

View from Europe

Mild economic recovery in 2002 will be characterised by minimal inflation and pricing power for companies, as well as further consolidation

UK banking valuations reflect unwarranted optimism

In the late 1990s and into 2000, sector was a powerful driver of return in European equity markets. Investors first rushed into the new economy and then fled from it into defensive sectors. Making the right calls on sector was crucial to investment success.

Today, however, most sectors are close to fair value. Outperformance must come from old-fashioned stock-picking, i.e. identifying companies with superior business models, products, distribution, and, ultimately, return on capital.

Both the US and Europe can be expected to experience mild economic recovery in

2002 and 2003, with Europe's rebound lagging that of the US by roughly six months.

As investors look ahead to renewed economic vigour in the region, European equity markets should rise modestly in 2002. This environment is likely to be characterised by minimal inflation and pricing power for companies, as well as further consolidation in many industries ranging from mining to telecoms.

The most interesting area in Europe at the moment is consumer cyclicals. Media is especially attractive. Although advertising is now in a global slump, its longer-term prospects are bright as European

advertising spending begins to approach American levels.

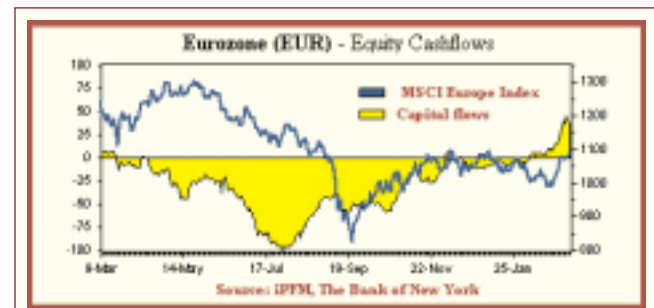
We also like certain chemical stocks, particularly the specialty companies further up the value chain. The industry is now in a funk, but its medium-term future is promising given cheaper oil feedstock and an ongoing industry consolidation that will aid pricing discipline.

Another favourite, on a selective basis, is insurance. Globally, the industry is benefiting from a pricing upcycle; more specific to the region, Germany's recent elimination of its capital gains tax will help its big insurers and reinsurers, notably Allianz

and Munich Re, sell off their equity stakes in low-margin businesses, freeing capital for better use.

The area to go most underweight in is banks, especially the major UK institutions. Banks are underprovisioning for loan losses at this point in the business cycle. Moreover, valuations in general, and those of the British clearing banks in particular, reflect unwarranted optimism that currently high profit margins will be sustained.

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Recent weeks have seen a sharp pick-up in the pace of international investment flows into European equities. But these inflows are relatively modest compared to many emerging equity markets.

The net buying since late September in both South Korean and Czech markets, for example, has been between three and five times what was sold during the first part of last year.

By contrast, the net buying of European equities seen since the middle of last year has only recently taken holdings back to where they stood at the start of 2001.