

International Stock Market Outlook First Quarter, 2007

Arthur A. Micheletti, CFA
Chief Economist and
Investment Strategist

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Executive Summary

Our outlook for international stocks continues to be very constructive. International valuations remain very attractive as rapid earnings growth has more than kept pace with sizable price gains. Given our expectation for continued growth and low inflation, the market environment is still positive. Finally, the market internals look healthy, with positive trends, momentum and breadth. The only negative is that international stocks have done so well for so long that they look overextended.

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Most of our valuation indicators suggest international stocks remain attractively valued relative to underlying global inflation and interest rates. Although international markets have risen significantly over the past few years, they are no more expensive than they were since earnings have risen just as fast. In addition, international stocks look marginally more attractive than U.S. stocks. We see both U.S. and international stocks as undervalued given the current economic and inflation environment.

International Stock Market Environment 3

The international stock market environment remains generally positive. Although foreign economic growth has slowed as U.S. growth has moderated, we expect global growth to continue. International inflation is well contained and lower than in the U.S. Despite some upward pressure on interest rates as central banks continue to tighten, we don't expect rates to move significantly higher. As a result, the international stock markets are likely to focus more on better earnings growth than on any rate increases.

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The price action of international stocks remains very constructive. The primary trend of the market is up. The relative momentum of global stocks versus U.S. stocks and global bonds is strong. Market breadth is in synch with the market trend, with advancing issues far outnumbering declining issue and new highs outstripping new lows. The main problem with the market internals is that, since international stocks have been outperforming for a long period of time, eventually, there should be a reversion to the mean performance. In addition, like U.S. stocks, international stocks look overbought and have deviated significantly from the long-term trend.

International Stock Market Valuation

From a valuation perspective, most of our indicators suggest international stocks remain attractively valued relative to underlying global inflation and interest rates. Although international markets have risen significantly over the past few years, they are no more expensive than they were since earnings have risen just as fast. In addition, international stocks look marginally more attractive than U.S. stocks. We see both U.S. and international stocks as undervalued given the current economic and inflation environment.

Valuation measures help us identify the relative attractiveness of international stocks compared to their own history and relative to other competing asset classes. We evaluate the attractiveness of international stocks based on the MSCI EAFE Composite price-to-earning (P/E) ratio, dividend yield, price/book value ratio and price/cash flow ratio. We evaluate these ratios relative to their five-year and ten-year moving averages to put them in a historical context.

While absolute multiples provide some perspective, they can be misleading since they shift over time relative to underlying inflation interest rate and economic conditions. To help mitigate this problem, we evaluate the fair value of global equities relative to a composite of global ten-year government bond yields.

In evaluating the relative attractiveness of international stocks versus U.S. stocks,

we compare their relative P/E, dividend yield, price/book value and price/cash flow ratios. This is also done relative to their five-year and ten-year moving averages.

There are a number of problems with valuation measures as investment tools. Although value tends to win in the long run, valuation measures can be notoriously early in identifying market bottoms and tops. To avoid being early, we tend to remain close to our long-term norm allocation until an asset class becomes extremely over or under valued. We also use other non-valuation tools to help us determine buy and sell points.

INTERNATIONAL STOCK MARKET VALUATION MONITOR

Indicator	Current Bias
EAFE Index Valuations vs. 5&10-yr. MAVs:	
Price/Earnings	Positive
Dividend Yield	Neutral
Price/Book Value	Negative
Price/Cash Flow	Neutral
MSCI World Fair Value Model	Stocks over bonds
Global E/P Yield vs. Bond Yield Momentum	Neutral
Ned Davis Research (NDR)	
Global Stock/Bond Model	Stocks over bonds
U.S. Stock Valuation*	Cheap
G-6 vs. U.S. Forward Earning P/E	Neutral
EAFE relative to U.S. vs. 5&10-yr. MAVs:	
Price/Earnings vs. 5-yr. MAV	International
Dividend Yield vs. 5-yr. MAV	Neutral
Price/Book Value vs. 5-yr. MAV	U.S.
Price/Cash Flow vs. 5 yr. MAV	Neutral
Pacific ex-Japan E/P vs. T-bills	T-Bills over stocks
Japan E/P vs. Bond Yield (y-y)	Stocks over bonds
MSCI Emerging vs. Developed Valuations	Developed

* From Bailard U.S. Stock Market Outlook
Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns

International Stock Market Environment

The international stock market environment remains generally positive.

Although foreign economic growth has slowed as U.S. growth has moderated, we expect global growth to continue. International inflation is well contained and actually lower than in the U.S. Despite some upward pressure on interest rates as central banks continue to tighten, we don't expect rates to move significantly higher. As a result, the international stock markets are likely to focus more on better earnings growth than on any rate increases.

Our analysis of the international market environment begins with a review of the U.S. economic outlook. If conditions in the U.S. are conducive to higher stock prices, conditions overseas tend to be positive as well. Although economic and market cycles differ, international stock markets still tend to be tied to the U.S. stock market, particularly at extremes. A bull market in the U.S. tends to float all boats and vice versa.

In addition to the outlook for the U.S., we monitor a number of key economic, inflation and interest rate indicators from overseas. Economic indicators include leading indicator composites, yield curves, forward earning revisions and consumer and business sentiment. In general, a positive outlook for foreign

economies is positive for earnings and stocks. However, if economic conditions lead to high and accelerating inflation, the environment for equities becomes less attractive. A deteriorating inflation outlook usually leads to higher interest rates and tighter monetary policy, which tends to restrain stock prices. Higher interest rates work to slow an overheated economy, dampen earning expectations and kindle recession fears.

Conversely, as economic conditions weaken, inflation and interest rate pressures ease, setting the stage for an eventual economic recovery. We monitor inflation pressures and expectations both directly through consumer prices indices and indirectly by monitoring interest rates and commodity prices.

INTERNATIONAL STOCK MARKET ENVIRONMENT MONITOR

Indicator	Current Bias
Bailard U.S. Market Outlook	Positive
U.S. Dollar and Bond Price (y-y)	Positive
Three-Month Interest Rate Composite	Negative
Long-Term Interest Rate Composite	Neutral
G-7 OECD Leading Indicator	Positive
Relative Leading Indicators	International
Yield Curve Composite	Neutral
Consumer Prices	Positive
Crude Oil Rate of Change	Positive
CRB Commodity Prices Rate of Change	Positive
Global Consumer Sentiment Composite	Positive
Global Business Sentiment Composite	Positive
Relative Business Sentiment Indicators	International
Ned Davis Research Allocation	
U.S. vs. International	International

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns.

International Stock Market Trend, Momentum and Breadth

The price action of international stocks remains very constructive. The primary trend of the market is up. The relative momentum of global stocks versus U.S. stocks and global bonds is strong. Market breadth is in synch with the market trend, with advancing issues far outnumbering declining issues and new highs outstripping new lows. The main problem with the market internals is that, since international stocks have been outperforming for a long period of time, eventually there should be a reversion to the mean performance. In addition, like U.S. stocks, international stocks look overbought and have deviated significantly from the long-term trend.

Trend indicators help keep our investment strategy in line with the primary direction of the market. We use the 200-day moving average as our primary trend indicator. If the moving average is rising, our bias is to be bullish. If it is falling, our bias is to be bearish. Although trend indicators don't give good signals at market tops or bottoms, they help keep us on the right side of big up moves and act as a stop loss to help minimize the downside risk of a major correction. When the market price deviates significantly from the longer term trend and the market becomes significantly overbought or oversold, we believe short-term counter-trend opportunities are created.

Momentum indicators help evaluate the strength of the overall market relative to other asset classes. We monitor the relative strength of global stocks to global bonds and U.S. stocks. Monitoring reversals in momentum after extreme

moves, together with other indicators, can help identify market turning points.

Breadth indicators include the number of new highs and lows, advancing versus declining issues, and the percent of country indices trading above or below their moving averages. When a lot of markets are trading above their 10-week and 40-week moving averages, breadth is high. High and rising breadth readings tend to be positive for stocks. However, extremely high breadth can reflect overbought conditions. When many stocks are trading higher and begin to reverse, a significant shift in the overall market momentum may occur. Extremely low breadth often occurs near market lows and indicates lower risk.

Other breadth indicators include the number of advancing versus declining

issues and the number of stocks hitting new highs versus new lows. We use the Ned Davis Global Composite of over 2500 stocks to evaluate breadth in the international stock market. When there are a lot of new highs and few new lows, the market is moving in a synchronized manner. When a lot of stocks are hitting new highs while many stocks are hitting new lows, breadth divergence and a potential top are indicated. When there are few new highs and many new lows, a selling climax and a market bottom is indicated. Advance/Decline measures can be utilized in the same manner to assess the market's internal health.

INTERNATIONAL STOCK MARKET TREND, MOMENTUM AND BREADTH MONITOR

Indicator	Current Bias
Ned Davis Research (NDR) Trend Composite	Bullish
Trend of 200-day MAV	Bullish
Deviation from Trend	Negative
Global vs. U.S. Relative Strength	Bullish
World Stock vs. Bond Momentum	Bullish
MSCI EAFE Index vs. S&P 500 Index	Bullish
% of markets above 10-wk. MAV	Bullish
% of markets above 40-wk. MAV	Bullish
Combo % markets above 10-wk. and 40-wk. MAV	Bullish
NDR Global Composite vs. 50-day MAV	Bullish
NDR Global Advance/Decline Line	Bullish
NDR Global New Highs-to-Lows	Bullish
Combo Price, AD line, New Highs/Lows	Bullish
Overbought vs. Oversold Indicator	Positive
NDR EAFE Index Composite Model	Neutral
Seasonality International vs. U.S. Stocks	Positive
Seasonality Global Stock vs. Bonds	Positive
Mean Reversion Global Stock vs. Bond	Bonds

Sources: Bailard Research, Ned Davis Research, Yardeni Research, Bear Stearns

Market Commentary

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call 800.BAILARD (800.224.5273)
or visit www.bailard.com.

Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404