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EUROPEAN MARKET COMMENT: WHY ARE U.K. EQUITIES OUTPERFORMING?

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Why Are U.K. Equities Outperforming?

U.K. equities are generally considered to be more defensive than continental European equities, outperforming during periods of market weakness and underperforming during bull markets. From March 2000 to May 2002, this pattern seems to have played out according to script, with the FTSE U.K. Index besting FTSE Europe ex U.K. by 16.7 percentage points (-8.1% compared with -24.8%, respectively) (see Table A).

However, although the U.K.'s higher market weighting to the classic defensive economic groups—non-cyclical consumer goods, resources, and utilities—helped U.K. equities to outperform, it was not the primary cause. Rather, since March 2000, U.K. equities have bested those on the Continent primarily because U.K. financials significantly outperformed their continental counterparts, returning 37.6% compared with -5.0%. In addition, while the brutal sell-off in tech equities spared neither region, the group had a lower weight in the FTSE U.K. Index relative to Europe ex U.K. (2.1% vs. 13.5% as of March 2000), which further boosted its relative performance.

The outperformance of financials in the United Kingdom was broad-based, with all of its constituent industries but one (investment companies) besting their counterparts in Europe ex U.K. The banking industry, which comprises 63.8% of the U.K. financial sector and 56.6% of the sector in the Continent as of March 2000, was the primary driver of this relative performance, returning 55.3% in the United Kingdom, compared with 4.3% in Europe ex U.K. from March 2000 through May 2002. The performance of the U.K. banking sector was enhanced by acquisition activity in the industry, as prices of takeover candidates rose in the wake of Royal Bank of Scotland's success in its contested battle for NatWest in March 2000. Investors were vindicated when Barclays bought Woolwich later in 2000 and when Bank of Scotland bought Halifax in 2001. Investors were also drawn by U.K. banks' low volatility, high dividend yields, and strong cash flows relative to those of bank shares in the Continent. In fact, in March 2000, U.K. banks traded at a P/E of 13.5 for earnings growth of 10% over the subsequent two years, while continental European banks traded at a P/E of 15.0 for earnings growth of only 5%. In addition, investors in the United Kingdom rotated into banks and out of oil and pharmaceuticals.

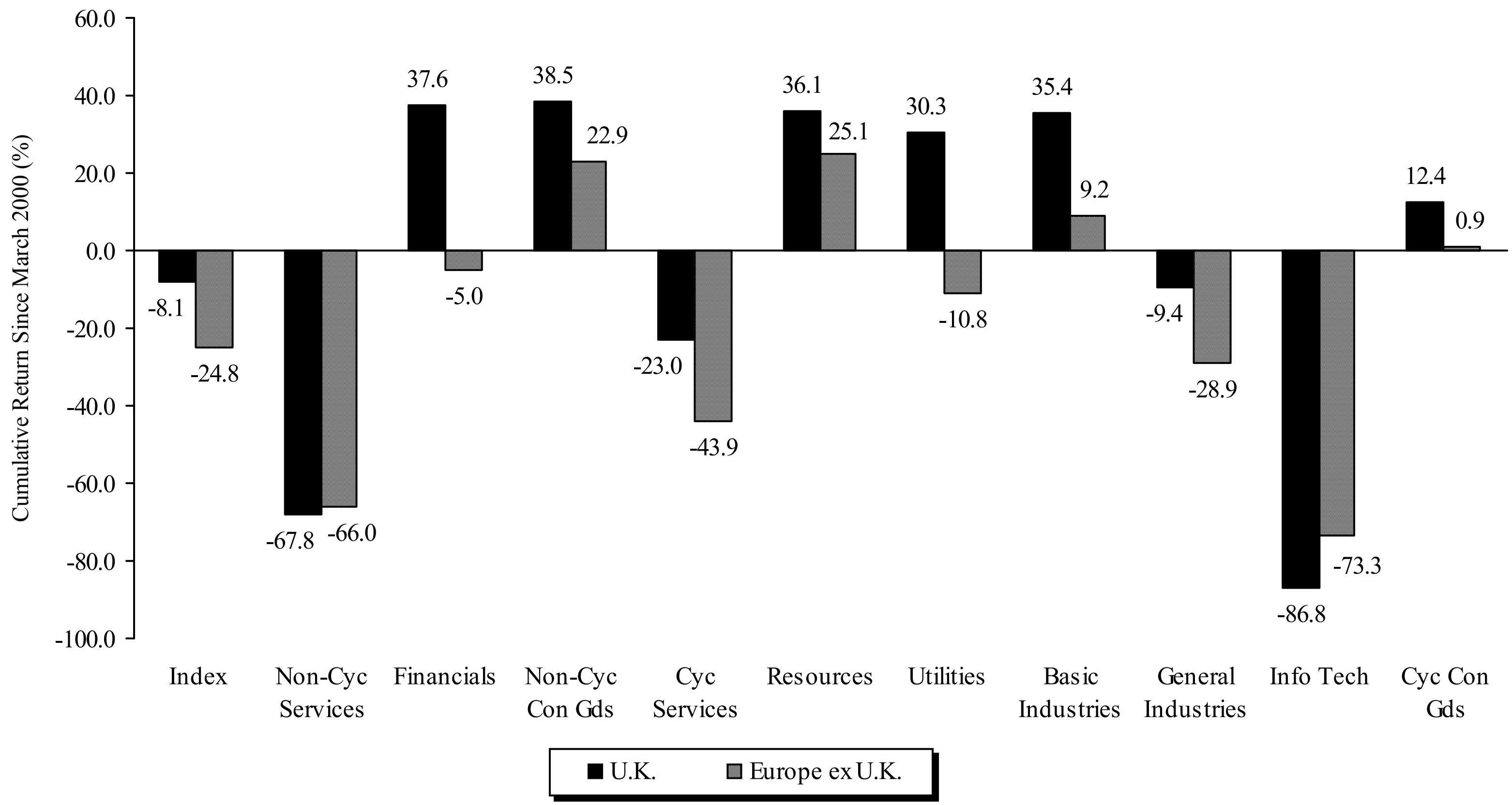
Going forward, if the current market slump continues, it seems reasonable to expect that FTSE U.K. will outperform FTSE Europe ex U.K. by a *marginal* degree simply because of its relatively larger weight in the classic defensive sectors. Beyond this base effect, however, because of significant changes in the characteristics of the information technology and financials sectors since March 2000, there is no reason to expect U.K. equities to continue to dramatically outperform those of the Continent. The overweight to information technology in the FTSE Europe ex U.K. Index relative to that of the FTSE U.K. Index has fallen from 11.4 percentage points (a 13.5% weight, compared to a 2.1% weight) to only

4.7 percentage points (5.4%, compared to 0.7%). Therefore, should technology shares continue to perform poorly, the impact on relative performance attributable to the sector weight differential will be cut by nearly 60%. In addition, the outlook for the relative performance between financial groups of the United Kingdom and Europe ex U.K. rests largely on the outlook for banks. Currently, the consensus believes that earnings prospects for European banks appear to be improving, while U.K. bank shares seem to be slowing. If these expectations are correct, the performance differential of the financial sectors should contract.

Table A

FTSE WORLD U.K. AND EUROPE EX U.K. ECONOMIC GROUP RETURNS

As of May 31, 2002



Source: Thomson Financial Datastream.

Notes: All data are in local currency. The economic groups are ordered in terms of their market capitalization weight in the FTSE World U.K. Index as of March 2000. For example, non-cyclical services accounted for the largest percentage of the U.K. index as of 31 March 2000 followed by financials, etc. Economic group market cap weights are detailed in Table B.

Table B

ECONOMIC GROUP COMPARISON BY MARKET CAP WEIGHT OF THE FTSE WORLD U.K. AND WORLD EUROPE EX U.K. INDEXES

	Percent of the Index (%)		Change in Weight Since:
FTSE World U.K.	31 March 2000	31 May 2002	31 March 2000
Non-Cyclical Services	24.8	10.4	-14.3
Financials	21.3	28.5	7.2
Non-Cyclical Consumer Goods	15.5	20.7	5.2
Cyclical Services	13.8	12.2	-1.6
Resources	13.3	19.0	5.6
Utilities	4.1	4.3	0.2
Basic Industries	2.4	2.1	-0.4
General Industries	2.3	2.0	-0.2
Information Technology	2.1	0.7	-1.4
Cyclical Consumer Goods	0.4	0.2	-0.2

	Percent of the Index (%)		Change in Weight Since:
FTSE World Europe ex U.K.	31 March 2000	31 May 2002	31 March 2000
Non-Cyclical Services	14.4	8.3	-6.0
Financials	25.8	29.2	3.3
Non-Cyclical Consumer Goods	11.5	17.4	5.9
Cyclical Services	6.1	6.3	0.2
Resources	6.6	9.7	3.2
Utilities	2.2	2.5	0.3
Basic Industries	5.2	7.4	2.2
General Industries	9.8	8.6	-1.2
Information Technology	13.5	5.4	-8.1
Cyclical Consumer Goods	5.0	5.2	0.2