CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

THE WORST OF TIMES—OR THE BEST OF TIMES?

December 2008

Seth Hurwitz
Kyle Anderson

Copyright © 2009 by Cambridge Associates LLC. All rights reserved.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of federal copyright laws (17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. This means that authorized members may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. An authorized member may disclose information or material from this report to its staff, trustees, or Investment Committee with the understanding that these individuals will treat it confidentially. Additionally, information from this report may be disclosed if disclosure is required by law or court order, but members are required to provide notice to CA reasonably in advance of such disclosure. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that are described in the report. This report is provided only to persons that CA believes to be "Accredited Investors" as that term is defined in Regulation D under the Securities Act of 1933. When applicable, investors should completely review all Fund offering materials before considering an investment. No part of this report is intended as a recommendation of any firm or any security. Factual information contained herein about investment firms and their returns which has not been independently verified has generally been collected from the firms themselves through the mail. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results delivered through the mail. The CA manager universe statistics, including medians, are derived from CA's proprietary database covering investment managers. These universe statistics and rankings exclude managers that exclude cash from their reported total returns, and for calculations including any years from 1998 to the present, those managers with less than $50 million in product assets. Returns for inactive (discontinued) managers are included if performance is available for the entire period measured. Performance results are generally gross of investment management fees. CA does not necessarily endorse or recommend the managers in this universe.

Cambridge Associates, LLC is a Massachusetts limited liability company with offices in Arlington, VA; Boston, MA; Dallas, TX; and Menlo Park, CA. Cambridge Associates Limited is registered as a limited company in England and Wales No. 06135829 and is authorised and regulated by the Financial Services Authority in the conduct of Investment Business. Cambridge Associates Limited, LLC is a Massachusetts limited liability company with a branch office in Sydney, Australia (ARBN 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G).

"We will not stand by and let the recession take its course."—British Prime Minister Gordon Brown

"This is a world-wide crisis and therefore we must find a world-wide solution. . . . [The answer] will be all the more effective insofar as we find it together, we speak with one and the same voice, and we build together the capitalism of the future."—French President Nicolas Sarkozy

"We have a bidding war where everyone in politics believes they have to top up every spending program that's been put to discussion. I say we should be honest to our citizens. Politics can take some of the sharpness out of it, but no matter how much any government does, the recession we are in now is unavoidable."—German Finance Minister Peer Steinbrück, *Newsweek*, December 15, 2008

A Most Difficult Year

As 2008 dawned we warned that the stage was set for disappointments on the European equities front. With returns on equity (ROEs) near record highs, earnings growth, particularly on the Continent, far above trend line, and valuations that were relatively rich, we were skeptical about the possibility of strong returns. From a broader perspective, we were concerned about high global imbalances and the fact that Europe and the United States were in the early stages of a credit crisis fueled by unusually high and unconstrained global debt issuance, much of the U.S. portion of which was of poor quality. Still, like most others, we had no sense of the cataclysm that awaited.

European equity prices dropped sharply at the start of 2008 and, despite brief rallies following the U.S. Federal Reserve's large January 21 rate cut and March bailout of Bear Stearns, fell into an abyss in June from which they have yet to recover. The nadir was reached on November 21, with the FTSE All-Share and MSCI Europe ex U.K. indices down 45.7% and 53.9%, respectively, from their June 2007 peaks. For the year as a whole, European stocks returned -43.2%, by far their worst performance since at least 1970, when our Europe-wide data begin. In local currency terms, continental European markets barely underperformed developed markets, while the United Kingdom actually outperformed all other developed markets. Meanwhile, the daily volatility of the FTSE All-Share, CAC 40, and SMI indices in 2008 was more than twice as great as in 2006 and 2007, with spreads between the highest and lowest daily returns[1] over three times as wide.

From a macro perspective, Europe at the end of 2008 looked far different than it had 12 months earlier. In the early part of the year, the region appeared most vulnerable to the potential fallout from U.S. financial sector woes (although the United Kingdom clearly faced significant consumer and housing-related issues as well) and inflation. Indeed, the European Central Bank boosted the policy rate to a seven-year high as late as July. By the end of the year, however, Europe was mired in a recession and more concerned about the possibility of *deflation*: central banks and governments had provided unprecedented support to the

[1] Price returns were examined with respect to the FTSE All-Share and SMI (Swiss Market Index) indices, while total return was used for the (French) CAC 40 Index.

financial system, monetary authorities had cut policy rates sharply (Table A), and policymakers had passed large fiscal stimulus packages.

While economic news and equity market performance have been dismal, valuations, which we had considered rich at the start of 2008, suddenly look much better than they have in many years. As we enter 2009 investors are thus faced with the question of whether valuations are compelling enough to outweigh what is certain to be a difficult stretch as Europe works its way back to recovery. Put another way, do current prices reflect all or most of the bad economic news we are likely to see in 2009 and beyond? We conclude that while earnings and ROEs have not yet corrected from cyclical highs and there are greater uncertainties than usual (and strong headwinds) with respect to economic growth, valuations incorporate enough of the downside possibilities to justify a neutral weight with respect to European equities. Still, a defensive-oriented approach, favoring high-quality equities, is also likely to best serve investors in the difficult environment of 2009.

The United Kingdom

Value and Large Caps Outperformed

U.K. shares returned -29.9% in 2008, their second-worst performance since 1900.[2] In a sharp reversal from 2007, value stocks outperformed growth stocks, notwithstanding 842 basis points (bps) of underperformance in the first half of 2008. The FTSE 100, meanwhile, outperformed the FTSE Small Cap and FTSE 250 (mid-cap) indices for the second consecutive year, despite first quarter underperformance. Outperformance thereafter was dramatic, particularly in the year's final three months. For 2008 as a whole, large caps outperformed small caps by 1,558 bps, making two-year outperformance an impressive 2,678 bps. Mid caps, meanwhile, bested small caps by 5.8 percentage points in 2008. Small caps appear to have been hit particularly hard by the sharp slowdown in transactional activity; as of mid-December announced merger & acquisition volume of £182.1 billion (US$336.5 billion) was about 13.7% less than in 2007.[3]

Health care (8.8%) was the only economic sector to post a positive return in 2008, with all nine other sectors returning -13.7% or worse. The precipitous decline in commodities in the second half of the year made materials the year's worst performer, notwithstanding a 15.6% return from January through June. Materials made up 22.4% of the FTSE All-Share's losses; however, this paled in comparison to financials, whose -48.9% return accounted for a staggering 43.6% of the index's losses (Table B). Financials, which were easily the index's largest component in 2006 and 2007, now account for a smaller share than energy.

While the problems in materials, energy, and, to a large extent, financials, were tied to external factors, weakness in other sectors resulted from strains in the domestic economy that were exacerbated by

[2] The FTSE All-Share Index returned -51.8% in 1974, on the heels of a -28.7% return in 1973. Equity returns prior to 1963 are based on the performance of the 30 largest stocks, reconstructed annually by Barclays (1900–35) and the FT30 Index (1935–62).
[3] The full year figure is used for 2007.

exceedingly high levels of consumer indebtedness, significant overbuilding, and an overreliance on the financial sector. These structural issues are analogous to those faced by the United States but, unlike the US$—which appreciated as the credit crisis gained steam in the late summer—the pound-sterling had fallen by year-end to its lowest level ever on a trade-weighted basis. For unhedged US$ and euro-based investors the fall in sterling more than negated the U.K. market's relative outperformance of other developed markets in 2008.

Valuations Are Much Improved

Earnings per share (EPS) in the United Kingdom for 2008 are expected to dip by only 5%, although this estimate represents a significant downward revision from projections made just a few months ago.[4] Because reported earnings held up much better than stock prices, price-earnings (P/E) multiples fell sharply during 2008. U.K. shares traded at 12.3 times trailing 12-month earnings at the beginning of the year, but are now priced at 6.9 times trailing earnings. This is their lowest level since 1981 and more than 1 standard deviation below their historical average since 1974. P/E multiples based upon normalized earnings metrics, such as ten-year average real earnings (11.3) and ROE-adjusted earnings[5] (9.3), meanwhile, fell by roughly similar amounts during 2008 and are at their lowest levels since 1984 and 1985, respectively (Table C). Our decision to move U.K. equities into fairly valued territory (from overvalued) in August and into the undervalued camp three months later reflected the decline in these normalized P/E ratios, notwithstanding the clear vulnerability of earnings and ROEs, which had been growing at near-cyclical highs (based upon the most recently reported data).

Other valuation metrics such as price-to-book (P/B), price-to-cash earnings (P/CE), ROE, and dividend yields (DYs) also suggest that U.K. equities have become cheap relative to their historical levels (Table D). On a historical basis U.K. stocks also look slightly cheap relative to continental equities using P/E, P/B, and P/CE ratios, but somewhat expensive on an ROE and DY basis (Table E). Relative to the developed world as a whole, meanwhile, U.K. valuations look cheap (Table F). Still, while ROE has fallen slightly, it remains over 1 standard deviation above its historical average, a level that likely cannot be sustained in the current economic environment (Table G). Likewise, DYs, which are at 18-year highs, will probably be cut by firms focused on maintaining balance sheet strength and flexibility. In particular, financial firms are highly unlikely to maintain current DYs of 11.6%.

Consensus analyst estimates call for a 10% decline in nominal 2009 EPS, with both energy (the index's largest component) and materials earnings expected to decline by 26% and utilities expected to deliver the highest upside of 14% earnings growth. This would be the worst earnings performance since 1999, yet there are good reasons to consider it overly optimistic given economic headwinds at home and abroad,

[4] EPS estimates used here and elsewhere in the text of this paper are as of January 5, 2009, and refer to earnings on a post-goodwill basis. Estimates for 2008 and 2009 (discussed later) refer to the MSCI U.K. Index rather than the FTSE All-Share Index.

[5] Normalized P/E ratios attempt to adjust valuations for earnings cyclicality, by comparing both earnings and profitability (ROE) to some sort of normative measure over the earnings cycle. Real normalized P/E ratios (also known as Shiller P/E ratios) compare price levels to the ten-year average of real (inflation-adjusted) 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.

the aforementioned structural problems, and the fact that earnings remain near a record high compared to trend-line growth. Earnings in the energy and materials sectors will likely depend on a broad-based global recovery while financials, a sector that has undergone some nationalization since September 2007, remain highly risky due to problems within both the United Kingdom and the global financial system. Meanwhile, earnings are apparently still well above their trend-line growth rate since 1970. Earnings data substantially lag equity price information, particularly in markets such as the United Kingdom where most firms do not report on a quarterly basis.[6] However, given that equity prices have fallen about 35% from their 2007 daily peak, far more than earnings have (earnings *increased* according to the most recently available data and also may have benefited due to a combination of sterling weakness and profits earned in US$), it seems clear that the market is pricing in a decrease of much higher magnitude than consensus analysts expect. It is noteworthy that during the four periods since 1970 when real earnings peaked, the average decline thereafter was 40.9% over 39 months—in each case to a level well below trend-line growth (Table H).

The Investment Outlook

The FTSE All-Share Index's 45.7% price decline from June 15, 2007, to November 21, 2008, was its second largest peak-to-trough decline since 1965. Although the index rose 16.9% from November 22 through the end of 2008, valuations, as noted above, remain highly attractive. Indeed, the present trailing 12-month P/E ratio is lower than that reached in all but two of the last 12 bear market troughs.[7] In this context, it is useful to note that high U.K. five-year equity returns have generally been preceded by relatively low P/E valuations and vice versa. Although there have been cases where very high valuations preceded high five-year returns, in only one case did a starting P/E of less than 14 result in a subsequent average annual compound return (AACR) of less than 10% (the AACR in that instance was 4.9%). Better subsequent five-year performance has also generally followed periods of both low normalized P/E ratios and high DYs.

Nevertheless, the economic outlook has continued to weaken, with GDP falling 0.6% in third quarter 2008 and 1.5% in fourth quarter 2008, following a flat second quarter. Wholesale and retail sales are down, production and housing have contracted significantly, and the Confederation of British Industry's measure of industrial orders in November indicated a steep slowdown in earnings growth over the next 12 months. Unemployment claims have risen for ten consecutive months (through November) and Goldman Sachs forecasts that the unemployment rate, which had risen to 6.1% by November, will hit 8.5% by January 2010. According to Goldman Sachs, private investment fell at an annualized rate of over 10% in 2008 and will decline by a record 16% in 2009. Analysts predict a significant fall in 2009 GDP, with the OECD forecasting a 1.1% contraction, followed by growth of less than 1% in 2010.

It is unclear whether the market is fully discounting weaknesses in the U.K. economy, especially considering that consumers are already overextended and the government may be running out of policy options. It has adopted a fiscal stimulus package of approximately £26 billion that includes a cut in the value-

[6] To calculate earnings we use current price information and P/E ratios supplied by MSCI. MSCI's P/E ratios are updated on an ongoing basis to reflect the most recent reported company earnings.
[7] Valuations represent monthly data based on the FTSE Total Non-Financial (1965–92) and FTSE All-Share (1993–2008).

added tax but this carries the potential to hurt long-term growth, as the German government has warned. The *Financial Times* has estimated that the 2009 deficit could reach 8% of GDP. The Bank of England (BOE), meanwhile, has already pushed down rates by 430 bps to 1.5%, a record low, diminishing its future policy options.[8]

Europe ex U.K.

Growth and Large Caps Outperformed

The MSCI Europe ex U.K. Index returned -43.2% in 2008, its worst year ever. Individual country returns ranged from -34.7% (Switzerland) to -70.5% (Ireland). In contrast to the United Kingdom, growth stocks outperformed value shares; the performance differential was large enough to enable pan-European growth stocks to best value stocks for the second straight year. While continental small caps outperformed during the first quarter, likely reflecting misplaced optimism that systemic risk had been contained, the wheel soon turned. For the year, large caps outperformed small and mid caps by 795 bps and 536 bps, respectively.

With economic reports growing progressively worse, sentiment hitting multi-year lows (Table I), and investors fleeing for the gates, no part of the market was spared. The best-performing sector, health care, returned -22.3%, while financials' -57.0% return put them at the bottom of the pack. Thanks to their disproportionate weight in the index, financials accounted for over one-third of the index's losses while industrials accounted for another 14.2% (Table J).

Valuations Are Much Improved

According to consensus analyst estimates, EPS for the Eurozone declined 15% in 2008. Since prices fell by a much larger amount, the P/E multiple dropped sharply over the course of the year. Continental shares, which traded at 13.7 times trailing 12-month earnings at the beginning of the year, are now priced at 9.0 times trailing earnings. This is the lowest since 1981 and more than 1 standard deviation below their historical average since 1974. P/E multiples based upon normalized ten-year earnings (11.7) and ROE-adjusted earnings (11.6) ratios, meanwhile, fell even further during 2008 and are at their lowest levels since March and July of 1985, respectively (Table K). As was the case with U.K. equities, this led us to move Europe ex U.K. equities to fairly valued from overvalued in August and then to undervalued in November.

From an earnings perspective, it appears that earnings of continental equities peaked at least five months earlier than their U.K. counterparts and may not have as far to drop. Indeed, on a normalized basis earnings of continental equities during the past cyclical bull market never reached their year 2000 highs; this sharply contrasts with the United Kingdom, whose normalized earnings high was reached in 2008.

[8] This includes the BOE's 50 bp rate cut in early January 2009.

Other valuation metrics also suggest that continental equity prices are now attractive (Table L). However, consensus projections for a 1% rise in EPS in 2009 are overly optimistic in our view, given that ROE is still over 1 standard deviation above its historical average and earnings remain well above their historical trend line (Tables M and N). The consensus estimate is perhaps more ambiguous than that used with respect to the United Kingdom given the different financial circumstances of the various member countries. Thus, German EPS are estimated to rise by 11% in 2009, following an expected 25% decline in 2008, while French EPS are projected to be down 4% in 2009 following a flat 2008. In any event, because equities prices reflect multi-year projections, regional consumer sentiment (and that of other export partners) and longer-term growth expectations will likely prove more important for equity prices than actual 2009 earnings.

The Investment Outlook

Eurozone GDP contracted by 0.2% in the second and third quarters of 2008, the first time since the currency union was formed in 1999 that GDP has fallen for two consecutive quarters. Real GDP growth is expected to be less than 1% for the year as a whole. The German economy, the Eurozone's largest, is particularly weak, having fallen by 0.4% and 0.5%, respectively, in the second and third quarters. German government and private forecasters believe German GDP will easily underperform its worst-ever year (-1.0% growth) since World War II and many believe it will fall by as much as 3%. Spain, Ireland, Hungary, Turkey, and Iceland[9] have also experienced severe downturns and Switzerland is poised to follow.

The near-term picture looks fairly grim despite the aforementioned consensus expectations that EPS will increase. As in the United Kingdom, the fact that prices have declined much more sharply than earnings indicates that the market is far more pessimistic than consensus estimates suggest. Indeed, employment in the Eurozone is expected to rise sharply in 2009 after falling for the first quarter ever (since the adoption of the euro) during the July–September period and by the largest monthly amount in 15 years in October. Spain has been hit particularly hard in this regard. Bankruptcies are also expected to jump. Eurozone private sector activity has contracted during each of the last seven months, with the decline in December the fastest since the survey began ten years ago. Investor and business confidence are down sharply, with German business confidence at a 25-year low. Ireland and Spain, among other countries, are wrestling with the fallout from a property bubble. Italy, which already is burdened with Western Europe's largest debt to GDP ratio, also has the Eurozone's second largest funding needs in 2009 (after Germany).

Corporate buybacks were strong in the third quarter, indicating that corporations saw their stocks as cheap even before the final slide in 2008. Still, investors must consider the possibility that the recovery might not ensue for some time or that current valuations still are not properly discounting economic weakness. One area of particular concern should be financials, which make up an outsized 22.2% of the index (nearly double that of any other economic sector), but which are expected to deliver 36.3% earnings growth, far more than any other sector. It was clear even before 2008 that European banks were highly exposed to U.S. financial

[9] While the latter three countries are not represented in the MSCI Europe Index of developed equity markets, they are part of Europe and serve as a useful gauge of regional economic conditions.

sector problems; events during the year revealed the extent to which such exposure encompassed not only subprime debt but also strains in interbank lending, US$-denominated debt repayments, the fallout from the Lehman Brothers bankruptcy, and the year's last bombshell, the estimated $50 billion blowup of the Madoff investment fund. Despite a P/E ratio of 8.0, continental European financials remain a risky proposition given global credit issues, some €1.4 trillion in refinancing needs before the end of 2011 (including €600 billion in 2009), and $1.5 trillion (9% of Europe ex U.K. GDP) worth of exposure to Eastern Europe, whose economic growth prospects are under stress and whose ability to repay debt, especially that denominated in euros, is unclear given the lack of large foreign currency reserves with which to combat potential currency declines against the euro. European bank profits will be flat over the next two years if loan impairments peak at 2% (higher than the level reached during the recession of the early 1990s), according to Credit Suisse analysts. In addition, real consumer spending in almost every developed European nation is expected to increase only slightly (or even decline) in 2009 and 2010, according to Capital Economics.

Finally, there exists the possibility of a larger fallout resulting from strains within the Eurozone structure itself. This is the biggest crisis since the euro was adopted and the stability and growth pact limits members' freedom of action. The market already perceives that some European nations are much stronger than others. This is manifest in heretofore unseen differences in member borrowing costs (Table O), as well as sharp differentials in the cost of protection against the possibility of sovereign defaults.

Conclusion

Even though analysts expect a decrease (U.K.) or modest increase (Europe ex U.K.) in 2009 EPS, pan-European equity prices discount even worse results. The rapidly deteriorating economy may drag share prices down to or even below November 2008 lows. This may make stocks with high DYs appear especially attractive, but well over 100 firms in the United Kingdom and continental Europe have been paying out more than 100% of their income in dividends.[10] Likewise, investors should be mindful that Eurozone corporations, especially in Germany and Italy, carry relatively high debt loads compared to U.S. and other developed market firms. Strained credit conditions are likely to make debt issuance more costly than usual while efforts to raise equity capital run the risk of diluting share values. All of this suggests that investors would do well to maintain or adapt a relatively defensive position.

In the final analysis, however, valuations in the United Kingdom and on the Continent are the best they have been in many years and patient investors should be rewarded at some point. We would therefore advise those investors that are underweight European equities to gradually increase their exposure to equal weight. Still, we do not expect a sustained rally in the short term given the many issues that need to be resolved before corporate strength and market confidence are restored. Such issues include a resolution of credit problems that are preventing the market from functioning normally and an improvement in growth prospects outside Europe.

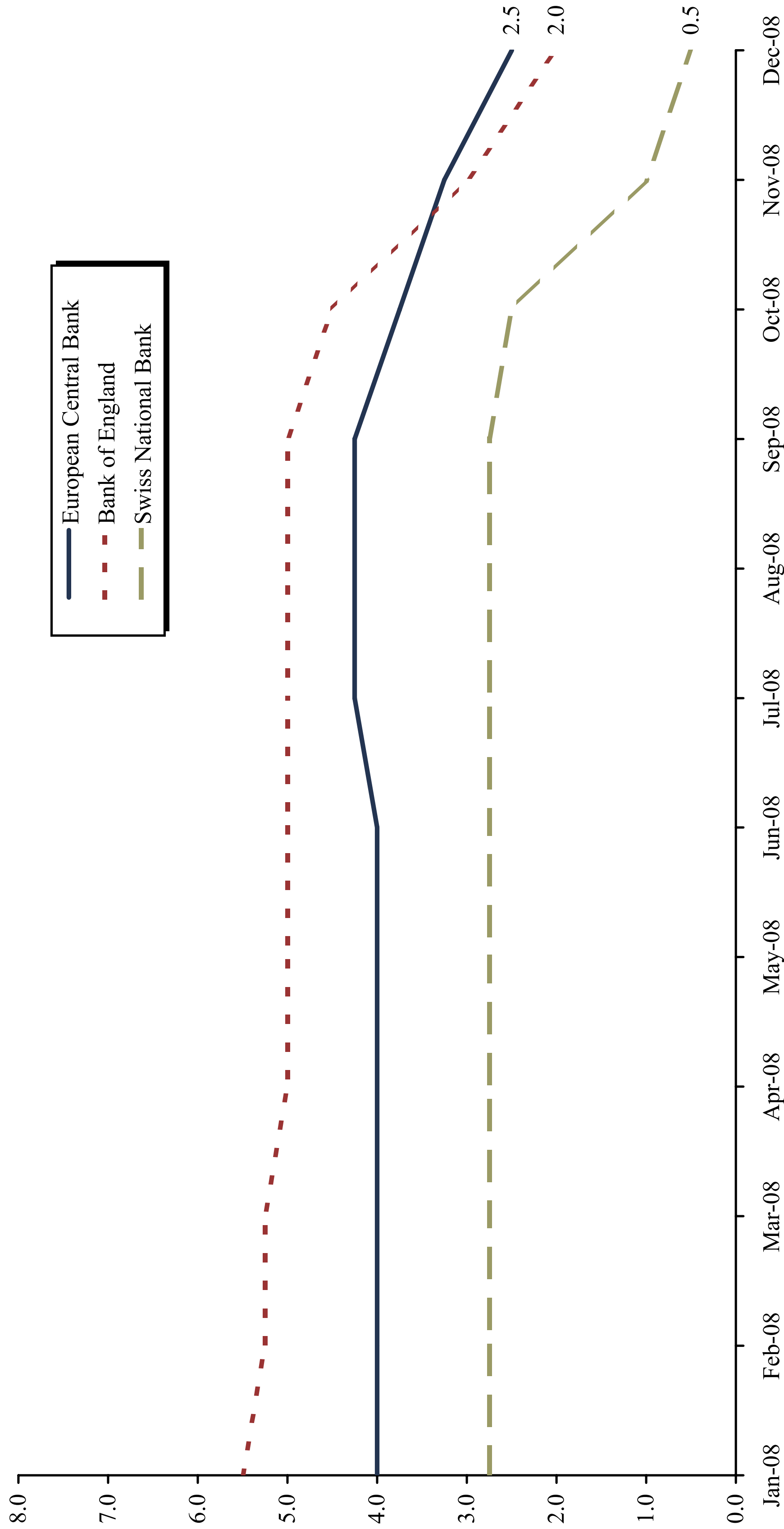
[10] Such firms made up 16.3% of the 523 dividend-paying firms included in the FTSE All-Share Index and 11.0% of the 356 dividend-paying firms included in the MSCI Europe ex U.K. Index.

While our advice extends to European equities as a whole, we note again that U.K. shares look slightly cheap relative to continental equities. In addition, the U.K. market may bounce back more quickly given the large government infusions and the fact that policymakers are able to act almost by definition in a faster and more directed manner than their continental counterparts, who operate under both federal and national regimes. Nevertheless, it is by no means clear that the United Kingdom's policy response will prove superior to the country-specific measures adopted on the Continent and it may in fact lay the seeds for even more serious long-term problems. The German economy is perhaps in a better position despite its heavy reliance on exports, given high German savings ratios and more prudent fiscal management by the government. France is moving much more quickly to spend its way out of the present difficulties, but remains constrained to some degree by the stability and growth pact. Notwithstanding continental Europe's own structural impediments to higher growth, that pact, with its emphasis on long-term fiscal stability and keeping inflation under control, should offer investors some comfort in the long, if not the short, term.

Table A

INTERNATIONAL POLICY RATES

31 January 2008 – 31 December 2008



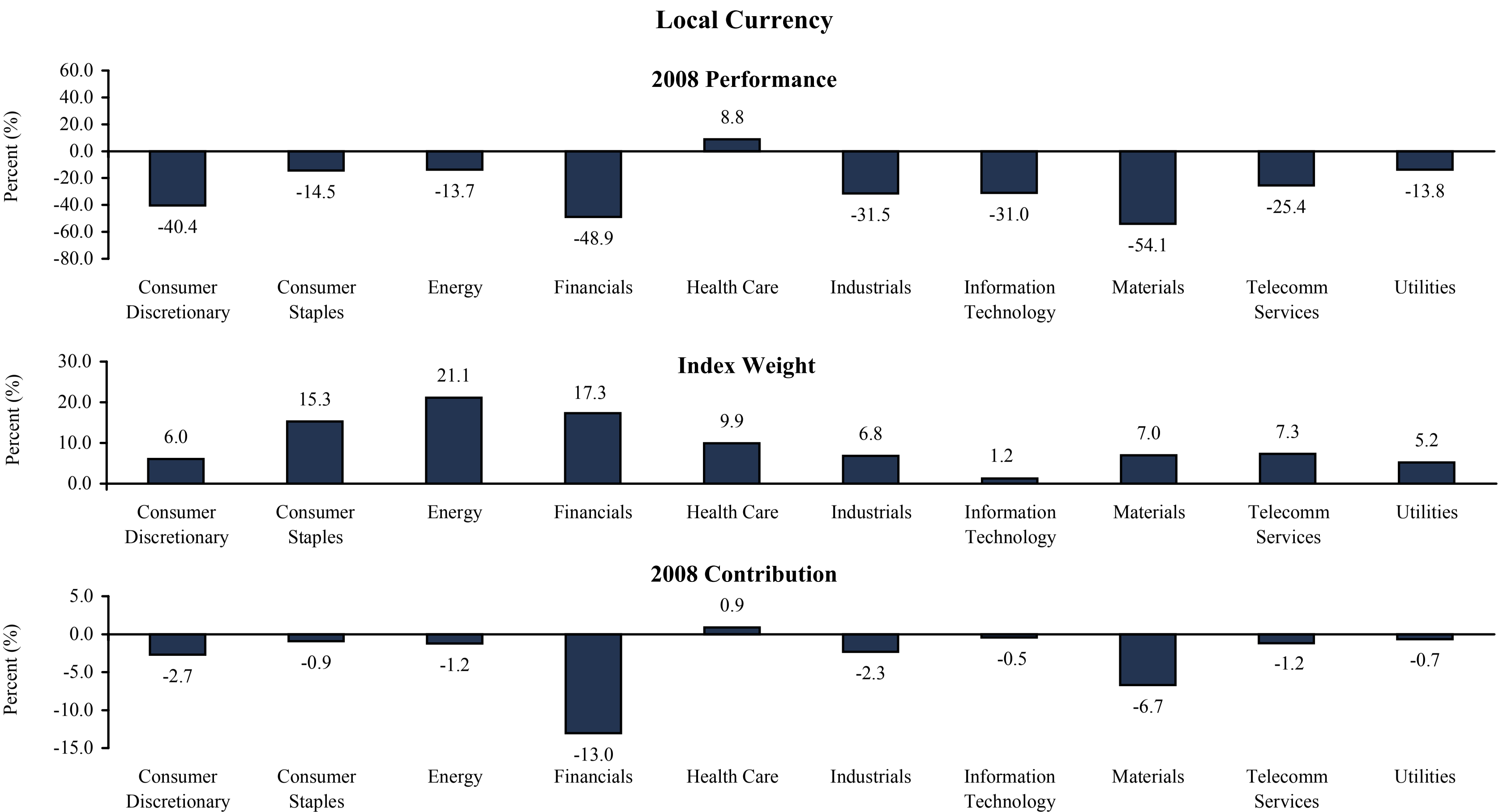
Source: Bloomberg L.P.

Table B

FTSE ALL-SHARE ECONOMIC SECTOR WEIGHTS AND CONTRIBUTION

As of 31 December 2008

Local Currency



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

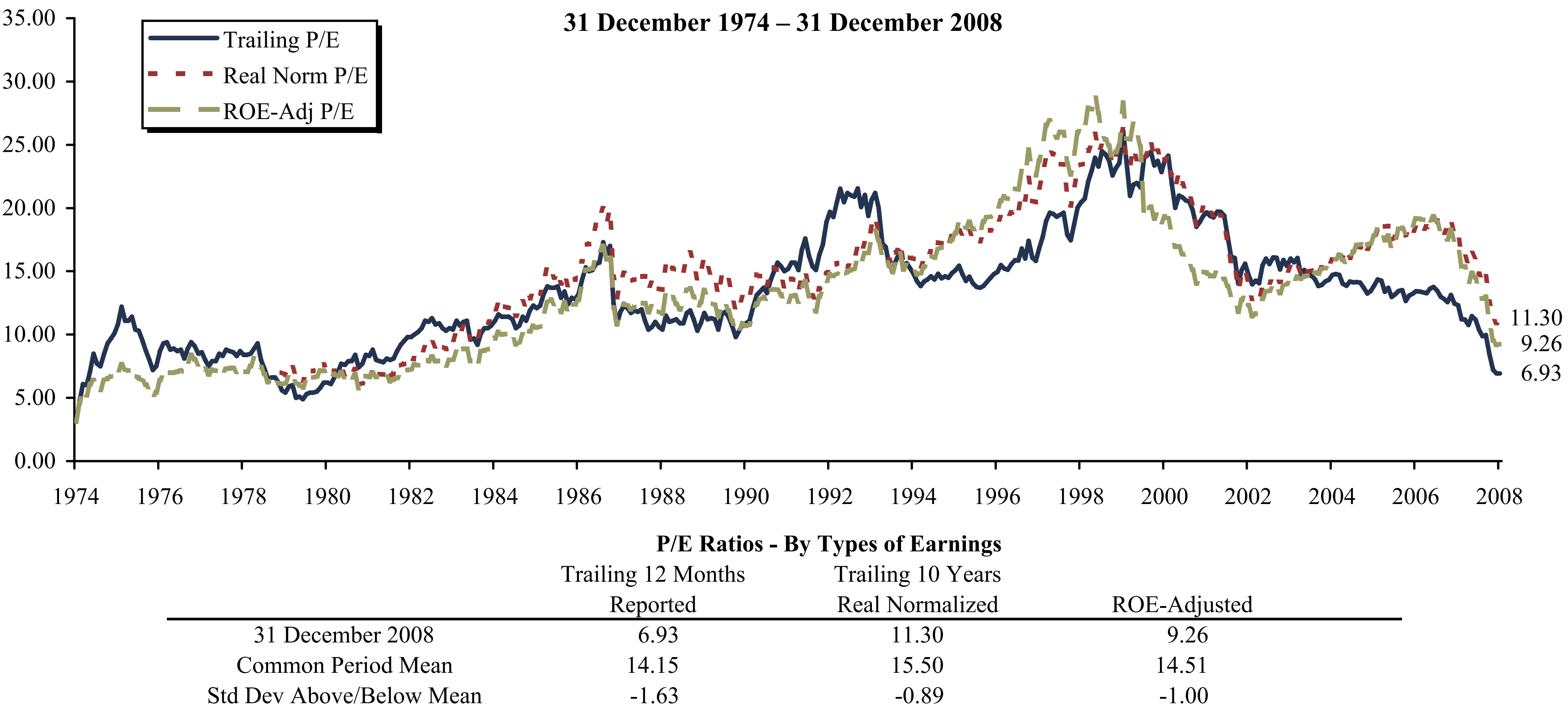
Notes: Weights may not total to 100% due to rounding. Approximately 2.7% of the index (accounting for 150 basis points of the index's return contribution) is not assigned to any sector and is therefore not shown in this exhibit.

Table C

PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

MSCI United Kingdom

31 December 1974 – 31 December 2008



P/E Ratios - By Types of Earnings

	Trailing 12 Months Reported	Trailing 10 Years Real Normalized	ROE-Adjusted
31 December 2008	6.93	11.30	9.26
Common Period Mean	14.15	15.50	14.51
Std Dev Above/Below Mean	-1.63	-0.89	-1.00

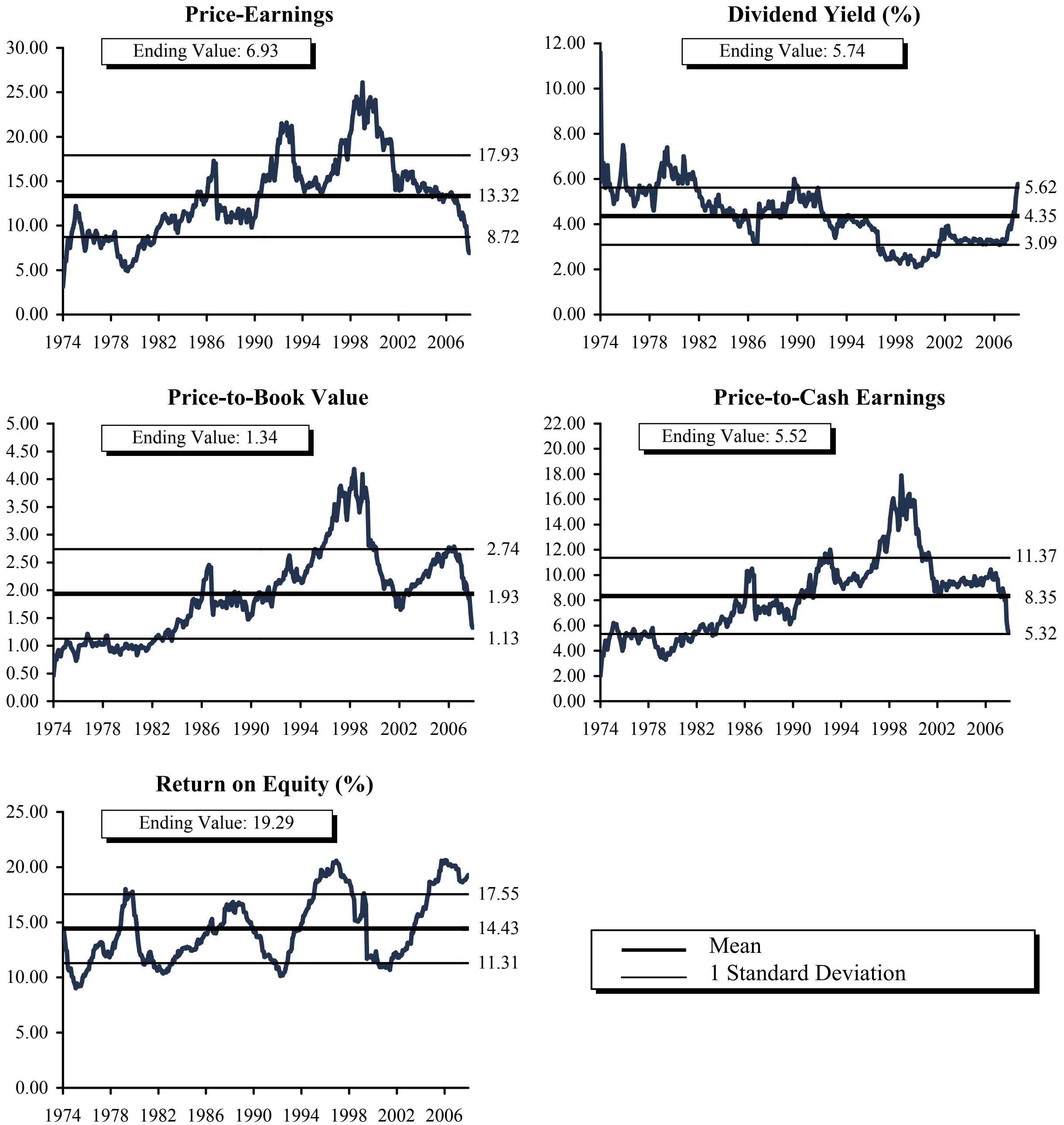
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price-earnings (P/E) ratios are calculated by dividing the current real index value by the annualized average real earnings for the trailing ten years. U.K. inflation data represent the Retail Price Index from 1974 through November 2003 and the U.K. CPI from December 2003 onward. Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its P/E ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to its post–1974 average. Common period represents data from November 1979 onward.
uk_158m

Table D

MSCI UNITED KINGDOM INDEX

31 December 1974 – 31 December 2008



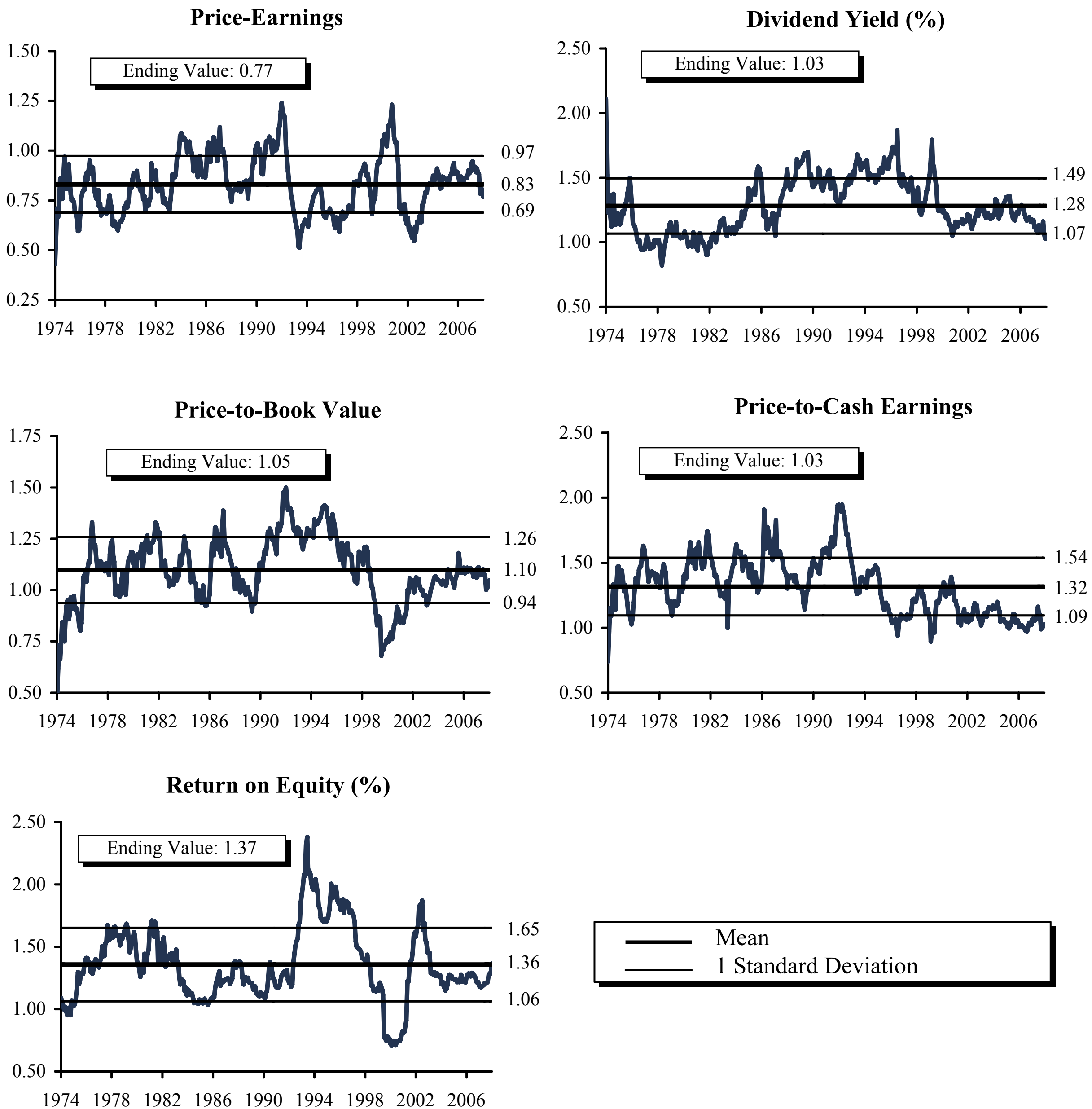
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.
027q

Table E

MSCI U.K. RELATIVE TO MSCI EUROPE EX U.K.

31 December 1974 – 31 December 2008



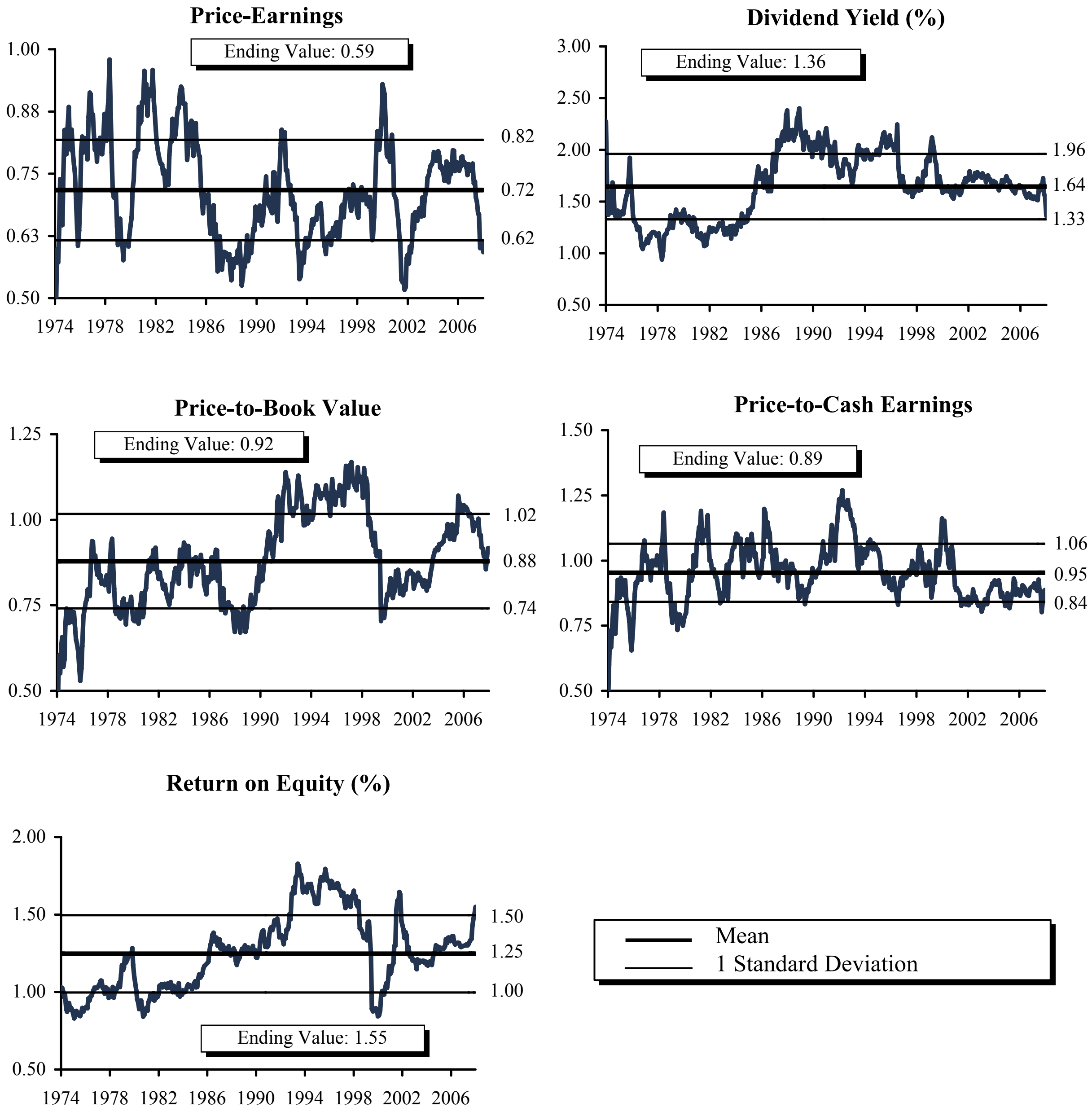
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.

Table F

MSCI U.K. RELATIVE TO MSCI WORLD EX U.K.

31 December 1974 – 31 December 2008

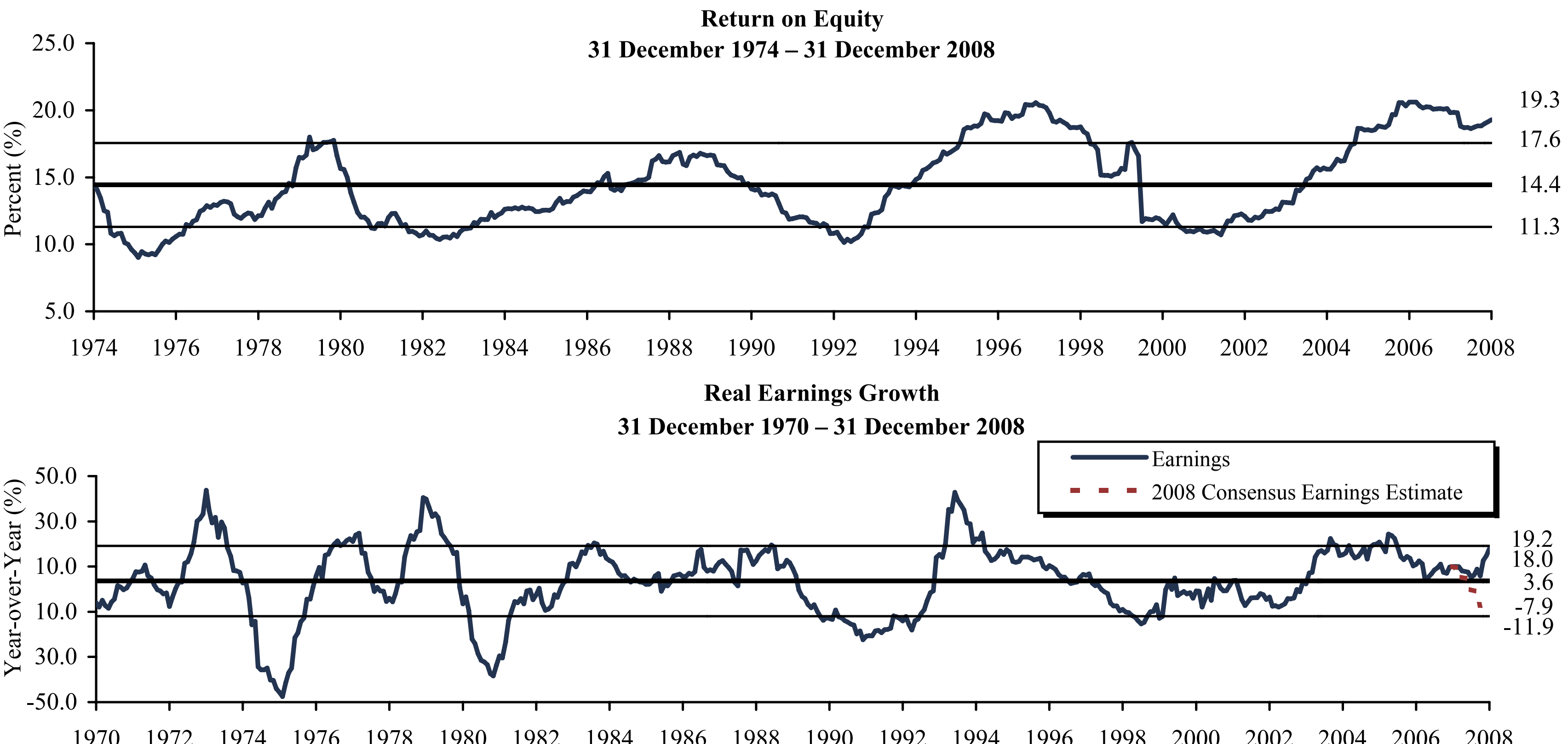


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.

Table G

MSCI U.K. RETURN ON EQUITY AND REAL EARNINGS GROWTH



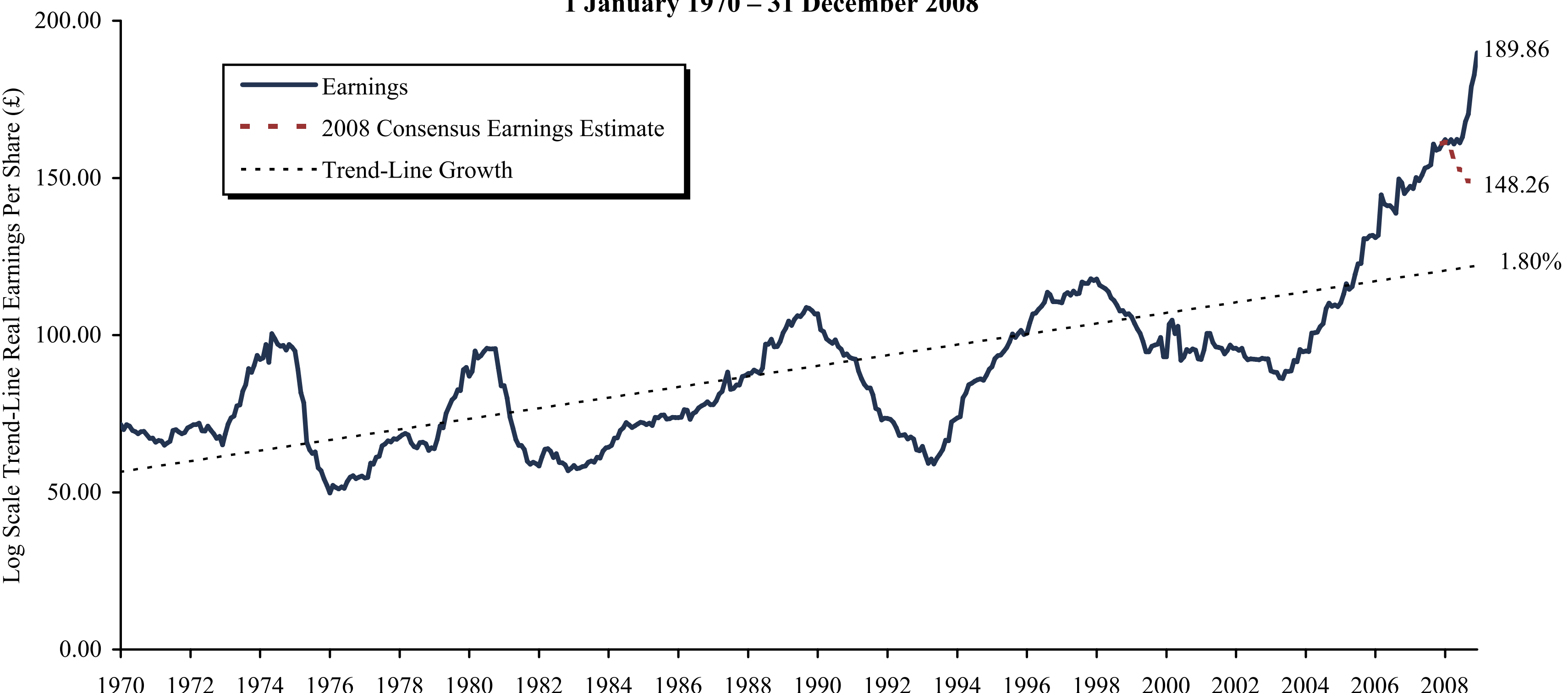
Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: U.K. inflation data represent the Retail Price Index from 1974 through November 2003 and the U.K. CPI from December 2003 onward. Real earnings are based on trailing 12-month earnings as reported by MSCI. Data for 2008 reflect the most recently available information, but it should be noted that many U.K. companies do not report on a quarterly basis. Accordingly, we have added a line showing the consensus estimate (as of January 12, 2009) for 2008 earnings. MSCI earnings include net income from continuing operations available to all equity shareholders, excluding extraordinary items, non-recurring items, minority interest, and preferred dividends (in cases where preferred shares do not exhibit equity-like characteristics). In contrast, J.P. Morgan consensus earnings estimates are on a post-goodwill basis.

Table H

MSCI U.K. REAL REPORTED EARNINGS

1 January 1970 – 31 December 2008



Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

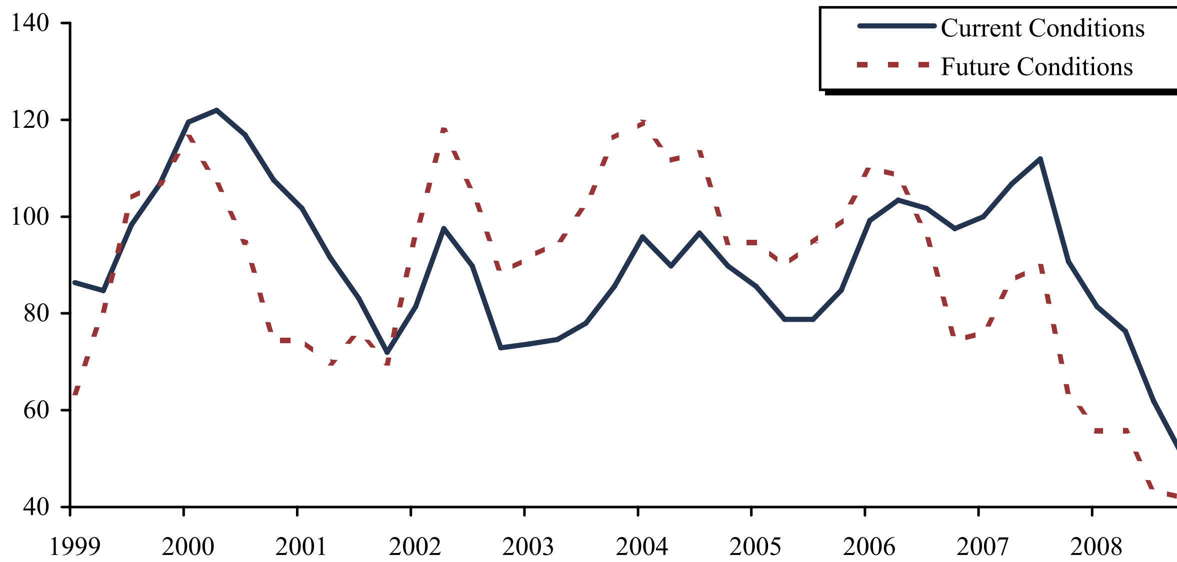
Notes: The average year-over-year real earnings growth rate of 3.6% is calculated arithmetically. U.K. inflation data represent the Retail Price Index from 1974 through November 2003 and the U.K. CPI from December 2003 onward. Real earnings are based on trailing 12-month earnings as reported by MSCI. Data for 2008 reflect the most recently available information, but it should be noted that many U.K. companies do not report on a quarterly basis. Accordingly, we have added a line showing the consensus estimate (as of January 12, 2009) for 2008 earnings. MSCI earnings include net income from continuing operations available to all equity shareholders, excluding extraordinary items, non-recurring items, minority interest, and preferred dividends (in cases where preferred shares do not exhibit equity-like characteristics). In contrast, J.P. Morgan consensus earnings estimates are on a post-goodwill basis.

Table I

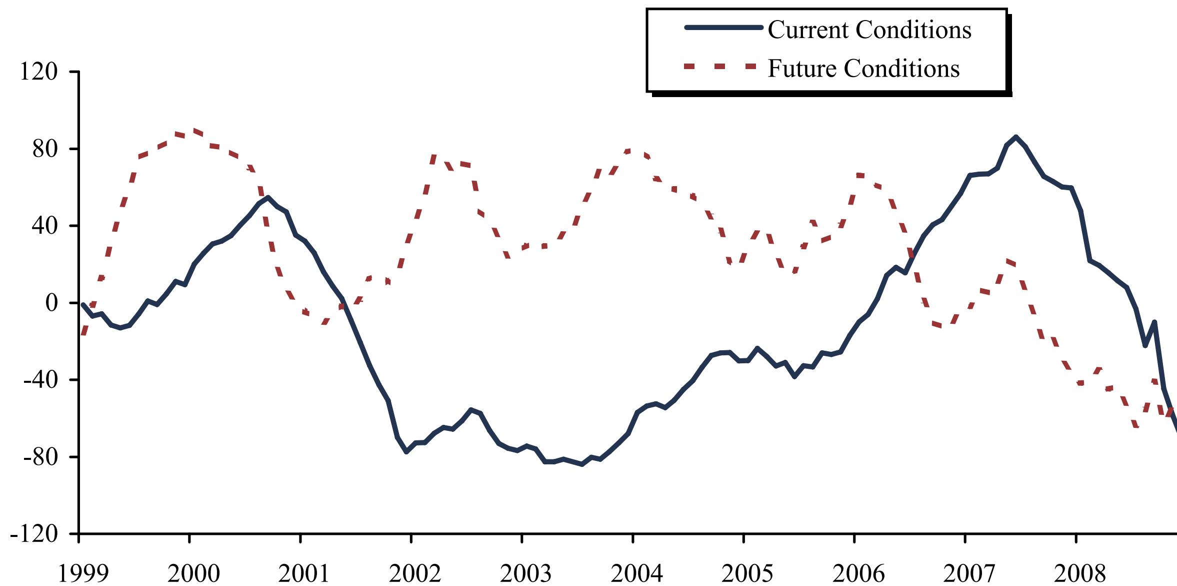
EUROPEAN SENTIMENT INDICATORS

1999–2008

IFO Eurozone Survey



ZEW Survey – Euroland Aggregate



Sources: IFO World Economic Survey, Thomson Datastream, and ZEW.

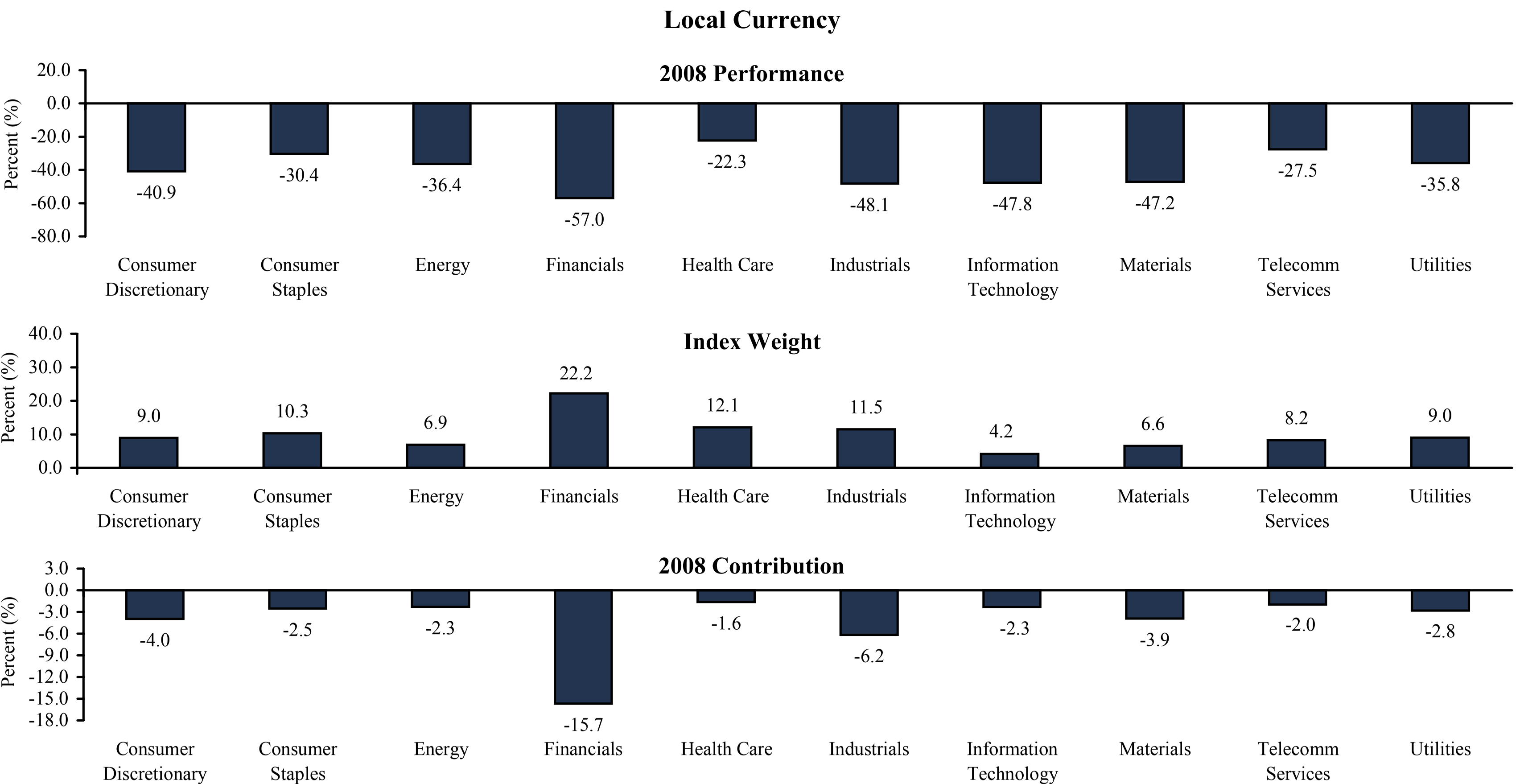
Note: IFO data are as of November 2008 and ZEW data are as of December 2008.

Table J

MSCI EUROPE EX U.K. ECONOMIC SECTOR WEIGHTS AND CONTRIBUTION

As of 31 December 2008

Local Currency



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

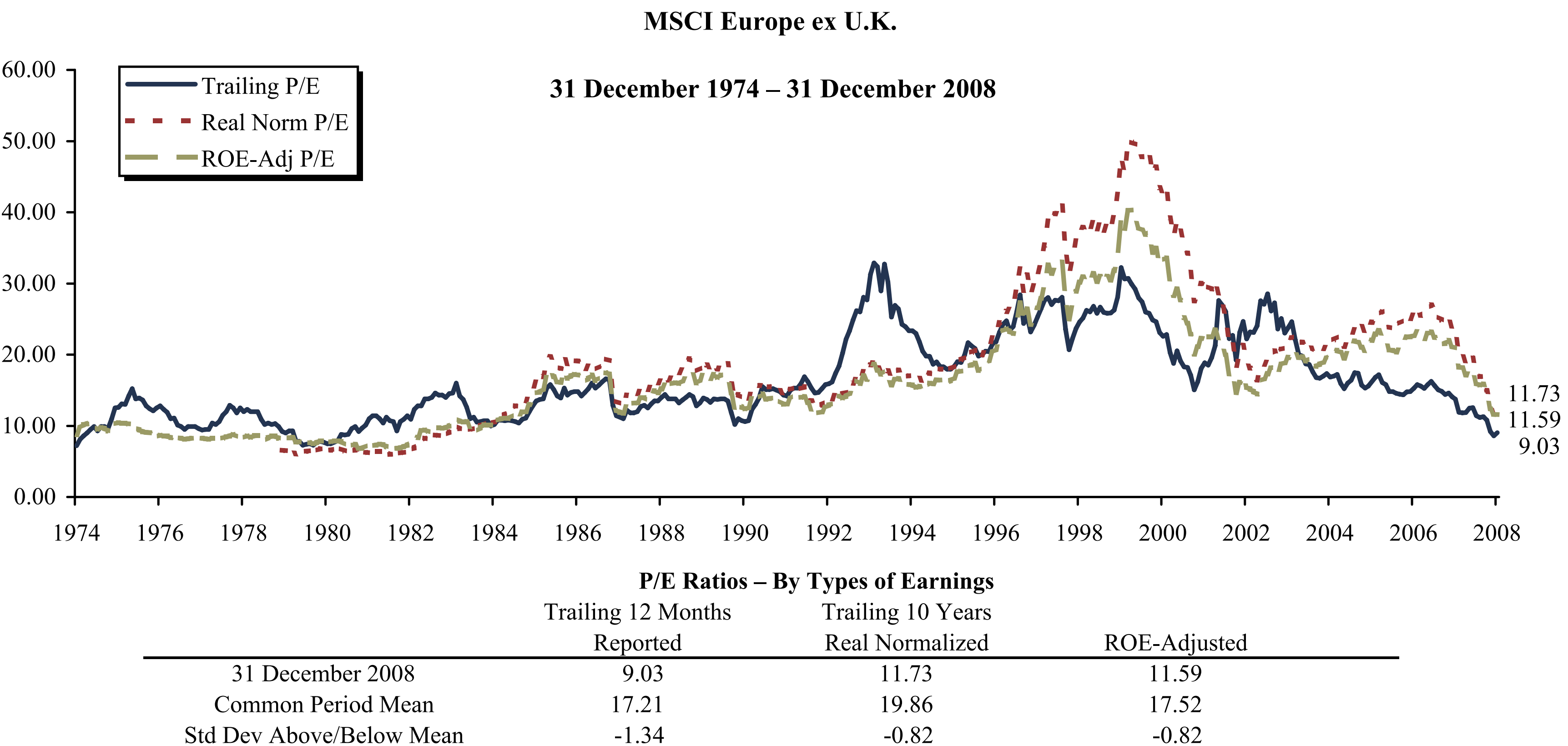
Note: Weights may not total to 100% due to rounding.

Table K

PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

MSCI Europe ex U.K.

31 December 1974 – 31 December 2008



P/E Ratios – By Types of Earnings

	Trailing 12 Months Reported	Trailing 10 Years Real Normalized	ROE-Adjusted
31 December 2008	9.03	11.73	11.59
Common Period Mean	17.21	19.86	17.52
Std Dev Above/Below Mean	-1.34	-0.82	-0.82

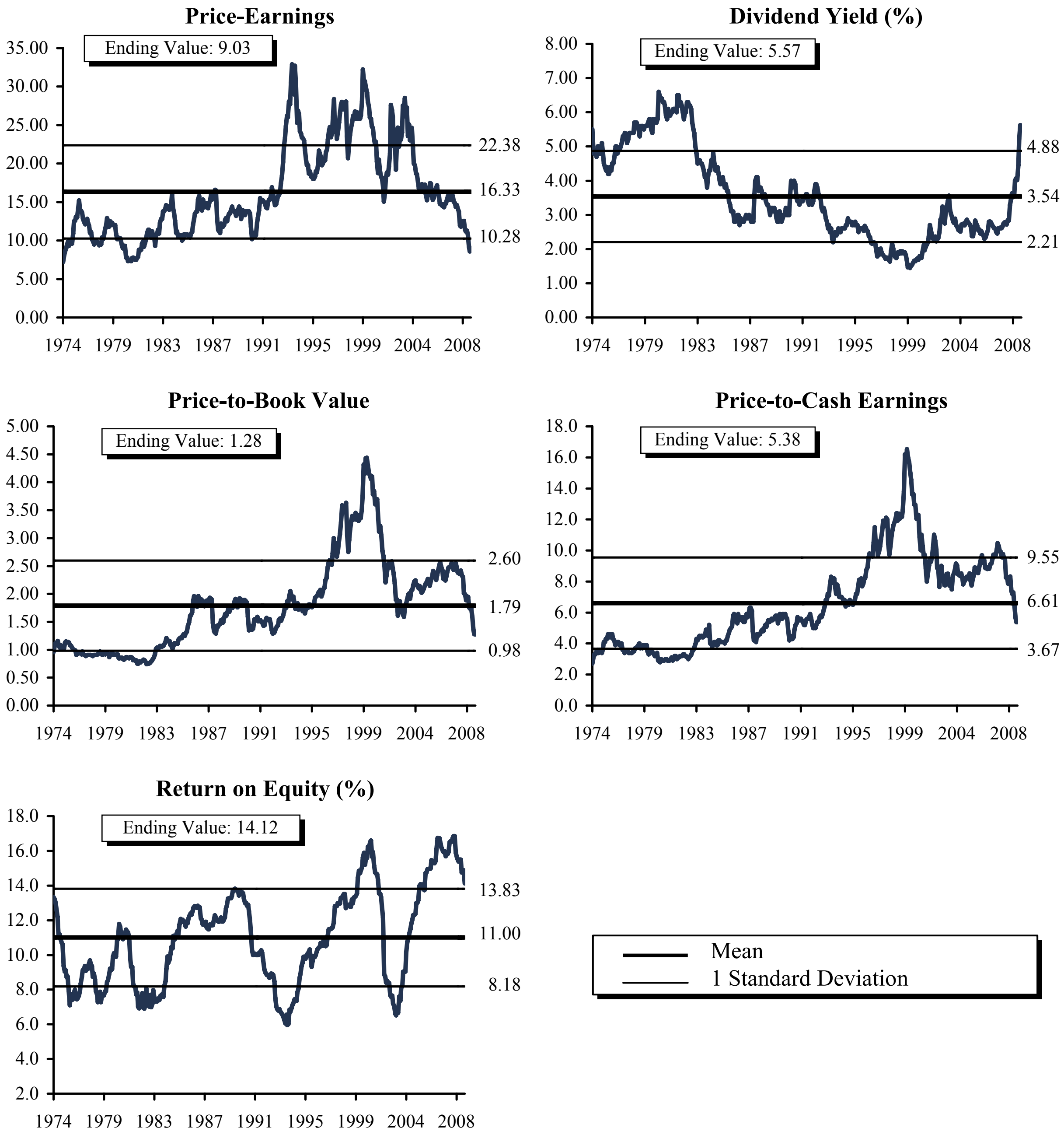
Sources: Global Financial Data, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price-earnings (P/E) ratios are calculated by dividing the current real index value by the annualized average real earnings for the trailing ten years. Inflation data are through 30 November 2008. Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its P/E ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to its post–1974 average. Common period represents data from 30 November 1979 onward.
uk_159m

Table L

MSCI EUROPE EX U.K. INDEX

31 December 1974 – 31 December 2008



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

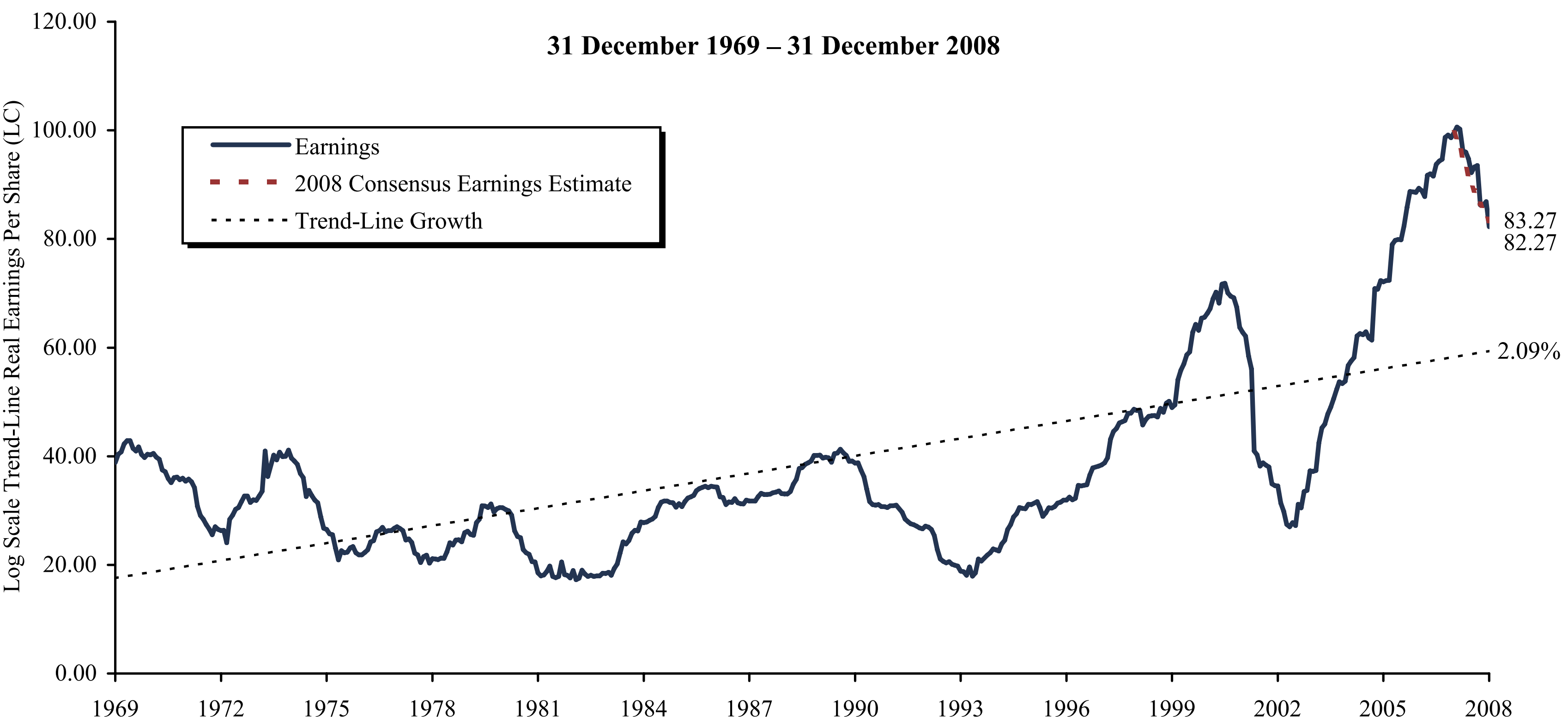
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.

398q

Table M

MSCI EUROPE EX U.K. REAL REPORTED EARNINGS

31 December 1969 – 31 December 2008

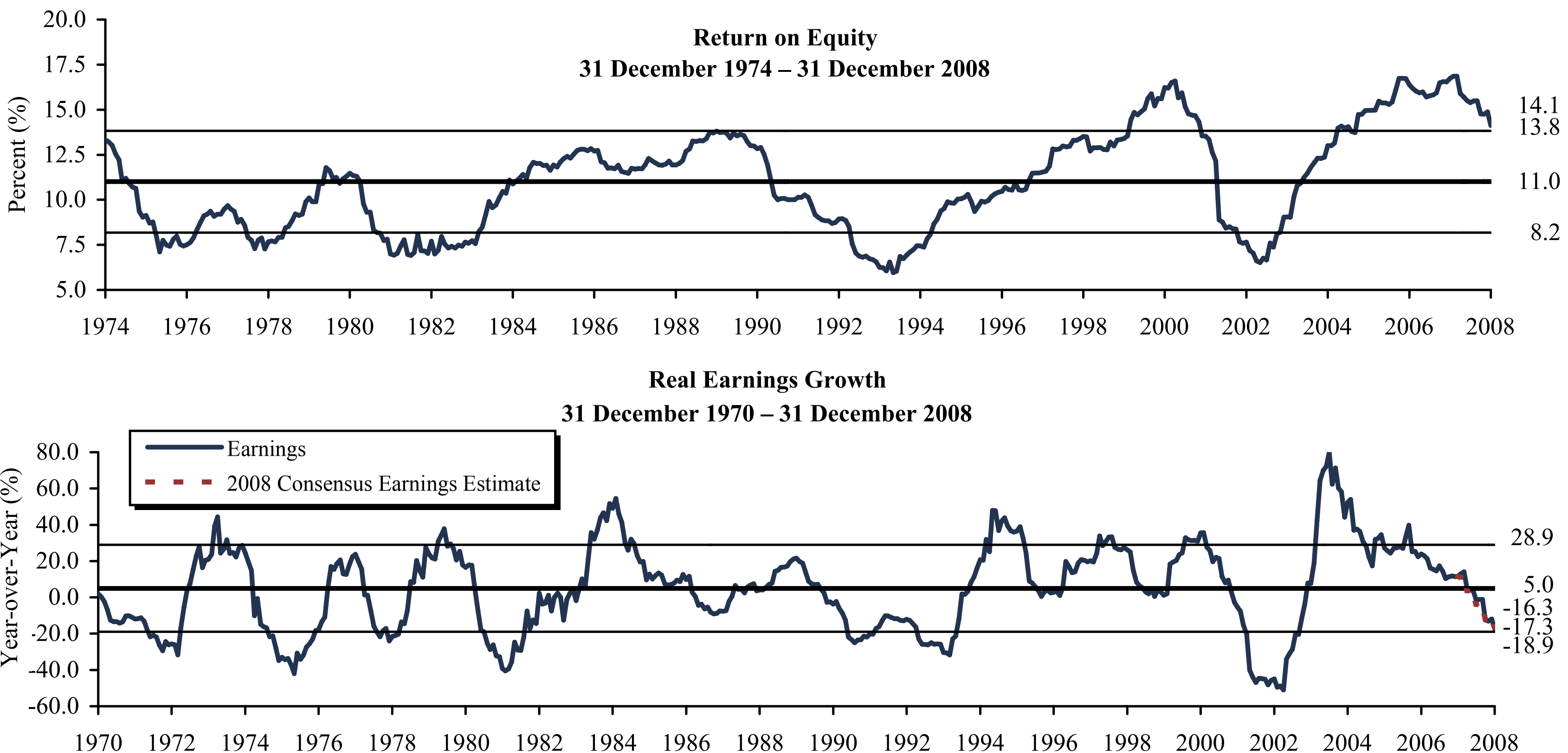


Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Data are in local currency. Reported earnings include goodwill amortization. Real earnings are inflation adjusted by the CPI Eurozone. The average year-over-year real earnings growth rate of 5.0% is calculated arithmetically. Real earnings are based on trailing 12-month earnings as reported by MSCI. Data for 2008 reflect the most recently available information, but it should be noted that many European companies do not report on a quarterly basis. Accordingly, we have added a line showing the J.P. Morgan Eurozone consensus estimate (as of January 12, 2009) for 2008 earnings. MSCI earnings include net income from continuing operations available to all equity shareholders, excluding extraordinary items, non-recurring items, minority interest, and preferred dividends (in cases where preferred shares do not exhibit equity-like characteristics). In contrast, J.P. Morgan consensus earnings estimates are on a post-goodwill basis.

Table N

MSCI EUROPE EX U.K. RETURN ON EQUITY AND REAL EARNINGS GROWTH



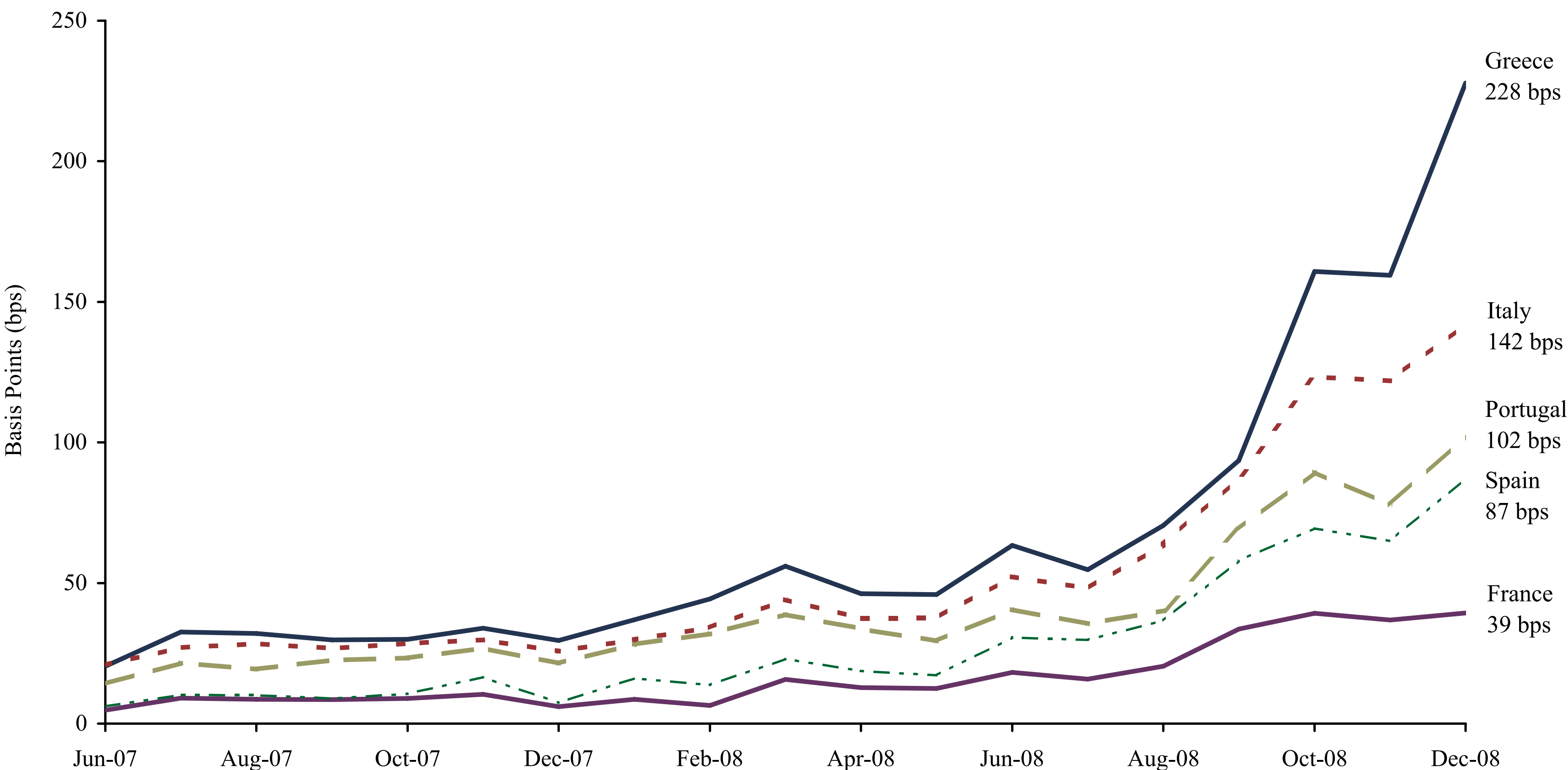
Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Real earnings are inflation adjusted by the CPI Eurozone. Real earnings are based on trailing 12-month earnings as reported by MSCI. Data for 2008 reflect the most recently available information, but it should be noted that many European companies do not report on a quarterly basis. Accordingly, we have added a line showing the J.P. Morgan Eurozone consensus estimate (as of January 12, 2009) for 2008 earnings. MSCI earnings include net income from continuing operations available to all equity shareholders, excluding extraordinary items, non-recurring items, minority interest, and preferred dividends (in cases where preferred shares do not exhibit equity-like characteristics). In contrast, J.P. Morgan consensus earnings estimates are on a post-goodwill basis.

Table O

EUROPEAN GOVERNMENT BOND YIELD SPREADS OVER BUNDS

30 June 2007 – 31 December 2008



Source: Thomson Datastream.