«Gentlemen don't buy stocks»

Both retail and institutional investors have completely missed the great bull market of the last three years. Some may be start feeling anxious about it. If they reallocate some cash into stocks, greater firepower may be added to the market.

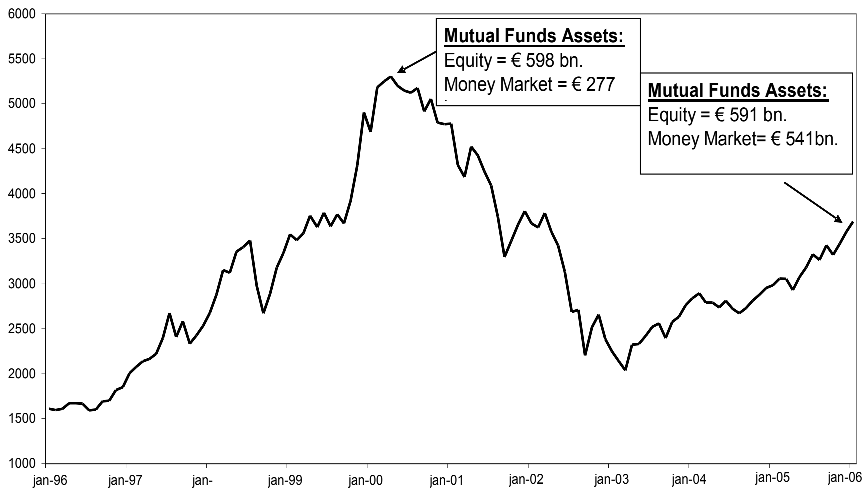
Since it bottomed out in 2003, the EMU stock market has doubled but with almost no participation by families and traditional savers. Indeed, the public has been acting herd like. People bought massive amounts of shares, both in the bourses and through intermediaries, at the heat of the bubble, only to suffer the bear movement all the way down. Paralysed with fear by the mammoth losses, they have subsequently failed to benefit from the bull tendency which blossomed in 2003.

And it was not only the "weak money" that behaved this way. From 2001 to 2004, professional managers dumped their stock positions and held record-low levels of shares in their portfolios just as the market was going up by 100 percent.

Pure and simple: families and institutional funds have had the worst timing ever. They bought the mania and sold the value.

If one looks at mutual fund figures, the data are impressive. Since 2001, inflows to equity mutual funds have collapsed. It is also the period when inflows to money market funds started going through the roof, even though they were yielding essentially nothing, or were actually negative when inflation and other expenses were taken into consideration. In Germany, there are €72 billion in money market funds, in Italy €84, and in France €385 billion. Taken together, that amount is of the same magnitude as assets held in equity funds. But cash has been returning a real –1% per year. "Well," says **Sabine Brack**, a broker located in Frankfurt, "when you talk to the typical saver he will tell you that earning nothing is better than losing 40% as happened in 2001. They are terrified." Brack also quotes the case of a relative of hers, a retired teacher, who bought a lot of new economy names in 2000. "He took a bath. He lived the bear market almost in a state of personal despair. When securities started rebounding, he was simply too demoralized and unnerved to enter the arena again."

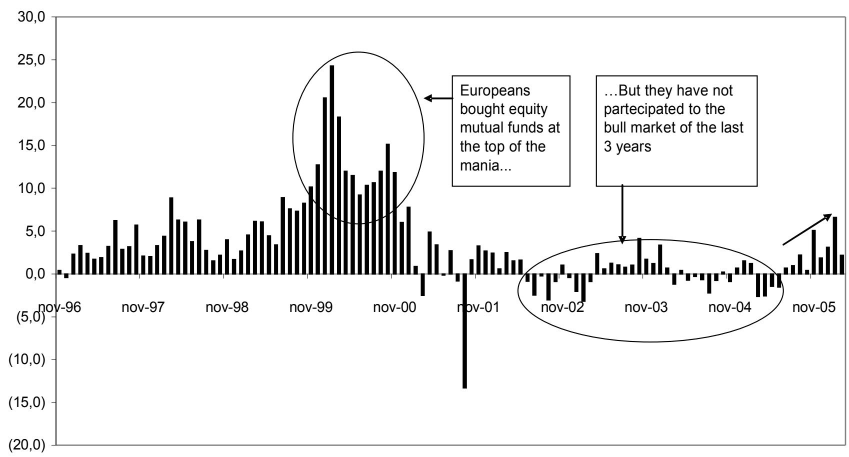
DJ Eurostoxx 50: Wild swings have misled the public



Note: Equity Mutual Funds (Germany, Fance, Italy); estimates

Compared to 2000, European retail investors have much more liquidity now. Net of expenses and inflation, that liquidity is yielding –1% per year. Some experts say that a breakout in bonds or a movement out of cash would be able to assure a new bull leg for equities.

Equity Inflows: Buying the Top, Selling the Bottom



Note: equity mutual funds (Germany, France, Italy)

Over the last 3 years, EMU bourses are up by 100 percent. But savers have not been involved, staying on the sideways. There are some anecdotes they may be tempted to rebalance gradually their portfolios, including some stocks.

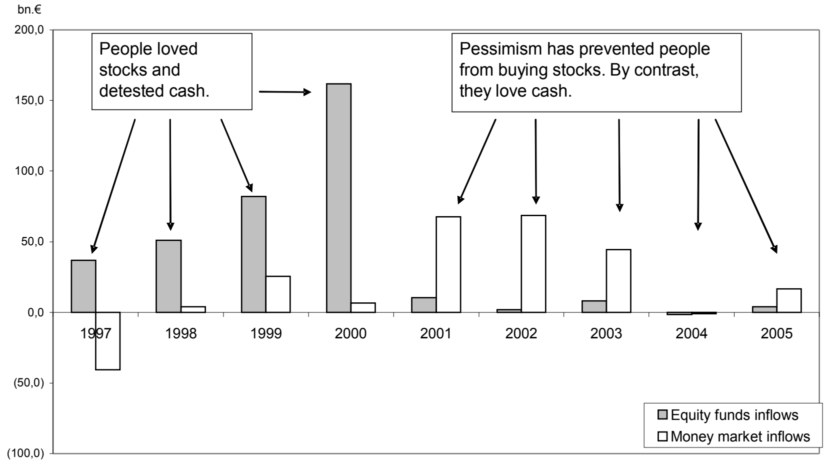
The Outlook

The point is that the behaviour of savers suggests a lingering pessimism and that if they can cast off their pessimism, a new source of money could fuel the bull market. Back in the second half of the 1970s, US mutual fund net sales were negative, and those were precisely the years which were incubating the great surge of the '80s and '90s. "In the summer of last year, 12-month cumulative inflows in equity funds hit zero," writes **Darren Brooks**, equity analyst at Citigroup. "But better news has emerged more recently with signs that retail investors are making tentative steps back to the equity market. We expect this improvement to continue with more people looking back on three strong years for European bourses and cautiously re-raise exposure to an outperforming asset class.” Recent mutual fund numbers seem to confirm that attitude with a strong outflow of bond funds and some inflow into equity funds.

“Data are encouraging,” confirms **Edmund Ng** of Morgan Stanley. “The six countries we track (Spain, Germany, the UK, France, Italy and Sweden, *ed. note*) registered a net inflow to equity funds of approximately €8.5 billion, after setting a 5-year record in February.” In fact a breakout on the downside in bonds has coincided with some shift from fixed-income to stocks. That should not come as a surprise. The sell-off in government securities has been meaningful, while European bourses continued to improve. Savers and managers who have been switching out of equities into bonds have forgone over 20% of performance.

According to **Kevin Gardiner**, chief strategist at HSBC, institutional players are likely to increase their exposure as well: “These equity returns,” he argues, “are being watched anxiously by those life assurance and pension funds who took more glamorous bonds to the ball. With relative low equity weightings, they must be a little nervous of having locked-in unnecessarily-low returns. This might not matter much to their defined-benefit scheme beneficiaries, but it will not help win new mandates.” Gardiner also thinks that “fund managers with long-term liabilities need long-duration assets to match those liabilities, and that stocks are perfect candidates.”

People have accumulated cash



Note: fund inflows (Germany, France, Italy).

Again, figures show the classic mistake of families as a class in being aggressive near a market top, and scary when the market has suffered a deep plunge that brings back prices in line with fundamentals.

Plentiful Liquidity

“Cash was used to pay down debt,” explains Kevin Gardiner, “but with debt to equity having fallen substantially, the cash has been targeted toward other aims, including merger and acquisition (M&A), bigger buy-backs etc. I recognize that the cost of borrowing has risen in 2006, but if my analysis is correct, a long wave in M&A activity is in the process of gaining momentum.”

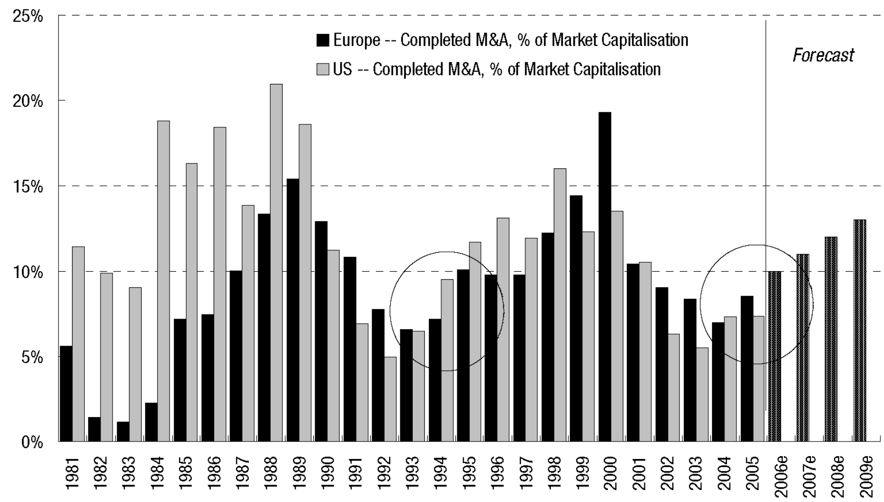
The outlook of Brooks is similar: “The M&A cycle was at a similar stage in 1995/1996,” he writes. “At the time, many investors thought that 1995 was the peak in the M&A cycle. However, it was just the beginning. We hear a very similar story from many investors now. M&A was last year’s story and we have already seen the top of the cycle. We disagree. The lack of easy growth available and the fact that companies are rich in cash and that we live in a low nominal GDP growth environment suggests to us that the rare and appealing arbitrage opportunity between cheap debt and expensive equity financing will continue to close. A pick-up in M&A activity is the logical result.”

Liquidity is generous at the macro level as well. The first two ECB refi rate hikes since October 2000 have not tightened liquidity conditions much, as growth in money supply is rising at a rapid rate. In March, M3 rose by 8.6%, well above nominal Gross Domestic Product and can still be considered supportive. Further, money supply tends to precede the EMU leading indicator by about six months.

In conclusion, a bull market is a strange receptacle of powers and forces. Liquidity is surely one of them. Savers’ behaviour suggests pessimism is common and sentiment is weak, hardly the characteristics of a long-term top. But the cheap cost of money, the ample reserve of resources enjoyed by families, and the fact that these resources are yielding so little in bonds and money market funds may be elements in favour of this equity bull market.

Staff

M&A Cycle Looks Set to Accelerate



Source: SDC and Citigroup Investment Research.

According to Darren Brooks of Citigroup the M&A activity is in the same position as in 1995-1996. Namely at the beginning, and not at the end, of a cycle. The only difference is that in the mid-90s M&A was financed by equity and now by cash and cheap money.