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# A Sizzling Year, With More Gains Ahead

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*Bourses likely to extend their winning streak in 2006.*

**Dow Jones Global Indexes | Global Stock Markets**

**THREE YEARS LEAN,** three years fat. Now what?

The European stock market is a few weeks away from finishing a third year with torrid gains. With the Dow Jones Stoxx pan-European index up 22% in local currencies this year, it likely will best last year's 10% increase, and a 14% rise in 2003. It also smokes this year's paltry advance of about 4% in the S&P 500 stock index. From 2000 through 2002, European stocks were down nearly 60% at their lows.

This year's buoyancy has many investors sanguine about the 2006 outlook, according to our admittedly unscientific study of the expectations of 13 fund managers on both sides of the Atlantic. Good times beget good sentiment, and the managers, on average, see European shares up 10% next year, versus expectations for 8% corporate-profit growth.

It might surprise some readers to know that the dollar-based investor has performed best in European issues, through both bull and bear markets. With the exception of 2000 and 2005, the euro has risen against the dollar since 1999. Consequently, the DJ Stoxx index is down just 7% in dollars over the past six years, and boasts a total return, including dividends of 10%. That compares with a 21% decline in euros, or a negative 6.6% total return. Over the same six years, the S&P 500 has fallen 15% in price terms, and posted a negative 6.6% total return. This year, however, with the greenback strong again, the DJ Stoxx is up just 6% in dollars.

What is behind the managers' positive outlook? The pros cite relatively low interest rates and bond yields; strong earnings growth; growing corporate cash balances, which bodes well for dividend growth and an already hot mergers and acquisitions scene, and improving European economic growth, albeit from low levels. But there are caveats, too.

"We're upbeat," says Sarah Arkle, chief investment officer for Threadneedle Asset Management. Stocks look attractive relative to bonds, she says, with profit growth modest, interest-rate increases limited and valuations attractive. The Stoxx dividend yield is a hair less than 3%, and not far from the German 10-year bund yield around 3.5%. When equity yields approach or top fixed-income yields, it's often taken as a sign that stocks are undervalued.

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The European economy is on a firm footing, adds Michael Perelstein, a portfolio manager with American Century Investment Management. Companies are sitting on record levels of cash, which could be spent on buybacks, increased dividends and capital investment, he says. The last bodes well for growth and tech stocks, he notes.

European stocks are still cheap on a price/earnings (P/E) basis, says Phillippe Brugere-Trelat, a fund manger with Franklin Templeton Investments. Granted, they are not as inexpensive as they were at the start of 2005 relative to U.S. stocks, but prices still are supportive, he adds.

The traditional discount to American P/Es has narrowed, notes Jacques Chahine, strategist for FactSet. With the Stoxx index trading at a P/E of 12.9 times earnings, and the S&P 500 at 14.8 times earnings, the spread in multiples has been almost halved to 1.9 from 3.7 a year ago, he says.

We found no bears in our survey, though a few investors are looking for a more modest increase of 5%. Much of the positive outlook already is in stock prices after this year's big run-up, they say. Higher energy prices and a stronger euro will be headwinds for Europe, and there are questions about how high the European Central Bank will raise rates.

Our prognosticators mainly look for the ECB to raise rates by just another half of a percentage point this year, which would bring the benchmark repurchase rate to 2.75%. That would still be an accommodative policy by almost any standards. However, as this column noted last week, the market's hopes are likely to be too dovish. Better-than-expected European growth, combined with inflation above the bank's target, could take rates higher than investors expect.

Stephen Docherty, head of global equities for Aberdeen Asset Management, says the ECB and inflation expectations are on his worry list. Stocks won't be helped, "if we see something aggressive from the ECB," he says. Sentiment is good, but perhaps not strong enough to overcome a bank intent on removing liquidity from the system by hiking rates. It also would be a negative for the current mergers and acquisitions boom.

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Among the fund managers' favorite stocks for 2006 is Germany's Fresenius Medical Care (ticker: FMS-P), which operates dialysis centers and hospitals, and offers clinical testing and services. Bruno Berry, a portfolio manager at Morely Fund Management, says Fresenius has good earnings-growth potential of 15% to 20% next year, about in line with its 2006 P/E ratio of 17 times.

Another Teutonic pick is the Deutsche Postbank (DEUPF), which was spun out of and is still controlled by the Deutsche Post. "It's a company with a great network [of branches] and a huge deposit base," notes Aberdeen's Docherty.

The bank, the biggest in the country based on the number of clients, is looking to expand in nontraditional ways with more product offerings, says Docherty. It has a P/E of 14 times.

Francis Claro, a money manager at Evergreen Investments, thinks USG People (USG NA), a provider of temporary employment services, will benefit from accelerating growth on the Continent. That should encourage job growth, and when European companies start hiring, they turn to temporary employment first. Claro looks for a 41% jump in earnings per share in 2006. USG's P/E ratio is 13.

In Italy, Heather Arnold, director of European equities for Putnam, likes UniCredito Italiano (UNCIF), the country's biggest bank. It sells for 1.7 times book value, which is cheaper than peers, and offers around a 4% dividend return, she says. Unicredito will benefit from cost-cutting at the newly acquired HVB Group, and is also the biggest western bank in fast-growing Eastern Europe.

Jeff Munroe, the chief investment officer of Newton Investment Management, likes France's

Societe Generale (SCGLF), which he says has a strong business franchise and should deliver 10% growth next year. It offers a combination of domestic banking opportunities and a nice investment bank, he adds. The stock trades for nine times his 2006 EPS estimate.

The basic-resources sector, up about 47% in local terms, and oil and gas, up 34%, are the best-performing sectors this year. No surprise there, given the rise in commodity prices. The only losing sector, so far, is telecommunications, down about 1%. Retail stocks are up just 7%.

Among the big countries, Switzerland leads, up 33% as of Friday. France, Germany, the Netherlands and Sweden are just about tied for second, up 22%-to-27%. Italian shares are up only 13%, however, as Italy suffers from the weakest economic growth.

Last week, the Dow Jones Stoxx pan-European index ended flat at 306.86.

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