IIF Weekly Insight

COVID-19 hammers equity valuations

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Emre Tiftik, Director of Sustainability Research, etiftik@iif.com
Paul Della Guardia, Financial Economist, pdellaguardia@iif.com
Jadranka Poljak, Policy Advisor, jpoljak@iif.com
Katherine Standbridge, Research Assistant, kstandbridge@iif.com

Editor: Sonja Gibbs, Managing Director and Head of Sustainable Finance, sgibbs@iif.com

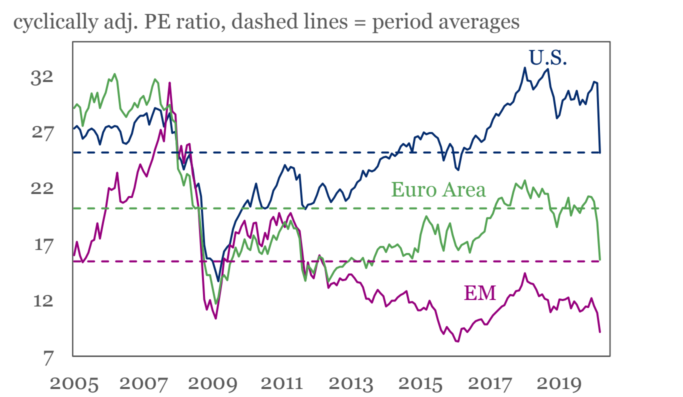
- COVID-19 sends equity valuations plummeting worldwide: the U.S. cyclically adjusted P/E ratio (price to average long-term real earnings) is just below its long-term average, while Germany, France and EMs CAPEs are already near historic lows
- While earnings multiples are below 2012-19 averages in most markets, valuations in Spain and Italy still look stretched
- Emerging market stocks are trading far below historical valuations, battered by uncertainty about disease preparedness and the outlook for capital flows, debt sustainability, economic recovery, export/tourism revenues, supply chains...
- Across low and lower-middle income countries, nearly 65% of public external debt is denominated in USD

Quagmire: The COVID-19 pandemic has erased more than $18 trillion from the value of global equities year to date, bringing the world's stock market capitalization down 20% to under $70tn. While a combination of aggressive monetary and fiscal policy responses over the past two weeks has helped to recoup some earlier losses, persistent uncertainty over the impact of COVID-19 has kept cross-asset volatility at very high levels. With both retail and institutional investors hoarding cash at an exceptional pace (U.S. money market fund assets hit $4.2tn last month, up from $3.6tn in Feb), lack of visibility on corporate earnings and anticipated job losses is undermining investor appetite for risk assets—particularly for stocks.

The prospect of prolonged economic disruption from COVID-19 has already prompted analysts to slash this year's corporate earnings estimates (or more accurately, guesstimates) by over 10%, varying from 5% in China to over 25% in Latin America. Year-to-date downward revisions across mature markets have been sharper in Canada (13%) and the Euro Area (12%) than in the U.S. (8%) and Japan (7%). Highlighting the point-in-time nature of the COVID-19 shock, analysts are now cutting earnings predictions much faster than they did during the 2008-09 global financial crisis. At the time, it took over seven months to see the same level of reduction in earnings estimates from the peak in mid-January 2008.

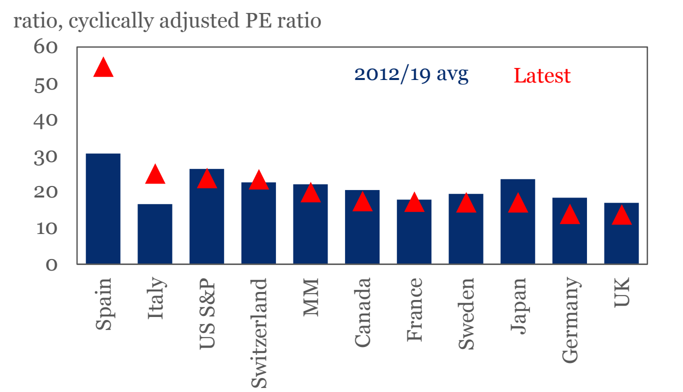
Given the wide variation in potential COVID-19 scenarios, it appears more difficult to value stocks through traditional forward-looking earnings-based measures. In this context, the cyclically adjusted price-to-earnings (CAPE - Chart 1) may be a better reflection of long-term valuation trends, as it measures the fair value of stock prices as a share of inflation-adjusted average earnings over the preceding 10 years. A few observations based on recent trends in CAPE ratios:

Chart 1: Stock valuations plummet as pandemic intensifies



*Source: Bloomberg, IIF; *average of Germany and France*

Chart 2: Cyclically adjusted equity valuations in Spain and Italy remain stretched even after the COVID-19 correction



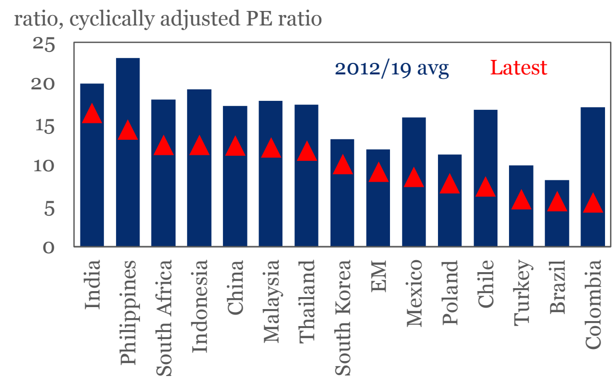
Source: Bloomberg, IIF

- **U.S. valuations at multi-year lows:** The sharp sell-off in U.S. equities has brought CAPE ratios below their 2005/19 average. Despite the abrupt correction, valuations remain well above the lows of the 2008/9 crisis (reflecting in part the expected boost from fiscal and monetary stimulus). Of note, it took over four years to regain pre-crisis valuations after the 2008/9 crisis.
- **European stocks at a 40% discount to U.S. peers**, with multiples for many Euro Area firms now at or near the lows of the 2008/9 global crisis and the 2011/12 Euro Area debt crisis. With CAPE valuations for Germany and France currently at their lowest since the 2013 taper tantrum, most European stocks now trade at a 40% discount to their U.S. peers.
- **Valuations still look stretched in Spain and Italy:** Compared to historical patterns, CAPE valuations for Spain and Italy are among the most misaligned in Europe, highlighting the risk of further price volatility (Chart 2).
- **Deeply discounted EM valuations:** Amid sharp portfolio equity outflows and tangible FX liquidity risks for highly indebted EM corporates, emerging market stocks on average currently trade far below historical averages (Chart 3) and at the biggest discount ever compared to U.S. stocks (some 65%). While valuations at these levels are compelling from a long-term perspective, concern about the outlook for growth and commodity prices—coupled with the immediate threat of the virus for under-developed healthcare systems—will weigh on risk appetite. Of note, the positive correlation between EM stocks and commodity prices remains near all-time highs.

Looming threat of sovereign debt distress: With an increasing number of countries turning to IMF emergency facilities for help in combatting COVID-19, the cost of insuring sovereign bonds against default has risen sharply for many emerging markets and low-income countries. Energy exporters have been worst hit, with CDS spreads rising over 750bp in Angola, Ecuador, Nigeria, and Zambia.

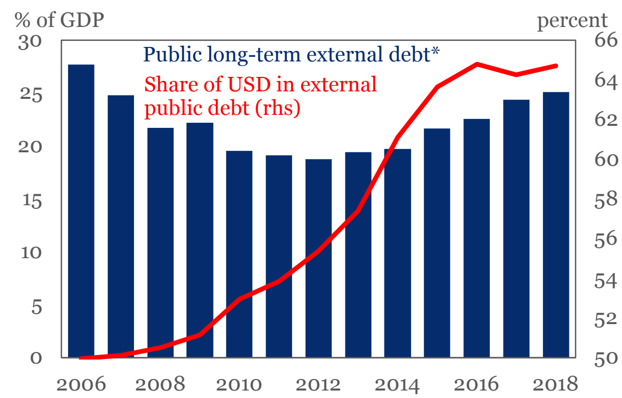
With outstanding public and publicly guaranteed long-term external debt of over 25% of GDP, many low and lower-middle income countries now face much higher debt servicing costs than a decade ago. Facing the prospect of a sharp contraction in global trade and remittance flows, the strength of the USD represents a major challenge for many sovereigns. Nearly 65% of public and publicly guaranteed external debt in low income countries is in USD (Chart 4). A closer look at high frequency data on sovereigns' borrowing shows that nearly $180 billion of bonds and loans will mature across the 89 low and low-middle income countries of our sample through the end of this year, with African countries responsible for nearly half of the total (Chart 5).

Chart 3: Emerging market stocks trade at record discounts to historical averages



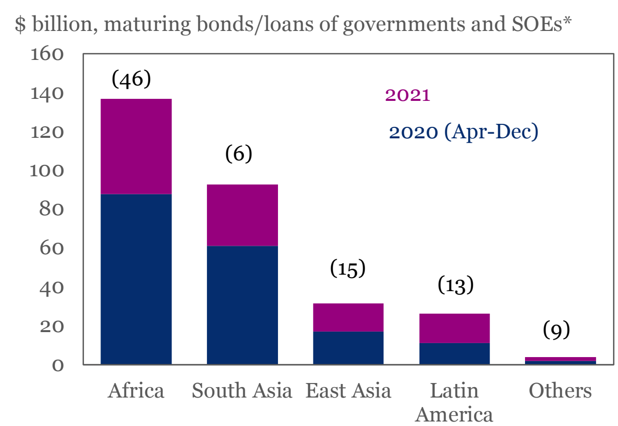
Source: Bloomberg, IIF

Chart 4: Low-income countries face heavy external debt burdens—amid high demand for U.S. dollar liquidity



Source: World Bank, IIF; includes publicly guaranteed debt

Chart 5: Fragile African countries face heavy redemption of nearly $140 billion through the end of 2020



*Source: Bloomberg, IIF; *number of countries in parentheses*

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