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EUROPEAN MARKET COMMENT

EUROPEAN MARKETS CHEER

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European Markets Rally in 2003

European markets garnered strong returns as global liquidity, improving global demand, European corporate balance sheet repair, and resilience in exports persevered over rising inflationary pressures in the United Kingdom and rapidly appreciating currencies.

After declining for two years, U.K. equity markets rebounded sharply in 2003, posting positive returns across the board. U.K. small-cap stocks led the way, echoing developed markets around the world, with the FTSE SmallCap Index returning 39.7% for the year, while the FTSE 250 returned an impressive 38.9%. (All returns are in local currency unless otherwise noted.) The FTSE All-Share, led by information technology and consumer cyclicals, which returned 65.8% and 61.6%, respectively, rebounded off its March 12 low by 42.3% to finish the year with a 20.9% return. Unlike U.S. equity markets, speculative issues were the worst performers: shares with price-to-earnings (P/E) less than 9.9 returned 47.3% for the year, while those with P/Es greater than 16.8 returned 22.1%.

During the final quarter of 2003, the U.K. rally began to broaden as non-cyclicals and utilities outperformed their technology and cyclical counterparts. If the rally continues to broaden, these economic groups could see further improvement as they lagged in 2003 despite lower valuations. In particular, the financials economic group could weigh on U.K. indices in 2004, as it constitutes 28.8% of the FTSE All-Share, and would suffer if policy interest rate increases proved to be more substantial than the market is pricing in today.

At the beginning of 2003, despite anemic economic growth forecasts of only 0.3%, continental Europe had what many thought to be overly optimistic earnings growth forecast of 37.1%. However, these expectations were easily met as global liquidity spurred U.S. and Asian demand and cost-cutting measures improved corporate bottom lines, generating earnings growth of 43%. The summer's stifling heat wave pushed up food and energy costs, triggering inflation fears and worries that the European Central Bank (ECB) would raise rates; however, the strong euro temporarily dispelled this notion. Continental equities participated in the year's global rally, with the MSCI Europe ex U.K. returning 20.3%. While France and Germany continue to capture a majority of headlines, many of continental Europe's smaller markets were strong participants in the rally. For example, Norway returned 42.2%, Greece 41.0%, and Sweden 35.9%. Also, the magnitude of performance disparity that characterized US equities was not apparent in continental markets. Stocks were not driven by the type of speculation that powered U.S. equities for the year: shares with P/Es less than 10.25 returned 31.8%, while those with P/Es greater than 22.0 returned 25.5%.

European credit markets, while underperforming equities, were also positive for the year, with the JPM Euro Government, LB Euro Aggregate, and LB Euro Aggregate Corporate Indices returning 2.9%, 4.5%, and 6.8%, respectively. While economic numbers continued to improve, the yield curve steepened throughout the year, with the short end undergoing high volatility. For example, short-term yields on German bunds began the year at 2.76%, then fell 58 basis points (bps), only to rise 40 bps in the final six months of the year to end at 2.58%, 18 bps lower than where they began. Long rates, on the other hand, were relatively stable, ending the year 6 bps higher at 4.84%. High yield was the leading performer in the credit market during 2003 with the Lehman Brothers Pan-European High-Yield Bond Index returning 28.5%.

U.K. gilt investors experienced their fourth straight year of positive returns with the JPM U.K. Government Bond Index returning 2.0% during 2003. Corporate bonds also had an impressive year, the LB Sterling Aggregate Corporate Index returning 7.1%. The U.K. gilt yield curve continued to flatten in 2003 as short rates (one to three years) beginning the year at 3.85% rose 54 bps to 4.39%, while long rates (ten+ years) climbed 28 bps to end the year at 4.74%. The flattening was exceptionally pronounced after June with the release of strong economic data, prompting fears that the Bank of England (BOE) would soon raise policy rates, which it did in November.

2004 Outlook

Having propelled equity markets to strong gains in 2003, will global liquidity and improved earnings continue to push markets higher in 2004? The consensus view is yes—albeit at a more moderate pace. The ECB could raise rates in response to improving economic fundamentals, strong consumer spending, and incipient inflation; however, this prospect is unlikely as long as the euro continues to appreciate. The euro may be poised for a short-term retreat, but the secular trend is upward, reducing the need for interest rate hikes to control inflation. In the United Kingdom, however, the consensus is already pricing in further BOE tightening of 100 bps by June 2004. While rate hikes do not always kill rallies, the liquidity-driven nature of the current rally has increased its vulnerability to a tightening of the spigot.

However, several valuations measures suggest U.K. equities remain fairly valued. For example, MSCI U.K. Index's current P/E is 16.0, compared to its post-1974 average of 13.4, its price-to-cash (P/CE) is currently 9.5, while its historical average is 8.2, its price-to-book (P/B) 2.1 compared to 1.9, and dividend yield (DY) 3.2 compared to 4.5. In addition, according to I/B/E/S, consensus earnings growth expectations for 2003 and 2004 seem fairly subdued for the United Kingdom—17.4% and 9.3%. On the other side of the coin, however, the rate hikes the consensus expects from the BOE would disproportionately hurt financial stocks that make up 28.8% of the FTSE All-Share.

Continental European equities are relatively more expensive on the basis of these metrics. The MSCI Europe ex U.K. Index's current P/E of 24.0 is 1.2 standard deviations above its post-1974 average of 16.5, its P/CE ratio is currently 8.9 relative to its historical average of 6.3, P/B 2.1 compared to 1.7, and DY 2.6 compared to 3.6. In addition, growth expectations appear rather aggressive, with earnings per share growth in the MSCI Europe ex U.K. Index expected to reach 22.4% in 2004, after rising 60.2% in 2003, according to I/B/E/S. For 2004, the consensus expects earnings to grow 36.5% for Germany and 18.6% for France; in 2003, earnings expanded 37.3% and 47.7%, respectively. Given the strong earnings growth experienced in Germany and France in 2003, another blockbuster year of earnings growth seems highly unlikely. The strengthening euro represents the primary risk to Europe's economy and capital markets. While corporate profit growth is expected to continue, many impediments still exist on the Continent. Structural reforms remain in their infancy, and while increased fiscal spending and tax cuts should help consumers in the short term, high unemployment remains a formidable barrier.

In addition, European markets will also have to accommodate the ascension of ten new countries to the EU (The Czech Republic, Hungary, Poland, Slovenia, Slovakia, Estonia, Latvia, Lithuania, Malta, and Cyprus) in May of 2004. While these countries will only add approximately 5% to the EU's GDP (although these countries could individually have 3% to 5% GDP growth), they will add 20% to the population, thereby increasing the pool of relatively cheap labor.

Another potential benefit is the potential for companies to increase top-line growth by increased exports to these "new" countries. However, much of these expectations are priced into the market, as European equities are somewhat expensive.

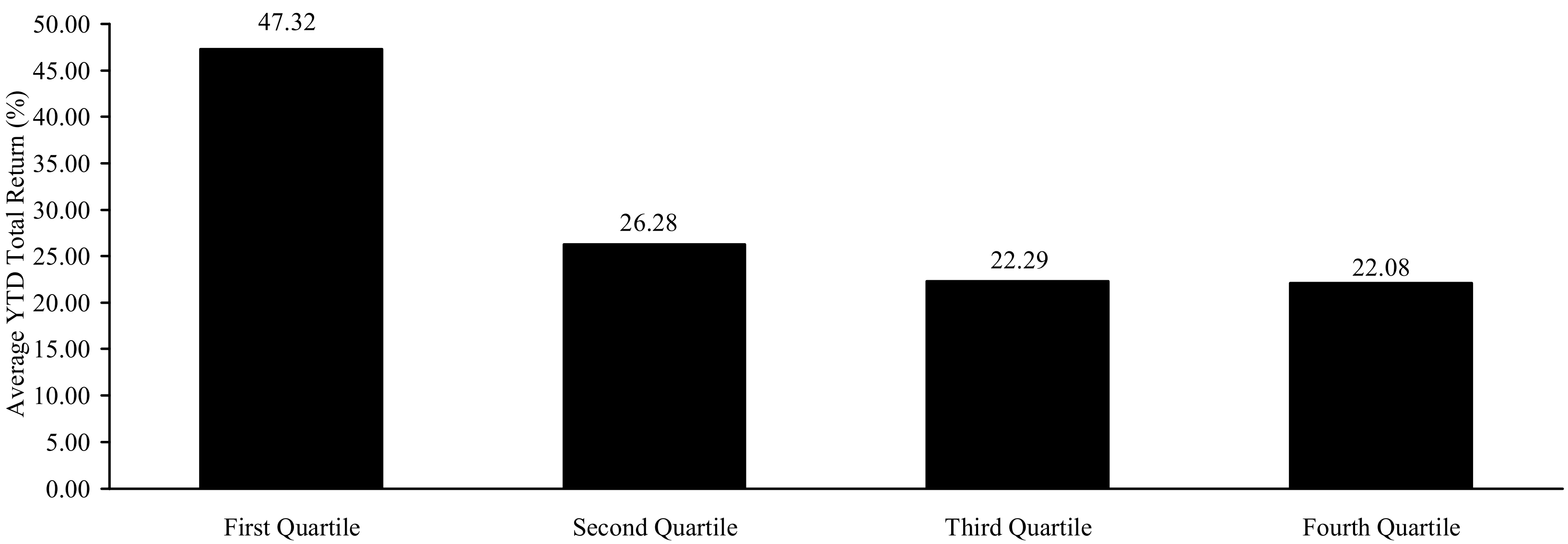
In the fixed income markets, yields on long-dated euro bonds could fall due to increased demand triggered by changes in pension solvency regulations. The major bright spot in 2003, high yield, could also come under pressure as junk issuance was up over 170% during 2003, its highest increase ever, much of it coming toward the end of the year after spreads had narrowed substantially.

Although European equity valuations are slightly rich, we continue to advise against underweighting equities, as continued liquidity is likely to extend the current rally. To mitigate valuation risks, we recommend holding a broadly diversified portfolio and rebalancing assiduously. In addition, investors may want to explore low-beta ways to implement their equity allocations by investing in long/short equity hedge funds, underweighting aggressive growth, and allocating assets to equity managers who raise cash when they cannot find stocks that meet their investment criteria. We would also favor nontraditional assets, such as commodities and natural resources, which are likely to benefit from central banks' reflationary policies.

Table A

MSCI U.K. YEAR-TO-DATE 2003 TOTAL RETURNS FOR PRICE-TO-EARNINGS QUARTILES

As of 31 December 2003



	Quartile			
31 December 2002	1	2	3	4
Average P/E Ratio	7.83	11.68	14.73	24.03
P/E Range	4.68 - 9.87	9.94 - 12.97	13.07 - 16.62	16.78 - 123.95

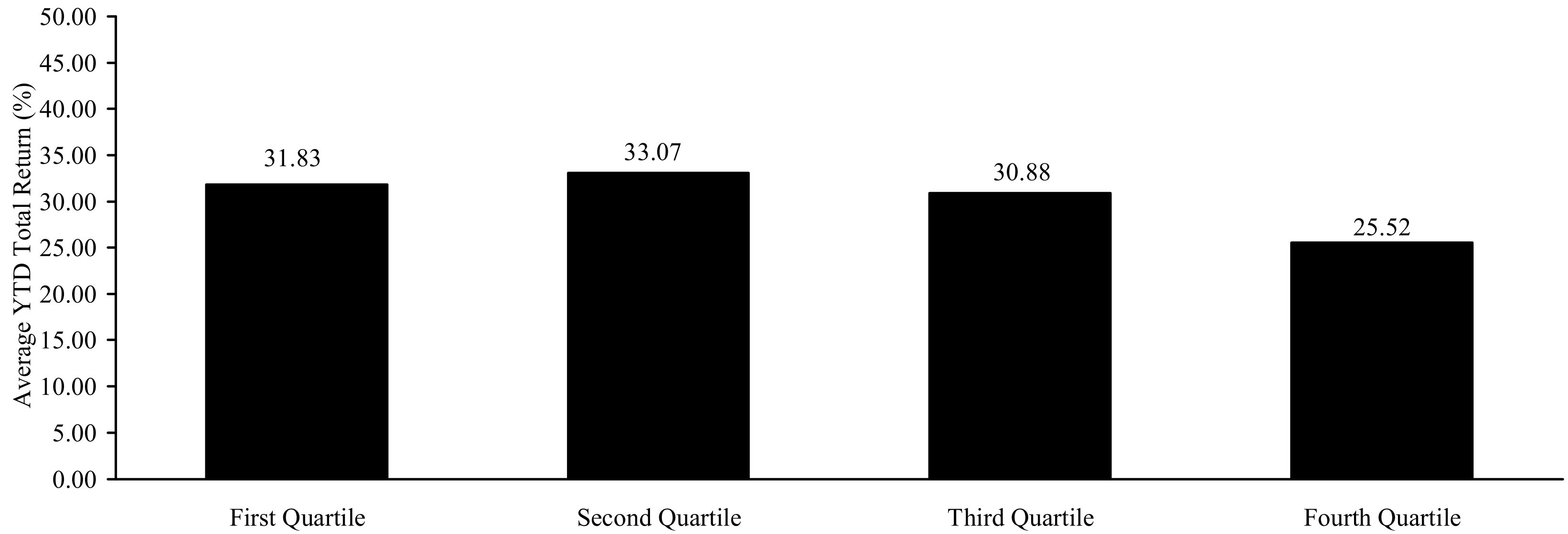
Source: Factset. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Notes: Twelve companies were excluded because they did not have a P/E ratio and/or a year-to-date return. P/E ratios are as of 31 December 2002. Total year-to-date return through 31 December 2003 for the MSCI U.K. Index is 18.76 and the average year-to-date total return through 31 December 2003 for all companies is 31.27. All data are in local currency.

Table B

MSCI EUROPE EX U.K. YEAR-TO-DATE 2003 TOTAL RETURNS FOR PRICE-TO-EARNINGS QUARTILES

As of 31 December 2003



	Quartile			
31 December 2002	1	2	3	4
Average P/E Ratio	7.76	12.55	17.85	181.34
P/E Range	0.93 - 10.25	10.25 - 14.57	14.64 - 21.87	22.03 - 10,000.00

Source: Factset. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Notes: Seventy companies were excluded because they did not have a P/E ratio and/or a year-to-date return. P/E ratios are as of 31 December 2002. Total year-to-date return through 31 December 2003 for the MSCI Europe ex U.K. Index is 24.34 and the average year-to-date total return through 31 December 2003 for all companies is 33.44. All data are in local currency.