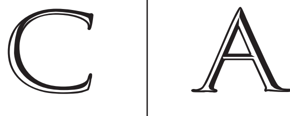

CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENT

EUROPEAN MARKETS ARE MODERATELY ATTRACTIVE

December 2004

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European equity markets had another strong year, with the FTSE All-Share and MSCI Europe ex U.K. returning 12.8% and 12.6%, respectively, which combined with 2003's returns of 20.9% and 20.3% have resulted in these markets regaining 66.3% and 43.3% of their market values prior to the start of the bear market in March 2000. At the beginning of 2004 most pundits viewed earnings forecasts for the United Kingdom and continental Europe (9.3% and 22.4%, respectively) as long shots. The projections, however, were not only met, but also were revised upwards throughout the year, with 2004 earnings growth now estimated to have been 11% in the United Kingdom and 39.5% on the Continent. While earnings projections have been revised downwards, have they been cut back enough to justify the increasing headwinds expected for these markets?

Europe ex U.K.

While the strong performance in 2004 was largely fueled by a recovery in earnings from depressed levels, it came in the face of strong headwinds. Cost-cutting measures overpowered a strengthening euro, rising energy prices, and a slow growing economy, enabling optimistic earnings growth estimates to be met. The real economy expanded only 1.8% in 2004, as consumer spending was flat and export growth began to slow in the summer at least in part under pressure from a rising euro, which made its strongest advance (7.8%) against the US$ since its inception, but increased only 2.1% on a trade-weighted basis.

Equities are expected to face continued headwinds in the short- to intermediate-term. The market consensus is that the euro will appreciate further, while domestic demand is expected to continue to be anemic. Some of this pressure could be alleviated if the European Central Bank (ECB) were to lower interest rates and/or the government pursued fiscal stimulus, but neither action seems likely. The ECB maintains its tightening stance and the market is pricing in an increase in short rates of 23 basis points (bps) in 2005, with no policy changes expected for the first half of the year. On one hand, the central bank speaks of the "dangerous" fall of the U.S. dollar, threatening intervention against further euro appreciation through a cut in policy rates. On the other hand, the ECB is perpetuating its hawkish reputation through constant references to the dangers of "sticky inflation" (currently at 2.2%), which is slightly above their target threshold of 2.0%. In addition, with the largest countries in Europe already in violation of the Growth and Stability Pact's deficit limits, fiscal stimulus should also be restrained.

These constraints appear to paint a gloomy picture for European equities; however, equities performed strongly in 2004 and earnings managed to outstrip analysts' lofty expectations even though most of these headwinds were present. Much of this strong performance was fueled by improvements in productivity, particularly in decelerating labor costs. Growth in unit labor costs approached 0% by year end, and actually fell in Germany. The prospects for further cost cutting appear positive as corporations should be motivated to offset the impact of rising export prices if euro appreciation continues as the market expects. In addition, the increased level of trade with emerging Asia and Europe should keep the pressure on to cut costs to remain competitive. Cost cutting should also be facilitated by Europe's relatively easy access to the less expensive labor of the new emerging European members of the EU.

The critical question, of course, is not whether the economic environment will remain anemic, or even if corporations will continue to successfully improve profit margins, but whether the market is pricing in these expectations and the likelihood that the market will be wrong. Clearly the market is pricing in significantly reduced earnings growth expectations: Earnings for the MSCI Europe ex U.K. Index are expected to grow 13.8% in 2005, down from the 39.5% growth experienced in 2004, but well above the average annual earnings growth of 8.8% since 1970. Looking out a little further, Eurozone consensus earnings growth assumptions for the next three to five years are down to 9%, which is also high relative to the historical average five-year earnings growth of 6.4% since 1970, but below the average expectation of 12% since 1989. It was reasonable to expect earnings to recover sharply following the 61% decline in earnings from their peak in July 2001 through the trough in April 2003, but as of year-end, earnings have recovered all but 16% of their peak values. Today, earnings expectations are perhaps slightly high relative to historical averages, but not excessively so, while valuations are near their long-term averages, with the MSCI Europe ex U.K.'s price-book (P/B) ratio, price-to-cash earnings (P/CE) ratio, and price-earnings (P/E) ratio only slightly above their long-term averages.

In the short term, we think the market is slightly more likely to disappoint than please, particularly given the tremendous earnings recovery already experienced. However, valuations are more reasonable than all other developed markets save Japan, and roughly equal to those of the United Kingdom. Longer term, we regard Europe as attractive, as Europe continues to very slowly make progress on structural reforms to improve labor flexibility and broaden and deepen its capital markets. Progress has been very slow, and should come to a complete halt in Germany until after the 2006 elections, but nonetheless has moved forward, as evidenced by recent corporate-friendly agreements with trade unions and increased labor supply from Eastern Europe.

United Kingdom

The strength of the U.K. equity market broadened in 2004 as all but one economic sector (technology) posted positive returns, with three of 2003's worst-performing economic sectors—general industrials, basic industries, and utilities—taking the lead, returning 26.0%, 24.9%, and 29.4%, respectively. Headwinds in the United Kingdom were present, but not as strong as in continental Europe, as the economy grew 3.1%; the highest rate in four years. Furthermore, despite all the press about the appreciating sterling reaching a 12-year high against the US$, it strengthened less than 1% on a trade-weighted basis. However, there were negative forces: the Bank of England (BOE) tightened short-term rates by 100 bps, European export demand was weak, and consumer spending slowed during the second half of the year. U.K. equities were bolstered by strong housing growth, which helped the financial sector, and strong appreciation in oil prices. The oil and banking sectors of the FTSE All-Share accounted for 70% of earnings growth over the past five years, while general resources and financials account for roughly 45% of the index's capitalization.

Presently, most pundits expect the U.K. economy to post moderate economic growth in 2005 at 2.4%. The recent inversion of the U.K. gilt curve, while slight, implies that the bond market believes the tightening phase of the economic cycle is over and that high real rates will begin to slow economic growth.

Many pundits are concerned that the recent weakness in the housing market will lead to a sharp slowdown in consumer spending, as consumers increase their savings as they see their wealth decline. While this reaction is certainly possible, the BOE believes the link between housing wealth and consumer spending has weakened in recent years. For example, consumer spending grew at the same rate over the last five years and the prior five-year period, even though housing prices grew at significantly different rates, doubling over the last five years and increasing only 25% during the prior five-year period. The impact on consumer spending is particularly important to the U.K. market, as roughly 17% of the FTSE All-Share capitalization is attributable to consumer-related shares.

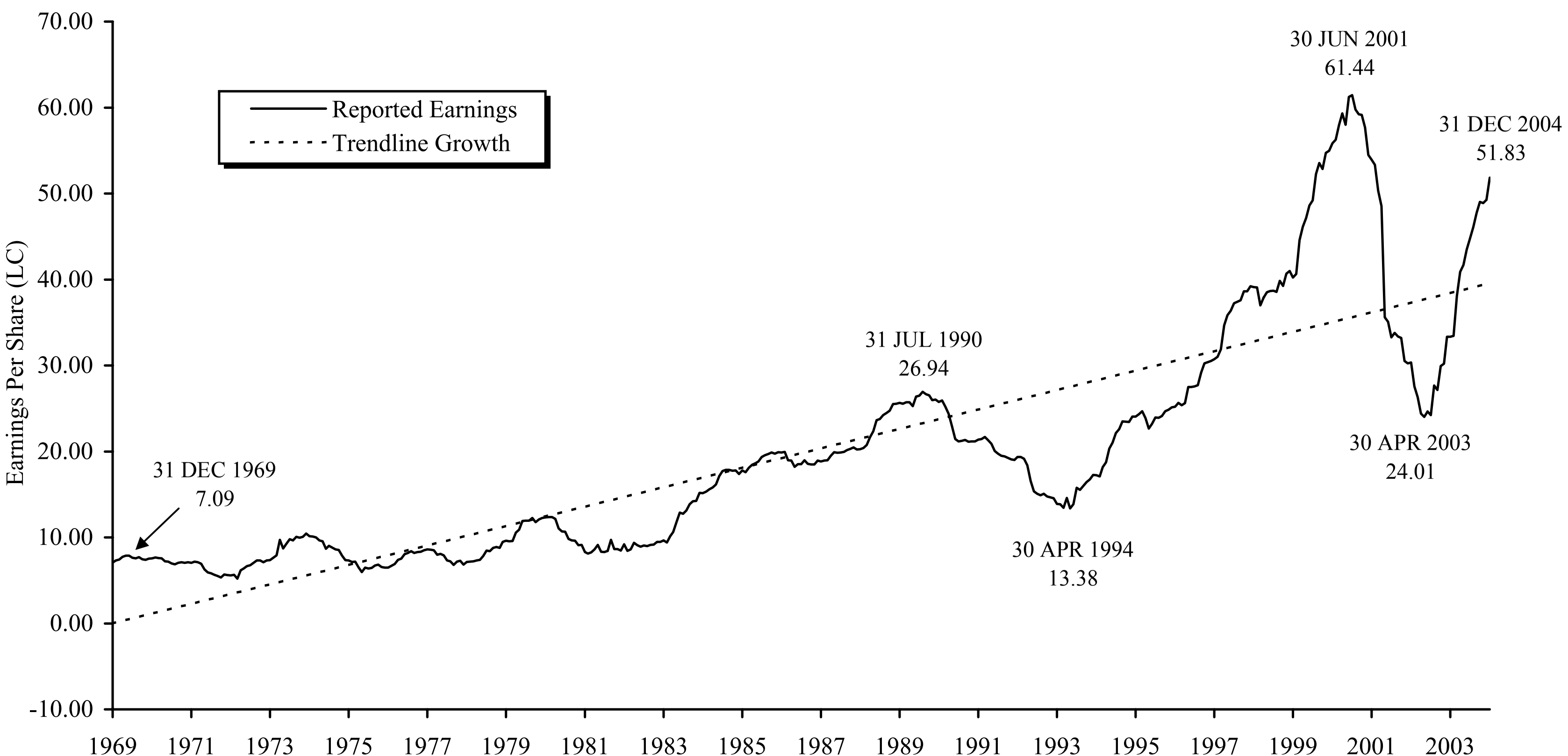
While the backdrop for equities has become slightly less attractive, earnings growth estimates have also dropped, with consensus estimates of 8% growth for 2005, down from the 11% growth experienced in 2004. Earnings growth of 8% is slightly below the 8.5% average annual growth experienced since 1962. However, the earnings cycle in the United Kingdom is more mature than that of most developed markets, as earnings have more than recovered from the nearly 30% drop experienced in 2001-02 and are now 15% above their March 2001 peak. While we would expect lower earnings growth than average at this stage in the cycle, earnings expectations are within reasonable bounds. However, the concentration of the U.K. market in finance, resource, and consumer-related sectors introduces a relatively high degree of uncertainty that earnings estimates will be met. U.K. equities are highly vulnerable to the direction of oil prices and the housing market, both directly through its impact on banking sector profits, and indirectly through the wealth effect's impact on consumer spending.

However, two positive factors make us relatively sanguine about U.K. equities, particularly in comparison to other developed markets. First, U.K. equities are fairly valued on the basis of P/B, P/CE, and P/E multiples relative to their long-term historical averages. Second, the relatively high dividend yield of 3.2% offsets some of the uncertainty in the earnings growth. Furthermore, as noted in our November 2004 European Market Comment: *U.K. Dividends on the Upswing*, prospects for future dividend growth are strong. For those who think dividends are unimportant, we would note that since 1973, dividends have accounted for more than three-quarters of U.K. equities' total return.

Table A

MSCI EUROPE EX UNITED KINGDOM REPORTED EARNINGS

31 December 1969 - 31 December 2004



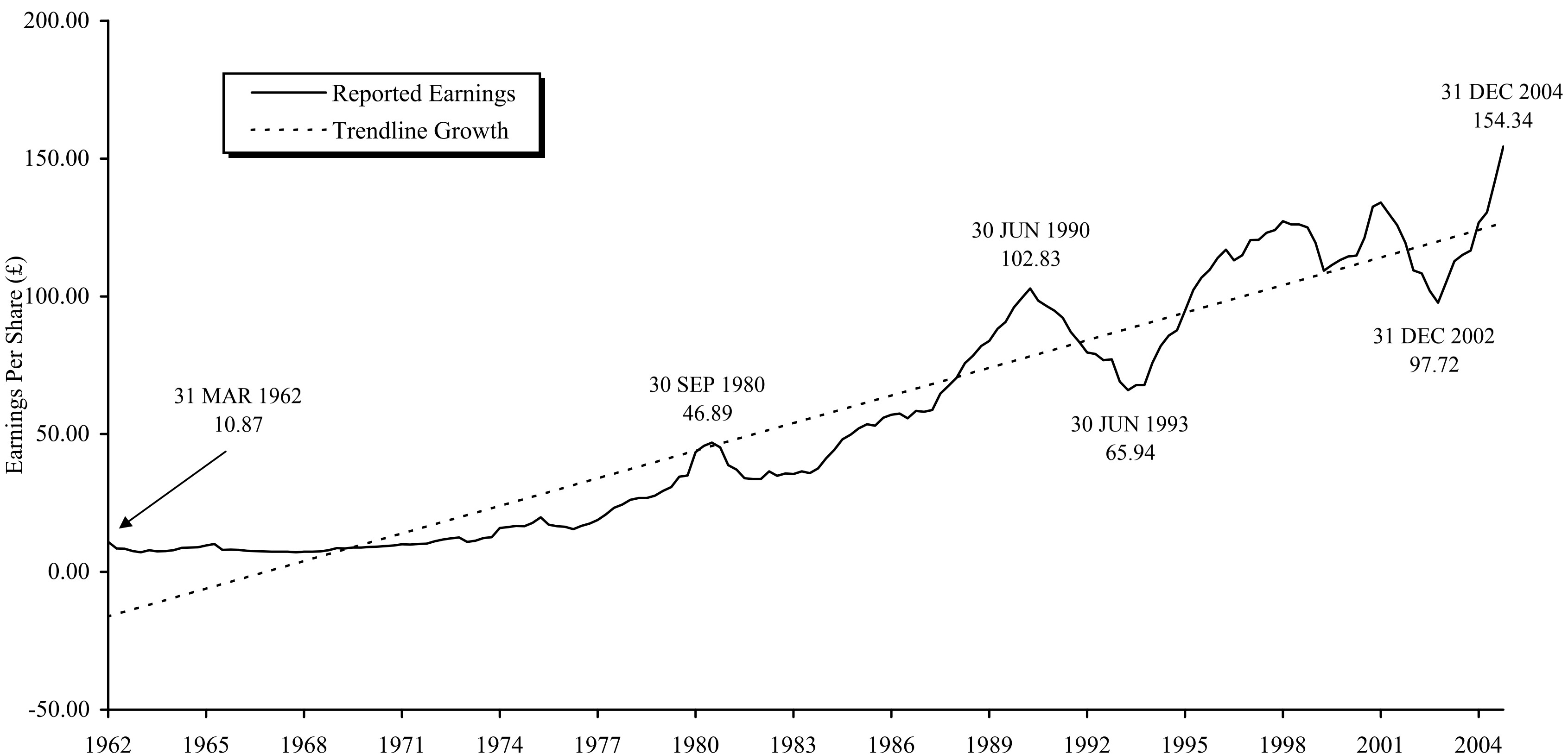
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: MSCI Europe ex U.K. had an average annual earnings growth rate of 8.83%.

Table B

FTSE ALL-SHARE REPORTED EARNINGS

31 March 1962 - 31 December 2004



Sources: FTSE International Limited and Thomson Datastream.

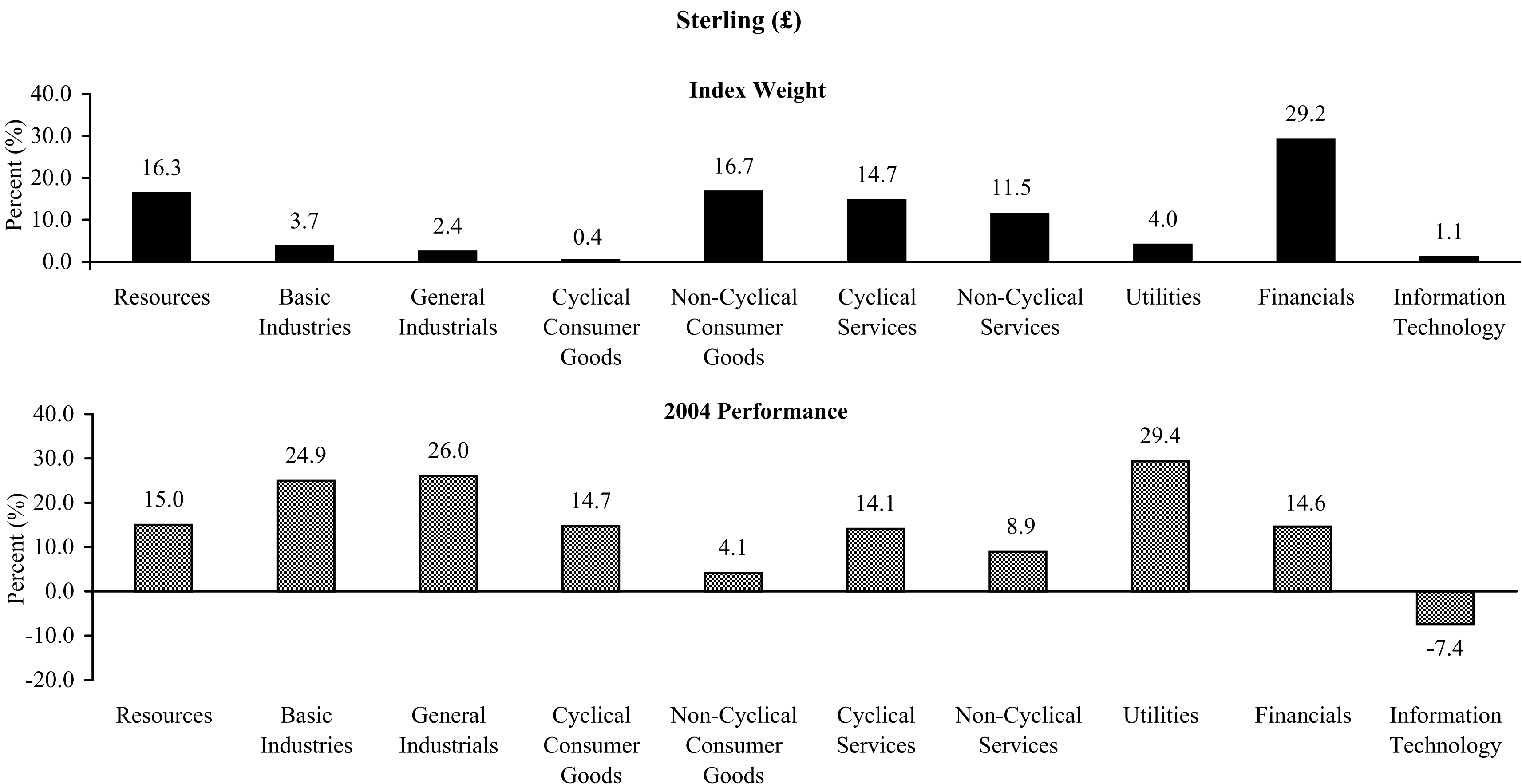
Note: The FTSE All-Share had an average annual earnings growth rate of 8.54%.

Table C

FTSE ALL-SHARE ECONOMIC GROUP WEIGHTS AND PERFORMANCE

As of 31 December 2004

Sterling (£)



Source: FTSE International Limited.

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