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Strategy: Euroletter

Tougher Times in 2010

2010. *We are bullish on growth, and bearish on the consequences of some stimulus withdrawal. We think the on-going rally will take MSCI Europe (latest 1085) as high as 1200, but we expect MSCI Europe to end 2010 at 1030, 5% down for the year. Reliable growth and inflation hedges are our themes.*

Strong growth, rising rates, tougher times. We expect that strong 2010 growth will prompt the start of stimulus withdrawal, and we continue to prefer equities over fixed income. We think equities will rise further near-term, but we expect MSCI Europe to end the year at 1030, 5% down from today's 1085, because we expect a consolidation in markets associated with the start of tightening and its impact on 2011 growth.

Buy reliable growth, inflation hedges, EM exposure. Our three largest OWs are Energy (+3), Materials (+2), Staples (+2). All have good growth prospects, high EM exposure, and are inflation hedges. We are also OW Healthcare (+1) as a value play with improving fundamentals. Our UWs are Utilities (-3), Financials (-2), Consumer Discretionary (-2), Tech (-1). All suffer under higher rates, and tightening in general. Our preferred stocks include Total, Wood Group, Xstrata, Syngenta, Diageo, Adidas, Roche, Cobham, SES, A2A.

Today's portfolio changes. We go from Neutral to -2% UW Financials, from -2% UW to N Industrials. We are buying Cobham, A2A, SocGen and selling BNP, Julius Baer, GAM. We expect EPS growth of 35% & 10% in 2010 & 2011 (consensus 29% & 23%).

Three key surprises. Our three potential surprises for 2010 are designed to challenge the consensus, and we consider them more likely than markets currently price in: 1) The US dollar rebounds, leading to developed equities outperforming emerging. 2) Pharma is a surprisingly large outperformer as it cuts costs and benefits from EM exposure and corporate actions. 3) The UK becomes the first of the G10 to have a major fiscal crisis as elections lead to a hung parliament.

Tougher Times in 2010

Strong growth, rising rates, tougher times for equities. Going into 2010, there are still many doubts about the sustainability of the nascent growth cycle, but we do not share them. Without tightening, we think growth is unlikely to falter. Therefore we are much more concerned about growth in 2011 than 2010, after the tightening has started. When recessions start, typically people don't expect it because companies are still very profitable, unemployment is low and the traditional yield curve inversion is dismissed as not meaningful this time. Equally, when the recession ends and a new growth cycle starts, like now, people do not believe in it because companies have low profitability, unemployment is high, and the traditional steep yield curve is dismissed as not meaningful, again.

35% EPS growth in 2010, 10% in 2011. Today, the global yield curve is very steep, the copper price is strong and weekly unemployment claims continue to fall. Our EGLI (earnings growth leading indicator) is forecasting 50% EPS growth in 2010, and our economists expect 3.7% global GDP growth, up from -1.2% in 2009. The 2010 growth outlook at zero percent rates and record stimulus is sound, we believe. The logical consequence of strong growth is rising rates, and that will dampen the outlook for equities at some point in 2010. We introduce our new EPS growth forecasts: 35% for 2010 (was 20%), 10% for 2011. See pages 10-11 for more detail on our earnings estimates.

Strong growth will encourage policymakers to start some stimulus withdrawal. With growth recovering, zero percent rates for an extended period of time will no longer be justified. Fiscal spending cuts, higher taxes, re-regulation, removing some of the liquidity measures would all be on the cards and potentially harmful. This ‘start of tightening’ moment always occurs early on in a growth cycle, such as 1994 and 2004. We are intrigued by how Bernanke will try to avoid starting the tightening like Greenspan did in 2004. It is now widely believed that Greenspan’s measured way of raising rates from 1%, starting in June of 2004, created the credit bubble. Therefore, Bernanke is likely to want to walk the tightrope of not creating another bubble nor shocking the market back into a recession through a big bond sell off. For instance, it is quite possible the Fed under Bernanke may start to raise rates quite late, but in bigger irregular steps, thus keeping rates low but introducing some uncertainty and reducing risk-taking behaviour.

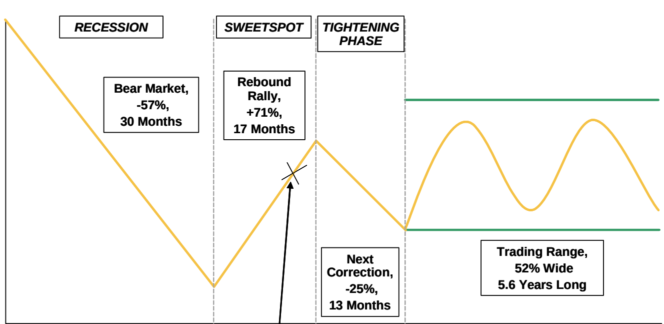
The tightening phase means tougher times for equities. We are concerned about deleveraging and the poor state of government finances. We expect that the withdrawal of stimulus will be a very dangerous period for the economy and markets; that when the tightening starts in earnest, markets will consolidate at best. Traditionally, as tightening starts equities consolidate for two quarters or more, commodities & defensives do best, tech & financials suffer. In the aftermath of secular bear markets the tightening phase tends to be more severe. We have written extensively on this, see for instance *The Tightening Checklist*, 26 October 2009.

But the tightening phase will start in earnest only after employment creation has started. Authorities will only dare to take some stimulus away when it becomes clear that the economy has fully turned the corner; when employment is being created; when some top-line growth is coming through; and when credit is more freely available, not just in the corporate bond market for sound large caps. Therefore we believe this tightening phase will start at some point in 2010 but only after we have had some more good news. At some point after employment creation has started, good economic news will become bad market news, as its implication will be higher rates and some tightening measures.

Our best guess is that MSCI Europe (latest value 1085) could go as high as 1200 near-term, as low as 950 during the tightening phase, and will end the year at 1030. The market can continue to rise towards normalized valuations of 1200 as long as the tightening phase has not started yet. We believe it will end 2010 at 1030. It may go as low as 950, consistent with our finding that in the aftermath of secular bear markets the tightening phase leads to an average 25% correction to equity markets. See pages 8-9 for more detail on our valuation framework. We prefer equities over credit and government bonds, and our asset allocation is 5% OW cash, neutral equities, 5% UW bonds (benchmark 10/50/40).

It may seem surprising that we expect high growth and weak equity markets in 2010, but history is on our side. A study of the past confirms this to be very normal. Our colleague Gerard Minack pointed us towards a detailed study by Dimson, Marsh & Staunton in their *Global Investment Returns Yearbook.* They found that not only is there no correlation between equity market returns and growth (either real GDP or real GDP per capita) over most time horizons, but the correlation is also frequently negative. We found a similar (lack of) correlation between strong EPS growth and equities. Equity markets are discounting mechanisms, and are driven

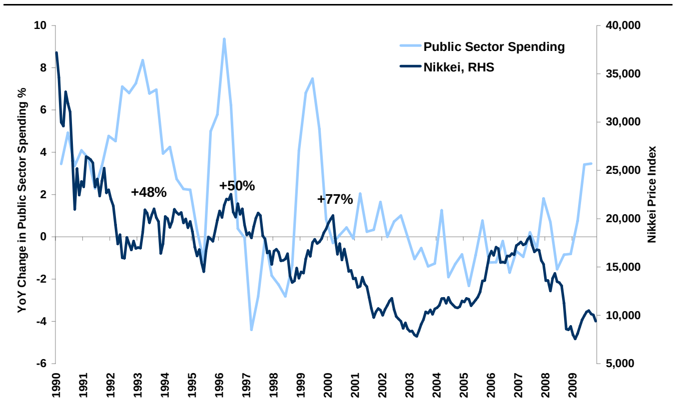
Exhibit 1
The Four Stages of the Typical Secular Bear Market and Its Aftermath



Currently we are approaching the end of the rebound rally, and the start of the tightening phase. MSCI Europe is up 57% in almost 8 months.

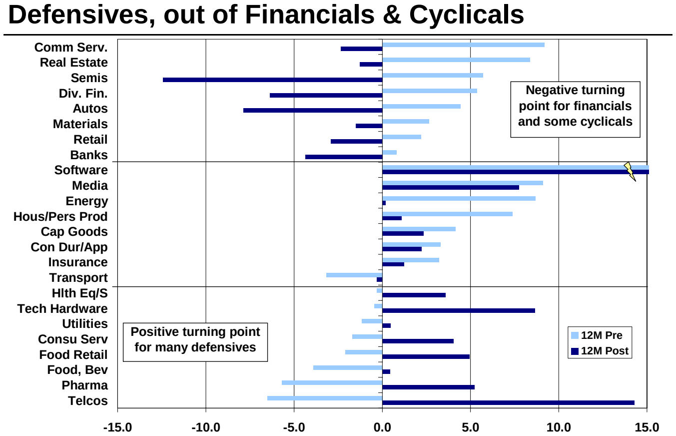
Note: Chart represents the typical secular bear market based on our sample of 19 such bear markets. See The Aftermath Of Secular Bear Markets from 10 August 2009 for more detail.
Source: Morgan Stanley Research

Exhibit 2
Japan multi-dipped as stimulus withdrawn



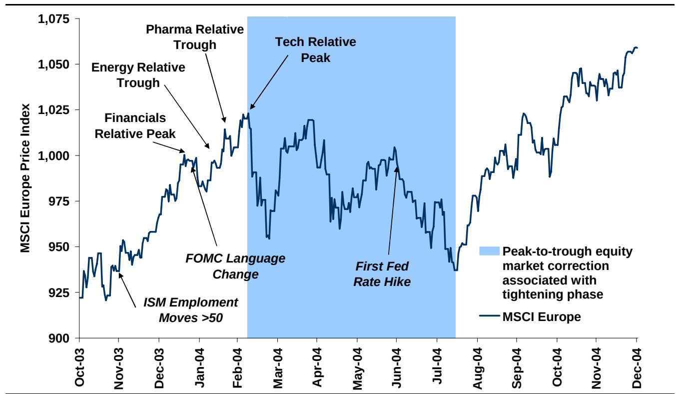
Source: Cabinet Office-Japan, Datastream, Morgan Stanley Research

Exhibit 3
Fed starting to tighten signals rotation into Defensives, out of Financials & Cyclicals



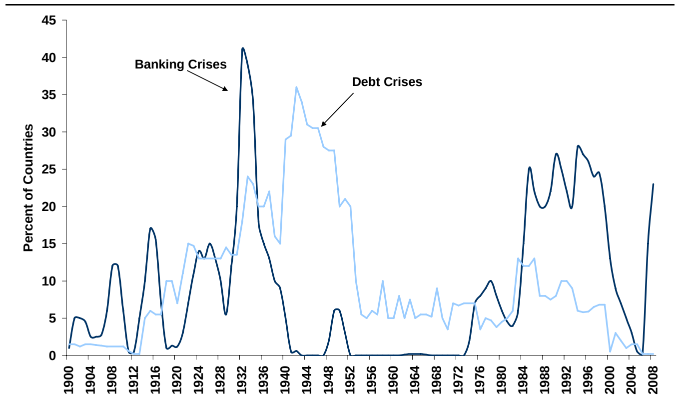
Source: MSCI, Datastream, Morgan Stanley Research

Exhibit 4
2004 tightening episode – from sweet spot to tightening was a slow process



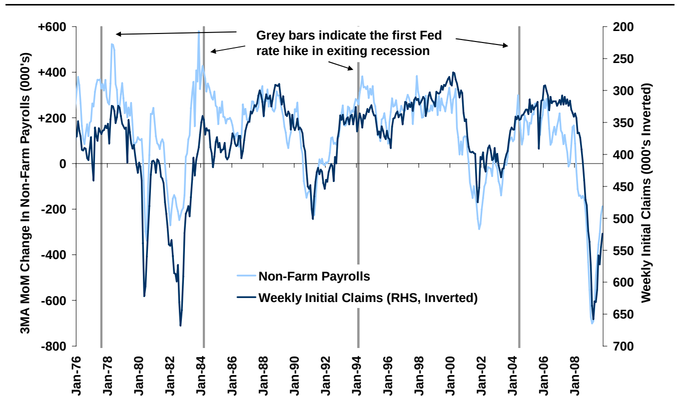
Source: MSCI, FRB, Morgan Stanley Research.

Exhibit 5
Sovereign Debt Crises Follow Banking Crises
Proportion of countries with banking and debt crises



Source: Banking Crises: An Equal Opportunity Menace by Carmen M. Reinhart and Kenneth S. Rogoff, Harvard University and NBER dated December 17, 2008

Exhibit 6
The first hike tends to happen when weekly claims reaches 350-400k



Source: Haver Analytics, BLS, Department of Labor, Federal Reserve, Morgan Stanley Research by valuations, rates, and changes in future growth prospects. The equity rally in 2009 has been all about anticipating the strong growth of 2010, and similarly 2010's equity market performance will be all about the prospects for 2011 and beyond.

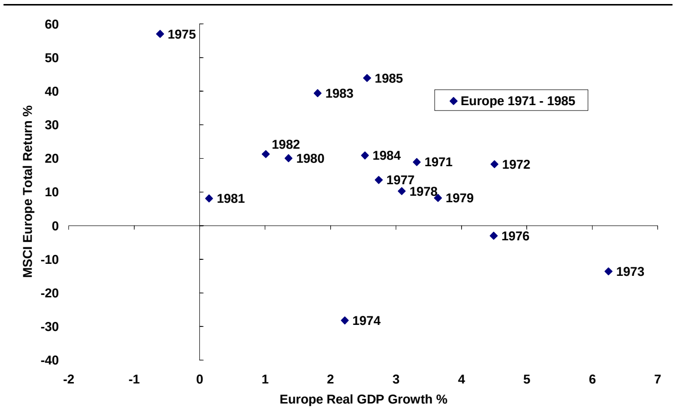
Indicators to watch. With this framework in mind, we believe investors should track the following indicators to decide when the consolidation phase associated with the start of tightening may start. We believe the direction of European equities is still very much dictated by what happens in the US, but China needs to be carefully monitored too.

1. **Inflation expectations.** The latest Fed statement states very clearly that the Fed would not necessarily start tightening when growth returns, as long as inflation and inflation expectations remain well behaved. We watch the breakeven rates in the US bond market, both the 10-year and the 5 year 5 year forward breakevens (USGGBE10 and USGG5Y5Y Index GO on Bloomberg). As an aside, we believe this cycle is likely to end in higher inflation than usual, as authorities will have a higher tolerance for it. We are not worried about problematic inflation in 2010, but we believe inflation will start an upward trend that could eventually become problematic. Gold remains an essential hedge for a variety of events, and we note that there is much more upside to gold's all-time high of ~US$2500 in inflation-adjusted terms if gold follows Jim Rogers' rule that in every bull market things go to new all-time highs.

2. **Employment growth.** Monthly payrolls, weekly unemployment claims, and ISM employment are three of the main components. As long as unemployment is rising, the tightening phase is unlikely to start. Once payrolls turn positive, or the unemployment rate starts falling (payrolls need to exceed 200k for the latter to happen), and once authorities become increasingly convinced that the economy is out of the woods, the risks will rise.

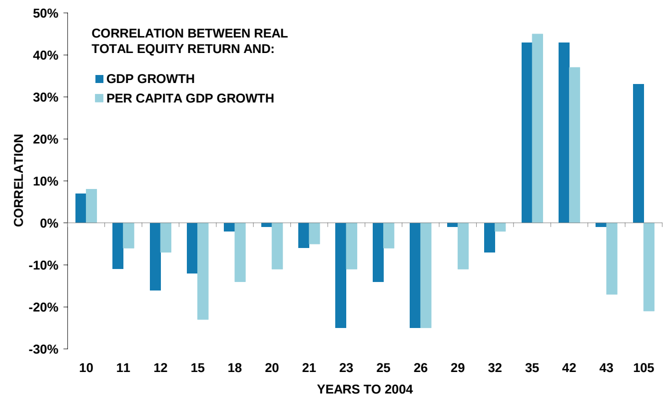
3. **Authorities' actions.** Important turning points could coincide with China initiating tightening measures, governments hiking taxes or cutting spending, potential Fed language changes, or re-regulation initiatives for the financial sector. We view the end of QE as the equivalent of a last cut, and the start of reverse repos and draining excess reserves as the equivalent of the first hike.

Exhibit 7
Europe 1971-1985: during this period equity returns were higher when real GDP growth was weaker



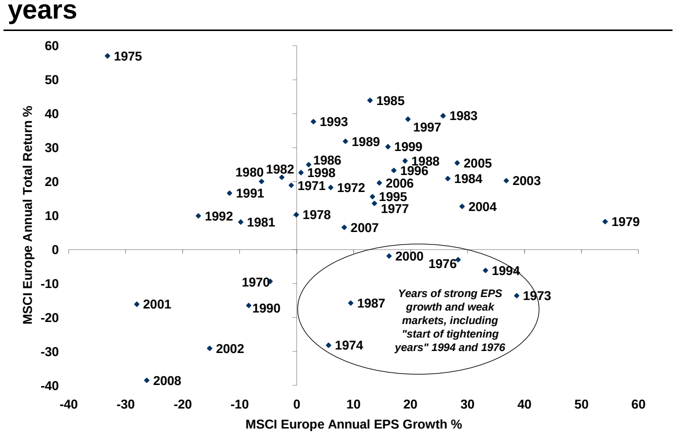
Source: MSCI, OECD, Morgan Stanley Research

Exhibit 8
Correlation between equity returns and GDP growth has often been negative



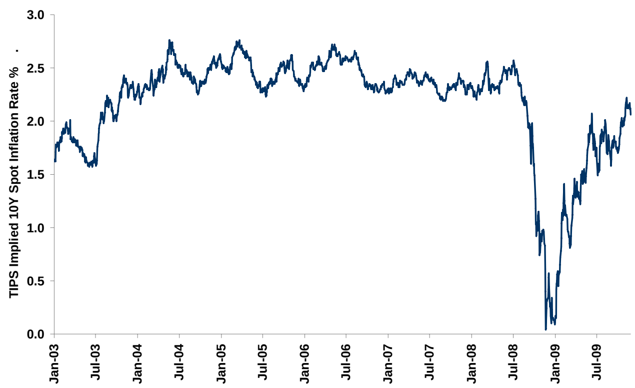
Note: The seemingly odd time horizons reflect when new markets were added to the sample set; there are 16 markets included over the full 105-year span. Source: Dimson, Marsh, Staunton & Elgeti, Global Investment Returns Yearbook, 2005; Morgan Stanley Research

Exhibit 9
MSCI Europe EPS growth and total return not always aligned, in particular in "start of tightening" years



Source: MSCI, Morgan Stanley Research

Exhibit 10
Watch 10 year breakeven inflation rates (%)

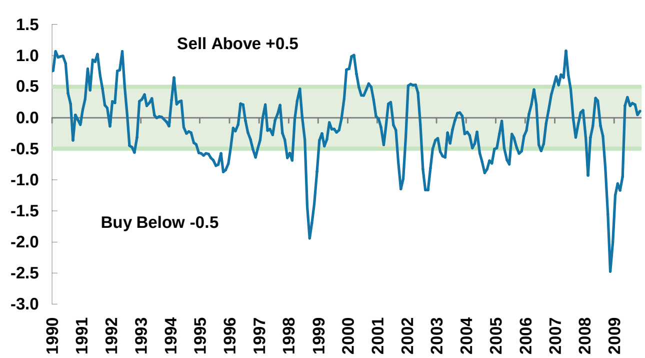


Source: Haver Analytics, Federal Reserve Board, Morgan Stanley Research

4. **Budget deficits.** In Japan during the 1990s, whenever public spending started falling on a year-on-year basis, equities peaked and went through a correction. We track budget deficits and we note that they are set to expand in 2010 and contract into 2011 on current forecasts.

5. **Bond yields.** Higher growth expectations will lead to rising rates. We believe there is a bond yield choking point, above which the growth outlook deteriorates rapidly. Rates are an important component in our market timing indicators (MTIs) and we will capture their impact through these. Our US economists expect 5%+ 10-year bond yields in 2010, which would be very bearish indeed.

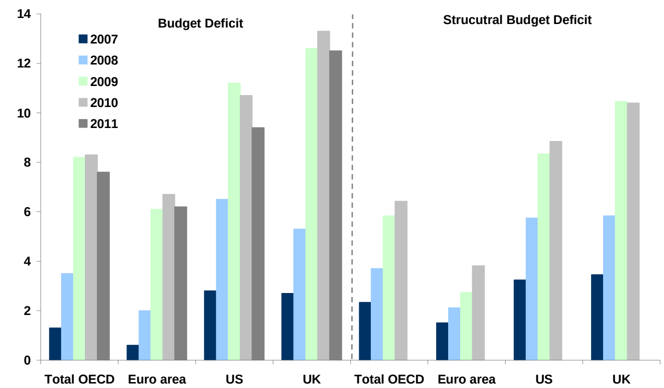
Exhibit 11
Combined Market Timing Indicator (+0.1)
Average of CVI, Fundamentals and Risk Indicators



Combined MTI Backtest	Backtest - 6 Mth Subsequent Performance if indicator (Since 1990) < -1.75	< -1.50	< -1.25	< -1.0	< -0.75	< -0.50	< -0.25	< 0.00	> 0.00	> +0.25	> +0.50	> +0.75	> +1.00
Average 6M Subsequent Performance %	22.4	21.2	14.9	6.4	5.4	9.2	8.7	7.7	-0.7	-5.5	-9.1	-6.4	-3.7
Hit Ratio %	100	100	100	71	71	85	86	81	47	28	21	27	0

Source: MSCI, Datastream, Morgan Stanley Research

Exhibit 12
Budget deficit (% of GDP) still expanding in 2010

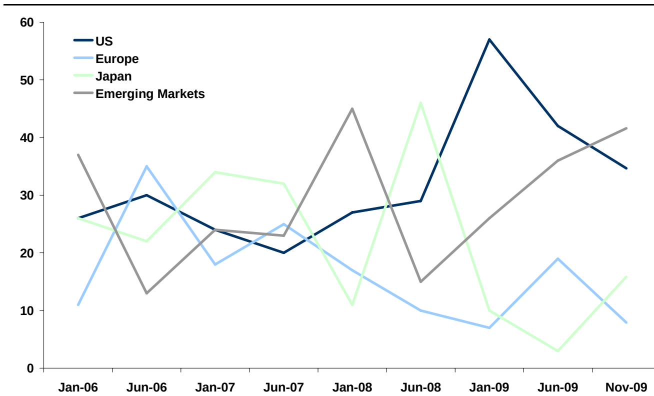


Source: OECD Economic Outlook, Morgan Stanley Research

6. **MTIs.** The latest signal from our MTIs was a buy signal in early November, when the combined market timing indicator briefly went below zero (see *The Trend Is Still Up*, 9 November 2009). At some point equity markets will have risen so much that the risk-reward of being long on a six-month view will no longer be good. Our market timing indicators can give us such a signal. When our combined market timing indicator (CMTI) is above +0.25, MSCI Europe has been down two-thirds of the time in the next six months, on average by 5%. We estimate that if we approach 1200 on MSCI Europe, we will get such a sell signal. Higher bond yields and generally more bullish sentiment could contribute to a sell signal, eventually, too.

7. **Sentiment indicators**. We will track sentiment indicators such as AAII bulls minus bears. In early November 2009 it reached -33, the 18th lowest weekly reading ever, thus

Exhibit 13
Europe and Japan the contrarian choices: interactive polling: best regional equity market next 12 months



Source: Morgan Stanley Research

confirming the buy signal from our MTIs. The latest 3-week moving average reading is still around 0. Some other sentiment indicators are at more worrying levels, such as the net futures on the NASDAQ at a 2 standard deviation long, and put/call ratios are low, but those indicators are more volatile and less reliable.

Today's portfolio changes: going UW Financials. In our European Model Portfolio we go from Neutral to -2% UW Financials, from -2% UW to N Industrials. Financials tend to underperform when rates rise, and also after leading indicators such as ISM new orders less inventories have peaked. Furthermore, risks of further re-regulation, higher taxes and political pressure in general could hurt the sector. We believe the logical consequence of the start of tightening is that Financials equities will underperform. Our credit strategists are bullish on financials paper, as corporate conservatism is likely to persist. Just like TMT after 2003, Banks' equities could underperform, and Banks' credit outperform.

We are buying Cobham, A2A, SocGen and selling BNP, Julius Baer, GAM. Cobham has been initiated on an OW by our analyst Rupinder Vig. It scores highly on our reliable growth screen, and trades on 10x 2010 PE for 13% EPS cagr between now and 2012. Rupinder is 18% above 2011 consensus EPS. As a result we go from -2% UW to N in Industrials. A2A is rated OW by our analyst Antonella Bianchessi and ranks highly on our private equity screen. She believes its 8% DY is sustainable, it trades on a 25% discount to the sector while having the highest FCF yield in the sector, and the group's gearing is wrongly perceived as too high. It trades on 10x 2010 PE, and Antonella expects 10% EPS cagr between 2009 and 2013. We stay -3% UW Utilities therefore we reduce our National Grid stake to buy A2A. Within Financials we sell GAM (not covered), BNP (EW, close to price target) and Julius Baer (OW), and buy SocGen (OW), which is our analyst's preferred French bank on 1.3x tangible book, on Maxence le Gouvello's estimates.

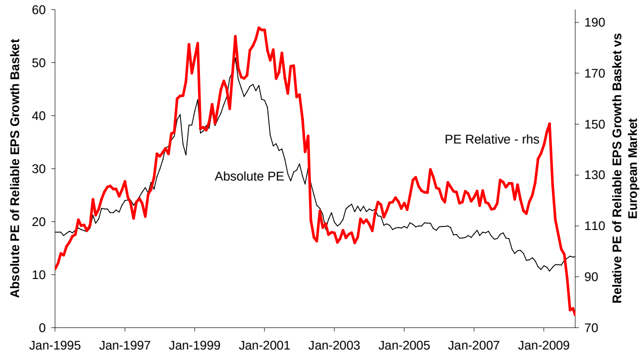
Sector themes: buy reliable growth, inflation hedges, EM exposure. Our three largest OWs are Energy (+3), Materials (+2), Staples (+2). All have good growth prospects, high EM exposure, and are inflation hedges. We are also OW Healthcare (+1) as a value play with improving fundamentals. Our largest UWs are Utilities (-3), Financials (-2), Consumer Discretionary (-2), Tech (-1). All would suffer from higher rates, and tightening in general.

Stock baskets / styles: quality, growth, value. We recently wrote in *Value, Growth & Quality Will Work Together*, 9 November 2009, that we believe a mixture of stock picking factors should be considered now. The four baskets we recommend are: reliable growth, Greenblatt & Piotroski combo, private equity, and equity carry (see our recent *Time to Prefer Equities over High-Quality Credit*, 2 October 2009).

More M&A. The other feature of 2010 is likely to be more M&A. Factors in favour of more M&A include strong earnings growth, generally strong balance sheets, competitive pressures. We think both large cap mergers of equals as well as M&A into weaker currency areas such as the UK should be expected. See also *M&A Prospects in the Next Up Cycle*, from 5 May 2009.

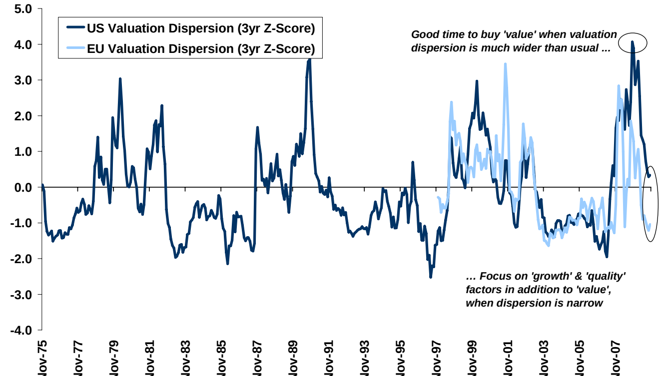
How will this growth cycle end? The next recession could be caused by one of three things, in our mind. First, in the

Exhibit 14
Reliable EPS growth basket at all-time PE relative low and at 23% discount to market



Source: Datastream, Morgan Stanley Research

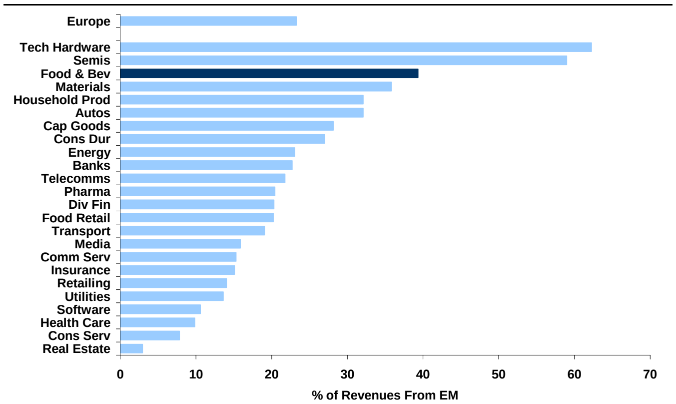
Exhibit 15
From very wide to narrow. Composite valuation factors dispersion (3 yr z-score) within sectors



Source: Morgan Stanley Quantitative and Derivative Strategies usual way of growth leading to inflationary pressures and overheating, but that won't happen this early into the growth cycle. Second, an oil spike driven by strong EM growth or geopolitical events could lead to the next DM recession. Third, the poor state of government finances could lead to a series of government bond & FX crises. Of these three ways, we view the third risk as the most concrete one for 2010. We will monitor the facts and revisit these scenarios, but for now the most likely outcome is that strong growth in 2010 leads to the start of tightening which in turn will hurt the 2011 growth outlook and equities alike.

Exhibit 16

Only Tech generates more revenues in EM than FBT



Source: Morgan Stanley Research

Exhibit 17

European sector performance when inflation high / rising (since 1976)

	Median Relative Performance (Ann'd)	Hit Ratio (Number Positive Perf.)
Energy	14.6	5 / 6
Food Beverage & Tobacco	**9.8**	**4 / 6**
Health Care Equipment & Services	6.8	4 / 6
Household & Personal Products	6.4	4 / 6
Real Estate	5.9	5 / 6
Pharmaceuticals Biotechnology & Life Sciences	5.0	4 / 6
Diversified Financials	12.3	3 / 5
Utilities	4.8	4 / 6
Capital Goods	3.1	4 / 6
Software & Services	9.9	3 / 6
Materials	6.2	3 / 6
Retailing	1.8	4 / 6
Consumer Services	2.2	3 / 6
Food & Staples Retailing	1.7	3 / 6
Transportation	1.5	3 / 6
Insurance	0.8	3 / 6
Banks	-0.5	3 / 6
Commercial & Professional Services	-1.5	3 / 6
Media	-2.2	1 / 6
Consumer Durables & Apparel	-5.9	1 / 6
Telecommunication Services	-11.4	1 / 6
Automobiles & Components	-9.7	0 / 6
Technology Hardware & Equipment	-10.6	0 / 6
Semiconductors & Semiconductor Equipment	-19.1	0 / 3
MSCI Europe (Absolute)	**1.7**	**3 / 6**

Note: Definition of high/rising inflation environment: Pre-1980 = Rising Inflation; Post-1980 = Inflation Above 3.5% & Rising. Periods: Dec-76 - Mar-80, Nov-83 - Mar-84, Apr-87 - Oct-90, Feb-00 - Jan-01, Jul-05 - Jun-06, Oct-07 - Aug-08. Sectors ranking based on combination of best to worst median performance and hit ratio. Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Shiller, Global Financial Data, MSCI, Datastream, Morgan Stanley Research

Exhibit 18

Market implied future earnings growth - 2011 base year

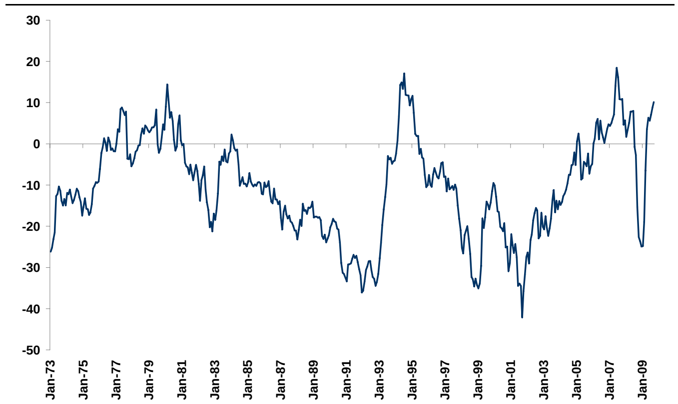
	PE 2011e	Relative PE 2011e	3 Year Beta	Market Implied 10Y EPS Growth
Telecommunication Services	9.8	0.9	0.7	-1.6
Pharmaceuticals Biotechnology & Life Sciences	10.4	1.0	0.7	-1.5
Food Beverage & Tobacco	**12.6**	**1.2**	**0.6**	**+0.2**
Food & Staples Retailing	11.8	1.1	0.7	+0.9
Energy	8.7	0.8	1.0	+1.0
Media	11.0	1.0	0.8	+1.0
Health Care Equipment & Services	13.7	1.3	0.6	+1.4
Utilities	11.0	1.0	0.8	+1.9
Household & Personal Products	16.5	1.6	0.6	+2.0
Insurance	7.5	0.7	1.3	+2.4
Technology Hardware & Equipment	11.1	1.1	0.9	+2.9
Software & Services	12.6	1.2	0.8	+3.4
Commercial & Professional Services	12.6	1.2	0.8	+3.5
Consumer Services	11.8	1.1	1.0	+4.4
Retailing	13.2	1.3	0.8	+4.3
Automobiles & Components	10.0	0.9	1.3	+5.7
Transportation	12.5	1.2	1.0	+5.8
Banks	9.2	0.9	1.4	+6.4
Diversified Financials	8.7	0.8	1.5	+6.7
Capital Goods	11.8	1.1	1.2	+6.9
Materials	11.2	1.1	1.3	+7.7
Consumer Durables & Apparel	14.5	1.4	1.0	+7.6
Semiconductors & Semiconductor Equipment	14.7	1.4	1.1	+8.6
Real Estate	15.6	1.5	1.1	+9.4
MSCI Europe	**10.5**			**+3.4**

Note: Ranked on lowest to highest implied growth
Source: MSCI, IBES, Morgan Stanley Research

Exhibit 19

European Cyclicals Getting More Expensive

% PD premium / discount vs defensives



Source: MSCI, Datastream, Morgan Stanley Research

Exhibit 20

Subsequent 12 month equity performance post the peak in ISM new order less inventory

	Median	Hit Ratio	Hit Ratio
MSCI Europe	**7.5**	**79%**	**11 / 14**
Utilities	**7.0**	**83%**	5 / 6
Materials	**3.8**	**83%**	5 / 6
Energy	**5.4**	**67%**	4 / 6
Telecommunication Services	**1.8**	**67%**	4 / 6
Consumer Staples	**6.7**	**50%**	3 / 6
Health Care	**1.5**	**50%**	3 / 6
Industrials	**0.3**	**50%**	3 / 6
Consumer Discretionary	**-0.1**	**50%**	3 / 6
Financials	**-4.7**	**33%**	2 / 6
Information Technology	**-11.3**	**17%**	1 / 6

Note: Absolute performance for MSCI Europe, relative performance for sectors.
Source: Morgan Stanley Research

5% Downside to Our Target

Valuation analysis – what is fair value? Determining fair value should be a key element in the investment process. We know the limitations of valuations, and therefore we consider fundamentals and sentiment, too. If one focuses solely on valuations, the risk is that one ignores two of Keynes' key lessons that "markets can remain irrational for longer than you can remain solvent" and "in the long run the market is a weighing machine, in the short run a voting machine". But knowing about fair value is an important starting point.

There is ~10% upside to reach normalized valuations across a range of measures. The latest MSCI Europe index value is 1085. Here we look at three methods: PE, PE & ROE, and DY / BY. We conclude there is some 10% upside to reach normal valuations on normal earnings.

- **14% upside to long-term average PE, implying MSCI Europe target of 1240.** There is 14% upside to MSCI Europe if the 2010 IBES PE of 12.9x rises to the average trailing PE since 1970 of 14.7x by the end of 2010.

- **11% upside to long-term average ROE and PE, implying MSCI Europe target of 1200.** There is 6% upside to reach 15x 12% ROE based on current trailing numbers. We could add BVPS growth till the end of 2010 to that number, expected by IBES to be a further 5%.

- **6% upside to long-term average DY/BY ratio, implying MSCI Europe target of 1150.** The long-term average DY/BY ratio in Europe has been 0.75 since 1920. If we assume higher growth leads to higher rates next year, with a European-wide bond yield of 4.5% at the end of 2010, the DY would deserve to be 3.4%. This implies 6% upside for MSCI Europe.

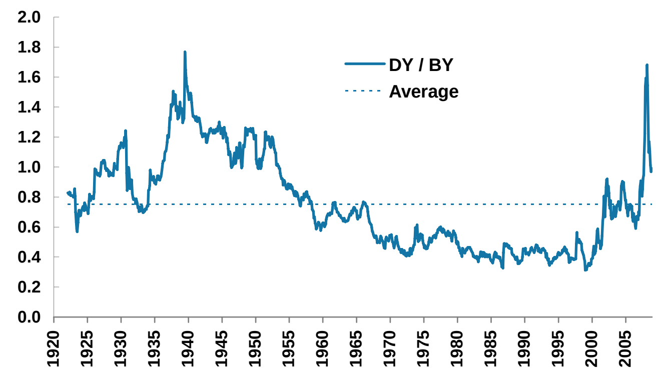
However, we do think that the "new normal" deserves less than average multiples. A variety of reasons leads us to believe that fair value in the next few years is less than the long-term averages just discussed. These reasons include

Exhibit 21
MSCI Europe - ROE, PE and DY in selected periods

	PE	ROE %	DY %
1970s - Now	14.7	12.1	3.9
1990 - Now	18.0	12.9	3.1
1970 - 89	11.4	11.1	4.7
1974 - 83	9.5	10.1	5.5
2000 - Now	16.9	13.9	3.0

Source: MSCI, Morgan Stanley Research

Exhibit 22
MSCI Europe - dividend yield divided by bond yield



Source: MSCI, Global Financial Data, Morgan Stanley Research

deleveraging, the poor state of government finances, financial regulation risk, and the likelihood that this economic cycle will be more volatile than past economic cycles due to the record amount of stimulus and its gradual withdrawal. Thus we think it is right to apply a 10-15% discount factor to these fair value estimates, leading to a fair value estimate for MSCI Europe of ~1030 based on this method. This estimate is very consistent with our CVI framework that we use to set our targets.

We update our bull / base / bear index target scenarios here. Changes are linked to a few factors. First, we roll our estimates forward one year to reflect our latest end of 2010 estimates. Second, in 2009 we based our index target scenarios on a mix of ROE & PE assumptions, and Shiller PE estimates. Looking into 2010 we prefer to use our CVI framework in our index target setting process, as usual.

- **Bear case "Inflation, FX and Bond Trouble" 750 on MSCI Europe, 31% downside**. In our bear case, record stimulus leads to fx volatility, a nascent inflation problem, a central bank credibility problem and government bonds

Exhibit 23
MSCI Europe - upside / downside based on mid-cycle P/E and ROE scenarios

		ROE %				
		10	**11**	**12**	**13**	**14**
PE	**11**	-36	**-29**	-23	-16	-10
	12	-30	-23	-16	-9	-1
	13	-24	-16	-9	-1	7
	14	-18	-10	-1	7	15
	15	-12	-3	**6**	14	23
	16	-6	3	13	22	31

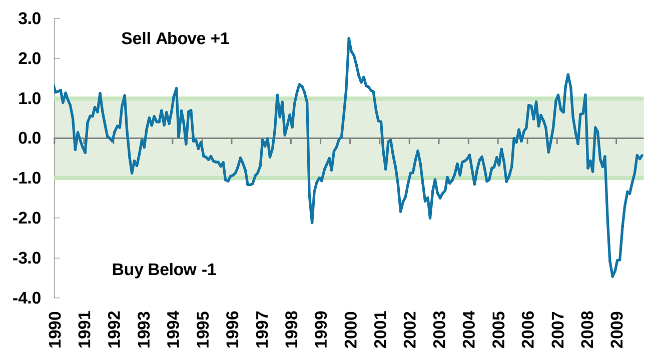
1970-89 **Last 35yrs**

Note: Table shows current upside / downside to MSCI Europe index based on different ROE and P/E scenarios, assuming constant book value. Source: MSCI, Morgan Stanley Research being under pressure as the market questions fiscal sustainability. Thus European 10-year bond yields spike 150 bps to 5%, and 3-month rates as well as headline CPI rise from below 1% to 2.5%, while EPS growth is less than expected at 20% as input costs bite. Using a CVI value of -1, this implies a MSCI Europe target of 750, an implied PE of 10, and 31% downside. Previously the bear case index target was 600 based on a Shiller PE approach.

- **Base case "High Growth, Higher Rates" 1030 on MSCI Europe, 5% downside.** Our base case is that high growth allows the tightening phase to start, while authorities are still perceived to be in control. There are worries about the impact of tightening on the 2011 growth outlook, and bond yields rise only 100bps to 4.5%, short rates reach 2%, CPI is well behaved at 1.8%, and EPS growth is 35%. Using a CVI value of -0.5, this implies a MSCI Europe target of 1030, an implied PE of 12.5, and 5% downside. Previously the base case index target was 850 based on a PE multiple of 12x on a mid-cycle 11% ROE.

- **Bull case "Goldilocks" 1400 on MSCI Europe, 29% upside.** This would be the best of all worlds. High growth, contained inflation, moderate tightening. Authorities decide that inflation pressures are well contained and that they should withdraw stimulus in a very measured way. Bond yields rise only marginally to 3.75%, short rates to 1.25%, CPI remains low at 1.5%. Using a CVI value of 0, this implies a MSCI Europe target of 1400, an implied PE of 15, and 29% upside. Our previous bull case index target was 1200 based on a mid-cycle PE multiple of 15x on a mid-cycle 12% ROE.

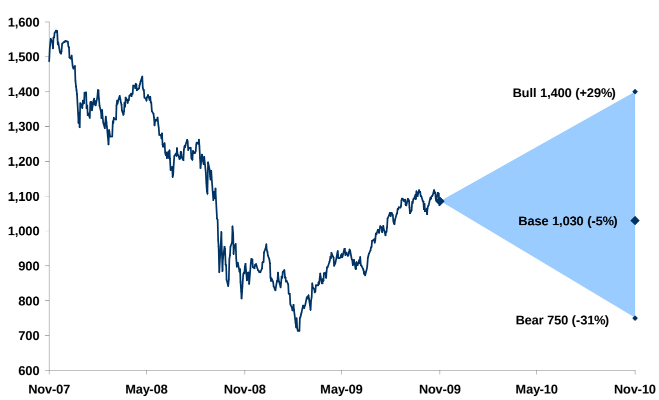
Exhibit 25
Composite Valuation Indicator (-0.4)



When the CVI is above / below ...	< -1.5	< -1.0	< -0.5	<0.0	>0.0	>0.5	>1.0	>1.5
N6M Perf (%)	9.3	7.9	6.9	7.5	1.8	-1.1	-4.8	-5.8
Hit Ratio (%)	88	84	84	85	59	50	35	31

Source: Morgan Stanley Research

Exhibit 24
MSCI Europe index target scenarios – 5% downside to our base case target



Source: MSCI, Morgan Stanley Research Estimates

Exhibit 26
MSCI Europe index target scenarios – 5% downside to our base case target

Bull Case 'Goldilocks': MSCI Europe 1,400 (29% upside)
Bond yields of 3.75%, short rates at 1.25%, CPI remains low at 1.5% and EPS growth is 50%.
Using a CVI value of 0, this implies a MSCI Europe target of 1400, and an implied PE of 15.

Base Case 'Strong Growth, Rising Rates': MSCI Europe 1,030 (5% downside)
Bond yields of 4.5%, short rates at 2%, CPI is well behaved at 1.8%, and EPS growth is 35%.
Using a CVI value of -0.5, this implies a MSCI Europe target of 1030 and an implied PE of 12.5.

Bear Case 'Inflation, FX and Bond Trouble': MSCI Europe 750 (31% downside)
Bond yields reach 5%, and 3M rates as well as headline CPI to reach 2.5%. EPS growth is less than expected at 20% as input costs bite. Using a CVI value of -1, this implies a MSCI Europe target of 750 and an implied PE of 10.

Source: MSCI, Morgan Stanley Research

Strong EPS Growth in 2010

Edmund Ng, CFA

Further signs of recovery prompt earnings upgrade. Previously, we had been expecting 20% earnings growth in Europe in 2010, which would be in-line with the first year of past recoveries (see Exhibit 27). With the continual improvement in key growth indicators, we believe a big recovery in earnings in 2010 is more likely now than it was a few months ago. For instance, unemployment claims have continued to fall, economic leading indicators have continued to rise further into the expansionary zone, the global yield curve has continued to steepen from record high levels, commodity prices have remained strong and global industrial production has swung from -21% Y/Y in Feb09 to +11% Y/Y in Sep09, the biggest increase in 35 years. Our 4-factor Earnings Growth Leading Indicator (EGLI) also suggests upside risks to our forecasts, as earnings could grow by 50% next year, even if economic activities and commodity prices stabilize at current levels.

V-shape EPS recovery in 2010 with earnings growth of 35%. Strong revenue growth will be the main driver of earnings growth next year, as we believe the deepest peak to trough decline in sales tends to be followed by the strongest recovery. Exhibit 28 suggests that history is on our side, and the ERM crisis is a neat illustration of our thinking - revenue fell by a record 9% between 1992 & 1993, followed by an equally remarkable 17% growth in sales in 1994. In 2009, revenue fell by a record-breaking 11%. Our new earnings forecast of 35% is now slightly above the consensus bottom-up estimate of 30%, putting 2010 as the second strongest 'year-one' recovery since 1970, marginally behind the 37% earnings growth we saw in 2003. Such strong earnings growth is central to our view that equities could rise a bit further near term, as we think most of the gains going forward will be driven by earnings growth, rather than multiple expansion.

Exhibit 27

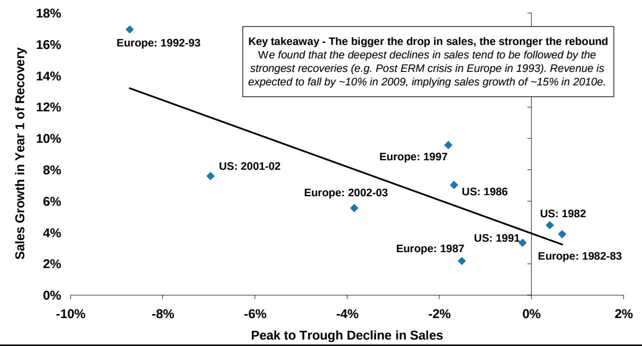
Revenue and earnings growth have averaged 9% and 20% during the first year of past recoveries …

	Average Recovery	
	Year 1	Year 2
Top-line Growth*	9%	13%
Operating Margin Expansion* (%Chg)	8%	12%
Earnings Growth**	20%	23%
%Earnings Loss Retraced	41%	96%

Note: *Historic revenue growth and margin expansion calculated based on annual data since 1982. **Historic earnings growth calculated based on monthly trailing earnings since 1970. Source: Worldscope, MSCI, Morgan Stanley Research

Exhibit 28

… but history suggests that the deepest downturn tends to be followed by the strongest the recovery

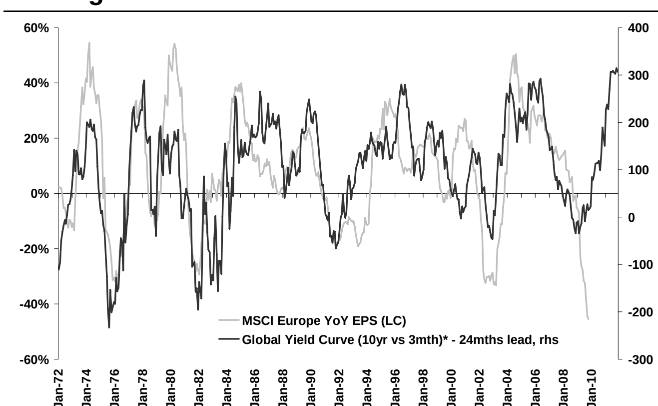


Note: shows peak to trough decline in sales in Europe and US, versus sales growth in the first year of the recovery that follows. Source: Worldscope, S&P, Morgan Stanley Research

Energy and Material the biggest drivers of earnings growth. With refining margins bumping along the bottom close to zero in Europe, the oil price is still the main driver of Energy earnings going forward. We expect strong earnings growth for Energy in 2010, reflecting our commodity team's above-consensus oil price forecast of $85/bbl in 2010 and $95/bbl in 2011 and $105/bbl long term. Mining companies should also see sizeable earnings growth in 2010, given the high sensitivity of their earnings to price rather than volume, and that most industrial metal prices would be 30-40% higher even if prices stay at current level for all of 2010. For financials, our new forecast incorporates the encouraging trends that we saw in recent earnings seasons, such as better than expected NPL formation in Western markets and the strength in

Exhibit 29

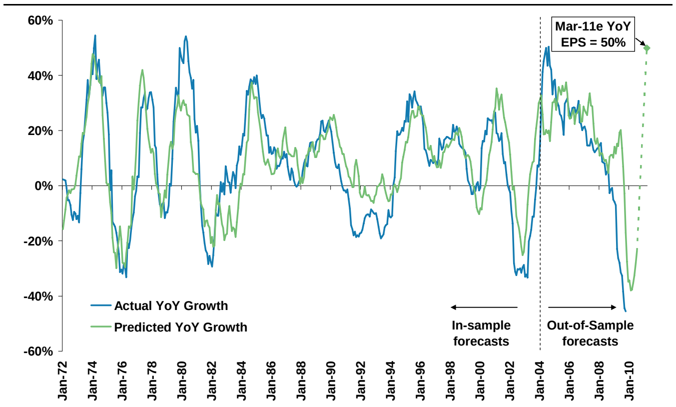
Record steep yield curve implies strong recovery in earnings in 2010 …



Note: *based on weighted average 10 year and 3 month government rates (60% US, 40% Europe). Source: MSCI, OECD, Haver, Morgan Stanley Research

Exhibit 30

… and our earnings growth leading indicator (EGLI) implies growth could be 50% in 2010



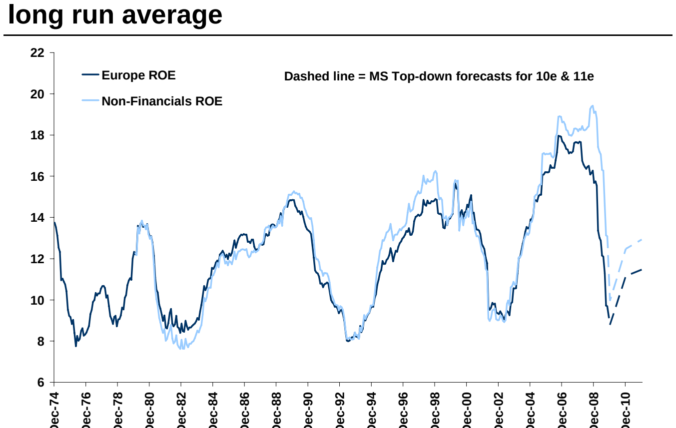
Note: 4-factor regression model that gives a 12-month lead on EPS growth for MSCI Europe. Factors include OECD leading indicator, IFO survey, commodity prices and global yield curve. Source: MSCI, S&P, IFO, OECD, GSCI, Haver, Datastream, Morgan Stanley Research

wholesale earnings. We also believe net interest margin (NIM) could surprise on the upside due to a combination of downward re-pricing of deposits, improved funding mix, and loan re-pricing after rate hikes in 2Q/3Q next year.

Weaker earnings growth of 10% in 2011 implies tougher times for equities in 2010. Earnings growth tends to be even stronger during the second year of past recoveries, averaging 23%, with the market recouping almost all of the earnings lost relative to their previous peak. We suspect history will not repeat itself in 2011. Rather, our thesis is that strong growth will lead to monetary and fiscal tightening at some point in 2010, and we are concerned about growth in 2011, after the tightening phase has started. We now expect 10% earnings growth for 2011, which is some 15% below consensus, reflecting our medium-term concerns including deleveraging among Anglo-Saxon consumers and financials institutions, deteriorating government finances and the negative impact of tighter monetary and fiscal policies such as higher taxes. Base effect also becomes less favourable given the strong growth that we expect in 2010. We believe the market will soon move away from the strong growth in 2010 to discount the weaker growth prospects for 2011, probably when the tightening phase starts in the next 1 to 2 quarters.

Exhibit 31

Our forecast implies return on equity to get back to long run average



Source: MSCI, Datastream, Morgan Stanley Research

Exhibit 32

Corporate Europe P&L

€ bn	2009	2010	2011
Operating Revenue	**5,542**	**6,373**	**6,692**
Operating Expenses	(4,928)	(5,584)	(5,826)
Other Operating Income /(Expense)	7	11	14
EBITDA	919	1,106	1,196
Depreciation	(298)	(307)	(317)
PTOP	**621**	**800**	**880**
Net Financial Income/(Expense)	(97)	(91)	(86)
Other Income/(Expense)	1	(1)	(1)
Profit Before Tax	525	708	793
Tax	(188)	(252)	(290)
Net Income	**337**	**456**	**503**
EPS	**332**	**448**	**493**
Growth YoY			
Operating Revenue	**-9%**	**15%**	**5%**
Operating Expenses	-9%	13%	4%
PTOP	**-11%**	**29%**	**10%**
Net Financial Income/(Expense)	10%	-6%	-5%
Profit Before Tax	-14%	35%	12%
Net Income	**-13%**	**35%**	**10%**
EPS	**-14%**	**35%**	**10%**
Ratios			
Operating (PTOP) Margin	**11.2%**	**12.5%**	**13.1%**
Net Margin	**6.1%**	**7.2%**	**7.5%**
Tax Rate	35.7%	35.6%	36.6%

Note: top-down forecasts based on MS coverage universe (currently 477 European stocks). Our key assumptions for 2010 are that top-line growth pick up from -9% to +15%, operating margins expand by 135bps. Our margin assumption is more than the average 70bps expansion during the 1st year of past recoveries, due to mix shift towards higher margin sectors like healthcare & staples. Source: Morgan Stanley Research estimates

Exhibit 33

Scenario to illustrate top-down forecasts by sector

	IBES Bottom-up EPS Growth		MS Bottom-up EPS Growth		MS Top-Down EPS Growth	
	2010	*2011*	*2010*	*2011*	*2010*	*2011*
Market	31%	23%	28%	26%	35%	10%
Market Ex-Financials	26%	18%	27%	20%	34%	11%
Market Ex Fin, Oil & Materials	21%	16%	14%	17%	24%	10%
Financials	50%	39%	30%	48%	40%	5%
Energy	36%	18%	52%	22%	60%	15%
Materials	44%	33%	89%	33%	70%	15%
Defensives	7%	8%	7%	8%	10%	10%
Cyclicals	58%	29%	37%	37%	60%	10%

Note: sector forecasts are not official top-down earnings forecasts. They illustrate a scenario that reconciles with our projections. Source: IBES, MSCI, Morgan Stanley Research Estimates.

Three Key Surprises for 2010

Ronan Carr, CFA

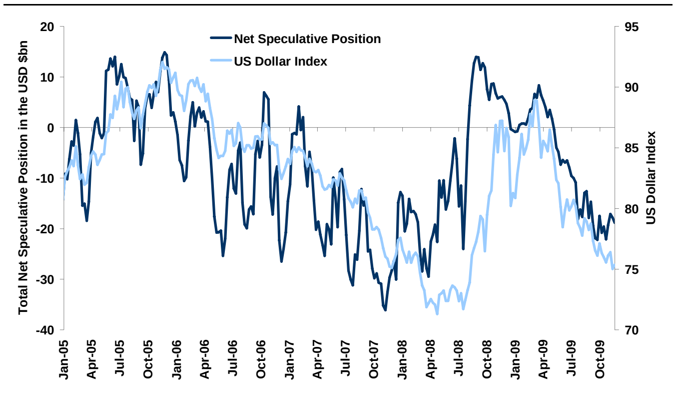
What could the big surprises be for the market? We consider three potential surprises for markets in 2010. These are designed to challenge the consensus, and in each case, we consider they are quite likely, definitely more likely than markets currently price in. First, the US dollar rebounds leading to developed equities outperforming emerging. Second, Pharma is a surprisingly large outperformer as it cuts costs and benefits from EM exposure and corporate actions. Third, the UK becomes the first of the G10 to have a major fiscal crisis as elections lead to a hung parliament. Other potential surprises we considered included:

A boom in food and agricultural prices; the Japanese yen weakens and Topix is the best performing global equity market; a geopolitical shock or high EM growth leads to a spike in oil prices; the cycle appears ever more normal and equity markets shrug off tighter monetary policy as a validation of the recovery.

Surprise #1: *The USD rebounds leading to DM outperforming EM.*

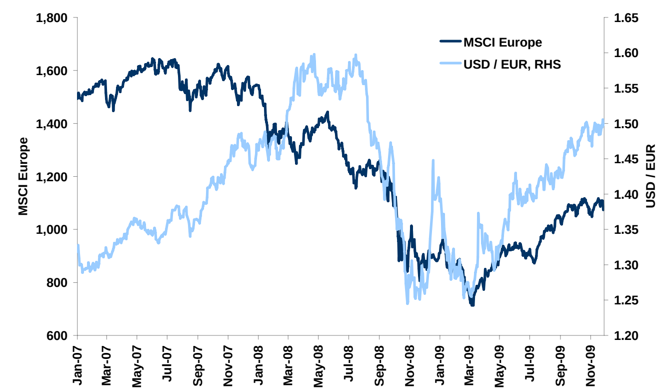
The dollar may strengthen as recovery begins to look sustainable. Bearishness on the dollar is widespread and a rebound in the greenback would certainly rank as a surprise versus consensus expectations and positioning. However, the bigger surprise may be that this is accompanied by rising not falling equity markets. The case for a stronger dollar is that the US economic recovery gathers momentum and the US starts stimulus withdrawal first as employment growth and credit creation comes through earlier than in other major regions (perhaps as early as 1Q10). Our FX team is projecting another 4% decline in the USD TWI (Fed's major currencies index), suggesting we are in the latter stages of the USD decline vs developed market currencies. Speculative positioning is very short the dollar, close to the record net short reached in 2007.

Exhibit 34
Investors are net short the USD (CFTC data)



Note: Total speculative positioning on the USD is based on the aggregate positioning on the AUD, CAD, CHF, EUR, GBP, JPY, MXN and NZD. Source: CFTC, Bloomberg, Haver Analytics, Factset, Morgan Stanley Research

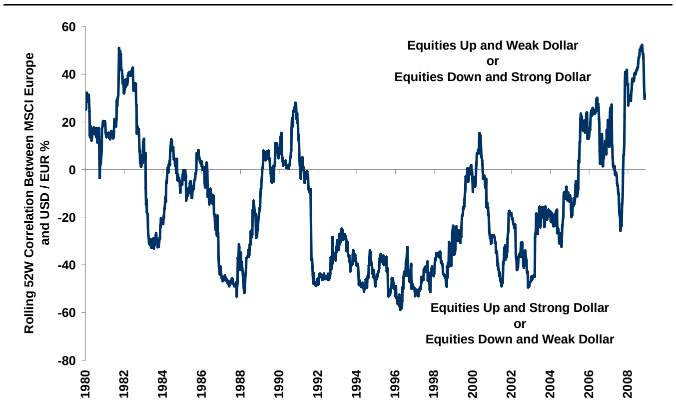
Exhibit 35
Equities are trading inversely to the dollar recently…



Source: MSCI, Datastream, Morgan Stanley Research

Stronger USD causes leadership shift to DM. With a dollar recovery and the Fed starting to withdraw liquidity the leadership in risky assets may shift back to developed market equities. The turnaround in the dollar causes a setback in commodity prices and developed equities start to beat emerging equities. Consensus bullishness on EM proves wrong as the growth delta versus expectations is a big positive

Exhibit 36
…but equity / FX correlations are not persistent through time



Source: MSCI, Datastream, Morgan Stanley Research in DM but neutral to a marginal negative in EM. S&P and MSCI Europe outperform MSCI EM. Within DM regions, the stronger USD should favour European and perhaps Japanese stocks more than US. In Europe, more defensive and consumer oriented EM plays (e.g. food, beverages & tobacco) benefit at the expense of higher beta global cyclicals such as miners and industrials.

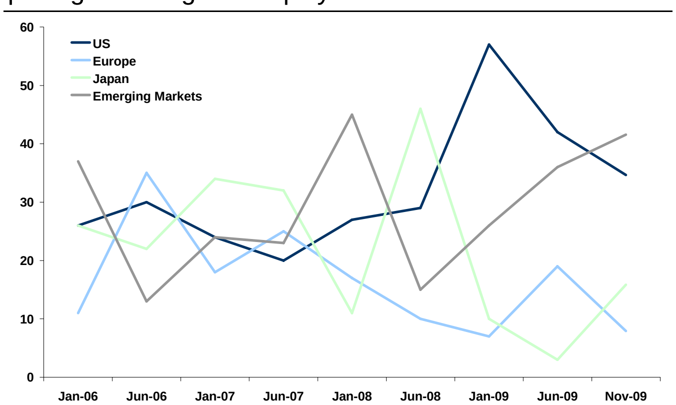
Correlation of dollar to equities may also fall. No doubt, a reversal in the dollar may be associated with some equity market weakness initially, given the very high correlation in recent months. In addition, to the extent dollar-funded carry trades drove risky assets in the last 6 months, as those are unwound, volatility is likely to increase. However, correlations between FX and stocks are not persistent through time and on a 6-12 month view it is conceivable to see both a stronger dollar and higher equity markets. Global equity markets may continue to rise in such a scenario as the stronger USD is driven by better absolute and relative US growth prospects (rather than by a risk reduction move), and an improvement in the perceptions of the US fiscal situation. This in turn signifies a better-balanced global economy (rather than one purely led by EM). Moreover, a stronger dollar would provide a boost to growth in other regions.

Surprise #2: *Pharma is a surprisingly large outperformer as it cuts costs and benefits from EM exposure and corporate actions.*

The surprise sector trade could be pharma. This is something of a forgotten sector, attractively valued but where micro fundamentals have the potential to meaningfully surprise on the upside. Positioning is slightly underweight (according to EPFR) and sentiment on the group is sceptical in the absence of a broader market sell-off. We have a modest overweight in the group consistent with our expectation for a broadening out in sector performance, a rotation into more defensive groups as the tightening phase approaches and lead indicators start to plateau and our preference for high quality (pharma stocks being very cash generative with very strong balance sheets). Valuation is very attractive, we believe, with a forward PE of 12.7, which is close to an all-time low relative to the market. Similarly, the DY is 3.6%, or 6% above the market's yield, which is almost 2 standard deviations cheap versus the historical average. Furthermore, on our Growth Discounter model and adjusting for beta, the sector discounts negative medium-term earnings growth (and the lowest of any sector).

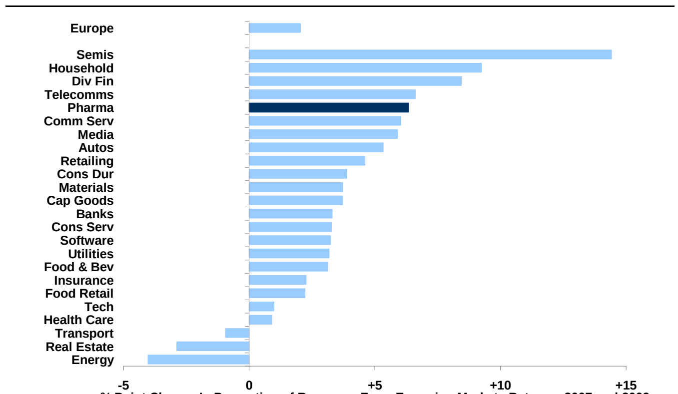
Consensus perceives the micro fundamentals poorly, as pharma valuation suggests. Medium-term growth is seen under continued pressure from patent expiries, tough regulation and a lack of new drugs. This is where we see the potential for a positive surprise. Firstly, we think regulatory concerns are overdone, with US healthcare reform widely flagged and in the price now, and with the FDA becoming more benign (drug approval rates are rising). Second, Andrew Baum believes the industry is changing the business model in reaction to the challenges of finding new blockbuster drugs. Under what he calls Pharma 2.0, big cap pharma has diversified in recent years into areas, such as vaccines, branded generics, and consumer health, that offer more visible and sustainable growth and profitability. Thirdly, the industry is expanding into emerging markets. Pharma's EM revenue share at 21% of sales is below average (23%), but is growing more quickly than average (+7pp versus +2pp for the overall market in the last 2 years). Pharma could become a surprise play on EM growth as healthcare spending is ramping up in some markets (e.g. expanding

Exhibit 37
Europe and Japan the contrarian choices: interactive polling: best regional equity market next 12 months



Source: Morgan Stanley Research

Exhibit 38
Pharma an emerging EM story?
Increase in revenue share from EM 2009e vs 2007



Source: Morgan Stanley Research

healthcare insurance in China). Fourth, near-term prospects could be boosted by restructuring. Several companies have new management focused on cutting costs and inefficient R&D.

Surprise #3: *UK becomes the first of the G10 to have a major fiscal crisis as elections lead to a hung parliament.*

UK fiscal crisis exacerbated by political gridlock. The poor state of government finances is one of the key risks we see in the medium-term. Therefore, one tail risk and potential surprise is that a government bond and FX crisis materializes already in 2010. One candidate for such a scenario is the UK where the upcoming elections could provide a catalyst, particularly if they result in a hung parliament. Such an outcome would likely lead to either a coalition or minority government where the ability to govern effectively will depend on the main party's ability to forge a consensus view to drive through necessary change. In the run-up to the election growing fears over a hung parliament would likely weigh on both the currency and gilt yields as it would represent something of a leap into the unknown (given that the last hung parliament in the UK happened in 1974) and would increase the probability that some of the rating agencies remove the UK's AAA status.

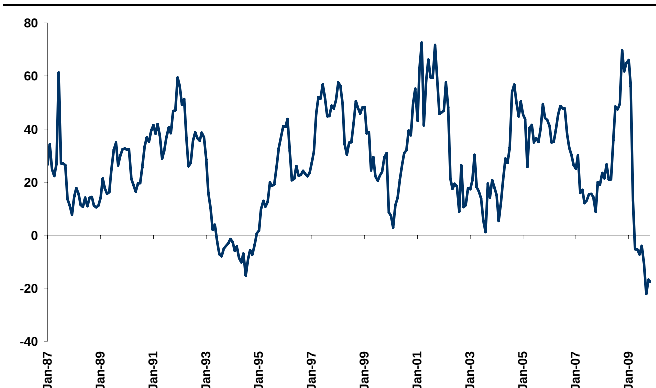
Weak UK macro backdrop. The context is an ugly fiscal picture, relatively weak economic recovery, aggressive monetary stimulus and political uncertainty. The fiscal deficit is among the worst globally at 13.3% in 2010, on OECD projections, and the Treasury's forecast for the public sector net debt gets to 79% in 2013-14. The UK's version of quantitative easing has been among the most aggressive in the world. BoE purchases of gilts by the end of the asset purchase program early next year will total £200bln. That would exceed net gilt issuance for the fiscal year of a projected £190bn, and likely leave the Bank holding c.33% of the conventional gilt market. Political opinion polls show a decline in the Conservative party's lead to levels where possibly no clear winner would emerge in a general election.

Severe weakness in GBP and gilts … In an extreme situation, a fiscal crisis could lead to some domestic capital flight, severe pound weakness and a sell-off in UK government bonds. The Bank of England may feel forced to hike rates to shore up confidence in monetary policy and stabilize the currency, threatening the fragile economic recovery. In such a scenario we would expect sterling to go to new lows (at least 10% downside on trade weighted GBP). Similarly, CDS protection on UK today trades at 64 versus a high of 165 in 1Q09. Gilt yields – 3.65% today – we think would trade through investment grade corporate bond yields, implying a widening of 150bp or more. According to Markit iBoxx data, benchmark spreads (i.e. over comparable gilts) are just 236bp for UK corporates and just 106-141bp for A-AA non-financial corporates (e.g. BP, Glaxosmithkline, Tesco).

… but UK equities may benefit. UK equities may be a net beneficiary of such a scenario. Historically, periods of GBP weakness are positive for the relative performance of UK versus both World and Europe ex UK equity markets (in local currency terms). The FTSE has a relatively low exposure to the domestic economy - we calculate that just 35% of UK stock market revenues come from the UK versus 43% from other developed regions and 22% from emerging markets. Conversely, a weaker currency would provide a boost to UK earnings, competitiveness and inward M&A activity. Note that 47% of UK market earnings (and 45% of market dividends) come from companies that report in USD.

Exhibit 39

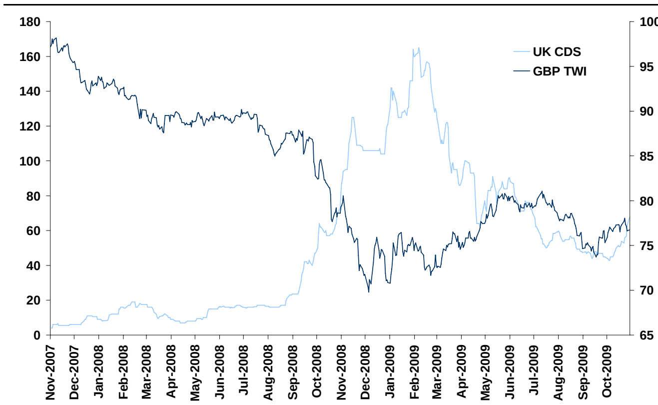
Pharma valuations at multi-decade lows: N12M PE premium / discount versus MSCI Europe



Source: MSCI, IBES, Datastream, Morgan Stanley

Exhibit 40

A severe fiscal crisis could send sterling back to the lows, a selloff in gilts and UK CDS higher



Source: Bloomberg, Morgan Stanley Research

Exhibit 41

European Stocks With 2009 Dividend Yield >4%; Dividend Cover >1.25x (09 & 10); DPS Growth (10 & 11) > 6%

Stock	Price	Market Cap ($mn)	% DY 09	Dividend Cover 09	Dividend Cover 10	% Dividend Growth 10	% Dividend Growth 11	% Net debt / Equity 09
ALLIANZ	€ 82.59	56,147	4.7	2.5	2.5	7.3	11.0	-
AMLIN	£ 3.78	3,082	4.8	3.7	2.9	8.1	7.7	-
BANCA GENERALI	€ 8.30	1,384	4.4	1.4	1.3	11.1	17.5	-
BANCO SANTANDER	€ 11.58	142,720	4.6	2.0	1.8	9.4	11.3	-
BRITISH AMERICAN TOBACCO	£ 18.50	60,903	5.2	1.5	1.5	8.2	8.9	104
BT GROUP	£ 1.45	18,472	4.7	2.0	2.0	8.8	10.0	3239
E. ON	€ 26.79	80,290	5.6	1.9	1.8	6.7	6.3	83
EDP ENERGIAS DE PORTUGAL	€ 3.08	16,119	5.1	1.6	1.5	7.6	8.8	220
ENAGAS	€ 14.31	5,117	5.0	1.7	1.7	8.3	9.0	186
FIRSTGROUP	£ 4.00	3,169	5.1	1.9	2.1	10.1	10.1	231
HERA	€ 1.63	2,523	5.2	1.3	1.3	9.3	9.6	117
HUHTAMAKI	€ 9.12	1,449	4.0	2.2	2.1	9.6	6.3	64
KPN (KON.)	€ 11.79	29,506	6.0	1.3	1.3	14.3	6.9	332
NATIONAL GRID	£ 6.58	26,695	5.8	1.5	1.4	8.0	8.0	467
OTE HELLENIC TELECOM.	€ 10.70	7,855	7.0	1.5	1.5	6.7	6.2	279
POHJOLA BANK A	€ 7.11	3,408	4.1	2.9	2.0	9.8	16.4	-
PROSAFE	NOK 31.50	1,278	4.2	3.3	3.0	52.2	34.3	325
REPSOL YPF	€ 18.51	33,837	4.6	1.5	1.9	11.2	11.1	67
RUBIS	€ 60.51	980	4.4	1.6	1.7	9.1	7.3	40
RWE STAMM	€ 62.09	52,535	5.6	1.8	1.9	6.7	6.7	79
SAINSBURY (J)	£ 3.27	9,956	4.3	1.6	1.6	8.3	10.8	37
TELEFONICA	€ 19.31	136,076	5.9	1.5	1.4	21.7	10.7	216
THOMAS COOK GROUP	£ 2.16	3,060	5.1	2.4	2.5	6.0	12.2	34
TUI TRAVEL	£ 2.44	4,493	4.3	2.2	2.1	12.3	16.1	14
ZURICH FINL SERVICES	SFr 221.30	32,418	5.3	1.9	2.2	8.5	8.4	-

Note: Prices have been updated as of 27 November 2009. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.
Source: MSCI, IBES, Factset, Worldscope, Morgan Stanley Research

Exhibit 42

MSCI Europe reliable growth screen

		% Qtrly Chnge in 12m Fwd EPS		St Dev of % Qtrly Change			Prob. of	OVERALL	12m Fwd	12m Fwd	OVERALL	12m Rel
	Price (LC)	Avg	Median(1)	2-year	5-year(2)	10-year	+'ve EPS ch(3)	RANK (1-3)	PE(4)	DY	RANK - Incl PE (1-4)	Perf (%)
CAPITA GROUP	7.2	6.1	5.0	1.0	2.0	3.0	100%	**1**	17.1	2.6	14	-14
SERCO GROUP	5.2	4.5	4.2	1.7	1.5	2.2	95%	**2**	16.2	1.3	10	10
NOVO NORDISK 'B'	329.0	4.0	4.0	2.2	2.2	2.6	91%	**3**	16.1	2.4	17	-8
HENNES & MAURITZ 'B'	416.4	4.8	4.8	3.3	3.3	4.3	84%	**4**	19.4	4.4	29	17
SAGE GROUP	2.2	4.6	3.8	2.9	2.2	3.6	90%	**5**	12.4	3.6	4	9
COBHAM	2.3	3.6	3.5	2.0	2.5	2.6	91%	**6**	11.4	2.6	3	7
TELEFONICA	19.3	3.7	4.3	3.7	3.4	4.4	81%	**7**	10.4	7.1	2	1
SANOFI-AVENTIS	51.2	3.9	3.6	1.8	2.7	4.3	85%	**8**	7.9	4.9	1	-2
RECKITT BENCKISER GROUP	31.2	2.3	3.3	2.2	1.8	2.0	87%	**9**	16.5	3.1	30	-6
FRESENIUS PREF. (XET)	44.7	4.2	3.9	1.4	2.4	9.7	78%	**10**	12.5	1.8	6	-14
SAP (XET)	32.1	4.4	4.0	4.3	3.5	5.2	81%	**11**	16.2	1.8	33	0
ASSA ABLOY 'B'	130.8	5.4	4.4	5.0	4.5	9.9	80%	**12**	14.3	2.8	24	40
TESCO	4.3	2.6	2.8	1.7	1.6	1.5	91%	**13**	13.6	3.2	23	21
WPP	5.8	3.0	3.2	4.1	3.5	4.5	86%	**14**	12.3	2.8	12	33
ESSILOR INTL.	38.8	2.9	2.8	2.7	2.5	2.4	87%	**15**	18.3	2.0	47	3
SGS 'N'	1284.0	3.1	3.2	1.9	3.0	8.1	80%	**16**	16.0	2.8	39	4
SCHINDLER 'P'	74.9	2.9	5.3	5.8	5.8	8.0	77%	**17**	15.4	2.7	36	27
ACS ACTIV.CONSTR.Y SERV.	33.7	4.8	4.3	5.8	6.7	5.4	83%	**18**	12.4	4.7	18	-10
NEXT	19.9	3.6	3.9	7.7	5.9	5.1	84%	**19**	11.0	3.1	7	50
SODEXO	37.5	3.0	3.3	3.3	3.3	4.3	77%	**20**	14.6	3.5	34	-21
L'OREAL	72.8	2.6	2.9	3.0	3.3	3.1	86%	**21**	20.0	2.1	60	-5
COLOPLAST 'B'	468.5	3.4	3.2	4.2	4.9	4.8	88%	**22**	18.4	1.8	56	12
BAE SYSTEMS	3.3	2.7	3.8	3.4	3.6	7.1	74%	**23**	8.0	5.1	5	-22
HERMES INTL.	95.9	3.2	2.7	3.7	3.0	3.8	85%	**24**	32.2	1.2	73	-19
CASINO GUICHARD-P	57.2	2.3	2.9	3.5	4.2	4.0	80%	**25**	11.5	4.8	27	5
KUHNE+NAGEL INTL.	97.4	3.8	3.8	7.6	7.2	6.4	82%	**26**	19.9	2.2	71	10
LINDT N	27500.0	2.7	2.9	7.1	5.6	4.4	90%	**27**	25.1	1.3	81	-23
BBV.ARGENTARIA	12.7	3.0	4.0	8.3	6.9	6.2	76%	**28**	9.5	4.2	13	30
RWE (XET)	62.1	2.9	2.7	3.0	3.1	5.7	79%	**29**	8.8	6.1	8	-22
BRITISH AMERICAN TOBACCO	18.5	2.3	2.3	1.7	2.0	4.9	81%	**30**	11.3	5.8	26	-9
DSV 'B'	88.0	6.2	5.7	9.2	8.4	12.9	77%	**31**	15.4	0.3	53	16
BALOISE 'R'	85.3	3.0	4.1	6.8	8.2	11.6	80%	**32**	8.2	5.4	9	5
BOUYGUES	33.5	3.9	4.4	6.0	5.6	9.1	70%	**33**	9.4	4.8	16	-13
VODAFONE GROUP	1.4	3.3	3.2	3.7	4.1	6.0	73%	**34**	9.1	5.9	15	-9
TECHNIP	46.5	2.3	4.5	8.7	8.5	9.6	77%	**35**	15.0	2.6	54	63
HEINEKEN	31.4	2.3	2.8	4.3	4.3	3.7	77%	**36**	13.2	2.3	43	21
ALLIANZ (XET)	82.6	2.8	4.3	7.6	8.4	9.3	77%	**37**	7.7	5.2	11	6
TUI TRAVEL	2.4	1.9	3.0	3.7	3.7	6.7	73%	**38**	9.4	4.9	22	-4
GETINGE	138.7	3.0	2.2	3.0	2.9	5.9	81%	**39**	13.9	2.1	48	20
NESTLE 'R'	48.3	2.3	2.7	2.9	3.0	3.3	73%	**40**	15.6	3.2	64	-8
ROLLS-ROYCE GROUP	4.8	2.3	3.3	4.0	6.0	7.7	74%	**41**	13.0	3.3	45	33
AIR LIQUIDE	77.8	1.8	2.2	3.2	2.5	2.4	79%	**42**	16.4	3.1	76	-3
PORSCHE AML.HLDG.	47.2	9.2	6.6	15.1	12.6	10.1	84%	**43**	8.2	1.9	20	-22
VINCI (EX SGE)	37.5	5.2	3.4	4.0	4.7	5.2	70%	**44**	13.2	4.1	49	-1
E ON (XET)	26.8	2.9	2.8	5.6	4.4	9.1	74%	**45**	9.1	5.9	25	-19
ASTRAZENECA	45.1	3.1	2.7	2.4	3.6	3.8	74%	**46**	7.4	5.5	19	-7
SCHNEIDER ELECTRIC	73.7	5.6	4.0	9.1	8.3	8.5	74%	**47**	16.5	3.1	83	24
HANNOVER RUCK. (XET)	32.2	3.6	3.0	9.3	6.2	8.2	74%	**48**	6.8	5.6	21	49
CRH	17.2	2.3	3.6	6.8	7.8	6.8	75%	**49**	15.4	3.7	70	-7
BANCO SANTANDER	11.6	2.9	4.0	10.0	7.4	7.0	71%	**50**	10.7	5.0	35	50
Average									13.6	3.5		5.9
Median									13.2	3.2		2.2
MSCI Europe Median Stock									13.6	3.2		

Note: Prices have been updated as of 27 November 2009. We rank stocks in the MSCI Europe index by 3 factors – 1) the median quarterly percentage change in consensus 12-month forward EPS estimates since 1995; 2) the standard deviation of these quarterly percentage changes in 12-month forward EPS over the last 5 years; 3) the probability that a quarterly percentage change is positive based on data since 1995. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.

Source: FactSet, Datastream, IBES, Morgan Stanley Research

Exhibit 43

Stocks with dividend yields above their credit yields, and sustainable and growing dividend streams

Issuer Name	Sector	Price	5y Implied Credit Yield	DY 09e	2yr DPS CAGR (09-11)	Avg FCFY (2010 & 11)	DY 09e Less Credit Yield	Rating
VIVENDI	Consumer Discretionary	€ 19.17	4.2%	6.7%	1.1%	16.4%	2.5%	Equal-Weight / I
UNITED BUSINESS MEDIA	Consumer Discretionary	£ 4.70	3.8%	5.1%	2.1%	7.6%	1.3%	Equal-Weight / I
PEARSON	Consumer Discretionary	£ 8.37	3.5%	4.5%	4.9%	5.6%	1.0%	Equal-Weight / I
WOLTERS KLUWER	Consumer Discretionary	€ 14.49	3.5%	4.5%	3.8%	10.7%	1.0%	Equal-Weight / I
SES A-FDR	Consumer Discretionary	€ 14.63	3.8%	4.7%	10.0%	6.3%	0.9%	Overweight / I
COMPASS GROUP	Consumer Discretionary	£ 4.03	3.4%	3.5%	12.0%	11.0%	0.1%	Overweight / I
BRITISH AMERICAN TOBACCO	Consumer Staples	£ 19.29	3.6%	5.0%	8.6%	8.1%	1.4%	Overweight / A
UNILEVER PLC	Consumer Staples	£ 17.75	3.3%	4.0%	4.9%	4.9%	0.7%	Underweight / I
SAINSBURY (J)	Consumer Staples	£ 3.32	3.9%	4.5%	6.6%	10.3%	0.6%	Overweight / I
DIAGEO	Consumer Staples	£ 10.21	3.7%	4.0%	8.6%	8.1%	0.3%	Overweight / I
BP	Energy	£ 5.82	3.4%	6.8%	3.3%	9.1%	3.4%	Overweight / A
ROYAL DUTCH SHELL B	Energy	£ 17.90	3.5%	6.2%	2.1%	5.9%	2.6%	Equal-Weight / A
TOTAL	Energy	€ 42.03	3.5%	5.6%	5.0%	6.5%	2.1%	Overweight / A
HANNOVER RUECKVERSICH.	Financials	€ 32.73	3.3%	6.7%	-1.9%	-	3.3%	Equal-Weight / I
MUENCHENER RUECKVERSICH.	Financials	€ 104.96	3.3%	5.1%	2.8%	-	1.8%	Equal-Weight / I
STANDARD LIFE	Financials	£ 2.16	4.2%	5.5%	2.0%	-	1.2%	Equal-Weight / I
UNIBAIL-RODAMCO	Financials	€ 156.65	4.4%	5.6%	3.1%	-	1.2%	Equal-Weight / C
ZURICH FINL SERVICES	Financials	SFr 226.60	3.7%	4.7%	9.9%	-	1.0%	Overweight / I
AVIVA	Financials	£ 3.95	4.2%	5.1%	3.0%	-	0.9%	Overweight / I
ALLIANZ	Financials	€ 83.84	3.6%	4.3%	8.6%	-	0.7%	Equal-Weight / I
GLAXOSMITHKLINE	Health Care	£ 12.41	3.5%	4.9%	5.6%	7.3%	1.4%	Equal-Weight / A
ASTRAZENECA	Health Care	£ 27.07	3.4%	4.8%	12.1%	13.5%	1.3%	Equal-Weight / A
SANOFI-AVENTIS	Health Care	€ 50.30	3.5%	4.4%	8.9%	11.0%	0.9%	Overweight / A
NOVARTIS	Health Care	SFr 54.00	3.3%	3.8%	1.2%	8.8%	0.5%	Equal-Weight / A
DEUTSCHE POST	Industrials	€ 12.59	3.4%	4.7%	19.0%	5.3%	1.3%	Underweight / I
ATLANTIA	Industrials	€ 17.86	3.6%	4.5%	7.5%	1.9%	0.9%	Overweight / I
BAE SYSTEMS	Industrials	£ 3.28	3.6%	4.4%	6.0%	10.8%	0.8%	Overweight / I
KONINKLIJKE DSM	Materials	€ 32.62	3.5%	4.2%	4.1%	6.4%	0.7%	Equal-Weight / I
DEUTSCHE TELEKOM	Telecommunication Services	€ 9.55	3.8%	8.4%	0.0%	13.7%	4.5%	Underweight / A
FRANCE TELECOM	Telecommunication Services	€ 17.05	3.5%	7.7%	3.5%	15.3%	4.2%	Equal-Weight / A
PORTUGAL TELECOM SGPS	Telecommunication Services	€ 8.07	3.8%	7.9%	0.0%	8.0%	4.2%	Equal-Weight / A
OTE HELLENIC TELECOM.	Telecommunication Services	€ 10.60	3.8%	7.1%	0.0%	15.6%	3.3%	Equal-Weight / A
SWISSCOM	Telecommunication Services	SFr 385.00	3.7%	6.6%	1.2%	9.6%	2.9%	Equal-Weight / A
TELEKOM AUSTRIA	Telecommunication Services	€ 11.64	3.7%	6.1%	0.0%	12.6%	2.4%	Equal-Weight / A
KPN (KON.)	Telecommunication Services	€ 11.89	3.6%	6.0%	17.0%	11.8%	2.4%	Overweight / A
TELEFONICA	Telecommunication Services	€ 19.38	3.8%	6.1%	12.3%	11.7%	2.3%	Overweight / A
VODAFONE GROUP	Telecommunication Services	£ 1.34	3.7%	5.7%	4.5%	6.0%	2.0%	Overweight / A
BT GROUP	Telecommunication Services	£ 1.45	4.4%	5.8%	12.5%	11.1%	1.3%	Overweight / A
CABLE & WIRELESS	Telecommunication Services	£ 1.36	5.5%	6.6%	10.0%	7.8%	1.2%	Equal-Weight / A
NATIONAL GRID	Utilities	£ 6.46	4.0%	6.1%	8.0%	6.0%	2.1%	Overweight / C
RWE STAMM	Utilities	€ 62.43	3.5%	5.6%	9.8%	1.5%	2.1%	Equal-Weight / C
CENTRICA	Utilities	£ 2.57	3.5%	5.1%	5.0%	7.1%	1.6%	Equal-Weight / C
E. ON	Utilities	€ 27.00	3.6%	4.9%	7.5%	4.0%	1.3%	Equal-Weight / C
GDF-SUEZ	Utilities	€ 28.93	3.6%	4.8%	9.5%	12.6%	1.2%	Overweight / C
EDP ENERGIAS DE PORTUGAL	Utilities	€ 3.04	4.0%	5.0%	7.3%	10.1%	1.0%	Equal-Weight / C
EDISON ORD	Utilities	€ 1.04	3.9%	4.6%	8.7%	11.6%	0.7%	Equal-Weight / C
IBERDROLA	Utilities	€ 6.41	3.9%	4.4%	8.5%	9.4%	0.5%	Equal-Weight / C

Note: Equity Carry Stocks are those with both 2010 ModelWare and IBES dividend yield greater than the stock's implied 5yr credit yield. Implied 5yr credit yield = stock's 5yr credit default swap plus 5yr swap rate in euros and sterling (50/50 weight). Screen updated as of 27 November 2009. Source: Markit iBoxx, MSCI, IBES, Bloomberg, Morgan Stanley Research. A = Attractive; I = In-line; C = Cautious; "-" Not covered by Morgan Stanley. ++ The rating for this company has been removed from consideration in this report because, under applicable law and/or Morgan Stanley policy, Morgan Stanley may be precluded from issuing such information with respect to this company at this time. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures. Prices updated as of 24 November 2009.

Exhibit 44

A value screen based on private equity criteria

Stock	Sector	Price (lc)	Market Cap ($mn)	FCF/ EV Yield	EV/ Fixed Assets	P/BV 2009	EBIT/ Int. Paid	Div Yld 2009	TOTAL
OESTERREICHISCHE POST	Transportation	€ 18.20	1,978	9.7	1.7	2.0	17.5	7.8	1
PARMALAT	Food Beverage & Tobacco	€ 1.96	4,742	7.5	3.2	1.1	16.6	5.3	2
GAME GROUP	Retailing	£ 1.57	847	16.9	2.6	1.5	14.7	4.0	3
SEMPERIT AG HOLDING	Automobiles & Components	€ 26.37	726	7.7	2.5	1.6	168.9	4.3	4
A2A	Utilities	€ 1.28	5,810	5.4	1.9	1.0	11.0	7.9	5
INT'L POWER	Utilities	£ 2.80	6,374	10.1	1.3	0.9	2.5	4.8	6
ENI	Energy	€ 16.73	99,933	12.9	1.4	1.3	3.3	5.9	7
VIVENDI	Media	€ 19.39	34,294	7.3	5.0	1.0	11.6	7.4	8
DRAX GROUP	Utilities	£ 4.20	2,797	12.2	1.4	2.0	16.4	3.1	9
DEUTSCHE TELEKOM	Telecommunication Services	€ 9.85	59,780	8.4	1.9	1.0	2.2	8.4	10
BAE SYSTEMS	Capital Goods	£ 3.31	18,351	14.5	4.3	1.5	9.6	5.1	11
ASCOPIAVE	Utilities	€ 1.55	570	5.1	1.4	1.1	6.9	5.5	12
THOMAS COOK GROUP	Consumer Services	£ 2.16	2,896	20.8	2.1	0.9	1.6	5.1	13
GAS NATURAL SDG	Utilities	€ 13.97	18,625	6.2	1.8	1.2	5.8	5.8	14
FRED. OLSEN ENERGY	Energy	NKr 221.00	2,599	7.4	2.0	2.3	12.8	11.3	15
FORTUM CORP	Utilities	€ 17.01	21,142	7.0	1.6	1.7	6.3	5.8	16
COMPUTACENTER	Software & Services	£ 2.55	715	10.9	4.2	1.3	19.5	3.1	17
PUBLIC POWER CORP	Utilities	€ 13.30	4,775	6.7	0.7	0.6	-1.0	6.7	17
WARTSILA B	Capital Goods	€ 25.30	3,593	12.3	6.7	1.7	20.1	5.1	19
KUONI REISEN NAMEN B	Consumer Services	SFr 329.50	971	8.2	2.9	1.6	50.9	2.9	20
BALFOUR BEATTY	Capital Goods	£ 2.57	3,000	14.7	5.1	1.9	18.5	4.5	21
HOLMEN B	Materials	SKr 176.00	1,713	6.3	0.8	1.0	3.1	4.6	22
EADS	Capital Goods	€ 11.98	15,369	32.8	0.2	0.9	4.6	1.6	23
SANOFI-AVENTIS	Pharmaceuticals Biotechnology & Life	€ 51.20	96,572	11.9	9.6	1.4	14.2	4.8	24
FRANCE TELECOM	Telecommunication Services	€ 17.33	65,887	9.3	3.1	1.6	3.9	8.3	25
SULZER	Capital Goods	SFr 79.55	2,683	9.6	4.0	1.6	42.1	2.8	26
TECHNIP	Energy	€ 46.49	6,908	11.6	3.2	1.7	17.7	2.8	27
MEDION	Retailing	€ 8.05	509	9.8	5.5	0.9	38.2	2.1	28
BOUYGUES ORD	Capital Goods	€ 33.48	16,317	7.3	2.6	1.4	5.5	5.0	29
BP	Energy	£ 5.84	176,898	4.0	1.7	1.7	27.3	5.9	30
TELECOM ITALIA ORD	Telecommunication Services	€ 1.06	21,381	8.5	3.1	0.8	2.2	4.6	31
OSTASIATISKE KOMPAGNIS	Food Beverage & Tobacco	DKr 188.00	500	9.2	3.5	1.3	10.8	2.7	32
GUYENNE ET GASCOGNE	Food & Staples Retailing	€ 62.50	668	3.3	3.4	1.2	158.2	5.6	33
ENEL	Utilities	€ 4.03	56,260	6.4	1.5	1.3	2.9	6.2	34
GDF-SUEZ	Utilities	€ 28.55	95,047	4.8	1.3	1.1	4.3	5.4	35
MARSTON'S	Consumer Services	£ 0.85	815	4.4	0.9	0.4	1.9	8.4	35
ZODIAC AEROSPACE	Capital Goods	€ 23.16	1,890	9.0	9.1	1.0	7.4	3.9	37
GREENE KING	Consumer Services	£ 4.06	1,401	6.1	1.2	0.9	1.5	5.3	38
MAYR-MELNHOF KARTON	Materials	€ 67.00	2,081	6.9	2.2	1.4	18.0	2.7	39
TUI TRAVEL	Consumer Services	£ 2.44	4,296	15.3	2.6	1.0	-1.1	4.6	40

Note: The overall rank is the rank of the average rank across all metrics shown. This method is used as a valuation tool only, this is not intended as a list of potential takeover targets. Prices updated as of 27 November 2009. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.
Source: IBES, Worldscope, Morgan Stanley Research

Exhibit 45

European Model Portfolio

OVERWEIGHTS	Benchmark Weight (%)	Portfolio Over + / Under - Weight	Portfolio Position
Energy (SXEP) BG, Total, Tullow Oil, BP, Repsol, Saras, Wood Group	11.2	+3.0	14.2
Cons Staples (SX3P*) Nestle, Diageo, Danone, Imperial Tobacco, British American Tobacco, Anheuser-Busch Inbev	11.9	+2.0	13.9
Materials (Basic Resources SXPP & Chemicals SX4P) Rio Tinto[2], Akzo Nobel, Xstrata Syngenta	9.2	+2.0	11.2
Healthcare (SXDP) Novartis, Roche, Bayer, Sanofi	10.1	+1.0	11.1
Industrials (SXNP) BAE System, Ryanair, TNT, Alstom, Cobham	9.4	+0.0	9.4

UNDERWEIGHTS	Benchmark Weight (%)	Portfolio Over + / Under - Weight	Portfolio Position
Telco (SXKP) KPN, Telefonica, Vodafone	7.1	+0.0	7.1
Insurance (SXIP) Legal & General, Admiral	5.3	+0.0	5.3
Banks (SX7P) BBVA, Santander, Unicredit Credit Agricole, Popolare[1], SocGen	14.6	-1.0	13.6
Div Fin & Real Estate (SXFP* & SX86P) Credit Suisse	4.9	-1.0	3.9
Tech (SX8P) SAP, Cap Gemini	2.7	-1.0	1.7
Cons Discr (Autos SXAP & Media SXMP*) SES, Fiat, Adidas	7.3	-2.0	5.3
Utilities (SX6P) National Grid, A2A	6.3	-3.0	3.3

MSCI Sectors

	Benchmark Weight (%)	Portfolio Over + / Under - Weight	Portfolio Position
Energy	11.2	+3.0	14.2
Consumer Staples	11.9	+2.0	13.9
Materials	9.2	+2.0	11.2
Health Care	10.1	+1.0	11.1
Industrials	9.4	+0.0	9.4
Telecommunication Services	7.1	+0.0	7.1
Information Technology	2.7	-1.0	1.7
Financials	24.8	-2.0	22.8
Consumer Discretionary	7.3	-2.0	5.3
Utilities	6.3	-3.0	3.3

* The mapping between GICS Sectors (such as Healthcare) and DJ Stoxx SuperSectors - Level 3 (such as SXDP) is imperfect in places. In particular, less than two-thirds of market cap of Consumer Discretionary, Consumer Staples and Diversified Financials is covered by the corresponding DJ Stoxx Supersectors.
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3. The equity position is allocated as the European Equity Model Portfolio. Bonds are allocated equally between France, Germany, the Netherlands and the UK. The bond position is invested in ten-year paper of these countries.
Source: MSCI/Exshare, Morgan Stanley Research

Prices as of 27 November 2009: BG Group (1126 P) Total (€41.865) Tullow Oil (1243 P) BP (583.8 P) Repsol YPF (€18.505) Saras (€1.985) Wood Group (John) (309.1 P) Rio Tinto Plc (3089.5 P) Akzo Nobel (€42.95) Xstrata (1072 P) Syngenta (Sfr 267) KPN (KON.) (€11.79) Telefonica (€19.31) Vodafone Group (138.4 P) Legal & General Group (80.95 P) Admiral Group (1064 P) Novartis (Sfr 55.65) Roche Holding Genuss (Sfr 166.6) Bayer (€51.16) Sanofi-Aventis (€51.2) BBVA (€12.7) Banco Santander (€11.58) Unicredit Ord (€2.325) Credit Agricole (€14.035) Banco Popolare (€5.595) Credit Suisse (Sfr 52.9) SAP Stamm (€32.09) Cap Gemini Sa (€31.05) Nestle (Sfr 48.29) Danone (€40.28) Imperial Tobacco Group (1776 P) British American Tobacco (1850 P) Anheuser-Busch Inbev (€33.805) BAE Systems (331 P) Ryanair Holdings (€2.835) TNT (€19.56) Alstom (€47.9) SES (€14.41) Fiat Ord (€9.845) National Grid (658 P) Adidas (€37.84) Diageo (1030 P) Cobham (227.4 P) A2A (€1.282) Societe Generale (€46.5) BNP Paribas (€55.14) Julius Baer (Sfr35.00) GAM Holding (Sfr 12.25) Tesco (429 p) Glaxosmithkline (1279 p)

List of recent publications

Title	Date
Strong Earnings Momentum to Drive Further Upside for Metals & Mining	27 July 2009
IP Excerpt: Watch Rates, Inflation, China	29 July 2009
The Aftermath of Secular Bear Markets	10 August 2009
Upgrading European Earnings - Trough in 3Q09, 20% Growth in 2010	17 August 2009
Sellers' Compendium August-2009	24 August 2009
European Economics & Strategy: Poor State of Government Finances & Implications for Equities	1 September 2009
Euroletter: The Rally Is Not Over Yet	7 September 2009
Portfolio Review: Overweight Commodities, Value & Quality	14 September 2009
IP Excerpt: Making Energy Our Biggest Overweight	17 September 2009
Euroletter: Global Exposure Guide 2009	21 September 2009
IP Excerpt: Pharma Looks Too Cheap	23 September 2009
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Source: Morgan Stanley Research

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