

Flash Economics

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At what level of abnormal undervaluation of equity markets has a correction started in the past?

Equity valuation in the United States and the euro zone is becoming abnormally low, while companies' financial situation remains very positive. At a certain level of undervaluation, the equity market must therefore rise again. We seek to determine when this configuration has already been seen in the past, and at what abnormally low valuation level a correction started.

When the PER falls to 14-15 in the United States and 11-12 in the euro zone, when the equity risk premium reaches around 6%, the undervaluation of equities relative to the fundamentals corrected in the past and the equity market picked up again. We are currently in this zone.

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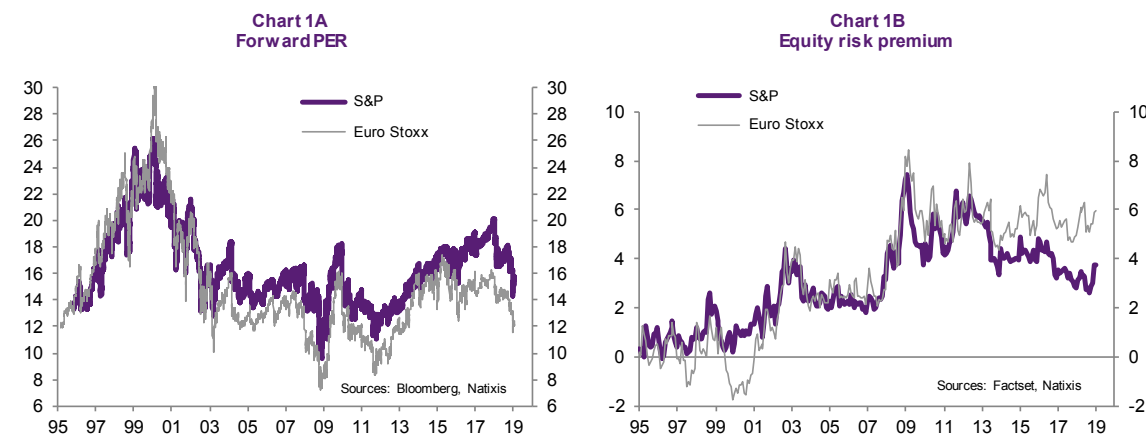
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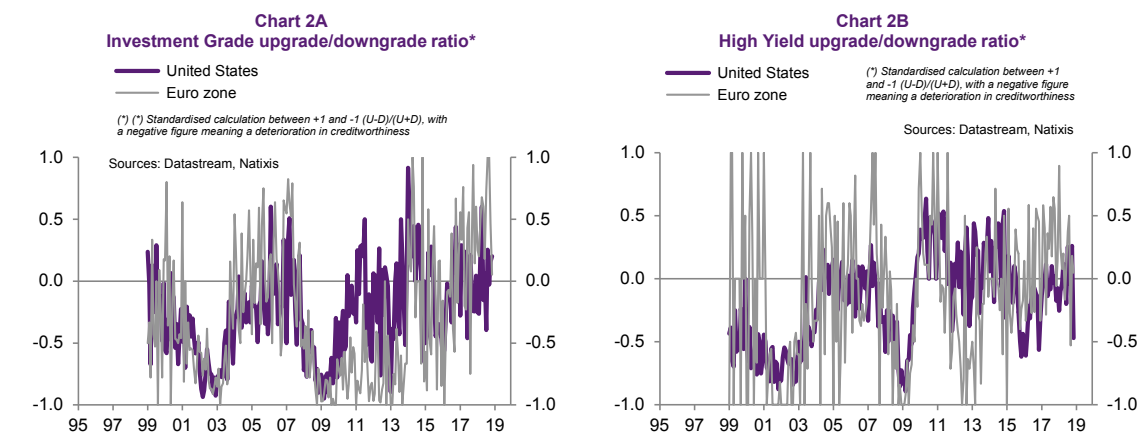
Low equity valuation despite companies' good financial situation

We look at the situations of the **United States and the euro zone**.

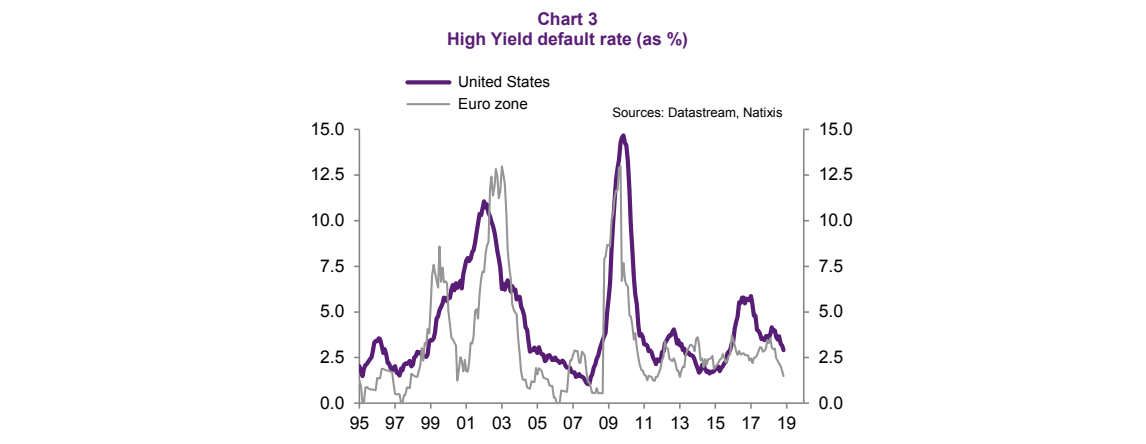
Equity valuation is currently low (Charts 1A and B), which is shocking since companies' financial situation remains very good:



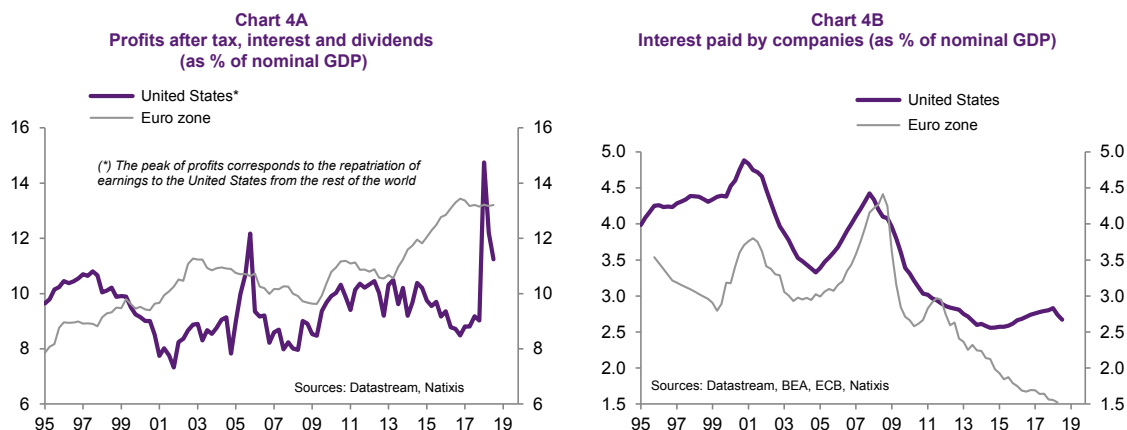
- **Improving ratings (Charts 2A and B), except for High Yield in the United States in the most recent period;**



- **Declining defaults (Chart 3);**



- **High profitability (Chart 4A)**, especially given the low level of interest paid on debt (**Chart 4B**).



Given this abnormally low level of equity valuation, we seek to determine **when there will be a correction**.

Have we already seen this configuration in the past?

We seek to determine:

- **Whether we have already seen a configuration in the past where the valuation of companies was low while their financial situation was good;**
- **At what level of undervaluation of equities there was then a correction.**

1- Have we already seen a similar configuration?

Charts 5A, B, C and D show that there was a decline in equity valuation in the United States while credit quality was good **from 2003 to 2005 and from 2009 to 2011**.

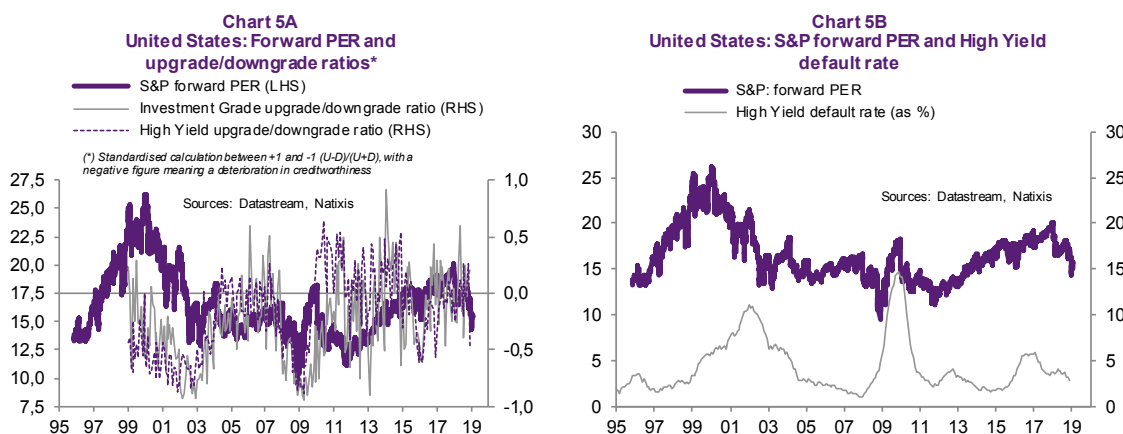


Chart 5C
United States: S&P equity risk premium and upgrade/downgrade ratios*

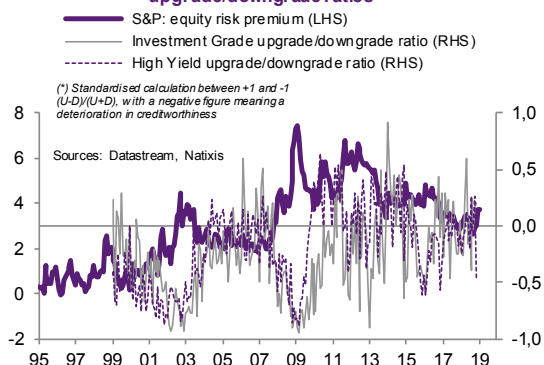
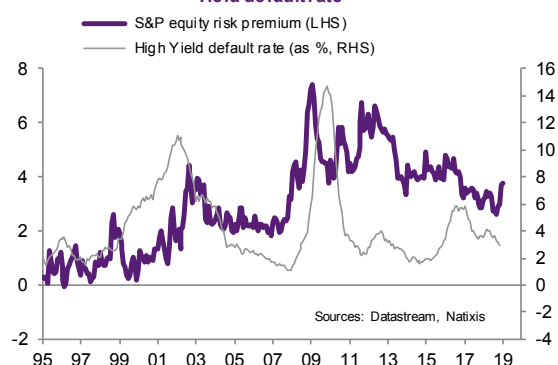


Chart 5D
United States: S&P equity risk premium and High Yield default rate



Charts 6A, B, C and D show that there was a decline in equity valuation in the euro zone while companies' financial situation was good from 2003 to 2005 and in 2010-2011.

Chart 6A
Euro zone: Forward PER and upgrade/downgrade ratios*

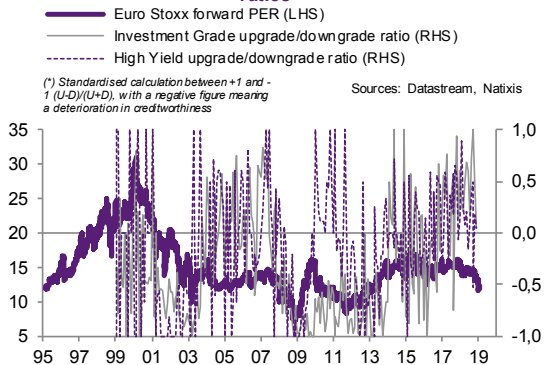


Chart 6B
Euro zone: Euro Stoxx forward PER and High Yield default rate

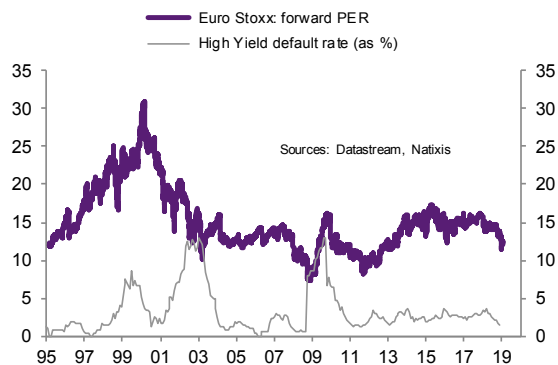


Chart 6C
Euro zone: Euro Stoxx equity risk premium and upgrade/downgrade ratios*

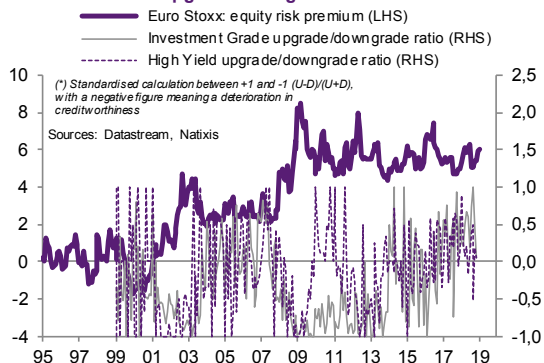
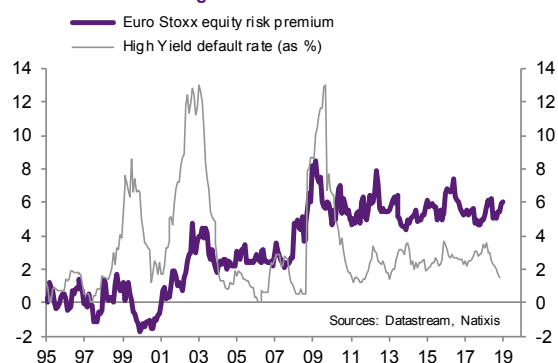


Chart 6D
Euro zone: Euro Stoxx equity risk premium and High Yield default rate



2- At what level of undervaluation was there a correction?

An abnormally low valuation of equities appeared in the United States from 2003 to 2005 and from 2009 to 2011 (see above, **Charts 5A, B, C and D**). **This low valuation corrected when the PER reached 14-15 and when the equity risk premium reached 3% in 2005 and 6% in 2012.**

An abnormally low valuation of equities appeared in the euro zone from 2003 to 2005 and in 2010-2011 (see above, **Charts 6A, B, C and D**). **This low valuation corrected when the PER reached 11-12 and when the equity risk premium reached 3% in 2005 and then 6.5% in 2012.**

Conclusion: Are we now far from the start of an equity market recovery?

Equity markets in the United States and the euro zone have fallen markedly in the recent period while companies' fundamentals are very good.

When this kind of inconsistency happened in the past, the equity market started to rise when the PER had fallen to 14-15 in the United States and 11-12 in the euro zone and the equity risk premium had risen to as much as 6%.

This shows that the equity market is now in the zone where it is likely to pick up.

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