

## **Non-U.S. Investing: Where Do We Go From Here?**

The current global bull market in stocks is just a little over four years old. From a strict technical perspective, our domestic stock market hit its last cycle low very early in October 2002, but market valuations essentially moving sideways through late-March 2003. Equity markets then began moving up, just as (perhaps ironically) bombs began to fly in Iraq. Since then, we've experienced what some observers have called "one of the great synchronous global bull markets ever." Much of the truth in that statement can be derived from the non-U.S. portion of the equation. The broad market index of stocks domiciled in *developed* market foreign countries (the MSCI World ex-U.S. index) has increased by 153% over the past four years. The broad market index of stocks domiciled in *emerging* market countries (the MSCI Emerging Markets index) has increased by 259% over the same time period, while the broad U.S. stock market has advanced by "just" 75%. The latter figure represents a 15% compound annualized return, so the term "just" is really a bit unfair. Nonetheless, the sun simply has not shone as brightly on domestic stocks during this bull market.

The question many investors often ask is when, and under what circumstances, these out-sized return discrepancies will turn around, and domestic stock markets will again outperform non-U.S. ones. All large market investors are naturally home-biased, and embedded in this basic question is something of an assumption that country market valuations have gotten fundamentally out of whack (there's a technical term for you) over the past 3-4 years, and are in need of a re-valuation.

We still haven't figured out how to see around corners, so can offer up no specific opinion about when the next global stock market correction will come (except to say it has been a very long time since the last one). But, we do have an opinion on the current relative valuation of important country/regional markets. From a basic fundamental perspective, non-U.S. stock markets remain generally well-priced compared to the U.S. market, although not as screamingly cheap as they were 3-4 years ago. Most major non-U.S. economies, including many important emerging markets, are also growing faster than that of the U.S., are less leveraged, and are considerably less reliant on other countries for their economic well-being. Such broad factors create a general tailwind at the back of companies domiciled inside their borders. We suspect this is a big reason why non-U.S. companies as a whole have grown their earnings faster than U.S. companies over the past 4 years. We also suspect these factors will continue to assist their future growth. They may not, of course, because this is a very complex issue and not all other factors may be equal, but it's normally much easier to expand sales and margins when your home country/region's economic environment is highly favorable.

Attached are three tables setting out – (1) comparative global market returns over time; (2) recent global stock market valuation metrics versus those observable at the end of 2004, and; (3) key economic and market factors most recently reported by the world's largest countries. Considered as a whole, data like this leads us to think the most pertinent question isn't whether non-U.S. stock markets are no longer "cheap" compared to the U.S., but why aren't they more expensive? For some years now, we've recommended institutional investors be rather aggressively invested in non-U.S. stocks (up to 40% of total equity positions). The data continues to support that.

## Index returns ( in US \$ terms)

	Results ending June 30, 2007								Calendar Year	
	Latest	Calendar	1 year	3 years	5 years	10 years	15 years	2005	2006	
	Quarter	YTD	%	% p.a.	% p.a.	% p.a.	% p.a.	%	%	
<b>EQUITY</b>										
<b>U.S.</b>										
S&P 500	6.3	7.0	20.6	11.7	10.7	7.1	11.2	4.9	15.8	
Russell 2000	4.4	6.5	16.4	13.5	13.9	9.1	11.9	4.6	18.4	
<b>Non-U.S. and Global</b>										
MSCI EAFE (Net)	6.4	10.7	27.0	22.2	17.7	7.7	9.4	13.5	26.3	
MSCI EUROPE	8.7	12.9	33.1	25.1	19.3	10.7	12.2	9.9	34.4	
MSCI JAPAN	(0.6)	2.9	7.3	12.9	12.5	1.7	4.2	25.6	6.3	
MSCI World Index	6.7	9.5	24.2	17.3	14.6	7.5	10.3	10.0	20.7	
S&P/Citigroup World x US Co.<\$2B	7.1	14.7	28.8	26.9	25.7	11.4	10.7	27.4	19.7	
<b>Emerging Markets</b>										
MSCI EM (EMERGING MARKETS)	15.1	17.8	45.5	38.7	30.7	9.4	11.2	34.5	32.6	
<b>FIXED INCOME</b>										
<b>U.S.</b>										
Citigroup US Broad Investment-Grade (USBIG) Bond Index	(0.6)	0.9	6.1	4.0	4.6	6.0	6.4	2.6	4.3	
Merrill Lynch High Yield Master II	0.3	3.1	11.8	9.0	11.8	6.3	8.1	2.7	11.8	
<b>Non-U.S.</b>										
Citigroup Non-USD World Government Bond Index	(1.8)	(0.8)	2.2	3.3	6.9	5.0	6.0	(9.2)	6.9	
Citigroup World Government Bond Index	(1.5)	(0.4)	2.9	3.3	6.3	5.3	6.1	(6.9)	6.1	

## Comparative Index returns ( in US\$ terms)

<b>EQUITY</b>										
<b>Non-U.S. Large Cap vs. U.S. Large Cap</b>										
MSCI EAFE (Net) vs S&P 500	0.1	3.8	6.4	10.6	7.0	0.5	(1.8)	8.6	10.6	
<b>Emerging Markets vs. U.S.</b>										
MSCI EM (EMERGING MARKETS) vs S&P 500	8.8	10.8	24.9	27.0	20.0	2.3	0.0	29.6	16.8	
<b>Small Cap vs. Large Cap</b>										
Russell 2000 vs S&P 500	(1.9)	(0.5)	(4.2)	1.8	3.2	1.9	0.7	(0.4)	2.6	
S&P/Citigroup World x US Co.<\$2B vs MSCI EAFE (Net)	0.6	4.0	1.8	4.6	8.0	3.7	1.3	13.8	(6.6)	
<b>FIXED INCOME</b>										
<b>Non-U.S. vs U.S.</b>										
Citi Non-\$ World Gov't Bonds vs Citi U.S. BIG Bond Index	(1.2)	(1.7)	(3.9)	(0.8)	2.4	(1.1)	(0.4)	(11.8)	2.6	
<b>High Yield vs Investment Grade</b>										
Merrill Lynch High Yield Master II vs Lehman US Aggregate Bond	0.8	2.1	5.6	5.0	7.3	0.3	1.7	0.3	7.4	
<b>BALANCED (Stocks vs Bonds)</b>										
<b>U.S.</b>										
S&P 500 vs Citi U.S. BIG Bond Index	6.9	6.1	14.5	7.7	6.2	1.1	4.8	2.3	11.5	
<b>Non-U.S.</b>										
MSCI EAFE (Net) vs Citigroup Non-\$ World Gov't Bond Index	8.2	11.5	24.8	19.0	10.8	2.7	3.4	22.7	19.4	
<b>Global</b>										
MSCI World Index vs Citigroup World Gov't Bond Index	8.3	9.9	21.3	14.0	8.3	2.2	4.2	16.9	14.5	

**Market Valuation Comparisons:**

**United States versus Selected Country/Regional Markets**

	P/CE Ratio				P/E Ratio				P/BV Ratio			
	Dec. 2004		April 2007		Dec. 2004		April 2007		Dec. 2004		April 2007	
		Relative To US		Relative To US		Relative To US		Relative To US		Relative To US		Relative To US
<b>USA</b>	<b>12.70</b>	<b>1.00</b>	<b>12.20</b>	<b>1.00</b>	<b>19.40</b>	<b>1.00</b>	<b>17.80</b>	<b>1.00</b>	<b>3.00</b>	<b>1.00</b>	<b>3.00</b>	<b>1.00</b>
<b>ACWI ex. USA</b>	8.50	0.67	10.10	0.83	16.60	0.86	16.00	0.90	2.10	0.70	2.50	0.83
<b>Emerging Markets</b>	7.30	0.57	9.70	0.80	<b>19.40</b>	1.00	15.80	0.89	1.90	<b>0.63</b>	2.60	0.87
<b>Asia</b>	<b>6.80</b>	<b>0.54</b>	<b>9.60</b>	<b>0.79</b>	<b>11.20</b>	<b>0.58</b>	<b>16.70</b>	<b>0.94</b>	<b>1.80</b>	<b>0.60</b>	<b>2.40</b>	<b>0.80</b>
China	7.20	0.57	10.10	0.83	13.80	0.71	18.90	1.06	2.00	0.67	3.00	1.00
India	13.00	1.02	16.20	1.33	17.70	0.91	21.80	1.22	3.60	1.20	5.00	1.67
<b>Latin America</b>	<b>7.40</b>	<b>0.58</b>	<b>9.40</b>	<b>0.77</b>	<b>13.10</b>	<b>0.68</b>	<b>14.90</b>	<b>0.84</b>	<b>2.10</b>	<b>0.70</b>	<b>2.80</b>	<b>0.93</b>
Brazil	6.40	0.50	8.20	0.67	47.20	2.43	13.50	0.76	2.20	0.73	3.20	1.07
Mexico	8.20	0.65	11.00	0.90	15.00	0.77	16.90	0.95	2.60	0.87	3.60	1.20
<b>Europe &amp; Middle East</b>	<b>7.50</b>	<b>0.59</b>	<b>9.20</b>	<b>0.75</b>	<b>12.60</b>	<b>0.65</b>	<b>13.80</b>	<b>0.78</b>	<b>1.80</b>	<b>0.60</b>	<b>2.40</b>	<b>0.80</b>
Russia	5.90	0.46	9.00	0.74	8.20	0.42	13.00	0.73	1.10	0.37	2.30	0.77
<b>Africa</b>												
South Africa	9.3	0.73	12.9	1.06	15	0.77	16.8	0.94	2.4	0.80	3.7	1.23

\*P/CE~ Price/Cash Earnings P/E~ Price/Earnings P/BV~Price/Book Value

## Global Economic and Financial Indicators: mid-July 2007

### Output, prices and jobs - (% change in latest year unless noted)

### Account balances, currencies, interest rates, and Markets

	<u>Gross Domestic Product</u>			<u>Industrial Production</u>	<u>Consumer Prices</u>	<u>Unemployment rate</u>	<u>Current Account Balance</u>			<u>Currency Appreciation</u>	<u>Interest Rates - Latest</u>		<u>Stock Market (Y-T-D Return)</u>
	latest 12 mo.	2007E	2008E	latest 12 mo.	latest 12 mo.	last reported	latest 12 mo.	% of GDP	vs. \$, 12 mos.	3-month	10-year gov't	local terms	
	% chg	% chg	% chg	%	% chg.	%	\$bn	%	% chg	% yield	% yield	%	
United States	1.9	2.1	2.7	1.6	2.7	4.5	(\$803)	(6.0)	na	5.25	5.04	7.5	
Japan	2.6	2.6	2.3	3.7	0.0	3.8	\$187	3.4	(5.69)	0.64	1.86	5.5	
China	11.1	10.3	9.7	18.1	3.4	9.5	\$250	8.1	5.40	3.11	4.12	42.3	
Britain	3.0	2.8	2.4	0.4	2.5	5.5	(\$93)	(3.2)	10.00	5.98	5.46	7.3	
Canada	2.0	2.5	2.7	(0.7)	2.2	6.1	\$19	1.6	4.72	4.42	4.55	8.9	
Germany	3.6	2.8	2.3	3.7	1.8	9.1	\$168	4.9	8.22	4.18	4.56	22.4	
Russia	7.9	6.7	6.4	6.7	8.5	6.9	\$87	5.7	4.67	10.00	6.12	(1.5)	
Australia	3.8	3.5	3.3	3.7	2.4	4.2	(\$44)	(5.4)	16.38	6.44	6.13	12.2	
Hong Kong	5.6	5.3	4.9	(1.5)	1.2	4.3	\$23	9.8	(0.51)	4.54	4.54	11.3	
India	9.1	8.1	7.6	13.6	6.6	7.6	(\$10)	(1.8)	13.83	7.37	8.34	7.9	
South Korea	4.0	4.3	4.6	6.6	2.5	3.4	\$5	0.2	2.93	5.01	5.44	28.2	
Taiwan	4.2	4.2	4.6	6.4	0.1	4.0	\$28	6.7	(1.22)	2.55	2.61	15.9	
Brazil	4.3	3.9	3.7	6.0	3.2	10.1	\$15	0.8	14.66	11.93	6.16	25.2	
Mexico	2.6	3.2	3.8	1.5	3.9	3.2	(\$6)	(1.4)	3.70	7.18	7.62	21.8	
South Africa	5.4	4.8	4.9	3.8	6.9	25.5	(\$17)	(6.0)	3.30	6.25	8.36	15.8	