



December 18, 2000

EQUITY MARKETS: TURNING OFF THE ALARM BELL

Key Points

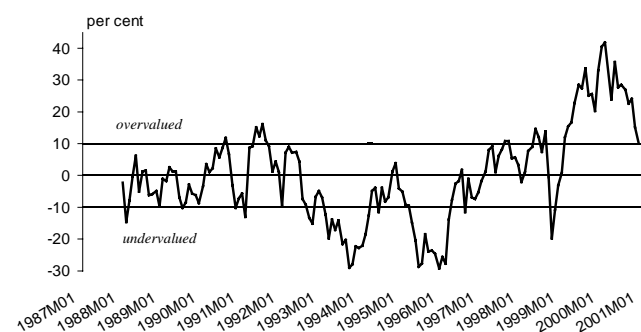
- The slide of the equity market has taken prices to more earthly levels.
- By the widely tracked Fed valuation model, neither the S&P 500 nor the TSE 300 indexes are now overvalued.
- However, we prefer an alternative yardstick. By our proprietary model, the S&P 500 is now 10% below fair value.
- The Canadian market is even more attractive, roughly 20% undervalued. These are the cheapest levels recorded since the 1998 liquidity crisis.
- While attractive valuation is no guarantee of a market rebound, this type of exercise does help to put things in perspective.

Time to freshen up those equity valuation tools?

There's a positive angle in the otherwise depressing story of North American stock markets in Y2K. Earlier this year, valuation gauges were flashing red lights. The subsequent slide has taken prices to more earthly levels. Can we turn off the alarm bell?

(1) S&P 500: No Longer Extremely Overvalued

% deviation from fair value by Fed model



Source: NBF Economic Research

The Fed valuation model

The signal provided earlier this year by the Fed model for S&P 500 valuation was a major cause for concern for many equity investors. Today, the same model says the chunk of the current P/E multiple that cannot be explained by fair valuation is much smaller (10%), suggesting that the S&P 500 is no longer extremely overvalued. This is comforting news.

Valuation from a different angle

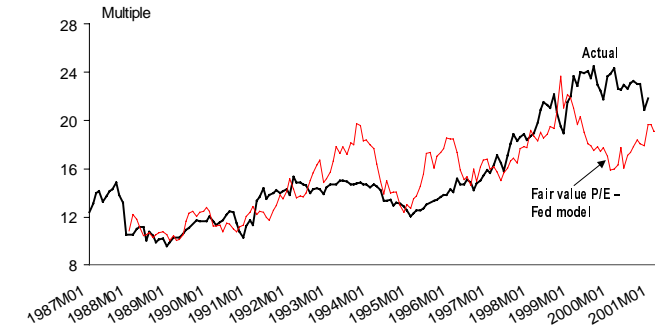
But is the Fed model an appropriate gauge of fair value? It uses a single determinant, the 10-year bond yield. As chart 2 illustrates, the fit between actual P/E and the fair-value P/E estimated from the Fed model is pretty loose. Could there be more to the story?

Economic and Strategy Group :

Clément Gignac (Chief Economist and Strategist) • Vincent Lépine (Senior Economist)
Stéphane Marion (Economist) • Leo Kolivakis (Economist)

(2) A Loose Fit

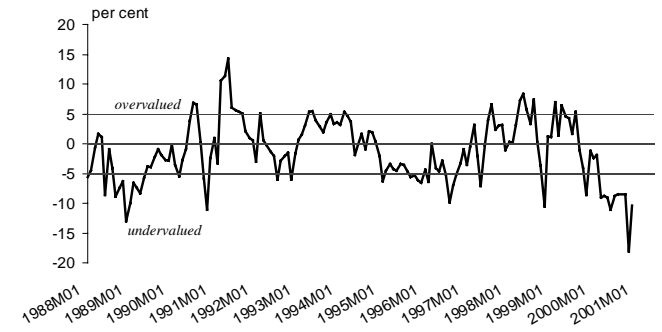
Fair-value P/E by the Fed model and actual forward P/E of the S&P 500



Source: NBF Economic Research

(4) S&P 500: Attractive Valuation

% deviation from fair value by NBF model

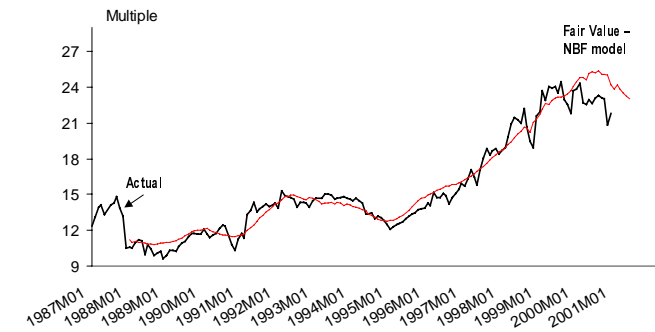


Source: NBF Economic Research

We believe so. Our proprietary S&P 500 valuation model adds four other variables to the story – inflation, liquidity, long-term earnings growth and financial risk. When these variables are folded into the equation, we come much closer to explaining recent P/E movements.

(3) An Alternative Yardstick

Fair-value P/E by the NBF model and actual forward P/E of the S&P 500



Source: NBF Research

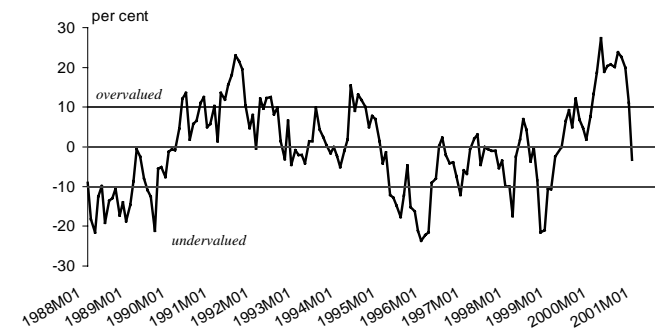
U.S. equities undervalued?

Chart 3 plots our estimated fair-value P/E for the S&P 500 along with the actual forward P/E. As can be seen, this model tracks the S&P 500 P/E much more closely, suggesting that the breathtaking expansion of the multiple in recent years has been warranted by economic and financial conditions. In other words, the rise in the risk premium has been more than offset by the decline in inflation expectations, the secular downtrend in bond yields, plentiful liquidity and ongoing optimism about long-term earnings growth.

By this reckoning, the market’s brutal retreat over the course of the year has left the S&P 500 about 10% undervalued – a signal very different from that of the Fed model.

(5) TSE 300: Slightly Undervalued ...

% deviation from fair value by Fed model



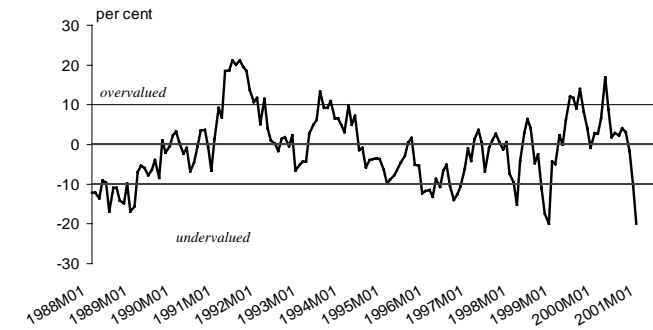
Source: NBF Economic Research

What about the TSE 300?

Turning to equity valuation in Canada, we find that by the Fed model, using only the 10-year bond yield, the TSE 300 is now 3% undervalued. This is quite a contrast from the 20% overvaluation reading of just three months ago.

(6) ... Or Marked Way Down?

% deviation from fair value by NBF model



Source: NBF Economic Research

We then applied our in-house valuation yardstick, using the same determinants as for the S&P 500. Again, it tracks the index P/E much more accurately.

By this model, Canadian equities are 20% undervalued at current P/Es – even more attractive than U.S. equities.

Bottom Line: turning off the alarm bell

The slide of the equity market has taken prices to more earthly levels. By our proprietary model, the S&P 500 is now 10% below fair value. The Canadian market is even more attractive, roughly 20% undervalued. These are the cheapest levels recorded since the 1998 liquidity crisis. Of course, the fact that valuation is attractive at current levels is no guarantee of a market rebound. This type of exercise does, however, help to put things in perspective.

Vincent Lépine

Vincent.lepine@nbfinancial.com

ECONOMIC CALENDAR : CANADA &
UNITED STATESThe Week Ahead
(December 18 - December 22)

US Indicators

Date	Time	Release	Month	Previous	Estimate	
					Consensus	NBF
19-Dec	08:30	Trade balance	October	\$34.95 B	\$34.95 B	\$34.95 B
19-Dec	14:00	FOMC Meeting		6.5%	6.5%	6.5%
20-Dec	08:30	Housing Starts	November	1.53 M	1.54 M	1.51M
21-Dec	08:30	GDP	2000Q3	2.4%	2.4%	2.4%
22-Dec	08:30	Durable goods	November	-5.5%	2.0%	0.0%

Canadian Indicators

Date	Time	Release	Month	Previous	Estimate	
					Consensus	NBF
18-Dec	08:30	Manufacturing Shipments	October	-1.0%	0.30%	0.2%
18-Dec	08:30	Inventories	October	1.0%	0.6%	0.5%
18-Dec	08:30	Unfilled orders	October	-0.8%	0.3%	0.1%
18-Dec	08:30	New orders	October	-1.6%	0.8%	0.3%
18-Dec	08:30	I/S ratio	October	1.34	1.34	1.35
19-Dec	08:30	Exports	October	\$34.95 B	\$35.1 B	\$35.0 B
19-Dec	08:30	Imports	October	\$30.65 B	\$30.8 B	\$30.74 B
19-Dec	08:30	Trade balance	October	4.3 B	4.2 B	4.3 B
19-Dec	08:30	Wholesale sales	October	-0.9%	0.5%	0.3%
19-Dec	08:30	Inventories	October	0.5%	0.30%	0.3%
20-Dec	08:30	Retail Sales	October	0.4%	0.0%	0.1%
20-Dec	08:30	<i>excl. autos</i>	October	0.4%	0.5%	0.2%
21-Dec	08:30	Help-wanted Index	December	181	182	178
22-Dec	08:30	GDP (factor cost)	October	0.0%	0.3%	0.2%

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