Where are the opportunities?

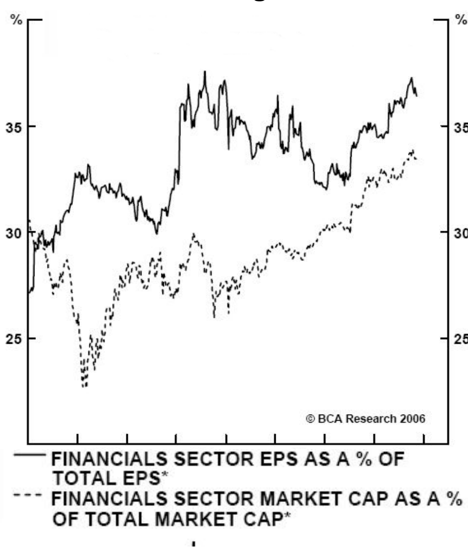
Sentiment and market positioning may suggest some profit taking, but good investments still abound in Europe. "Yes" for Germany, Retail, Oil, Telecoms. "No" for Banks and small-caps.

By Sciarretta Vincenzo

Since they bottomed out in mid-June, European bourses have taken off, gaining about 22%. Therefore, some turbulence is possible. Globally, we record some speculative froth: the ratio of bulls to bears, and the level of selling among corporate executives and directors at companies listed on either the New York Stock Exchange and American Stock Exchange have reached the altitude that triggered a correction in May-June. Also the attractiveness of the continental stock market is beginning to enter investors' consciousness. According to a survey of professionals' expectations, euro-zone equities are now deemed to have the most favourable corporate-earnings prospects, and represent one of the most undervalued regions in the world. Unfortunately, in the fourth quarter of 2005, that diagnosis was associated to Japan, which since then has been less satisfactory.

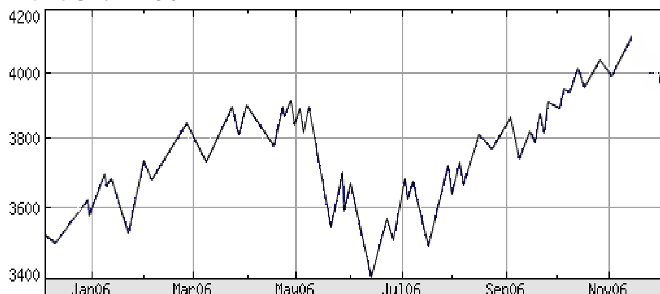
However, if a setback occurs, it should turn out to be merely a temporary interruption that is due to a short-term indigestion. "Fundamentals are still sound," argues **Tammo Greetfeld** of Unicredit-HypoVereinsbank.

"The dividend yield of the Euro Stoxx 50 based on the dividends estimated for 2006 (and paid in 2007 *ed. note*) is 3.3%. Based on the dividends estimated for 2007, it leaps to 3.6%. The appeal of equities becomes visible in a long-term comparison. The shareholder's average return profits from rising dividends, while on a bond investment, the return is limited to the current coupon, namely a meagre 3.6-3.7% in Germany."



If the experts interviewed by *TheEuropeanside* are right, equity investors have no major reason to abandon ship, but they are advised to adjust their portfolios and focus on some specific themes.

"First, you should lighten up on small-caps," says **Alain Bokobza**, head of Pan-European equity strategy at Société Générale. "Small-cap out-performance has been one of the uppermost topic during the advance which began in 2003. For some time they were selling at a discount from large-caps; now, they sell at a premium. I don't see any good reason to maintain generous positions in this area. I also believe selling pressures will continue to push down the dollar. Therefore I would recommend primarily stocks that stand to benefit from domestic activity. For example retail, whose appeal rests on its rapid



German Stocks benefit from tax reforms

Once again, good news are emerging for the German stock market. *TheEuropeanSide* wants to offer a recapitulation of what happened in the last few weeks.

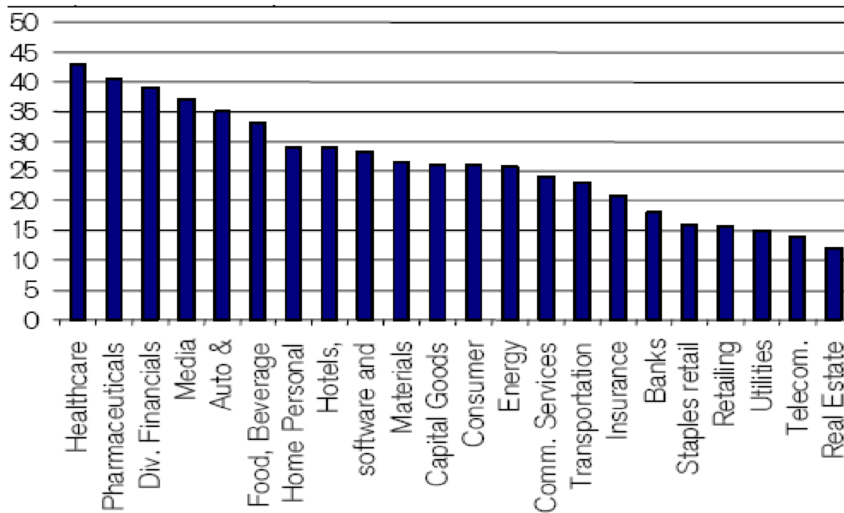
The ruling coalition led by Angela Merkel agreed early in November to change the levy applied to corporate earnings. In the abstract, the reform will cut corporate tax rates from the current 38.65% to 29.8% at the beginning of 2008.

In the most concrete terms possible, since the reform extends the tax base markedly, the real burden would be equivalent to a rate of 35-36%, with a net relief estimated between 5 and 8.5 billion euros.

"The reduction ," explains Tammo Greetfeld of Unicredit-HypoVereinsbank, "will benefit only companies that generate earnings in Germany." "Profits of the Dax stocks should increase by 3-5%. The advantage for MDax companies will be even greater because, on average, they report a much higher ratio of earnings at home." **Ronan Carr** of Morgan Stanley emphasizes that "potential winners have a combination of relatively ...

continued on page 3

European sector exposure to the US



Source: Credit Suisse

The experts suggest you should accord preference to domestic-oriented companies.

restructuring, its inviting valuations and the good dynamism of demand."

By contrast, it may be time "to reduce bank exposure into strength," claims **Ian MacFarlane** of BCA Research. "The banking sector is over-owned and currently accounts for 22% of all earnings in the euro-zone and 20% of the market capitalization. The ratio for broader financials is close to 36% and 33% respectively. The wave of takeovers and the structural change and consolidation in the industry explain and justify some of the increase in earnings importance. But valuations, while below the market norm, are above the historic ratio to the overall market. This is true on both a p/e basis as well as a cyclical-adjusted measure such as price-to-book." Mr. MacFarlane adds that "if one wants to stay in the banking sector, the place to be is probably Germany." " German banks are trading well below regional standards on a price-to-book basis. Moreover, the economy of the Country is still in the early stage of recovery and the real estate market remains very depressed with plenty of upside."

The experts also suggest keeping in mind the role of an appreciating currency because the euro is up decisively. Looking at the past, there has not been a consistent relationship between the euro weakening/strengthening and stock market performance. Moreover, there is no sign that a muscular exchange rate is damaging profitability. Over the past 3 years, G6 forward earnings have soared by 78%, on average. But the most brilliant gain (109%) was recorded by Germany, while the weakest (55%) was attributable to the US. A strong euro attracts foreign money as well. According to **Ed Yardeni**'s data, "from January 2004 through September 2006, $303.4 billion poured into US mutual funds that invest overseas, while domestic funds attracted $233.8 billion." An important share is coming to the Old Continent.

By contrast, the impact of currency swings has been higher on a sector basis. **Kevin Gardiner** - HSBC's head of global equity strategy - suggests that "although obvious, investors should accord preference to domestic-oriented companies." As can be seen from the chart above, in Europe, Healthcare Equipment and Pharma have the largest exposure to the US, followed by Financials, Media and Auto. Real Estate, Utilities, Telecoms and Retail have the lowest exposure.

One can also look at single names. Here are a few examples offered by Credit Suisse analysts. On the negative side, "Electrolux sells 35% of its products in the US, plus some turnover in Asian, while ABN Amro's earnings growth is also highly dependent on the US due to its large interest in the US mortgage market." On the other hand, "real estate company Meinl is involved in the development and management of commercial real estate properties in Central and Eastern Europe and has extremely limited dollar positions." Further examples include "German utility E.On with a 4% exposure to North America and Tesco with a 5%." Both the companies have appealing fundamentals, according to **Beat Alpiger** and **Pascal Rohner** of Credit Suisse.

All in all, a market setback may be more an opportunity than a danger.

continued from page 2

....low interest and depreciation expenses and a high effective tax rate such as BASF, Stada, Porsche, Solarworld, United Internet and Beiersdorf."

When the effective levy is low and interest and depreciation expenses are high, the advantage decreases and may even become a loss. Potential losers are TUI, Deutsche Telecom, and perhaps Lufthansa, Bayer and RWE.

Finally, in the coming months the German equity market will probably also be influenced by another news. All private investment income is to be subject to a 25% withholding tax from January 1, 2009. Currently, if you hold equities for over a year, capital gains are tax free. The new rule applies to purchases from January 2009. "If, as it seems probable, the withholding tax legislation were in fact to imply that capital gains on equities purchases before the end of 2008 can also be realized tax free after 2009, this would be a strong incentive to buy before the end of 2009", comments Mr. Greetfeld.