



# International Markets

## Outlook for the Second Half of 2009

July 2009

### **Invesco Aim's International Growth portfolio managers Matt Dennis, Barrett Sides and Borge Endresen share their views on the current global market environment.**

International markets experienced an explosive rally in the second quarter of 2009, as signs began to emerge that government economic stimulus packages may be stabilizing the global economy. The MSCI EAFE Index gained 25.43% in the period – the sharpest quarterly gain since the 1980s.

However, we remain cautious about the outlook for the second half of the year, as there is still much uncertainty about the ultimate success of the stimulus efforts. For the long-term, our outlook is more favorable. We believe that U.S. investors are, for the most part, still underexposed to international markets, especially emerging markets. Even though flows have improved somewhat, they started from a base of extreme underexposure, in our opinion.

### **Looking back at the rally**

On a regional basis, emerging markets led the quarter, with the MSCI Emerging Markets Index gaining 34.73%. On a cap-size basis, small caps beat large caps, with the MSCI World ex-U.S. Small Cap Index returning 34.09%.

The second-quarter rally was not surprising, in our opinion, considering that the MSCI EAFE Index had fallen by more than 50% since late 2007 and international equities had become quite undervalued at the apex of the financial crisis.

#### **Performance as of June 30, 2009 (%)**

	3 MO Cum	YTD Cum	1 YR Ann	3 YR Ann	5 YR Ann	10 YR Ann
MSCI EAFE Index	25.43	7.95	-31.35	-7.98	2.31	1.18
MSCI Europe Index	25.26	7.03	-34.53	-8.39	2.31	1.30
MSCI Japan Index	23.05	2.59	-23.12	-10.16	-0.60	-1.17
MSCI AC Asia Pacific ex-Japan Index	33.07	33.01	-22.21	2.26	11.47	5.94
MSCI Emerging Markets Index	34.73	36.01	-28.07	2.95	14.72	8.70
MSCI World ex-U.S. Small Cap Index	34.09	22.13	-29.64	-9.84	2.53	5.27
S&P 500 Index	15.92	3.19	-26.20	-8.22	-2.24	-2.22

Source: Lipper Inc.

Returns are annualized for periods of one year or more, cumulative for periods under one year.

An investment cannot be made directly in an index.

Past performance cannot guarantee comparable future results.

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All data as of June 30, 2009 unless otherwise noted.

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### Looking ahead to the second half

The rally took much of the undervaluation out of the equity markets, meaning that second half returns will be driven more by earnings than valuation. With economic growth still in question, we believe the scope for earnings-driven equity returns is uncertain. In the short term, we believe share prices may consolidate after such a hard and fast run-up. In the long-term, however, we are more optimistic.

### Europe

While U.S. investors have been pulling out of Europe as of late, we believe the region's valuation and risk/reward profile are compelling. European equities are valued at close to a 35% discount to U.S. equities – near 35-year lows.<sup>1</sup> To compare, the average discount over the last 35 years is around 20%.

Europe has been more of a “stimulus spectator” rather than a player. However, because Europe's economy is export-sensitive, we believe global stimulus efforts could potentially offer some ballast to the region by closing some of this valuation gap.

In short, we view Europe as undervalued and underowned by U.S. investors, and we believe there are good opportunities to be found.

### Japan

Like Europe, Japan has been more on the sidelines of the economic stimulus movement. Its government has been constrained by a high debt-to-GDP ratio. Japan's stimulus measures so far have been more about incentives – such as tax breaks for homebuyers – and less about direct injections into the economy.

We have seen a flattening in the rate of deterioration for several macro conditions – unemployment, business confidence and consumption – but we still haven't seen the spark that will really get the economy moving. We believe that, for the most part, the Japanese market is near fair value.

### Asia ex-Japan

The Asia ex-Japan region experienced a major rally in the second quarter, with the exception of Australia. Australia's financials sector, a significant part of that market, proved less resilient than some of its Asian counterparts. Furthermore, the relatively defensive nature of the Australian market also proved a hindrance in this very strong rally.

Asia-centric stocks did particularly well, as much of this region has been somewhat insulated from the severity of the global contraction. Overall, consumer spending has remained reasonably strong, and real estate has been fairly resilient. However, we believe several non-Japan markets in Asia are approaching fair value right now.

### Emerging markets

For the most part, emerging markets have not experienced banking or balance sheet crises in the way that developed markets have, and the region still has dry powder to stimulate growth. The MSCI Emerging Markets Index is running between a 5% to 10% discount to its 10-year-average price-to-book and price-to-earnings ratios, which we believe is appropriate in today's global environment.

Within this asset class, China has been at the forefront of the government stimulus movement, and the results have been quick and visible (unlike in the U.S., where stimulus funds have largely served to bail out the financial sector.) The “cash-rich” government has been successful in moving jobs away from export-oriented areas and into domestic infrastructure, and the country's GDP growth rate has not collapsed, as many feared it would.

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### Small caps

From a cap-size perspective, international large-cap stocks are dependent on exports into the industrialized world, while small caps can be seen as a play on emerging market demand.

We believe small caps are inherently attractive and offer far larger opportunities for the second half. While the valuation gap between international small caps and international large caps has closed, there is still a significant valuation discount for foreign small caps compared to U.S. small caps. The MSCI World ex-U.S. Small Cap Index traded at a 27% discount to the Russell 2000 Index at the end of the second quarter.

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### Implications for investors

As experienced investment managers, we realize that we can only control our investment process; we can't control the market.

We're focused on companies with strong generative cash flows and high return on capital. We believe these companies should be able to continue generating relatively stronger returns, even in a more difficult environment. In emerging markets, we focus on established and dominant local franchises with good cash flow.

Our "EQV" investment philosophy and process emphasizes companies with attractive earnings, quality and valuation characteristics, and we believe the current, more challenging environment really underlines the importance and timeliness of quality.

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1 Source: Morgan Stanley, "Valuation Gap Europe versus U.S. Close to 35-Year Low," June 22, 2009  
Additional sources: Invesco Aim, Lipper Inc., Thomson Financial, MSCI, Frank Russell & Co.

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