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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENT

EUROPEAN EQUITIES SOAR, BUT REMAIN MODESTLY ATTRACTIVE

December 2005

Celia Dallas
Taekyung Han

European Equities Soar, but Remain Modestly Attractive

European equities soared full speed ahead through 2005, with the FTSE All-Share returning 22.0% and the MSCI Europe ex U.K. Index, 27.7%. Since March 2003, when these markets reached their most recent low, they have returned a cumulative 79.3% and 98.1%, respectively, despite significant economic and political challenges. However, earnings have more than kept pace, keeping valuations reasonable.

The United Kingdom

The U.K. market faced significant headwinds in 2005. Real GDP growth sank from 3.1% in 2004 to an estimated 1.7% in 2005, as manufacturing output contracted, export growth fell, and consumer spending slowed in the wake of a softening housing market and rising oil prices. The Bank of England eased in August for the first time in two years, cutting policy interest rates by 25 basis points (bps). Looking forward, the consensus believes that the U.K. economy has made a soft landing and that GDP growth will be 2.1% in 2006. Futures markets are pricing in another 25 bps of easing in early 2006.

However, the U.K. equity market fared well in this environment and particularly benefited from rising energy prices. Resources, which make up 22.2% of the FTSE All-Share's capitalization, returned 37.0%, accounting for 6 percentage points, or just over 25%, of the index's return. Financials, which now represent 27.4% of the index's capitalization, returned 17.2%, to make up just over 20% of the market's return (5.0%). While resources and financials were responsible for almost half of the FTSE All-Share return, performance was broad based, with every economic group earning positive returns ranging from 3.3% for non-cyclical services to 46.7% for general industrials (Table A).

Resources also dominated earnings growth, with the consensus estimating U.K. earnings grew 11% in 2005, nearly two-thirds of which (7 percentage points) was from oil and mining stocks. Looking forward, earnings expectations for 2006 are 8.5%, which is slightly below the average annual growth experience since 1963, but well above the inflation-adjusted average of 2.4% (Table B). However, real earnings have been equal to or above 5.5% (current earnings expectations expressed in real terms, assuming 3% inflation priced into long-dated gilts) 41.9% of the time since our earnings data begins in 1963. This implies earnings growth assumptions are somewhat aggressive, but not terribly so. We generally would expect earnings growth to be below historical averages following a period of such rapid growth, but given the concentration of the index in resources and financials, future earnings growth is largely contingent upon the conditions of those economic groups.

Overall, we continue to be somewhat sanguine about U.K. equities, as the market is fairly valued based on price-earnings (P/E) and price-to-cash earnings ratios, offers better value than Europe ex U.K. and U.S. equity markets, and offers an attractive dividend yield (DY) of about 3.0% (Tables C and D). Morgan Stanley estimates that the DY is over 4% if adjusted to include buybacks. In addition, prospects for future dividend growth are strong, as dividends grew 7.5% in 2004 and 14.2% in 2005, compared to a post-1924 average annual growth rate of 5.7%. The reasonable valuations limit the downside risk, while the relatively strong dividend prospects compensate for some of the uncertainty in earnings growth.

Europe ex U.K.

European markets experienced a similar stark juxtaposition of a stagnant economy and soaring equity markets, with real GDP growth for the EMU an estimated 1.4% for the year, while equities returned 25.4%, as represented by the MSCI EMU Index. Economic growth picked up in July, largely due to improved export growth as the euro weakened relative to the US$. The pickup in growth was strong enough to spur the European Central Bank to raise policy rates by 25 bps in early December; the first such increase in five years. Futures markets are pricing in an additional 50 bps of hikes in the first half of 2006. We would also expect fiscal stimulus to remain somewhat constrained since the largest countries in Europe remain in violation of the Growth and Stability Pact's deficit limits and Germany's new Chancellor, Angela Merkel, seems committed to raising VAT and cutting the budget deficit. Consensus GDP growth estimates for 2006 are for improved, but slow growth expectations of 1.8%

However, equity performance was far stronger, as earnings expansion has been fueled by corporate restructuring, as well as improved labor market flexibility and access to Eastern Europe's less expensive labor pool. Equity performance was broad based, with every economic group in the MSCI Europe ex U.K. Index posting returns greater than 20%, save telecommunication services. Financials, which account for nearly one-third of the index, were responsible for roughly the same percentage of the index return after clocking up a 32.3% return for the year. While the market is heavily concentrated in finance, the remaining 70% of the index is well diversified across sectors which range in capitalization weights from 5.9% for information technology to 9.8% for consumer discretionary (Table E).

While capital appreciation was strong, earnings growth was even more significant, as the earnings of the MSCI Europe ex U.K. Index expanded 29.9% in 2005, and have grown a cumulative 149.9% since their low at the end of April 2003. The consensus now expects earnings growth to cool to 9.9% in 2006. From an historical perspective, this growth rate is quite ambitious since earnings have grown at an average rate of 9.4% in nominal terms and 3.5% in real terms since 1970 (Table F). Earnings growth has been equal to or less than 7.9% in real terms (9.9% expectations less roughly 2.0% inflation expectations priced into European bond markets) only 44.4% of the time. However, the landscape in Europe appears to be changing, ever so gradually, with improvements in business conditions enhancing corporations' ability to compete. A sustained period of above average earnings growth would not be unusual under these conditions. In addition, we are not terribly concerned about the impact of rising policy rates and the potential for continued flattening of the yield curve on the outlook for financial shares. As the *Bank Credit Analyst* points out, financial stocks can still benefit in this environment given the brisk pace of private credit growth, which increased at a 10% annual rate in late 2005.

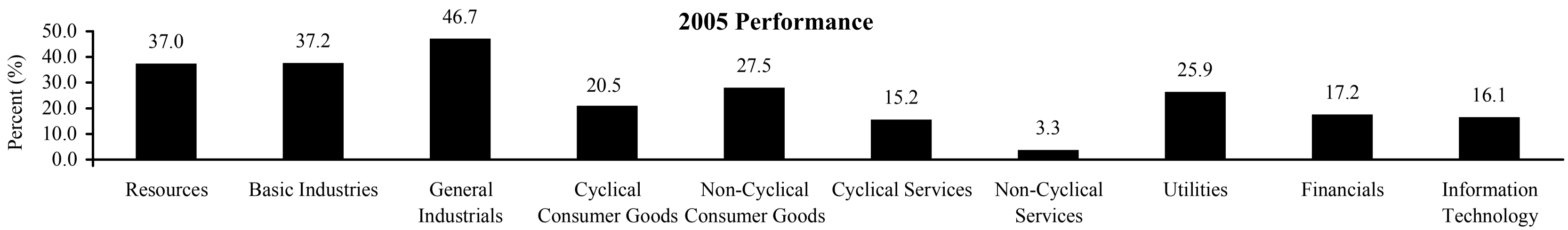
While there is certainly a risk that earnings will disappoint in 2006, longer term, we believe that Europe ex U.K. equities have significant upside potential given the degree to which corporations can still benefit from improving labor flexibility, restructuring, and deepening and broadening capital markets. Progress has historically been slow and periodically faces setbacks, but this is to be expected when any region undergoes significant reform. Further, downside risk is somewhat limited by reasonable valuations, as equities appear roughly fairly valued based on P/E ratios, are comparably priced relative to most other developed markets, and are less expensive than U.S. equities (Tables G and H). As a result, we continue to regard European markets as modestly attractive.

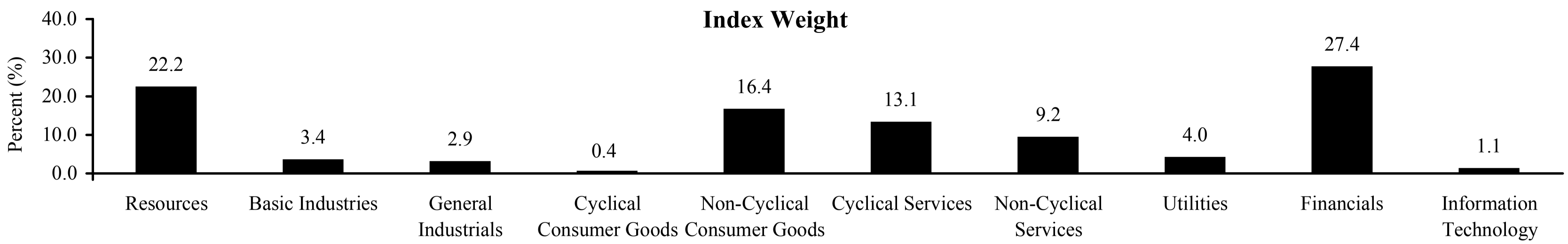
Table A

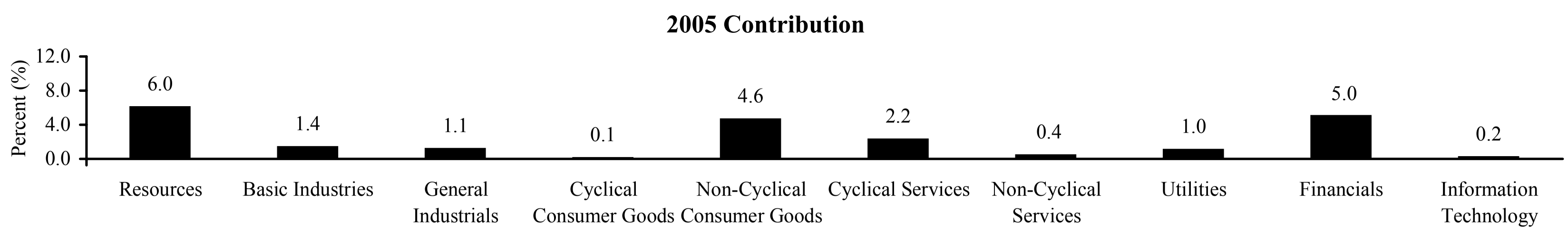
FTSE ALL-SHARE ECONOMIC GROUP WEIGHTS AND CONTRIBUTION

As of 31 December 2005

Sterling (£)







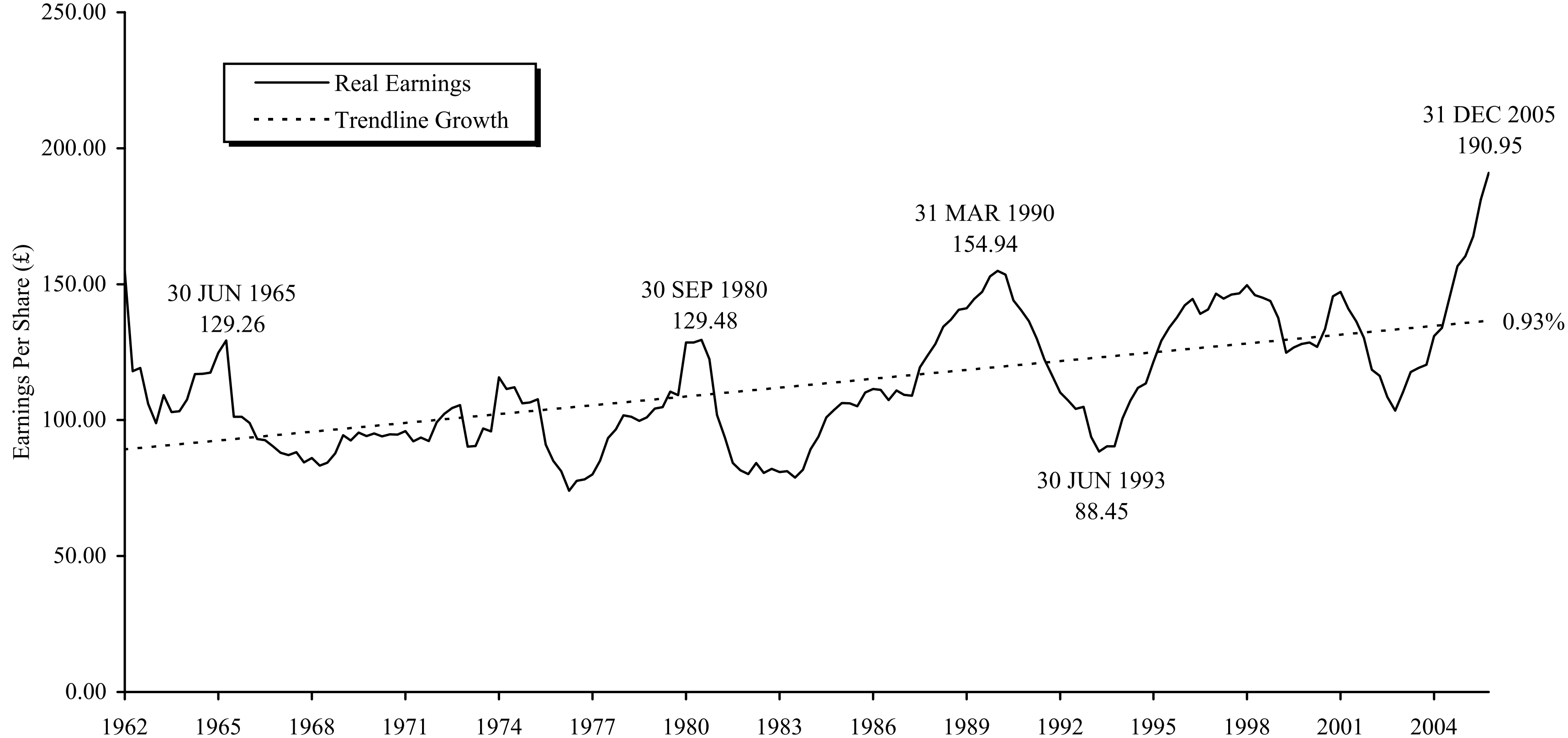
Source: FTSE International Limited.

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

Table B

FTSE ALL-SHARE REAL REPORTED EARNINGS

1 January 1962 - 31 December 2005



Sources: FTSE International Limited and Thomson Datastream.

Notes: Real earnings are calculated on a third quarter 2005 sterling basis. The average year-over-year real earnings growth rate of 1.9% 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.

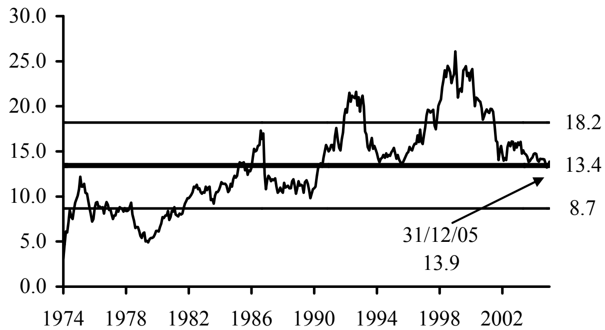
Table C

U.K. EQUITY MARKET VALUATIONS

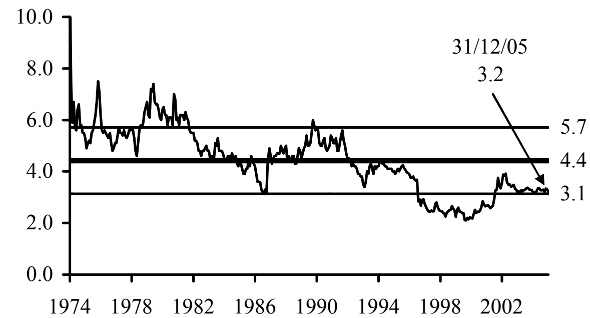
MSCI United Kingdom

31 December 1974 - 31 December 2005

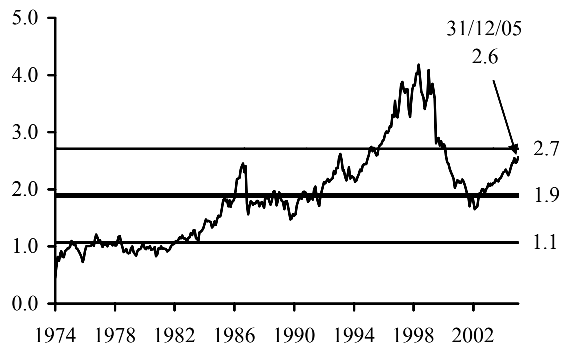
Price-Earnings



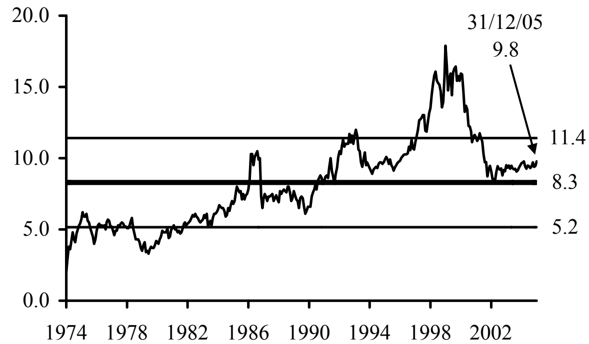
Dividend Yield (%)



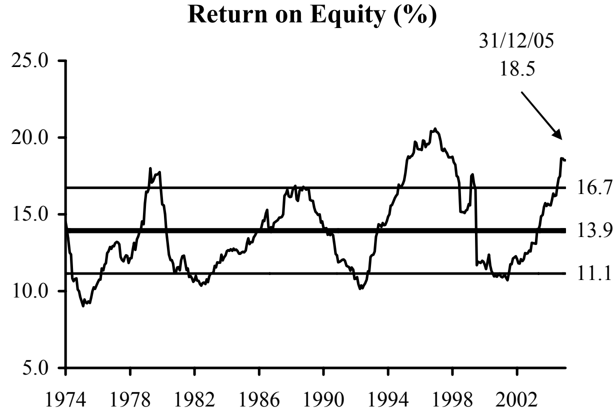
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



Mean
One Standard Deviation

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

Notes: Return on equity is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.
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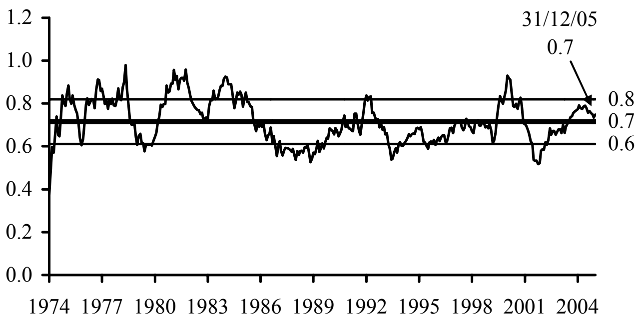
Table D

RELATIVE U.K. EQUITY MARKET VALUATIONS

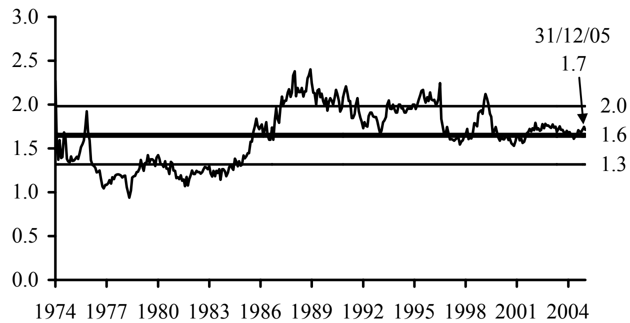
MSCI United Kingdom relative to MSCI World ex U.K.

31 December 1974 - 31 December 2005

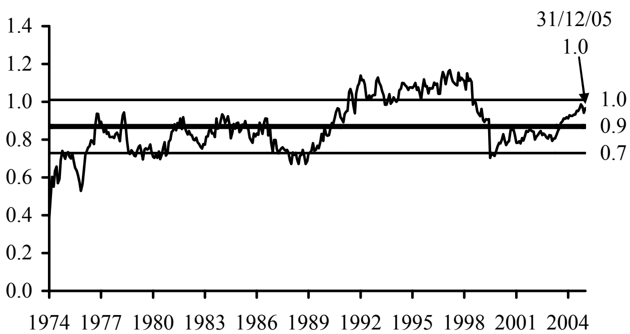
Price-Earnings



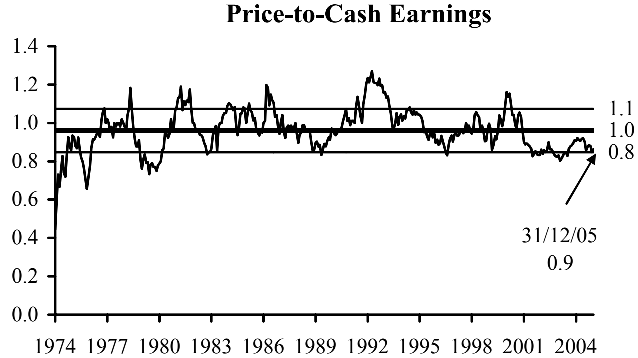
Dividend Yield (%)



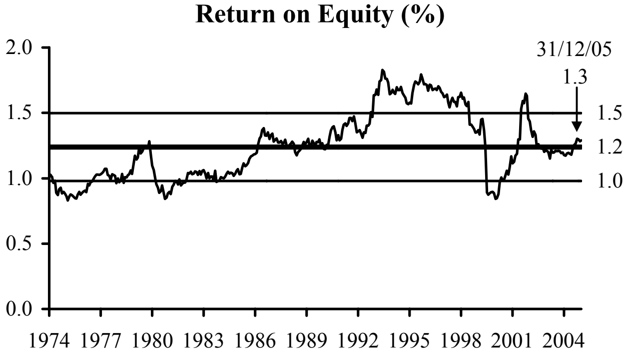
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



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

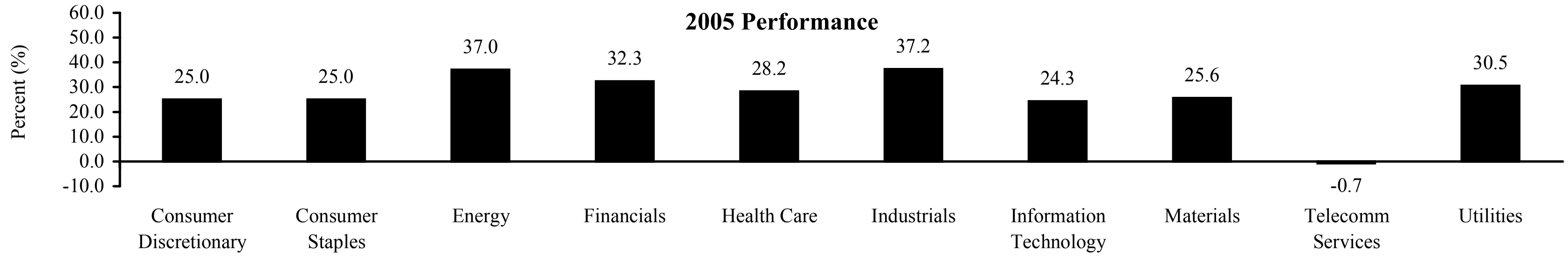
Notes: Return on equity is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.

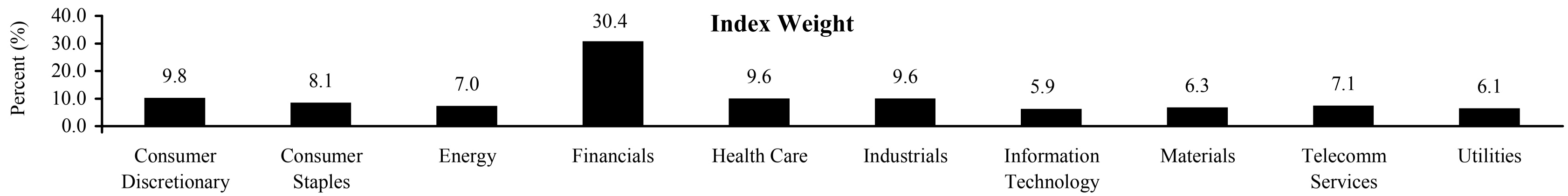
Table E

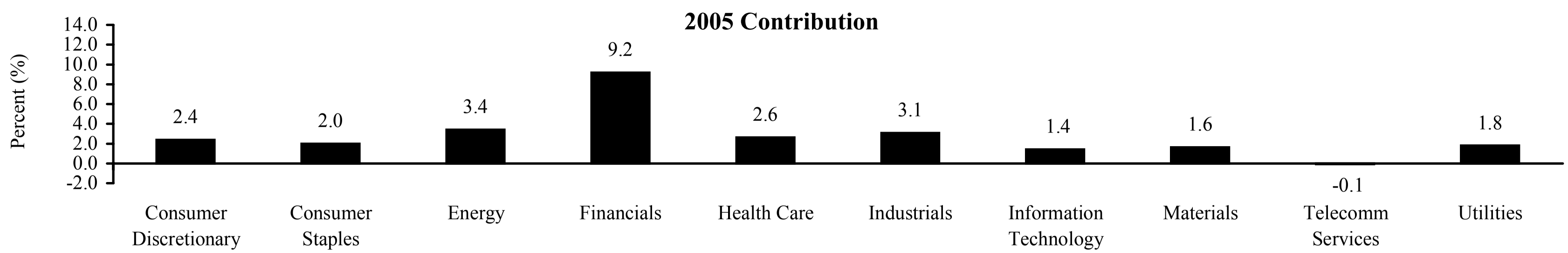
MSCI EUROPE EX U.K. ECONOMIC GROUP WEIGHTS AND CONTRIBUTION

As of 31 December 2005

Local Currency







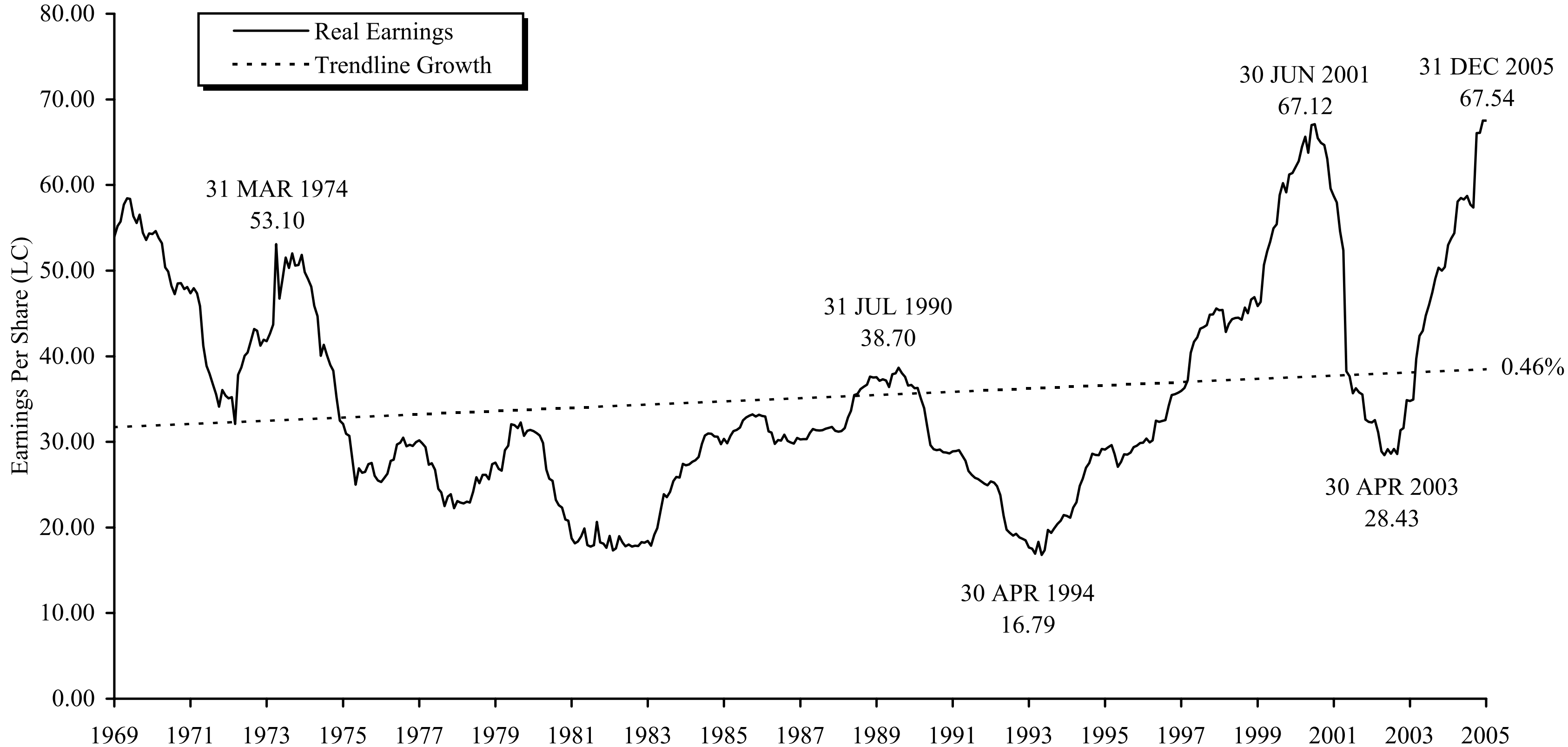
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

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

Table F

MSCI EUROPE EX U.K. REAL REPORTED EARNINGS

31 December 1969 - 31 December 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 based as of 30 November 2005 on an euro basis. The average year-over-year real earnings growth rate of 3.1% 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 (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.

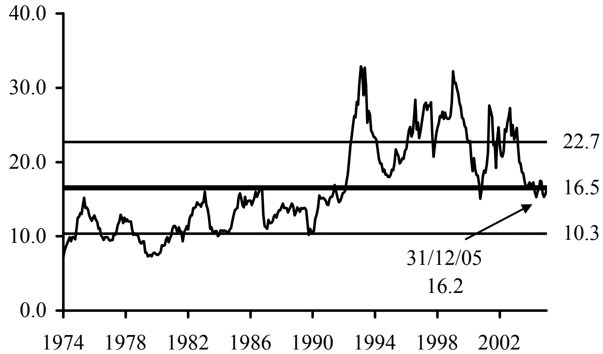
Table G

EUROPE EX U.K. EQUITY MARKET VALUATIONS

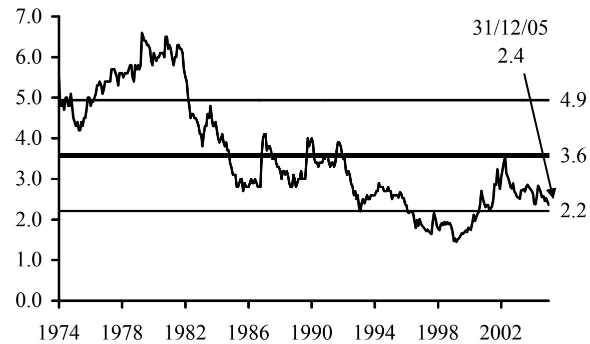
MSCI Europe ex U.K

31 December 1974 - 31 December 2005

Price-Earnings

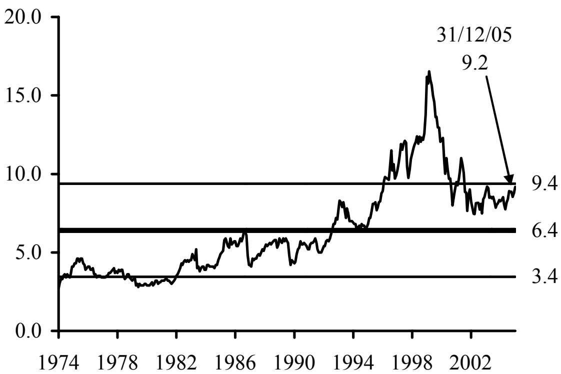


Dividend Yield (%)

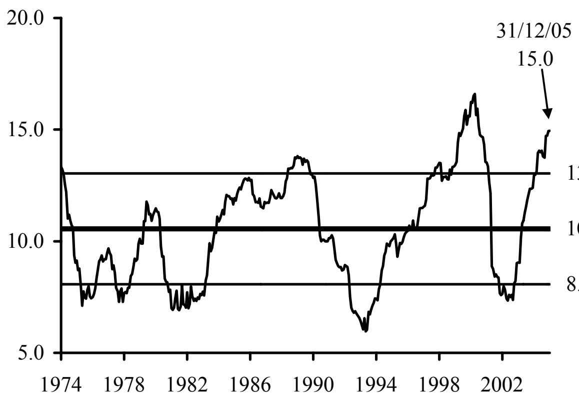


Price-to-Book Value

Price-to-Cash Earnings



Return on Equity (%)



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

Notes: Return on equity is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.

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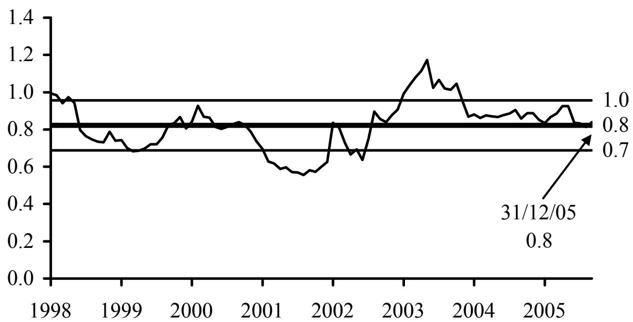
Table H

RELATIVE EUROPE EX U.K. EQUITY MARKET VALUATIONS

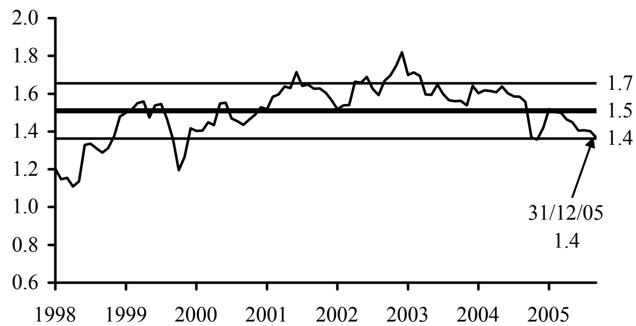
MSCI Europe ex U.K. relative to MSCI World ex Europe

30 April 1998 - 31 December 2005

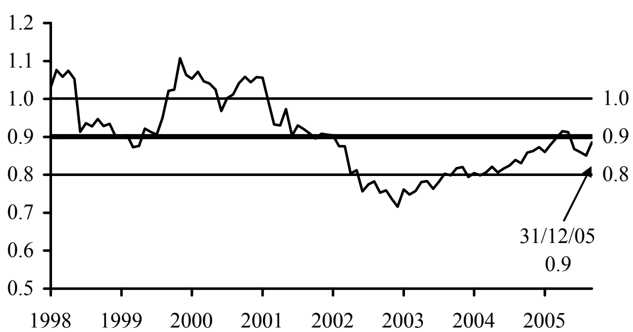
Price-Earnings



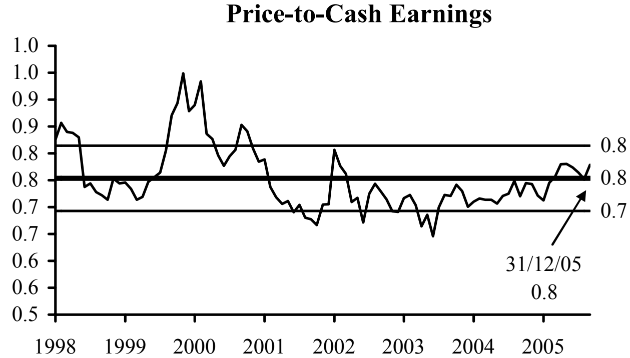
Dividend Yield (%)



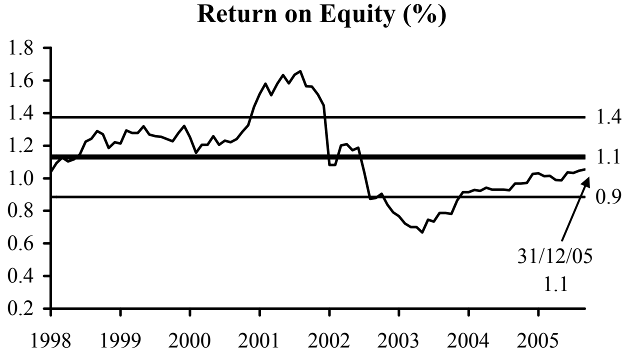
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



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