CAMBRIDGE ASSOCIATES LLC

2011 OUTLOOK
EUROPEAN MARKET COMMENTARY

European Equities: Cautiously More Optimistic

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2011 Outlook European Market Commentary

European Equities: Cautiously More Optimistic

Wade O'Brien & Lisa Miller

European equity valuations are reasonable from a historical perspective—pessimism about sovereign finances and a slow recovery may be fully priced in.

"Why [is] the World [Down but] Not Out? At the core of this issue, and why so many people can't get it, because they are not prepared to get it, is that us wonderfully developed countries aren't the key drivers in economic life anymore." —Jim O'Neill, Chief U.S. Economist at Goldman Sachs, September 3, 2010.

"The European debt problem is certainly not behind us, though the chances of it being managed rather than getting out of control because it is not managed have greatly improved."—Bridgewater Associates, May 11, 2010.

Regular readers of our research may not find this 2011 European outlook very dissimilar from the version we published around 12 months ago. In discussing the foundations of the 2009 equity market recovery, we cautioned a year ago that many of the underlying causes of the 2008–09 credit crisis, including excess leverage, had yet to be addressed. At some point, we reasoned, the possible ways to address this problem, which included fiscal austerity measures by governments and reduced expenditure by consumers, were likely to weigh on economic growth and corporate earnings. For this reason, we were cautious on the 2010 outlook for European equities, though the exposure of European companies to rapidly growing emerging markets, as well as unchallenging equity valuations, somewhat mitigated these concerns.

Nearly 12 months on, valuations have changed very little and sovereign debt concerns remain elevated, yet we find ourselves somewhat more constructive in our outlook. This is due to several factors, including better visibility on the ability of European companies to generate profits despite an anemic recovery, stronger economic growth in certain core European countries, and the willingness of politicians and central bankers to take decisive action to contain the sovereign debt crisis. Although a permanent solution for excess leverage may not be any closer and growth concerns still persist, we are encouraged by the conversations taking place and have a better sense of what the future might hold. Put another way, it is difficult to argue that there are many downside risks for European equities of which investors are unaware. From a portfolio allocation perspective, we would not be overweight European equities given current valuations and macro risks. However, were a macro-related equity sell-off to push current valuations even further below global peers, we would consider adding to positions.

2010 in Review: All About Sovereign Debts

In our 2010 outlook, we rightly fixated on the sovereign debt problem, though we may have underestimated just how close it would come to a tipping point earlier in the year. Indeed, macro concerns dominated equity markets for much of 2010. A flare-up in funding spreads for some peripheral European nations early in 2010 set off a chain of events that nearly pushed the Eurozone to a breaking point. The good news was that we (and others) may also have underestimated the resolve of European politicians to ensure that the monetary union remained intact, though of course the possible insolvency of the European banking sector limited the political options. In retrospect, the €750 billion support package for indebted

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sovereigns announced in May was not the turning point for the equity markets it initially appeared to be, though confirmation that the support package could be used effectively after the Irish bailout at the end of November looked to tip the MSCI Europe ex U.K. into the black for the year.

While sovereign stress was the headline, a number of other developments in 2010 also moved European equity markets. These include the publication of stress tests in July that purported to reveal the health of the European banks (but had widely recognized shortcomings), an oil spill in the Gulf of Mexico that at one point erased more than 50% of the market capitalization of one of the largest stocks in the FTSE® 100, and the resilience of export-oriented firm earnings, particularly those with exposure to emerging markets.

In some respects, developments outside Europe may have been more important for many of its companies than domestic events. The resurgent economic growth of emerging markets, facilitated by their healthy balance sheets, contrasted starkly with that of the developed world. European companies that were heavily exposed to rapidly growing markets, such as those in Asia and Latin America, benefitted from increased profits that helped to offset the drag of slower domestic growth. Not all emerging markets exposure proved a panacea, of course. Eastern European nations such as Hungary and Romania struggled over the course of the year with austerity programs required by EU and International Monetary Fund (IMF) assistance; going into year-end, stalling growth dimmed the outlook for these countries.

Looking ahead to 2011, macro themes again seem likely to dominate. Going into year-end, attention was fully focused on peripheral country sovereign debt and banking systems. European equity valuations, which actually changed little over the course of 2010, reflect many of these concerns. To a certain extent, improved earnings and growth prospects at the company level seem to have been nearly offset by growing pessimism about macroeconomic conditions. This begets the question of whether investors are ignoring the global earning capabilities of some companies due to concerns over domestic operations. In either event, the potential for increased volatility may make higher valuations in 2011 difficult to justify.

Weighing all of these factors, we again find ourselves somewhat agnostic on Europe. While macro challenges are significant (and may expand), and the pain of austerity looms, it appears that some of this is already priced in. We also believe some core European countries are in better shape than imagined, and that companies across the region have the ability to grow foreign earnings to offset any domestic slowdown. Finally, we note that contrary to popular opinion, austerity measures are not always negative for equity markets, and that the link between economic growth and equity performance is often weak.

The United Kingdom

Performance in 2010

The FTSE® All-Share Index had returned 6.9% through the end of November 2010, following a 30.1% return for the full year 2009. In line with other global equity markets, the market followed a seesaw pattern for most of the year, up in the first quarter and down during the second, until a 6.5% return in September looked to put it firmly in the black for the year.

Valuations Have Moved Little

Despite volatile equity markets and macro concerns over the course of the year, many valuation measures for U.K. equities in November were similar to where they began the year. This was especially true of normalized earnings metrics,

which by definition are less volatile and which we prefer as they give a better picture of *sustainable* earnings (and have tended to be more predictive) than do 12-month measures.[1] For example, the Shiller P/E multiple for the MSCI U.K. Index was 12.7 at the end of November, nearly unchanged from 13.0 at the start of the year and below its long-term average of 15.3 (Exhibit 1). The trend-line P/E ratio was also almost unchanged, ending the period at 12.4, just a hair below its 12.6 starting point in January and well below its long-term average of 17.6. Finally, the ROE-adjusted P/E ratio decreased during the year, from 13.8 to 12.5, slightly above its long-term average of 12.3.

In contrast, valuation metrics based on trailing 12-month earnings show a material decline in valuation multiples as stock prices did not keep pace with the strong improvement in earnings over the year (Exhibit 2). The FTSE® All-Share[2] traded at 12.1 times trailing 12-month earnings at the end of November, down from 19.0 at the start of the year, and well below the long-term average trailing P/E ratio of 16.6. Improved earnings also meant that the ROE for U.K. stocks rose during the year, to 14.8% in November from 10.2% at the beginning of January, in turn lowering the ROE-adjusted P/E to 14.6 from 15.9.

Meanwhile, the dividend yield (DY) on the FTSE® All-Share was 3.1% at the end of November, slightly below where it began 2010 and its long-term average of 4.2%. At the end of the third quarter, this DY was higher than the yield on ten-year U.K. gilts (Exhibit 3), a rare occurrence over the past 50 years.

Compared to the MSCI Europe ex U.K. Index, the FTSE® All-Share now looks more expensive on a trailing P/E basis, although the relatively steeper collapse and subsequent improvement in earnings for Europe ex U.K. stocks distorts the comparison. On many other metrics, such as price to book, ROE-adjusted P/E, and DY, relative valuations are very similar to their 2010 starting levels (Exhibit 4).

Looking more globally (relative to MSCI World ex U.K.), similar themes emerge. U.K. equities trade at a discounted trailing 12-month P/E multiple relative to MSCI World ex U.K., though this discount is much smaller than at 2009 year-end given the recovery in global earnings and thus a collapsed P/E multiple (Exhibit 5). U.K. equities trade at a slightly lower ROE-adjusted P/E ratio than that of other developed markets, though the ratio between the two has changed little since the start of the year. Finally, DYs in the United Kingdom remain generous compared to those of other developed markets equities, though slightly less so than in 2009.

In short, valuations remain below long-term norms, suggesting the market has remained reasonably valued despite the improvement in earnings. However, valuations are not low enough to provide a large cushion should earnings again start to deteriorate. While this is not our base case scenario, it is certainly a consideration given global uncertainties and looming government austerity programs.

As always, the outlook for earnings is key for equity valuations. At the end of 2009, consensus estimates called for a 24% increase in 2010 EPS,

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[1] Normalized price-earnings (P/E) ratios attempt to adjust valuations for earnings cyclicality, by comparing both earnings and profitability (return on equity [ROE]) to some sort of normative measure over the earnings cycle. Normalized real P/E ratios (also known as Shiller P/E ratios) compare price levels to the ten-year average of real (inflation-adjusted) earnings per share (EPS), while ROE-adjusted P/Es adjust the current P/E multiple by the ratio of the current level of ROE compared to its historical norm.

[2] Data for the FTSE® All-Share have been used in calculating current (as opposed to normalized) valuations, given considerations around the timing and adjustments to recent reported earnings data for the MSCI U.K. Index.

with almost every sector expected to post gains. While seemingly impressive, U.K. earnings have actually grown at a faster clip, and are now expected to increase 37% this year. This growth should, of course, be considered in light of the 40% collapse in earnings in 2009. Looking ahead to 2011, expectations are for a still-respectable 17% increase in earnings. This increase would take earnings by the end of 2011 back to levels last seen in third quarter 2008, still 13% below peak earnings seen in 2007.

The Investment Outlook

This October, the U.K. government announced sweeping austerity measures, which include cutting payrolls by 490,000 jobs and trimming spending by £81 billion over the next four years. These austerity measures are likely to raise unemployment and reduce consumer spending, and further delay a necessary consumer deleveraging. On the surface, this may not present the most attractive investment backdrop. However, equity investors should consider two things. First, austerity measures in the United Kingdom historically have been associated with rising, as opposed to falling, local equity markets. Second, and to repeat a theme we discussed last year, U.K. corporate profits are not just about domestic GDP growth.

Even with these austerity measures, the OECD still expects that U.K. GDP will grow at nearly 1.7% in 2011, above the rate expected for many European peers (Exhibit 6). Global GDP growth, which the IMF and OECD estimate to be 4.2% in 2011, may be a better indicator of potential demand for goods and services provided by many U.K.-domiciled firms. Estimates of the percentage of sales and profits earned by U.K. companies abroad vary. In aggregate, 35% of U.K.-listed company revenue is estimated to come from the United Kingdom. However, large-cap companies, such as those in the FTSE® 100, may earn as much as 80% of their revenue abroad. While a significant percentage of these revenues come from the Eurozone, over 20% of revenue may come from emerging markets.

Given the revenue mix of some U.K. industries and their weights in the indices, continuing growth in emerging markets may have an outsized impact on local equity performance. The basic materials and oil & gas sectors make up 13% and 16%, respectively, of the FTSE® All-Share (Exhibit 7); both are heavily exposed to emerging markets. Meanwhile, U.K. financials, which represent almost one-quarter of the FTSE® All-Share capitalization, are also very exposed to international activities. This is especially obvious for Asian-focused banks like HSBC and Standard Chartered, but local insurance companies like Old Mutual and Prudential also have sizable foreign operations.

The balancing act for investors in 2011 will be to weigh the benefits to these stocks of their emerging markets exposure against the drag that domestic operations might create. Given the attractive foreign exposure of U.K. companies, domestic economic headwinds, and the average valuations discussed above, we find ourselves of two minds on the outlook for U.K. equities. If emerging markets growth continues to accelerate, many firms listed in the United Kingdom will find themselves large beneficiaries. This is not guaranteed, of course, and emerging markets growth could disappoint or fall victim to global tensions over currencies or trade. On the other hand, any of a number of dynamics in the domestic market or even the rest of Europe could help negate this upside potential. Going into year-end, the concern about exposures to Ireland weighing on U.K. bank stocks gives a preview of these possible dynamics.

The inflationary outlook is an additional key variable in 2011. The annual rate of consumer price inflation in the United Kingdom was 3.2% through the end of October, stubbornly above government targets. Expectations about future

inflation in turn have also risen, but remain modest relative to historical experience. Should inflation expectations continue to rise next year, stocks may benefit from two perspectives. First, stocks in sectors with leverage over pricing, like materials and oil & gas, will likely benefit. Second, if inflation rises unexpectedly, it will erode real returns on bonds, and might cause investors to reverse some of the relative bets they have made on bonds in 2010. This assumes, of course, that inflation is accompanied by at least modest growth; so-called stagflation could leave both equities and fixed income vulnerable.

Europe ex U.K.

Performance in 2010[3]

The MSCI Europe ex U.K. Index had returned a paltry -0.5% through the end of November 2010, following a 27.7% return in 2009. Performance varied significantly across the region, however, with macro concerns weighing heavily on the periphery. The gap between Denmark's index-best 30.5% return and Greece's index-worst -38.2% return was nearly 7,000 basis points (Exhibit 8). While Germany turned in a strong performance, returning 11.7%, returns from other heavyweights such as France and Switzerland were more modest, explaining the weak overall index performance.

Rising Earnings Improve Valuations

European corporate earnings staged a healthy recovery in 2010. While the consensus estimate at the end of 2009 was for a 28% increase in 2010 Eurozone (year-over-year) earnings, given better-than-expected company results, by the end of November the full-year increase was expected to be 34%. Countries such as Germany (current 2010 consensus estimate of 55%) were expected to show even stronger gains. Given limited price gains across many indices through November, metrics such as P/E ratios have collapsed, making stocks appear more affordable. As an example, given the 2008–09 earnings collapse, stocks at year-end 2009 traded at 23.6 times trailing 12-month earnings; this metric had fallen to 13.3 by November 2010. In a similar vein, the ROE for European companies improved by around 60% to 11.1%, albeit from a depressed base.

Our preferred normalized valuation metrics, including trailing ten-year real P/E (Shiller) ratios and ROE-adjusted P/E ratios, indicate valuations are similar to last year's values and suggest European equities are reasonably priced. The trailing ten-year P/E multiple is now 13.7, down modestly from 14.2 at the beginning of the year and well below its long-term average of 19.4. The ROE-adjusted P/E multiple is 13.5, also below its long-term average of 14.7 (Exhibit 9). It is worth noting, however, that valuations in our post-1970 dataset have been elevated relative to longer-term equity data and thus may be unduly distorted by the lofty valuations seen a decade ago. In our opinion, fair value multiples may be lower than those suggested by the long-term average multiples since the 1970s, particularly given the degree of uncertainty surrounding conditions today.

Other metrics such as price to book also dropped slightly, to 1.5 as of November, which is just below the level at which it began the year and below its long-term average of 1.8 (Exhibit 10). Finally, the DY of Europe ex U.K. equities was little changed at 3.4%. This yield was slightly above that available from core European sovereign bonds, though a heavy sell-off in the bond market going into year-end saw this differential rapidly disappearing. Government bond yields had exceeded DYs for most of the past 50 years, though in September 2008 this relationship inverted and bonds have only topped equities on one occasion since that date.

[3] Returns in this section are in local currency terms.

A year ago, we questioned the optimism embedded in 2010 Eurozone earnings forecasts, which were expected to increase by 28% this year. Our suspicion was based on both the historical tendency of analysts to overestimate profits, and also the unusually high uncertainty about the current year's prospects given our concerns about the outlook, most notably related to sovereign debt and austerity programs. Our suspicion proved wide of the mark; profits had rebounded strongly through the end of the third quarter and are expected to increase by 34% for the full year. Were earnings to increase by this amount, it would merely take them back to levels seen during the spring of 2009, given the 53% collapse in earnings that year. On a similar note, the 15% forecast increase for 2011 will come from a higher base, but still leave earnings below those seen as recently as February 2009.

The Investment Outlook

In providing our investment outlook for 2011, we are tempted to just dust off our advice from a year ago, when we cautioned about imbalances in the system that needed to be addressed, the pain of looming austerity measures, and the condition of banking system. The year 2010 brought limited progress on many of these issues. This is reflected in sovereign debt spreads that have recently traded at historical highs for some peripheral countries (Exhibit 11); growing debt burdens (Exhibit 12); the lack of political consensus in some countries about implementing austerity budgets; and the growing dependence of peripheral financials on funding from the European Central Bank (ECB).

However, last year's outlook will not suffice as 2010 unfortunately has also brought new concerns, which include intense focus on a fragile monetary union that ties uncompetitive peripheral European countries into an exchange rate that reflects the strength and wishes of the northern core. Many peripheral countries have found, and likely will continue to find, it extremely difficult to outgrow debt burdens without the aid of a weak currency.

This situation will likely take a long time to resolve, although stricter European agreements on public spending and financing in the future would provide some assistance. In the meantime, one silver lining of the sovereign debt crisis has been the euro's weakening against many currencies in 2010 (Exhibit 13). In addition, the ECB has helped to defuse tensions by stepping up its purchases of peripheral sovereign bonds (Exhibit 14), in effect lowering borrowing costs for the periphery via the implied balance sheet strength of the core. Such purchases may even be increased in 2011, given large refinancing requirements for European sovereigns and banks (Exhibit 15). In many respects, the ECB has little choice—core European banks have sizable holdings of debt issued by peripheral financials, and thus a liquidity crisis for the latter could turn into a solvency crisis for the former (Exhibit 16).

However, we cannot help but feel that a few things have changed over the course of the year, offering at least some excuse for optimism. The European Union has been severely tested and has shown surprising unity in circling its wagons to fight off the attacks of the bond vigilantes. This is not to say the announced support facilities are a long-term solution or to ignore their considerable execution risks, but rather to acknowledge that some extreme tail risks such as sovereign default seem to have been taken off the table, at least in the short term. The intermediate term, of course, is a different story, and we note that historically, countries with debt levels as high as those seen among peripheral European countries have often resorted to default or debt restructuring. We are encouraged by the announcement in late November that EU leaders will create a more permanent European Stability Mechanism (ESM) when current stabilization arrangements expire in 2013. We also note that recent proposals regarding

debt restructuring for sovereign bonds issued prior to 2013 have met fierce political resistance. While this pushes an eventual resolution of this crisis farther out into the future, it also reduces the risk of a liquidity crisis morphing into a solvency issue and buys more time for countries to improve their financial positions.

In addition, several core European economies have exceeded the muted growth expectations for the Eurozone going into 2010 and recovered fairly well. The consensus estimate is now that real German GDP growth will be 3.5% in 2010; it was just 1.6% last December. The continued growth in 2011 of core European nations like France and Germany should ensure that a double-dip recession does not materialize for the Eurozone, and is much more significant to the overall health of European corporate earnings than forecasts for Greece or other peripherals. It is worth remembering that Greece, Ireland, Portugal, and Spain combined compose less than 10% of the market capitalization for the MSCI Europe ex U.K. Index.

Given that we are entering the second year of significant sovereign debt concerns, the passage of time has brought some benefits. Companies have had time to prepare by tweaking business models and fortifying balance sheets, aided by robust debt markets. In a different way, time has also allowed some of the recent concerns to be priced in to markets, and to a certain extent, for risk to be re-allocated among those best prepared to manage it. For example, Barclays Capital recently estimated that 30 debt-holder groups may own as much as two-thirds of outstanding Greek government bonds. At a minimum, when Greek sovereign bond spreads imply a 50% probability of default over the next three to five years, it appears at least a reasonable level of risk is priced in.

Finally, over the course of 2010, investors have increasingly recognized the disconnect between pessimism about European macroeconomic data and relatively healthy corporate earnings. Earnings have beaten expectations in 2010 across a number of industries, including carmakers like BMW, Daimler, and Volkswagen; luxury good makers such as LVMH and Richemont; and mining firms like BHP Billiton and Rio Tinto. Helping these firms beat expectations have been foreign earnings, which in many cases continue to grow at faster rates and deliver higher margins than domestic equivalents. Meanwhile, growth prospects for other domestic-focused companies and sectors may be lower for the near term; but, as evidenced by their relative underperformance year-to-date, some of this may be already be priced in.

Conclusion

Normalized valuations for U.K. and European equities have changed little over the course of 2010, though the improvement in corporate earnings has meant that P/E ratios based on trailing 12-month earnings have dropped. While most European equity markets going into the final weeks of 2010 seem likely to post respectable gains for the year, this performance has probably been driven as much by changing risk appetite stemming from anticipation of additional quantitative easing in the United States as it has been from improved confidence, driven by corporate earnings and economic data in Europe.

Looking ahead, several things will probably need to happen for equities to consolidate this year's gains and move higher in 2011. One of these will be for companies to continue delivering strong earnings growth. This seems feasible given how far earnings fell in 2009, improving economic data, and company exposure to healthy emerging markets demand. Sovereign debt problems and any ensuing austerity measures may filter through

and put pressure on earnings for some firms, but large multinationals from core European nations that have greater exposure to foreign markets than to peripheral European markets will be somewhat insulated from this risk. For smaller and mid-sized companies that tend to be more exposed to domestic conditions, the downside risk is higher.

The second thing that needs to occur is for risk appetite to persist going into 2011, and for investors to continue to isolate the noise regarding the sovereign debt crisis from information that is material to corporate earnings. These two things seem far less likely, but looked at differently; bouts of panicked selling may create buying opportunities as companies with solid prospects are sold off in sympathy with those with much weaker fundamentals.

Finally, and on a related note, the quieting of macro fears would create the greatest upside potential for European stocks in 2011, although this is subject to political negotiations and the whims of the bond market, two things that are notoriously hard to predict. If political momentum behind the ESM stalls, if one of the peripherals proves unable or unwilling to push through austerity measures, or if bond markets simply become impatient at the speed of reform, equities could be hit quite quickly.

In assessing downside dangers, macro risks clearly will dominate in 2011, and the task of European leaders is far from complete. Examples of policy positions that may need to be rethought include the proposed size of the European Financial Stability Facility and the terms on which the ECB lends to banks. On a global level, the rising tension over monetary policies is another risk. The inability of world leaders to find common ground on this topic in 2011 could introduce unexpected volatility in foreign exchange and other capital markets, or simply make trade more difficult. This would create significant problems for exporters, potentially turning a diversified geographic revenue mix into both an asset and a liability.

However daunting these macro risks are, it is hard to argue that they are not at least somewhat reflected in current valuations. Over the course of 2010, investors have punished stock and bond markets of the most profligate spenders severely. We take some encouragement that investors are discriminating at least among countries. However, we also suspect that some solid companies with good earnings prospects have suffered in the process. Finding long-term solutions to the sovereign debt problem will be a multiyear process, and we are in the early stages. Therefore, downside risks are likely to stay with us for some time. However, whether *too much* macro pessimism is priced in to equities at this point is worth asking. In the face of uncertainty, investors typically assume the worst. Today, that has been reflected in a number of pessimistic forecasts, such as what losses on sovereign bond holdings will be for European banks, and how peripheral banks may see liquidity dry up in 2011. We could envisage a scenario in which austerity targets are met or at least amended, stabilization assistance works as intended, and other concerns such as those over currency wars dissipate. This environment would allow investors to refocus on fundamentals and correlations to drop. It may also allow investors to refocus on valuations, which for European equities are among the least challenging globally.

Sizing European equities in a portfolio is a difficult task, given the unknowns facing investors, which include sovereign debt worries, currency valuations, and relatively opaque bank disclosures. We could not justify an overweight given these concerns. Conversely, inexpensive equity valuations, the willingness of politicians to provide further assistance to the periphery and its banks, and the earnings resilience of many companies provide some upside potential and discourage an under-

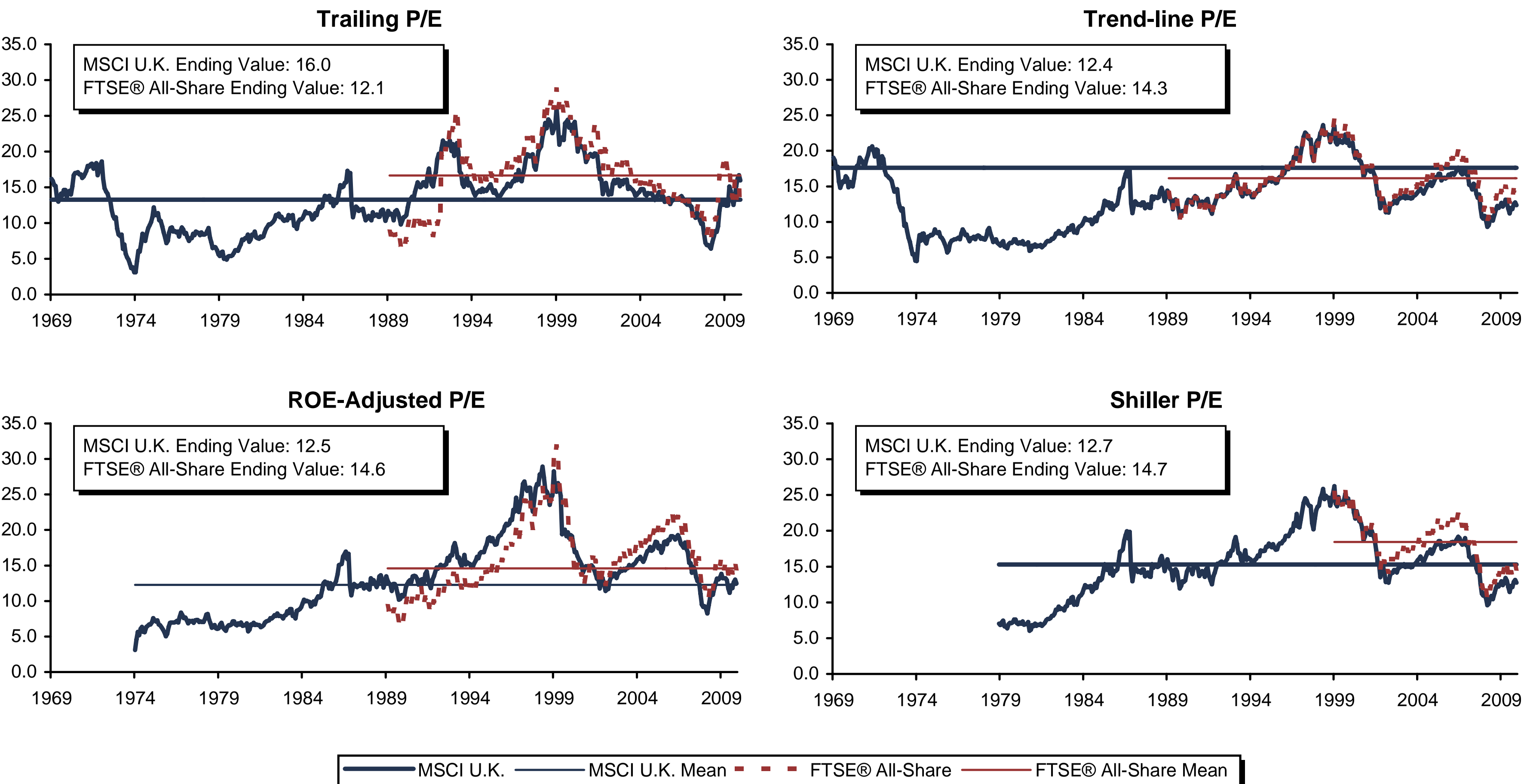
weight. On balance, therefore, we are again neutral about European equities.

In conclusion, we feel like we better understand what risks for European stocks are on the table, and we believe politicians have taken a few off, at least in the short term. In 2011, we will be vigilant about monitoring macro headwinds, yet have seen many companies deliver strong results this year despite these exact conditions. As a result, we are less gloomy than 12 months ago. Should prices weaken further, we might consider a recommendation to add exposure to European stocks in the months ahead, but we would do so only after careful study of any associated changes in fundamental conditions. Ongoing discussions about bailouts and the strings attached to them are likely to trigger further volatility, and even more attractive valuations could yet be seen. ■

Exhibit 1

U.K. Index Price-Earnings Valuations

31 December 1969 – 30 November 2010



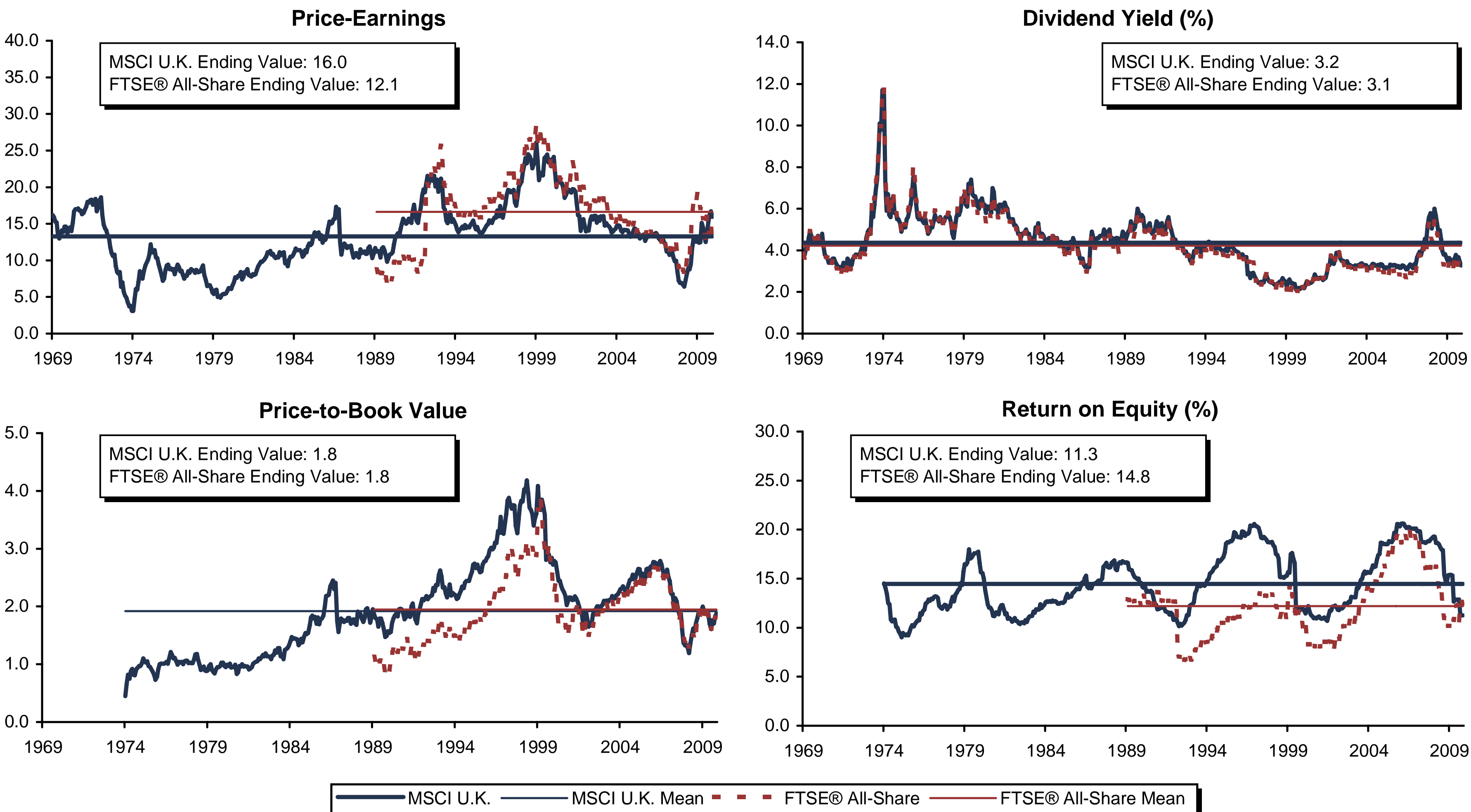
Sources: Factset Research Systems, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: U.K. earnings are deflated by the U.K. RPI from 1969 to November 2003 and the U.K. CPI from December 2003 to present. Return on equity (ROE) is calculated by dividing the index's price-to-book value ratio by its price-earnings (P/E) ratio. The MSCI ROE-adjusted P/E data start on 31 December 1974 and the FTSE on 31 January 1990. The MSCI Shiller P/E data start on 30 November 1979 and the FTSE on 31 December 1999. U.K. CPI data are as of 30 November 2010. To minimize the impact of bubble periods on valuations, we have excluded the years 1998–2000 from our historical average and standard deviation calculations for the ROE-adjusted P/E.

Exhibit 2

U.K. Index Valuations: MSCI U.K. and FTSE® All-Share

31 December 1969 – 30 November 2010

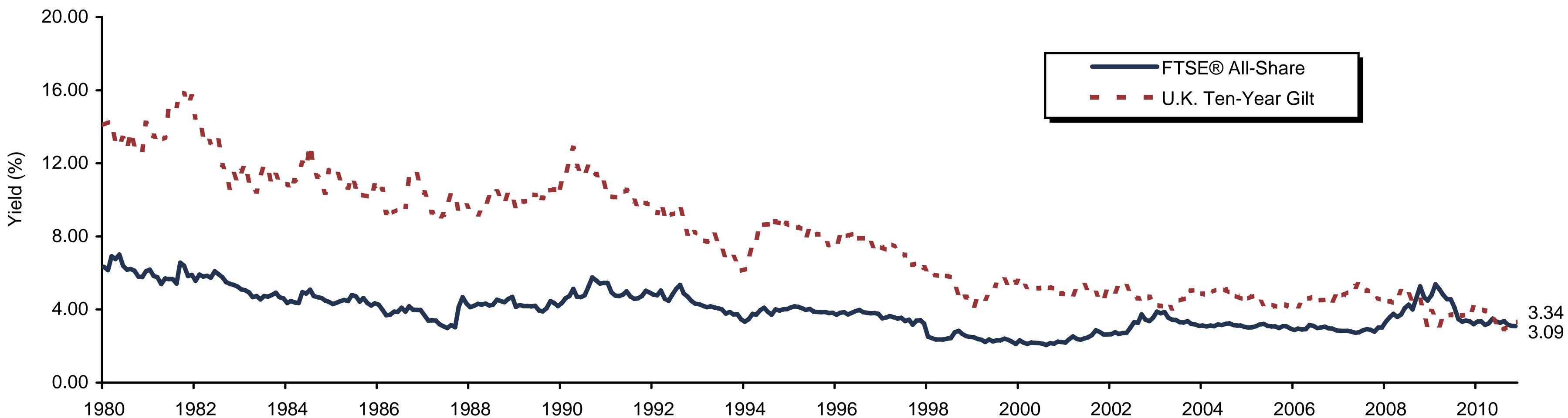


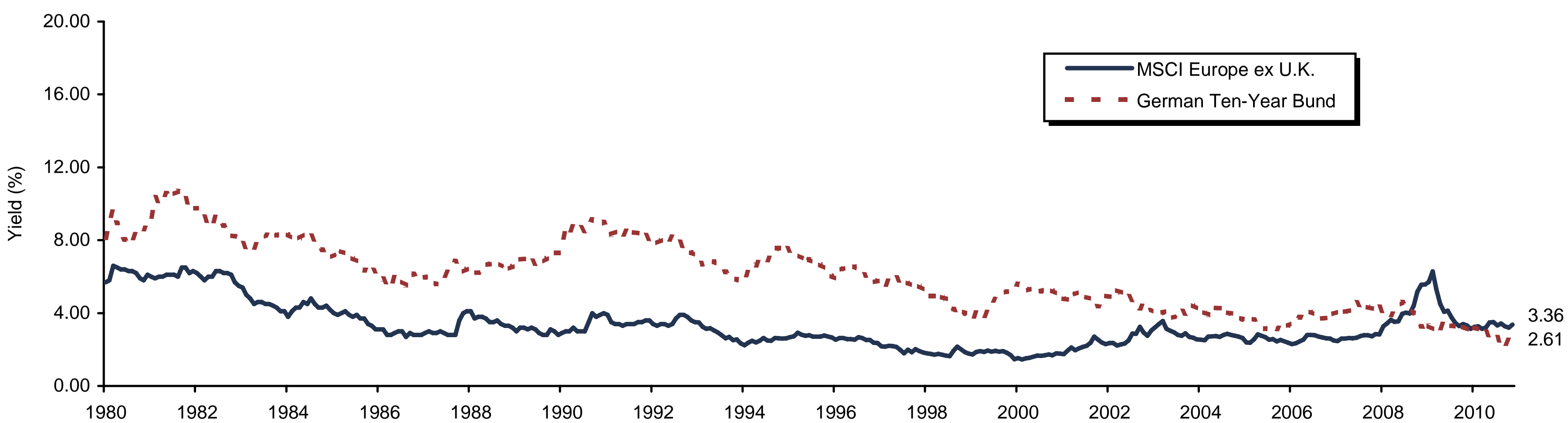
Sources: Factset Reseach Systems, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book (P/B) value ratio by its price-earnings (P/E) ratio. The MSCI P/E data start on 31 December 1969 and the FTSE on 31 January 1990. The MSCI and FTSE dividend yield data begin on 31 December 1969. The MSCI P/B data start on 31 December 1974 and the FTSE on 31 January 1990. The MSCI ROE data begin 31 December 1974 and the FTSE on 31 January 1990.

Exhibit 3

Yield Comparisons

31 January 1980 – 30 November 2010



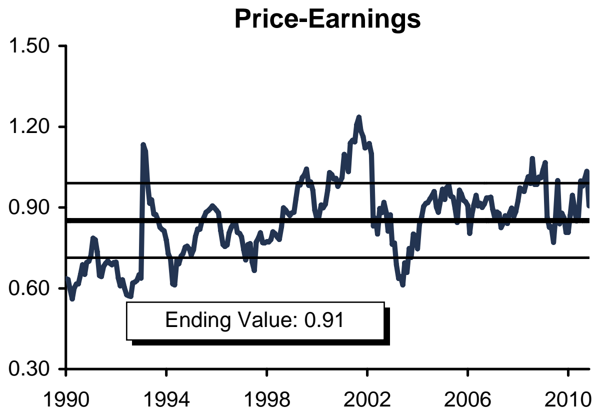


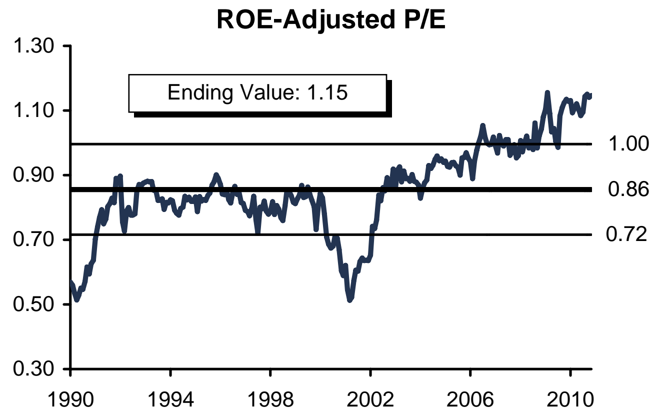
Sources: FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

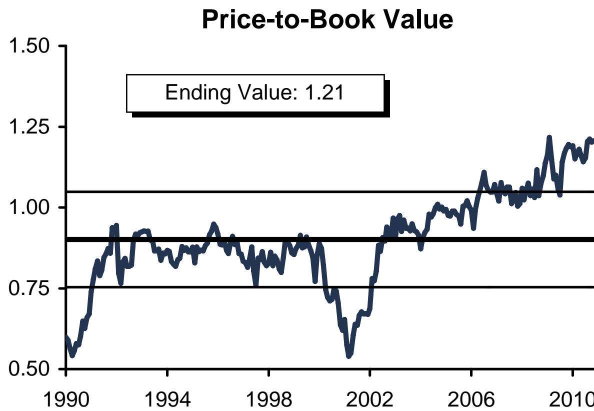
Exhibit 4

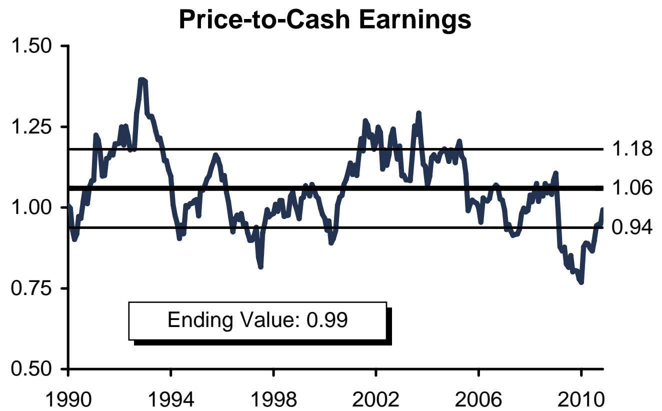
FTSE® All-Share Relative to MSCI Europe ex U.K.

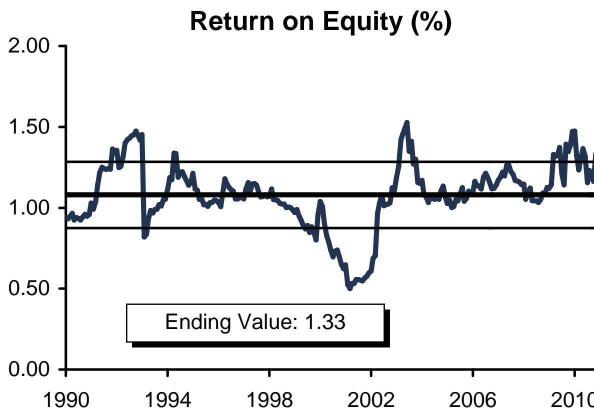
31 January 1990 – 30 November 2010

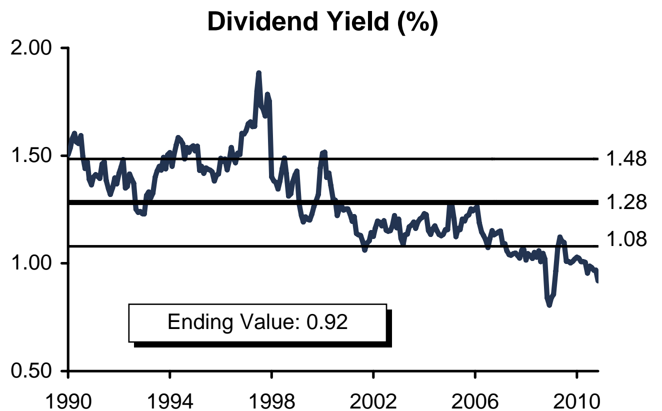


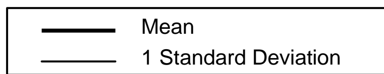












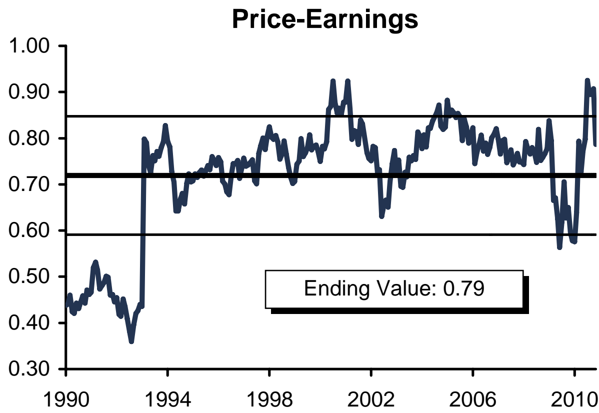
Sources: Factset Research Systems, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

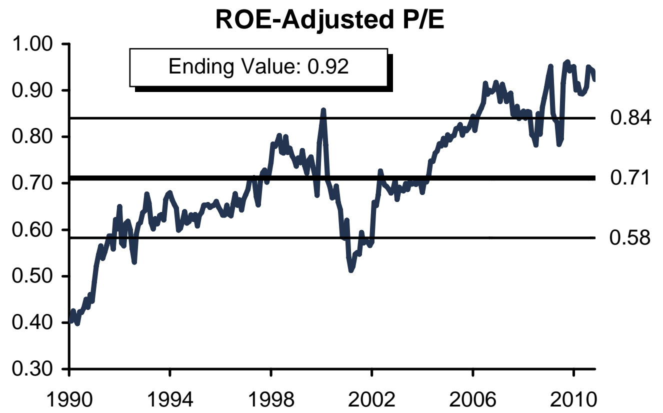
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE.

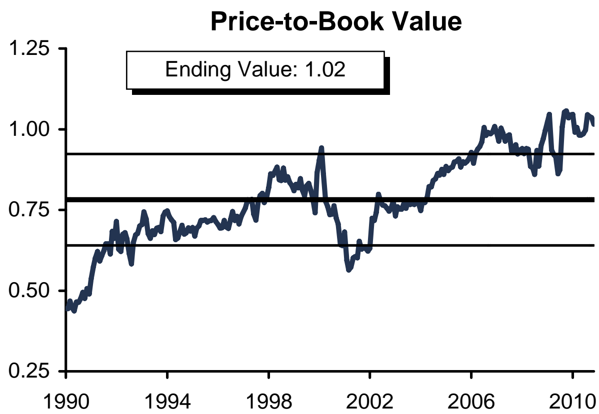
Exhibit 5

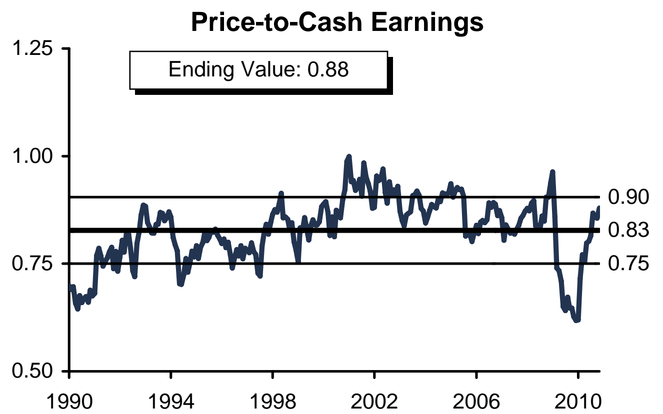
FTSE® All-Share Relative to MSCI World ex U.K.

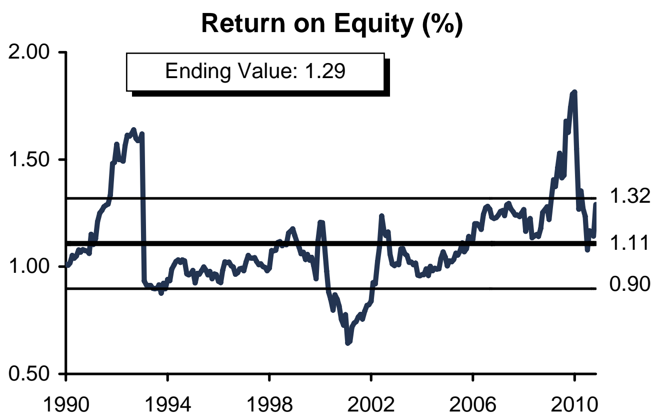
31 January 1990 – 30 November 2010

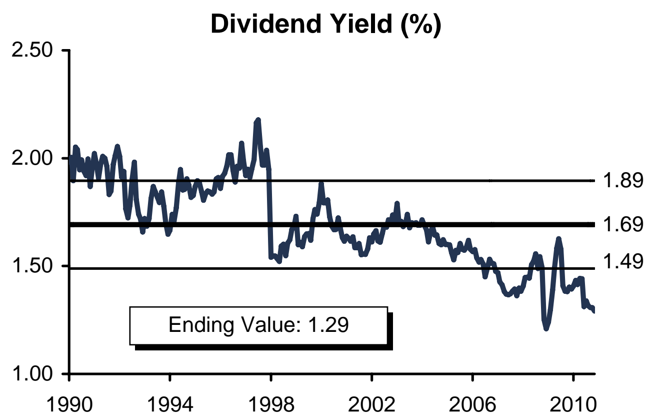


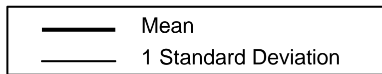












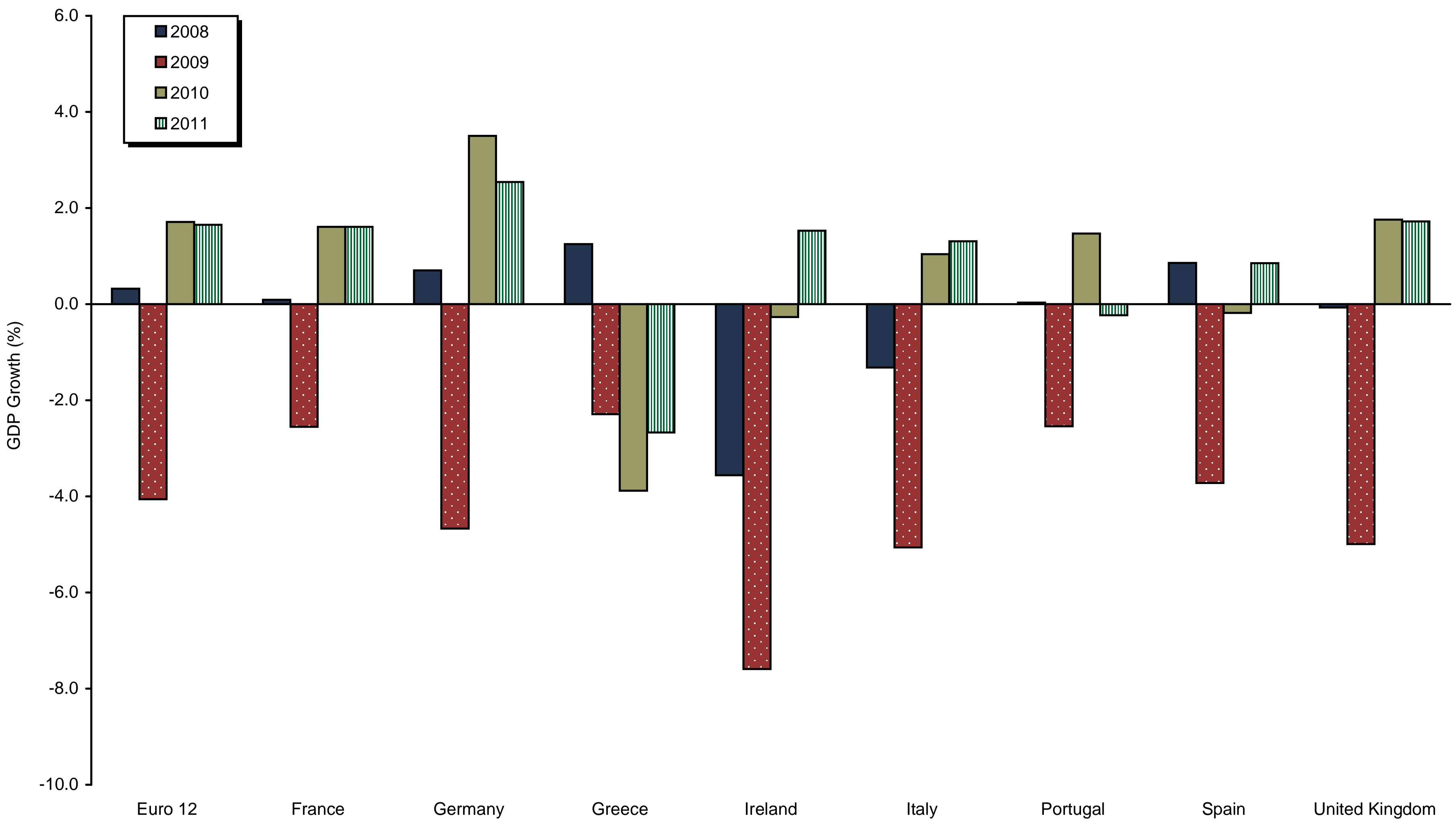
Sources: Factset Research Systems, FTSE International Limited, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to the long-term historical average ROE.

Exhibit 6

Annual GDP Growth

2008–11

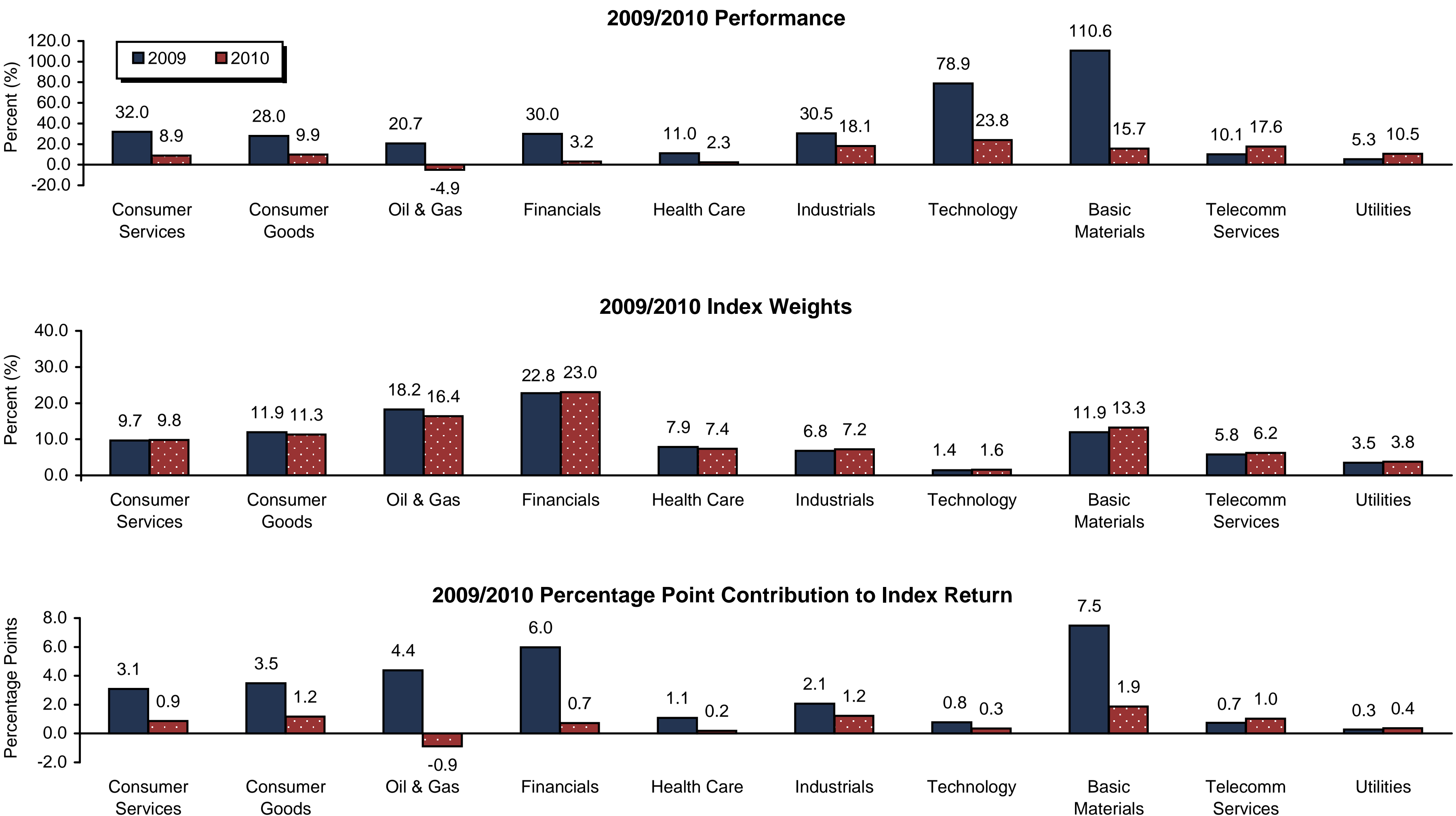


Sources: OECD and Thomson Datastream.
Notes: Data for 2010 and 2011 are estimates as of December 2010. GDP growth data are in real terms.

Exhibit 7

FTSE® All-Share Economic Sector Weights and Contribution to Return

2009–10 • Pound Sterling



Sources: FTSE International Limited and Thomson Datastream.

Notes: Weights may not total to 100% due to rounding. ICB sectors shown for FTSE® All-Share Index. Data for 2009 are calendar year and for 2010 are year-to-date through November 30.

Exhibit 8

MSCI Europe ex U.K. Country and Economic Sector Weights and Contribution to Return

As of 30 November 2010 • Euro

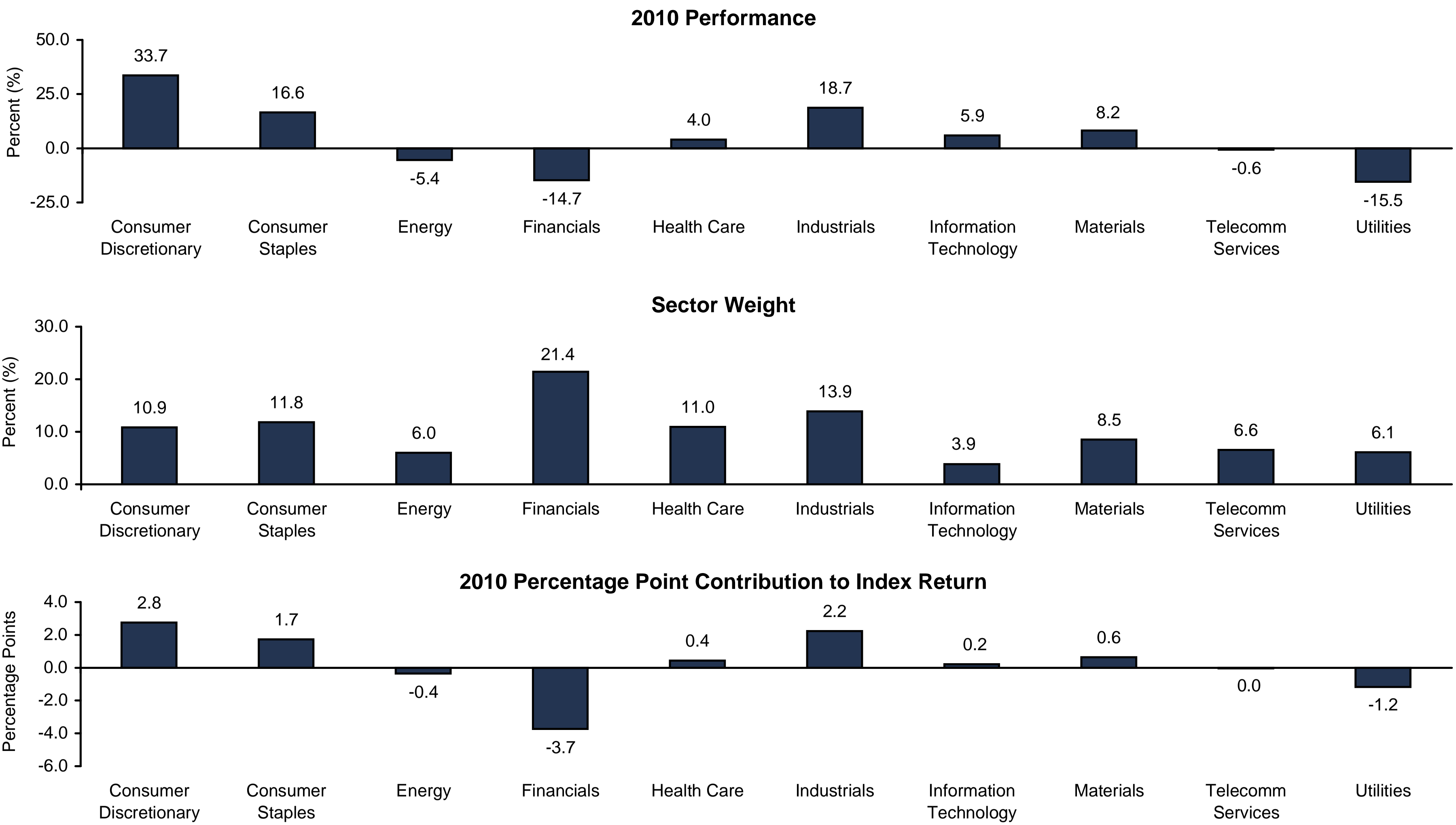
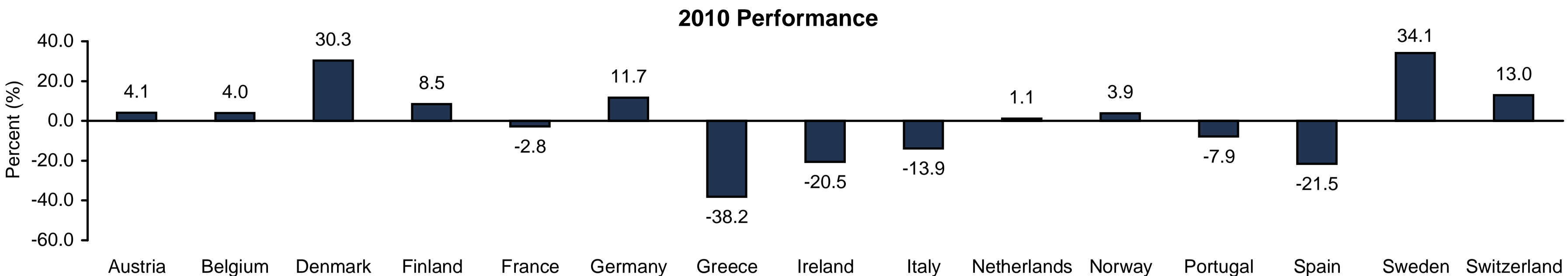
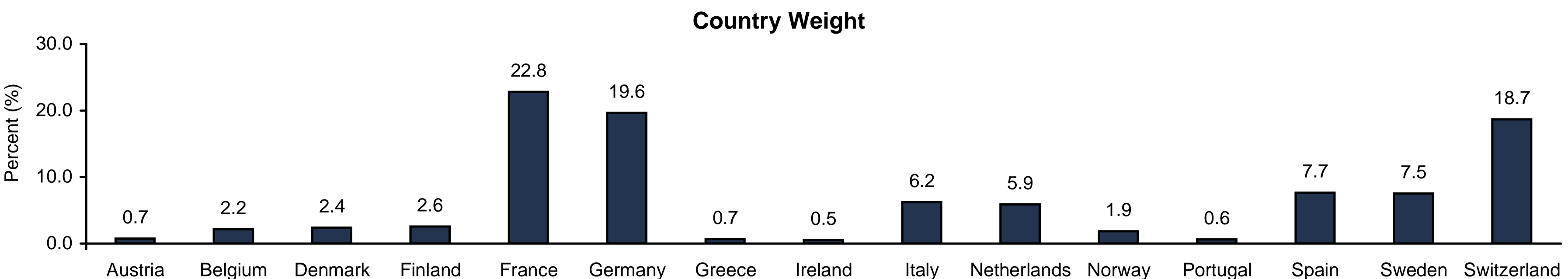


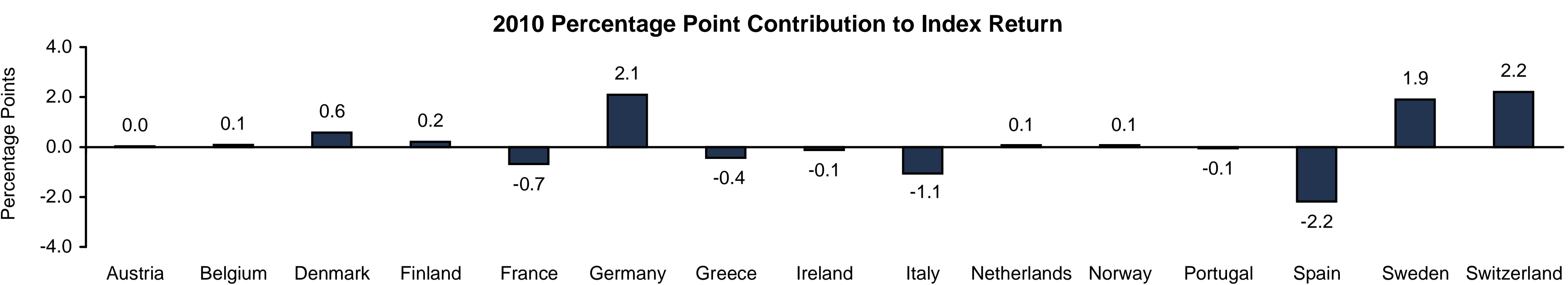
Exhibit 8 (continued)

MSCI Europe ex U.K. Country and Economic Sector Weights and Contribution to Return

As of 30 November 2010 • Euro







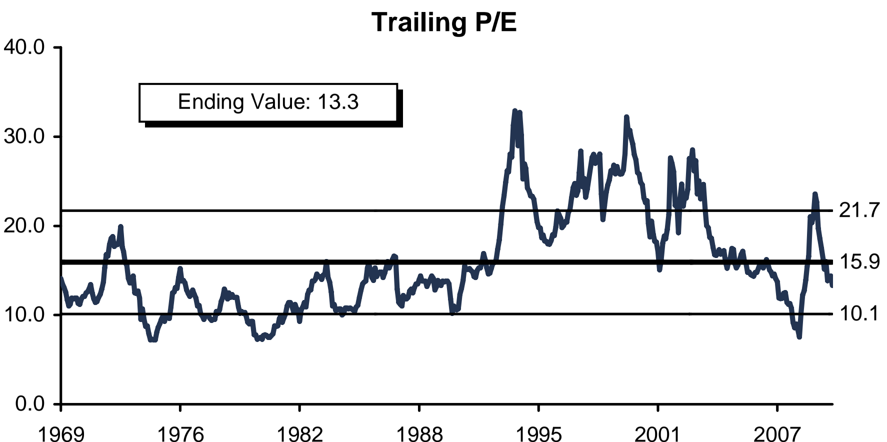
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: GICS sector classifications used for MSCI Europe ex U.K. Weights may not total to 100% due to rounding.

Exhibit 9

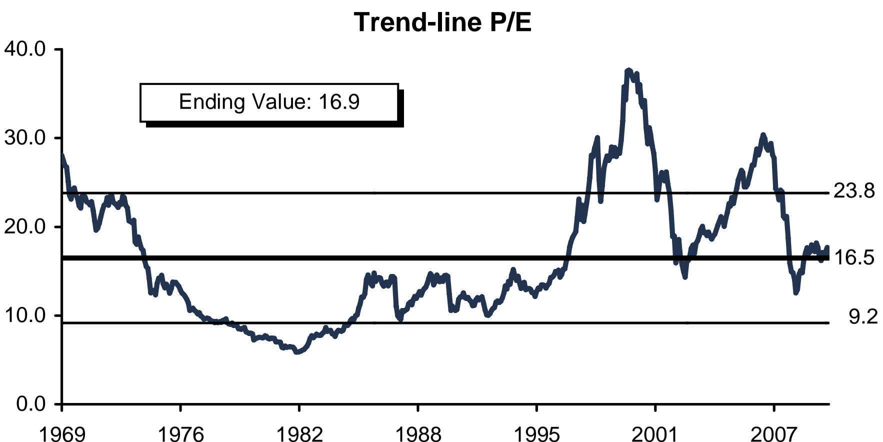
MSCI Europe ex U.K. Price-Earnings Valuations

31 December 1969 – 30 November 2010

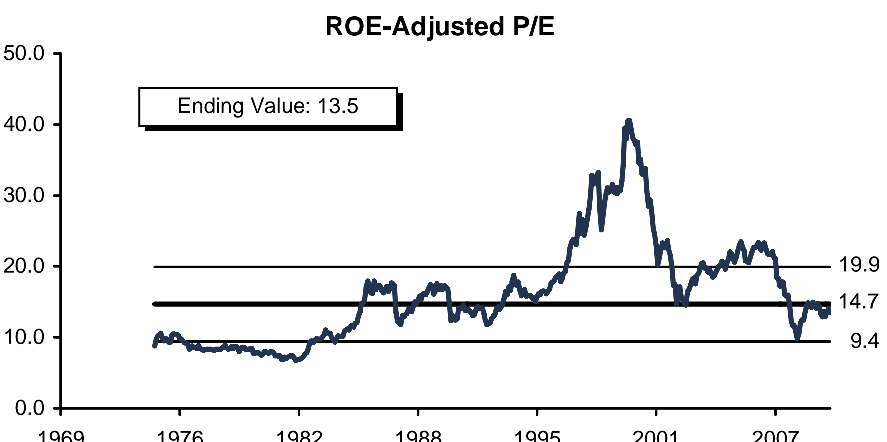
Trailing P/E



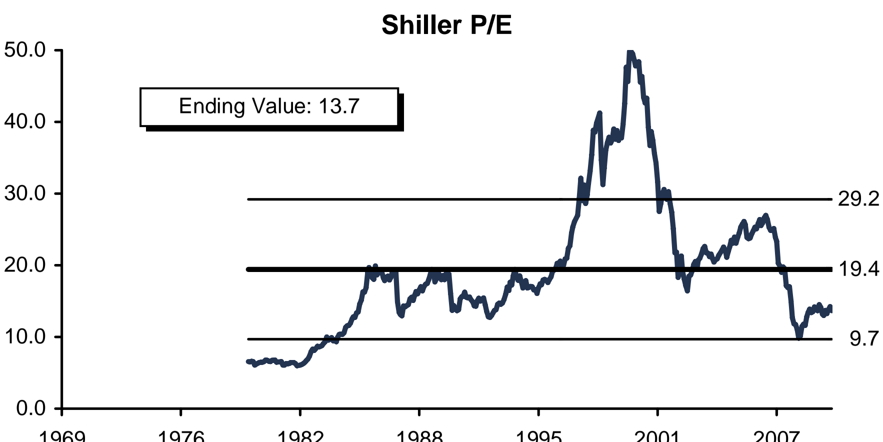
Trend-line P/E



ROE-Adjusted P/E



Shiller P/E

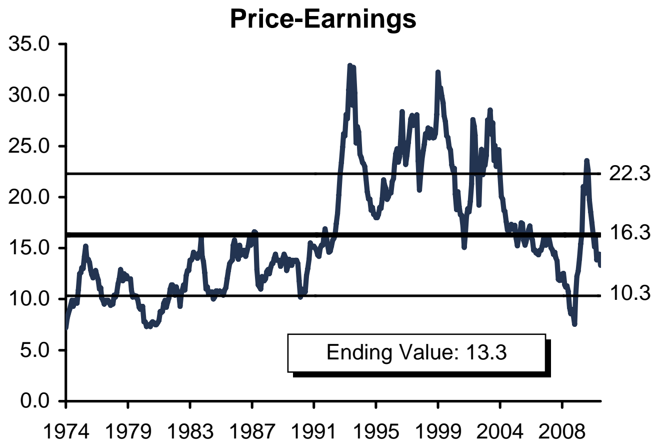


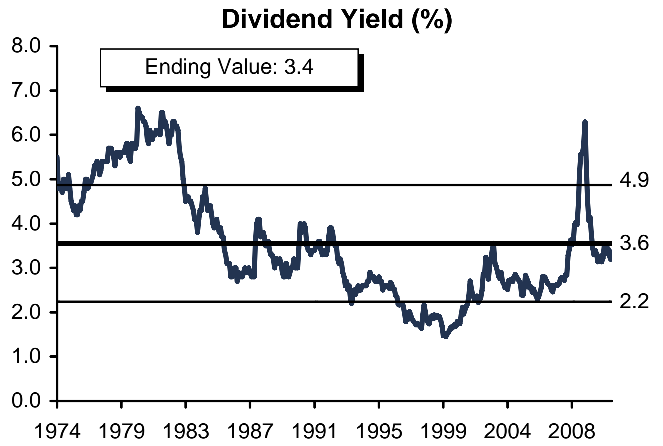
Sources: Global Financial Data, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Earnings deflated by CPI-Eurozone with data before 1996 based on a historical composite calculated by Global Financial Data, Inc. Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E data start on 31 December 1974. The Shiller P/E data start on 30 November 1979. To minimize the impact of bubble periods on valuations, we have excluded the years 1998–2000 from our historical average and standard deviation calculations for the ROE-adjusted P/E.
uk_259m

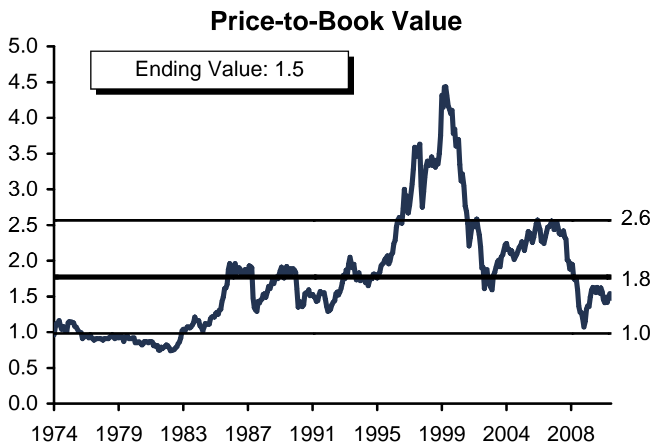
Exhibit 10

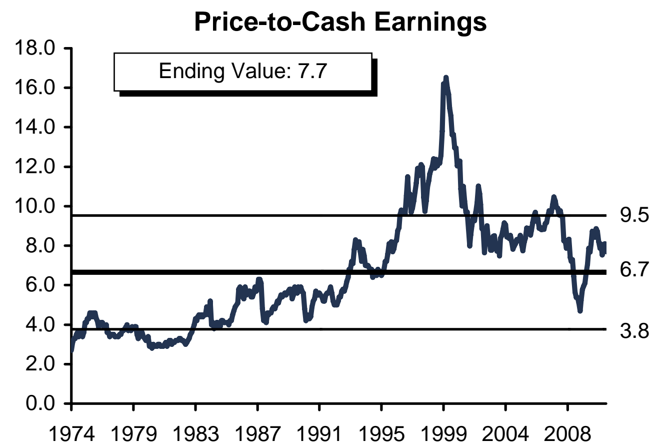
MSCI Europe ex U.K. Index Valuations

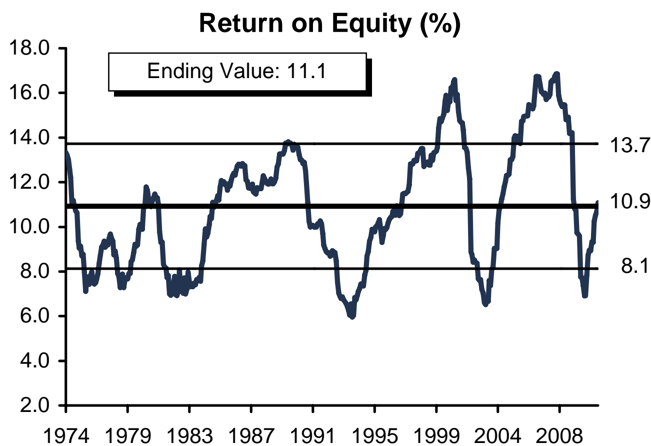
31 December 1974 – 30 November 2010











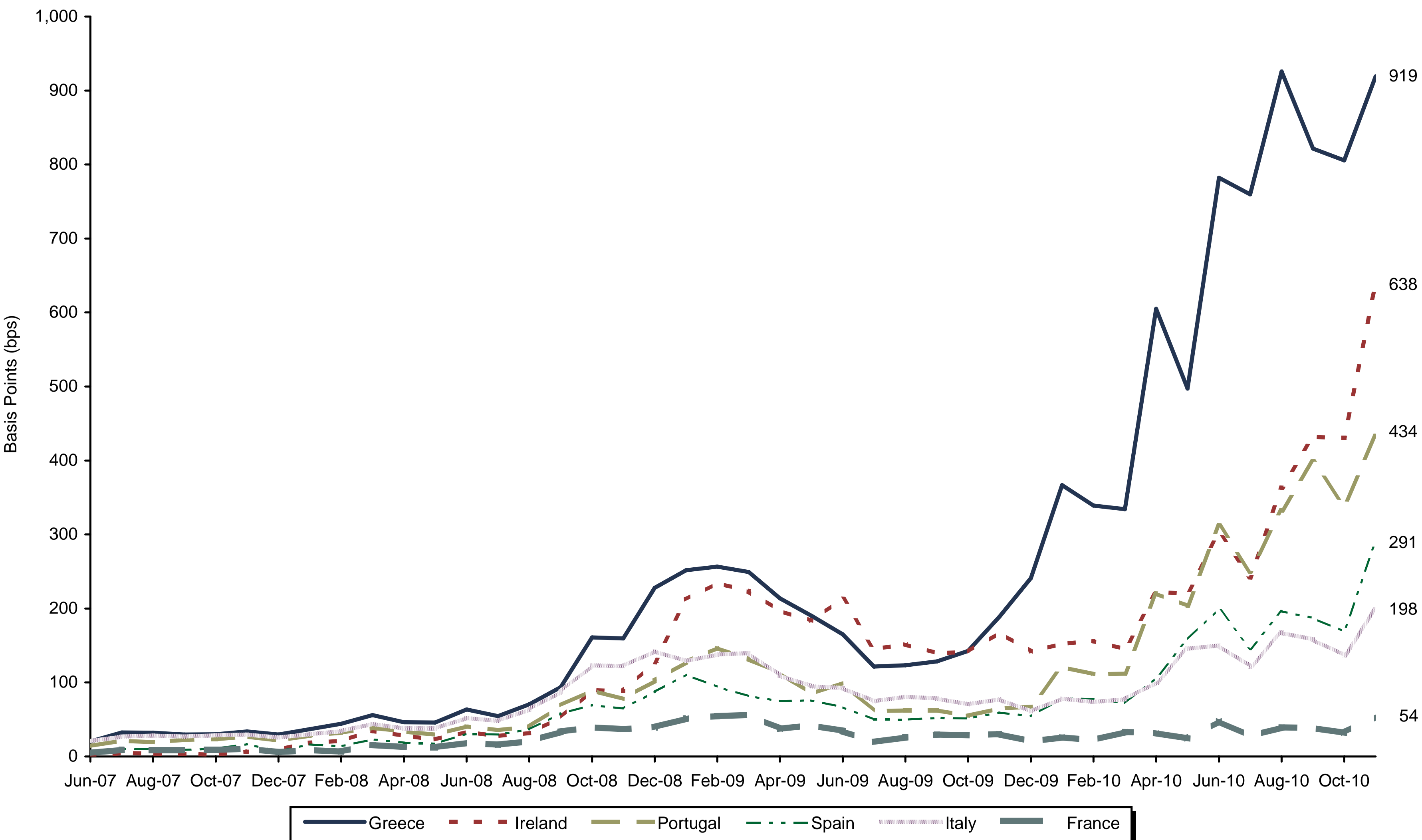
Mean
1 Standard Deviation

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.
398q

Exhibit 11

European Government Bond Yield Spreads Over Bunds

30 June 2007 – 30 November 2010

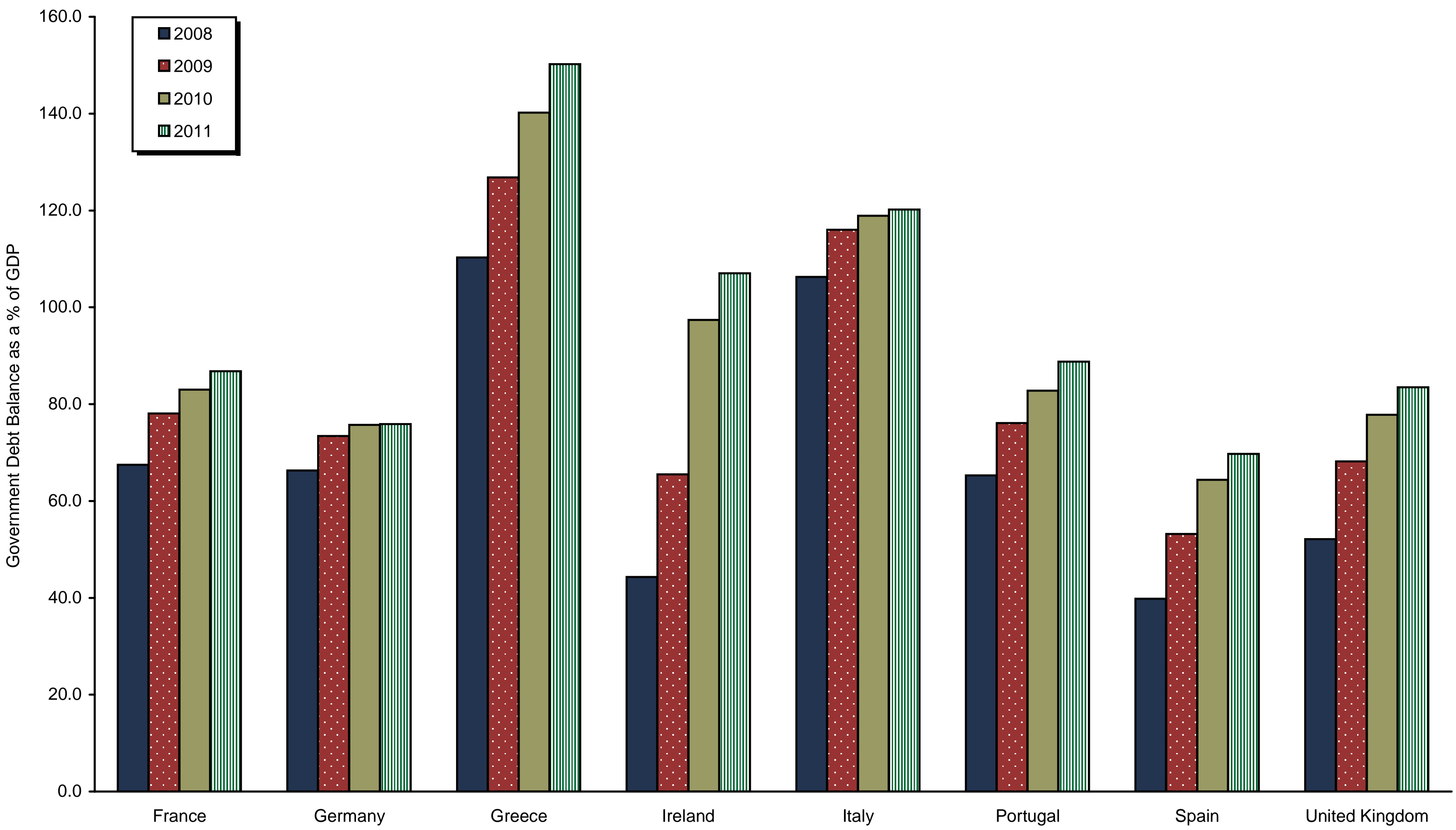


Source: Thomson Datastream.

Exhibit 12

Debt as a Percentage of GDP

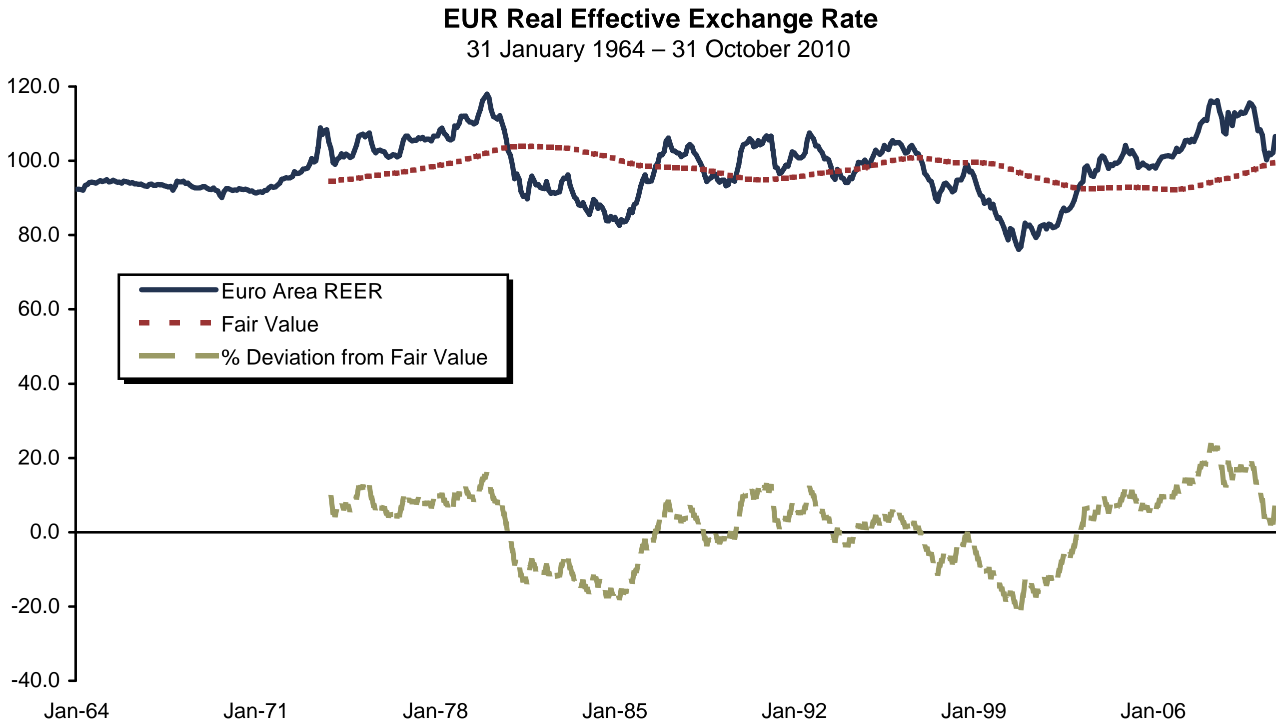
2008–11

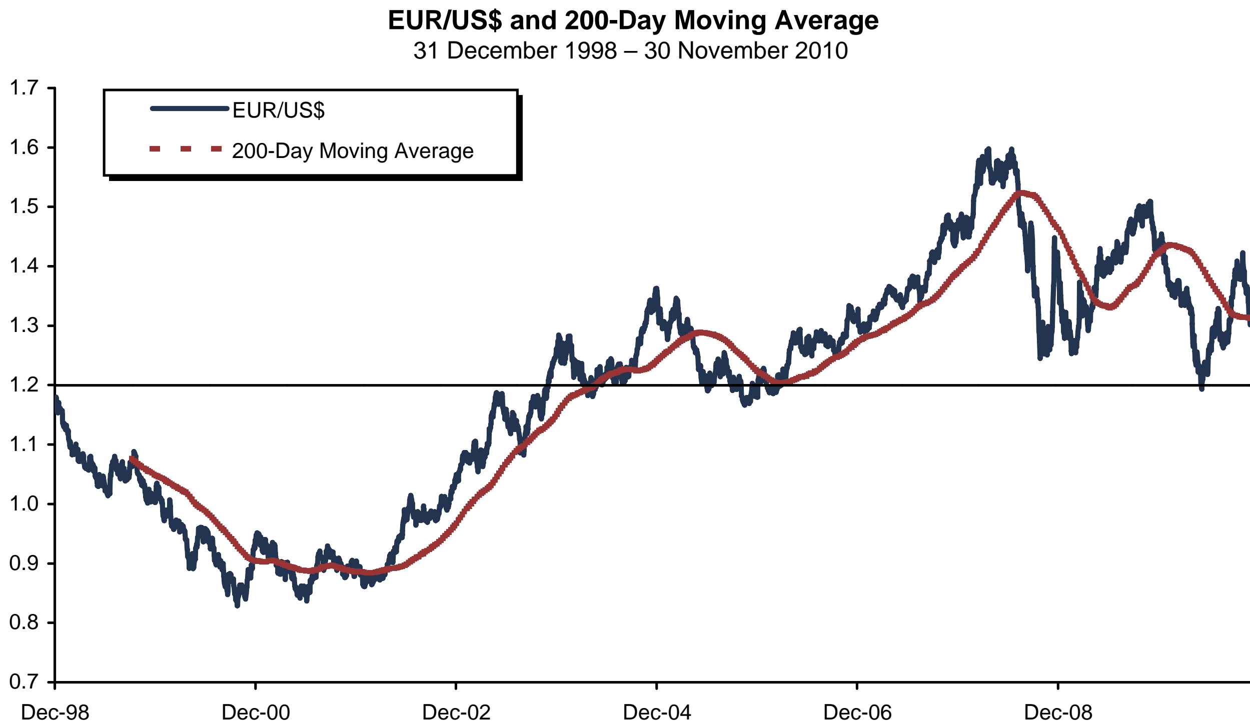


Sources: European Commission and Thomson Datastream.
Note: Data for 2010 and 2011 are estimates as of December 2010.

Exhibit 13

Euro Exchange Rates



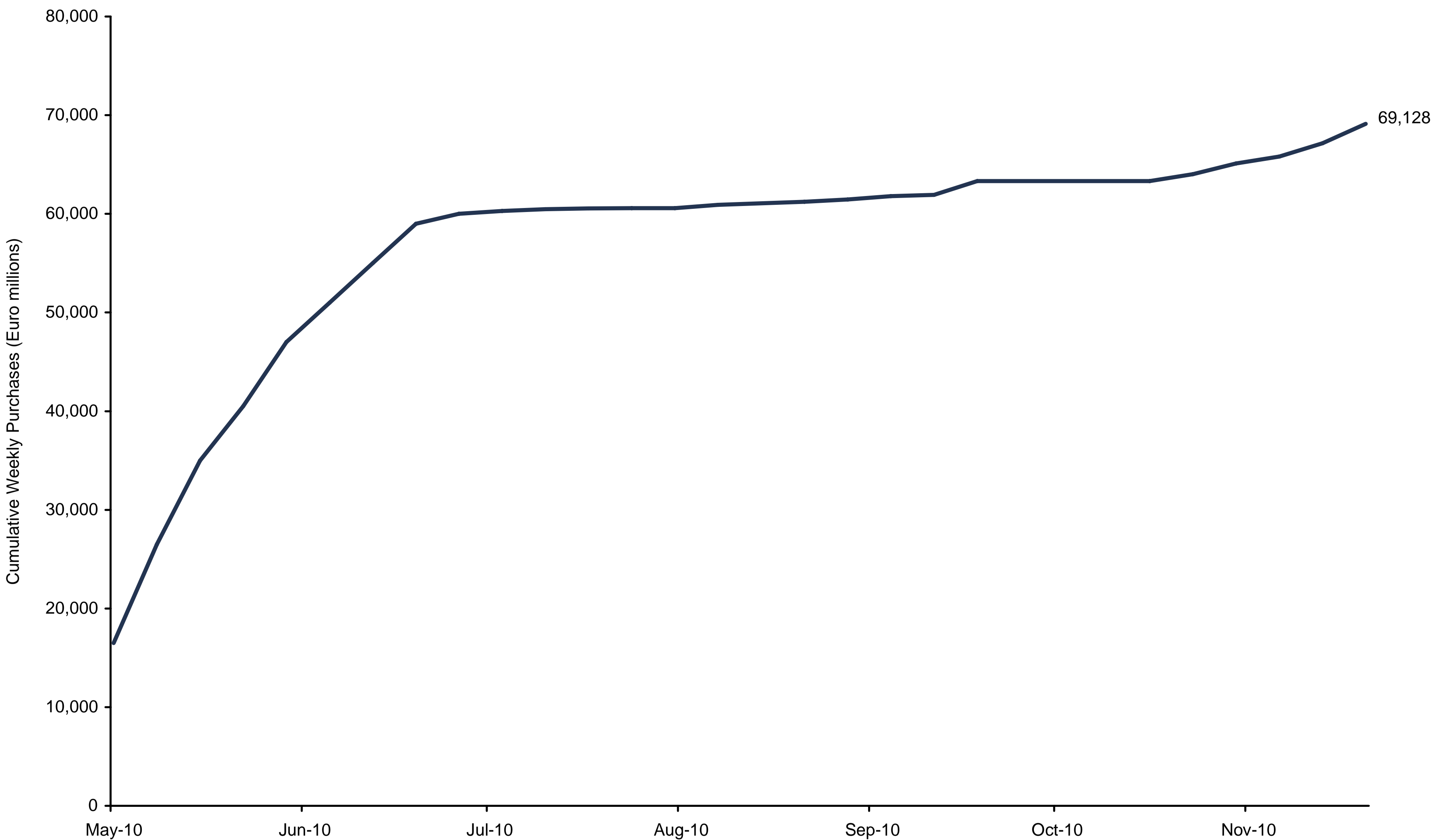


Sources: Bank for International Settlements and Thomson Datastream.
Notes: EUR real effective exchange rate (REER) graph uses monthly data. EUR/US$ graph uses daily data. REER is calculated as geometric-weighted averages of bilateral exchange rates for 27 economies adjusted by relative consumer prices. Fair value represents the REER ten-year moving average.

Exhibit 14

ECB Purchases of European Sovereign Debt via the Securities Market Program

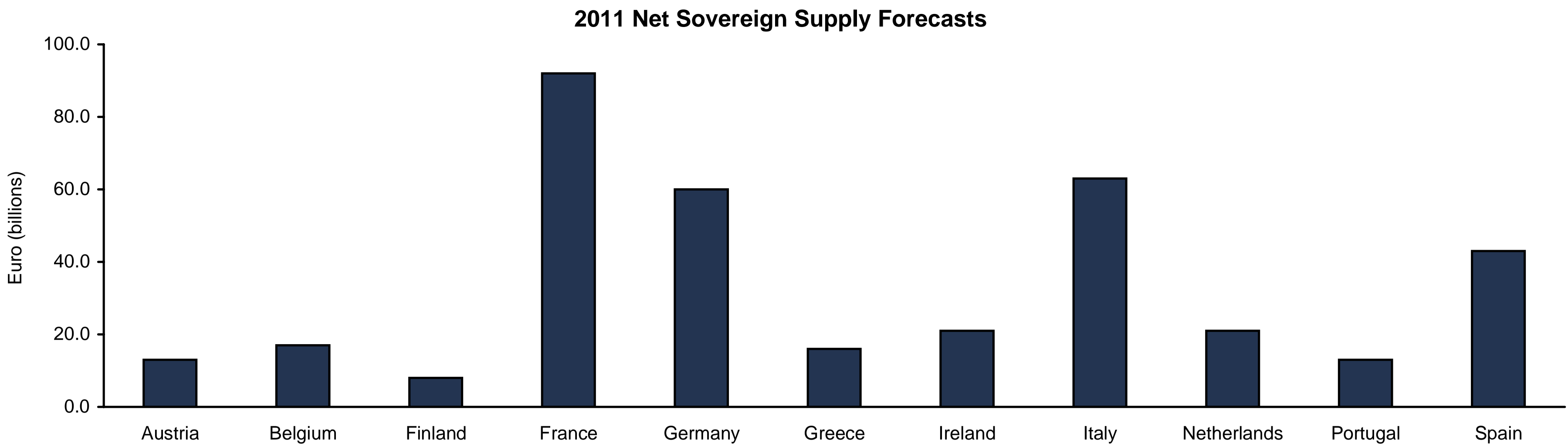
14 May 2010 – 3 December 2010

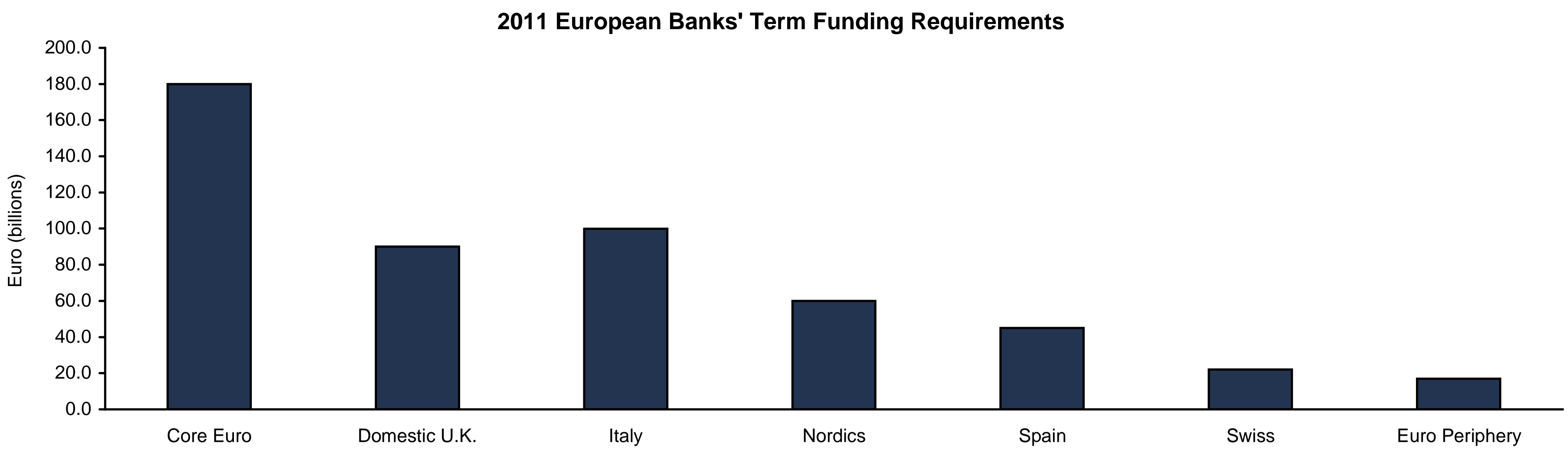


Source: Bloomberg L.P.

Exhibit 15

2011 European Sovereign and Bank Funding Requirements





Sources: BofA Merrill Lynch and Morgan Stanley.
Note: Net sovereign supply forecasts for 2011 include bond issuance, bill issuance, and other financing.

Exhibit 16

Cross-Border Banking Claims

30 June 2010 • U.S. Dollar (millions)

Exposure to:	French Banks	German Banks	Greek Banks	Irish Banks	Italian Banks	Portuguese Banks	Spanish Banks	U.K. Banks
France		196,838	1,851	18,110	31,575	8,209	26,261	257,107
Germany	255,002		5,727	32,108	254,379	3,925	39,080	172,184
Greece	53,469	36,840		7,801	5,347	10,031	925	11,980
Ireland	50,084	138,567	461		15,284	19,384	13,976	148,513
Italy	418,939	153,721	485	40,917		3,403	32,635	66,757
Portugal	41,904	37,240	101	5,146	4,734		78,288	22,386
Spain	162,439	181,648	673	25,342	25,556	23,086		110,845
United Kingdom	327,720	462,070	19,734	208,970	44,031	7,718	386,370	

Source: Bank for International Settlements.
Note: Data are preliminary.