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CAMBRIDGE ASSOCIATES LLC

# EUROPEAN MARKET COMMENTARY

# EUROPEAN EQUITIES: LOWER PRICES, BUT HOW MUCH VALUE?

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## European Equities: Lower Prices, But How Much Value?

We last addressed the question of European equity valuations in April as global stock markets were rallying following the "rescue" of U.S. investment bank Bear Stearns and talk was rampant that the worst of the sell-off was behind us. At the time, we concluded that both U.K. and continental equities remained slightly overvalued despite deceptively low price-earnings (P/E) ratios based on trailing 12-month earnings. Our rationale was that both earnings and return on equity (ROE) remained at peak levels and forward earnings expectations were undeservedly rosy, while the heavy market concentration in financial shares (and energy in the United Kingdom) was also of concern.[1] In short, the case for equities was not as compelling as it might have at first appeared.

Since then European equities have tumbled some 20% to their mid-July lows, and have only rebounded slightly in August, while economic conditions in both the United Kingdom and Eurozone have deteriorated, with predictions of recession now in the air. Having dropped almost 30% since last summer's peak, however, stock market prices now discount a good deal of the earnings decline that concerned us, such that we now consider both U.K. and Europe ex U.K. equities as has having entered the "fair-value" range.[2] Despite this rating revision, we still view the outlook for European equities as unattractive, and continue to advise a cautious stance because we suspect valuations will fall through fair value to undervalued before the downturn in the global economic cycle has run its course. While we cannot know when and at what level equity valuations will eventually bottom, we believe markets will remain under pressure in the months ahead as fundamentals continue to deteriorate, undermining the likelihood of any sustainable rally.

### Fair-Value Territory

With July 31 headline P/E ratios (based on trailing 12-month earnings) at the seemingly depressed levels of 9.9 and 11.2 for the MSCI U.K. and Europe ex U.K. indices, respectively, it is easy to assume equities are very cheap since conventional wisdom holds that P/E ratios at such levels have preceded strong future returns. However, as we have repeatedly stressed, such ratios remain misleading at this point in the cycle and appear low due to the fact that earnings per share (EPS) have yet to fall meaningfully, while conversely, such ratios will appear overstated at the market trough, when earnings will be collapsing faster than share prices (Tables A and B). In other words, low P/E ratios due to stretched earnings and ROE are value traps, while low P/Es due to depressed profitability are buys. Thus, to adjust for the inherent cyclicality of earnings, ROE, and profit margins, investors need to "normalize" P/E ratios to arrive at a more credible and sustainable level of profitability over the business cycle. This is especially important in the current environment because unusually liberal access to remarkably cheap credit had enabled companies to ramp up profits during the recent credit boom—which has now gone bust.

[1] Please see our April 2008 Market Commentary *European Equities Are Not Cheap*.
[2] For a monthly review of all our asset class valuations, please see our *Notes on Current Valuations* publication, available on our website and in our *Monthly Resources* report.

Tables C–E present three such normalized measures (ten-year average real earnings, long-term trend-line earnings, and ROE-adjusted P/E ratios) for U.K., Europe ex U.K., and pan-European equities based on MSCI data since 1970. While unadjusted trailing P/E ratios showed equities as reasonably priced at last summer's peak (with U.K. and Europe ex U.K. equities at P/E ratios of about 14 and 16, respectively), nearly all of our normalized measures stood at a P/E ratio close to or above 20 in May 2007, or 1 standard deviation above historical average, implying overvaluation. By this July, however, nearly all our metrics for U.K. and Europe ex U.K. equities had fallen close to historical norms. Consequently, while trailing ratios point to undervaluation, our normalized valuations tell us equities are merely reasonably priced.[3] (For a more detailed description of our normalized valuation measures, see the Appendix at the end of this commentary.)

It is also worth noting that price-to-book ratios, price-to-cash earnings ratios, and dividend yields (DYs) have also returned to historical average levels in Europe (Tables F–H). While DYs at over 4% seem quite attractive, especially compared to those on offer from U.S., Japanese, and emerging markets equities, this partly reflects the juicy yields on heavily weighted financial stocks in the United Kingdom and the Continent, which may be cut in coming quarters. Relative to those of the MSCI World and MSCI U.S. equity indices, the ROE-adjusted P/E ratio of pan-European equities has retreated from overvalued in early 2007 to fairly valued today, which accounts for their relative underperformance (Table I).

But what do we mean by "fair value"? Does that not imply equities are attractively priced? Not necessarily. While some analysts assign explicit fair-value price targets based on discounted cash-flow models (which are highly influenced by interest rate assumptions) or forecasted earnings and target P/E ratios, this implies a false level of precision. In our opinion, fair value encompasses a wide range of relatively neutral valuations and expectations, and often serves as a way station on the path from over- to undervalued, and vice versa. In other words, fair value does not imply the market has cleared, as equities can undergo long periods of over- and undervaluation during which fair value serves as either a ceiling or a floor. For example, European equities fell from clearly overvalued in 1972 to quite cheap in 1974 without ever stopping at the fair-value station, and remained undervalued for the next decade. Conversely, from the mid-1980s to the mid-1990s, equities bounced around fair value before running up to unprecedented levels during the late 1990s, during which any notion of returning to historical fair-value range was discarded.

**What's Priced In?**

As noted above, by mid-July U.K. and continental equities had fallen 24% and 32%, respectively, from their 2007 peaks. Yet unlike U.S. equities, this has taken place amid still rising EPS, implying that nearly all of the losses thus far for European equities represent multiple contraction, suggesting that investors are discounting sizable declines in future earnings. Indeed, the typical "earnings recession" in Europe

[3] Our valuation work has shown that "normalized" valuations provide a superior metric to trailing P/E ratios. Based on analysis of P/E ratios to subsequent five-year returns over 1979–2006, trailing P/E ratios had an R-squared of 58% for U.K. equities, while ten-year average real earnings and ROE-adjusted P/E ratios had an R-squared of over 80%. For Europe ex U.K., the disparity between coefficients of determination was even more striking; only 20% for trailing P/E ratios but over 60% for "normalized" ratios, reflecting the greater cyclicality of continental markets/earnings. Please see our March 2006 Market Commentary *European Equities Getting Pricey*.

witnesses a 30% to 40% fall in reported EPS over an average duration of two years (although the cycle in the 1990s took nearly three years to complete), while the typical bear market sees equities decline close to 30%. In other words, these markets currently discount standard recession expectations.

Even analysts' expectations have been reined in recently, with earnings revisions ratios falling sharply (i.e., more companies are receiving earnings downgrades than upgrades), adding to the bearish mood. However, consensus earnings growth estimates still seem disconnected from reality, expecting slightly positive earnings growth for 2008 and double-digit growth for 2009. Indeed, much of the weakness for 2008 is based solely on the financial and consumer discretionary sectors, rather than broad-based earnings weakness. Although the three-month average revision ratio ended July at 0.57, it fell to well below 0.40 during the 1990–93 and 2001–03 earnings cycles, according to analysis by Merrill Lynch, implying fewer than 40 upgrades for every 100 downgrades.

This brings us back to the undeniable fact that earnings fall sharply during a recession, especially one that seems to be spreading globally from the United States to Europe, Japan, and possibly even the emerging world, which has provided much of the growth for European and U.K. companies over this cycle. Real earnings in the United Kingdom remain 44% over their ten-year average, and some 38% above what trend-line growth would imply. These figures are even starker for continental equities, at 51% above their ten-year average and a staggering 95% above their long-term trend. While the latter statistic may overstate the case,[4] at the risk of whipping a horse to death, Tables J and K show that earnings always fall back to trend and their ten-year average, if not sharply below, over the economic cycle. Therefore, while U.K. and European equities have discounted the "typical" cycle, the current level of earnings implies the potential for above-average losses should profits revert to the mean. Moreover, as we discussed in April, the financial sector generated an outsized portion of the previous rise in total market earnings and its future contribution will likely be much more modest.

## A Challenging Outlook

Some commentators have argued that with the onset of what seems to be a global economic slowdown, inflation pressures in Europe and the rest of the developed world may soon moderate, especially now that commodity prices have come off the boil. Waning inflation would allow both the Bank of England and the European Central Bank to begin aggressively lowering policy rates, sparking an equity rally via multiple expansions as investors look beyond already discounted earnings losses and bid stocks higher. While equities may rally on any such indication of lower interest rates, we still think it premature to expect the emergence of a new bull market at this time.

[4] It could be argued that the massive restructuring of European (and especially German) companies, combined with the introduction of the euro (which makes intra-Eurozone trade much more stable) and the outsourcing of production to low-cost Eastern Europe and Asia, represents a sustainable shift in profitability relative to the past, and thereby the trend line should be steeper than in the past.

According to Goldman Sachs, on average European equities have bottomed seven months before the trough in earnings, although there is high variance around this figure. Since the average earnings cycle is two years in duration, and U.K. and continental earnings have just begun to turn down, a reasonable guesstimate would be a bottom in earnings in summer 2010, placing a rebound in the markets in late 2009. Goldman Sachs also points out that U.S. earnings lead European earnings by roughly a year on average and although consensus expectations are still betting on a bottom in U.S. earnings in third quarter 2008, this looks increasingly unlikely. These analyses reinforce our view that, "fair" valuations notwithstanding, European equities are unlikely to mount a sustained recovery in the next several months.

Indeed, historical precedent indicates that although equity markets often bottom in advance of corporate recovery, they rarely undergo a sustained rebound until earnings visibly improve. The time to accumulate equities aggressively is when earnings, profit margins, and ROE are depressed, and therefore have substantial room to rise based on improving prospects. Consequently, while encouraged by the improvement in European valuations, we still think that it is too early in the cycle to buy and that equities remain vulnerable to weaker global growth. At a minimum, we would expect choppy, volatile markets to persist into 2009, at which time there may be enough visibility for equities to break free. Such an environment may present opportunities for talented managers, but argues that investors should generally remain defensive until greater clarity emerges as to the path of the global economy. In sum, at only average valuation levels, European equities do not yet offer compelling value.

# APPENDIX

**"Normalized" P/E Ratios**

In our valuation work, we look at three different types of price-earnings (P/E) ratios that seek to provide a better picture of sustainable earnings power over the economic cycle (i.e., ten years or so).

**Ten-year average real earnings P/E ratio.** Sometimes referred to as the real normalized P/E (in Cambridge parlance) or the Shiller P/E (after Yale University's Robert Shiller) or even the Graham and Dodd P/E (who first advocated smoothing earnings over the cycle). This ratio compares current stock prices to the ten-year average of real (inflation-adjusted) earnings per share. Data begin in 1980 for European equities.

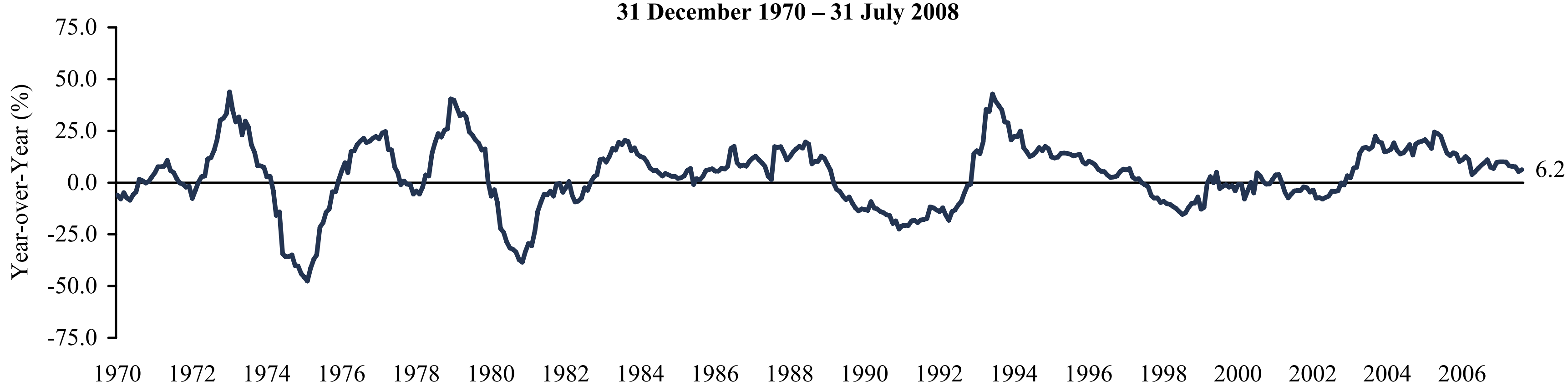
**Return on equity (ROE)-adjusted P/E ratio.** This ratio adjusts the current trailing P/E ratio for the current level of ROE by multiplying the current P/E by the ratio of current ROE relative to a sustainable average ROE. We assume an average ROE of 12 for developed equity markets. Data begin in 1975.

**Trend-line P/E ratio.** This measure compares current stock prices to the level of earnings predicted by long-term earnings growth based on a simple linear regression. Earnings always return to (if not fall through) trend during an economic downturn, although any trend-line analysis is highly influenced by the period on which the trend is based (i.e., one runs the risk of missing a secular shift), while the trend line itself changes over time. Data begin in 1970.

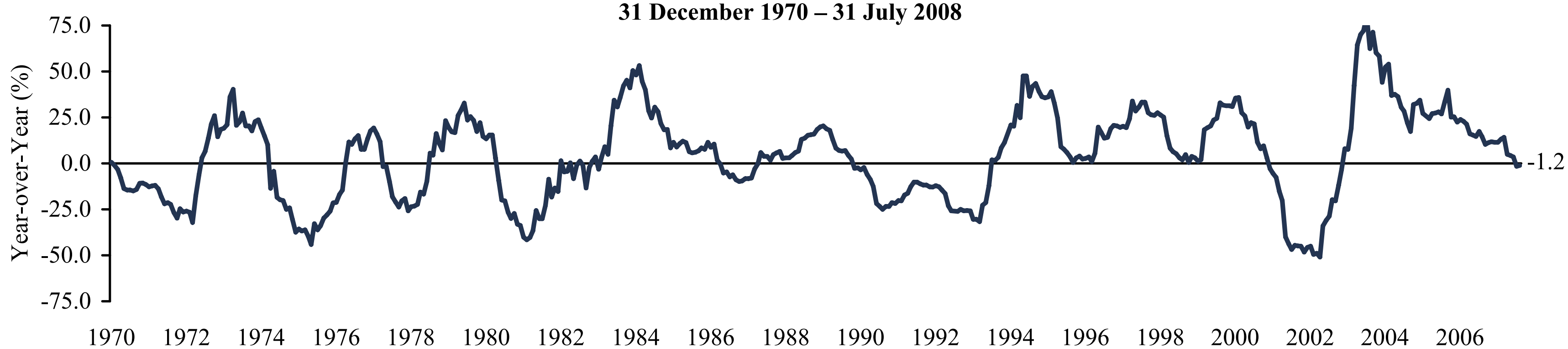
## Table A

### REAL ANNUAL EARNINGS PER SHARE GROWTH

**MSCI U.K.**
**31 December 1970 – 31 July 2008**




**MSCI Europe ex U.K.**
**31 December 1970 – 31 July 2008**



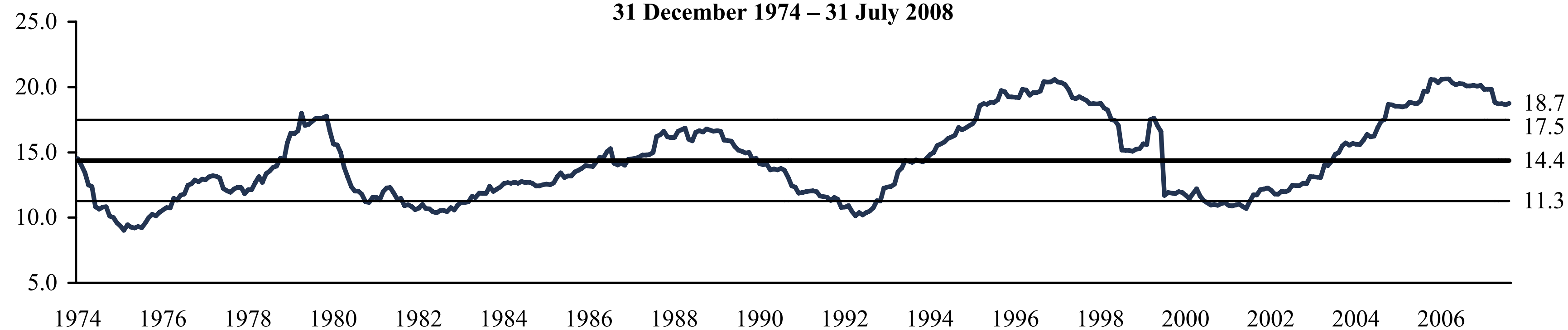

Sources: Global Financial Data, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: MSCI U.K. earnings per share (EPS) are deflated by the U.K. RPI from 1969 to November 2003 and the U.K. CPI from December 2003 to present. MSCI Europe ex U.K. EPS are deflated by CPI-Eurozone with data before 1995 based on a historical composite calculated by Global Financial Data.

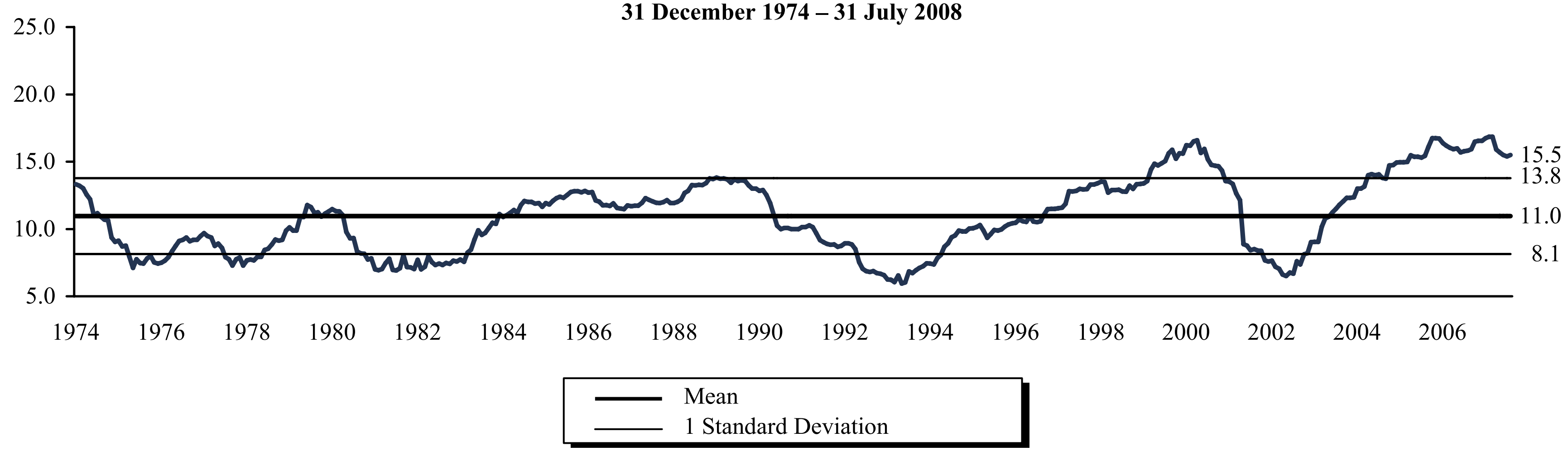
**Table B**

**RETURN ON EQUITY**

**MSCI U.K.**
**31 December 1974 – 31 July 2008**




**MSCI Europe ex U.K.**
**31 December 1974 – 31 July 2008**



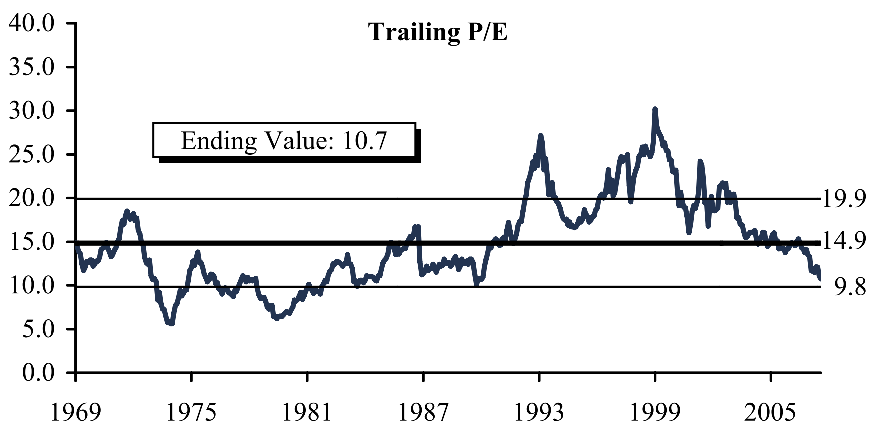

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

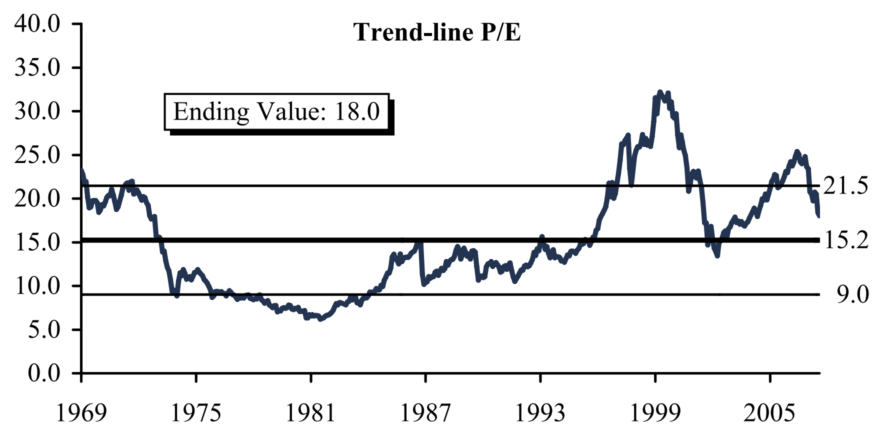
Note: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.

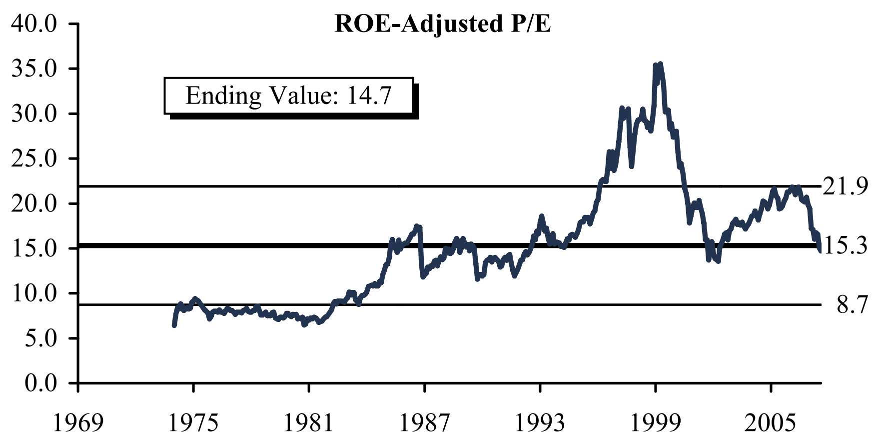
**Table C**

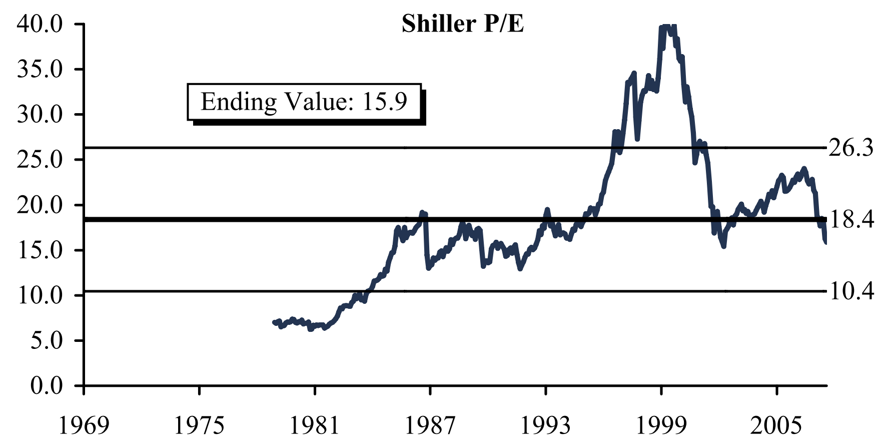
**MSCI EUROPE PRICE-EARNINGS VALUATIONS**

**31 December 1969 – 31 July 2008**




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

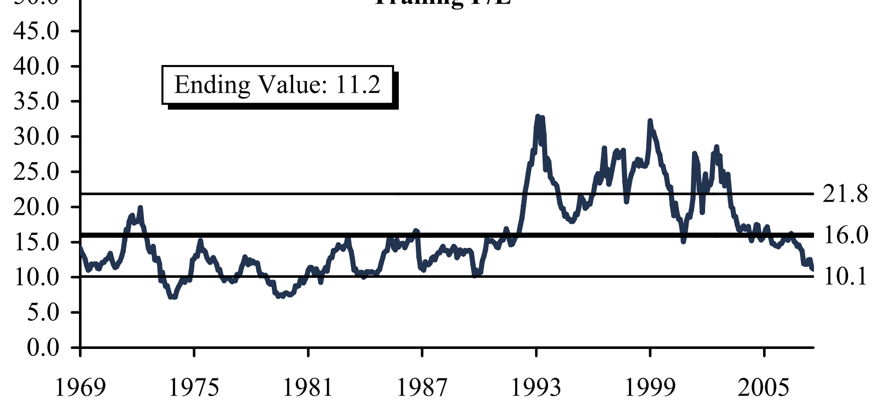
Notes: Earnings are deflated by CPI-Eurozone with data before 1995 based on a historical composite calculated by Global Financial Data. The ROE-adjusted P/E data start on 31 December 1974. The Shiller P/E data start on 30 November 1979.

**Table D**

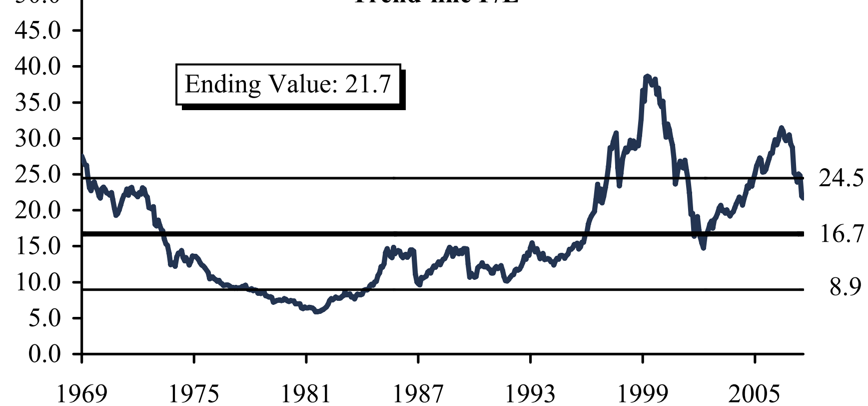
**MSCI EUROPE EX U.K. PRICE-EARNINGS VALUATIONS**

**31 December 1969 – 31 July 2008**

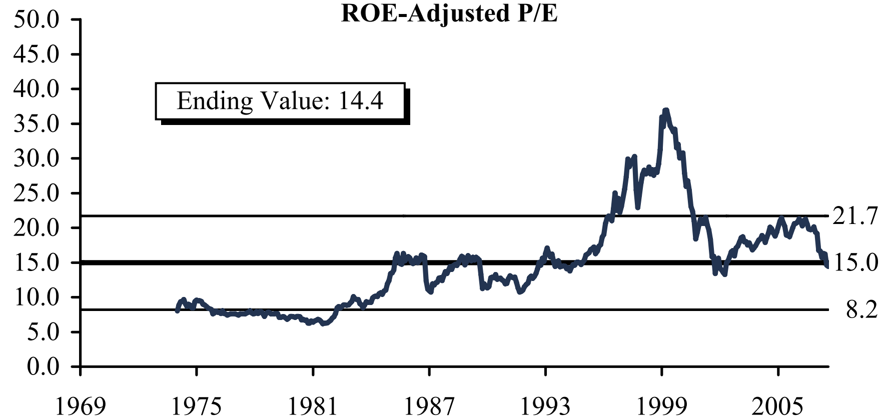
**Trailing P/E**



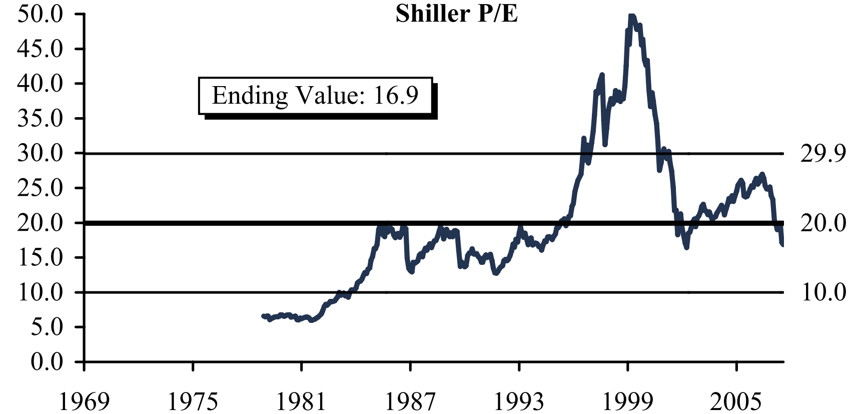

**Trend-line P/E**




**ROE-Adjusted P/E**




**Shiller P/E**



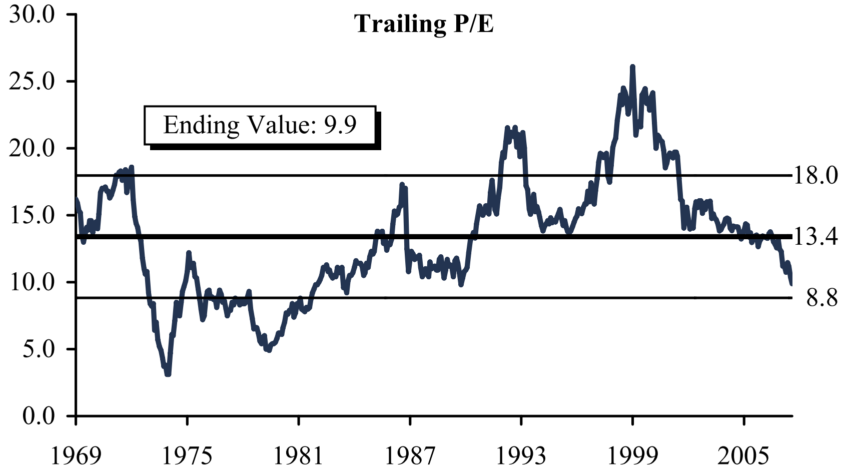

Sources: Global Financial Data, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

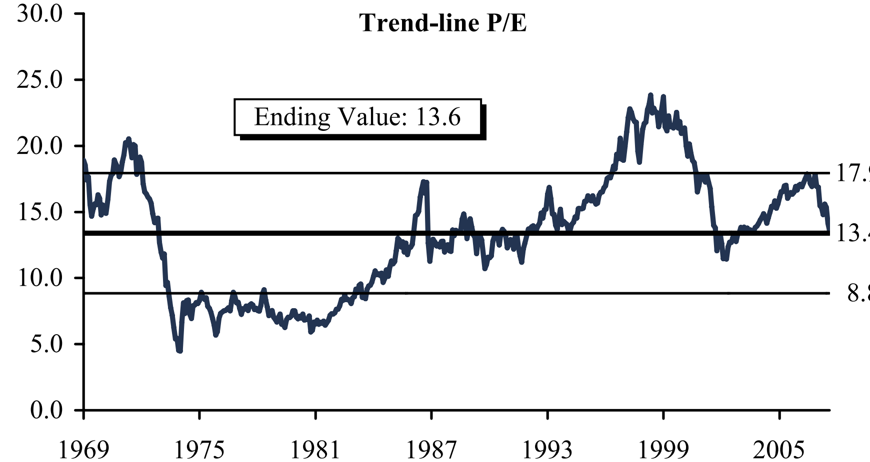
Notes: Earnings deflated by CPI-Eurozone with data before 1995 based on a historical composite calculated by Global Financial Data. The ROE-adjusted P/E data start on 31 December 1974. The Shiller P/E data start on 30 November 1979.

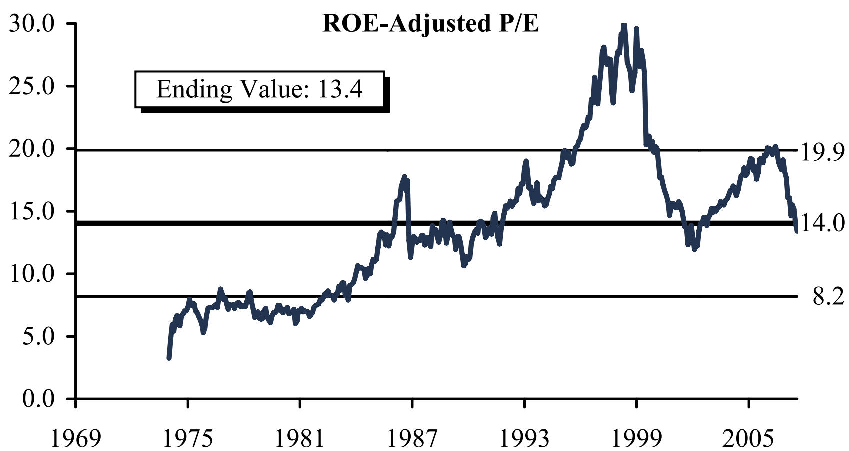
**Table E**

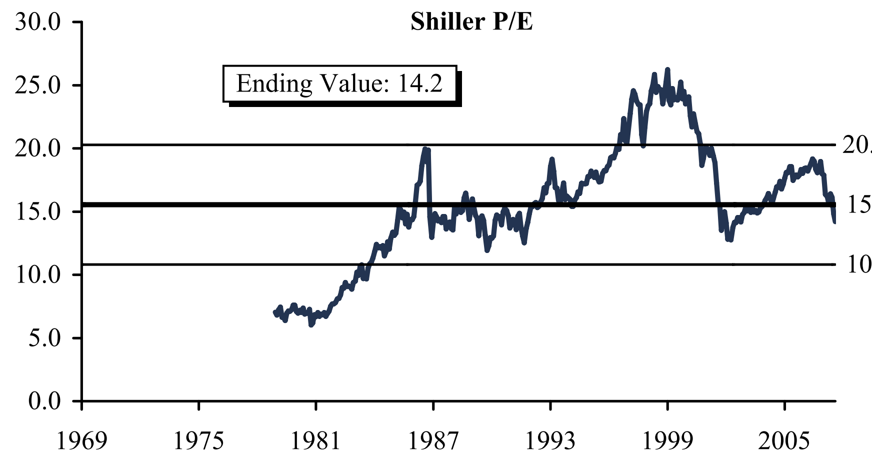
**MSCI U.K. PRICE-EARNINGS VALUATIONS**

**31 December 1969 – 31 July 2008**




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

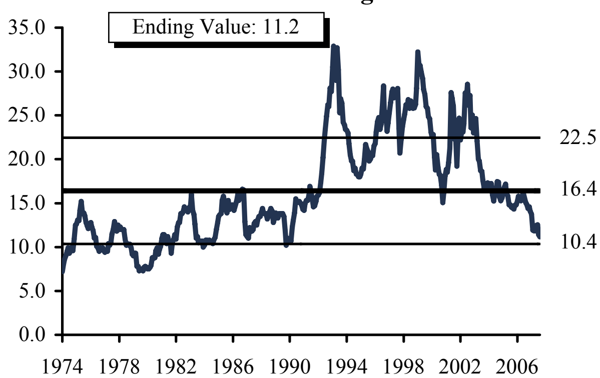
Notes: U.K. earnings are deflated by the U.K. RPI from 1969 to November 2003 and the U.K. CPI from December 2003 to present. The ROE-adjusted P/E data start on 31 December 1974. The Shiller P/E data start on 30 November 1979.

**Table F**

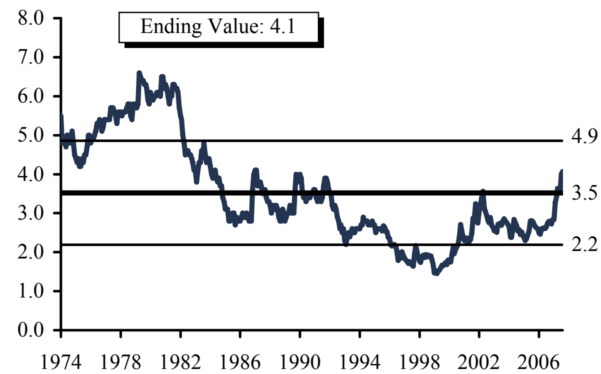
**MSCI Europe ex U.K. Index**

**31 December 1974 – 31 July 2008**

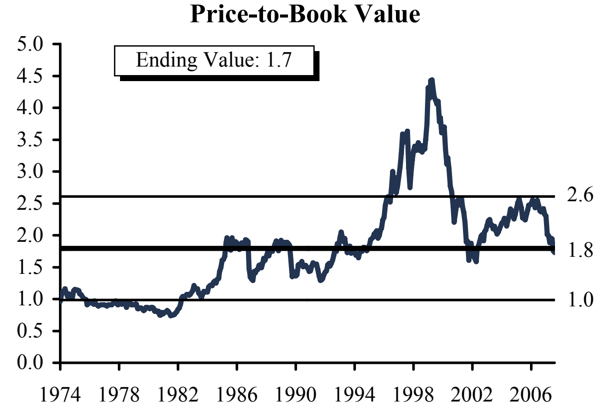
**Price-Earnings**



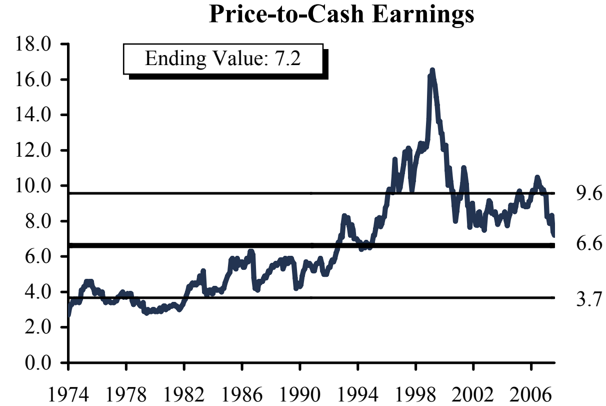

**Dividend Yield (%)**



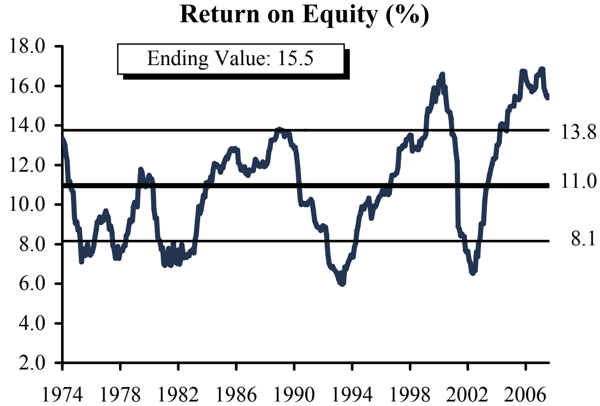

**Price-to-Book Value**




**Price-to-Cash Earnings**




**Return on Equity (%)**





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

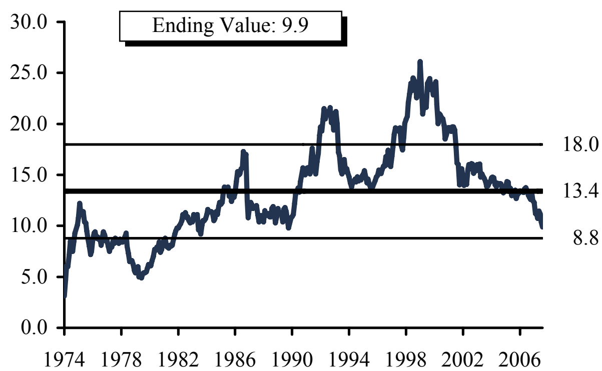
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.
398q

# Table G

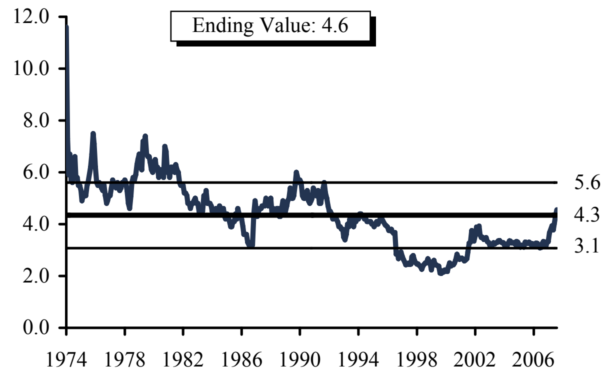
## MSCI United Kingdom Index

## 31 December 1974 – 31 July 2008

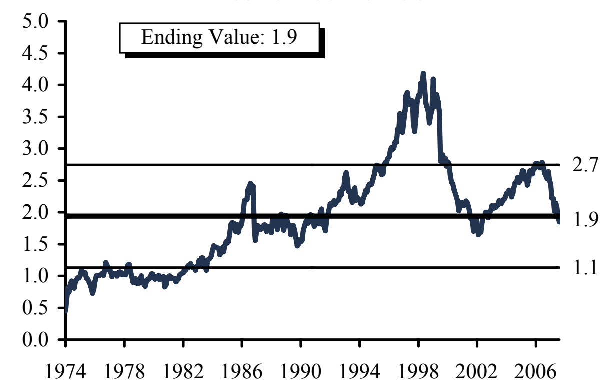
### Price-Earnings



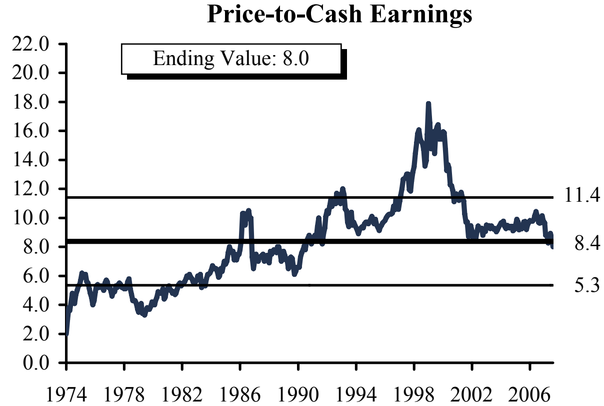

### Dividend Yield (%)



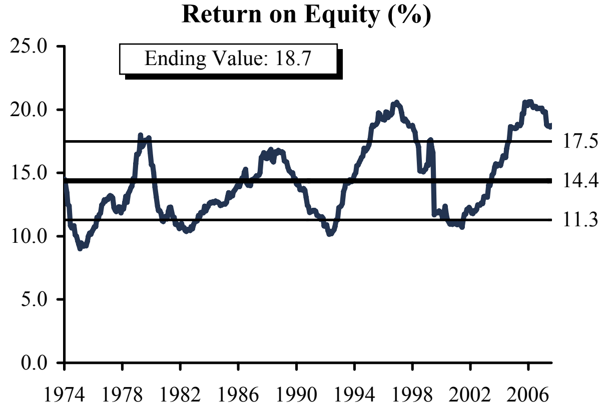

### Price-to-Book Value




### Price-to-Cash Earnings




### Return on Equity (%)





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

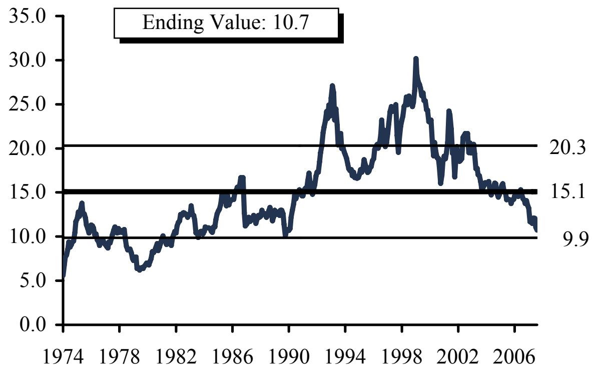
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.
027q

## Table H

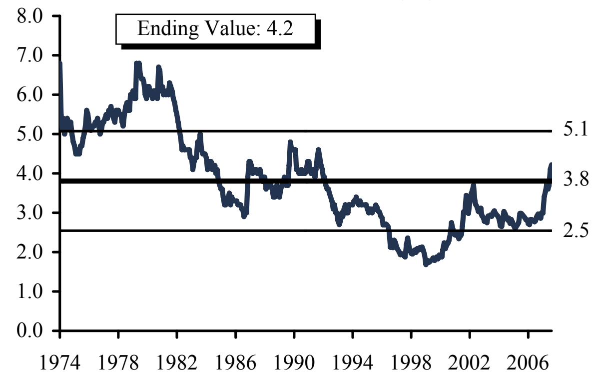
## MSCI Europe Index

## 31 December 1974 – 31 July 2008

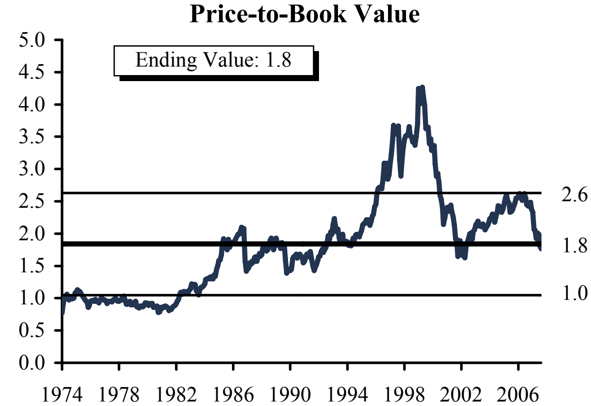
**Price-Earnings**



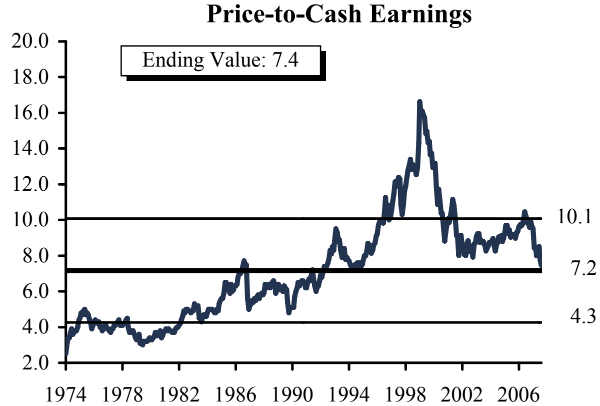

**Dividend Yield (%)**



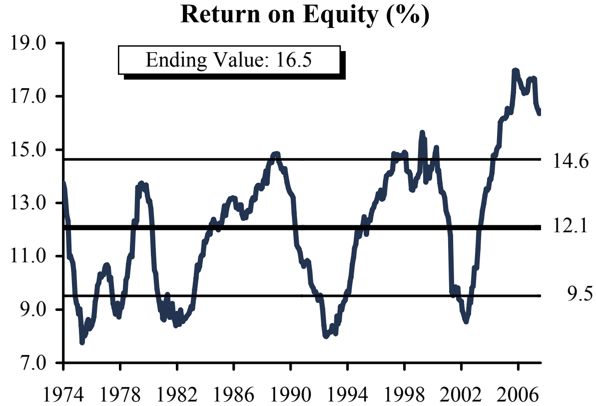

**Price-to-Book Value**




**Price-to-Cash Earnings**




**Return on Equity (%)**





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

Notes: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.
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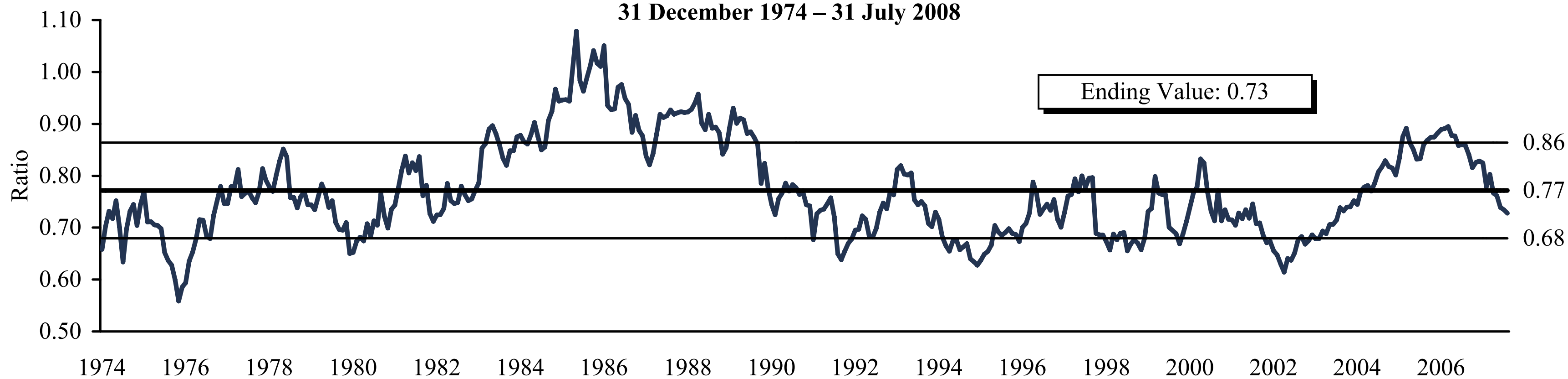
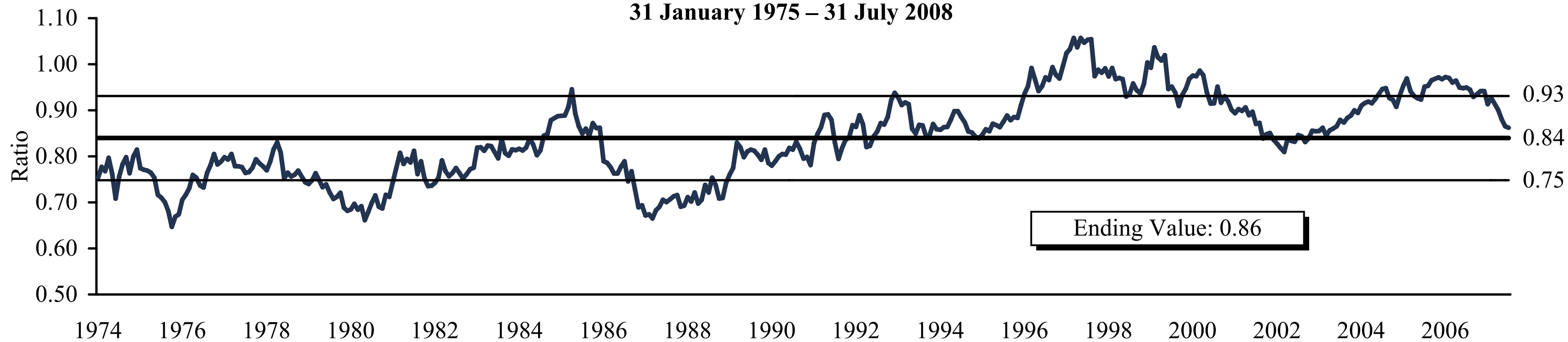
## Table I

## RELATIVE ROE-ADJUSTED PRICE-EARNINGS RATIOS

**MSCI Europe Relative to MSCI U.S.**
**31 December 1974 – 31 July 2008**




**MSCI Europe Relative to MSCI World**
**31 January 1975 – 31 July 2008**



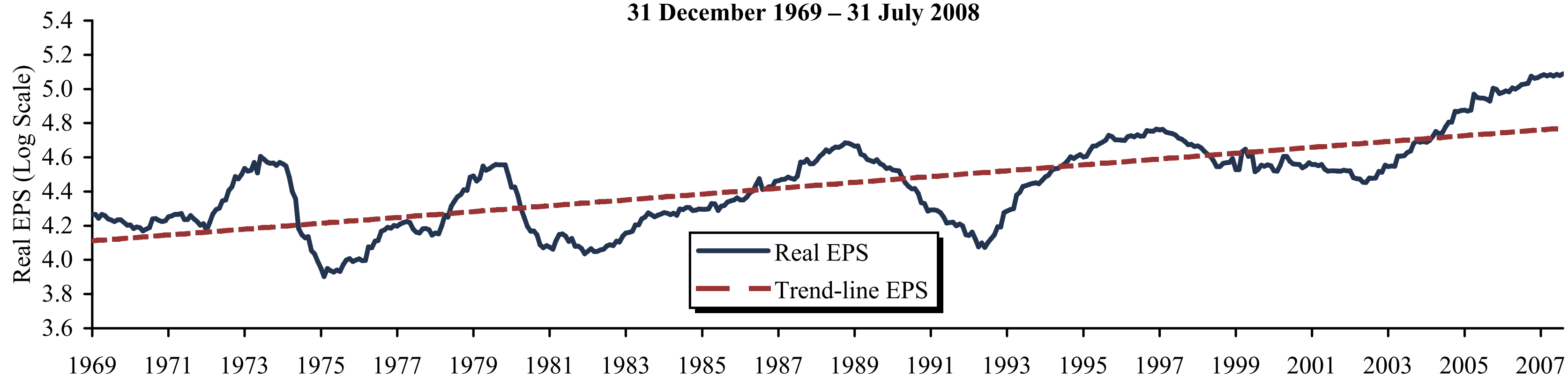

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-to-earnings (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 an assumed long-term historical average ROE of 12 for equity markets.

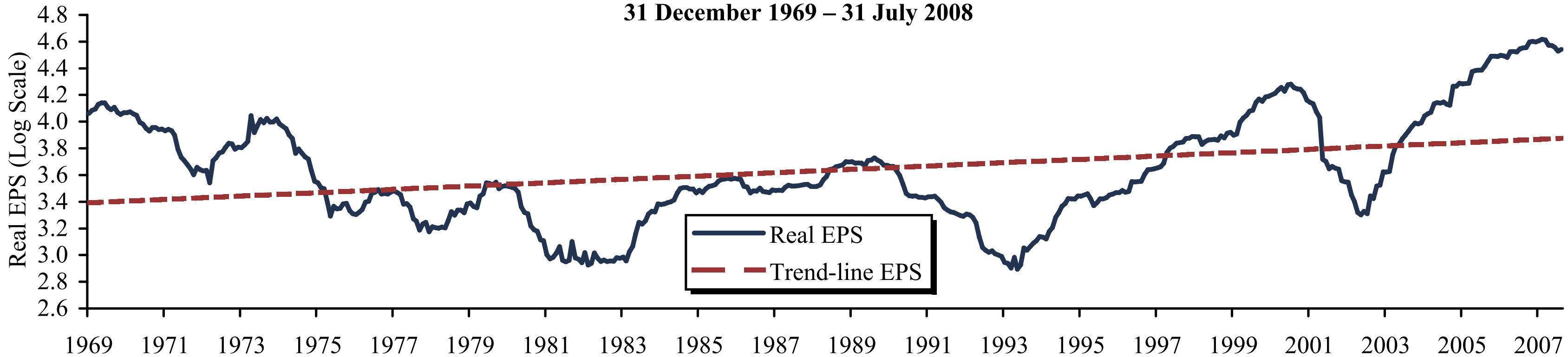
**Table J**

**REAL EARNINGS OF MSCI U.K. AND MSCI EUROPE EX U.K.**

**MSCI U.K.**
**31 December 1969 – 31 July 2008**




**MSCI Europe ex U.K.**
**31 December 1969 – 31 July 2008**



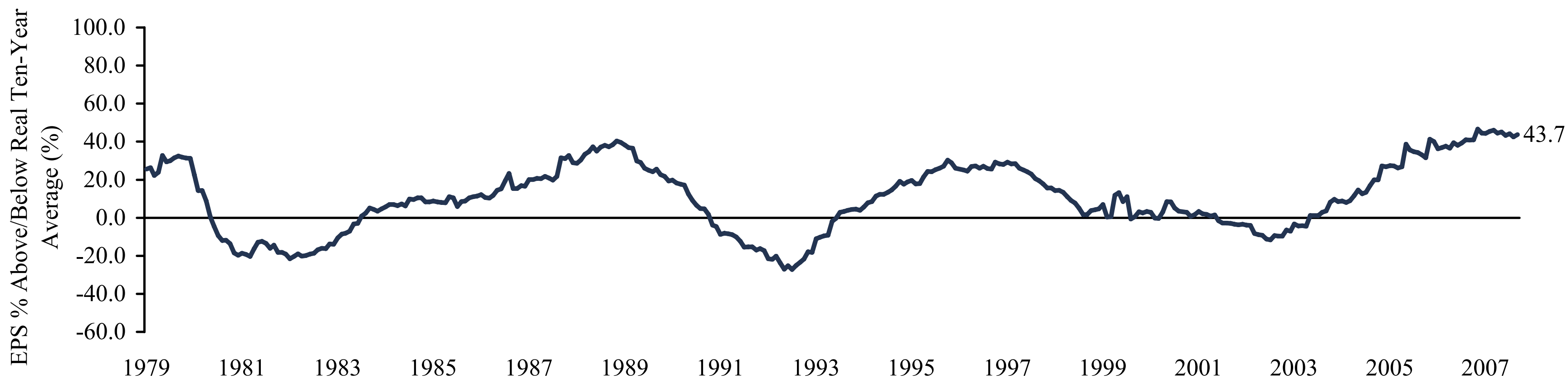

Sources: Global Financial Data, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: MSCI U.K. earnings per share (EPS) deflated by U.K. RPI from 1969 to November 2003, and the U.K. CPI from December 2003 to present. MSCI Europe ex U.K. EPS are deflated by CPI-Eurozone with data before 1995 based on a historical composite calculated by Global Financial Data. Trend-line earnings based upon simple linear regression.

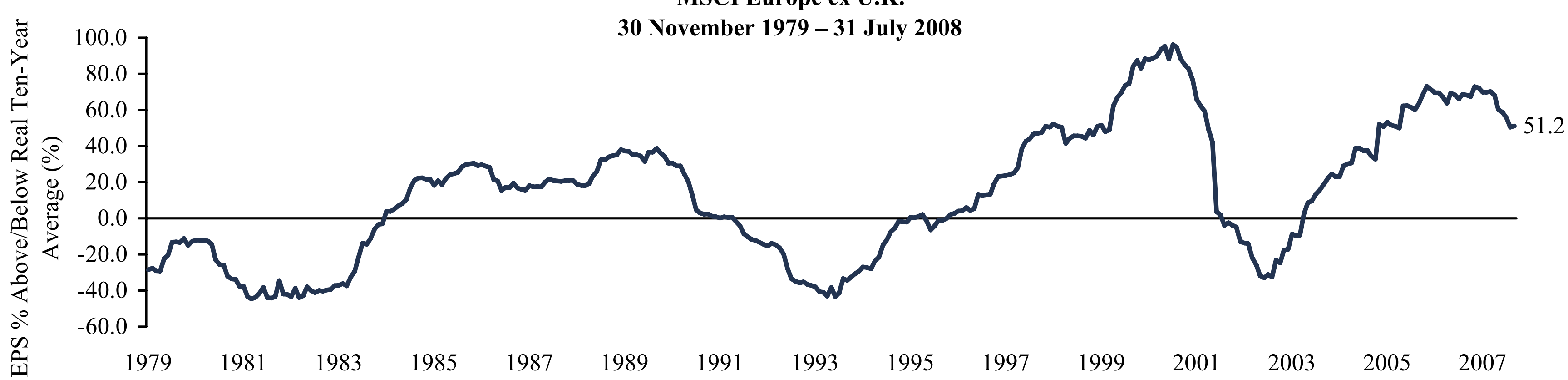
## Table K

### REAL EARNINGS PER SHARE PERCENT ABOVE/BELOW NORMALIZED TEN-YEAR AVERAGE LEVEL

**MSCI U.K.**
**30 November 1979 – 31 July 2008**




**MSCI Europe ex U.K.**
**30 November 1979 – 31 July 2008**




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

Notes: MSCI U.K. earnings per share (EPS) are deflated by U.K. RPI from 1969 to November 2003, and the U.K. CPU from December 2003 to present. MSCI Europe ex U.K. EPS are deflated by CPI-Eurozone with data before 1995 based on a historical composite calculated by Global Financial Data.