Where is speculation?

Some argue European stocks are in a bubble. But if so, the bubble lacks its main ingredient, massive participation by the public. The out-performance of small- and mid-caps is the consequence of this lack of participation. And the scramble for liquidity makes stocks even more valuable driving interest rates down.

By Vincenzo Sciarretta

Now and then we are told that European stocks are in a bubble or, at least, that they have been going up too far too fast under the impetus of speculation. Well, that may be, however, the mix lacks one of its distinguishing features, gigantic participation by households, retail investors, money managers, and mom and pop.

There is a famous old anecdote: Bernard Baruch - a legendary investor - was having a shoeshine on Wall Street, and the shoeshine boy was giving hot tips to him. He went back and sold all his stocks.

It is the same nature of a boom market that it attracts ever-increasing amounts of money. At some point everyone piles in. But this time, the tendency is moving into reverse gear. People stay on the sidelines. European stocks have doubled. Mid-caps have gone up by 150% and yet this has not exerted the usual attraction on savers and managers.

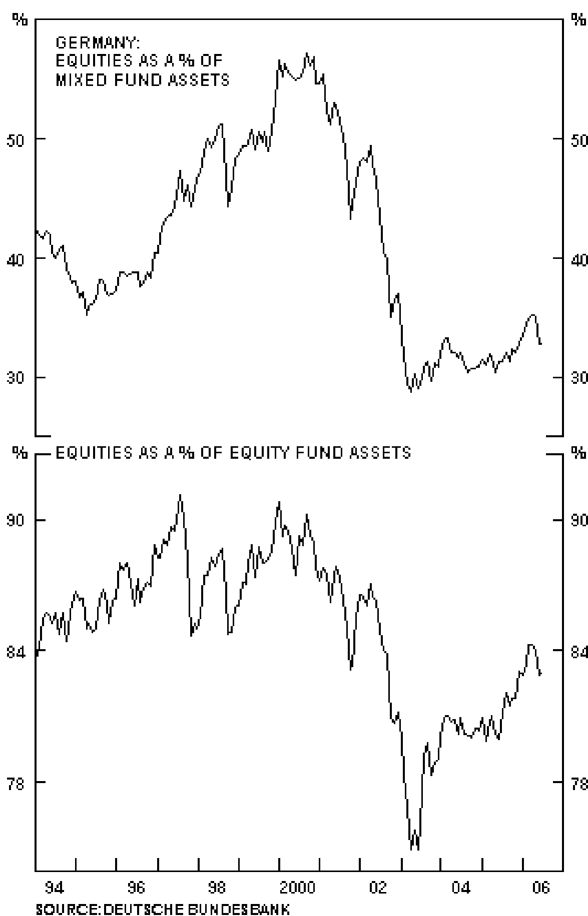
It has been amply recognized that mutual fund flows are the mirror image of the widespread fear felt by retail investors. Until now, in 2006, net redemptions have prevailed in Germany and Italy, while in France money market funds attracted as much as four times the resources channelled into equity funds. When the four largest economies on the Continent (Germany, France, Italy, and Spain) are taken into consideration, these are the figures for the first 8 months of the year: a meager €10 bn went to stocks against €37 bn to money market funds, although the latter group offers a negative real yield if overhead expenses are included.

Mid-caps versus Large-caps: lack of funds causing mid-caps outperformance

The lack of participation by traditional savers and households is also producing curious results. For instance, most observers claim that if small- and mid-caps have been doing far better than large-caps, this is a clear sign of a market under the influence of speculation. Instead the conclusion may be misleading.

According to a Citigroup's report, the out-performance of small- and mid-caps hinges on the anaemic inflow of funds into listed equities. They write

Managers are not overweighting stocks



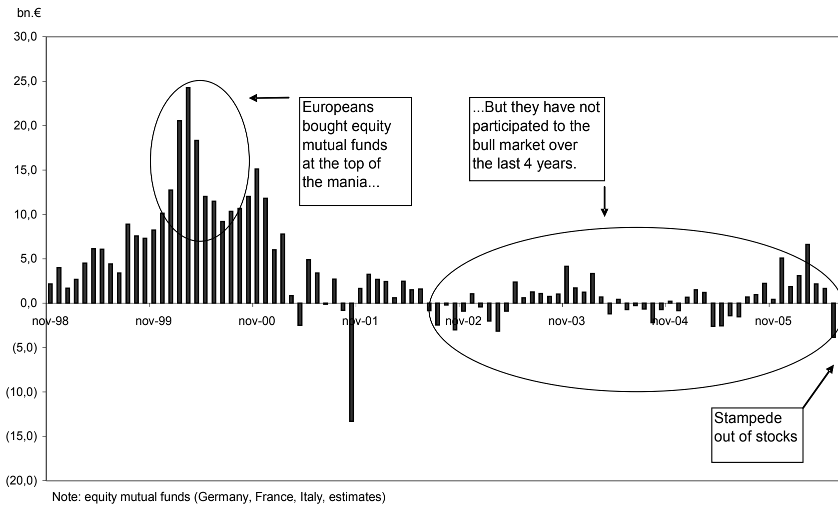
German funds had a significantly larger stock exposure during the '90s. Chart provided by BCA Research.

The Global Interdependence Center & the College of Physicians of Philadelphia present

Avian Flu, Pandemic Diseases and their Economic and Social Consequences: A Template for Preparedness

Thursday, September 28, 2006 ▪ 7:45am-5:15pm ▪ College of Physicians of Philadelphia, 19 South 22nd Street
$75 for GIC members, NABE members & College Fellows; $150 for non-members; $50 for students
For more info and to register, call 215-563-3737 or go to: www.interdependence.org

Equity Inflows: buying the top, selling the bottom



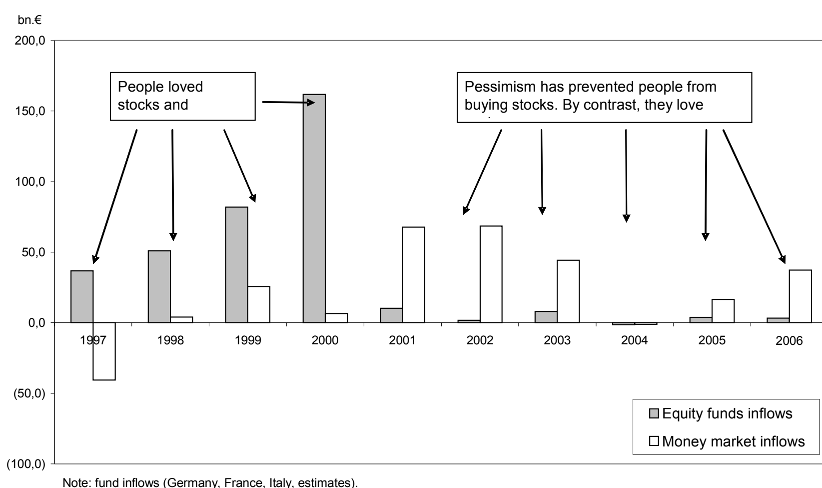
Over the last 4 years, EMU bourses have gone up by 100 percent, but savers are not benefiting, staying on the sidelines. In May and June they panicked again in response to a short-term setback.

that "fund flows have been the single most important driver of performance trends across the size spectrum in the European market. The first point to make about large-caps is of course that they are large. The DJ Stoxx Large-Cap and FTSE 100 indices are both 6 times the size of their mid-cap peers. It takes a lot more capital to re-rate the large-cap stocks than it does to re-rate the mid-caps. There was plenty of money around at the top of the bull market. Institutions were channelling noticeable amounts of liquidity into stock markets. In Europe, money was pouring into equity mutual funds and insurance companies were raising exposure to this hot asset class. The capital needed to be invested in the market, and the most liquid place to put it was large-caps. Back then, large-caps enjoyed a liquidity premium.

However, those heady days now seem a long way off. Fund flows into equities collapsed through the bear market. Saver sentiment remains very fragile. The recent sell-off (in May and June ed. note) provoked the second biggest monthly outflows ever for the European mutual fund industry."

By contrast, the boom has been fuelled by merger & acquisition (M&A) activity which finds its way into mid-caps because they are

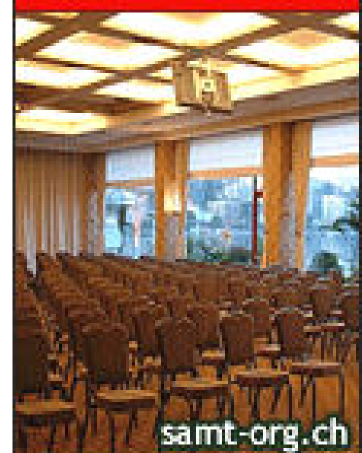
People have accumulated cash



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 prices back in line with the fundamentals.

19th Annual IFTA Conference

New Methods for Intermarket Technical Analysis



more digestible and tend to be less politically sensitive. Citigroup's report shows that back in 2000 around 7% of both the DJ Stoxx Large- and Mid-Cap indices were acquired, namely the same percentage. On the contrary in 2006 4% of the DJ Stoxx Mid-Cap Index has been acquired, twice the level of the DJ Stoxx Large-Cap Index.

Citigroup's team also underlines another way in which traditional saver caution has favoured stocks without favouring the savers: portfolio flows out of listed companies have fed government obligations, pushing down yields. Flows have also favoured private equity. In turn, the two factors have driven the use of cheap debt to retire expensive equity.

Individual investors remain in the doldrums.

Some also note that a sign of an over-excited market is the fact that many analysts are inclined to be optimistic on the outlook for euro-zone bourses. On the whole, the fact is true, but the optimism is hardly reflected in the behaviour of money managers, whose equity exposure remains significantly lower than during the latter half of the 90's (see chart).

As we mentioned, retail investors and households are still very cautious and, as a consequence, are quite liquid. The primary reason for their dark pessimism seems to be the bitter disappointment they endured with the New Economy mania, coupled with the fact that most of the stocks they accumulated in that period never recovered their poise and still show mammoth losses.

"I was as badly caught as the next fellow," says Francois Lasserre, a Parisian teacher. "I haven't bought any stocks since the Twin Towers attack. From time to time I check the skeletons in my portfolio and they are going nowhere, rebounding only to some extent. Where do I have my money? Essentially in the current account."

"In 2000-2001 stocks were likely around 70% of my financial assets," echoes Mirko Terrenzio, at 38 a salesman in the pharmaceutical sector in Pescara, Italy. "Now the share is probably about 30%. In the meantime I have bought a small flat with the intent to rent it to some students. I admit I don't see many outlets for my money, but I have learned that stocks are risky."

Mr. Terrenzio and Mr. Lasserre give a good reflection of the current state of affairs. They bought a lot at the top of the bubble and have stayed on the sidelines since European bourses bottomed out in 2002-2003. And the fact that many individual investors are very nervous about stocks is perhaps proved by mutual funds data. Last February and March, equity fund inflows started to show some modest signs of dynamism in response to three years of a booming market. But as soon as the May-June correction materialized, sales took off. In reaction to a short-term crisis, retail investors panicked. There was a stampede. Morgan Stanley's equity team reports that for the six countries they track, that is Spain, Germany, UK, France, Italy and Sweden, there was a record outflow in June. More than after 9/11.

In the meantime, it looks like 2006 will be another year by +10%.

www.theeuropeanside.com

TO RECEIVE THIS MAGAZINE FOR FREE YOU JUST NEED A CLICK

www.theeuropeanside.com

www.theeuropeanside.com

FOR YOUR ADVERTISING ON
THE EUROPEAN SIDE
SEND TO:
ADVERTISING@THEEUROPEANSIDE.COM