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EUROPEAN MARKET COMMENT: OUTLOOK

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Outlook

European equity markets performed dismally in 2001, as the synchronous global slowdown dampened demand and put downward pressure on prices, reducing earnings by an estimated 14%. The MSCI Europe Index returned -19.9%, with nine of the 16 constituent countries experiencing returns below -20% in US$, including Germany, France, Italy, the Netherlands, and Switzerland. Three factors are critical in promoting improvement in the outlook for Europe: a recovery in the U.S. economy, continued strength in U.K. consumer spending, and structural improvements in continental Europe.

Despite broad expectations that Europe's domestic market was sizeable enough to provide shelter from a U.S.-led economic downturn, eurozone GDP rose less than half a percent in both the second and third quarters of last year, and corporate profits for the Continent fell an estimated 22.1% for the year. The United Kingdom managed to continue its expansion, but at a reduced pace. While eurozone and U.K. exports to the United States account for less than 5% of GDP, looking solely at cross-border sales, or "trade," to determine linkages between Europe and the United States is insufficient. European corporations significantly increased their direct investment in the United States in the late 1990s, with major acquisitions including BP's purchase of Amoco and Daimler's purchase of Chrysler. Investment flows are even more significant for the United Kingdom, as approximately 40% of overseas direct investment in Britain is by U.S. companies, and similarly, 40% of all outward investment by British companies is in the United States. The U.S. downturn limited direct investment in the United Kingdom, and hit U.S. profits by British companies. In addition, Morgan Stanley recently reported a little-recognised fact: most of the goods eurozone companies sell to U.S. companies are made through sales to U.S. foreign affiliates in Europe, not through cross-border sales. For example, in 1998, the latest date for which these data are available, the EU sold $1.13 trillion of goods and services to the United States. Exports, or cross-border sales, accounted for only 16% of the total, while the remaining 84% were attributable to sales to U.S. foreign affiliates. European firms have suffered not only from reduced demand from European affiliates of U.S. firms, but also from disappointing sales in their own U.S.-based affiliates. For example, German affiliates reported losses of $2.8 billion for the year through September, compared to a $2.6 billion gain in all of 2000. Morgan Stanley estimates that EU affiliated firms' income declined 25% to 30% in 2001, following a 17% increase in 2000. In other words, what happens in the United States has far greater impact on the European economy and equity markets than cross-border trade would suggest.

U.K. GDP growth has been in general decline since the third quarter of 2000, but the United Kingdom has escaped recession, at least for the time being, as the consumer continues to drive the economy despite a recession in the industrial sector. Retail spending is growing at an annual rate of nearly 5.5% as of October 2001, while the industrial sector is contracting at a 4% rate. Consumers continue to borrow and actually increased their borrowing activity during 2001, while the housing market also remains strong. The consumer has remained resilient largely because fiscal and monetary stimulus has proven effective and unemployment has remained very low. According to a Goldman Sachs analysis, monetary and fiscal easing has resulted in an increase in real disposable income of approximately 5% for a worker with a mortgage in the United Kingdom. In addition, the unemployment rate, at 3.2%, remains just above the 26-year low of 3.1%, but has increased over the last several months. Corporate profits have fallen, but remained positive, with earnings growing an estimated 4% at a time when all other major developed markets saw their earnings contract. Since the contribution of business investment to growth is likely to remain subdued, given the deterioration of business confidence, the decline in profitability, and the deceleration of corporate bank borrowing, any serious retrenchment by consumers could well drag the economy into recession.

While accommodative fiscal and monetary policy in the United Kingdom have kept the tills ringing in High Street shops, other Europeans have not been as fortunate, as the European economy is on the brink of recession and retail sales growth and industrial production continue their downward trajectory. European surveys on consumer confidence, industrial production expectations, and retail business outlook reflect a pessimistic view by both businesses and consumers, although business expectations improved slightly in December from November's low levels. At 8.3%, unemployment in the eurozone is lower than the 11.5% experienced in 1996, but is still high and has been rising for the last several months. However, the fall in consumer price inflation from a peak of 3.4% in May to 2.0% in December has served to limit the decline in real wages to some degree. Retail spending is declining at a 0.5% annual rate as of October 2001, with increases unlikely unless real wages increase through either further reductions in inflation or a decline in the unemployment rate.

Europe's macroeconomic policy will exert a neutral to negative influence on the region's equities. Inflation has dropped to 2%, providing the European Central Bank with some flexibility to reduce interest rates. However, fiscal stimulus will be limited, as the EU's Stability and Growth Pact places a 3% ceiling on budget deficits as a percentage of GDP, and Germany and France are already pushing up against this ceiling under their current policies. With limited prospects for monetary and fiscal policy, Europe's economy and equity markets will probably be driven by the speed and magnitude of global economic recovery and corporate spending. Unlike their U.S. counterparts, European corporations did not participate in excessive capital expenditures in the latter part of the 1990s and are likely to resume spending once profitability returns. However, earnings will depend on global demand, energy prices, and cost cutting through corporate restructuring, only the last of which is subject to corporate control.

Longer term, capital markets will be looking for meaningful structural improvements to promote growth in the eurozone. Without reform of taxation, corporate regulation, social security, and labour regimes, the region will not fully benefit from the common market. However, little progress can be expected on these fronts in 2002, since both France and Germany have elections impending, and in both countries the opponents of reform wield considerable political clout.

Both the bond and equity markets have priced in expectations for a global economic recovery between the middle to end of 2002, as evidenced by interest rate hikes priced into forward yield curves and aggressive consensus earnings growth estimates. While most of the optimism is focused on the United States, where bond markets are pricing in 150 to 175 basis points (bps) of federal funds rate increases in one year, European short-term rates are also expected to increase, but to a lesser degree. U.K. short-term rates are priced to rise 140 bps, while the European refinancing rate is expected to increase 50 bps by the end of 2002. Similarly, consensus earnings growth estimates compiled by Thomson Financial clearly price in a recovery, with expectations for the S&P 500 of 22.9% for 2002, for FTSE Europe ex U.K., 18.5%, and for the FTSE 100, a much more sanguine 5.7%. Analysts are particularly optimistic about the prospects for Germany, where manufacturing remains a far greater percentage of GDP than in the United States, France, or the United Kingdom. Corporate earnings in the I/B/E/S German universe are expected to grow nearly 45% in 2002. Since evidence of a global economic recovery is shaky at best, risks are high that the consensus will be disappointed.