Sterling's
World Report

Is Europe Kaput for Investors?

European politicians are in a state of shock after voters in France and the Netherlands forcefully rejected the EU constitution. Plans for a "United States of Europe" to counter the geopolitical weight of the U.S.A. must now be put on indefinite hold. The euro fell by 6% against the U.S. dollar from mid-April to early June in response to concerns about weaker growth in Europe and diminished prospects for constructive economic reform in the wake of the constitutional crisis (See Chart 1). Hopes that the euro would become a reserve currency to rival the U.S. dollar must also be postponed now that Europe's political future has become far less certain.

Does all of this mean that Europe is kaput as a place for investors to make money? In our opinion, the answer is: "Non."

Despite all the hand-wringing among politicians and the chattering classes, business as usual should continue for European consumers and corporations. The rejection of the constitution does not signal the end of either the European Union or the European Monetary Union. Instead, the EU will continue to function under the Nice Treaty that was put into force in 2003. We have little doubt that EU officials will find a way to muddle through the current confusion, perhaps with some kind of "institutional accord" that will permit the EU Council and Parliament to make key interim appointments for several years while political leaders put together Plan B.

To be sure, market participants are concerned about the development of "EU policy paralysis" that could hinder important economic reforms that the EU commission has been attempting to initiate. However, we recall many periods during U.S. history when "policy gridlock" in Washington was viewed rather benignly by market participants.

ECB Likely to be Market Friendly

Is the European Central Bank (ECB) likely to make major changes to its monetary policies because of the political confusion? We doubt it, although some market analysts believe that the ECB will feel some pressure to be more accommodative – i.e. pro-growth – than it has been in the past. Most market analysts who had expected the ECB to raise rates later this year had already begun to back away from

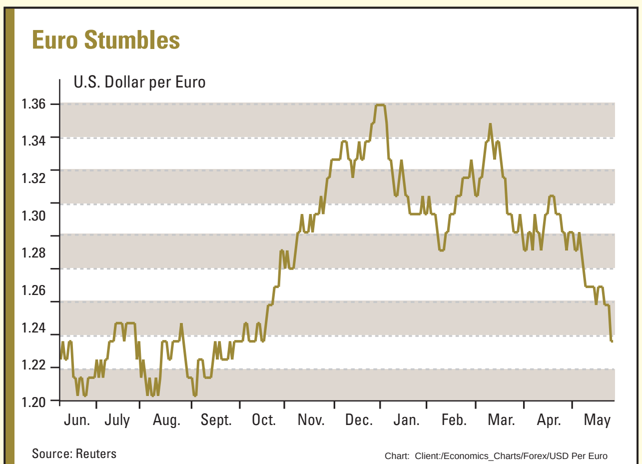

Chart 1: The euro has fallen sharply in recent weeks in response to weak economic data and the political fallout of votes rejecting the European Constitution.

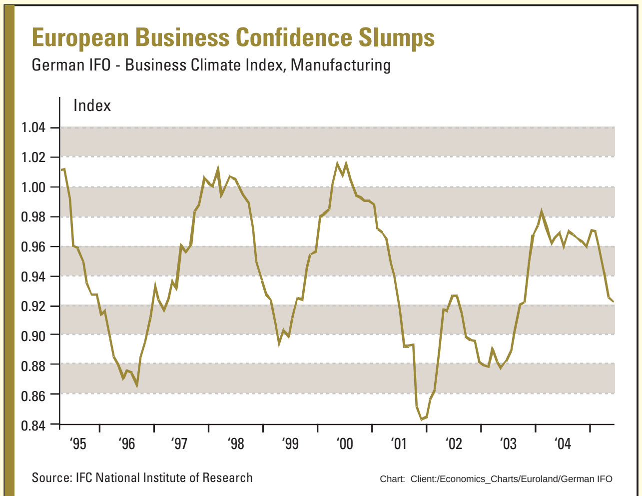

Chart 2: Business confidence across Europe has tumbled this year due to weak exports and the negative impact of high oil prices.

that view based on weak economic data, and the latest political developments also argue against the ECB moving to raise rates any time soon (See Chart 2).

Indeed, ECB President Jean-Claude Trichet has signalled that he is not entirely deaf to mounting calls for an interest rate cut in response to recent economic weakness. At a minimum, that suggests that euro-zone short-term interest rates should remain near the 2% level for many months to come, after having been at that level for two years. However, if economic data were to weaken further, it appears that the way is being cleared for further monetary easing.

Judging from recent trends in European bond markets, investors are not overly concerned about inflation pressures. As shown in Chart 3, the yield on European 10-year bonds has tumbled to close to 3.2%. Such a low level of bond yields should help support equity prices because investors are basically being forced to consider riskier asset classes in order to earn higher returns.

As we noted in last month's World Report, a "Fed model" calculation for European equities shows equities to be quite undervalued versus bonds. On a 12-month forward earnings basis, the price-earnings ratio for equities on the Continent is a surprisingly low 12.6 times. In contrast, the effective price-earnings ratio for 10-year euro-zone government bonds is 31.0 times. So on the basis of that comparison, equities in Europe are nearly 60% undervalued relative to bonds!

European Companies are Profitable

And while politicians in Europe may have dithered, European corporate managements have generally been busy cutting costs and restructuring to maintain their position in increasingly competitive global markets. As a result, cash flow has been strong, balance sheets have improved in recent years, and the return on equity among European companies (excluding financials) is currently a healthy 10.3% on the continent and 10.8% in the U.K. That is roughly in line with corporate profitability in the U.S., even though European valuations are generally substantially lower.

Are the risks of recession any higher in Europe than elsewhere in the world? With European short-term rates at 2% and a long-term rate of 3.2%, the yield curve in Europe

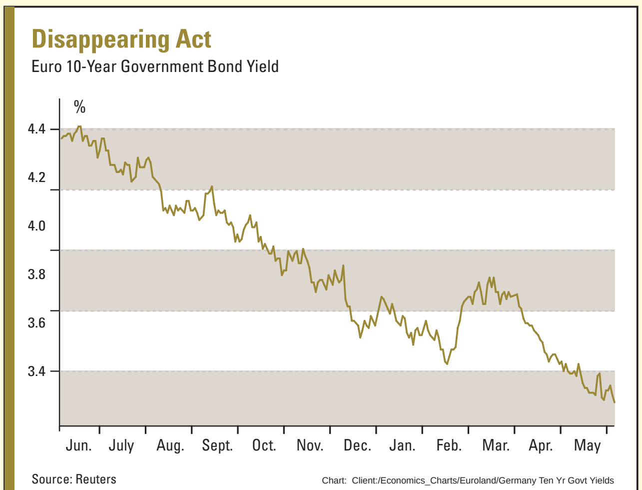

Chart 3: Reflecting Europe's sluggish economic environment, bond yields have tumbled. With the earnings yield on equities of nearly 8%, European equities look attractive versus bonds.

remains positively sloped – and in fact is now more positively sloped than in the U.S. And while the Federal Reserve is clearly set to tighten policy at least one more time, the ECB currently has little to worry about on the inflation front.

To be sure, if oil prices were to break above $60 US a barrel, European growth would suffer along with growth in the rest of the world. But our sense is that worries about a European recession are overdone. As we noted in our Winter 2005 World Report, stock markets often do best following periods when investors have been very nervous about the outlook. That's because the worries are often more than adequately factored into market prices. As worries subsequently ease, stock prices often power ahead based not only on earnings growth but also on improving valuations.

As Warren Buffet once said, you often pay a high price in the stock market for a cheery consensus. In the wake of the recent political turmoil, there clearly is not a cheery consensus regarding European markets. With Europe trading at 12.6 times earning, we think many of the obvious concerns are already clearly in the price.

Euro-phoria to Euro-phobia?

Even though the euro has lost ground this year, many analysts still consider it to be somewhat overvalued. For example, the foreign exchange team at Credit Suisse First Boston now expects the euro to move toward a level of 1.10 U.S. dollars per euro over the next 12 months, compared with a current level of about 1.23. That would represent a decline of about 11% against the U.S. dollar and would obviously cut into returns earned by dollar-based investors.

That said, from long experience we know that currency markets can swing wildly from one theme to another and reverse course dramatically. While the *thèmes du jour* may be political gridlock and an economic soft spot in Europe, investors should not lose sight of the huge U.S. external imbalance. Many academic analysts believe that the trade-weighted dollar still needs to fall by 30% or more over the next several years to help correct that imbalance.

If that is correct, the euro will need to become even more "overvalued" than it is currently and is more likely to strengthen rather than weaken over the next several years. Thus, while higher interest rates this year have helped to strengthen the dollar against the euro, there are strong reasons to doubt that that trend is sustainable on a longer-term basis. Unless EU institutions start to disintegrate quickly following the recent political shock, which we highly doubt will be the case, reasons for international investors to diversify away from some portion of their U.S. dollar holdings will most likely come to the fore again in the not-to-distant future.

Our bottom line is this: While trading sentiment may have swung from the Euro-phoria of a few years ago to Euro-phobia now, long-term investors may wish to take a different perspective. European stocks are attractively valued, monetary policy is accommodative, and European corporations are generally doing very well. We continue to have nearly one-third of our global equity exposure in Europe and will be tempted to add more on any further weakness.

In short, this is no time for *schadenfreude*, at least for international investors. We suspect Europe will recover from this shock and do just fine – much as it recovered from the shock of the breakdown of European Monetary System in 1992.

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