The International Perspective and the Outlook for Foreign Capital Markets

ENDOWMENT MANAGERS and fiduciaries looking for high returns outside the U.S. will find limited opportunities in foreign capital markets. Although foreign capital markets offer valuable diversification opportunities, superior long-term returns will be hard to come by and only with the assumption of greater risk. The industrial economies of Japan and Europe are growing more slowly than the U.S., and they face bigger long-term challenges. Emerging economies are growing robustly, but what Ben Bernanke termed the worldwide "glut of savings" has reduced risk premiums to the point where returns may not compensate for the greater risk of investing in emerging markets. Endowment portfolios should include a significant international component. Just don't expect exceptional risk-adjusted returns in the long term.

Figure IO.1 shows a comparison of price changes from December 2000 through 30 September 2006 on several major stock market indices. On a local currency basis, investors in Brazil and Japan made out best, with positive price appreciation. Investors in the U.S. just broke even, and investors in the UK, Europe, and China lost value. Market value losses would have been ameliorated to some extent by dividends, which are not accounted for in Figure IO.1.

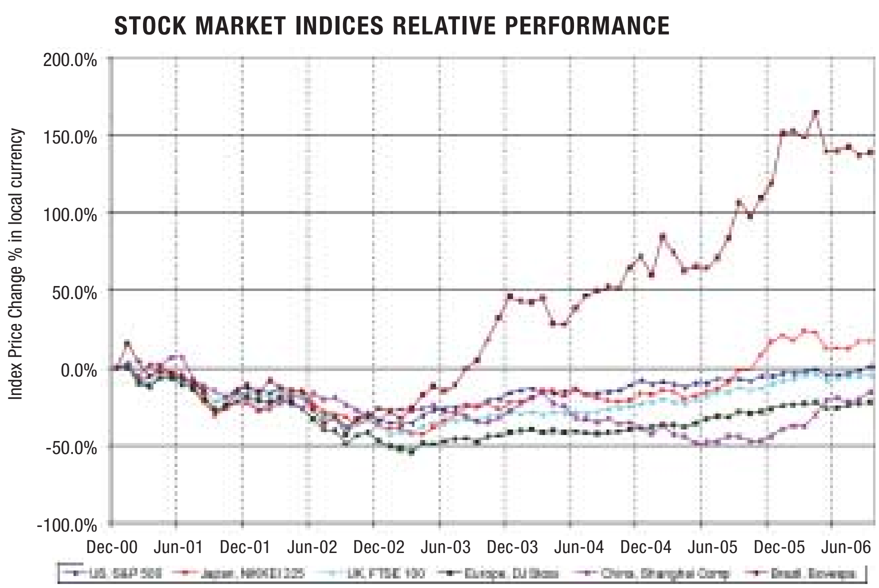

Figure IO.1: Stock Market Indices Relative Performance from December 31, 2000
Source: Bloomberg and *Advisor* calculations

Real economic growth in Europe and Japan is forecast at 1.9% and 2.1% for 2007 compared to 3.3% for the U.S., according to the International Monetary Fund April 2006 *World Economic Outlook*. Confidence in the U.S. economy has underpinned the global appetite for U.S. investments and led to an appreciation in the dollar throughout 2005, despite record current account deficits. The dollar has given back some of this appreciation so far this year against the euro and the pound, but remains above its starting values for 2005 against both currencies. Against the yen, the dollar has continued to appreciate this year, increasing in value 1.1% on a spot rate basis from the start of the year through the end of September.

Fundamental valuations throughout most of the industrial economies outside the U.S. offer as much long-term down-side risk as up-side potential. Although Japan is emerging from a decade of virtually no growth and corporate earnings are improving rapidly, overall economic growth in both Japan and the European Union will be slow. Both areas face significant long-term challenges due to aging populations and the need for further structural and fiscal reforms, which are likely to be made more difficult by their demographics. Near-term growth appears stronger in the UK and Scandinavia, but both areas face the same long-term demographic challenges as the European Union.

Emerging economies are growing more rapidly and may offer more opportunities, but even here the picture is mixed. China, despite its astronomical growth, is a better products market for now than an investment market. Other markets in East Asia, central Europe, and Latin America offer selective opportunities for those willing to assume a larger degree of risk.

Forecasting capital market returns is never an easy task, but forecasting foreign capital markets returns is even more hazardous. With the notable exception of the UK, reliable information regarding long-term historical returns for international markets does not exist. Although the S&P 500 index and the Dow Jones industrial average both have histories that stretch back several generations, most European indices are less than twenty-five years old. The oldest of the major overseas market indices, the NIKKEI 225, dates only from 1949. As a consequence, valuation benchmarks are less reliable since they are based on shorter histories. National financial data about foreign economies is also generally less robust and timely than that about the U.S. economy.

The largest source of uncertainty, however, is the presence of significant global imbalances among nations and the persistence of anomalous capital flows, interest rate levels, and to a lesser extent, exchange rates. The imbalances are the result of some of the largest trade and current account deficits and surpluses among nations in history, and shifts in historical patterns of savings and investment. Emerging economies, traditional users of capital provided by mature industrial economies, have become suppliers of capital to industrial economies. These capital flows have helped finance large fiscal deficits in industrial countries, particularly in the U.S., while keeping long-term interest rates low and offsetting declining savings rates throughout the U.S., Japan, and Europe (while, perhaps, contributing to the decline in savings in the U.S. and Europe through the rapid increase in house prices associated with low interest rates). A substantial buildup of foreign currency reserves in China, Japan, and South Korea has supported a dollar value inconsistent with the level of U.S. interest rates and current account imbalances.

The current state of global imbalances cannot continue for long: large current account deficits and surpluses; large fiscal deficits in the U.S., Japan, and Europe; near record-low interest rates; record-low savings rates in industrial countries; low investment rates in emerging economies; and capital flowing from emerging economies to industrial economies. An adjustment process is inevitable.

What the adjustments will be, how they will occur, and the ramifications they will have on the global economy and world financial markets remain to be seen. To the extent that policy makers are slow to respond, markets are likely to force adjustments that may be more abrupt and destabilizing. Fortunately, it is in the mutual interest of policy makers worldwide to engineer adjustments that are not abrupt and destabilizing. There is a considerable risk, however, that domestic political pressures may make it difficult for some nations to implement policies that will address global imbalances in the most prudent or timely manner. Consider the cases of internal structural reforms in emerging markets, greater exchange rate flexibility in China, or reduced fiscal deficits in the U.S., Europe, and Japan.

What can we expect? In the long-term, we can expect a dollar that is lower in value than it is today and long-term interest rates that are higher than they are today – on both a real and nominal basis. We can expect an increase in investment in emerging economies and a decrease in the capital flowing from emerging economies, although perhaps not to such an extent as to completely reverse their role as suppliers of capital to the industrial world. We cannot expect a significant increase in savings in Europe or Japan, however; their aging populations will not support it.

With all of this by way of background, then, our capital market expectations for foreign markets are as follows. See the country-specific sections that follow for a commentary by area/country.

Very strong economic growth and improved monetary and fiscal health translate into high potential returns from emerging-market stocks.

Japan is better positioned than the U.S. and the UK to deal with adjustments to global imbalances.

JAPAN

As noted above, the Japanese economy is growing again and appears to have good prospects for continued positive, albeit modest, growth (+2.1% real GDP growth for 2007). With projections for a moderately strong balance of payments position (+2.9% of GDP for 2007) partially offsetting a large fiscal deficit position (-5.4% of GDP), Japan is better positioned than the U.S. and the UK to deal with adjustments to global imbalances. Unlike the U.S., however, Japan faces the challenges of a shrinking population and low productivity.

In the context of modest economic growth, projected capital market returns from Japan depend on corporate earnings growth, changes in earnings valuation, and – for U.S. investors – changes in the relative value of the yen and dollar. Analysts project strong (12.6%) earnings growth for Japan over the next five years – stronger than for the U.S., UK, euro area, and Nordic area. Only Canada is projected to experience greater earnings growth.

The Japanese stock market is typically valued at a higher earnings multiple than the U.S. market. The median month-end price/earnings multiple of estimated forward earnings for the NIKKEI 225 has been 57.5 since 1993, although the multiple has been trending lower. Since January 2003, the median multiple has been 34.6. The same holds true for the broader TOPIX index of all free-floating section one shares on the Tokyo exchange. Valuations have been relatively immune to changes in interest rates since 1993. Although interest rates are likely to increase, with a 10-year bond yield of less than 2.0%, equity valuations appear to have as much up-side potential as down-side risk. See Figure IO.2.

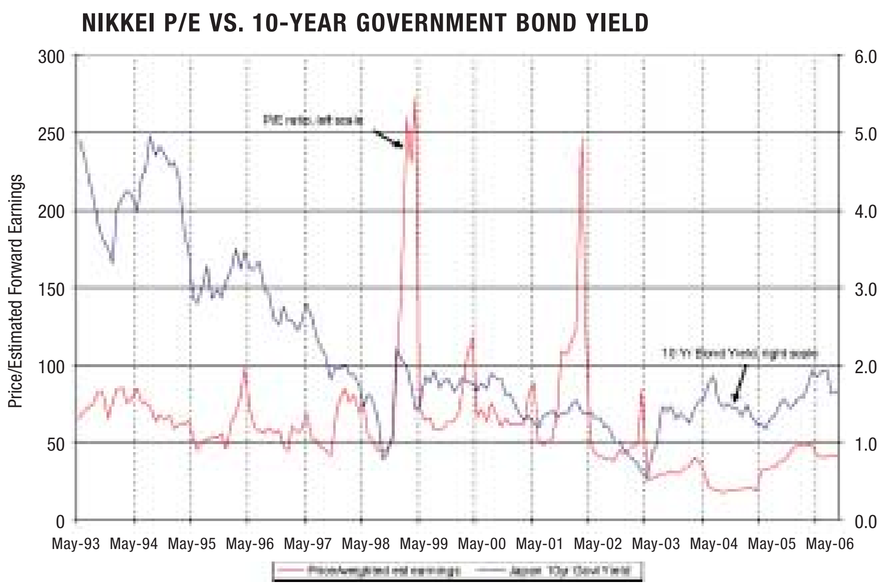

Figure IO.2: NIKKEI P/E ratio versus 10-Year Government Bond Yield

Source: Bloomberg

Overall, we expect the NIKKEI 225 index to be between 18,700 and 19,300 by 30 June 2009. At this level, total yen returns will be between 8.2% and 9.4% on a compound annual basis, including a 1.0% dividend yield.

Forward rates in the foreign exchange market project that the dollar will decline in value relative to the yen through 2009, giving U.S. investors in the Japanese market the potential for additional return. Relative to a spot market of 116 yen to the dollar, forward rate projections of 100 yen to the dollar by year end 2009 translate into a 4.3% annual return through appreciation of the yen alone.

In total, U.S. investors can expect a total return from the Japanese stock market of between 12.5% and 13.7% per year, with approximately one-third of this return coming from the projected depreciation of the dollar versus the yen.

EURO AREA

Prospects for the euro area (the twelve members of the European Union that use the euro as their common currency) are for very slow economic growth, moderate fiscal deficits, and an overall balance in the area's current account. Projected real economic growth for 2007 of 1.9% (according to the International Monetary Fund) is the lowest among the world's industrial economies. Projected fiscal deficits of 2.1% of GDP, however, are also the lowest. Thanks to substantial projected current account surpluses for Germany, Belgium, the Netherlands, Finland, and Luxembourg, the euro area is projected to have no surplus or deficit in its aggregate balance of payments.

Unfortunately, unlike Japan, where corporate earnings are expected to make a substantial recovery despite overall slow economic growth, euro area corporate earnings are projected to grow more slowly over the next five years than in the U.S. or Japan. The table in figure IO.3 shows the growth estimates derived from mid-September earnings estimates of nearly 5,000 analysts' reports on the companies that make up the major stock indices in the euro area.

EURO AREA EARNINGS GROWTH ESTIMATES

Country	Index	# of companies	Current year to trailing 12 months	Next year to current year	Long-term
France	CAC-40	40	3.5%	7.3%	9.7%
Germany	DAX	30	-1.9%	11.5%	7.2%
Italy	S&P/MIB	40	0.3%	10.5%	7.7%
Spain	IBEX 35	35	-7.6%	9.6%	12.4%
the Netherlands	Amsterdam Exchanges	24	-6.6%	4.6%	5.2%
Finland	OMX Helsinki	117	14.8%	11.6%	6.1%
Belgium	BEL 20	20	-16.1%	7.4%	8.0%
Average			**-1.1%**	**8.8%**	**8.4%**

Figure IO.3: Euro Area Earnings Growth Estimates
Source: Bloomberg

The long-term (five-year) annual growth estimate of 8.4% is substantially above the projected nominal annual growth rate of 4.7% for the euro area economy. Here again we see analysts forecasting more rapid growth for corporate earnings than for the overall economy – a condition which cannot be long sustained and which must lead to some healthy skepticism about the long-term projections.

Figure IO.4 charts the P/E multiples to forward estimated earnings on the major euro area stock indices from April 2005 to September 2006. With the exceptions of Helsinki and Amsterdam, most markets are valuing projected forward earnings at approximately thirteen times. As the chart indicates, valuations of projected earnings appear to have converged over the past eighteen months.

EURO AREA STOCK MARKET P/E RATIOS TO ESTIMATED EARNINGS

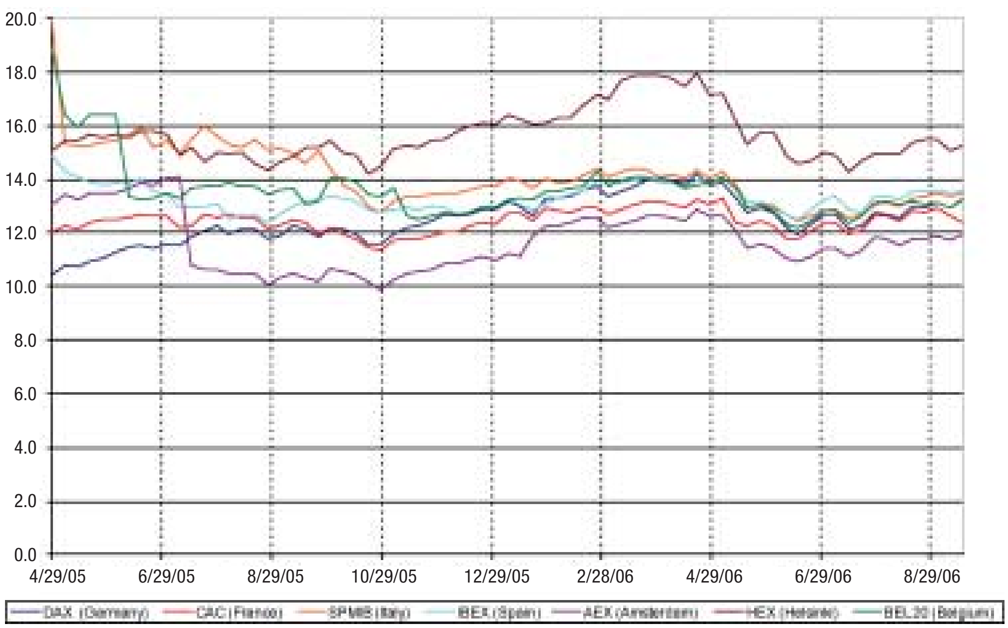

Figure IO.4: Euro Area Stock Indices, Price to Estimated Earnings
Source: Bloomberg and *Advisor* calculations

Earning valuations are in line with historical averages and offer as much down-side risk as up-side potential. In aggregate, euro area stocks were trading in mid-September at the long-term median P/E to forward earnings of 13.2, excluding Germany. The median long-term P/E ratio for Germany (23.9) is significantly higher than the medians for the other markets, but given the recent convergence of European market valuations, we discount the impact of the median for German stocks and conclude that earnings valuations for euro area stocks are mid-range. Given the slow growth forecast for the euro area economy and corporate earnings, and the structural challenges facing many euro area companies, we see no motivation for the markets to increase their valuation of earnings without a change in any of these factors.

We expect euro area stocks to return 11.25% annually over the next three to five years on a euro basis. This projection is derived using an 8% annual growth factor for earnings, no change in P/E multiples, and an average dividend return of 3.0%. Although we have reservations about projecting a higher return on euro area stocks than U.S. stocks, the earnings recovery over the past five years has been much stronger in the U.S. than in the euro area – approximately 100% for the S&P 500 compared to 60% for the euro area.

Forward rates in the foreign exchange market project that the dollar will suffer a modest decline in value relative to the euro through 2010, giving U.S. investors the potential for additional return. Relative to a spot market of $1.28 per euro, forward rate projections of $1.33 to the euro by year end 2009 translate into a 1.25% annual return through appreciation of the euro. In total, U.S. investors can expect a total return from euro area stocks of approximately 12.5%.

UK companies are enjoying the highest rate of profitability in the past forty years.

UNITED KINGDOM (UK)

Although the UK economy is less than one-fourth the size of the euro area economy or the U.S. economy, its capital markets play a disproportionately large global role. London is the world's third largest stock market, and the FTSE 100 has a market capitalization of 55% of the combined market capitalizations of the major euro area indices.

In more than a geographic sense, the United Kingdom is situated between Europe and the U.S. Real economic growth for the UK (5.27% for 2006 and 2007 combined) is projected to be higher than Europe or Japan, but lower than the U.S. United Kingdom fiscal deficits are projected to be lower than the U.S. (and Japan) but higher than Europe. The balance of payments for the UK is projected to be negative (-2.8% of GDP for 2007) compared to Europe's balanced position, but not as negative as the U.S. (all projections are from the International Monetary Fund *World Economic Outlook*, April 2006).

In demographics, the same picture applies. The UK population is growing more slowly than the U.S., but not as slowly as Europe. Its population is aging more rapidly than the U.S., but not as rapidly as Europe. It faces the same challenge as most of the world's industrial nations of providing social security for an increasing retired sector, but its sector will be smaller (as a percent of total) than Europe's, Japan's, (or China's), but not as small as the for U.S. (projections from the United Nations, *Human Development Report 2005*).

With a stronger economic outlook and a culture more receptive to the demands of global commerce than continental Europe, UK companies are projected to enjoy stronger long-term earnings growth than their continental peers (9.3% versus 8.4%), based on a mid-September comparison of approximately 1,600 analyst projections for FTSE 100 stocks with approximately 4,900 analyst projections for the stocks in the major euro area indices. UK companies are also enjoying the highest rate of profitability in the past forty years. Figure IO.5 shows profitability for non-financial UK companies. Although the increase in profitability has been boosted somewhat by oil and gas profits, even without these profits, UK profitability is at a modern all-time high.

The market's valuation of earnings is modest by recent historical standards at approximately 12.2 times estimated forward earnings as of late September. Since 1993, the FTSE 100 has traded at a median month-end multiple of 19.5 times forward earnings. Eliminating the top 20% of all values (equivalent to all P/E multiples over 35) reduces the median to 18.1 times forward earnings, still considerably higher than the late summer 2006 valuation range.

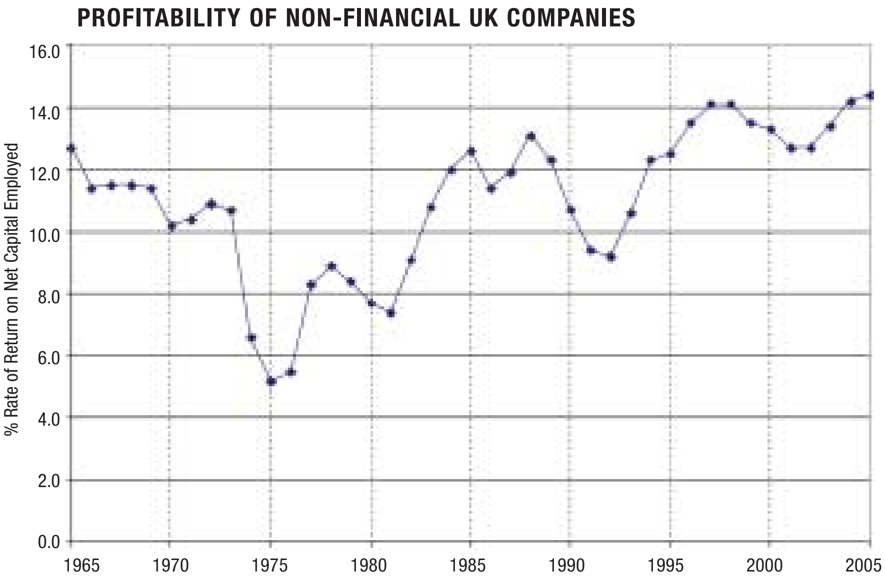

Figure IO.5: Profitability of Non-financial UK Companies

Source: Office of National Statistics

If the market's earnings multiple doesn't change and earnings increase at 9.3% per year, the FTSE 100 index will reach 7,800 by the third quarter of 2009. Should the earnings multiple increase to 15.0, the index will reach 9,500. Total returns under these scenarios are 13.2% and 21.0% per year, respectively, in pounds sterling. United States investors can expect about the same returns, since the forward currency markets show only a marginal appreciation of the pound relative to the dollar (0.1% per year) over the next several years.

How reasonable is it to project that the FTSE 100 will experience stronger earnings growth than the S&P 500 and an increase in its market multiple while the valuation of U.S. equity earnings stays unchanged? This is the sixty-four thousand dollar question. Earnings growth for the FTSE 100 has been comparable to that of the S&P 500 over the past five years, but weaker over the past ten years. UK corporate profits are not as far outside the long-term range of their share of national income as is the case in the U.S. It remains to be seen whether this means that UK corporate earnings have more room to grow or that UK labor costs are less flexible and will be a drag on earnings. In view of these uncertainties, we will use the lower end of our range of projected total returns (13.3% including the appreciation of the pound sterling) for our asset allocation model.

EMERGING MARKETS

Emerging markets are the last international area we consider. This is a broad category including more than 140 countries spanning the globe and including the world's two most populous nations, China and India. In total, this group accounts for nearly 85% of world population, nearly 50% of world production of goods and services, 70% of world currency reserves, and more than 40% of world exports. Real economic growth in emerging-market nations has been and is projected to be at more than double the growth rate of advanced economies. Despite this economic power, emerging economy stock markets account for less than 20% of world stock market capitalization.

It is a mistake to think of the world's emerging markets as all of one type, though. The capital markets of China, India, Russia, Brazil, and Mexico, to name a few, are distinctive and different from each other and more varied than New York, London, and Tokyo. What we might say about this group in general will almost certainly not be true of any one individual market in particular.

So why lump them all together? For three reasons. First, they must be reckoned with because of the opportunity they offer due to their rapid growth. Second, we have neither the time nor the historical data to do a comprehensive, comparative study of the risk/return characteristics of the many emerging economy capital markets, presuming even that the markets are sufficiently developed to have such characteristics. And third, for all of their variety, they do have one thing in common: high risk due at least partly to the developing state of the accounting, reporting, legal, and regulatory standards and institutions, which are already well developed in mature capital markets.

Earnings valuations on the major stock indices in China, India, and Brazil have increased this year but are at or lower than their April/May peaks.

In the long term, we can expect a dollar that is lower in value than today and interest rates that are higher.

Endowments and foundations that invest in emerging markets are well advised, therefore, to diversify their investments across the entire category. As tempting as it might be to take a bet on China, Brazil, or Malaysia, prudence dictates that we diversify the risk of any one of these markets with investments in others. Knowledgeable investors know that what we don't know and understand about each of these markets is as important as what we do know, and that accordingly we should not be betting on any one.

The strong growth prospects of emerging markets have often made them enticing places to invest. But as recently as late 80s and early 90s, many of these economies had poor fiscal and/or monetary controls that led to rampant inflation, currency devaluations, and debt crises. Today as a group, however, the picture is different. With small fiscal deficits, low inflation, and balance of payment surpluses, emerging markets have appreciating currencies and have become net lenders to the advanced economies. The favorable track record is not long, but it is impressive.

Very strong economic growth and improved monetary and fiscal health translate into high potential returns. On a local currency basis, we expect emerging-market stocks to return 15% per year, based on nominal economic growth of 12% per year. Returns could exceed 15% if earnings growth substantially exceeds economic growth or if earnings valuations increase. Our 15% projection assumes a modest level of corporate earnings growth on top of nominal economic growth, but no change in overall earnings valuation. Earnings valuations on the major stock indices in China, India, and Brazil have increased this year, but are at or lower than their April/May peaks. Valuations in Mexico and Russia have declined this year. Valuations range from a low of approximately ten times estimated forward earnings for the Bovespa Index in Brazil to a high of approximately twenty-two times estimated forward earnings for the Shanghai and Shenzhen 300 Index in China. Although these ranges appear to compare favorably with earnings valuations in the U.S. or Europe, we are well advised to be cautious in interpreting them, since earnings in all cases may not be reported on a comparable basis.

We are not including any projected gain from currency appreciation in our projected returns from emerging-market stocks, contrary to our long-term expectation of a decline in the value of the dollar against most world currencies. Although late summer/early fall forward exchange rates indicate that the Chinese yuan is expected to appreciate approximately 2% per year over the next four years, the expectations for other emerging-market currencies are mixed.

FOREIGN BOND MARKETS

Asset allocation options for international diversification also include the foreign bond markets. We include two broad categories of foreign bonds: investment-grade corporate bonds and emerging-market sovereign debt.

Foreign, investment-grade, corporate bonds give U.S. endowment managers and fiduciaries the opportunity to achieve the broadest diversification possible in a relatively low-risk investment category, while capturing interest rate differentials between U.S. and foreign capital markets. Returns from this asset category are a function of foreign interest rates, credit spreads, and currency gains/losses (where applicable; many foreign bonds are issued in dollars).

Figure IO.6 compares benchmark 10-year government bond yields around the world. Among the world's advanced economies, the U.S. currently has the highest long-term rates. Japan has the lowest at less than 2.0%. The euro area (for which we use Germany as a proxy) and the UK are also lower than the U.S. Rates in Poland and Brazil are shown as representative of rates in emerging markets.

Long-term rates in other advanced economies are likely to remain lower than U.S. rates because of the large fiscal and current account imbalances in the U.S. International Monetary Fund projections indicate that the U.S. will require more than $1 trillion annually to finance its combined federal and current account deficit.

Credit spreads around the world have decreased like credit spreads in the U.S. due to the global "savings glut." The European Central Bank (ECB) reports that credit spreads on AAA, AA, and A rated corporate bonds are near the lowest levels they have been since 1999, ranging from approximately 0.15% to 0.60%. Although credit spreads on Japanese corporate bonds have increased modestly this year, spreads on AA and A rated bonds are still below 0.20%.

Taking all factors into account, U.S. investors are not likely to realize returns of more than 4.5% on foreign investment-grade corporate bonds. Although an increase in credit spreads may increase returns for currently issued bonds, such an increase would adversely impact the values of bonds held in portfolio.

As can be seen from Figure IO.6, investors may achieve higher bond returns by buying the sovereign debt of emerging-market nations like Brazil. Investing in emerging-market sovereign debt is essentially an alternative way to invest in below investment-grade bonds with the investor assuming the risk of a government default rather than a corporate default. Emerging-market sovereign debt has typically yielded a premium of 5.0% to 8.0% over U.S. treasury bonds of comparable maturity, although sovereign credit spreads have been as narrow as 1.0% and as wide as 15.0%. Figure IO.7 reports emerging-market sovereign spreads since December 1995.

10-YEAR GOVERNMENT BOND RATES

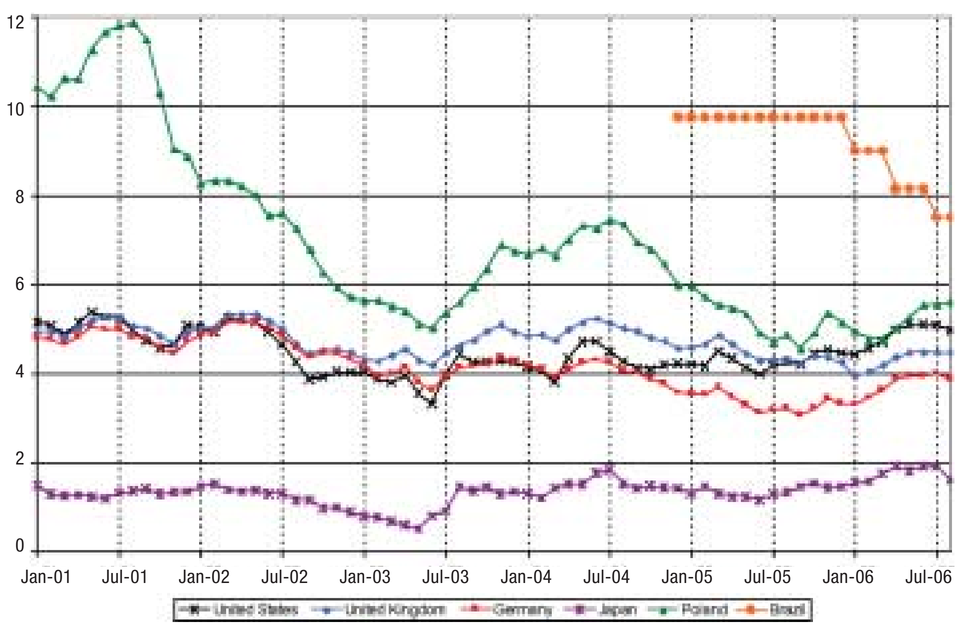

Figure IO.6: 10-Year Government Bond Rates
Source: Federal Reserve Board, European Central Bank, Bank of Japan, Central Bank of Brazil

Sovereign spreads in Latin America and Europe/Middle East/Africa have been decreasing since 2002, while spreads in Asia have been decreasing since the end of 2004. Overall, sovereign spreads are at or near their lowest levels over the past ten years. If economic conditions continue to improve in emerging-market economies, as forecasters expect them to, and if institutional and political stability persists, sovereign spreads may continue to decrease, adding an extra return potential to current investors.

For the purposes of our formulating our portfolio returns expectations, however, we expect spreads to remain at current levels, and investors to realize a return of 2.0% to 3.0% above Treasuries from emerging-market sovereign debt for a total return of approximately 7.5%.

EMERGING-MARKET SOVEREIGN SPREADS

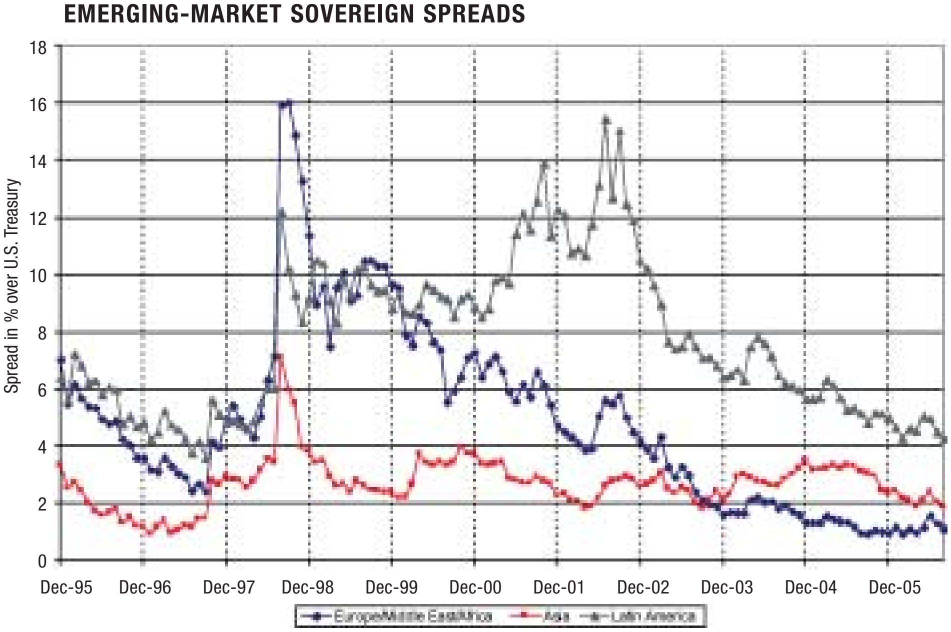

Figure IO.7: Emerging Market Sovereign Spreads
Source: Merrill Lynch, Bloomberg, Federal Reserve Board, and *Advisor* calculations