beginning of the year (Table A). Economic activity has been hit by contracting manufacturing output, falling export growth, and slowing consumer spending; retail sales have been slowing and house prices virtually flat for 11 months. In August, the Bank of England has attempted to reverse the abrupt decline by reducing policy interest rates 25 basis points to 4.5%, marking the first rate cut in two years. For 2006, real economic activity is expected to grow 2.4%, a pace equivalent to its post-1955 real GDP trendline annual growth.

Stock prices, while rising for the year, have not kept up with earnings growth. MSCI U.K.'s price-earnings (P/E) has actually contracted this year, from 14.7 at the beginning of the year to 14.2 currently. Consensus earnings growth expectations have improved, but only slightly. At the beginning of 2005, the consensus expected MSCI U.K. earnings to grow 8% for 2005, and actual reported earnings have risen at a 13.6% pace so far this year. For 2006, the consensus currently expects only a modest increase: 6.6% compared with a 6.0% forecast at the beginning of 2005.

This year's equity performance can be primarily attributed to rising oil prices. The FTSE All-Share has returned 11.9% year-to-date, thanks primarily to the resources industry group, which has contributed 4.1 percentage points to the index's performance. At the beginning of the year, the consensus expected oil stock profits to fall 6% in 2005, but the current growth forecast has risen to 25%.

The heavy concentration of the All-Share also contributed to its year-to-date performance.¹ The three largest sectors—financials, resources, and non-cyclical consumer goods—make up 65.1% of the index's total market cap, and combined they accounted for 8.7 percentage points (or 73%) of the index's year-to-date return.

¹ For an in-depth discussion of its concentration, please see our June 2005 European Market Comment: *The All-Share Grows More Concentrated*.

On the Continent, More Broad-Based Performance

A similar investment dynamic has unfolded on the Continent, but the performance drivers differ from those in the United Kingdom in several key areas. As with the United Kingdom, equity investors have largely dismissed economic concerns, even prognostications of an impending collapse in EMU. Real GDP is currently expanding at a 1.2% pace, and is now expected to grow 1.4% for the full year, slower than the 1.7% forecast registered at the beginning of the year (Table D). While consumer spending remains sluggish, industrial production seems to be accelerating, thanks to stronger export demand and weaker currency, and corporate cash flows have been healthy. For 2006, the Continent's economy is generally expected to grow 1.7% to 2.0%.

As with the U.K. market, the P/E of MSCI Europe ex U.K. has contracted slightly this year, from 17.5 to 16.9, with aggregate earnings growth outpacing the rise in stock prices. Earnings growth forecasts have been revised modestly upward for MSCI Europe ex U.K. The current consensus calls for pre-goodwill earnings to grow 8.2% for 2005 and 9.2% for 2006.

However, unlike the United Kingdom, the primary driver of the eurozone index's 17.2% return year-to-date has been the financials sector, contributing 4.3 percentage points to the overall performance (Table F). Energy has been by far the best-performing sector, returning a whopping 30.2%, but, with a market cap weight of 7.4%, it has contributed only 2.8 points to the index's aggregate performance.

Furthermore, MSCI Europe ex U.K. is far less concentrated than its U.K. counterpart. While financials is by far the largest sector, accounting for 29.1% of the index's total market cap, consumer discretionary is a distant second, with 10.1%, and the market cap of the remaining eight sectors range from 6.0% to 9.7%.

Going Forward, the Interplay of Macro

The outlook for U.K. equities largely depends on how three macro developments will affect the market's largest sectors. The U.K. economy would benefit from sterling weakness, which would provide a fillip for manufacturing and exports. However, the financials sector faces headwinds from potential further yield curve inversion and stagnant consumer loan growth, while consumer goods are vulnerable to flat or softening housing prices, particularly given high level of debt among households. The resources group is largely a bet on future oil prices, and the consensus seems to believe current high levels are unsustainable; the group's earnings are expected to contract 6.2% in 2006.

Expectations are quite low for the Continent's economy. While exports would benefit from a potential depreciation of the euro, the region is more heavily dependent on exports than is the United Kingdom, and therefore more vulnerable to a global slowdown (and leveraged for an upswing). Financials would certainly be hurt from additional flattening (or inverting) yield curve, while the outlook for consumer-

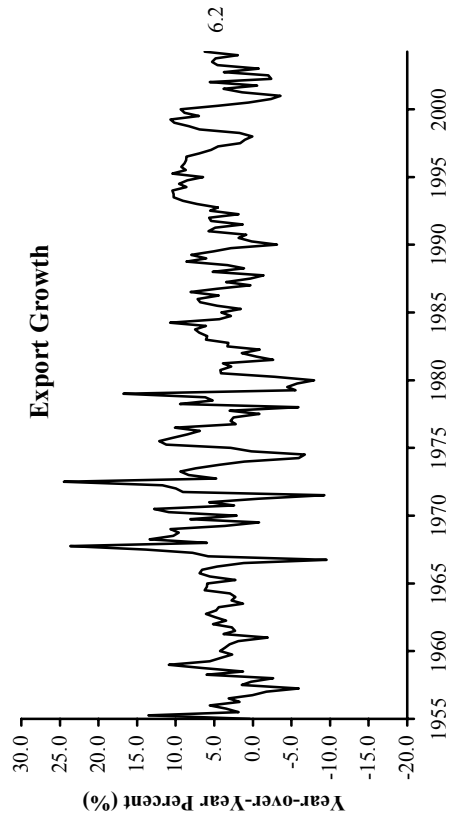
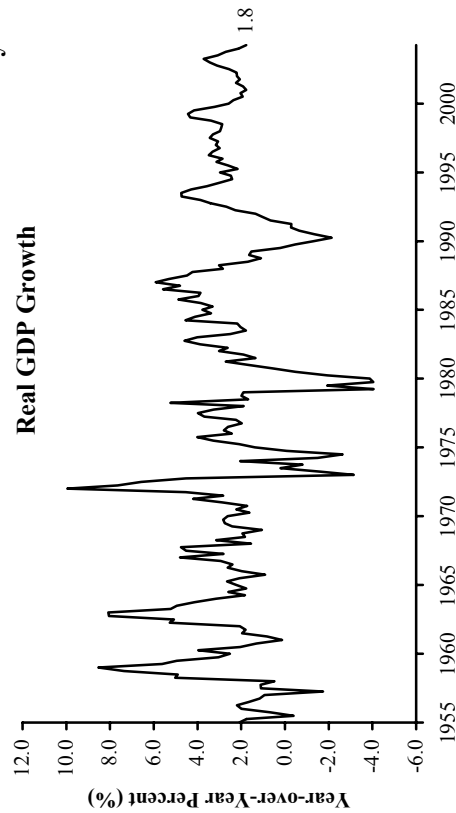
related sectors is not optimistic. However, we believe much of the gloom is already discounted in equity prices.

Relative equity valuations suggest the United Kingdom is slightly more attractive than the Continent (Table G). While MSCI U.K. is considerably cheap on a relative price-to-cash earnings basis, it is roughly comparable according to P/E, price-to-book, and dividend yield metrics. Both markets are slightly more attractive than other developed markets, particularly U.S. equities, based on MSCI index valuations.

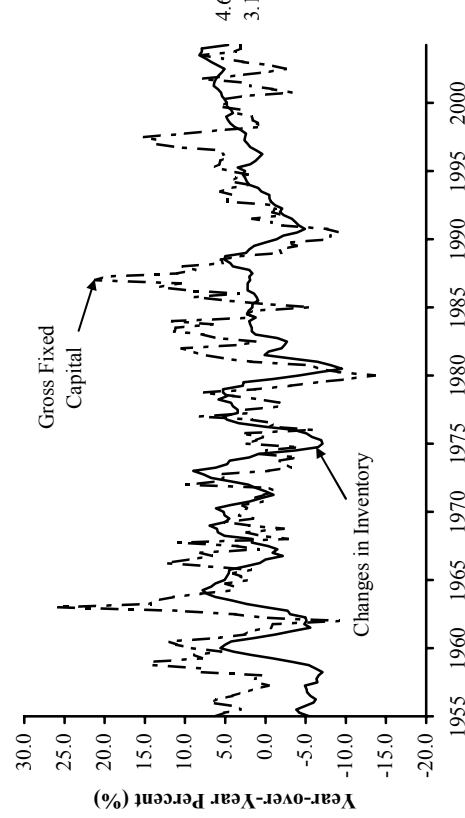
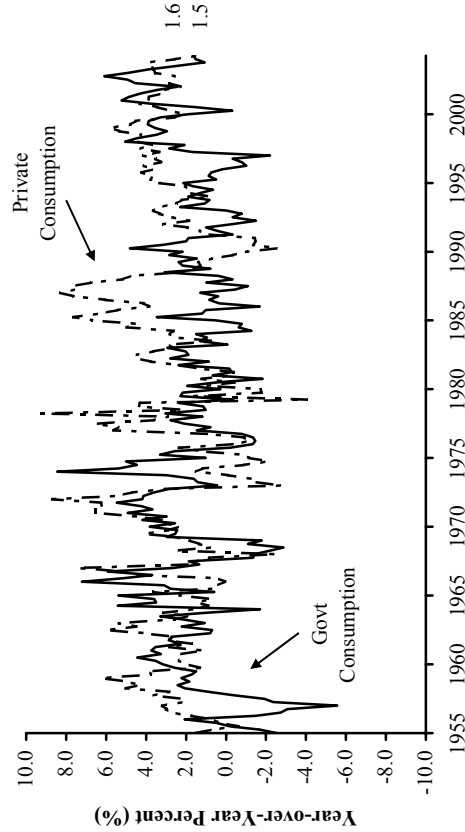
Table A

U.K. MACROECONOMIC INDICATORS

1 January 1955 - 30 June 2005



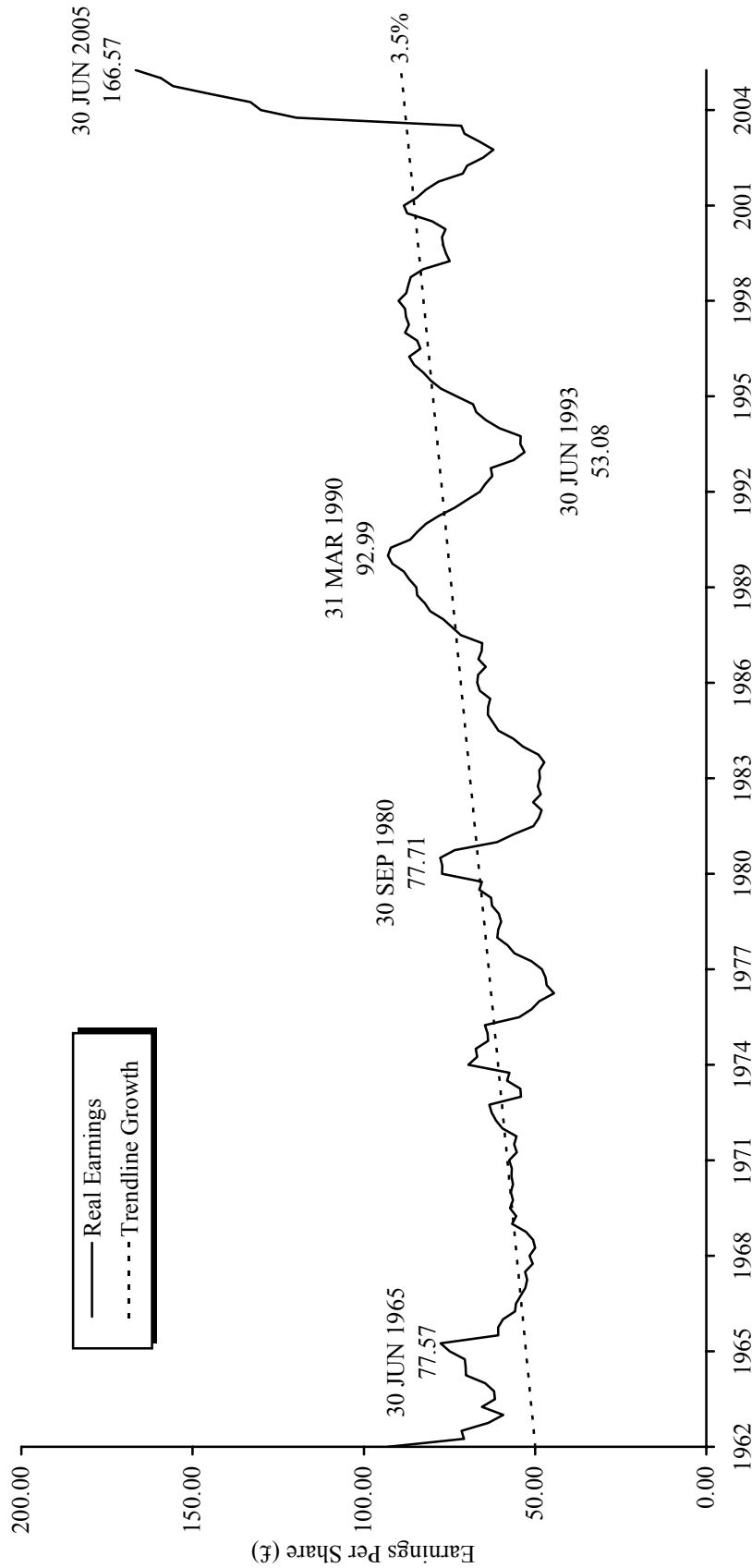
Domestic Demand Growth



Sources: U.K. Office of National Statistics and Thomson Datastream.

Notes: Changes in inventory data are through first quarter 2005. All data are reported in U.K. sterling.

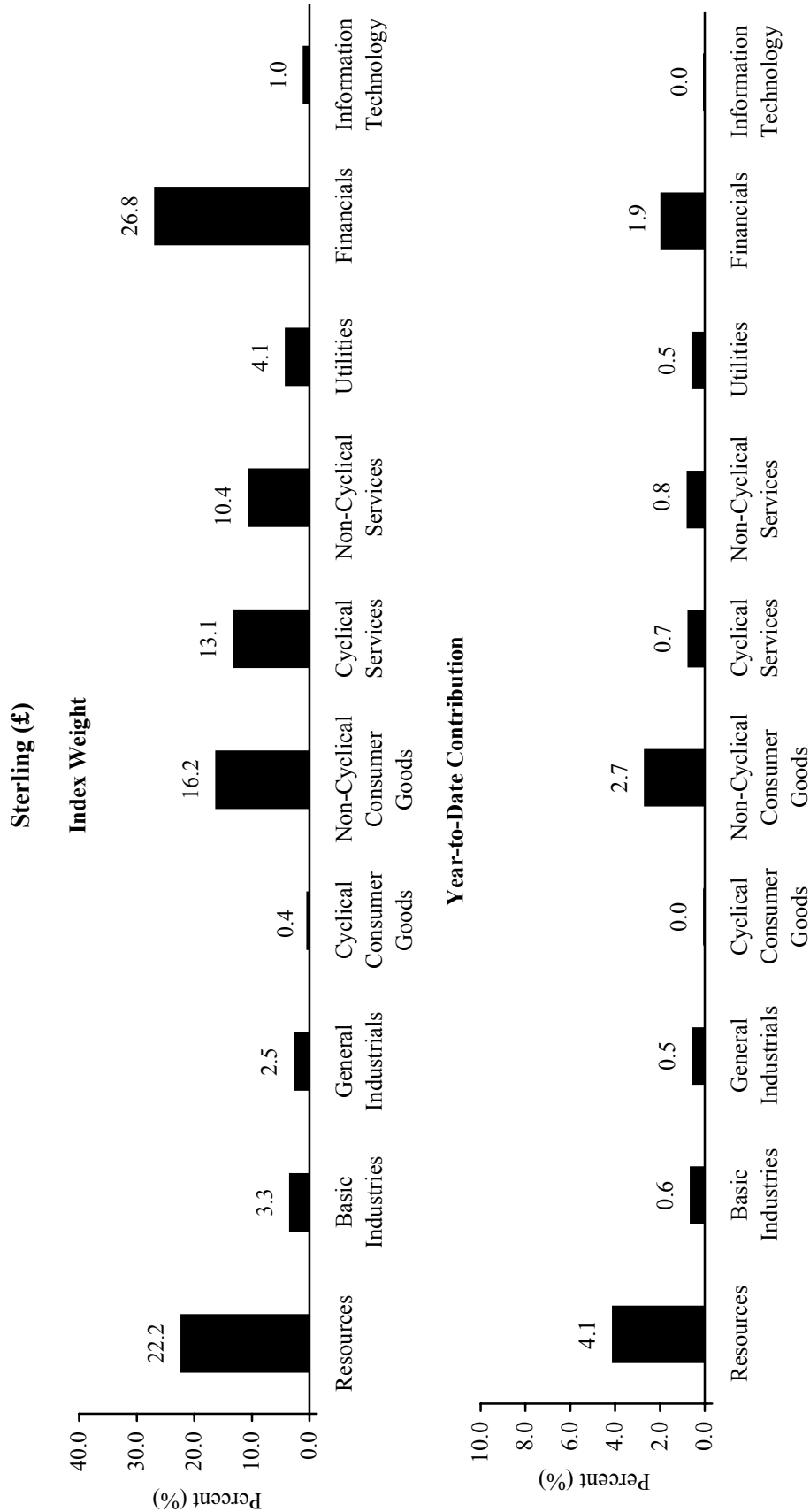
Table B
FTSE ALL-SHARE REAL REPORTED EARNINGS
1 January 1962 - 30 June 2005



Sources: FTSE International Limited and Thomson Datastream.

Notes: Real earnings are calculated on a 2005 sterling basis. The average year-over-year real earnings growth rate of 3.5% is calculated arithmetically. U.K. inflation data are represented by the U.K. RPI for the period 1962 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.

Table C
FTSE ALL-SHARE ECONOMIC GROUP WEIGHTS AND CONTRIBUTION
As of 31 July 2005

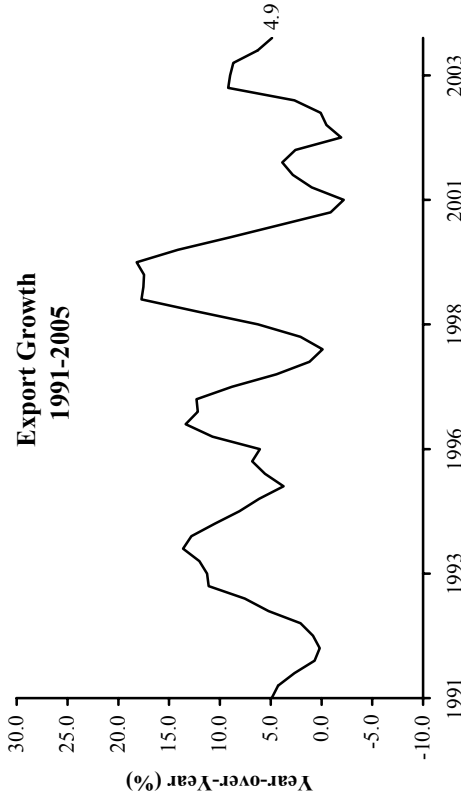
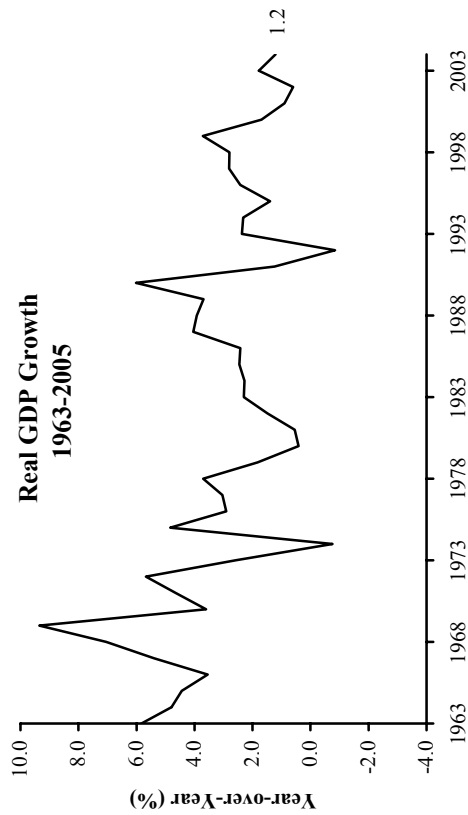


Source: FTSE International Limited.

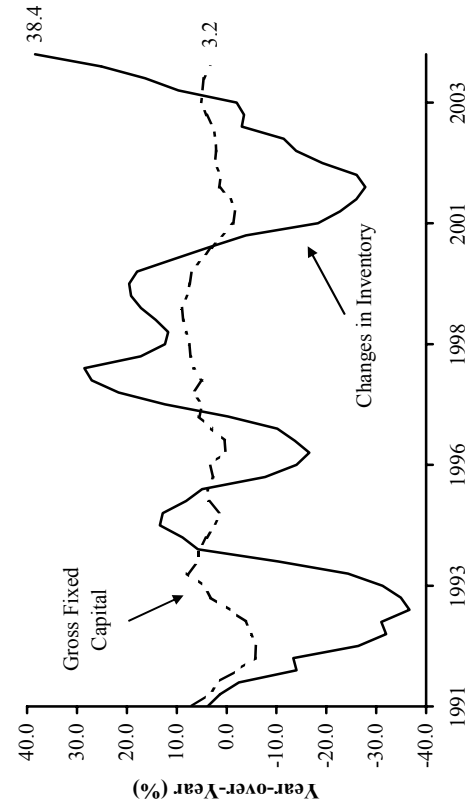
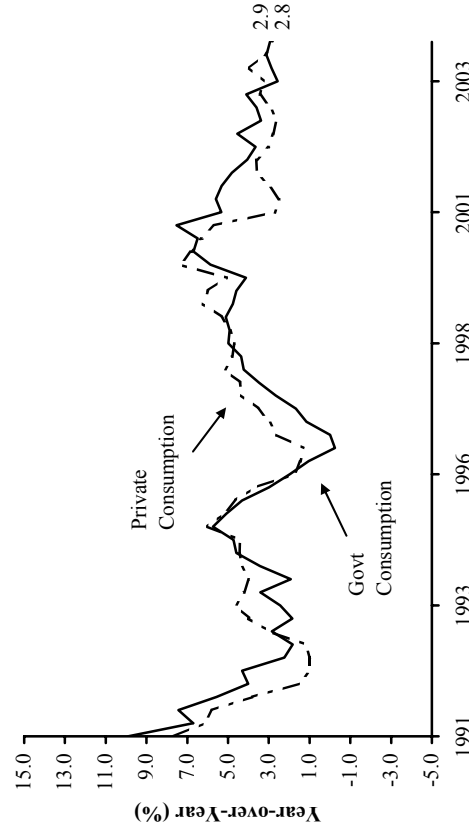
Note: Weights may not total to 100% due to rounding.

Table D

EMU MACROECONOMIC INDICATORS



Domestic Demand Growth
First Quarter 1991 - Second Quarter 2005



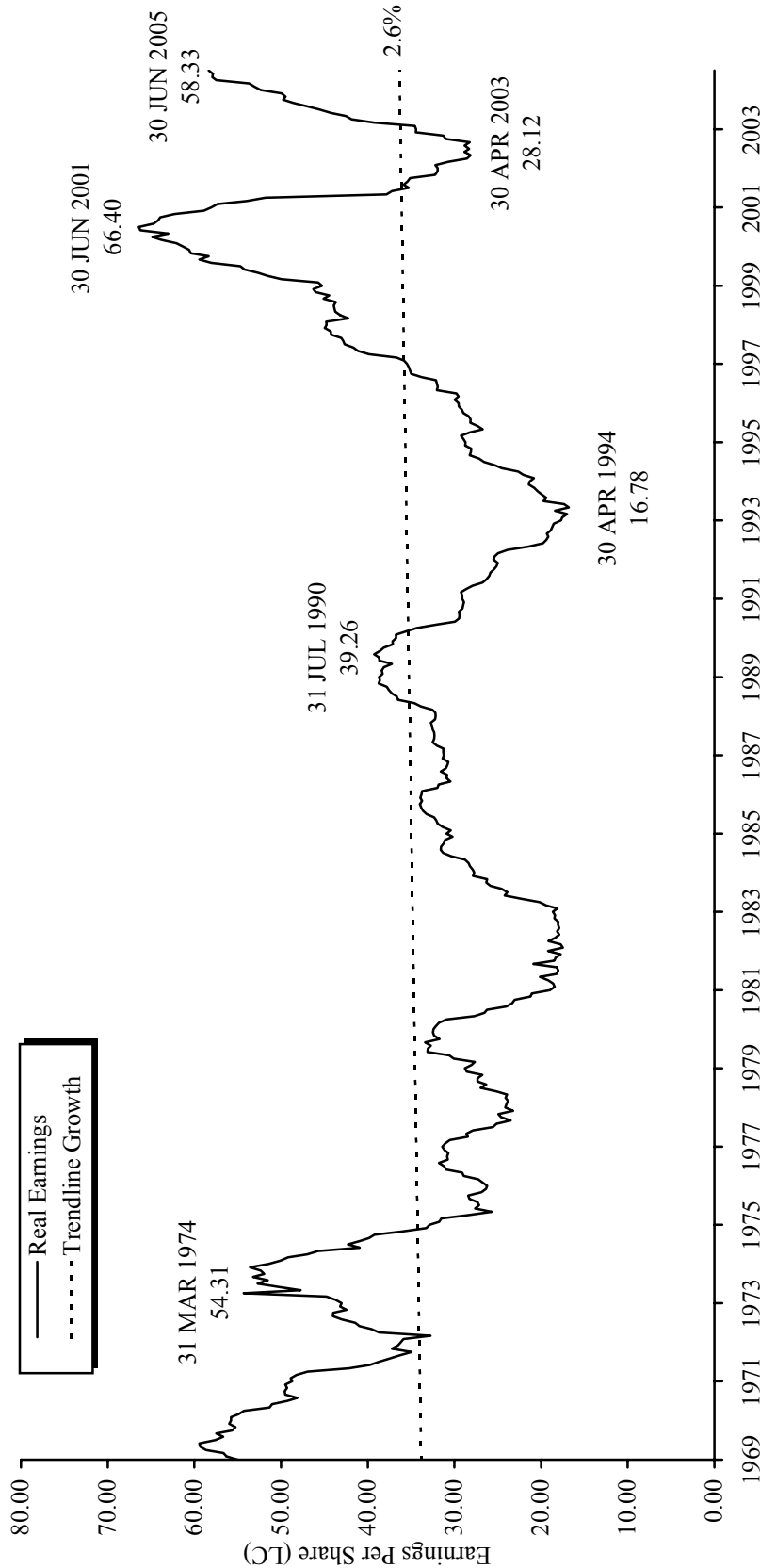
Source: Thomson Datastream.

Notes: Real GDP reported by the OECD on an annual basis in June. Data for 2005 are through second quarter. All data are reported in euros.

Table E

MSCI EUROPE EX UNITED KINGDOM REAL REPORTED EARNINGS

31 December 1969 - 30 June 2005

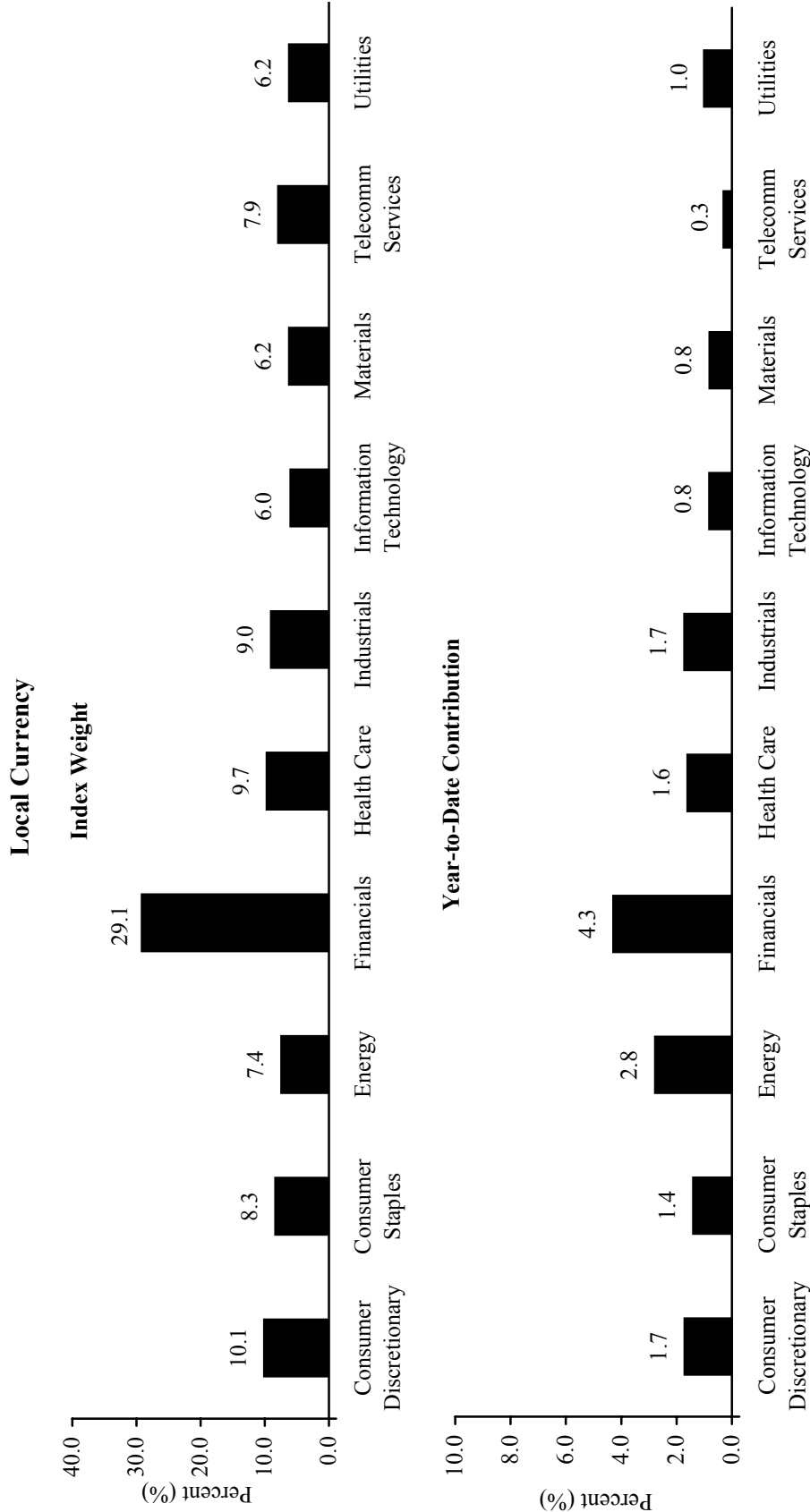


Sources: Global Financial Data, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Reported earnings include goodwill amortization. Real earnings are calculated on a 2005 euro basis. The average year-over-year real earnings growth rate of 2.6% is calculated arithmetically. 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 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.

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

As of 31 July 2005



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

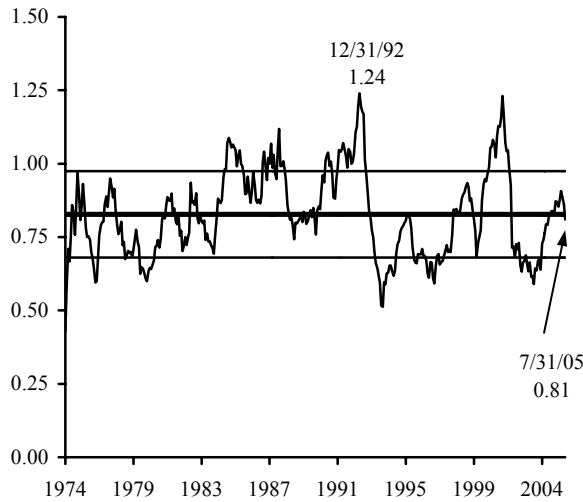
Note: Weights may not total to 100% due to rounding.

Table G

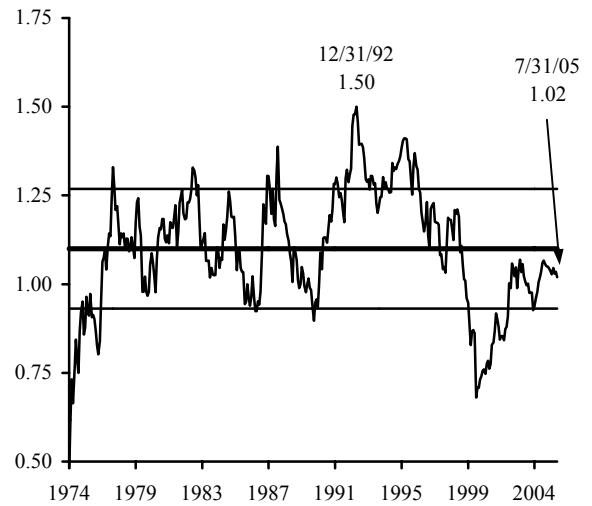
RELATIVE VALUATIONS: MSCI U.K. TO MSCI EUROPE EX U.K.

31 December 1974 - 31 July 2005

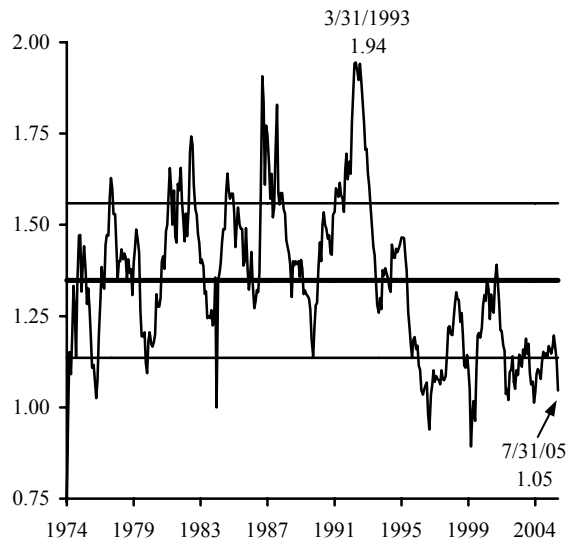
Price-Earnings



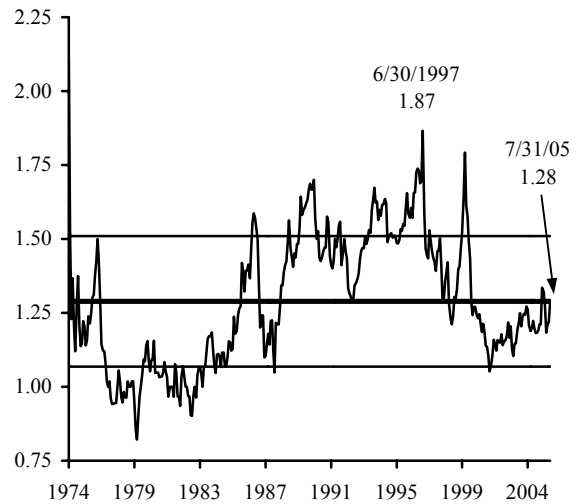
Price-to-Book Value



Price-to-Cash Earnings



Dividend Yield (%)



— Mean
 — One Standard Deviation

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