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U.S. MARKET COMMENT: INSIDE THE U.S. EQUITY MARKET

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Inside the U.S. Equity Market - Green Shoots Among the Ruins

Mesmerized by the carnage in the Nasdaq Composite, many investors have neglected compelling values in other areas of the market. The persistent disparity among valuations across different sectors indicates the likelihood that high P/E stocks will continue to disappoint, while overlooked issues at the other end of the valuation spectrum should outperform.

Disparities and Misleading Impressions

Since last March, many areas of the market have been pummeled, while others have shown a surprising degree of resilience. Although 2000 saw a stunning surge in the percentage of stocks among all capitalization styles that *declined* 30% or 50% from their 52-week highs (see Tables A and B), the proportion of stocks that *rose* 10%, 30%, and 50% from their 52-week lows also increased dramatically (see Table C). Similarly, although the S&P 500's current P/E of 27.3 is down only modestly from its year-end 1999 multiple of 30.5, suggesting the potential for further pain if earnings continue to disappoint, there are many sectors and industry groups with substantially lower multiples. For example, while the P/E of the S&P 500's technology sector is 32.3, the transportation and financial sectors have much lower P/Es of 16.1 and 20.0, respectively. Disparate valuations among industry groups paint this picture in even starker terms. The multiple of the communication equipment and manufacturers group is 113.4; computers (network), 75.8; computers (peripherals), 87.6; entertainment, 160.0; biotech 56.6; and health care hospital management, 53.6. In contrast, the automobiles group has a P/E of 7.9; money center banks, 14.5; homebuilding, 8.4; and savings and loans, 14.3.

Furthermore, the proportion of lofty P/E stocks within the overall market is gradually shrinking. The number of S&P 500 stocks with P/Es above 30 has declined to 27.4% from 33.3% in 1998, while their market-cap weight has also fallen to 45.0% from 60.1% in 1999 (see Table D). Conversely, the number and weight of stocks that carry P/Es below 16 has increased from 1998 levels. Meanwhile, the middle continues to shrink. Whether computed on a cap-weighted or numerical basis, fewer stocks carry P/Es between 16 and 30 compared to 1998 and 1999.

The same phenomenon is evident in the Nasdaq Composite. The Nasdaq is down 45.1% from last March, but still carries a lofty P/E of 130.8 (see page 72 for Exhibit 172m). On a cap-weighted basis, 38.4% of the index has a P/E above 30, compared with 83.7% only six months ago; 25.9% with a P/E between 16 and 30, compared with 9.0%; and 35.7% with a P/E below 16, compared with 7.3% last July. On a numerical basis, 10.9% of Nasdaq companies carry a P/E above 30, compared to 26.4% six months ago; 11.0% between 16 and 30, compared with 19.4%; and 78.1% below 16, compared with 54.3% last

July. As these data indicate, a relatively small number of very large-cap stocks are responsible for the very high multiples at which the composite index sells, while the disparity between growth and value persists.

Routers vs. Washing Machines

In last July's *U.S. Market Update*, we illustrated the phenomenon of disparities among valuations by contrasting the assumptions built into the prices of two representative companies, Cisco and Sears. At that time, Cisco was priced at $62.5 and carried a P/E of 118, while Sears was priced at $31.0 and carried a P/E of 7.3. Analyzing the assumptions that underlay the long-term earnings growth expectations, at that time we calculated the net present value of Cisco to be $57.8 (7.5% below its price), and Sears $94.9 (206% above its price). Six months later, the price of Cisco has fallen 40.2%, while Sears has risen 25.0%.

Although this has obviously narrowed the valuation gap between these two representative stocks, investors may still be assuming overly optimistic earnings growth for bellwether tech issues like Cisco: for example, the current I/B/E/S consensus estimate of 32% earnings growth over the next three to five years looks increasingly unlikely in light of the company's recent announcements about stalled revenue growth and a probable decline in next quarter's earnings. With Cisco's P/E now at 72 and Sears at 10, we would continue to argue, as we did last July, that the potential for further disappointment in the large-cap technology stocks remains acute. The probability of sufficient earnings growth to validate the Nasdaq's P/E of 130.8 seems as remote as ever, while large swathes of the old economy have already discounted the considerable pain they will undoubtedly endure as the economy decelerates, and are therefore priced to outperform going forward. In summary, despite value's trouncing of growth last year, we suspect this was simply the first (albeit spectacular) innings in what will prove a continued reversion to the mean in favor of value.

Table A

MAJOR INDEX EQUITIES DECLINING 20%, 30%, 40%, 50% AND 90% FROM 52-WEEK HIGH

February 1, 2000 - January 31, 2001

Index	Equities		-20%+	-30%+	-40%+	-50%+	-90%+
S&P 500		Totals:	205	126	85	53	0
Count =	500	Percent:	41%	25%	17%	11%	0%
NYSE		Totals:	782	508	345	236	11
Count =	1924	Percent:	41%	26%	18%	12%	1%
Nasdaq Exchange		Totals:	3301	2926	2590	2235	446
Count =	4437	Percent:	74%	66%	58%	50%	10%
AMEX		Totals:	451	377	329	263	31
Count =	652	Percent:	69%	58%	50%	40%	5%

Source: Standard & Poor's Compustat.

Note: NYSE, AMEX, and Nasdaq Exchange are common stocks only, and exclude ADR's, preferred stock, and mutual funds.

Table B

S&P 500 SECTOR ANALYSIS: PERCENT OF EQUITIES BY SECTOR DECLINING 10%, 30% AND 50% FROM 52-WEEK HIGH

As of January 31, 2001

S&P 500

	Number of Companies				Percent of Sector (%)		
Economic Sector	Sector	-10%	-30%	-50%	-10%	-30%	-50%
Basic Materials	42	33	9	0	78.6	21.4	0.0
Capital Goods	50	29	9	1	58.0	18.0	2.0
Communication	12	12	7	6	100.0	58.3	50.0
Consumer-Cyclicals	75	46	16	2	61.3	21.3	2.7
Consumer-Staples	53	36	5	0	67.9	9.4	0.0
Energy	26	15	1	0	57.7	3.8	0.0
Financial	73	38	2	0	52.1	2.7	0.0
Health Care	39	32	9	1	82.1	23.1	2.6
Technology	81	78	65	40	96.3	80.2	49.4
Transportation	10	6	1	0	60.0	10.0	0.0
Utilities	39	33	2	2	84.6	5.1	5.1
Total	500	358	126	52	71.6	25.2	10.4

Large-Cap

	Number of Companies				Percent of Sector (%)		
Economic Sector	Large-Cap	-10%	-30%	-50%	-10%	-30%	-50%
Basic Materials	5	4	1	0	80.0	20.0	0.0
Capital Goods	14	8	0	0	57.1	0.0	0.0
Communication	11	11	7	6	100.0	63.6	54.5
Consumer-Cyclicals	20	13	5	1	65.0	25.0	5.0
Consumer-Staples	28	19	1	0	67.9	3.6	0.0
Energy	10	6	0	0	60.0	0.0	0.0
Financial	41	22	1	0	53.7	2.4	0.0
Health Care	19	14	2	0	73.7	10.5	0.0
Technology	44	41	33	20	93.2	75.0	45.5
Transportation	4	1	0	0	25.0	0.0	0.0
Utilities	11	10	0	0	90.9	0.0	0.0
Total	207	149	50	27	72.0	24.2	13.0

Mid- to Small-Cap

	Number of Companies				Percent of Sector (%)		
Economic Sector	Mid- to Small-Cap	-10%	-30%	-50%	-10%	-30%	-50%
Basic Materials	37	29	8	0	78.4	21.6	0.0
Capital Goods	36	21	9	1	58.3	25.0	2.8
Communication	1	1	0	0	100.0	0.0	0.0
Consumer-Cyclicals	55	33	11	1	60.0	20.0	1.8
Consumer-Staples	25	17	4	0	68.0	16.0	0.0
Energy	16	9	1	0	56.3	6.3	0.0
Financial	31	15	1	0	48.4	3.2	0.0
Health Care	20	18	7	1	90.0	35.0	5.0
Technology	37	37	32	20	100.0	86.5	54.1
Transportation	6	5	1	0	83.3	16.7	0.0
Utilities	28	23	2	2	82.1	7.1	7.1
Total	292	208	76	25	71.2	26.0	8.6

Source: Calculated from data provided by Standard & Poor's Compustat.

Notes: For the purposes of these analyses, large-capitalization equities are defined as issues with capitalizations of greater than $10,980 million. Mid- to small-capitalization equities are defined as the remaining issues in the S&P 500.

Table C

MAJOR INDEX EQUITIES INCREASING 20%, 30%, 40%, 50% AND 90% FROM 52-WEEK LOW

February 1, 2000 - January 31, 2001

Index	Equities		20%+	30%+	40%+	50%+	90%+
S&P 500		Totals:	475	433	385	296	105
Count =	500	Percent:	95%	87%	77%	59%	21%
NYSE		Totals:	1762	1552	1321	1059	424
Count =	1924	Percent:	92%	81%	69%	55%	22%
Nasdaq Exchange		Totals:	4126	3808	3448	3079	1781
Count =	4437	Percent:	93%	86%	78%	69%	40%
AMEX		Totals:	560	493	432	369	222
Count =	652	Percent:	86%	76%	66%	57%	34%

Source: Standard & Poor's Compustat.

Note: NYSE, AMEX, and Nasdaq Exchange are common stocks only, and exclude ADR's, preferred stock, and mutual funds.

Table D

S&P 500 PRICE-EARNINGS RATIOS

		Number of Companies/ Percentage of S&P 500	Percentage of S&P 500 by Market Capitalization
December 31, 2000			
30 and above		127 / 27.4	45.0
16 and below		170 / 36.7	16.3
Median P/E	**20.0**		
December 31, 1999			
30 and above		149 / 31.8	60.1
16 and below		163 / 34.8	11.5
Median P/E	**20.4**		
December 31, 1998			
30 and above		144 / 33.3	54.8
16 and below		101 / 23.3	7.7
Median P/E	**23.1**		

Source: Calculated from data provided by Standard & Poor's Compustat.

Notes: Price-earnings ratio analyses excludes companies with deficit or collapsed earnings. Percentages may not total 100% due to missing, incomplete, or not meaningful data.