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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT

THE DECELERATING WORLD AND ITS INVESTMENT IMPLICATIONS

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What Worked in 2004

The global economy was clearly on the simmer in 2004. Real growth is expected to clock in at a 4.5% clip, which would be its fastest pace since 1988. China's investment boom spurred global demand for industrial products and metals, while surging oil prices, from February's $36 low to October's $56 peak, powered oil-related equities and energy-centric commodity indices. In a world with very few undervalued asset classes, investors spent the year buying value and yield to the degree they could find them. Value thrashed growth, especially among small caps, while cyclical stocks, REITs, and most fixed income segments also experienced strong returns. With high beta underperforming, technology and health care were the MSCI World Index's worst-performing sectors. Defensive and mega-cap stocks fell into disfavor in 2004. Investors who believed 2003 marked the peak of the global cyclical boom, and positioned their portfolios accordingly, clearly struggled for the year.

The sliding greenback provided a fillip for investors in non-US$-denominated assets who translated their profits back to US$. There is a strong consensus that the US$ sell-off will continue, raising the possibility of a rally in the short term given markets' propensity to prove the consensus wrong. Regardless of the direction of the US$ in the short term, the downward pressure on the US$ is clear as the budget and current account deficits have resulted in the United States becoming increasingly dependent on foreign investors to finance the deficit. These concerns are likely to worry investors for years to come. Furthermore, valuations are generally more attractive in non-U.S. markets than in U.S. markets, bolstering the case that investors with heavy US$ exposure should increase their allocations to non-U.S. equities.

In 2004, the equities of the economy with the highest growth (United States) underperformed those of other developed markets, while those of the economy with the slowest growth (continental Europe) enjoyed the highest returns. This year was the first year since 1993 that all major non-U.S. equity markets, including emerging equities, bested the primary U.S. indices. We do not believe this decoupling is merely an anomaly or quaint anecdote; equities go up and down on the basis of expectations and risk assessments, not the speed of economic growth (though of course the link is apparent over longer time periods). The key is whether earnings growth expectations are met, raised, or lowered, as well as whether risk assessments are changed. It is quite likely, we believe, that 2004's disconnect between equity returns and economic growth will grow more pronounced in the new year and beyond. Equities could post mediocre or negative returns despite healthy economic growth (and vice versa). Indeed, we expect that the U.S. market may experience a period in which the economy is going great guns, but the stock market swoons while pundits lament the market's irrational behavior, before this secular bear market is over.

For some, the biggest surprise of the year was U.S. interest rates. Instead of moving sharply higher in 2004, as was widely anticipated (and hyped), U.S. ten-year Treasury yields ended the year at 4.24%, 3 basis points (bps) lower than their year-beginning point, though they fell to a low of 3.70% in March and climbed to a high of 4.89% in June. Most global fixed income segments enjoyed another up year; corporate yield spreads narrowed sharply, and sovereign yield curves underwent flattening pressure, with long yields falling more than short-dated yields.[1]

Given that we continue to believe that we are in a secular bear market in which undervalued assets are difficult to find, we continue to recommend investors hold a broadly diversified portfolio and rebalance assiduously. Bear market rallies can be quite strong, but the current rally is getting long in the tooth and has developed more speculative elements in recent months, increasing the importance of adopting a defensive posture. Investors should continue to explore low-beta strategies to implement equity allocations, including selectively investing in long/short equity hedge funds and underweighting aggressive growth/overweighting quality. Despite the recent surge in commodity prices, we also continue to favor real assets, such as commodities and natural resources, as a hedge against cyclical inflation. Finally, for investors with adequate resources to do so, we recommend pursuing incremental returns through managers who seem best able to add alpha in this uncertain environment.[2]

Competing Scenarios for 2005

In 2005, the U.S. Federal Reserve will continue to raise policy interest rates, the US$ sell-off will persist, and corporations will pick up the pace of dividend issuance and share buybacks—on these overarching themes, bulls and bears generally agree. Their crystal balls cast conflicting forecasts, however, about the implications of these trends, the speed at which they will unfold, and the extent to which other growth engines will offset their effects.

The bulls tend to downplay the implications of higher policy interest rates in the United States. While Fed Chairman Greenspan will raise rates, the pace will be “measured” and the endpoint “neutral,” which will sustain U.S. growth without drying up liquidity, the bulls believe. According to them, Asia’s continuing economic boom will ease any cross-Pacific turbulence caused by tighter financial conditions emanating from the United States, which will assure the wheels of global trade remain well-greased and working smoothly. Dynamic global trade should also spark the economies of continental Europe and Japan, both of which have nearly stalled in recent months. So, global GDP growth will probably slow, the bulls believe, but only to around trend, 3.5%—nothing more substantial. Within this benign-to-positive macro environment, corporations, armed with cash-swollen balance sheets, are poised to expand their pace of capital spending, primarily in industrial sectors. Firms will also return cash to shareholders by raising dividend payouts, share buybacks, and merger and acquisition activity. The bulls also maintain that cyclical stocks will continue to outperform in the next upleg of the equity rally.

In contrast, the bears worry that removing the Fed-provided punch bowl will dry up global liquidity. In addition, the depreciating US$ will stifle domestic demand in the United States, thereby slowing continental European and Asian exports, which will not only dampen global trade but also strain the current

[1] The U.K. gilt curve remains inverted, though the point of inversion moved from five-year point to the one-year, and in Japan higher long yields steepened the curve considerably.
[2] For a more detailed discussion of the rationale behind our recommendations, see our June 2004 paper *The Best Offense is a Good Defense* the latest in our *Asset Allocation in the Current Environment* series.

global exchange rate regime. This global entropic environment will increase investor risk aversion and force them to ratchet down earnings growth expectations. With high equity valuations—primarily in the United States—the bears urge investors to adopt a defensive bias and move to high-quality, high-dividend paying equities.

Global Survey—Learning to Love Pessimism

Right now, the consensus has its money on the bear scenario. High-quality, defensive stocks are generally expected to outperform in 2005, as the earnings cycle turns away from cyclicals. In fact, earnings growth for MSCI World is expected to slow sharply, from 37.4% in 2004 to 14.6% in 2005[3] (see Table A). This is almost entirely due to substantially lower expectations for cyclicals, as each cyclical sector is expected to decelerate by one-third to one-half; the only sectors where growth is expected to accelerate from 2004 levels are utilities and consumer staples. While the new year is expected to usher in slower growth, global equity valuations are generally supportive. The index is roughly fairly valued according to several valuation metrics. Since earnings rose faster in 2004 than did equity prices, valuations of MSCI World actually fell during the year; its year-end price-earnings ratio was 18.4, compared to the year-beginning level of 22.4.

We continue to believe global equities are in the midst of a cyclical bull rally within a secular bear market. The following regional overview paints a global landscape of lower economic and earnings growth. This does not necessarily bode poorly for all equities, however, because performance is all about expectations. The key is not whether the slowdown will actually materialize per se, but whether these rather sober expectations will prove too conservative, as was the case in 2004,[4] or whether they still contain too much optimism and must be reduced as 2005 progresses.

The United States—Re-entering the Atmosphere

If the consensus proves correct, U.S. equities will underperform all major non-U.S. markets for the second straight year in 2005. S&P 500 earnings are expected to increase 10.5% in 2005, a considerable slowdown from 19.1% growth in 2004. Of course, the consensus is rarely correct,[5] but drilling deeper into the composition of expected earnings growth reveals a considerably different view of the earnings cycle than in 2004 when cyclicals powered equities. The new year is expected to favor defensive sectors and high-quality stocks, with only the consumer staples, utility, and telecom sectors expected to see earnings rise from 2004 growth levels. Since February 2004, when consensus forecasts for 2005 began to be posted, analysts have lowered growth estimates for every sector, save utilities. In part, this reflects expectations that real economic activity will decelerate to 3.5% growth from 4.4% in 2004. The rate of earnings growth that

[3] This is considerably faster than the index's post-1970 average of 7.9% nominal growth.
[4] At the beginning of 2004, the consensus expected MSCI World earnings to grow 15.2%.
[5] For the S&P 500, since 1986 there have only been five years when consensus earnings growth expectations made at the beginning of the year proved *less* optimistic than actual earnings growth (including 2004). In other words, 74% of the time analysts were forced to lower their expectations as the year unfolded.

eventually materializes will depend on the impact of higher policy interest rates and whether corporate profits will begin to erode under the pressure of rising unit labor costs; both of which have not yet been evident. To us, current high equity valuations suggest risks to U.S. equities are to the downside.

The United Kingdom—Restrained Returns

Although the U.K.'s real economy hummed along at a 3.3% clip in 2004, its equities underperformed all major markets, save Japan. Earnings growth exceeded the year-beginning expectations, but only slightly, 11% compared with 9.3%. For 2005, with the consensus expecting real GDP to grow a healthy 3.1%,[6] the performance of equity markets depends on whether profits will grow faster than their current expectations of 8% for 2005 and 6% for 2006. Valuations are currently generally supportive of U.K. equities, with most metrics only slightly higher than their historical averages. Going forward, the primary risk may be the same factor that allowed U.K. equities to outperform those of the United States in recent years. Over the past five years, oil and banking stocks accounted for 70% of earnings growth of the FTSE All-Share, and resources and financials currently make up 45.5% of the index's market cap. The market is quite vulnerable to the underperformance of these two industry groups.

Continental Europe—Pessimism Baked in

Escargot-speed economic growth certainly did not hurt equity returns on the Continent in 2004. The real economy expanded 1.8% for the year, the slowest pace among developed economies, with growth pretty much stalling in their third quarter, most noticeably in France and Germany. However, MSCI Europe ex U.K. earnings grew 39.5% in 2004—substantially higher than expectations of 22.4% growth registered at the beginning of the year. Presumably, the more sober earnings growth forecast of 13.8% for 2005 already discounts the deteriorating economic outlook, where real growth is forecast to edge up only 1.7%. Furthermore, equities should receive support from fairly attractive valuations. The risk of course is that earnings growth expectations will be ratcheted down even further, which could occur if euro appreciation continues to crimp export growth, while a further slowdown in wage growth squeezes domestic demand.

Japan—the Bumpy Path Upward

Slowing export and capital spending growth have put Japan's economic recovery into question, and the consensus expects dark clouds to linger. After expanding 2.9% in 2004, the real economy is anticipated to grow only 1.5% in 2005. However, the expansion's underpinnings remain intact, for profit growth, private demand, and financial conditions remain strong. The consensus expects earnings for the Topix to grow 14.9% in 2005, a healthy pace but down considerably from the 39.2% rate registered in 2004. Going into the new year, equities face two primary risks. First, a larger-than-expected slowdown in China's economy would hurt exports and domestic demand. The second risk is yen strength. Given that a 10% appreciation in the

[6] The United Kingdom's post-1955 real GDP trendline annual growth is 2.4%.

currency would cut real GDP by about 20 bps, and that the ¥ rose 4.6% against the US$ (but fell 2.9% against the €) for the year, the consensus of further appreciation could indeed be serious. It would be quite surprising, indeed a testament of authorities' confidence in the economy, if the Japanese government brakes from their practice of intervening in the currency markets during the first quarter of the new year (Japan's fiscal year ends March 31). Japanese equity valuations are currently moderately cheaper than their historical averages.

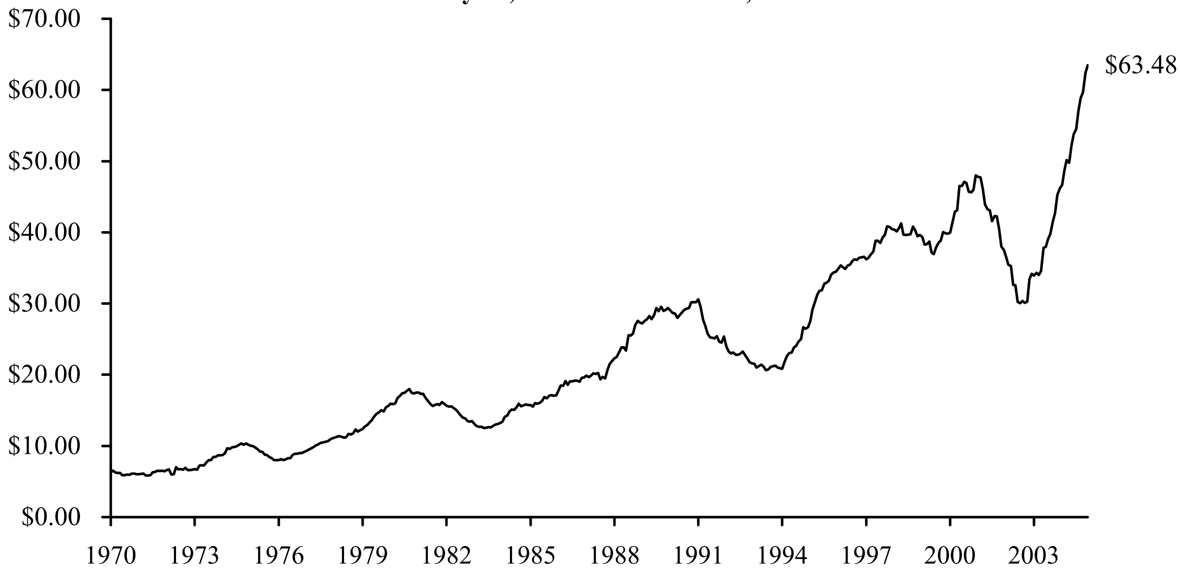
Emerging Markets Equities—Stall Speed

In 2004, emerging markets equities enjoyed dramatically better-than-expected earnings growth of 34.1%—nearly double the 18.2% consensus expectations at the beginning of the year. However, for the new year investors are apparently battening down the hatches, with earnings in the MSCI Emerging Markets Index expected to slow dramatically to 7.3% in 2005. Slowing export growth is expected to savage earnings growth in emerging Asia where the consensus currently expects MSCI Emerging Markets Asia earnings growth to screech to a halt: 3.5% growth in 2005, compared to 47.7% growth in 2004. Korea is the primary culprit; earnings growth there is expected to plunge from 62.2% in 2004 to only 3.1% in 2005. While these expectations seem to herald the return of the asset class's notorious volatility, they increase the likelihood of a positive earnings surprise. At the same time, supportive valuations should cushion the effects if the imminent slowdown is more severe than expected.

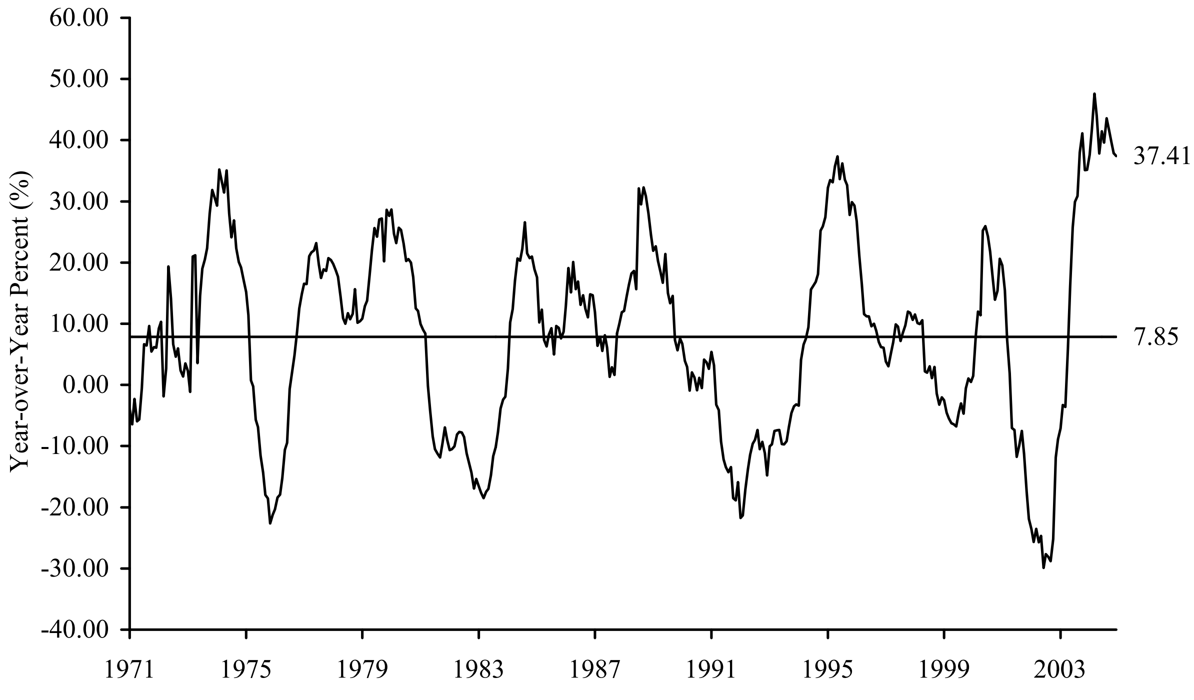
Table A

MSCI WORLD INDEX REPORTED EARNINGS

Earnings Per Share
January 31, 1970 - December 31, 2004



Earnings Growth
January 31, 1971 - December 31, 2004



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Data are in U.S. dollars.