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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

EUROPEAN EQUITIES: PRICED FOR PERFECTION?

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European Equities: Priced for Perfection?

In March 2006, we opined that continental European equities looked pricey from a cyclical standpoint, but attractive on a long-term perspective.[1] Our view was based on the belief that, while prices had gotten ahead of current fundamentals, markets were still relatively pessimistic about prospects for long-term structural reforms, even as many countries had already made significant strides in this area. Since that time, continental European markets have outperformed their developed peers, at least partly due to investors cottoning to the idea that European economic growth is on the upswing. Indeed, there has been much talk recently of "decoupling," whereby European economies and markets continue to strengthen, while the U.S. economy slows and U.S. markets soften. As a result, we now believe continental European equities are at the very least fully priced. As we noted in our prior piece, European markets appear expensive on virtually all metrics, save price-earnings (P/E) multiples based on trailing 12-month earnings, which have been held down by rapid earnings growth in recent years (Tables A and B). The latest run-up appears to be based, at least in part, on increasingly favorable views of long-term structural changes. In short, while in March 2006 there was significant room for upside surprises due to investor pessimism, we believe the risk of investor disappointment now outweighs the potential for positive surprises.

Changes in Latitudes, Changes in Attitudes…

Since our March 2006 piece, continental European equities have outpaced other developed markets by roughly 700 basis points (bps). Measured in euro terms, the gap has been much wider (nearly 1,500 bps) due to persistent strength in the euro versus the US$ and Japanese yen. It is true, of course, that the move in European equities (as in much of the world) has been supported by earnings growth: the P/E multiple for continental Europe at the end of May (based on 12-month trailing earnings on the MSCI Europe ex U.K. Index) was 16.2, virtually unchanged from the end of March 2006. However, when we adjust multiples for earnings cyclicality and today's high levels of return on equity (ROE), valuations look a sight worse (Table C).

We would also note that the *median* P/E of stocks in the MSCI Europe ex U.K. Index today (19.2) is higher than the aggregate index multiple (16.2). In other words, while half of European equities have a multiple of more than 19.2, overall multiples are being held down by a few large-cap names. As shown in Table D, the top two deciles of the index (sorted by market cap) are below the overall index P/E of 16.2; indeed, the average P/E of the top two deciles is 15.4,[2] versus 18.1 for the rest of the index. This is the opposite of the situation that prevailed in the late 1990s and early 2000s, when index P/Es were pulled higher by a relatively few very expensive large caps. At the end of 2000, for example, the index P/E was 22.6 and the median P/E, 18.2. Current high valuations for small and mid caps, of course, are at least partly due to the "bid premium" caused by the ongoing merger and acquisition (M&A) boom. While such an effect is impossible to quantify, it will almost surely shrink when the M&A frenzy finally slows.

[1] Please see our March 2006 European Market Commentary: *European Equities Getting Pricey*.
[2] We use a harmonic rather than arithmetic average in order to minimize the impact of outliers.

Still, the valuations picture looked much the same 16 months ago; what *has* changed is investor sentiment, which has become significantly more bullish. Merrill Lynch, for example, recently found that 56% of global fund managers were overweight European equities—the highest level since January 2000—with additional managers planning to overweight the region in the near future. Further, according to the Zew survey of institutional investors, the assessment of current economic conditions in Europe hit an all-time high in June, while the gap between perception of conditions in Europe and the United States was the largest since 1992.

Annus Mirabilis Economicus?

Increased investor optimism toward Europe is certainly not without merit, as the Eurozone economy has accelerated over the past year in the face of headwinds such as rising interest rates, tighter fiscal policy, a strong euro, and a slowing U.S. economy (Tables E and F). The debate now centers on whether the current upswing represents a sustainable, structural shift in European growth potential, or whether sentiment has become overly optimistic precisely when economic growth is peaking. While we recognize economic growth is often uncorrelated with financial market performance, most bullish forecasts rely, at least in part, on continued strength in the Eurozone economy. Therefore, it is worth noting that recent growth has been buoyed by several external and one-off factors, including a series of housing booms across the Continent (Table G) and a surge in German exports (especially to the emerging world).

Consider, for example, the Spanish economy, which accounts for only 11% of total Eurozone GDP, yet was responsible for one-third of Eurozone domestic demand growth over 2002-06,[3] largely due to spillover effects from an extraordinary housing boom that has since gone bust. The rebound in German growth in 2006, meanwhile (which accounted for over one-third of total Eurozone growth for the year), was driven almost entirely by exports and business investment. Arguably then, much of Europe's recent growth surge can be attributed to liquidity-fueled housing booms and the *global* economic boom, rather than an economic renaissance in Europe.

Further, given the recent rise in global bond yields, the hawkish tone of the European Central Bank (ECB), and predictions that global growth will moderate in 2007, it seems quite plausible the Eurozone recovery will fail to live up to recently heightened expectations, especially after such a strong showing in 2006. Indeed, consumption slumped in first quarter following a 3% increase in the German value added tax, and recent economic data have been on the soft side as well. And despite cooling housing markets (Eurozone housing price appreciation and mortgage growth peaked last year, while the Spanish boom came to an abrupt end in May), the ECB remains focused on combating rapid credit growth, with markets expecting at least 50 bps of further tightening on top of policy rates already at their highest level (4.00%) since 2001.

Still, we recognize the possibility that economic growth will continue to pick up, especially if animal spirits take hold in Germany. However, even in such a scenario, upside for equity investors is likely to be limited given current valuations (unless further gains are driven by multiple expansion, which in our view is

[3] "Housing to Reduce Euroland Imbalances," *Monthly Review 214*, Lombard Street Research, April 2007.

highly unlikely), while continued above-trend growth could also push inflation significantly higher. It is true that inflation has remained relatively muted in recent years despite a sharp drop in unemployment, largely due to labor market reforms that have allowed structural employment to increase without pushing up wages. However, Europe's unemployment rate remains structurally high relative to that of other developed economies (Table H), and wages have recently begun to rise, suggesting further declines in unemployment may lead to higher inflation. In short, while it is certainly *possible* the European economy will enjoy a low-inflation boom over the next few years, such an outcome is far from a foregone conclusion.

A French Revolution?

While we do not often comment on politics, the electoral success of Nicolas Sarkozy and his center-right UMP party are an encouraging sign that the French are finally willing to accept changes to their economic system. Sarkozy's proposed reforms, while not revolutionary, are certainly a step in the right direction (pun intended), and *could* be a positive development for all of Europe. For example, some of the more significant reforms include tax breaks on overtime pay (for both employees and employers), a cap on wealth taxes, tax deductibility for mortgage interest payments, limits on the rights of public transportation workers to strike, and proposals to trim the French bureaucracy and allow universities greater autonomy. While it remains to be seen just how many of these reforms are actually enacted (and in what guise), investors should be heartened that such discussions are finally taking place, although we would note that the long-term benefits of reform are typically realized only after a period of short-term economic pain. (As an aside, Bridgewater Associates recently suggested European and American politics may be "converging," with labor's share of the pie set to increase in the United States and fall in Europe. This, of course, could have a significant impact on relative rates of profit growth.)

Conclusion

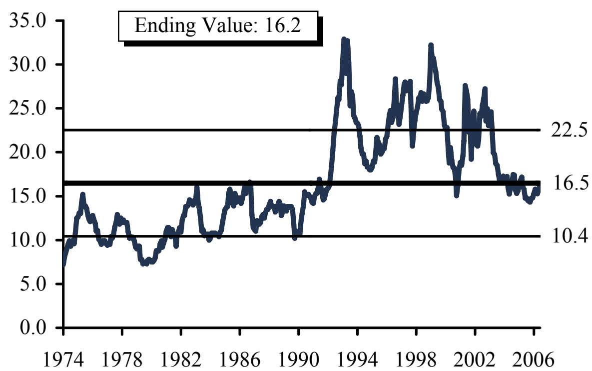
We do not have any definitive insights into the future of the European economy (or any other economies, for that matter). However, given that most investors seem to have bought into the structural reform thesis, going long the European restructuring/growth story has gone from being a contrarian play to very much a consensus trade. As a result, financial markets are not priced for *either* a moderation in Eurozone growth or materially higher inflation/interest rates, despite the very real risk that one (or both) come to pass. In short, we believe downside risk now outweighs potential upside reward. Still, as European valuations do not look particularly different from those of other developed markets (or from the broad swath of highly priced asset classes in general), there is probably not much to be gained from underweighting the region.

Table A

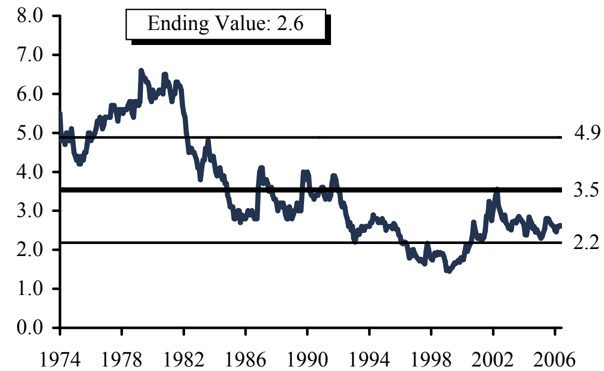
MSCI EUROPE EX U.K. VALUATIONS

31 December 1974 - 31 May 2007

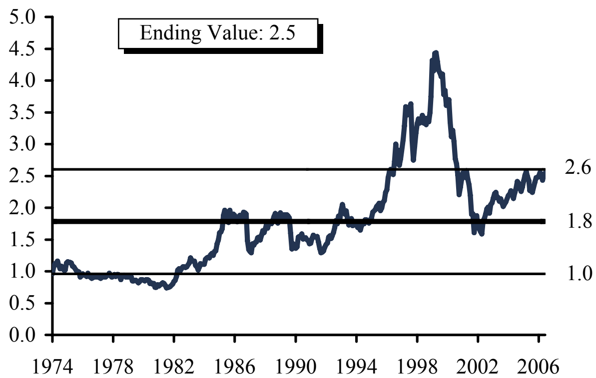
Price-Earnings



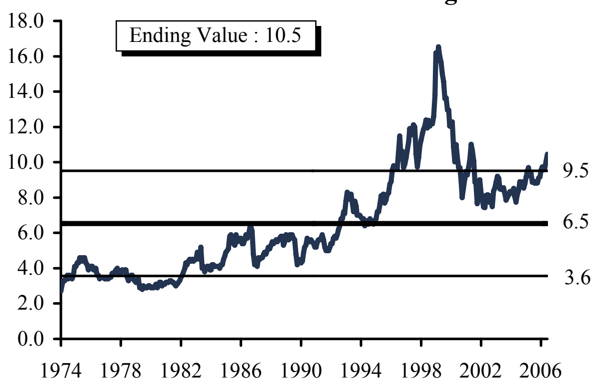
Dividend Yield (%)



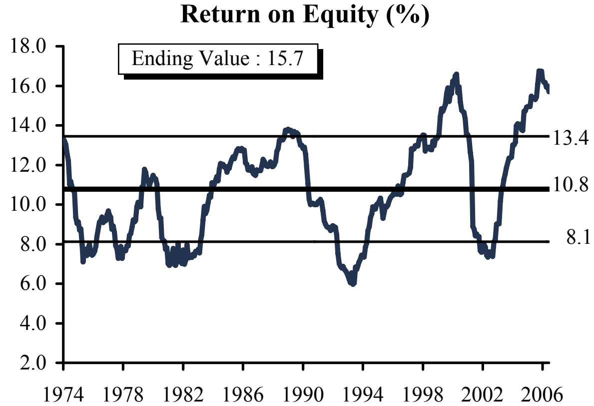
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



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

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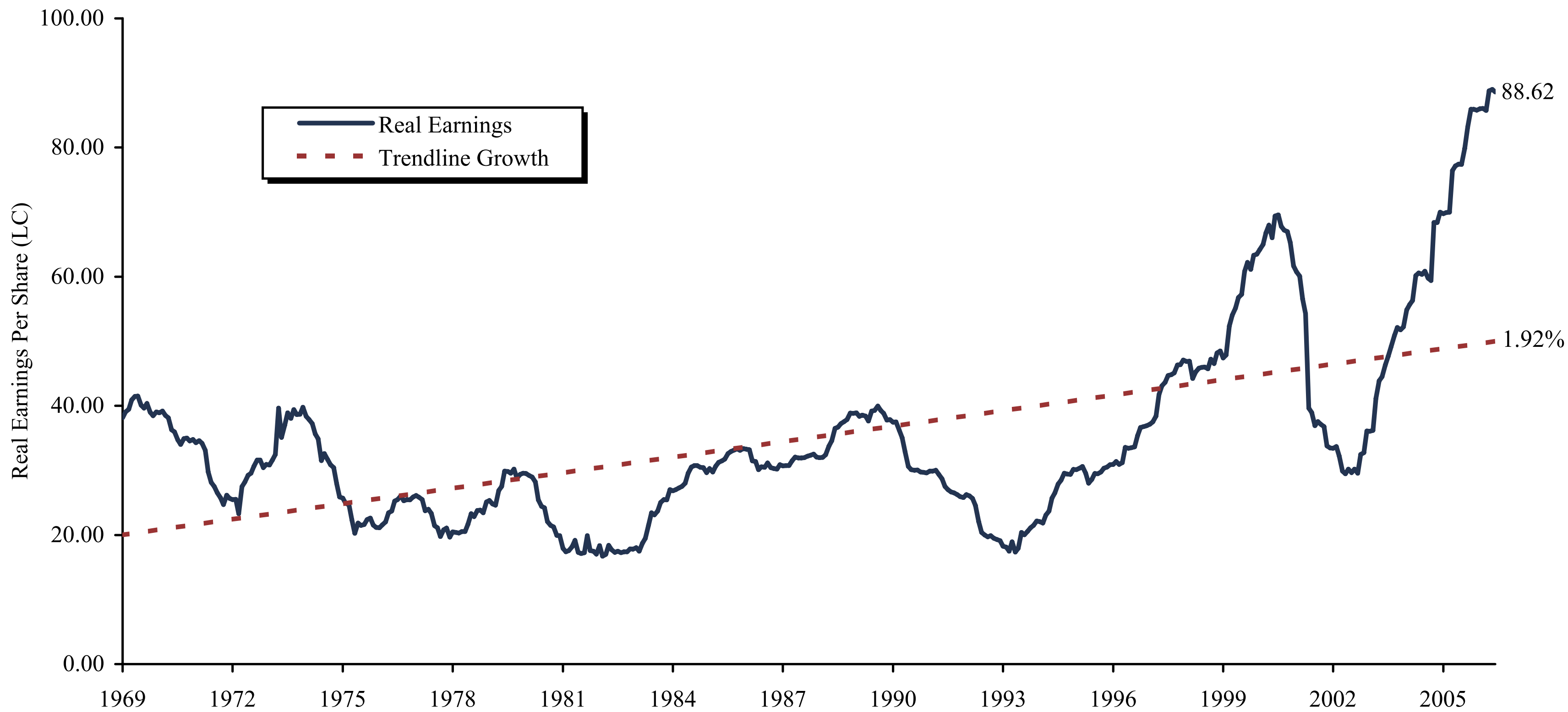
Table B

MSCI EUROPE EX U.K. REAL REPORTED EARNINGS

31 December 1969 - 31 May 2007



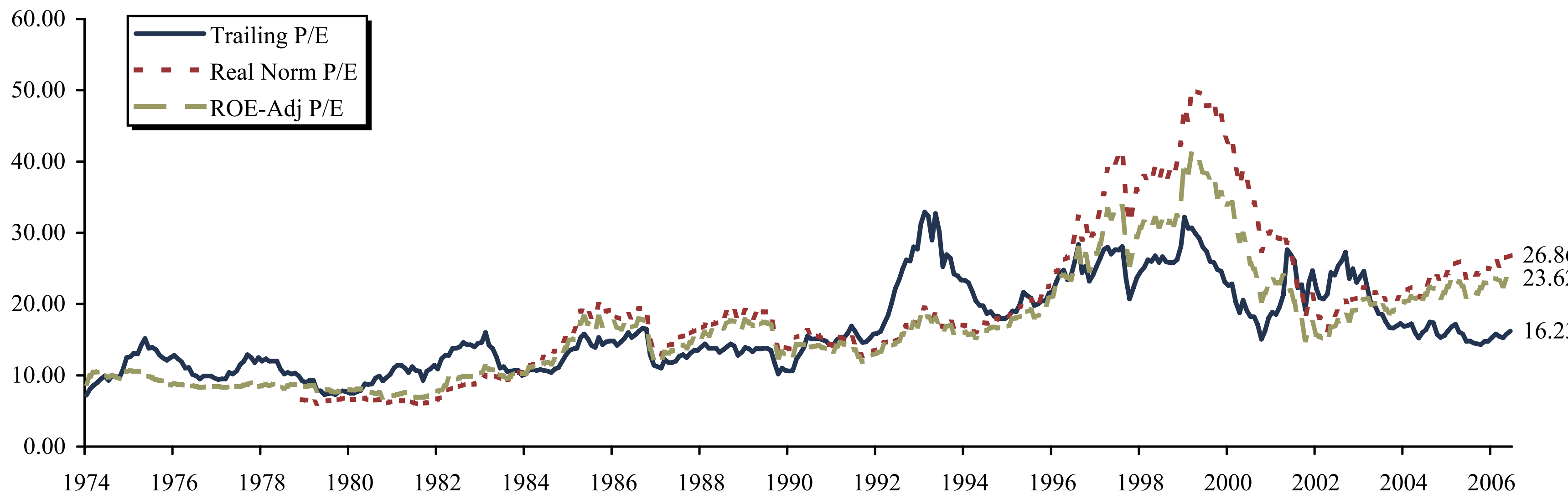
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Data are in local currency. Reported earnings include goodwill amortization. Real earnings are based on Eurozone CPI as of 31 May 2007. The average year-over-year real earnings growth rate of 4.9% is calculated arithmetically.

Table C

MSCI EUROPE EX U.K. PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

31 December 1974 - 31 May 2007



P/E Ratios - By Types of Earnings

	Trailing 12 Months Reported	Trailing 10 Years Real Normalized	ROE-Adjusted
May 31, 2007	16.23	26.86	23.62
Common Period Mean	17.43	19.86	17.86
Std Dev Above/Below Mean	-0.20	0.69	0.76

Sources: Global Financial Data, 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 May 31, 2007. 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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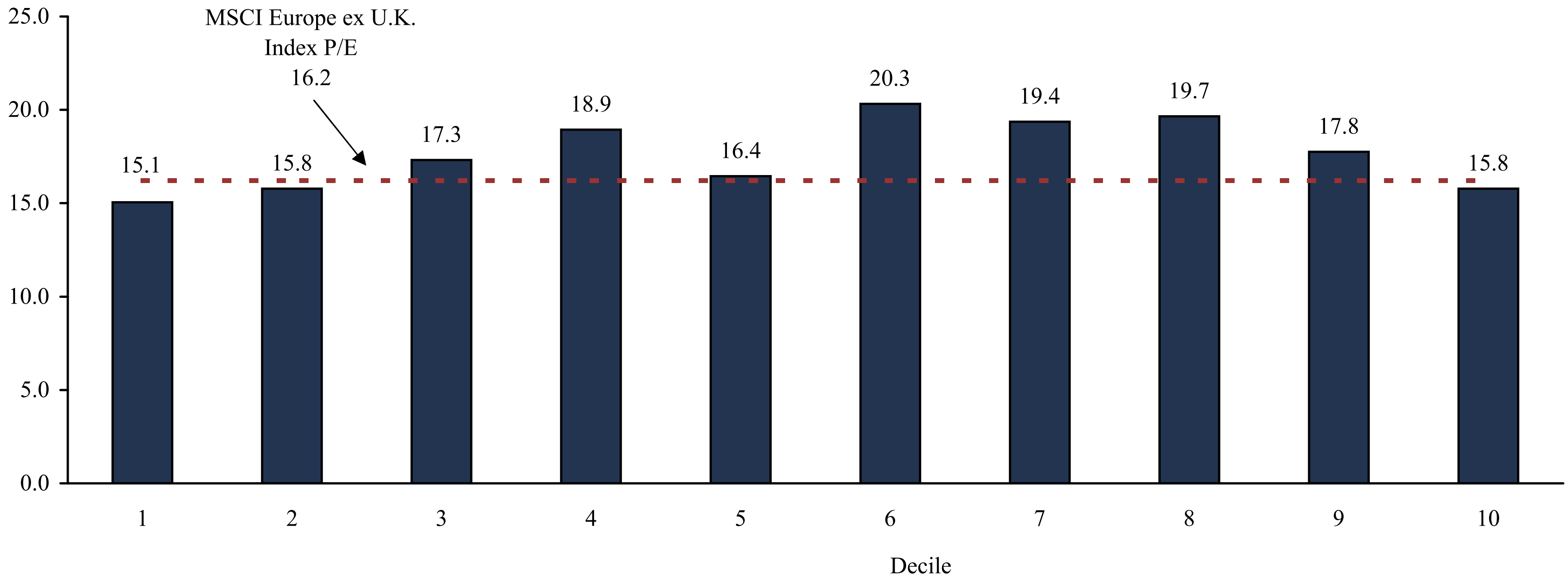
Table D

MSCI EUROPE EX U.K. PRICE-EARNINGS RATIO MARKET CAPITALIZATION DECILES

As of 31 May 2007



	Largest Companies									Smallest Companies
	1	2	3	4	5	6	7	8	9	10
Market Capitalization ($ millions)	2,446,914.0	883,487.8	489,999.9	306,619.9	214,653.3	149,914.9	114,469.2	85,290.3	61,804.4	34,388.6
Weighting (%)	51.1	18.5	10.2	6.4	4.5	3.1	2.4	1.8	1.3	0.7

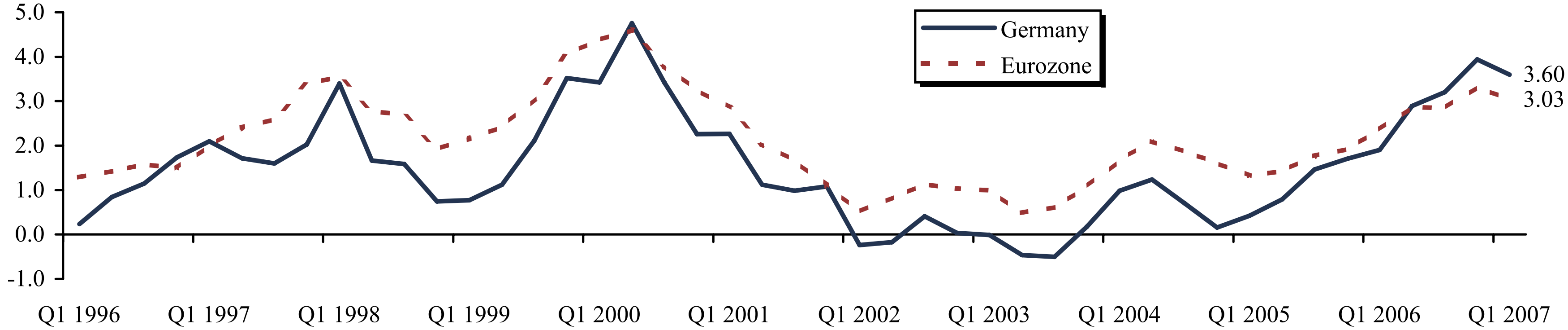
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

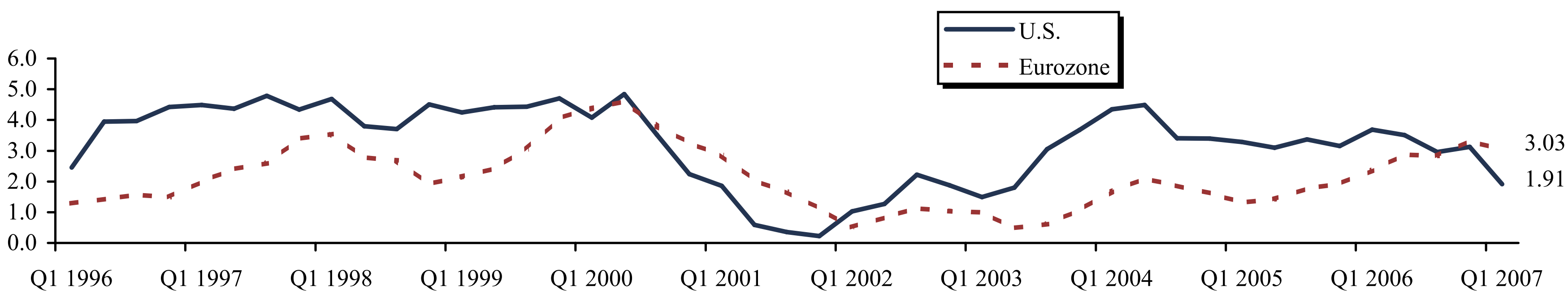
Notes: Market capitalization decile price-earnings (P/E) ratios based on harmonic averages. Data excludes companies with negative P/E ratios (14 companies) and outliers with P/E ratios greater than 100 (eight companies).

Table E

GROSS DOMESTIC PRODUCT GROWTH RATES

31 March 1996 - 31 March 2007





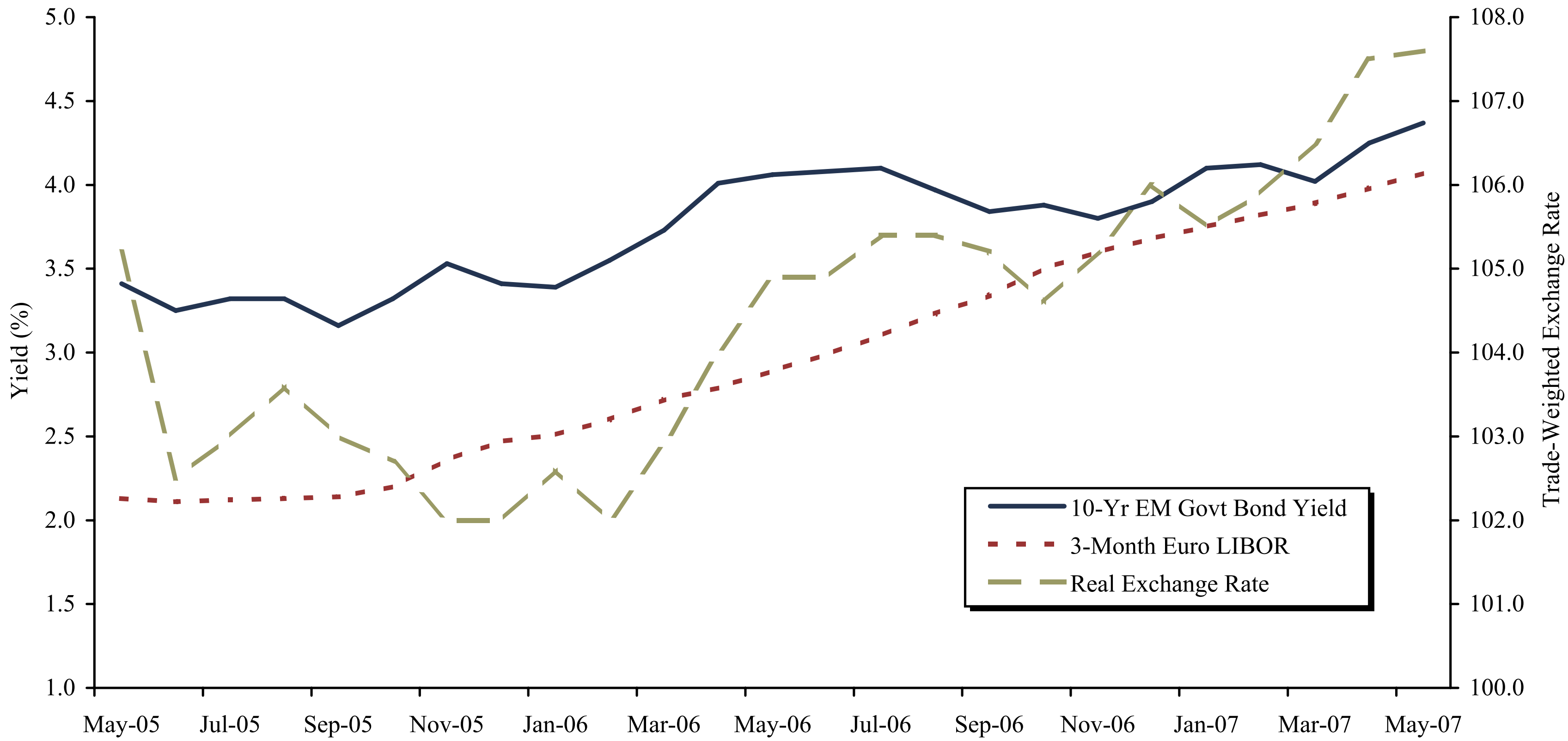
Source: Thomson Datastream.

Note: GDP growth rate calculated on a rolling four-quarter basis.

Table F

INTEREST AND EXCHANGE RATES

31 May 2005 - 31 May 2007



Source: Thomson Datastream.

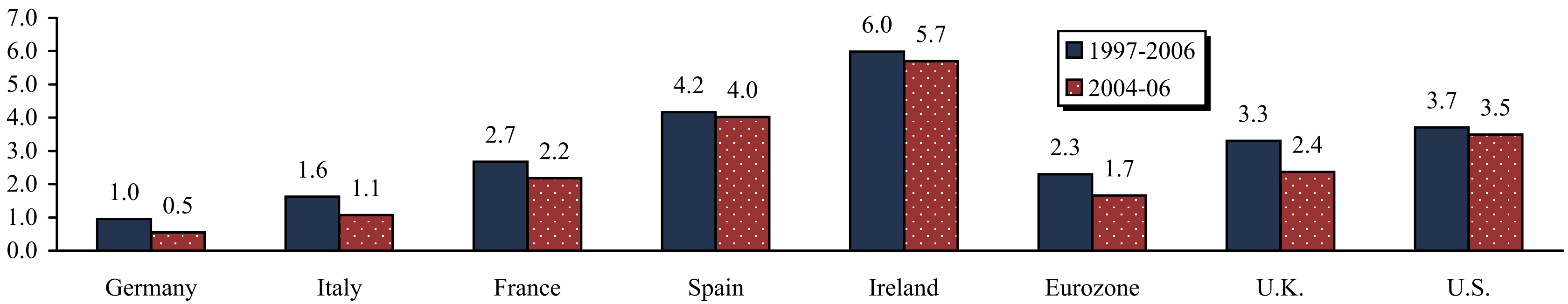
Note: The real exchange rate is the emerging markets effective narrow exchange rate discounted by the CPI.

Table G

HOUSING PRICE AND CONSUMPTION GROWTH

Cumulative Housing Price Appreciation
1 January 2000 - 31 December 2006

Average Annual Consumption Growth
1 January 1997 - 31 December 2006



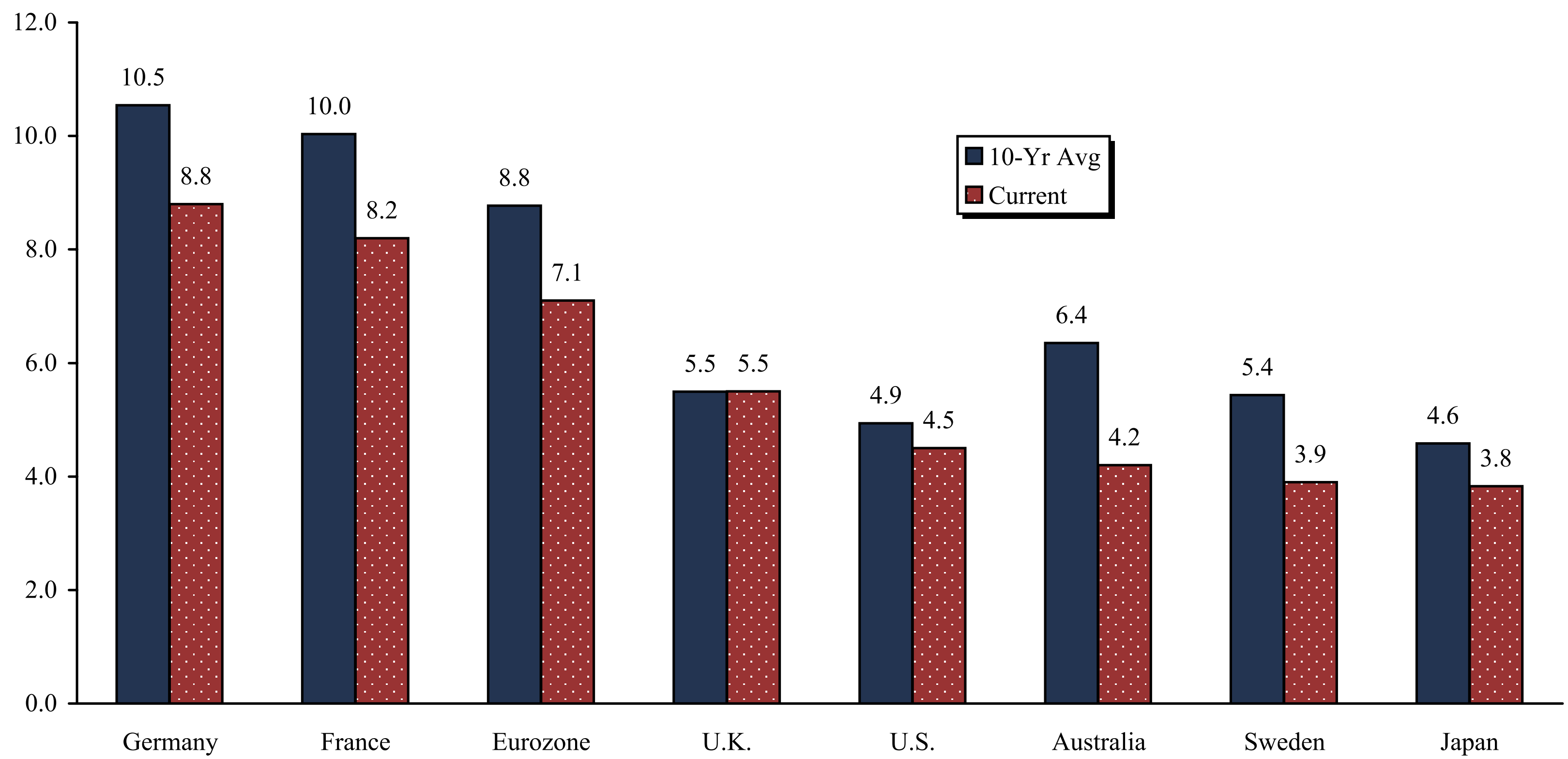
Sources: Thomson Datastream, J.P. Morgan, Nationwide, and S&P Case/Shiller.

Note: Ireland 1997-2006 average annual consumption begins 1 April 1997.

Table H

UNEMPLOYMENT RATES

As of 30 June 2007



Source: Thomson Datastream.

Notes: Average ten-year unemployment rates are based on figure from 31 January 1997 to 31 December 2006. Current unemployment rates are as of 31 March 2007 for the United Kingdom; 30 April 2007 for Eurozone, France, and Japan; 31 May 2007 for Australia, Sweden, and the United States; and 30 June 2007 for Germany.