# WHAT'S ON THE HORIZON FOR EUROPE IN 2007

by Chris Rice - Head of European Equities

I have moved into 2007 with a lot of confidence in the European economy. A lot of momentum has built up over the past 12 months, which means as we move into the first quarter things look quite good.

However, there are two clouds on the horizon. The first is that the US economy has shown some signs of slowing down. Europe is predominantly an export-led economy so if there is a change in economic conditions in the dollar block that has a reasonably big impact on Europe because of the net trade effect. Of the big economic blocks Europe is the most dependent on trade.

The second cloud is that the German economy had a big boost last year from tax changes but that will change with this month's VAT increase, from 16% to 19%. There were a lot of purchases by consumers ahead of that, which grew the German economy, but that will probably pull back.

That said, in the first half of this year the Eurozone economy should continue to be one of the safer ones globally. Interest rates are still supportive with the rise in UK base rates not reflected by the ECB. There are likely to be two more rate rises in 2007 though. So, while times are good, we could see some moderation in growth in the E.urozone, like has been seen in the US over the past 12 months.

At the stock market level, it should be another good first half in terms of profits, though not quite as good as last year. Profits have been strong since 2004 but have been falling each year since then. Between 2004 and 2005 was the big recovery period and 2006 was the middle of the cycle with more than 20% earnings growth. I think it will be difficult to achieve much more than 10% this year.

The oil sector will prove a big drag on profitability. With the oil price coming down $25 from its peak we will see down profits rather than up profits. More cyclical areas might also prove difficult in the second part of the year because they have been driving growth. Engineering companies, for example, have been fantastic, especially when the impact of China is considered. However, I think they definitely have to come down, particularly as they are also impacted by the performance of the oil sector.

Bringing my views on the economy, market and companies together, there is every reason to think that things will be okay in the first half of this year. Risks will arise in the second half because we are in the fifth year of recovery, meaning banks will have to continue raising rates to bring in excess liquidity and credit growth. Credit growth is too strong at the moment with bank lending rising at about 14% per annum in Europe - above 10% causes inflationary pressures. Interest rates are still not high enough to stop the creation of inflationary pressures so central banks will want to slow things down.

In terms of the fund, we have had a position for many years of being overweight peripheral European markets at the expense of core markets because the former have benefited disproportionately from low interest rates. For example, Ireland and Spain have fared better than Germany. However, we are relative-value investors and we are finding less value in those markets now. The fund's biggest overweight at the moment is Switzerland. Its stock market does not tend to be correlated to it's economy as most of the stocks are actually large international companies.

Within the Swiss market I particularly like private banks because they are highly profitable and reasonably fast growing, with the bulk of growth coming from Asia. Julius Baer, a very old Swiss private bank, is the biggest overweight in the portfolio. It is a major acquisition and is now in a position to benefit from the growth in the private banking sector.

Geographically, the fund has slightly come back towards the core European economies over the past six months and I am now starting to look at France again. The best-performing market last year was Spain, which means there is not a lot of value left there. I feel as the European economy begins to slow and interest rates begin to increase it is a good time to come back to the core.

Looking ahead to the rest of the year, among the issues that will prompt caution in the second half is the valuation of small and mid-cap shares. I have spoken about this for the past two to three years but when you look at the three major markets of Germany, France and the UK today, these shares trade at 18 times earnings and at a 30% to 40% premium to large caps. That is the biggest ever premium they have enjoyed over large caps. I do not think small and mid caps will collapse but I cannot see the market having another good year without large caps going up. Our view is that, even if small and medium-sized companies go up another 20%, it would not add that much to the market's return. Large caps have to perform this year: finally investors will be forced to buy these shares, which they have left alone since 2000. The fund has been positioned along these lines for about a year, which did us very well in the summer, but in the rally at the end of the year it left us behind a bit.

A lot of our big positions at the moment are in large caps, mainly consumer and financials stocks. Among the big names are Heineken and Henkel. These trade at around 15 times earnings for about 10% to 11% growth. A mixture of reasonable valuation and reasonable growth will be what the market wants in a slowing year.

In terms of financials stocks, I still like Credit Suisse and investment banks such as Deutsche Bank. One area I have recently added to is insurance. These stocks trade at about 10 to 11 times earnings so are very cheap while a lot are not as exposed to equities as they were in the bear market of 2002. They are now far less risky investments but still trade at a 30% discount to the market. I have been buying stocks like Axa in France and ZFS in Switzerland.

## Chris Rice - Head of the European Team

Chris Rice joined Cazenove in 2002. As Head of European (ex UK ) equities, he is responsible for all aspects of European (ex UK ) equity strategy, portfolio construction and performance. He is manager of the Cazenove European Fund (onshore), The Cazenove European Equity (ex UK ) Fund (offshore) and The Cazenove European Equity Absolute Return Fund. He is responsible for sector research in Banks & Specialty Finance (including Property), Oil & Gas, Media, General Retailers, Personal Care/Luxury Goods and Support Services. Chris joined from HSBC Asset Management ( Europe ) Ltd where he held a similar position, responsible for their retail and institutional Pan-European and European equity funds. Prior to HSBC, he was a Japanese and European fund manager at Scottish Amicable Investment Managers. Chris graduated from the University of Salford with First Class Honours in Finance and Accounting as well as a MPhil in Monetary Economics from the University of Glasgow and he is IIMR qualified. He is a Director of Cazenove Capital Management and has 16 years of investment experience.

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