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EUROPEAN MARKET COMMENT

IS THE CYCLICAL UPTURN IN EUROPEAN EQUITIES JUSTIFIED?

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Robert Lang
Rowan Harmer

Is the Cyclical Upturn in European Equities Justified?

Fueled by signs that the region's economy is picking up, European equities have jumped more than 20% since April. Cyclical shares have led the advance, which not only typically signifies the onset of economic recovery but also suggests the rally has been powered by genuine economic forces rather than mere speculative stirrings. While the rally in the United Kingdom seems to have legs, however, the surge in Continental equities may have outrun economic fundamentals and equity valuations.

While No Bargain, U.K. Equity Prices Seem Reasonable

Courtesy of low interest rates, hardy consumer spending, and the never-say-die housing market, the FTSE All-Share has returned 19.0% since April. The rally has been primarily driven by the cyclical services and financials economic groups, though information technology, cyclical consumer goods, and basic industries are also up smartly for the year. Benign macroeconomic conditions should continue to support cyclical groups, though industrial production needs to pick up in order for them to fuel the next leg of the rally—and this indicator may be picking up as well. Net rates of return on capital in the manufacturing sector have risen from a low of 5.5% in the fourth quarter 2001 to 7.0% in the first quarter of 2003, while those in corporate sector as a whole have edged up from 11.4% to 12.1%. Furthermore, the consensus expects the U.K.'s economy to grow 1.9% in 2003 and 2.4% in 2004, while stability in the labor market has supported domestic demand and house prices have thus far decelerated slowly, not collapsed. Exporters have received a substantial fillip from the 10% depreciation in the sterling trade-weighted exchange rate over the past three quarters.

After sliding earlier in the year, corporate profits in the United Kingdom have rebounded in recent months, and growth is expected to accelerate in coming months. For the year ending in July, FTSE All-Share profits rose 9.6%, compared with -18.4% growth for the year ending in January, while the consensus expects 12.4% growth over the next 12 months, according to I/B/E/S.

This constructive economic picture reinforces our view that equities in the United Kingdom offer reasonably attractive value. The MSCI U.K. Index appears fairly valued based on its own historical averages, with its price-to-earnings (P/E), price-to-book (P/B), and price-to-cash earnings (P/CE) metrics down to levels roughly comparable to their 24-year averages (see Tables A and B). From its December 1999 peak to the end of July 2003, the index's P/E ratio fell 38% from 26.1 to 16.1; P/B 51% from 4.1 to 2.0; and P/CE 49% from 17.9 to 9.2. MSCI U.K. remains slightly expensive according to its dividend yield (DY), and quite expensive based on its return on equity (ROE), however.

The Continent — Risks to the Downside

A similar, though more tentative, dynamic is being played out across the Channel where the Eurozone's recovery remains vulnerable to structural economic problems, weak domestic demand, and excessive dependence on the U.S. economy. However, the Continental economies appear to be on the mend, with domestic demand beginning to revive and business condition surveys tick up. However, the manufacturing sector remains anemic and the euro's appreciation is constraining export growth. Led by basic industries and financials shares, European equities have appreciated more than 20% since April, with German equities particularly strong.

Although earnings for companies in the MSCI Europe ex U.K. Index have improved in recent months, growth remains deep in the red: -18% for the year ending in July, compared with -48.4% for the year ending in January. While a modest cyclical upturn should support earnings growth, failure to meet consensus expectations of 0.6% growth in 2003 and 1.7% in 2004 would deflate the rather aggressive expectations for corporate earnings: 12-month forward growth expectations are 34.2% for FTSE Europe ex U.K., and 32.8% for Germany, 59.2% for Norway, 60.7% for Spain, and 105.5% for Sweden, according to I/B/E/S.

This tenuous outlook underscores our view that the risks to Continental equities remain to the downside (see Tables B and C). The P/B and P/CE measures suggest Eurozone equities are fairly priced relative to their historical averages—from its peak in March 2000, the P/B ratio of MSCI Europe ex U.K. has dropped 54% from 4.3 to 2.0, and its P/CE down 53% from 16.5 to 7.7—while shares are slightly rich based on their DY and quite expensive according to their ROE. Continental equities are expensive primarily because their P/E ratio has fallen only 19% from their December 1999 peak of 32.2 to 26.1, a level that is 1.3 standard deviations above its post-1979 average. The multiple has been kept aloft because France and Germany, which together account for almost 40% of the index, carry extremely high P/Es of 56.3 and 41.3, respectively.

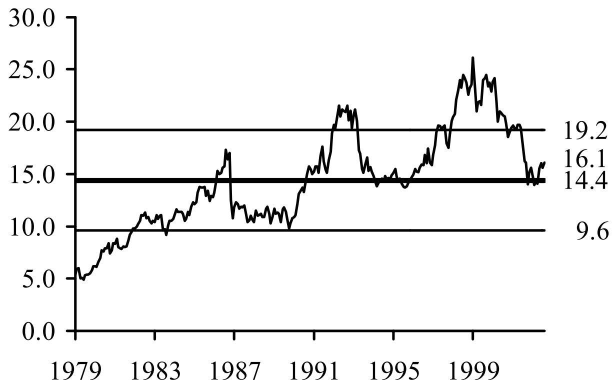
Although summer tailwinds from the United States should help bolster the Eurozone economies, investors should assume the indifferent-to-unaccommodating macroeconomic and political conditions on the Continent will persist. Lofty P/Es, especially in France and Germany, suggest equity prices are quite stretched and vulnerable to disappointment. Until multiples on the Continent begin to fall, the United Kingdom looks like a safer bet.

Table A

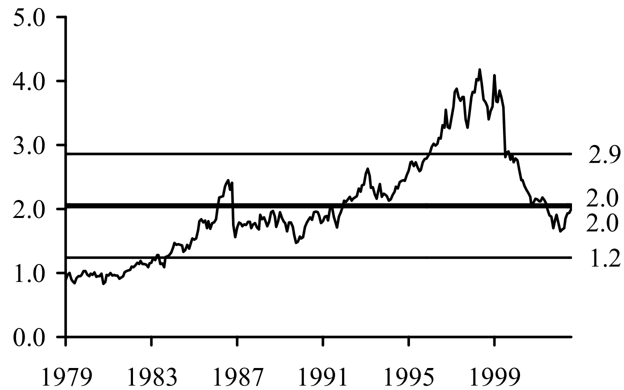
MSCI UNITED KINGDOM VALUATIONS

31 December 1979 - 31 July 2003

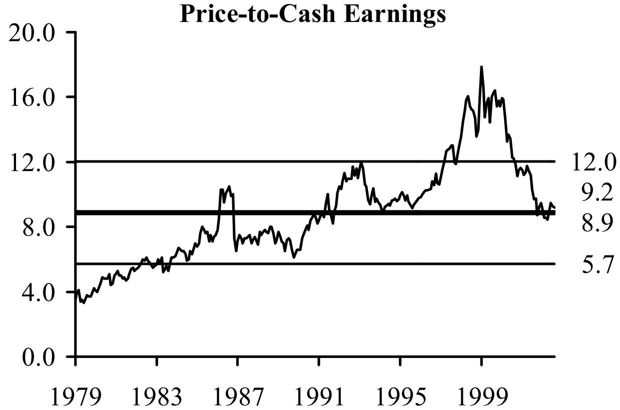
Price-Earnings



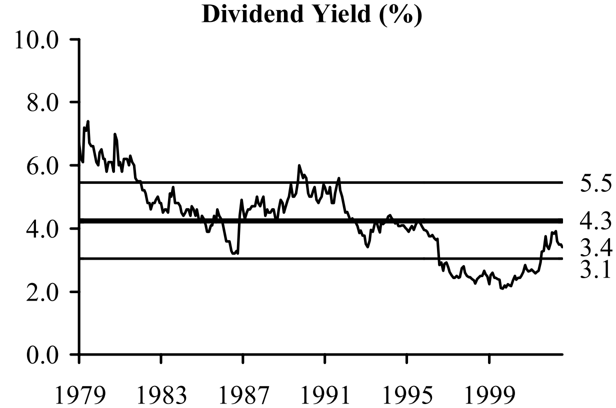
Price-to-Book Value



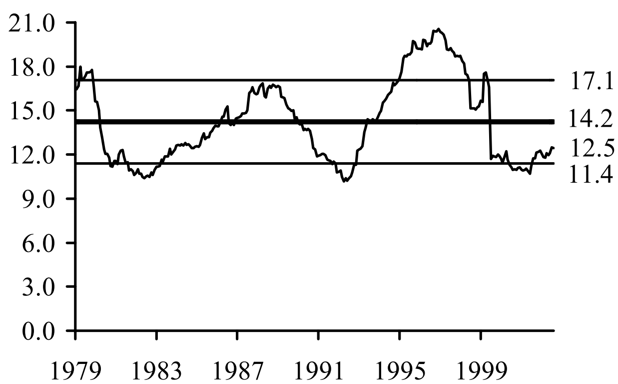
Price-to-Cash Earnings



Dividend Yield (%)



Return on Equity (%)



Mean
One Standard Deviation

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

Notes: ROE 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 B

MSCI U.K. AND EUROPE EX U.K. INDEX VALUATIONS AT THE START OF THE BEAR MARKET AND TODAY

31 December 1979 - 31 July 2003

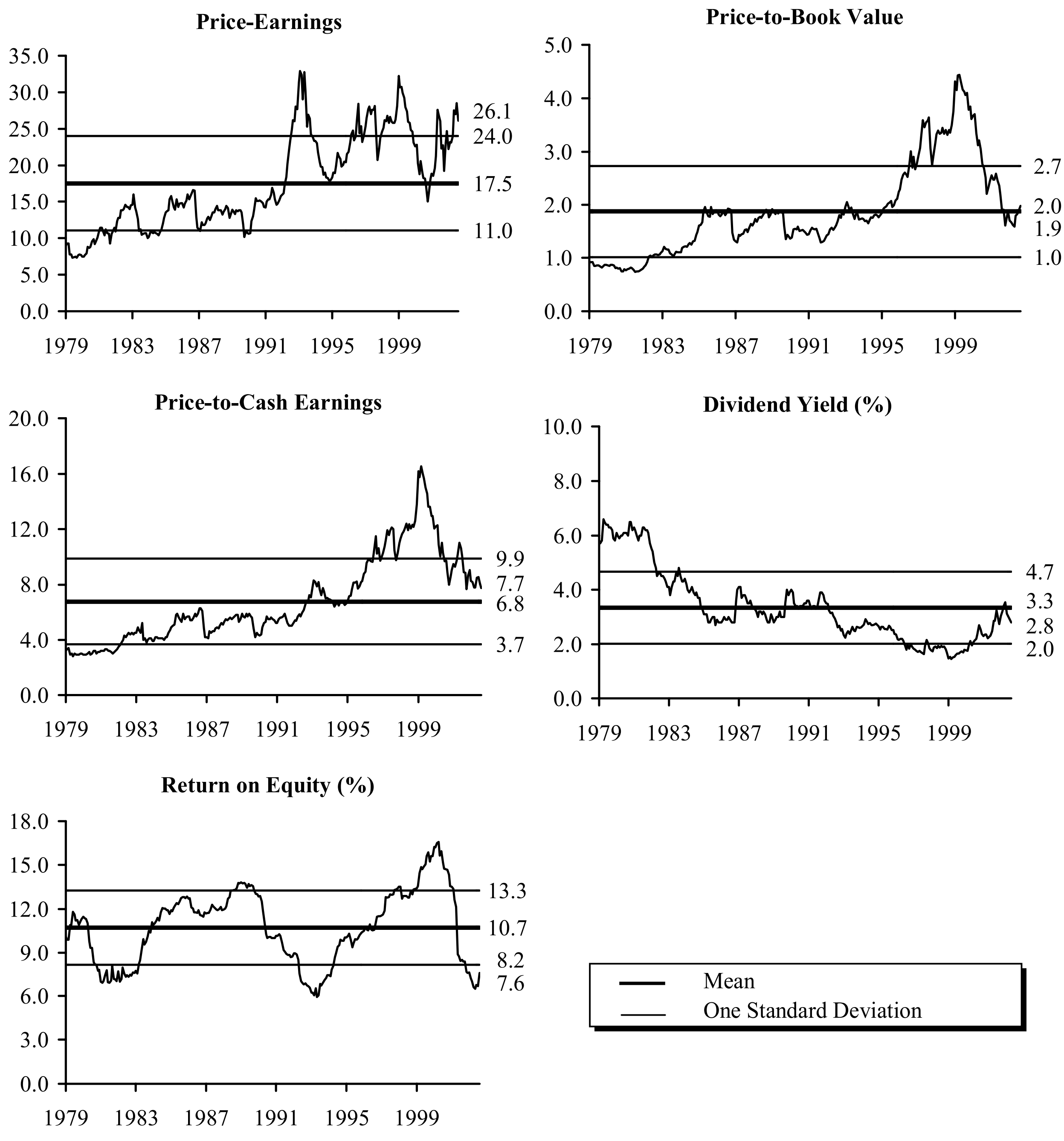
	MSCI U.K.		MSCI Europe ex U.K.	
	31 Dec 99	31 Jul 03	31 Dec 99	31 Jul 03
Price-Earnings	26.1	16.1	32.2	26.1
Mean	13.5	14.4	16.5	17.5
Number of Standard Deviations Away From Mean	2.8	0.4	2.5	1.3
Price-to-Cash Earnings	17.9	9.2	16.2	7.7
Mean	8.3	8.9	6.1	6.8
Number of Standard Deviations Away From Mean	3.4	0.1	3.9	0.3
Price-to-Book Value	4.1	2.0	4.3	2.0
Mean	2.0	2.0	1.7	1.9
Number of Standard Deviations Away From Mean	2.5	-0.1	3.6	0.1
Dividend Yield (%)	2.2	3.4	1.5	2.8
Mean	4.5	4.3	3.5	3.3
Number of Standard Deviations Away From Mean	-2.1	-0.7	-1.5	-0.4

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

Table C

MSCI EUROPE EX U.K. VALUATIONS

31 December 1979 - 31 July 2003



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Notes: ROE 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.