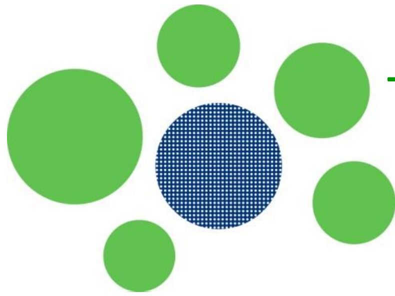

The COVID-19 Stock Market Downturn: Expected Growth or Discount Rate?

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The conclusion, that stock returns are largely affected by a change in the implied growth rate, and only to a lesser extent by a change in discount rate, is relevant also for the valuation of non-listed companies.

In June 2020, Pascal Böni (Tilburg University) and Heinz Zimmermann (University of Basel) issued a paper "THE COVID-19 STOCK MARKET DOWNTURN: EXPECTED GROWTH OR DISCOUNT RATE?". They use the Gordon (1959) constant growth model to explain stock returns of S&P500 index constituents during the COVID-19 implied market downturn and subsequent V-shaped recovery.

Stock returns are largely affected by a change in the implied growth rate w and only to a lesser extent by a change in discount rate k, the latter typically used to explain stock returns in the classical asset pricing literature.

The authors reach this conclusion by using ordinary least squares (OLS) regressions of stock returns on the unobservable Gordon factors, which they estimate from firm level valuation ratios D/P, P/E and P/B.

The effects from a decrease in implied growth outweigh those from an in-crease in discount rate by a factor of approximately 1.6 to 1.7, implying the COVID-19 stock market downturn is of long-term rather than transitory character.

The authors evaluate the performance of the Gordon factors for an early period of the Global Financial Crisis (GFC) and find strong support for their observations.

Paul Mencke

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