LAZARD

2009Q3 **Outlook**

EUROPEAN EQUITY / JULY 2009

# Focus on High-Quality, Financially Productive Companies

European markets rallied strongly in the second quarter, as signs of a recovery appeared. In April, a number of strong first quarter earnings reports and more optimistic assessments on the global economy provided an upbeat tone, which resulted in an increase in performance in April and May. Data releases have been more varied over the past two months, and the market did cool in June, as many assess the prospects for the macroeconomic recovery in the second half of the year.

As many valuations were beginning to price-in Doomsday scenarios, it is not surprising that the market bounced after it appeared clear that a depression had been avoided. Having said that, the rebound in performance of European equity markets in the second quarter does not imply that the status of the real economy is changed dramatically. Our view, gleaned from meetings with many of Europe's top companies, is that the corporate environment still remains relatively poor. While economic surveys are beginning to look more positive, it must be considered that they are coming from a historically low base.

From a macroeconomic perspective, it should be remembered that Europe is in better shape than many other regions. Household debt is significantly lower, because when the rest of the world was leveraging up, ahead of the downturn, core parts of Europe were already deleveraging. This has left Europeans with a strong household balance sheet, and while demand has been relatively low, we believe the prospects for a recovery are sound.

The recovery has also been helped by new issuance in bond and equity markets, and indeed some companies have been able to raise new financing for proactive, rather than defensive, purposes. This has enabled some of the weaker companies to survive, while stronger companies have recovered quicker than anticipated.

Looking forward, we think that there are three major themes for investors to contemplate in the second half of 2009:

- First, we believe that a growing emphasis will be placed on analyzing companies' underlying levels of activity and demand. As we move towards the end of 2009, the supportive wave of economic sentiment may start to dissipate, revealing levels of activity and demand that may not be as positive as some commentators are currently predicting. This is particularly true when one considers the likelihood that many companies will be operating with excess capacity for some time. The impact of this on profitability could be significant for many companies

- Second, what will be the reaction if analysts' 2010 consensus estimates have been too optimistic? Over the past year, sell-side estimates have swung widely on market sentiment, often overestimating the real impact at both ends of the spectrum. However, as analysts have largely not factored in the same level of downturn for 2010—it appears as though near-peak margins are being factored in for the non-financial sectors of the market—revisions are likely

- Finally, we believe there are significant stock opportunities arising in high-quality companies where the valuation is now compelling

As a consequence of these factors, we believe the recovery, however shaped, will be more stock specific than what the equity market is currently pricing. The ability to sustain profits through a difficult macroeconomic environment is now paramount, and we think that firms with a dominant market position or a strong brand are best placed to generate sustainable returns in varying market conditions.

At the sector level, we favor: consumer services, as the European consumer has been less impacted by the global downturn and sales remain surprisingly robust; health care, as, in our view, the ongoing strength of revenues in the sector is not reflected in current valuations, and cash flows have been largely underestimated; and industrials, focusing on non-cyclical companies.

The positive response to further fiscal and monetary stimulus and the second quarter rally were the first real signs of optimism in this cycle. We believe that the equity market will continue to be volatile and that the recovery is unlikely to be in a straight line. However, investors can take heart that some valuations remain attractive and that the potential for returns to be generated from bottom-up, fundamental stock picking has been much increased due to the sell-off. As we have consistently emphasized, we firmly believe that the quality of companies is still extremely important. We think that a focus on high-quality, cash-generative companies will help investors to find the resilient stocks needed for the short term and will leave them well positioned for the long term.

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**NOTES:**

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