

Style and the Euro - Some Preliminary Evidence from the First Six Months -

The euro has been with us now for only seven months, but it is already possible to recognize some of the structure's early implications regarding eurozone sectors and, equally significantly, eurozone Styles. The recent ten months (August 1998 – January 1999; and February 1999 – June 1999) offer clear evidence that Style patterns are coherent and relevant across and within the eurozone, that they apply within the principal eurozone economic sectors, and that they are intelligently interpretable against economic and market fundamentals. However, just like the economies, political environments and markets to which they are related, eurozone Style factors will require sophisticated, flexible and adaptable forecasting methodologies.

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Looking into the euro environment from the perspective of late 1998, the economic foundation for Style looked solid and compelling. Across the eurozone:

Inflation was to stay subdued	- so high growth, high capital investing companies would not be disadvantaged; and consequently,
Interest rates would remain low	- so investors could afford to take a longer view and benefit from securities' Growth potential;
Economic growth would be stable	- so the profitability cycle would favour companies with apparent profitability and Growth potential;
Currencies would be fixed regionally	- so the larger, more export-oriented, typically Growth, companies would enjoy further predictability; and,
Increased foreign interest	- was focusing, naturally, on internationally traded brands, which are also, generally, the more Growth oriented companies.

And, sure enough, the expectation of this environment resulted in a very significant and strongly cohesive Style reward pattern over the months immediately approaching the introduction of the euro - and for one month into its existence. Large Growth stocks performed strongly and uniformly, while Small Value stocks performed uniformly weakly.

Style Relative Return Patterns among the Major Eurozone Markets and the UK (Percent Gains 31/8/1998 to 31/1/1999)

Style	Eurozone	France	Germany	Netherlands	Italy	Spain	Ireland	UK
Large / Value	-1.9	1.2	-5.2	-3.4	-1.4	-0.6	-2.9	-2.8
Large / Growth	5.3	5.0	7.7	4.9	2.7	3.8	10.5	5.5
Small / Value	-8.9	-14.9	-6.5	-9.3	-2.8	-7.1	-18.5	-7.8
Small / Growth	-4.7	-10.1	-4.2	1.0	-2.9	4.6	-8.9	-3.8
Total Market	17.6	18.3	11.5	10.2	17.6	18.9	23.5	12.2

Note: Eurozone includes the 11 markets within the initial formation of the Euro (Germany, France, The Netherlands, Belgium, Luxembourg, Italy, Ireland, Spain, Portugal, Austria, Finland). The total sample comprises 2741 traded securities, and returns are the cumulative market-relative total returns (including income) earned from investing in the indicated Style portfolios. The eurozone analysis is presented in Country Adjusted and Sector Adjusted (using the 10 economic groups within the FTSE Actuaries Industry Classification System) format, i.e., after having adjusted for industrial sector distortions and country to country distortions. Individual market analysis is Sector Adjusted only. Size is the primary sort, where Large is the top 80% by capitalization and Small the bottom 20%. Value is taken to be the top half, by capitalization, of each size category, sorted by Book Value per Share to Share Price, and rebalanced every 6 months; Growth is simplified as the other half within each size category.

The indicated Style returns are total returns relative to the local market, while the Total Market returns are total returns quoted in the euro or sterling.

But the situation was quickly to change.

Very soon after the New Year and the implementation of the euro regime of preparatory fixed exchange rates, the economic foundation started to shake. Political and military concerns from the Kosovo crisis rebounded across the eurozone, highlighting disparate political perspectives and resolve, and souring international attitudes towards the new currency. The suspicions of budgetary crises in Italy, and possibly also France and Germany, and evidence of corruption within the central European administration did not help. And the occasional hint of upward interest rate pressure from across the Atlantic also contributed to change the economic perception, virtually over a month end.

As the euro declined relative to the US dollar and sterling, the European equity markets experienced a bout of unnerving uncertainty, increased volatility, and sporadic weakness. But there was also growing speculation that economic growth could be significantly stronger.

**Style Relative Return Patterns among the Major Eurozone Markets and the UK
(Percent Gains 1/2/1999 to 30/6/1999)**

Style	Euro Zone	France	Germany	Netherlands	Italy	Spain	Ireland	UK
Large / Value	2.4	-0.4	4.5	2.6	3.8	3.0	2.6	3.5
Large / Growth	-3.6	-2.5	-4.1	-6.5	-3.4	-0.8	-5.5	-4.9
Small / Value	4.9	8.8	3.1	12.9	0.4	-5.3	21.5	6.8
Small / Growth	-0.4	4.1	-2.9	1.9	-2.2	-3.5	-6.0	0.1
Total Market	6.3	9.2	4.6	8.9	4.7	3.0	6.2	8.0

Just as it was the Large Growth stocks that led the way higher, in anticipation of the creation of the euro, with Small Value trailing furthest behind, the change of tone brought about a complete reversal in the prevailing reward patterns. Just one month into the new regime, Small Value stocks were dramatically outperforming (with only 1 exception) as Large Growth stocks lagged consistently behind.

But just because the Style turning points may be dependent upon changing economic, political and market conditions and may be difficult to predict, it doesn't mean that Style is any less relevant. Striking evidence of eurozone Styles is available at a deeper level.

Current questions surrounding convergence and the feasibility of managing eurozone equity portfolios across broad market sectors, lead towards a more detailed, sector specific analysis of the recent pattern of returns.

Style Performance within the Major Equity Market Sectors

The Eurozone

	Financials		Info Tech		Consumers		Services		Industrials	
	before	after	before	after	before	after	before	after	before	after
Large / Growth	6.6	-12.3	-3.1	-2.3	5.1	0.2	2.3	-0.6	9.4	-5.3
Small / Value	-5.9	7.7	-15.0	-0.6	-14.6	7.3	-6.0	7.8	-14.9	10.9
Sector Return	13.7	0.1	21.8	18.2	14.4	2.0	25.9	3.3	10.4	16.2

France

	Financials		Info Tech		Consumers		Services		Industrials	
	before	after	before	after	before	after	before	after	before	after
Large / Growth	5.9	-6.8	n/a	n/a	12.8	3.4	1.8	3.2	5.5	-9.4
Small / Value	-10.7	6.7	n/a	n/a	-28.9	4.7	-5.9	20.1	-13.4	11.6
Sector Return	19.7	4.0	n/a	n/a	24.3	6.7	21.4	5.6	9.4	12.5

Germany

	Financials		Info Tech		Consumers		Services		Industrials	
	before	after	before	after	before	after	before	after	before	after
Large / Growth	14.3	-12.5	n/a	n/a	3.7	-2.0	7.0	-1.5	16.2	-2.9
Small / Value	-6.1	4.1	n/a	n/a	-8.2	10.7	-0.1	8.1	-18.4	12.7
Sector Return	12.0	-1.7	n/a	n/a	5.3	-0.8	48.7	0.3	9.9	21.5

The Netherlands

	Financials		Info Tech		Consumers		Services		Industrials	
	before	after	before	after	before	after	before	after	before	after
Large / Growth	8.4	-23.0	n/a	n/a	-2.8	-2.8	6.0	2.7	7.0	-7.3
Small / Value	-4.7	23.5	n/a	n/a	-7.1	9.8	-22.0	20.3	-23.1	8.2
Sector Return	10.5	-2.7	n/a	n/a	18.1	0.1	15.6	-5.9	6.4	29.8

Italy

	Financials		Info Tech		Consumers		Services		Industrials	
	before	after	before	after	before	after	before	after	before	after
Large / Growth	11.3	-4.8	n/a	n/a	1.6	2.6	-4.8	-5.6	-5.0	0.7
Small / Value	-2.4	11.1	n/a	n/a	-3.6	-4.5	-0.1	-9.8	-3.1	3.4
Sector Return	11.9	1.7	n/a	n/a	6.6	6.4	25.8	8.5	13.5	10.0

Spain

	Financials		Info Tech		Consumers		Services		Industrials	
	before	after	before	after	before	after	before	after	before	after
Large / Growth	0.1	1.5	n/a	n/a	8.1	0.5	-1.1	0.7	6.7	-9.2
Small / Value	-8.4	-12.0	n/a	n/a	-2.1	-1.7	-7.1	-3.4	-12.8	9.6
Sector Return	9.2	12.0	n/a	n/a	4.6	-1.8	14.8	9.4	23.6	-7.3

The United Kingdom

	Financials		Info Tech		Consumers		Services		Industrials	
	before	after	before	after	before	after	before	after	before	after
Large / Growth	-1.0	-5.7	-3.7	-7.0	7.3	-1.4	12.6	-6.0	-0.5	-7.3
Small / Value	-6.6	0.3	-3.0	27.5	-15.3	14.8	-13.3	12.2	1.1	4.1
Sector Return	11.6	17.2	21.1	1.9	6.8	-4.2	18.2	4.3	7.4	27.2

Note: See previous notes for the definitions of the Large / Growth and Small / Value Style rewards. Rewards are quoted relative to the returns of the total relevant equity market sector. Sector returns are reported in absolute total return terms, in euro or sterling.

“before” signifies the 5 months ending at the end of January 1999; “after” signifies the 5 months ending at the end of June 1999.

“n/a” signifies that the data are too sparse to define meaningful Styles within these sectors.

The principle observations are immediate:

- 1 There are strong patterns of **Sector Performance** across the region:
 - a In all markets except the UK and Spain, the performance of the Financials sector softened consistently from the end of January onwards.
 - b In a manner which would be consistent with the expectation of a strong economic resurgence and a broad recovery among cyclical stocks, Consumers and Services stocks softened uniformly across the region. And, with the exception of Spain and possibly Italy, all Industrial sectors across the region rebounded very strongly from the end of January.
- 2 There are also strong patterns of **Style Performance** across the region:
 - a Large Growth stocks softened from January onwards across most sectors in all European markets. This occurred in 20 of 25 possible situations (Reviewing 5 sectors in the UK, and 4 each in France, Germany, The Netherlands, Italy and Spain; Style data within Ireland are sparse.);
 - b Small Value stocks strengthened dramatically within the major eurozone markets from January onwards. And, across all markets and sectors, *post* January performance exceeded *pre* January performance in 22 of 25 possible situations.

The preliminary conclusions from the first 6 months of life of the euro strongly favour euro convergence and the relevance of Style within and across the eurozone.

There appears to be significant convergence affecting equity market sector performance and Style reward patterns across the major markets of the eurozone. These patterns of performance are interpretable (and therefore possibly predictable) in terms of the market and economic fundamentals. And clearly, Style patterns are coherent across the eurozone and within eurozone sectors, as well as within the structure of the constituent markets themselves.

While it is always advisable to recognize the caveats:

- 1 this has been a period of very dramatic historic change marked by a pronounced reversal in market sentiment and Style trends – perhaps less demanding times would give less clear-cut results; and,
- 2 the analysis principally applies to only the 2 most distinct Style clusters – research should also address the detail of the reward patterns of other key factors;

it is clear that Style is rapidly becoming a very rewarding management instrument for European equity portfolios.