The Stock Market Correction Will Not Turn into a Rout

Analysts tend be optimistic despite the recent decline in equity prices.

By Vincenzo Sciarretta

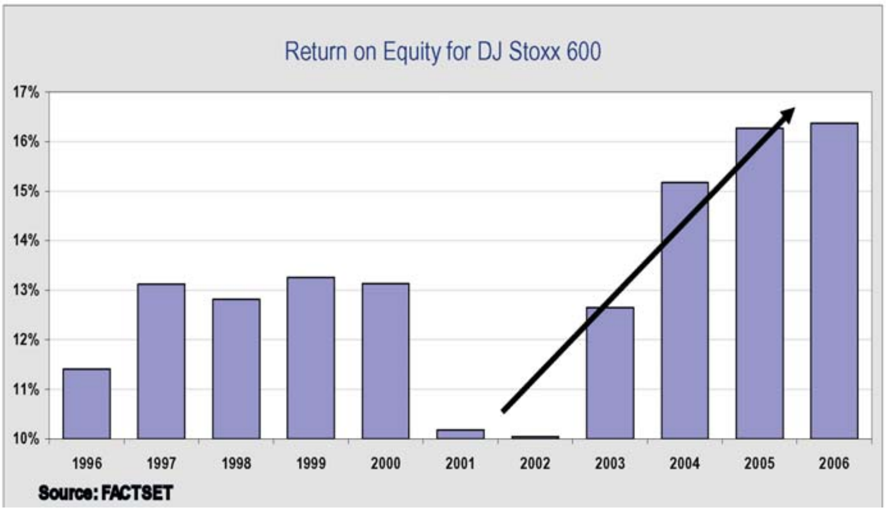
"I was out for a marketing trip," says **Robert Jukes** of Credit Suisse, recalling the recent setback of European equities, "and when I came back home I found that market mood had switched from euphoria to fear in a couple of days. However, I do think the outlook remains bullish for stocks."

Most professionals share Jukes's point of view and refuse to panic. They believe that there may be a touch of indigestion after three consecutive years of soaring assets, but that the correction is bound to be temporary. The bullish camp is still convinced that strong worldwide economic activity, the best corporate balance sheets on record, labour-limited pricing power, and the multiplication of outlets for sales will reinforce one another to produce a rapid raise in corporate earnings. They also believe that thanks to European integration, eastward expansion, together with the opening of international markets and competition, corporate earnings can grow fast without triggering inflation.

"We hate to deal with naïve measures of value," says Mr. Jukes, "but price/earnings (p/e) ratios do not suggest overvaluation. Stocks gave ground in response to an inflationary scare, which is a momentary scare, because the dynamic of prices is contained within the constraints of the structural forces of dis-inflation, namely deregulation, outsourcing, technology, and wholesale restructuring in Europe."

In similar fashion, **Marco Ravagli** of Deutsche Bank, argues that the correction is very unlikely to turn into a rout. "When selling pressure abates," he claims, "the market ought to recover, because the fundamentals are sound." He points to oil companies, industrials, and financial names as areas where opportunities are re-emerging. "Financials stand to benefit from the current wave of mergers and acquisitions, which is far from over. Industrials are aided by eastward expansion and the Asian boom. European corporations are able to maintain a level of business well in excess of domestic demand by selling machinery and capital goods abroad under the impetus of the newly industrialized countries. And finally oil companies are simply cheap enough to run the risk. Roughly speaking, their multiples discount an oil price around $50 a barrel, which offers some margin for mistakes."

TheEuropeanSide is not finding many analysts really bearish on the prospects of continental bourses. However, some do express a few concerns and reservations. **Jean-Luc Buchalet** of Factset, for example, points to the role exerted by the common currency, saying, "the higher euro is in the process of increasing pricing pressures for our exporters. Generally speaking, a 10% gain in the euro's value would cut European firms' profits by 5%. In 2005, a



European corporations are in excellent shape

Boom, where is the boom?

Lawrence Klein, Nobel Price

Cheers could be heard stateside and history did not repeat itself last week, as GDP growth in the US was revised upwards from 4.8% to 5.3% for the first quarter of 2006. Observers have tended to see GDP revisions for the US move downwards, in recent years, while GDP estimates for the EMU have generally been revised upwards since 1999. But not this time. Leading the cheering was US Commerce Secretary Carlos M. Gutierrez who said, "We have established a solid economic foundation in America, which will allow us to build even more jobs and opportunities in the future with the right policies." Amidst all this optimism, your editor has encountered some moderate scepticism in the person of Lawrence Klein, the 1980 Nobel Prize laureate in Economics. In support of his scepticism, he emphasized that the new rules employed in America under Bill Clinton and Alan Greenspan to quantify the economic figures tend to reduce inflation and increase the gross national product.

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These 'hedonic rules,' as they call them, lower the inflation rate and were devised "in a very biased way," Klein said. "Only improvements, I mean hedonic improvements were incorporated and no hedonic setbacks. For instance they say that people are better off because of information technology, and this is true. But they narrowed seats on the airplanes and they crowded people in the airports, and made no subtractions." Because of the new rules, Klein does not exclude the possibility that a 3-4% growth would correspond to a 2-3% growth rate under the old rules for the US economy. "And that is not a boom," he noted.

strengthening currency and tighter monetary policies penalised US equities; European markets now face the same situation." Buchalet also believes that the dollar will suffer from an unsustainable current account deficit: "America needs almost $2.5 bn in foreign capital every day, an amount which accounts for two-thirds of world savings. Thus, I expect the euro to maintain a bullish bias and earnings may pay a price."

An analyst who does diverge from the consensus opinion on the negative side is **Teun Draaisma** of Morgan Stanley. While not bearish, he would suggest waiting for ideally another 10% decline before buying euro-zone stocks. He writes, "valuations are not as cheap as they appear." The reason why the consensus opinion invites scrutiny is that it is based on peak cycle figures. Mr. Draaisma explains, "2007 p/e based on IBES estimates is probably 12.5, but if one uses mid-cycle ROE of 12% rather than the generally accepted 2007 ROE of 16.6%, the corresponding mid-cycle p/e is as high as 17.5. In other words, there are many expensive stocks around and if there is any value in the market, we believe it is among large caps."

It may be that Mr. Draaisma is right and the market is vulnerable to another corrective leg. Or the group consensus may have it right with the view that stocks are very attractive right now. What we do not hear is many experts ready to say that this correction could easily turn into a bear market Then again, we do not know if this is good news or not.