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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENTARY

GLOBAL SURVEY—VIVE LA DIFFÉRENCE?

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Global Survey—Vive la Différence?

Leo Tolstoy, in the opening line to *Anna Karenina*, famously remarked that, “Happy families are all alike; every unhappy family is unhappy in its own way.” Capital markets are not families (despite both having strong dysfunctional tendencies), but Tolstoy’s timeless remark is nevertheless applicable to the current market environment. To wit, from early 2003 through early 2007, virtually all asset classes increased in unison, with equities, bonds, commodities, and just about everything else riding the liquidity wave (i.e., happy markets). Over the past few months, conditions have deteriorated rapidly, with credit markets seizing up and central banks injecting copious liquidity to combat the ebbing tide. While the credit crisis is a global phenomenon,[1] certain regions will suffer more than others—in other words, the “happy family” has fallen on hard times. The main question, then, is what we should expect from different regions that, while suffering from a similar malaise, are likely to be “unhappy” in their own ways.

To recap our view on the current environment,[2] we believe the unfolding credit crisis will be long-lasting and quite deep, with ripple effects worldwide and in all sectors. The era of easy money and cheap credit seems to be drawing to a close, and with it the extreme profits of not only the financial sector, but corporations in general. Financials are likely to see earnings cut significantly, of course, with one-off gains from mortgage originations, debt securitization, proprietary trading, and merger and acquisition (M&A) activity not likely to recur on the same scale, but we also expect companies in other sectors to suffer if and when the crisis spills over into “real” economic activity. The recent actions of central banks, meanwhile, while perhaps delaying the inevitable, cannot forestall forever the disposal of bad debts, nor can they pump money into the financial system without further stoking inflationary fires that seem already to be kindling—gold has risen 1.6% since the Federal Reserve cut interest rates on September 18, 2007, while the yield on the benchmark ten-year U.S. Treasury bond has risen by 13 basis points (bps).

It is also worth noting that equity markets in general have suffered little from the credit turmoil, and that correlations have been relatively high. In fact, despite heightened volatility and breathless coverage from news media, many markets remain close to all-time highs (Table A).

The United States—Epicenter of the Subprime Quake

To steal a characterization from a former central banker, action in U.S. equity markets over the past few months has been a “conundrum,” with markets holding their own (albeit with a good bit of volatility) even as credit markets have imploded. Indeed, equity markets actually closed *higher* on September 18, 2007 (the day the Federal Reserve cut policy rates by 50 bps), than they did on August 7, 2007, when the Fed decided to leave rates alone due to “solid growth in employment and incomes and a robust global economy.”

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[1] For more details, please see our August 2007 Market Commentary *The Jig Is Up: The End of Easy Credit.*

[2] Ibid.

As we have articulated many times over the past several years, we continue to believe U.S. equities are overvalued, and that long-term returns are likely to lag historical averages. While many observers argue U.S. equities are reasonably valued due to the S&P 500 price-earnings (P/E) ratio of 17 based on trailing 12-month earnings, metrics that adjust for today's cyclically elevated level of profits tell a far different story. As shown in Table B, positive returns for U.S. equities will depend on profits continuing to rise from historically elevated levels, and/or multiples on those earnings remaining above historical averages. Further, considering that the current crisis has its roots in the United States, these markets are likely to be particularly vulnerable in the case of a global economic downturn. Finally, the vulnerable financial sector makes up 20% of the S&P 500, and accounted for 28.6% of earnings over the past 12 months. These companies are likely to see earnings fall significantly, as one-off gains from areas such as debt securitization have dried up, while bad debts held on their books (or in off-balance-sheet entities) will eventually need to be recognized and marked-to-market.

There is one caveat to this general outlook. Given the Federal Reserve's recent actions, and its seeming ambivalence to the impact of rate cuts on the US$, it is possible equity markets could appreciate for a time in *nominal* terms, while losing ground in *real* (inflation-adjusted) terms, as well as in other currencies as the US$ depreciates. Indeed, to some degree such a phenomenon has already occurred. For the five years ended in August, for example, a period almost universally labeled a "bull market," the S&P 500 returned a cumulative 76.2% in US$, 35.2% in pounds, and 26.8% in euros. However, adjusted for inflation, the index returned 53.2% in US$ (average annual compound return [AACR] of 8.9%), 15.0% in pounds (AACR of 2.8%) and 14.2% in euros (AACR of 2.7%).

The United Kingdom—No Zealot Like a Convert[3]

U.K. equities swooned along with their global peers in late July through early August, then bounced back after the Fed cut its discount rate on August 17. But the most interesting machinations involved the abrupt about-face of Bank of England (BOE) Governor Mervyn King, who initially criticized other central banks (specifically the European Central Bank [ECB] and the Fed) for bailing out banks and investors, then reversed course to not only attempt a bailout of troubled lender Northern Rock, but also promise to inject tens of billions of pounds into money markets. The U.K. government also stepped into the fray after the BOE's actions failed to halt a run on Northern Rock, essentially pledging to backstop deposits at *all* banks.[4]

Our outlook for U.K. equities remains much the same, as P/E multiples look reasonable on a trailing 12-month basis, but quite high when adjusted for current high profits and return on equity. As in the United States, positive returns will depend on profits continuing to increase at a rapid rate while multiples remain elevated (or even rise further), a tall order given that recent earnings growth has relied heavily on energy and

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[3] We cover the U.K. and continental European markets in more depth in this month's Market Commentary *The Trouble with European Financials.*

[4] We should note that the old system of U.K. deposit insurance differed substantially from that of the United States. While U.S. depositors are guaranteed on deposits up to US$100,000, U.K. deposit insurance only covered 100% of the first £2,000 and 90% of the next £35,000.

financials, and future growth in financial sector earnings is likely to be constrained by the ongoing credit mess. (Energy companies, of course, could continue to be large contributors if oil prices remain elevated.) Finally, the United Kingdom also appears vulnerable to a housing bust, as housing prices remain high relative to income, while late payments and foreclosures have begun to tick higher.

Continental Europe—Trouble Brewing?[5]

Continental equities also dipped in late June through early August, then recovered along with other global markets. The ECB was initially the most active central bank, injecting more than €100 billion into the banking system in just a few days in August, as several institutions (mostly in Germany) appeared on the verge of collapse. More revelations are expected, as institutions in France, Spain, and the Netherlands have also indicated they have high levels of subprime exposure.

Indeed, while continental Europe is by no means the most overvalued global equity region, it is among the most vulnerable to spillover from the credit crisis. To begin with, there appear to be many institutions with a significant chunk of bad debt on their books, although this is virtually impossible to quantify. Further, as we have recently discussed, investors seem to have collectively "bought into" the Continent's economic revival; as a result, share prices are likely to be vulnerable to "surprises" on the downside. The boom in M&As, meanwhile, which has boosted both financial sector earnings and equity multiples, appears to be winding down as the easy credit spigot shuts off. Finally, while the United States has declined in importance as a trading partner—the share of EU-15 exports going to the United States has fallen from 25% in 2000 to 19% in 2006—it still represents the Continent's largest export market, although exports admittedly represent a relatively small share of European GDP. In short, we are not enamored of the "decoupling" thesis; if the United States sneezes, Europe seems likely to catch cold.

Emerging Europe has actually held up relatively well during the downturn, thanks largely to strong returns from Russia (which makes up 55% of the index) driven by soaring commodity prices. While strong commodity prices may certainly provide some support going forward, many countries in the region are running significant current account deficits, and remain in the midst of crucial reform processes.[6] Further, many countries issued significant quantities of euro-denominated debt in advance of their joining the European Monetary Union, and are thus particularly vulnerable to runs on their currencies. Thus, a global financial crisis has the potential to hurt Eastern Europe in several ways: "hot money" could flee currencies, export markets could dry up, and governments could come under intense pressure to curtail reforms. While we believe much of the recent reform has been of a long-term structural nature, investors interested in allocating money to the region may find more attractive entry points in the future.

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[5] Please see footnote 3.

[6] For more details, please see our February 2007 Market Commentary *All Quiet on the Eastern Front?*

Japan—Another False Dawn?

As shown in Table A, Japanese equities peaked out earlier, fell further, and have since recovered less than other major equity markets. Indeed, investors seem to have soured on the Japanese recovery story they so recently embraced. According to a recent Merrill Lynch survey, investors are now underweight Japan for the first time since July 2003, while investors looking to reduce their weighting outnumber those looking to add to positions for the first time since June 2006. According to Merrill Lynch, "The stance toward Japan worsened [from the August survey to September's] for every question (economic outlook, inflation expectations, earnings outlook)."

We remain positive on Japan, although we acknowledge the outlook has darkened a bit in recent months. While former Prime Minister Shinzo Abe had been slow to implement reforms, the prospects for reform under the new Prime Minister, Yasuo Fukuda, remain unclear. Economic data, meanwhile, continue to be muted, although there has been little evidence of backsliding. Still, as discussed above, most investors appear to have given up on Japan (again), perhaps due to the country's nearly two-decade history of false starts. It is also true, of course, that exporters will be hurt if the global downturn intensifies, while continued unwinding of the carry trade (where investors borrow yen and buy higher-yielding currencies with the proceeds) would pressure exporters by driving the currency higher.

Overall, the extreme negative sentiment toward Japan makes us want to be buyers, particularly in light of fundamentals that, while not great, are not terrible, either. The country's economy has at the very least shown signs of stabilization, while corporate profits appear to have room to run. Thus, while it is certainly possible Japan will disappoint once again, downside risk seems lower than potential upside reward.

Pacific ex Japan—Lots of Moving Parts

Pacific ex Japan equities have held up better than those of most other developed markets during the recent bout of volatility, due to the resource-heavy Australian index (which makes up roughly two-thirds of the index), as well as Hong Kong equities, which have ridden the coattails of the skyrocketing Chinese equity market. While we continue to be constructive on this region from a strategic perspective, valuations have become excessive, and fallout from unwinding carry trades (particularly for Australia and New Zealand) has the potential to create instability in the short to medium term.

Further, while the "decoupling" thesis that Asian economies and markets (along with those of Europe) can continue to power ahead without the U.S. locomotive has some merit, we do not believe they will be immune to a U.S. slowdown. However, the degree to which decoupling has occurred should serve to soften the blow, particularly in those few markets that have managed to spark domestic demand. While it is difficult to pin down specific trade numbers, much of intra-Asian trade remains that of "intermediate" goods—i.e., the end consumer is still outside the region, predominantly in the United States. As *The Economist Intelligence Unit* recently put it, "While the fallout from the US subprime sector remains largely a financial story for now—and its consequences for Asian stock markets, currencies, interest rates and lending should not be ignored—the *key risk for the region* is the possibility of a slowdown in US import demand." (Emphasis added.)

For emerging Asia, the story remains centered on China, where equity indices continue to set all-time records even as official inflation numbers have ramped higher. Indeed, for the three months ended August 31, 2007, emerging Asia returned 12.9%, with China returning a stunning 31.9% and Korea, 9.2%. As noted above, we do not fully believe that such economies and markets have completely de-linked from the United States; however, considering the rapid growth available in much of emerging Asia, coupled with investors' desire to flee the US$ given the Fed's most recent actions, emerging Asian markets could continue to head higher over the next few months if the credit crisis does not appreciably worsen.

Emerging Markets Equities—Short-Term Pain Equals Long-Term Gain?

Many clients have inquired whether now is the time to sell—or at least lighten—emerging markets equities positions that have grown exponentially in recent years. In short, our answer is…it depends. While we remain positive on emerging markets for the long term, they remain high-beta assets, and are likely to suffer disproportionately if the credit crisis worsens.

Looking at valuations, emerging markets multiples have recently eclipsed those of developed markets, and look expensive on any metric other than trailing 12-month earnings.[7] While high valuations alone are never enough to sink an asset class, they do drag down prospective returns; indeed, as with Pacific ex Japan, while emerging markets remain attractive from a strategic perspective, much of the low-hanging (i.e., short-term) fruit has already been picked. Further, the recent outperformance of emerging markets equities relative to those of developed markets could exacerbate any downturn, with investors and managers looking to lock-in gains.

Conclusion—The More Things Change…

Put simply, recent market gyrations have done little to sway our market outlook. We have been warning of credit excesses for quite some time, and expected that problems would manifest themselves at some point—the only question was when and where. What is different today is that there is now a catalyst for change; i.e., the "when" has become a bit clearer, while the "where" remains murky. In short, while it seems likely U.S. equity markets will lag non-U.S. markets for a reasonable period of time (particularly when denominated in non-US$ currencies), the unknown nature of exposure to bad debt (particularly, but not exclusively, in Europe) along with the still-untested concept of "decoupling" makes predictions quite difficult.

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[7] For more details, please see our April 2007 Market Commentary *Emerging Markets Equities Have Become Overvalued.*

So what should investors do? At the risk of sounding like a broken record…our advice remains largely the same. We believe investors should stay diversified among high-quality assets (especially and most importantly among asset classes with different *economic* bases of return), rebalancing frequently to take advantage of relative changes in asset prices. While the recent increase in volatility has arguably increased the potential for short-term gains through tactical maneuvers, the flip side is that investors who choose wrong are vulnerable to sharp drawdowns over a compressed time period. For those tempted to hold cash, meanwhile, we would caution that the execution of a tactical cash allocation is often more complicated than it first appears,[8] although for those willing to accept some degree of tracking error, a go-slow approach to investing fresh or surplus capital to take advantage of better valuations down the road may be a valid strategy, particularly given the paucity of bargain-priced assets currently on offer. Finally, while a number of distressed funds have sprung up to take advantage of the unfolding subprime mess, we believe the unwinding of credit excesses is likely to play out over a period of several years; thus, while some of the current crop of funds may indeed post good returns, investors should not feel a need to jump into such funds lest they miss the opportunity. Continued, and perhaps better, distressed opportunities should be expected over the next several years.

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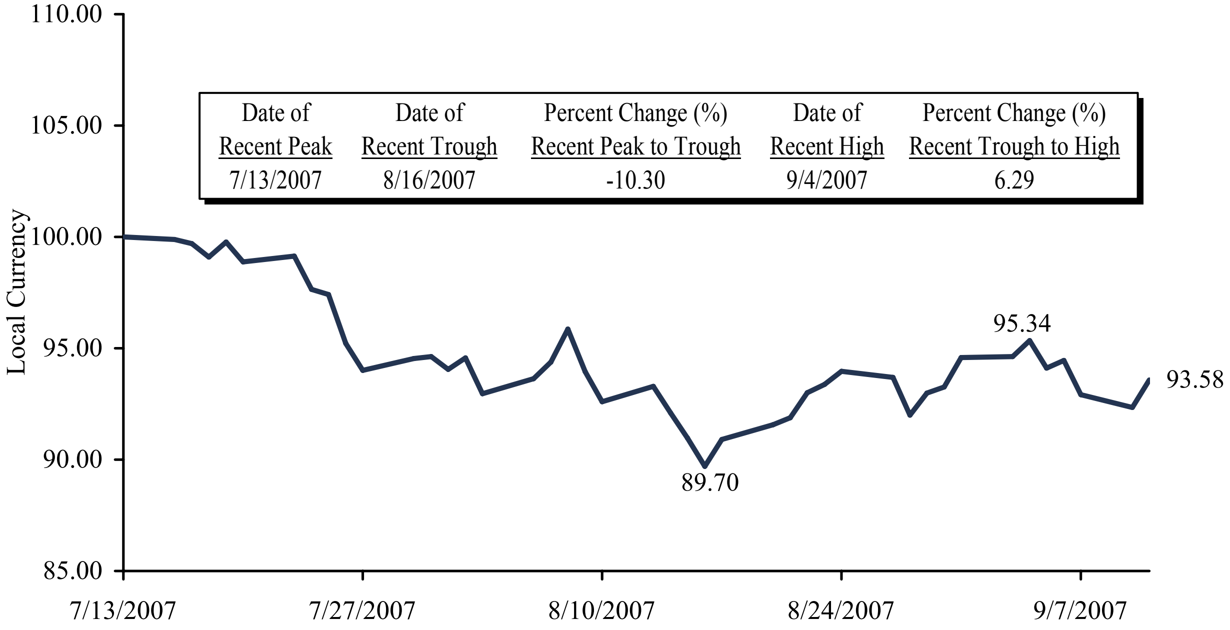
[8] For more details, please see our May 2007 Market Commentary *Why Not Hold Cash?*

Table A

VARIOUS MSCI INDICES FROM 2007 PEAKS TO TROUGHS

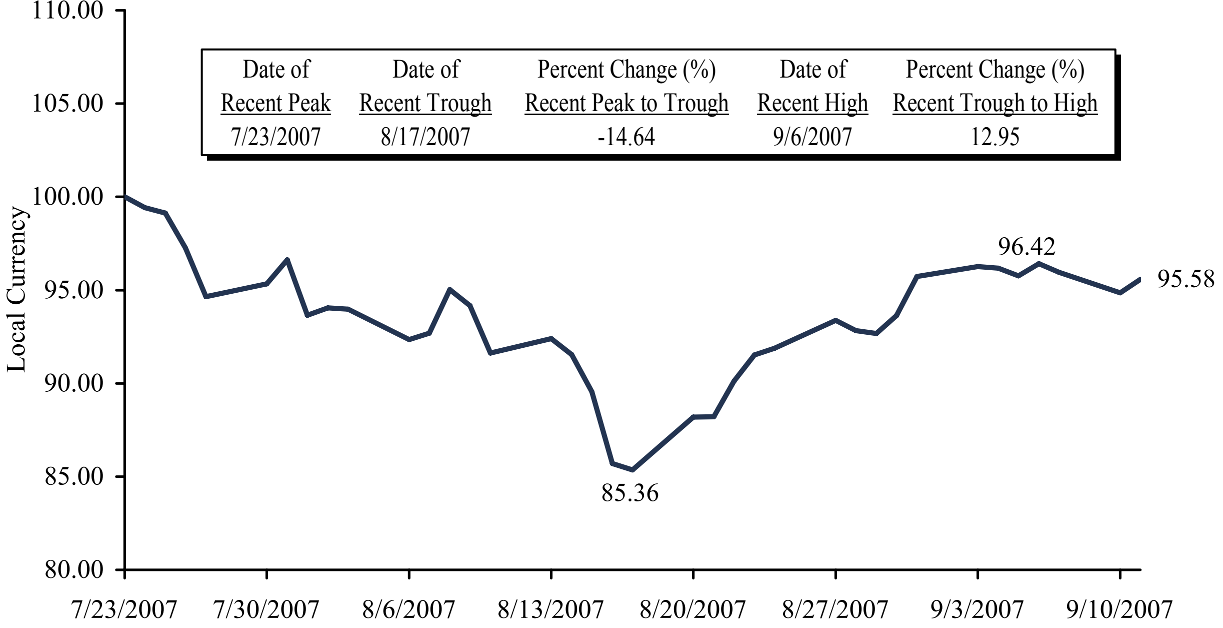
Most Recent Peak - September 11, 2007

MSCI World Cumulative Wealth
(July 13, 2007 = 100.00)



Date of Recent Peak	Date of Recent Trough	Percent Change (%) Recent Peak to Trough	Date of Recent High	Percent Change (%) Recent Trough to High
7/13/2007	8/16/2007	-10.30	9/4/2007	6.29

MSCI Emerging Markets Cumulative Wealth
(July 23, 2007 = 100.00)



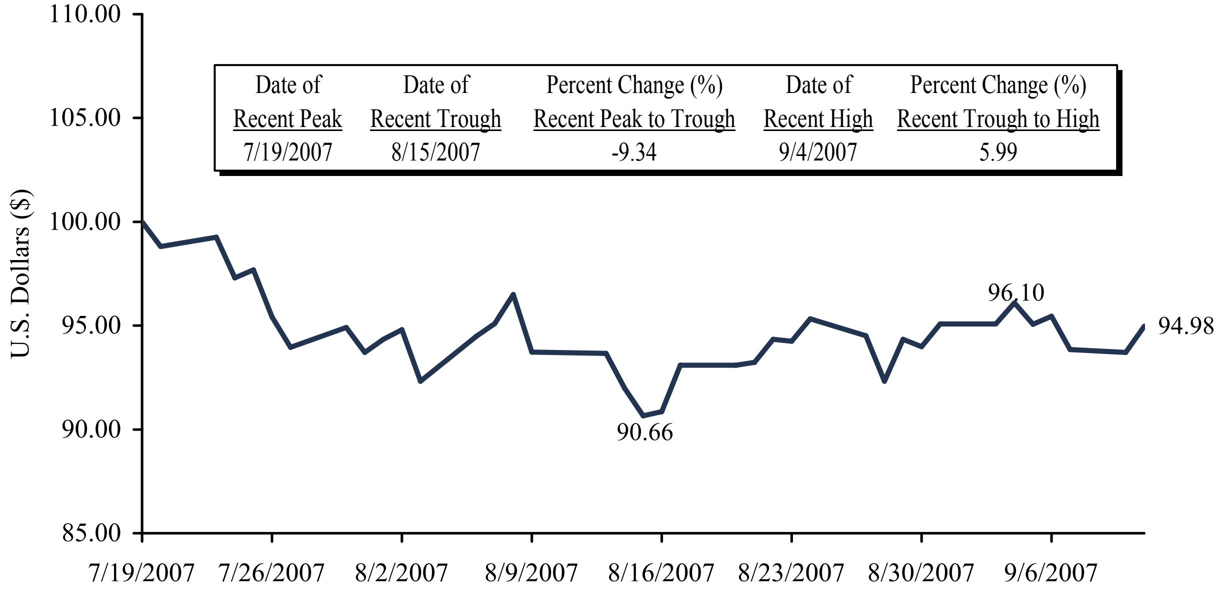
Date of Recent Peak	Date of Recent Trough	Percent Change (%) Recent Peak to Trough	Date of Recent High	Percent Change (%) Recent Trough to High
7/23/2007	8/17/2007	-14.64	9/6/2007	12.95

Table A (continued)

VARIOUS MSCI INDICES FROM 2007 PEAKS TO TROUGHS

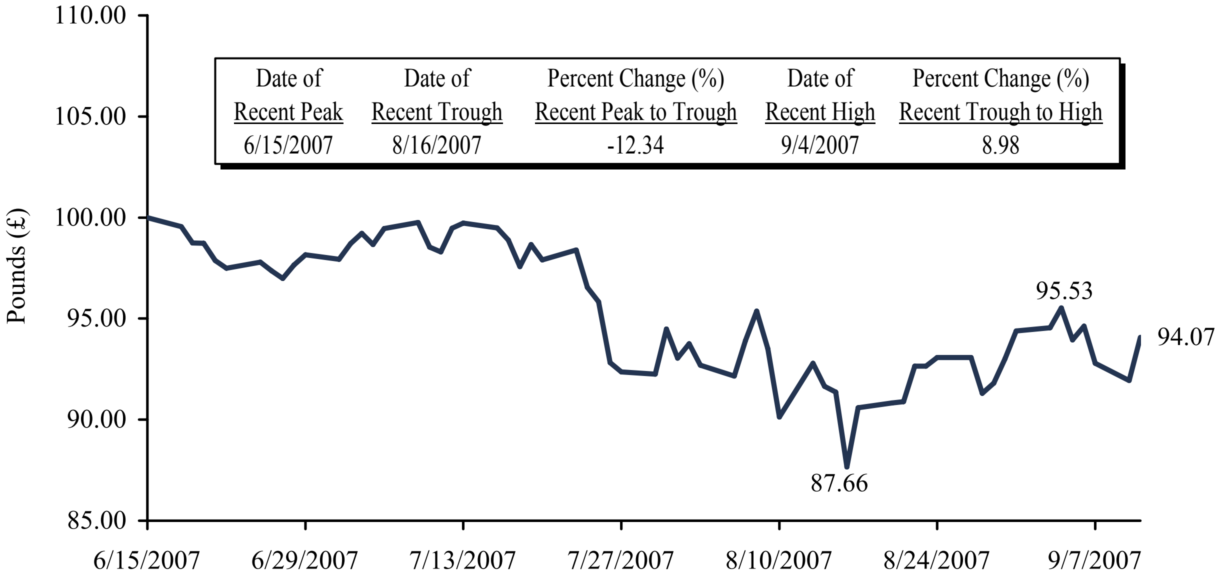
Most Recent Peak - September 11, 2007

MSCI USA Cumulative Wealth
(July 19, 2007 = US$100.00)



Date of Recent Peak	Date of Recent Trough	Percent Change (%) Recent Peak to Trough	Date of Recent High	Percent Change (%) Recent Trough to High
7/19/2007	8/15/2007	-9.34	9/4/2007	5.99

MSCI U.K. Cumulative Wealth
(June 15, 2007 = £100.00)



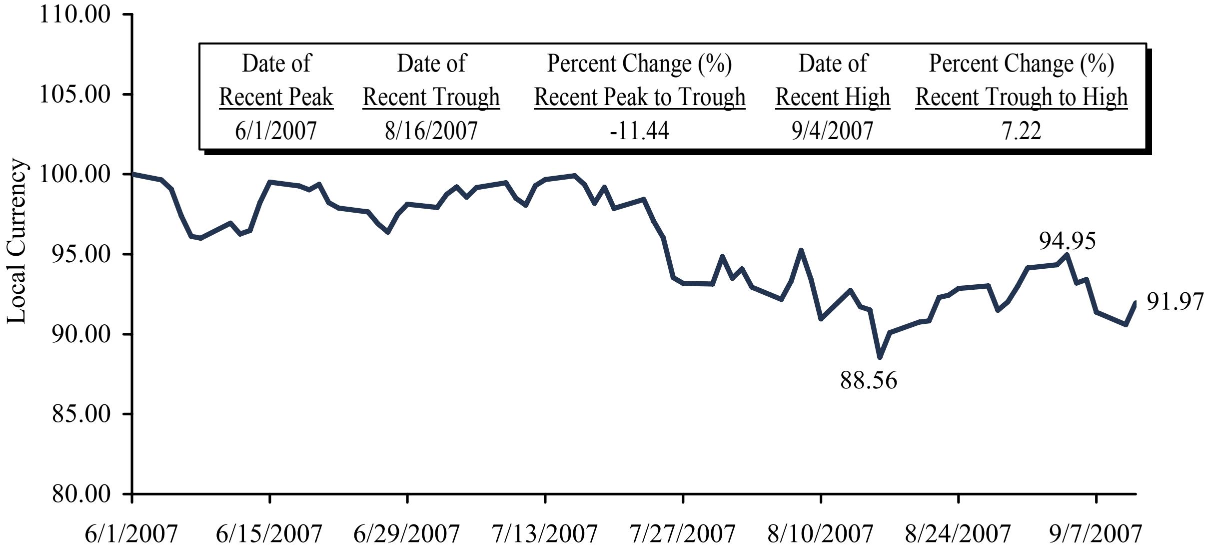
Date of Recent Peak	Date of Recent Trough	Percent Change (%) Recent Peak to Trough	Date of Recent High	Percent Change (%) Recent Trough to High
6/15/2007	8/16/2007	-12.34	9/4/2007	8.98

Table A (continued)

VARIOUS MSCI INDICES FROM 2007 PEAKS TO TROUGHS

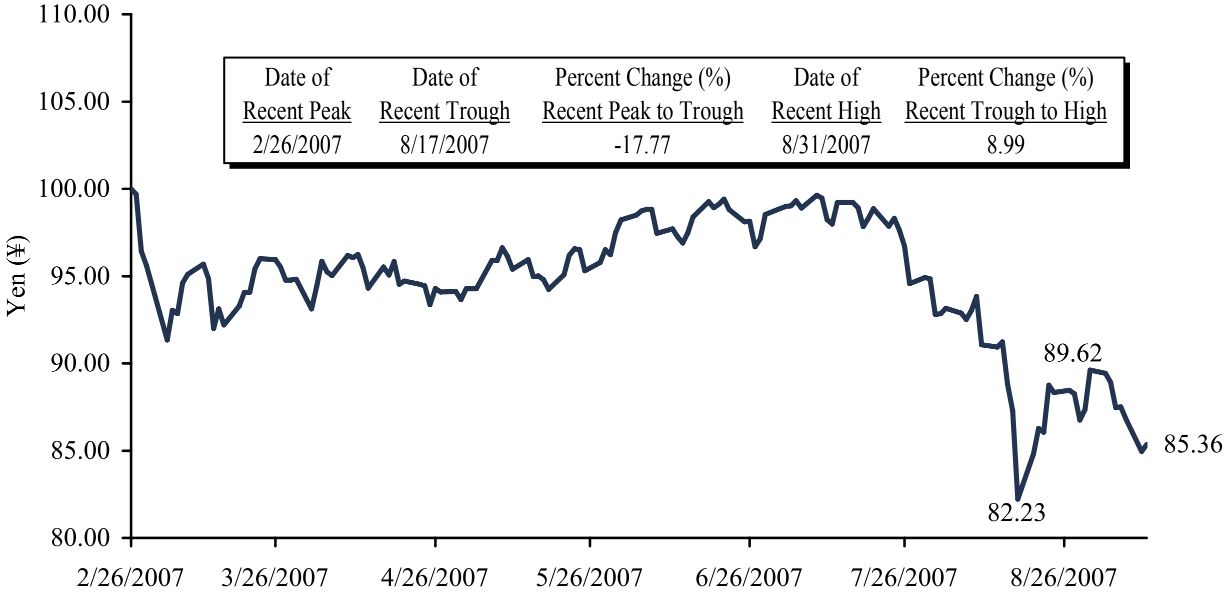
Most Recent Peak - September 11, 2007

MSCI Europe ex U.K. Cumulative Wealth
(June 1, 2007 = 100.00)



Date of Recent Peak	Date of Recent Trough	Percent Change (%) Recent Peak to Trough	Date of Recent High	Percent Change (%) Recent Trough to High
6/1/2007	8/16/2007	-11.44	9/4/2007	7.22

MSCI Japan Cumulative Wealth
(February 26, 2007 = ¥100.00)



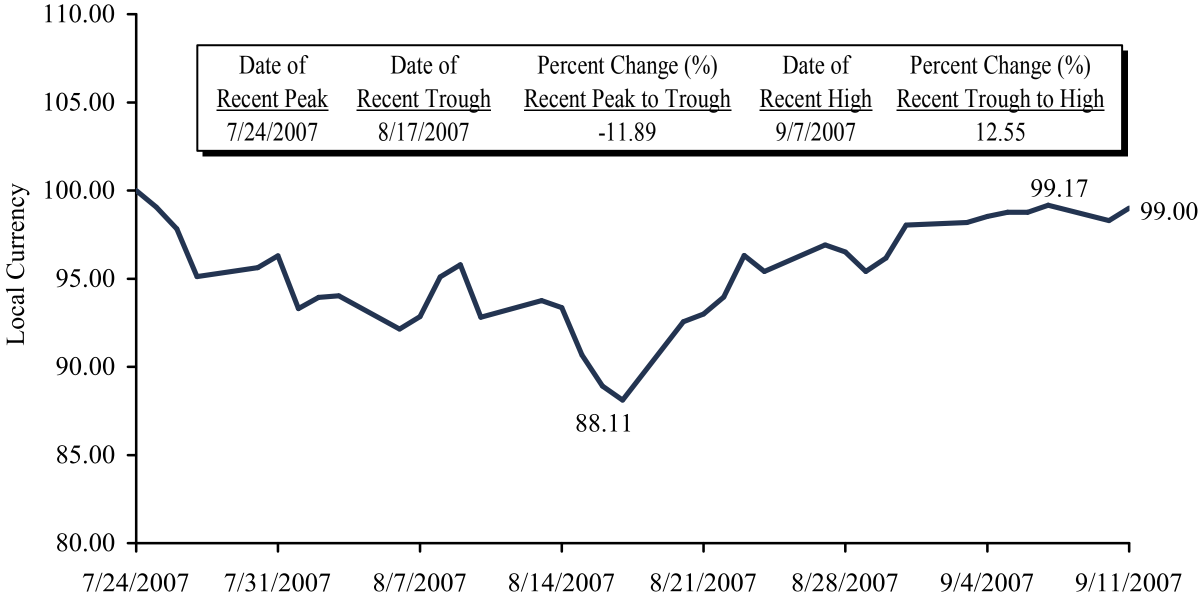
Date of Recent Peak	Date of Recent Trough	Percent Change (%) Recent Peak to Trough	Date of Recent High	Percent Change (%) Recent Trough to High
2/26/2007	8/17/2007	-17.77	8/31/2007	8.99

Table A (continued)

VARIOUS MSCI INDICES FROM 2007 PEAKS TO TROUGHS

Most Recent Peak - September 11, 2007

MSCI Pacific ex Japan Cumulative Wealth
(July 24, 2007 = 100.00)



Date of Recent Peak	Date of Recent Trough	Percent Change (%) Recent Peak to Trough	Date of Recent High	Percent Change (%) Recent Trough to High
7/24/2007	8/17/2007	-11.89	9/7/2007	12.55

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Table B

HOW MUCH WOULD EQUITY MARKETS APPRECIATE UNDER THE FOLLOWING EARNINGS GROWTH AND P/E ASSUMPTIONS?

As of August 31, 2007

MSCI World		Average Annual Compound Growth	Growth* Plus One Std Dev	Growth* Minus One Std Dev
		6.4%	12.3%	0.6%
		5-Year Average Annual Compound Price Appreciation		
Current P/E Ratio	16.3	6.4	12.3	0.6
Average P/E Ratio	17.9	8.4	14.4	2.6
Avg P/E + 1 Std Dev	24.3	15.3	21.6	9.1
Avg P/E - 1 Std Dev	11.5	-0.7	4.8	-6.1

MSCI USA		Average Annual Compound Growth	Growth* Plus One Std Dev	Growth* Minus One Std Dev
		7.5%	13.2%	1.2%
		5-Year Average Annual Compound Price Appreciation		
Current P/E Ratio	17.3	7.5	13.2	1.2
Average P/E Ratio	16.7	6.8	12.4	0.5
Avg P/E + 1 Std Dev	23.2	14.0	20.0	7.3
Avg P/E - 1 Std Dev	10.3	-3.1	2.0	-8.8

MSCI U.K.		Average Annual Compound Growth	Growth* Plus One Std Dev	Growth* Minus One Std Dev
		8.5%	15.1%	2.2%
		5-Year Average Annual Compound Price Appreciation		
Current P/E Ratio	12.8	8.5	15.1	2.2
Average P/E Ratio	13.4	9.7	29.8	-7.6
Avg P/E + 1 Std Dev	18.0	16.3	23.3	9.5
Avg P/E - 1 Std Dev	8.8	0.6	6.7	-5.3

MSCI Europe ex U.K.		Average Annual Compound Growth	Growth* Plus One Std Dev	Growth* Minus One Std Dev
		6.7%	15.1%	-1.3%
		5-Year Average Annual Compound Price Appreciation		
Current P/E Ratio	14.9	6.7	15.1	-1.3
Average P/E Ratio	15.9	8.1	16.7	0.0
Avg P/E + 1 Std Dev	21.6	15.0	24.1	6.4
Avg P/E - 1 Std Dev	10.1	-1.2	6.6	-8.6

Sample Interpretation:
Given a particular earnings growth assumption and price-earnings (P/E) ratio, this exhibit illustrates the expected average annual price change for MSCI indices. For example, if MSCI World earnings grew at their average annual compound growth rate of 6.4% over the next five years, and the P/E ratio at the end of five years is 11.5 (or 1 standard deviation lower than its long-term average), then the price of the MSCI World Index would *decrease* by 0.7% annually over the next five years.

Table B (continued)

HOW MUCH WOULD EQUITY MARKETS APPRECIATE UNDER THE FOLLOWING EARNINGS GROWTH AND P/E ASSUMPTIONS?

As of August 31, 2007

MSCI Emerging Markets		Average Annual Compound Growth	Growth* Plus One Std Dev	Growth* Minus One Std Dev
		12.9%	19.7%	5.3%
		5-Year Average Annual Compound Price Appreciation		
Current P/E Ratio	17.0	12.9	19.7	5.3
Average P/E Ratio	16.4	12.0	18.9	4.5
Avg P/E + 1 Std Dev	21.1	17.8	25.0	9.9
Avg P/E - 1 Std Dev	11.7	4.8	11.2	-2.3

MSCI Pacific ex Japan		Average Annual Compound Growth	Growth* Plus One Std Dev	Growth* Minus One Std Dev
		5.3%	12.6%	-1.8%
		5-Year Average Annual Compound Price Appreciation		
Current P/E Ratio	17.5	5.3	12.6	-1.8
Average P/E Ratio	16.5	4.0	11.2	-3.0
Avg P/E + 1 Std Dev	19.9	7.9	15.5	0.7
Avg P/E - 1 Std Dev	13.1	-0.7	6.2	-7.4

MSCI Japan**		Average Annual Compound Growth	Growth* Plus One Std Dev	Growth* Minus One Std Dev
		4.6%	9.0%	-2.0%
		5-Year Average Annual Compound Price Appreciation		
Current P/E Ratio	9.5	4.6	9.0	-2.0
Average P/E Ratio	9.5	4.6	9.1	-2.0
Avg P/E + 1 Std Dev	12.9	11.2	15.9	4.2
Avg P/E - 1 Std Dev	6.1	-4.3	-0.2	-10.3

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

Notes: P/E data for MSCI USA, MSCI U.K., and MSCI Europe ex U.K. indices start on December 31, 1969; for MSCI World Index on March 31, 1970; for MSCI Pacific ex JP Index on December 31, 1984; and for MSCI Emerging Markets Index on December 31, 1995. Earnings growth rates data for MSCI USA, MSCI U.K., and MSCI Europe ex U.K. indices start on January 1, 1970; for MSCI World and MSCI Japan indices on January 1, 1971; for MSCI Pacific ex JP Index on January 1, 1985; and for MSCI Emerging Markets Index on January 1, 1996.

* Average earnings growth plus and minus standard deviations is based on the arithmetic mean.

** For MSCI Japan price-to-cash earnings (P/CE) ratios were use instead of P/E due to the volatility and extreme levels of historical P/E ratios. P/CE ratios for MSCI Japan start on March 31, 1970.