C | A

CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

EUROPEAN EQUITY LEADERSHIP STILL CONCENTRATED

September 2006

Aaron Costello
Taekyung Han

European Equity Leadership Still Concentrated

Up until very recently Eurozone economic performance has been sluggish at best, yet subpar economic growth has not been a hindrance to European equities. Since bottoming in March 2003, bourses on the Continent have roared back to life, with the MSCI Europe ex U.K. Index returning 110.2%, vastly outperforming the MSCI U.S.A. (62.5%), MSCI U.K. (82.7%), MSCI Japan (109.0%), and the MSCI World (80.2%) indices over the same period.[1]

This disconnect between the corporate sector and the broader economy partly reflects that while policymakers have balked at making painful reforms, the corporate sector has undergone a broad restructuring, slashing costs by outsourcing new production to emerging Europe and successfully negotiating lower wages and longer hours form workers at home. In fact, the deep corporate restructuring may be partly responsible for the anemic economic growth; nervousness over the future of employment and wage growth has crushed consumer demand. Nevertheless, weak domestic conditions in Europe have coincided with an environment of abundant global liquidity and low interest rates, allowing corporate Europe to pay down debts and enjoy a low cost of capital, helping to fuel merger and acquisition (M&A) activity across the region. A booming global economy outside of Europe has also provided support to corporate earnings both via exports and robust financial market activity. Partly as a result, since March 2003, earnings per share have surged ahead, growing 198%, while profitability has more than doubled, with return on equity (ROE) rising from 7% to 16%, far above its long-term average of 11%.

Given the ominous clouds forming on the horizon regarding the outlook for global growth, now seems an appropriate time to look at whether the European equity rally will continue to be resilient. We review the drivers of equity performance over the last several years to address this critical question.

A Rally Without Borders

Looking across the region we see that performance over the three-year rally has been broad-based with 13 of the 15 constituent countries posting returns in excess of 100%, and with the top three performing markets producing returns in excess of 200% (Table A). While the region (as measured by the MSCI Index) covers roughly 450 companies, on par with the large U.S., U.K., and Japanese benchmarks, individual country markets can be highly concentrated, with market performance likely reflecting a strong sector bias. For example, of the top four performing markets, Norway's energy sector makes up 58% of the market, while financials account for the majority of the Greek (54%), Austrian (44%), and Belgian (64%) markets. Even in Switzerland, currently Europe's second largest market, financial and health care stocks account for 65% of the market. Notable exceptions are France, Germany,

[1] Cumulative returns from March 1, 2003 to August 31, 2006. All returns are net total returns in local currency terms, unless otherwise noted.

and Sweden, whose compositions are more evenly spread across sectors.[2] Given the heavy concentrations apparent in individual markets and the diminished impact of returns from smaller markets, sector performance seems more of a driver of overall returns than geography. In other words, it is not really "where" you invest in Europe, but in "what." For example, the contribution to overall returns from the financial and health care sectors outweighs the contribution from France and Germany combined.

Know What You Own

Despite strong returns across individual markets and sectors, the boom in continental equities has been increasingly dependent upon the financial sector. The financial sector has seen its share of total earnings increase from 33.6% in March 2003 to 37.3% in August 2006. Financials have been even more important in driving earnings *growth*, accounting for nearly 39% of aggregate earnings growth over this period and 44.3% year-to-date (Tables C and D).

The increasing share of total earnings and earnings growth has translated into strong performance. Financials have returned a cumulative 159.9% since March 2003 and seen their share of European market capitalization grow from 23.8% in March 2003 to 32.0% in August 2006, their largest market weight since our sector data began in December 1994. As a result, financials have been the largest contributor to continental equity returns, accounting for one-third of total market performance since March 2003 (Table B). Outside of financials, sector weightings are more evenly distributed across the market, ranging from 10.1% for industrials to 5.3% for information technology, with similar contributions to market return.

Yet with financials now accounting for the lion's share of market earnings, earnings growth, and incremental return, it is increasingly important to assess the risks facing the sector. As we have discussed recently, the outlook for earnings growth in Europe is reasonably positive given the recent acceleration in Eurozone economic growth, although substantial headwinds are forming on the horizon, which may pose a threat to what appear to be cyclically stretched earnings and valuations.[3]

Can the Good Times Last?

Over the past three years financials have benefited from a benign credit environment, strong recovery in global equity markets, roaring M&A activity, and increased corporate confidence and activity. Yet there are signs all these tailwinds are waning. The European Central Bank (ECB) has become increasingly hawkish, concerned about what it views as excessive credit growth and froth in certain

[2] Based on the MSCI equity universe, which is a fair representation of the free-float-adjusted opportunity set available to foreign investors. The MSCI indices, however, focus on large- and mid-cap shares, and therefore should not be construed to represent the total equity market capitalization of any country.
[3] Please see our March and April 2006 European Market Commentaries, *European Equities Getting Pricey* and *Are Earnings Poised to Disappoint?*

property markets. After keeping policy rates on hold since 2002, the ECB has increased rates by 100 basis points (bps) over the past few quarters to 3.00%. The markets are now beginning to discount a climb in policy rates to 3.75% by year's end. Meanwhile, both the IFO and ZEW surveys of business expectations have turned down recently, indicating concern over the direction of future growth, a sentiment reflected by falling long-term bond yields. This has resulted in a flat yield curve in Europe, with only a 52-bp spread between three-month paper and ten-year German bunds. An inverted yield curve would certainly be a negative development for financial earnings, as would slowing loan and credit growth due to tightened liquidity.

Rising interest rates also pose a threat to the rapacious M&A activity taking place across Europe, which has been fueled in part by abundant credit and a low cost of capital, in addition to genuine cross-border consolidation opportunities. According to Thomson Financial, announced European M&A volume reached $905.9 billion in the first half of 2006, almost double the volume of deals over the same period in 2005. Not only have financials benefited from the advisory fee bonanza generated by this flurry of activity, but the sector has been an active participant, accounting for $144.5 billion of the announced volume. After such a blistering first half we have already seen some slowing of deal flow. A cause for concern is the growing average premium paid on deals, which has risen from the low double digits in 2005 to closer to 20% as of late, according to Bloomberg. So far the markets have been sanguine in respect to this, viewing most large public deals as strategic in nature and financed with cash instead of equity or excessive leverage. The same cannot be said of activity by European buyout and private equity funds, which have been taking full advantage of tight spreads on high-yield bonds and other low cost sources of structured funding to lever-up and pursue transactions. Continued rises in borrowing costs and a widening of credit spreads could negatively impact the M&A cycle and the banks that have helped fund it so far.

As the second quarter results for Deutsche Bank revealed, financials remain exposed to any downturn in global financial markets, as propriety trading has been a substantial source of revenue for large banks, as have prime dealer- and other hedge fund-related services. The market sell-off in May resulted in losses by Deutsche's equity prop-desk of nearly €100 million. Rising volatility may see other investment banks wrong-footed by the markets. Further upheaval in financial markets or a sustained rise in risk aversion could see profits generated from equity and fixed income underwriting and other related business dry up as well.

Conclusion

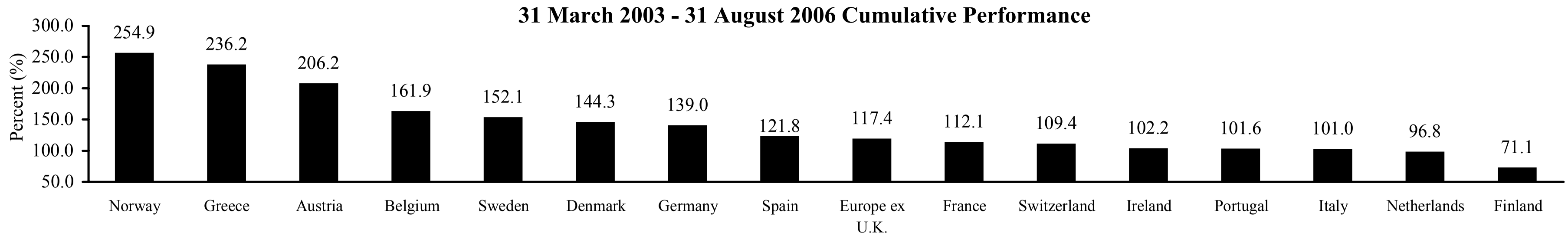
While earnings growth and ROE are clearly hovering near peak levels and destined to revert toward the "mean," it remains unclear exactly to what "mean" European profitability will return to. Some of the rise in ROE is clearly structural, as corporate Europe has begun to restructure and consolidate. Yet we would feel more comfortable toward European markets if returns and earnings growth were to broaden away from the financial sector. While fundamentals are not horrible for financials, clearly some of the recent surge in earnings will prove ephemeral, and it remains to be seen whether other sectors can support the market if financials flounder. While European consumers may be well positioned to weather any downshift in economic growth, much of the growth in European exports is tied to emerging markets, which are substantially more geared to the global, as well as U.S. economic cycle. Until it is clear that earnings strength and returns will broaden to other sectors and/or cyclically adjusted valuation metrics improve substantially, we will maintain our cautious outlook toward continental equities.

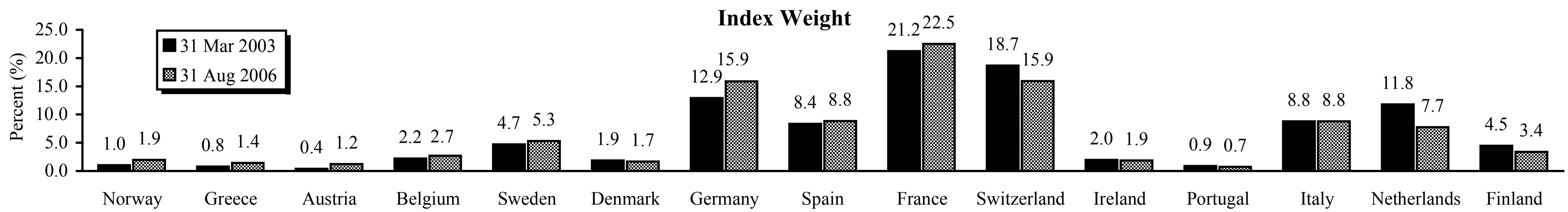
Table A

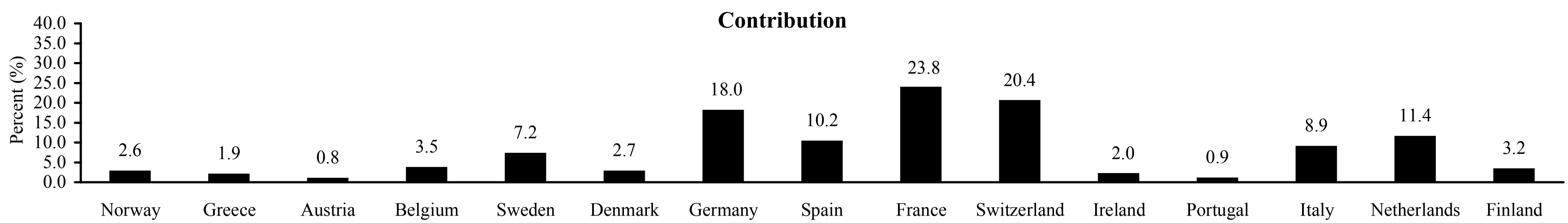
MSCI EUROPE EX U.K. COUNTRY WEIGHTS AND CONTRIBUTION

As of 31 August 2006

Local Currency







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

Notes: Percentages may not total due to rounding. Contribution refers to actual percentage points each country contributed to the composite's total return.

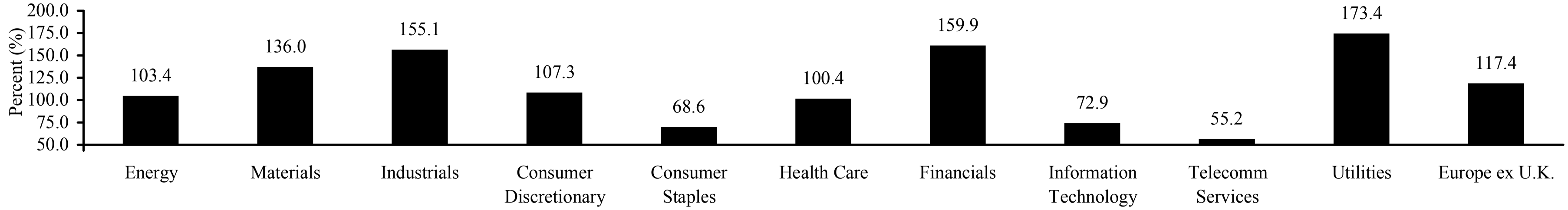
Table B

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

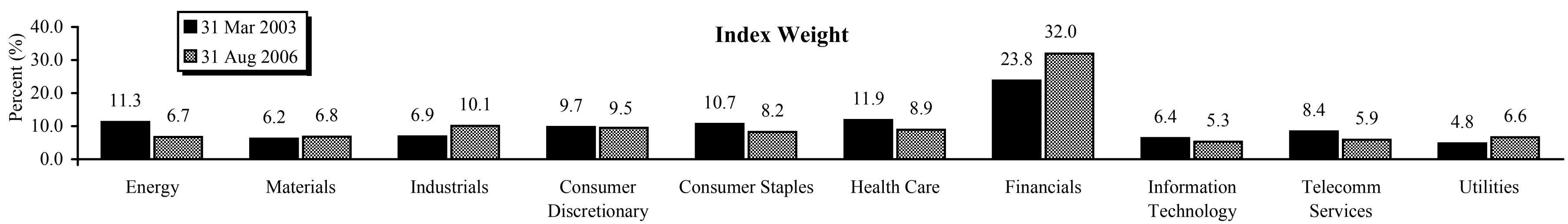
As of 31 August 2006

Local Currency

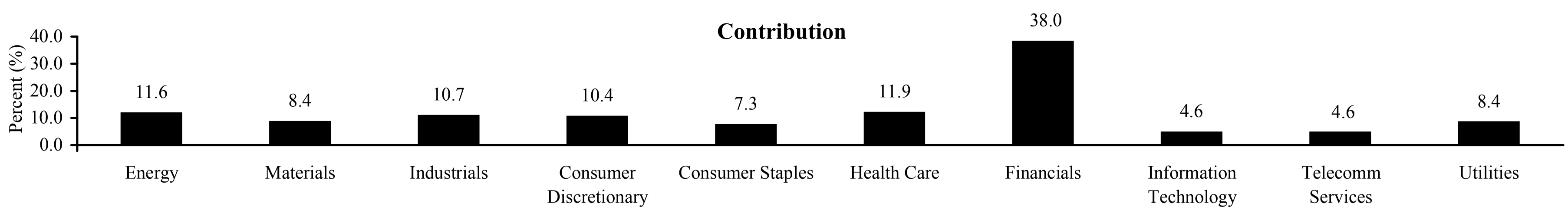
31 March 2003 - 31 August 2006 Cumulative Performance



Index Weight



Contribution



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

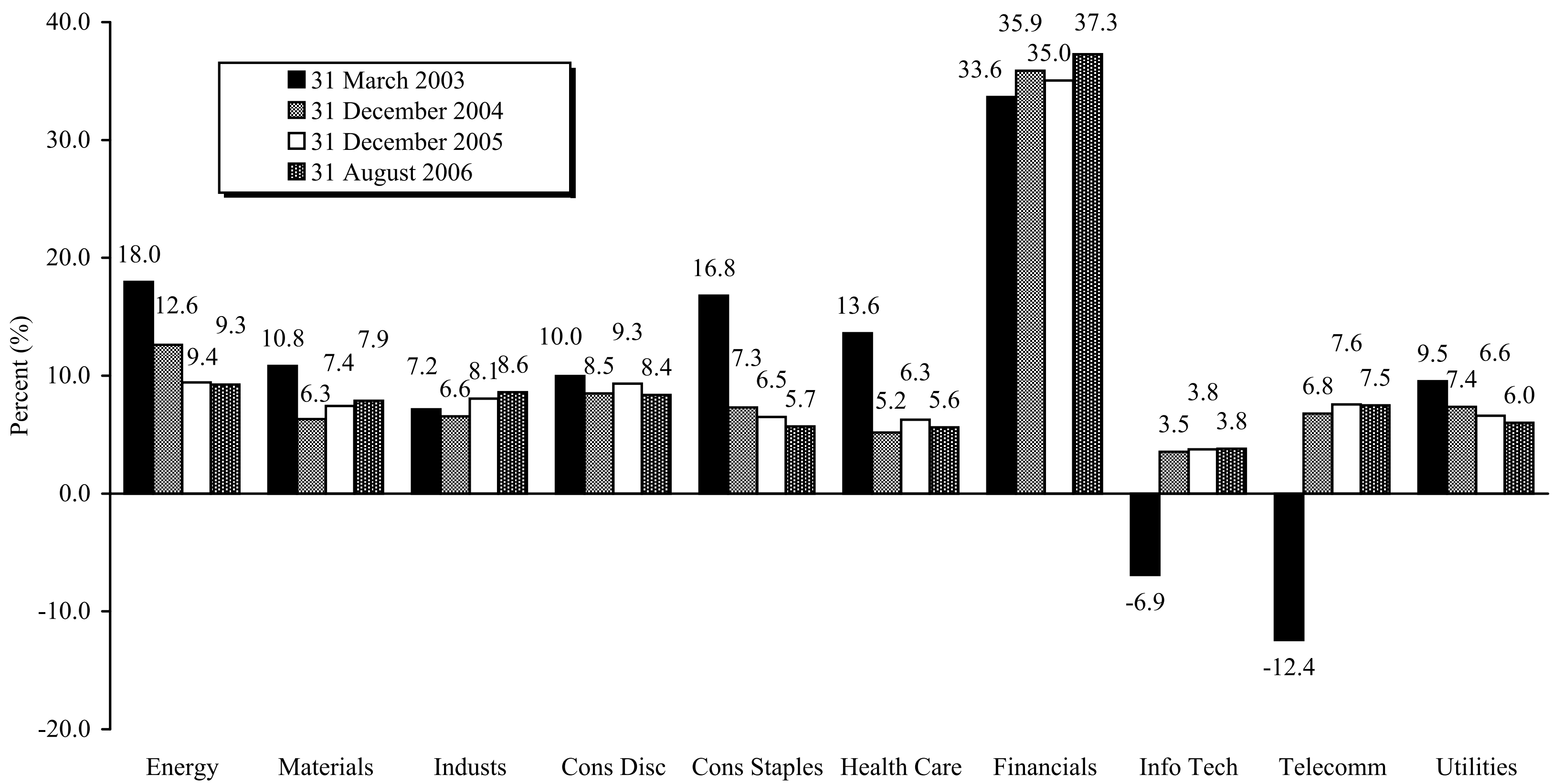
Notes: Percentages may not total due to rounding. Contribution refers to actual percentage points each sector contributed to the composite's total return.

Table C

SHARE OF AGGREGATE EARNINGS

MSCI Europe ex U.K. Index

31 March 2003 - 31 August 2006



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

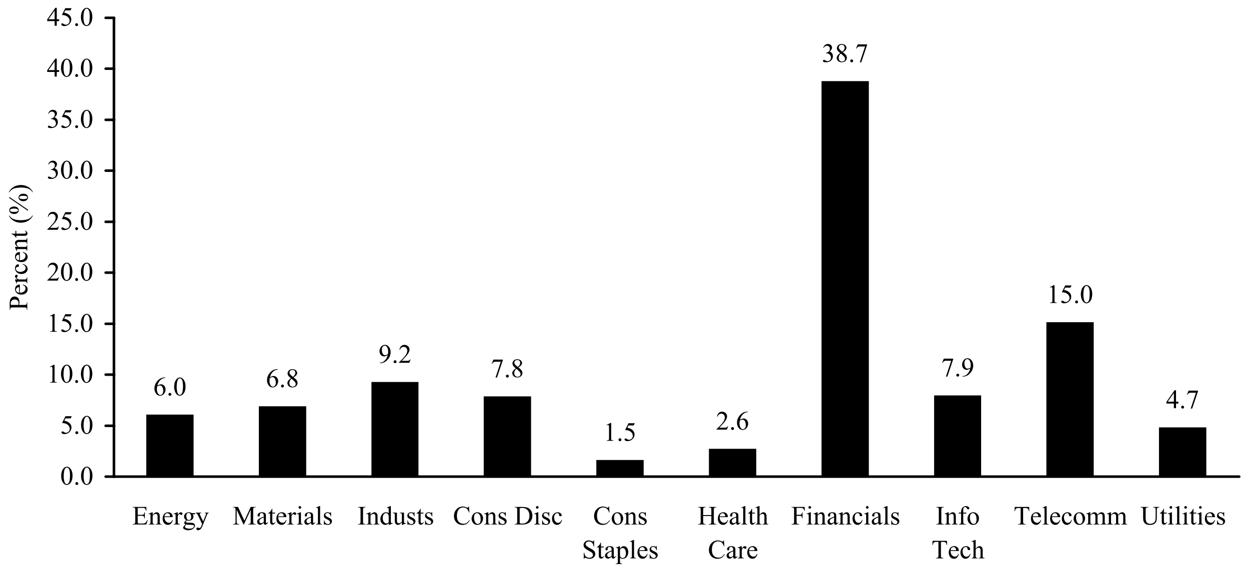
Table D

SHARE OF AGGREGATE EARNINGS GROWTH

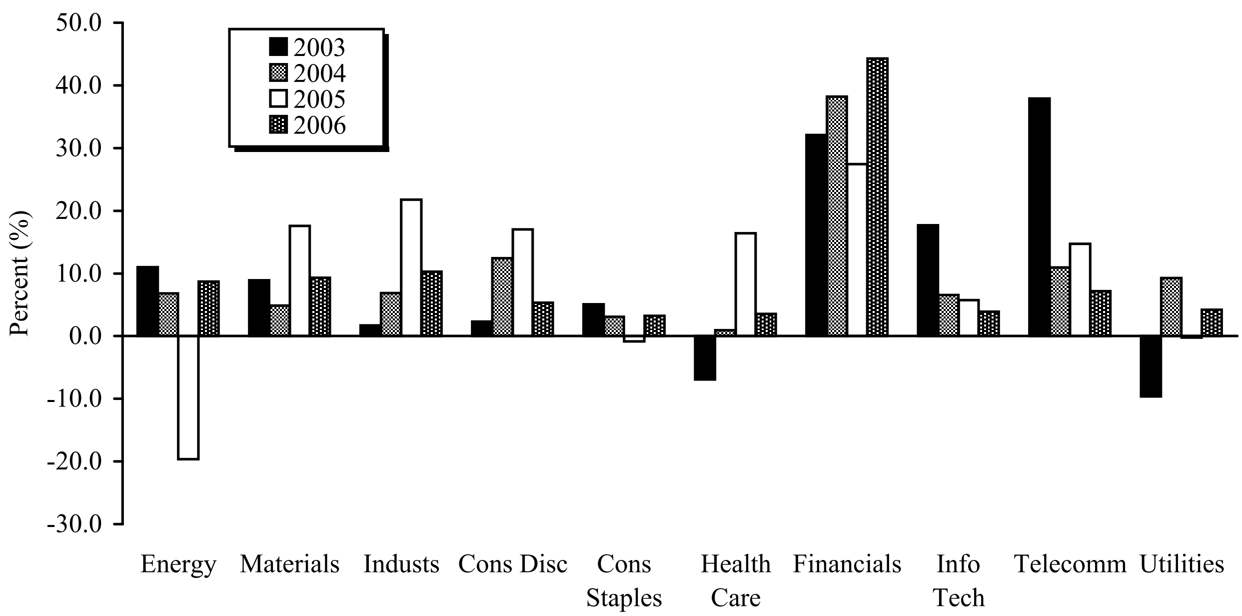
MSCI Europe ex U.K. Index

31 March 2003 - 31 August 2006

Full Period



On an Annual Basis



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

Notes: Data for 2006 are year-to-date through 31 August 2006. Percentages may not total due to rounding.