Ten experts judge the outlook for the final 100 days of 2006.

Expect a year-end rally in European stocks

A benign macro environment, attractive valuations, M&A and a large pool of liquidity mutually reinforce each other to produce the conditions for an advance.

By Vincenzo Sciarretta

As far as European stocks are concerned, professional forecasters still lean toward a good and constructive scenario for the last 100 days of 2006. Eight out of the ten banks surveyed by *TheEuropeanSide* this week expect the stock market to go up, two predict a flat trend and none foresee a decline.

Until now, 2006 has been satisfactory. Total return, including dividends, is near 10% for most continental

bourses. Foreign investors are even happier, since the euro has appreciated by 5 to 6% both against the dollar and the yen, making the gain associated with the purchase of stocks in Frankfurt, Paris, Madrid or Milan particularly excellent.

Yet, the potential for further appreciation has not come to an end, according to the analysts.

"We remain over-weighted on equity markets," says **Florent Bronès** of BNP Paribas. "A recession in the US is unlikely, we still expect some profit growth, and equity markets continue to be undervalued. The up-trend is fuelled by merger and acquisition (M&A) activity, supported by the current visibility of cash flow." The diagnosis formulated by Bronès is largely shared by the experts interviewed for this article.

However, the single most important variable is identified by the fact that European stocks are discounted from their fair value, or at least in line with the fundamentals. "Yes, they seem attractively priced, especially compared to bonds", says **Ian Richards** of ABN AMRO echoed by most of his colleagues. The price/earnings multiple (P/E) is 13 in an environment where 10-year government obligations yield less than 4%. Furthermore, market consensus expects DJ Euro Stoxx 50 earnings to rise 9.8% this year, followed by another 7.2% in 2007.

Although none of the professionals in our list think European equity markets are expensive, some consider them fair valued instead of cheap. For example, **Ad van Tiggelen** of ING Investment Management argues, "We are approaching the end of a period of extraordinarily strong earnings growth, where new profit margin records have been set almost everywhere in the world, and this has kept markets looking cheap on P/Es all the way. The relative low multiples are understandable, since investors are reluctant to pay too much on peak margins."

Others are more inclined to be optimistic in that regard. "It is true that earnings to GDP ratios attained new high grounds recently," argues **Alain Bokobza** of Société Générale, "but the trend must be viewed within the conceptual framework of a globalized world. Profits in Germany, Italy or France may out-perform decisively their countries' economic dynamism because a French or German or Italian multinational company is benefiting from the multiplication of its outlets, say in Asia or Eastern Europe. Therefore it may be misleading to contend that since earnings are high compared to the size of the domestic economy, their

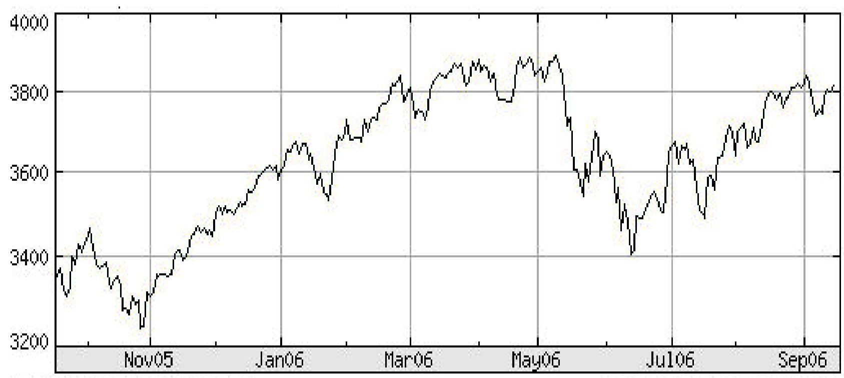
Pan-European stocks ought to go up, they say

Bank	Analyst	Year-end target
HSBC	Kevin Gardiner	+4-5%
BNP Paribas	Florent Bronès	+4-5%
Societe Generale	Alain Bokobza	+4%
Fortis	Frank Vranken	sideways
CitiGroup	Robert Buckland, Mario Sprecafico	+4%
ING Investment	Ad van Tiggelen	+6% in 12 months
Commerzbank	Groene Meyer	+2-3%
Morgan Stanley	Edmund Ng	+10%
ABN AMRO	Ian Richards	+2-3%
Credit Suisse	Team	sideways

Source: TheEuropeanSide

Predictions are generally referred to the DJ Euro Stoxx 50; eight analysts see some upside potential, two a flat market, and no one a decline.

DJ Eurostoxx 50: approaching new highs



Outperformance following Fed Pause

Company	Sector	Period 1 (May-'89 to May '90)	Period 2 (Feb.-'95 to Feb.-'96)	Period 3 (May 2000 to
Volkswagen	Automobiles	74.6%	19.6%	44.3%
Porsche	Automobiles	59.9%	16.2%	42.2%
Fortis	Banks	10.5%	30.2%	17.7%
Allied Irish Banks	Banks	18.6%	15.2%	35.6%
Air Liquide	Chemicals	20.0%	10.4%	45.6%
CRH	Construction	18.0%	16.7%	29.4%
Union Fenosa	Electricity	23.0%	25.3%	14.2%
Ahold Kon.	Food & Drug Ret.	21.5%	10.5%	50.4%
Celesio	Food & Drug Ret.	55.8%	28.5%	47.5%
Colruyt	Food & Drug Ret.	49.2%	17.0%	11.1%
Orkla	Food & Drug Ret.	28.8%	11.7%	33.9%
RWE	Utility	75.3%	19.0%	29.0%
Gas Natural	Utility	25.4%	49.4%	12.9%
Aguas de Barcelona	Utility	41.0%	41.5%	32.6%
Ing	Life Insurance	na	16.6%	36.6%
Resolution	Life Insurance	20.8%	47.5%	17.1%
Reed Elsevier	Media	13.2%	16.9%	58.8%
Wolters Kluwer	Media	12.8%	11.3%	35.3%
Anglo American	Mining	na	31.2%	88.2%
Muenchener Ruck	Nonlife Insurance	32.4%	15.3%	13.6%
Sampo "a"	Nonlife Insurance		15.8%	31.9%
Cairn Energy	Oil & Gas Producers	10.4%	68.6%	123.4%
Tullow Oil	Oil & Gas Producers	na	31.5%	100.5%
L'Oreal	Personal Goods	24.8%	13.7%	17.3%
Richemont	Personal Goods	40.4%	46.1%	24.4%
Sanofi-Aventis	Pharma	19.2%	22.6%	87.4%
Altana	Pharma	12.9%	21.4%	120.3%
Elan	Pharma	na	37.3%	46.7%
SAP	Software	58.8%	63.1%	12.1%
Sodexho	Travel & Leisure	28.5%	79.8%	50.2%

Souce: Société Générale

Many sense that the US monetary authority has moved to the sidelines, thus it may be worth giving a look at the names of the European stocks which have outperformed by more than 10% over 1 year, following the last three Fed pauses.

level in unsustainable."

Fortis' **Frank Vranken**, who bets on a flat market for the next few months, also stresses that "European bourses look cheap on account of low bond yields. But if interest rates rebound, stocks do not look cheap any longer."

On the positive front, **Mario Sprecafico** of Citigroup, outlines a scenario where "commodities are in the process of moderating, relaxing pricing pressures, and inflation has been kept at bay."

Alain Bokobza proposes giving a look at a group of European stocks which have outperformed by more than 10% over the 12 months following the peak in the US federal funds rate. He has considered the three most recent pauses in 1989-90, in 1995-1996 and in 2000-01 (see table). Of course, Bokobza's premise is that the probability of a pause by the Federal Reserve is noticeable.

If we speak of risks the dominant factor recurring in our panel is the eventuality that a contraction in the US housing sector precipitates a recession in North America, which, in turn, depresses international economic activity. Risk number two is that inflation surprises on the upside, forcing Western central banks to tighten monetary policy more than currently envisioned. Finally, wholesale terrorism and a pandemic contagion are quoted as less probable threats.

Of all the professional forecasters we have talked to, Morgan Stanley's **Edmund Ng** has shown the greatest optimism, "In our opinion, the outlook for the European stock market is rosy, implying even a 10% upside by yearend. We have increased our EPS (earnings per share ed. note) growth prediction for 2006, and we think the macro prospects are benign with inflation fears having peaked and ripe for a significant downturn. Despite this attractive situation, caution is still prevailing, as proved by redemptions in equity mutual funds or massive long positions in 10-year US bonds futures, all elements providing a healthy base for the rally to go on." If that analysis is correct, there might be some fireworks to celebrate the turn of the year.