European strategy 2005: the slowdown year

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Morgan Stanley Equity Research advises clients on the outlook for financial markets on a 3-12 month view. This article summarises the views of the European Equity Strategy Team, co-headed by the authors. It addresses economic trends, market direction, asset allocation, as well as sector and style selection.

The theme of 2005 is the slowdown and its impact on financial markets

2005 should be a good year for equities if there is just a slowdown and no recession. Typically, slowdown years are very good for equities; we expect EPS growth to slow down from 25% in 2004 to 9% in 2005. There have been 15 EPS growth slowdown years in Europe since 1970. Normally, the slowdown is already in the price, unless it turns into a recession. 12 of the 15 slowdown years since 1970 saw equity markets up 19% on average. While markets do very well in slowdown years, the sector mix may be quite surprising. The sectors that outperform most consistently are Staples and Pharma, while it is the Cyclicals that underperform most consistently. We expect the same themes in 2005.

European equity valuations are attractive. Pre-goodwill IBES P/E is 12.9. If next year is a normal year, as we expect, the markets should trade on normal multiples, which we believe are 14 times P/E. It may well be that markets go into overshoot territory and will trade at a PE>14, as they often do. But with the structural problems still out there, we believe it is unwise to chase markets beyond fair value.

Market drivers

US payrolls have turned the corner. All indicators of US job creation are encouraging. We look, for instance, at ISM employment, which is still comfortably above 50; at weekly claims, which are consistent with 200-300k of monthly non-farm payroll creation and the payrolls itself, which have been volatile but good. Companies are generating bumper profits and balance sheets are strong. Business confidence may gradually return with lower commodity prices and election uncertainty removed. There is pent-up demand for labour, as job creation has lagged in this recovery. Finally, productivity growth is declining from a 40-year high on a trend basis; to expand revenues, companies will have to hire more staff.

Oil prices are likely to come down further. The oil price is crucial to the market outlook. We assume USD35 Brent on average for 2005. Various forces are driving oil

prices lower. First, with the end of hurricanes and hurricane season, production in areas such as the Gulf of Mexico has increased. This has already led to a marked increase in inventories, and since a few weeks ago inventories are actually higher than one year ago. Second, speculators had large net long positions, but are currently back to neutral, which is a good sign, since this group of speculators has a very good track record. Third, the situation in many production areas in the world seems to have improved in the last three months, including Russia, Nigeria, Venezuela and Norway.

A China slowdown would lead to lower commodity prices. The link between Chinese growth and commodity prices has been very strong. There has hardly been any slowdown yet, though, most impressively illustrated by the Baltic Dry Index reaching new highs recently. The case for a slowdown is still strong though, as growth is above trend and inflation risk is still there, despite year-on-year inflation having eased to 2.8% in November. The Chinese central bank has started to hike rates, and to outsiders like us, the cycle has all the inklings of a classical «boom-bust» scenario. Real estate and foreign direct investment are the two drivers that could turn the apparent soft landing into a hard landing eventually, and remember: every hard landing has looked like a soft landing first.

We do not question the terrific long-term growth potential, but we do fear big swings in the cycle.

The medium-term outlook: dreamland for now

The market oscillates between two extremes: Dreamland and Armageddon.

Dreamland is that we grow out of the structural problems gradually. Armageddon is when the much feared consumer and property-related recession actually happens. As long as the structural problems persist, we think markets are range-bound between 750 and 1150 on MSCI Europe.

For now, we think dreamland is becoming more likely, with China having some sort of soft landing, oil prices falling, the dollar slowly correcting and savings rates dropping outside the US. Eventually, we believe Armageddon will follow Dreamland, and we would expect the momentum to swing the other way at some point in 2005.

What are the prerequisites for dreamland?

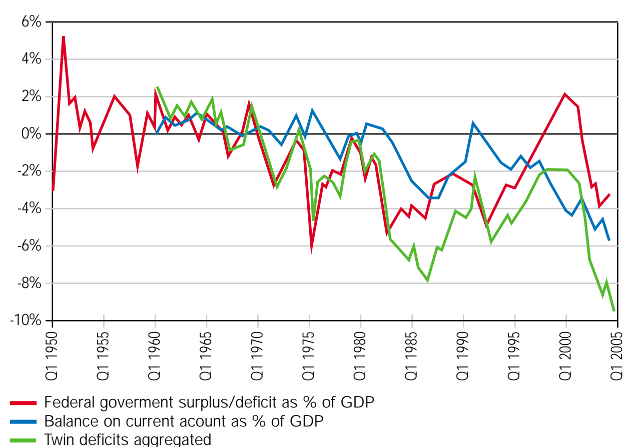
Global savings rates convergence. Domestic demand in Europe and Asia increases, such that global growth imbalances recede, and the US current account deficit gets smaller, thus taking the pressure off the USD. Savings rates converge, with the US savings rate up and European and Asian savings rates down. This savings rate convergence would be more likely if real rates rose in the US and stayed low elsewhere.

A bit of inflation. Consumer debt levels are eroded over time by slightly elevated but stable inflation at around 3%. This may be hard to obtain in a globalised and highly competitive economy.

Low rates and stable property. Property markets stagnate without collapsing as interest rates stay relatively low. A combination of somewhat higher inflation while rates stay low seems a difficult balancing act and may inflate further bubbles, but it could well happen as long as worries about the future persist while current growth is excellent, just like we have had in 2004.

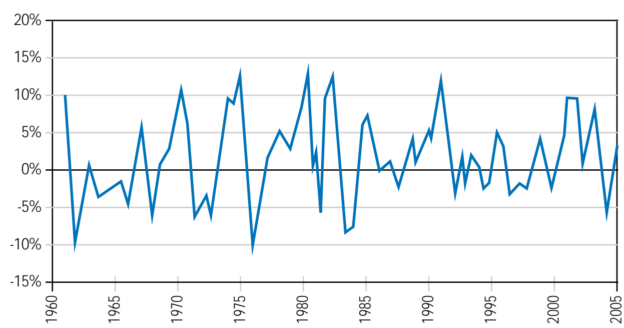
Income generation. Income generation takes over as a driver of growth in the US, through reasonable payrolls and wage growth. In addition, if income generation is strong enough the Fed could raise rates, which would stabilise real estate and help restore the savings rate.

Figure 1 | US current account balance and US federal goverment surplus/deficit (% of GDP)



Source: Datastream, Morgan Stanley Research

Figure 2 | OECD US leading indicator (%,YoY)



Source: Datastream, Morgan Stanley Research

Gradually lower commodity prices. Commodity prices fall gradually in the coming years, providing a boost to growth. In this scenario, the commodity price bubble of 2004 will be looked back upon as the perfect redistributor of growth from 2004 to future years, just as monetary and fiscal drivers of growth had no steam left.

The structural problems, however, have become larger in the last few years. Usually, recessions solve imbalances. The US recession of 2001 has not. Consumer debt levels have risen further, the savings rate has stayed around 0%, and twin deficits have ballooned (see figure 1). We would become more cautious if:

- The MSCI Europe hits our fair value price target of 1130;
- US bond yields rise towards 5% because then consumer debt levels and property markets would be at risk; and
- Leading indicators deteriorate, with danger signs from ISM new orders below 52, OECD leading indicator year-on-year turning negative or the US yield curve inverting (see figure 2).

Growth

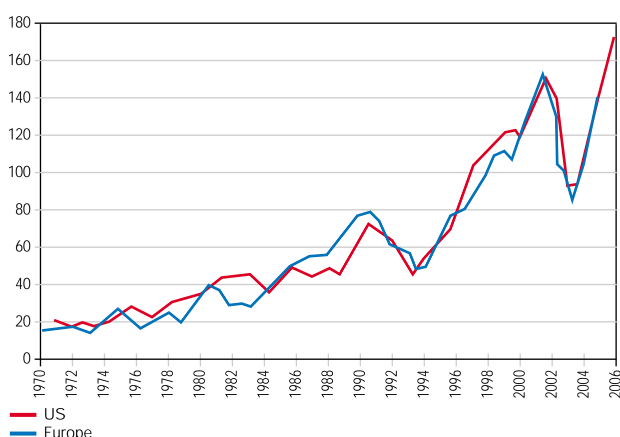
Many people wonder what the driver of growth may be in 2005, as many artificial growth drivers such as ultra-low interest rates and fiscal expansion will diminish. Our answer is: income generation, with payrolls as well as salaries showing very good signs of life (see figure 3). Second, capex may well surprise on the upside. The charts on this page show that capex has been very subdued in the last few years. If business confidence returns – possibly due to aspects such as lower oil prices and less political uncertainty – capex could very well follow (see figure 4). This aside, we do not conclude from this that one should buy Capital Goods stocks, as we believe their valuations are not attractive. Two sectors that could benefit from this trend, though, would be Media as well as Software & Services, both of which we are overweight.

Sector allocations

Pharma: The contrarian choice

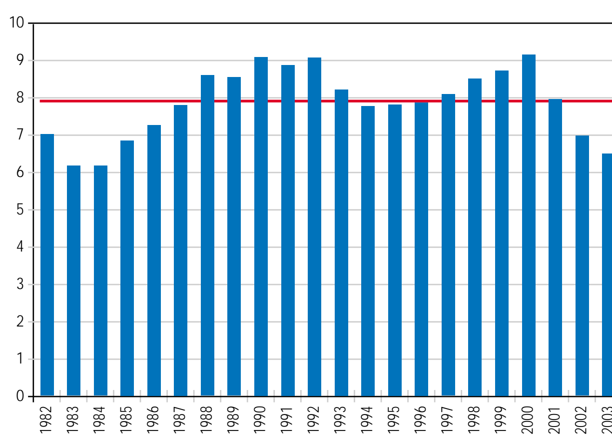
- **Attractive valuations.** Pharma just had 3 years of underperformance. We moved to a 1%-point overweight position in Pharma in mid-April, and we currently like it because it is unloved as well as attractively valued. Our valuation models indicate that this is a very attractive entry level for three reasons: first, implied 10-year EPS growth of about 7% is similar to a sector like Capital Goods. Our analysts expect 11% 5-year EPS growth, leaving an unambitious 3.5% for the remainder of the decade. Second, its relative dividend yield is at the most attractive level since our data started. Third, our dividend yield -based sector rotation tool gives a strong buy signal for Pharma.
- **Supportive macro factors.** Pharma historically is one of the best sectors during periods when the USD is weak; when the yield curve flattens; when the Fed is tightening; and when EPS growth slows down.
- **Trigger – industry response.** This is a sector in trouble for various reasons, including lack of pipeline and pressure on prices. From a top-down perspective it looks like a steal, from a bottom-up perspective it looks very problematic. To us, the trigger for outperformance would be if the industry reacts, through for instance increased buybacks and/or dividends; through cost cutting; or through consolidation. But we think at these price levels the risk/reward of being overweight Pharma is very good.

Figure 3 | MSCI Europe & US EPS (US lagged 12m)



Source: Datastream, Morgan Stanley Research

Figure 4 | Europe total ex-financial, capex/sales (%)



Source: Datastream, Morgan Stanley Research

Staples: Food prices have come down

- **Much of what we have said about pharma could be said about the food manufacturers too.** They are out of favour, have underperformed, and are attractively valued on some of the measures we look at. The problem is that the consumer environment may still be deteriorating, as hard discounters and private labels gain market share. However, if and when we become more cautious on the outlook for equities, this sector would be a good candidate to add to.
- **Valuations have improved.** On our «growth discounter», these stocks now discount 4.4% EPS growth for the next 10 years. Our analyst shows it for individual stocks as well, with stocks on average discounting 3%-point less growth than he thinks is realistic.

Oil: Defensive but not cheap

- **This sector is not cheap anymore.** Oil was our largest overweight going into 2004, as we felt valuations were attractive, while we also believed in the higher-oil-price-for-longer thesis. Now that the valuation has deteriorated significantly, and the market is universally expecting a higher oil price for longer, the case for buying the oil sector is much less compelling. Indeed, in August we moved back to neutral. We find it significant that even oil companies are now adjusting their long-term oil price expectations, which will lead to increased capex and deteriorating returns, eventually. This sector also suffers from a weaker USD.

Telco: Consensus overweight but still attractively valued

- **The equity carry sector.** Telecoms is one of our biggest overweight positions. The Telecoms sector is now the equity carry sector, with a 2005 IBES dividend yield of 3.7%, and an average credit yield of 3.5%. This is the ultimate free cash flow sector. It is also one of the sectors with the highest FCF minus DY, suggesting that payouts could rise even further.
- **Risks.** We see two main risks to our overweight position. First, abuse of cash flows. But, markets are pricing in quite a bit of that risk already. Our analysts calculate that implied capex-to-sales is 16% between now and 2008. They forecast only 13-14%, as, in contrast to the US, there is no need to deploy fibre-to-the-home connections since existing local copper connections are sufficient to

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satisfy demand. The second risk is more serious, and it is that Telecoms is now a big consensus overweight. Quite often, though, the consensus is right, and as long as valuations are attractive we intend to remain overweight.

Technology: It was just a trade

- **IT was oversold in August.** We bought Semis and Software in August, as we thought high beta sectors were oversold. First, ASM-L was at the lower end of its historical valuation range on P/B or P/Sales. Second, IT seriously lagged the normal behaviour of the highest beta sector post major bear markets.
- **Since December we are back to underweight in IT.** In December, we sold ASM-L again, as valuations were higher and sentiment had improved. In addition, the good news on PC demand was out in the market with Intel's pre-announcement, while there is a looming inventory problem in handsets as the major manufacturers have ramped up production in anticipation of gaining market share. And, in any case, Semis are expensive on an absolute basis.

Banks: Be aware of the downgrades and higher rates

- **Asymmetric risk.** The next big move is down, in our view, but we are not quite sure about the timing. As long as growth is good, rates stay low and the curve stays steep, banks' operating environment will be good. This has been the case this year, but still banks have underperformed by 1%. That does illustrate our point: limited upside risk as ROE levels are already very high, and significant downside risks if rates rise, the property market slows, lending volumes slow, margins are hit, consumer debt becomes a problem and the yield curve flattens.
- **Banks are our biggest underweight.** There is strong link between higher rates and Banks' underperformance. The first cracks may already be appearing, with UK mortgage approvals falling off a cliff, and Australian and UK property markets starting to falter. We also think it is a misconception to believe that this sector is cheap. The discount of P/BV or P/E to the market is less than usual, while both the BV and the E for Banks are probably too high.

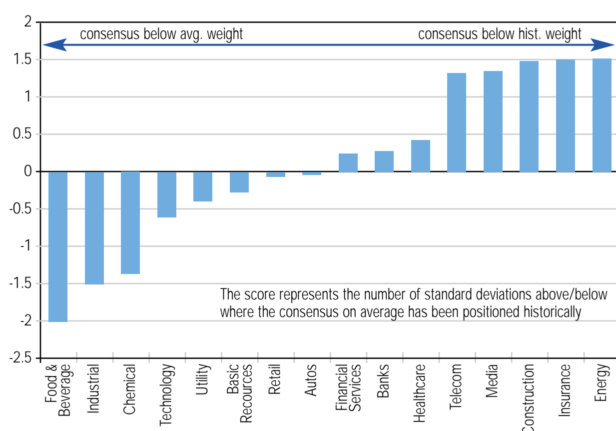
Styles

Our rule is to find the stocks whose payouts can rise. We try to look out for stocks that have room to further grow their dividends or buybacks. We believe that true growth will be a highly valued property in 2005.

In terms of trends/promising trends, we see the following:

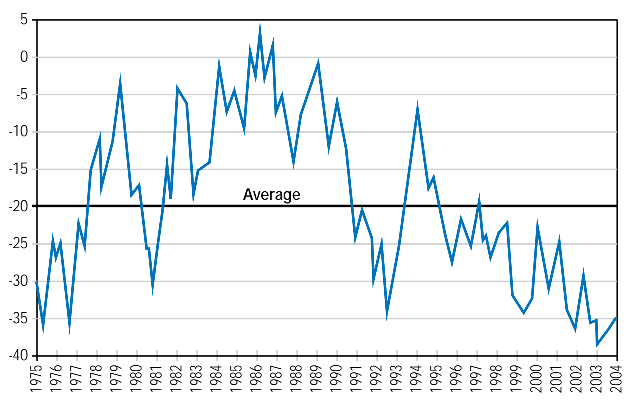
- **More corporate activity ahead.** Low interest rates and attractive valuations have attracted venture capitalist, private equity and corporate buyers more generally, in 2004. The is a long list of companies which would have attractive characteristics for a buyout, such as being attractively valued, underleveraged, high dividends and high free cash flow.
- **Unusually large valuation discount in favour of Europe.** Europe should trade at a discount to the US, as trend GDP growth as well as returns are higher in the US. The average discount since 30 years has been 19%, on a combination of measures (see figure 6). Currently, the discount is much larger, at 33%. We do not think this is justified, and therefore *we recommend an overweight Europe, underweight US position*. Additional reasons include that our forecast 2005 EPS growth in Europe at 9% is higher than in the US at 7%; that productivity seems

Figure 5 | Sector consensus weightings in Europe, Nov. 2004



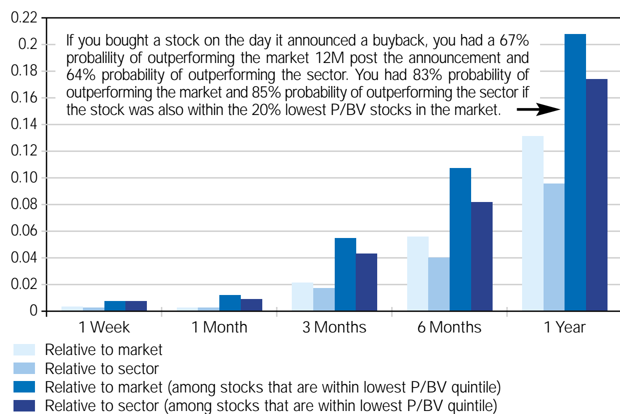
Source: Based on monthly Russell Mellon Cap data. Data since May 1999, DJ Stoxx sectors

Figure 6 | Valuations MSCI Europe relative to MSCI USA, average across PB, PCE, DY



Source: Datastream, Morgan Stanley Research

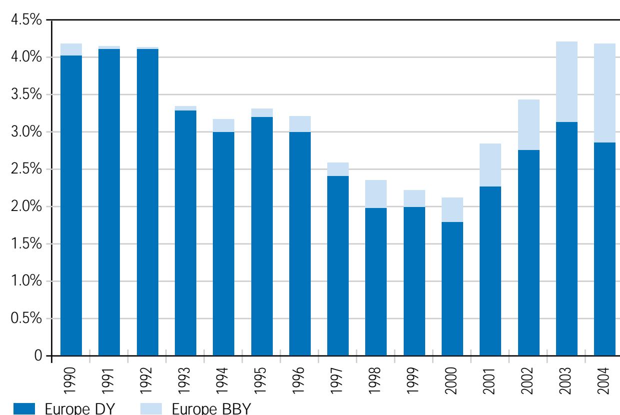
Figure 7 | Relative stock performance post buyback announcement



Note: Based on 5942 observations of MSCI Europe constituents only. Buyback announcements refer to announcements recorded in Bloomberg Corporate Action Calender since 1.1.1997.

Source: Bloomberg, MSCI, Morgan Stanley Research

Figure 8 | MSCI Europe - dividend yield and buyback yield



Note: 2004 buyback yield is annualised YTD announced data.

Source: Bloomberg, MSCI, Worldscope, Morgan Stanley Research

to be going up in Europe, more recently, and down in the US; that structural problems are more prevalent in the US, such as high consumer debt and overvalued property; and that there are nascent signs of real structural reform in Europe with, for instance, tax cuts in Italy, reversal of the 35-hour work week, and labour markets deals in Germany. Recent discussions with US investors also reveal a larger than normal interest in overseas equities.

› **The case for large caps is as strong as ever.** Many institutional investors have suffered from the small cap effect, which has made it hard to outperform. Conversely, small cap funds have performed very well. The fact that small cap funds are at the top of performance tables and therefore attract investment flows has caused the latest bout of small cap outperformance. By our account, this is now a small cap bubble. Valuations look stretched, and large caps are at 15-year relative valuation lows. Small caps have a lower FCF yield and higher leverage than large caps, which is negative in a slowdown and higher interest rate environment.

› **Buybacks are a useful stock-picking tool.** We discovered that stocks tend to outperform after their buyback announcement. We trawled through almost 6,000 announcements on the Bloomberg corporate actions database, which lists every buyback announced in Europe since 1997. A strategy that bought on announcement would have seen 13% average annual outperformance of the market since then. If the stock is also cheap (as measured by being in the lowest quintile based on P/BV), that outperformance rises to 21%). Buybacks are an increasingly important element in total return for European equities (see figures 7 and 8).

So, in conclusion, going into 2005 we recommend to overweight equities, underweight bonds, as the growth outlook should improve somehwat in the first few months, based on stable to lower commodity prices as well as improving payrolls. However, we do anticipate a turning point possibly quite early in the year, as leading indicators deteriorate or as equities reach fair value. Then, we would want to position ourselves more cautiously as a result. Already currently, our sector recommendations are quite defensive.