

C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT: EUROPEAN EQUITY VALUATIONS

May 2002

Celia Dallas
Robert Lang
William Nasgovitz

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European Equity Valuations

Between year-end 1999 and April 30, 2002, U.K. equities fell 20.6% and continental European equities fell 24.2%. At the start of this bear market, both U.K. and continental European equities were overvalued. Now, two years and four months into a bear market, shares in both regions are much closer to fair value and U.K. equities appear relatively less expensive.

Valuations Then

At the end of 1999, U.K. equities were less expensive than those of the Continent on the basis of price-to-earnings (P/Es) ratios and dividend yields, about equally valued on the basis of price-to-book (P/Bs) ratios, and slightly more expensive on the basis of price-to-cash earnings (P/CEs) ratios. However, equities in both the United Kingdom and in Europe were overvalued. As shown in Table A, the P/E ratio of the MSCI U.K. Index was 26.1, and that of the MSCI Europe ex U.K. Index was 32.2—both more than two standard deviations above their post-1980 averages. P/CE and P/B ratios were also well above their long-term averages, while dividend yields were well below.

Because accounting standards, risk tolerances, and the acceptance of equities vary across countries in Europe, valuations in the United Kingdom and the Continent differ, even on average over relatively long time horizons. For example, since 1980, relative to the Continent, U.K. equities have traded at P/Es approximately 15% lower and P/CEs approximately 40% higher. Therefore, it is also useful to evaluate the ratio of U.K. valuation metrics to those of the Continent to determine if these ratios are above or below their historical averages. On this basis, U.K. equities ended the bull market with relatively lower valuations than those of the Continent on the basis of all four valuation metrics examined (see Table B).

Valuations Now

As of April 30, 2002, valuations in both regions are much improved. P/E ratios in the United Kingdom fell nearly 25% to 19.7, while those of the Continent fell almost 15% to 27.6. Valuation metrics in both regions fell from roughly two to three standard deviations above their long-term averages to a maximum of approximately 1.5 times at present (see Table A). While prices in both equity markets fell comparable amounts, U.K. equity fundamentals held up relatively well during the global economic slowdown, making them a slightly better value today than they were at the end of 1999 relative to continental European equities. For example, between December 31, 1999 and April 30, 2002, earnings per share increased 5.1% in the United Kingdom, compared to an 11.5% decline in continental European earnings, based on the MSCI indexes. In both regions, book values and cash earnings increased over the period,

expanding at a faster rate in the United Kingdom than in the remainder of Europe. The notable exception to this trend is dividends, which fell 6.8% in the United Kingdom, but increased 17.5% in Europe over the same period.

P/Es based on consensus earnings expectations for the next 12 months are comparable for the United Kingdom and other major European markets. The forward P/E for the United Kingdom is 22.6, compared to 24.4 for Germany, 21.1 for France, and 20.1 for Italy, according to Thomson Financial. However, as would be expected, earnings growth expectations for the next 12 months vary significantly across Europe, with Germany (85%), Norway (60%), and Sweden (60%) at the high end, and Finland (0%), Spain (10%), and Ireland (10%) at the low end. The United Kingdom falls near the median, with earnings growth expectations of 22%. While it is reasonable to assume that the countries that experienced the greatest decline in earnings will benefit the most from an economic recovery, these markets are subject to a high degree of risk that earnings will fail to meet the aggressive expectations of 60%+ growth over the next 12 months or so.

Coming into this bear market, both U.K. and continental European equities were expensive, while U.K. equities were slightly less expensive than those of the remainder of Europe. Two years and four months into a bear market, both U.K. and continental European equities are much closer to fair value, with U.K. equity valuations generally falling further. However, valuation metrics provide somewhat mixed results, with P/Es, P/CEs, and P/Bs ratios falling more for U.K. equities than for those of the Continent, and dividend yields of continental European equities improving more than those of the United Kingdom.

We remain cautiously optimistic about investing in European equities. While we characterize U.K. and continental European equities as fairly valued, they are at the high end of our fair-value range. Nonetheless, European equity valuations did not get as stretched as those of their U.S. counterparts in the late-1990s, and remain much less extended today. However, downside risk remains, as history has demonstrated time and time again that valuations often move from fairly valued to undervalued before bear markets come to an end.

Table A

**MSCI U.K. AND EUROPE EX U.K. INDEX VALUATIONS AT THE
START OF THE BEAR MARKET AND TODAY**

31 December 1979 - 30 April 2002

	MSCI U.K.		MSCI Europe ex U.K.	
	<u>31 Dec 99</u>	<u>30 Apr 02</u>	<u>31 Dec 99</u>	<u>30 Apr 02</u>
Price-earnings	26.1	19.7	32.2	27.6
Mean	13.5	14.3	16.4	17.1
Number of Standard				
Deviations Above Mean	2.8	1.1	2.5	1.6
Price-cash-earnings	17.9	11.4	16.2	11.0
Mean	8.3	8.9	6.1	6.7
Number of Standard				
Deviations Above Mean	3.3	0.8	3.7	1.4
Price-to-book	4.1	2.2	4.3	2.5
Mean	2.0	2.1	1.7	1.9
Number of Standard				
Deviations Above Mean	2.5	0.1	3.4	0.6
Dividend Yield	2.2	2.6	1.5	2.3
Mean	4.5	4.3	3.5	3.4
Number of Standard				
Deviations Below Mean	2.0	1.3	1.5	0.8

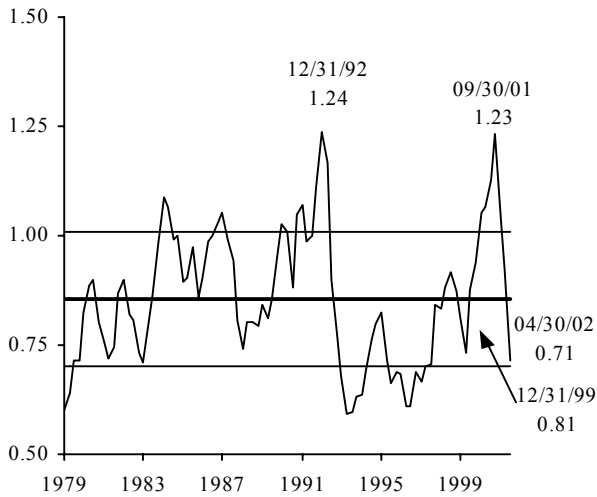
Source: Thomson Financial Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Table B

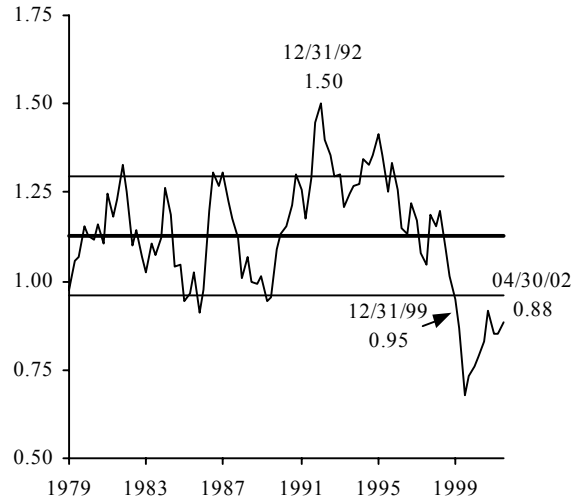
RELATIVE VALUATIONS: MSCI U.K. TO EUROPE EX U.K.

31 December 1979 - 30 April 2002

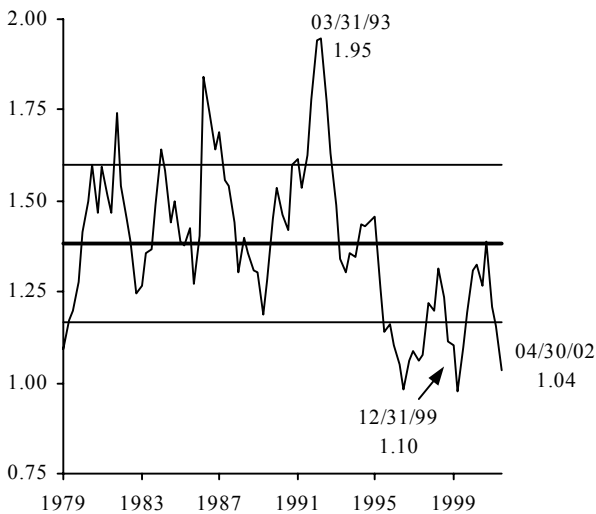
Price-Earnings



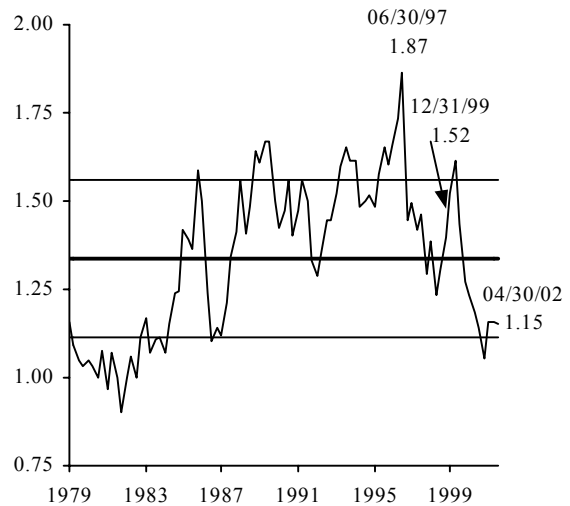
Price-to-Book Value



Price-to-Cash Earnings



Dividend Yield (%)



—	Mean
- - -	One Standard Deviation

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