WACHOVIA SECURITIES

The Week

FINANCIAL SERVICES GROUP: ADVISORY SERVICES • INVESTMENT STRATEGY

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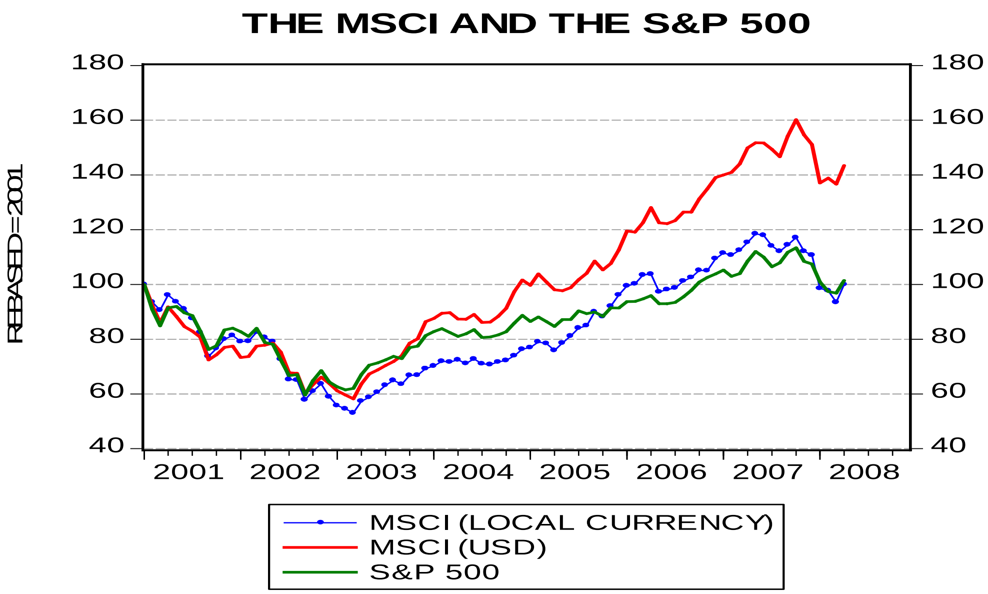
Developed Nation Equities

- Since 2001, a hypothetical investor holding the MSCI Europe, Australasia, and Far East (EAFE) stock index, an index of 21 developed country stock markets, would have seen his investment, denominated in U.S. dollars, peak at a 60% gain last year (see chart on page 2). Interestingly enough, that same EAFE index, denominated in local currencies, would have seen gains nearly equal to the S&P 500 over the same time frame. *Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation and political and economic changes. This may result in greater price volatility.* The index is presented to provide you with an understanding of its historic long-term performance and is not presented to illustrate the performance of any security. Investors cannot directly purchase any index.
- During the 1970s, it was commonly believed that owning foreign developed stocks would offer potential diversification benefits to a traditional domestic stock portfolio. That's because they didn't tend to move together; from 1969 to 1980, the EAFE (in U.S. dollar terms) and the S&P 500 only tracked each other 56% of the time. Classic portfolio theory suggests that holding assets that are uncorrelated lowers the risk of that portfolio. *Correlation refers to a statistical measure of how two securities move in relation to each other. Diversification cannot eliminate the risk of fluctuating prices and uncertain returns.*
- Since that time, however, the behavior of the EAFE, regardless of currency denomination, has become increasingly linked to the S&P 500. This development is consistent with increased globalization, in our opinion. As part of the deregulation which began in the late 1970s, the United States became increasingly open to foreign trade and investment. The rest of the developed world, to a greater or lesser extent, followed this policy. This led to the linking of supply chains, more closely interconnecting the world economy. The end result is that domestic and developed nation equity markets tend to move according to similar fundamental factors. For example, a slowing economy in the United States will tend to bring slower growth abroad as well, and visa versa.
- However, we believe it is clear that there are some differences in the returns from overseas investing. The data tends to support the idea that most of these differences are due to exchange rates rather than dissimilarities caused by local conditions. Thus, when making foreign investment decisions, especially in developed nations, currency expectations are critical in our view.
- In the April 27 edition of The Week, we discussed the potential for a G-7 "rescue" of the greenback. In that report, we noted that the dollar had reached a level of undervaluation that, in the past, had coincided with joint actions by the G-7 nations to boost the dollar. There have recently been comments from U.S. and European officials indicating the need to boost the dollar and ease the euro. The dollar has recovered modestly from the time of that earlier report and is still deeply undervalued, based on purchasing power parity. Why does the G-7 tend to behave in such a manner? Currencies that are at valuation extremes tend to cause problems in both the strong currency and weak currency nations, hurting growth in the former and causing inflation in the latter. If the dollar continues to rally, we believe some degree of underperformance in foreign developed nation stocks, at least to the U.S. dollar based investor, is possible.
- In this week's chart of the week, we examine the EAFE index in both local currency terms and dollar terms, along with the S&P 500.

Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.

Chart of the Week:



For illustrative purposes only. This does not reflect the performance of any specific investment.
Past performance is no guarantee of future results

Sources: Haver Analytics, Wachovia Securities

On this chart, we rebase the EAFE equity index for developed nations along with the S&P 500 to January 2001. Within the EAFE we include the index in local currency terms and in U.S. dollar (USD) terms. Note that the S&P 500 and the EAFE in local currency terms tend to track closely together. In fact, from mid-2002, the S&P 500 outperformed the EAFE in local currency terms; this outperformance persisted until late 2005.

It is worth noting, referring to the above chart, that for a U.S. dollar based investor, foreign stocks have clearly done better than domestic equities since the market trough in 2003. And, given the close link of foreign equities to U.S. equities in local currency terms, this outperformance appears to be due to the weakness of the U.S. dollar. Thus, the key to the performance of this asset class likely rests on the future path of the U.S. dollar; if we are correct in our expectation of a stronger dollar, foreign developed equities could underperform domestic equities.

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