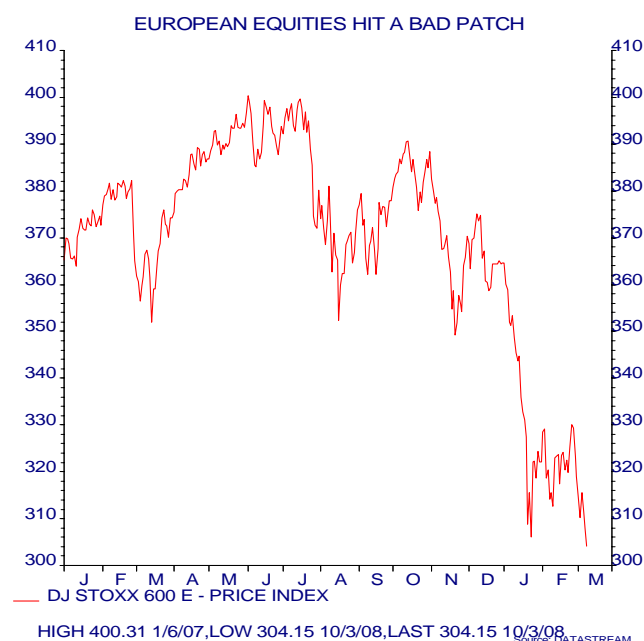


Strategy Matters

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European Equity Markets – More Bad News to Come?

European equity markets have had a torrid time over the last few months but there could be more bad news to come. To understand why, it is necessary to appreciate the importance of global developments for the region's equity markets.



The first point to note is that all the world's developed equity markets (and many emerging markets) are highly correlated, and have been for several years. It would be extremely unusual for European markets to rise for a sustained period while other markets, especially the US market, were falling. There are a number of reasons why this is the case. First, the US economy is still, by some distance, the world's largest. What happens there has an impact on every other economy in the world. Second, many of the forces that are driving equity markets are global in nature – for example the rise in oil and other commodity prices. And third, the largest companies quoted on most equity markets are multinationals, which derive only a

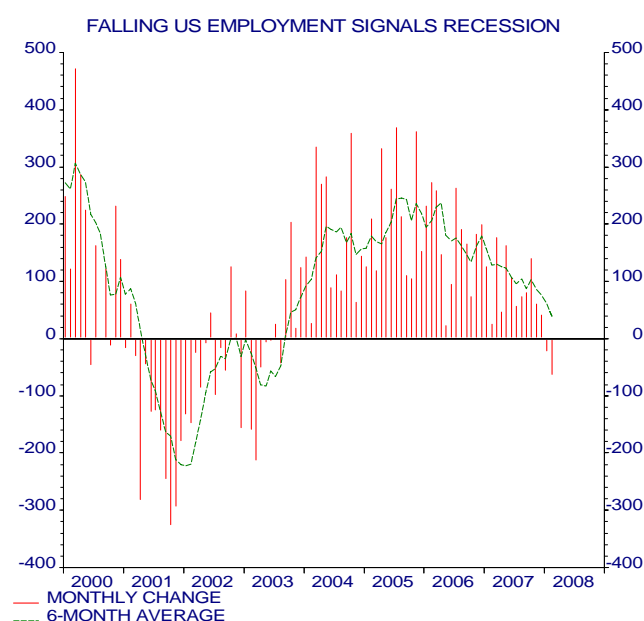
small portion of their profits from activities in their domestic market.

This globalization of equity markets benefited the performance of European markets between 2003 and the middle of 2007. Over this period, the performance of the European economy was moderate at best. There were some strong areas, like the financial sector in the UK and exporters in Germany, but also weak parts, such as retail spending across much of the Continent. However, equity markets produced stellar returns thanks to the strength of the global economy and to the efforts of companies to control costs and so boost profit margins.

For the rest of 2008 the outlook for the European economy does not look too bad. Leading indicators, such as measures of consumer and business confidence, have declined, suggesting that output growth will slow. But, so far, the level of confidence is consistent with growth only a little below its sustainable trend rate. While there are obvious weak points in the economy, such as the UK housing market and Spanish construction, other parts are holding up reasonably well and the European economy looks set to grow faster than the US economy in 2008.

However, this is of little import as far as the outlook for European equity markets is concerned. The European economy is not going to do so well that equity markets in the region will be able to ignore global developments. Indeed, they are likely to be driven mainly by the two factors that are concerning all financial markets right now: the length and depth of any US recession and the risk of further disruption in the financial system. On both counts, the outlook is not good.

Now that it has been reported that employment fell in January and February, the argument about whether or not the US economy is in recession is over. It looks like a recession, it feels like a recession, therefore it is a recession. And the likelihood is that for the next few months at least it will get worse. Consumer spending growth seems sure to slow as a result of falling employment and house prices. This will lead to further cutbacks in economic activity. Not until households receive tax rebates around the middle of the year is there much hope of improvement.



Meanwhile, bad news continues to drip out of the financial system. Credit and money market spreads are widening. Hedge funds are being forced to close or to liquidate positions. Even government bond spreads within the European Monetary Union are widening. Banks' balance sheets have been impaired and they are cutting back on credit availability. This all serves to increase risk aversion and have a negative effect on equity markets, including European markets.

Over the next few months, therefore, European equity markets could reach new lows for this cycle as the US economic news deteriorates and more bad news comes out of the financial system. Valuation appears to offer support (on some measures European equity markets are as cheap as they have been for over fifteen years) but weaker global growth is likely to be

accompanied by sizeable downgrades to earnings estimates, so valuation measures are probably misleading.

If the US recession turns out to be a mild one and the financial system begins to stabilize, then European markets should do better in the second half of the year. Some of the best gains in equity markets are made towards the end of recessions and in the early stages of recoveries. However, it is too soon to be confident that this will be the outcome. In particular, there is a danger that economic weakness and financial sector problems feed off each other to turn a mild downturn into a serious recession.

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