

MARKET OUTLOOK



NICK SHERIDAN ON EUROPEAN EQUITIES – FEBRUARY 2008

European equities were unable to shake-off the volatility that plagued stockmarkets in 2007 and suffered further falls in early 2008. Nick Sheridan, fund manager of the New Star European Value Fund, believes it may be some months before clarity returns and it is important for investors to position their portfolios accordingly.



Forecasting stockmarket movements taking a six- or 12-month view is as difficult now as it has been for years. The overriding factor is macroeconomic, with investors being asked to make a call on whether they believe the US will slip into a sustained recession.

With the leading minds at the world's central banks unable to shed meaningful light, it would be foolish to claim to know the answer. The scales are finely balanced and it is likely to be many months before any meaningful steer is given on which way the US will finally tip.

Aside from the pressures of the US slowdown, constructing the bear case for Europe is relatively easy. Banks have undergone a prolonged spell of solid returns generated by structured products and leveraged balance sheets. The credit crunch has closed both avenues and it may be difficult to find alternatives. Consumers in most mature European markets are also over-gearred, with university education costs rising, house prices inflated and pension provision under-funded. As the impact of an ageing population bites, consumers may rein in their spending, possibly for a prolonged period.

The bull case for Continental European equities, however, can also be compelling. Structurally the eurozone and the companies operating within its borders have changed from a decade ago. At a corporate level, costs are being stripped out, production is being moved overseas effectively and returns on invested capital have increased. The European Central Bank also still has room to manoeuvre.

Valuations are also supportive. In 2007 retail investors sold equities at levels in excess of previous cycles and there are now compelling reasons for buyers to return. Analysts forecast potential returns of as much as 25% by the year end, with the prospective price earnings ratio for European equities at 10.7, its lowest level in 15 years* (see chart 1). For asset allocators, equities look particularly cheap relative to bonds, with the risk-adjusted yield gap between the two at 3.65 percentage points, the widest since 1980*. In addition, dividend yields are 2% above the prevailing real yield, with the dividend covered 1.6 times by cash flow.

Chart 1: Pan-European 12-Month Forward PE



Source: Lehman Brothers, FTSE, IBES, Exshare

European companies have announced buybacks equivalent to 1.3% of the European market cap over the past year. Net of these buybacks, issuance has been slow compared to historical norms and this has positive implications for the future market returns. With stocks trading lower, this presents an ideal opportunity to effect corporate buybacks, potentially further supporting a stockmarket rally. On a risk basis, Europe also looks attractive on current valuations (see chart 2).

Chart 2: European Risk (high/low)



Source: Lehman Brothers, FTSE, IBES, Exshare

While valuations support Continental European equities, a deep US recession has the potential to negate all. Until further data sheds more light on the health of the financial sector, the US consumer and the scope for additional monetary easing, stockmarkets around the world will struggle to price risk accurately. In the interim, volatility is likely to remain high, with stockmarkets driven by fear rather than fundamental analysis. Central banks must prove their mettle and, if they are successful, a stockmarket rebound is likely to follow. With the jury still out, a focus on attractively-valued companies with debt-light balance sheets appears the most prudent approach.

*Figures at 25 January 2008. Source: Lehman Brothers

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- Active portfolio management
- Distinctive value investment process
- Stock specific, with no deliberate sector or country bias

FUND AT A GLANCE

Launch date:	01.10.1997*
Base currency:	Sterling
Other currency classes:	€ share class: launch date 03.09.2007
ISIN EUR:	GB00B1XQM616
Bloomberg:	NEWSEVE LN
Sedol:	B1XQM61
Registration:	UK, Italy, Spain, France

Fund information at 31 January 2008.

*Originally authorised as the Tilney European Growth Fund on 1 October 1997

HOW TO CONTACT NEW STAR INTERNATIONAL

INTERNATIONAL INVESTMENT SERVICES

Phone: +353 1 475 8000
Email: dublin@newstaram.com
Web: www.newstaram.com

INTERNATIONAL DEALING AND ADMINISTRATION

Phone: +353 1 853 8732
Fax: +353 1 853 8536