



WILLIAM STERLING

STERLING'S WORLD REPORT



Is Europe the Tortoise to the U.S. Hare?

We have made the case for some time that non-U.S. equity markets appear likely to outpace the U.S. market over the next few years. Many of the reasons we have put forward focus on concerns about the U.S. regarding valuation, economic imbalances and associated risks to the U.S. dollar.

That said, to have any conviction about moving more assets to non-U.S. markets, it is important to consider the positive reasons for investing overseas other than scaling back exposure to the U.S. market. Since Europe and Japan represent the lion's share of non-U.S. market opportunities, that means looking at both areas in some detail. In our last report, we outlined our positive outlook for Japan. In this report, we will make the case for why Europe is also likely to outperform the U.S. despite its rather lacklustre reputation among many investors.

Chart 1 shows a long-term view of the relative performance of the MSCI Europe Index versus the MSCI U.S. Index. The chart makes it clear why many investors have had a

disappointing experience with European equities. Even though Europe has outperformed the U.S. for the last few years, it underperformed the U.S. massively in the 1990s.

In the 1990s, the U.S. economy was energized by the technology boom and was understandably viewed as being far more dynamic than Europe based on its pro-growth tax and regulatory environment. In contrast, investors have viewed Europe as over-taxed, over-regulated, over-priced, and unlikely to come out ahead in the global economic performance derby. At one point in the mid-1990s, one prominent U.S. investment strategist referred to Europe as a gigantic theme park, which people will visit only to see museums and statues reflecting past glories. The real money, it was argued, would be made in Asia. That observation was made just a few months before Asia became engulfed in a wave of currency crises that devastated Asian stock markets. Europe, it turned out, was a fine place to weather that storm.

Even today, the financial crew at CNBC often interjects their morning market reports with comments like, "Let's see how the socialists are doing today," leaving diplomacy to the pros like Donald Rumsfeld. Ironically, despite Europe's well-known economic problems, in U.S. dollar terms its markets have outpaced the U.S. by nearly 25% since mid-1999, even though many European markets experienced more severe bear market declines in the 2000-2002 period.

The Hare and the Tortoise?

As shown in Chart 2, Europe is currently experiencing a modest economic upswing. More of the same in 2005 is foreshadowed by a variety of European leading economic

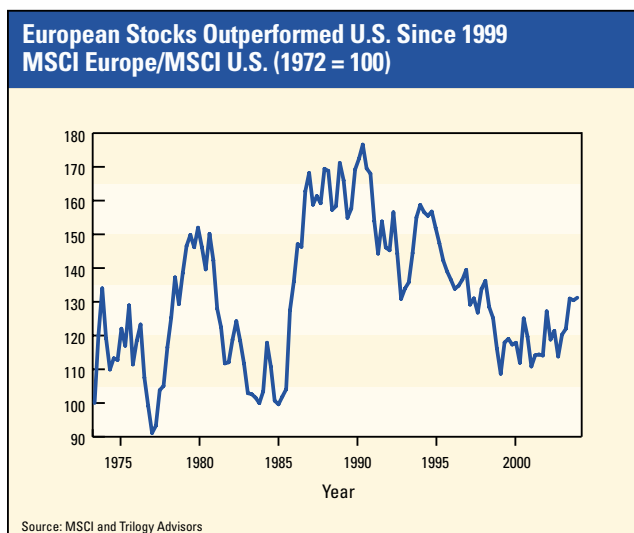


Chart 1: European equities lagged U.S. equities badly in the 1990s, but have outpaced the U.S. market by nearly 25% since mid-1999.



indicators and the very positively sloped yield curve (which reflects extremely low short-term interest rates relative to long-term rates). Most economists are expecting growth of about 2% this year and next for Europe, which is considerably lower than the 3.5% to 4.0% numbers anticipated for the U.S.

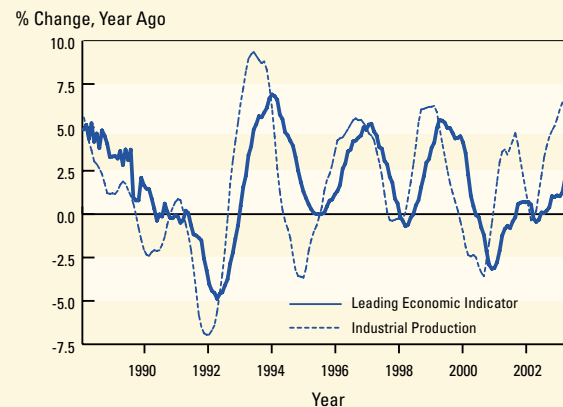
From an investment point of view, this could easily turn out to be a case of the hare and the tortoise. The reason is that the U.S. has been racing ahead because of huge monetary and fiscal policy stimulus in recent years that is probably unsustainable. Huge tax cuts under the Bush administration have left a budget deficit of nearly \$500 billion that will tie the hands of the next administration no matter what the outcome of the November presidential election. Likewise, even with the recent soft economic data, most Federal Reserve watchers continue to expect that the Fed will withdraw the current extreme degree of monetary stimulus over the next year or so as it attempts to normalize the U.S. interest rate environment and prevent inflation expectations from accelerating.

The slower growth in Europe means that the European Central Bank (ECB) is feeling no pressure to raise interest rates any time soon. Core inflation rates have been receding in most European nations and wage increases have remained subdued. That has lessened fears that the oil price spike will lead to broad inflation pressures and should permit the ECB to keep monetary policy on hold through the rest of this year even as the Fed continues to nudge interest rates higher. Moreover, even if the ECB begins to raise rates next year, as many economists expect, the rate hikes should be very modest, reflecting Europe's more moderate growth trajectory.

The outlook for European fiscal policy is basically neutral. France and Germany are still technically in violation of their budget deficit limits (no more than 3% of GDP) mandated by Europe's Stability and Growth Pact, but have no plans for major fiscal retrenchment anytime soon. It is likely that the finance ministers of Europe prefer to grow their way out of their deficits and will lean on the ECB to cut them some slack. As long as core inflation pressures remain subdued and the euro remains firm against the dollar, the ECB will be in a position to be co-operative.

With Europe running a modest external surplus while the U.S. is struggling with a current account balance in excess of \$500 billion, we think the odds are high that the euro will continue to appreciate against the U.S. dollar over the next year or so. That would provide international investors with a positive tailwind for returns versus investing in the U.S.

Moderate Growth for Europe Leading Economic Indicator & Industrial Production



Source: Eurostat / OECD

Chart: Client / Economics Chart / Euroland/Eur LEI IP

Chart 2: European leading economic indicators point to continued modest growth in 2005. The good news is that upward pressure on interest rates or inflation is likely to be subdued.

How large of a tailwind? No one can know for sure, but we noticed recently that the well-respected economics and strategy team at Citigroup is forecasting a move in the U.S. dollar/euro exchange rate from 1.21 currently to 1.36 in a year's time. That would represent a move of 12%, which would be quite significant in a period of modest stock and bond market returns.

Because of the importance of currency swings, we have found historically that international markets frequently outperform the U.S. market during periods of dollar weakness. If the Citigroup forecast is anywhere close to correct, we can think of no reason why this period would be an exception.

More Competitive?

Although the macroeconomic environment in Europe appears comfortably dull, which is not always a bad thing, the microeconomic environment may become more interesting due to the catalyst of European Union (EU) enlargement. As of May 1, 2004, 10 new countries joined the EU. The new entrants included eight Eastern European nations as well as the small island nations of Cyprus and Malta.

These countries will add nearly 20% to the EU's population, or roughly the equivalent of Germany. They will add only 5% to the EU's total GDP, reflecting their lower standards of living and cheaper wages. What these countries bring to Europe is cheap, well-educated labour in addition to significantly lower corporate tax regimes. The result is



likely to be considerable pressure on “Old Europe” to deregulate its labour markets and reconsider its high corporate tax regimes.

With capital and labour free to move within the EU, expect to see more direct investment in the new member states as capital moves to where it can earn the highest returns. A recent Merrill Lynch study highlighted the difference in labour costs by looking at costs for hiring temporary workers in different EU countries. In the Netherlands, a white-collar temp may cost as much as €25 per hour. In Italy, the cost is nearly €18 per hour. In Portugal, the cost comes down to €8 per hour and in Poland, it's as low as €3.50 per hour.

In effect, EU enlargement may act like the North America Free Trade Agreement (NAFTA) as a catalyst for many European companies to become more competitive by re-engineering their operations in Old Europe, or by relocating operations to New Europe. The result could be a surge in European productivity and upward revisions in estimates of Europe's growth potential.

Tax regime differences between Old and New Europe are also stark. The difference in tax rates between Old Europe (the EU-15) and New Europe (the AC-10, for accession countries) is 12 percentage points on average. However, many of the new members are moving in the direction of highly competitive tax regimes designed to attract new business investment. Estonia, for example, is currently offering a tax rate of 0% on non-resident business investment. Hungary has a rate of 18% and Poland is changing its rate from 27% to 19%. Austria, a member of the EU-15, recently cut its corporate tax rate from 34% to 25% in the face of much lower taxes in nearby Hungary, Slovakia, and Slovenia. The temptation for Finland's Nokia to relocate to nearby Estonia must be enormous. Against this backdrop, a wave of tax shopping and jurisdiction jumping by European corporations seems inevitable.

This story has not received a great deal of play in the North American media, which has been focused on far more dramatic stories like the troubles in the Middle East. But this is a major economic development for Europe that could well have far-reaching consequences for European productivity and growth. Overall, we believe it will have positive effects on European equity markets. We are also hopeful that it will give an edge to active investors who focus their research efforts on identifying the beneficiaries of this important structural change.

European Valuations Remain Attractive

Last but not least, European stock markets remain attractively valued despite the market rebound in 2003. European markets are trading at a substantial discount to the U.S. market by every major conventional valuation barometer. Based on trailing earnings, for example, the average price/earnings ratio in Europe is 15.5 times, versus 18.4 in the U.S. That represents a discount of nearly 16%. On other measures, such as price-to-cash earnings or dividend yield, the European discount is even starker, ranging from 30% to 40%.

That does not mean that European stocks are guaranteed to outperform U.S. stocks by 30% to 40% over the next several years. Some of the valuation differences may well be warranted by higher growth prospects for U.S. firms. However, lower valuations in Europe imply a lower overall risk that valuation contraction will eat into investor returns in coming years. And the dividend yield of 3% looks pretty robust for investors who have had to become accustomed to near-zero returns on bank deposits and money market funds in recent years.

One final point: Although European equity markets have faltered in recent months as investors worried about the impact of higher oil prices, Europe is generally considered to be the most positively geared of the three major economic regions to a decline in oil prices going forward. We continue to believe that the correction in oil prices has further to run based on an ample buildup of oil inventories and evidence of an excessive degree of speculative demand in oil markets. Accordingly, if oil prices continue to back off their recent highs, we would expect European markets to benefit disproportionately.

In short, prospects for continued moderate growth, low inflation, pro-growth monetary policy, and a strong currency suggest that European markets will continue to outperform the U.S. market for several years to come. Depending on how strong a catalyst for better growth EU enlargement turns to be, Europe's margin of outperformance could be substantial.

Bonne chance,

A handwritten signature in black ink that reads "William Sterling".

William Sterling, Chief Investment Officer
Trilogy Advisors, LLC