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GLOBAL MARKET COMMENT

DEJA VU? LOW-QUALITY EQUITIES RISE AGAIN

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Deja Vu? Low-Quality Equities Rise Again

What is driving the global equity rally? The composition of the recent rally looks far more like a speculative, liquidity-driven bounce than the sustainable start of a new bull market. Amazingly, after three years of a grueling bear market that itself followed an epic speculative mania, investors seem to have once again thrown caution to the wind and embraced a supremely optimistic view of the future. To wit, the equities that have risen the most this year are, in a pattern eerily reminiscent of 1999-2000, the ones lacking earnings.

The outperformance of companies with negative earnings is quite remarkable: the average year-to-date return of the 170 EAFE companies that had negative earnings at the beginning of the year is 55.0%, compared to the average return of 26.8% for the roughly 1,200 companies in the index at the start of the year. (Returns are as of October 31, and all returns are total returns in local currency.) In other words, despite assurances from strategists and other observers that investors "learned their lesson" during the bear market, investors in global markets seem to have once again gravitated to the lowest-quality shares and been richly rewarded for doing so (at least thus far). This behavior is strikingly similar to that experienced in 1999, when equities with negative earnings far outdistanced their profitable peers. Of the 80 companies that had negative earnings at the start of 1999, the average return for the year was 52.1%, compared to an average return of 24.8% for all companies in the index.

There are differences between the two periods, of course. In contrast to 1999, the equities gaining the most this year have been smaller firms, while in 1999 larger firms drove the overall index higher. For example, the average stock this year has handily outperformed the market-cap weighted index return of 15.8% for the year through October 31, while the average stock underperformed the 33.5% index return in 1999. In addition, the least expensive equities have also been strong performers in 2003, with the least expensive quartile (excluding those with negative earnings) returning an average of 32.5%—stronger than any other valuation quartile, but a good deal weaker than profitless companies. These differences may reflect the different macro environment, given that valuations still matter in the aftermath of the popping of the bubble market and the tendency of small-cap stocks to outperform in the early days of an economic recovery.

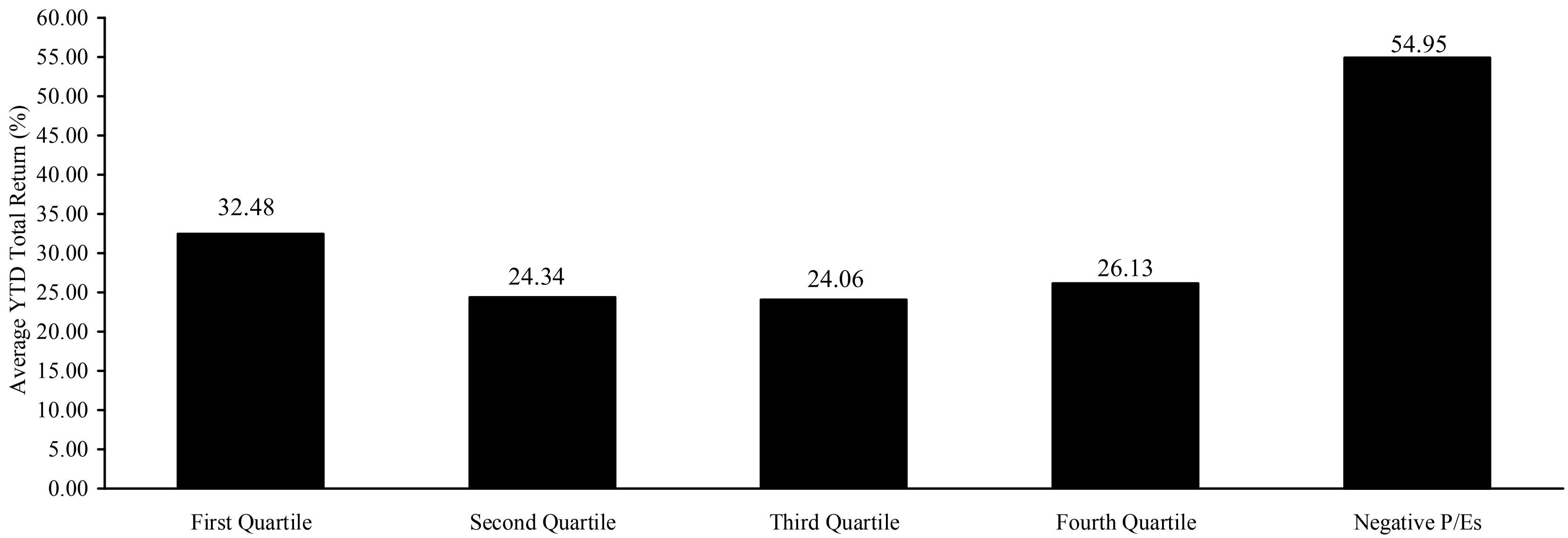
It is also true that higher earnings expectations are more reasonable today than they were in 1999, as the global economy is recovering from a downturn rather than topping off an historic boom. Analysts certainly are expecting good things, as estimates for 2004 profit growth range from 11.2% for the United Kingdom to 49.4% for Germany. While we tend to take analysts' estimates with a grain of salt, investors should be cognizant that if the current recovery gains purchase, earnings could grow strongly and perhaps justify market behavior that appears quite speculative at the moment.

The return to speculative activity is exactly what should be expected within a secular bear market, although the fervor with which investors have reverted to bubble-era behavior so soon after the end of the mania is somewhat surprising. Investors should continue to view global equities with a great deal of caution, but recognize that the rally could have more legs, particularly if the rally carries over to larger- capitalization stocks.

Table A

MSCI EAFE INDEX YEAR-TO-DATE 2003 TOTAL RETURNS FOR PRICE-TO-EARNINGS QUARTILES

As of October 31, 2003



	Quartile			
December 31, 2002	1	2	3	4
Average P/E Ratio	8.74	14.39	20.54	114.87
P/E Range	0.93 - 11.86	11.87 - 16.88	16.89 - 25.51	25.89 - 10,000.00

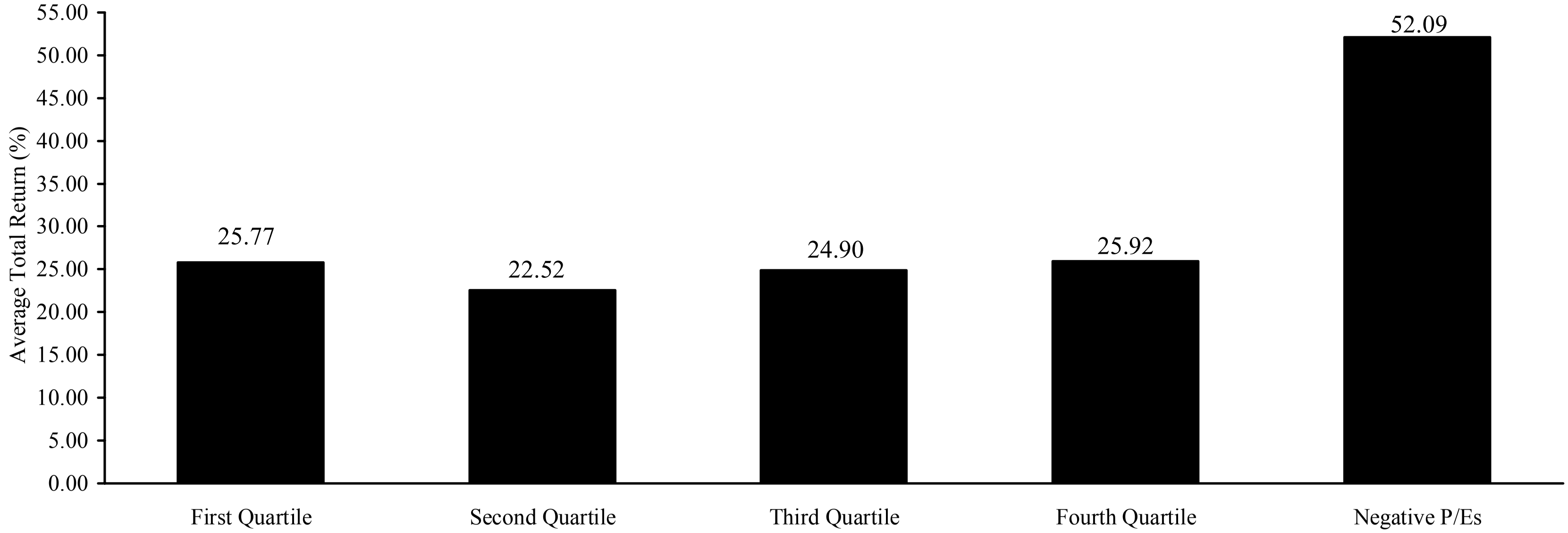
Source: Factset. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Notes: Thirty-four companies were excluded because they did not have P/E and/or a year-to-date return. Companies with negative P/E ratios were not taken into account to calculate the quartiles. P/E ratios are as of December 31, 2002. Companies are as of October 31, 2003. Total year-to-date return through October 31, 2003, for MSCI EAFE is 15.77 and the average year-to-date total return through October 31, 2003, for all companies is 26.75. All data are in local currency.

Table B

MSCI EAFE INDEX 1999 TOTAL RETURNS FOR PRICE-TO-EARNINGS QUARTILES

As of December 31, 1999



	Quartile			
December 31, 1998	1	2	3	4
Average P/E Ratio	10.16	17.62	26.30	168.02
P/E Range	3.27 - 14.27	14.29 - 21.21	21.22 - 32.68	32.74 - 10,000.00

Source: Factset. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Notes: Seventy-four companies were excluded because they did not have P/E and/or a year-to-date return. Companies with negative P/E ratios were not taken into account to calculate the quartiles. P/E ratios are as of December 31, 1998. Total return for 1999 for MSCI EAFE is 33.46 and the average total return for 1999 for all companies is 24.78. All data are in local currency.