The Dynamics of Value Comovement across Global Equity Markets**

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Abstract

The ratio between share price and current earnings per share, the Price Earning (PE) ratio, is widely considered to be an effective gauge of under/overvaluation of a corporation's stock. Arguably, a more reliable indicator, the Cyclically-Adjusted Price Earning ratio or CAPE, can be obtained by replacing current earnings with a measure of PERMANENT EARNINGS i.e. the profits that a corporation is able to earn, on average, over the medium to long run. In this study, we aim to understand the cross-sectional aspects of the dynamics of the valuation metrics across global stock markets including both developed and emerging markets. We use a time varying DCC model to exploit the dynamics in correlations, by introducing the notion of value spread between CAPE and the respective Market Index from 2002 to 2014 for 34 countries. Value spread is statistically significant during the 2008 crisis for asset allocation. The signal can be utilized for better asset allocation as it allows one to interpret the common movements in the stock market for under/overvaluation trends. These estimates clearly indicate periods of misvaluation in our sample. Furthermore, our simulations suggest that the model can provide early warning signs for asset mispricing in real time on a global scale and formation of asset bubbles.

Keywords: Asset Pricing, PE Ratio, CAPE, Price-Earning Ratio, Financial crisis, Value Portfolio, Equity Markets, DCC-GARCH Models.

JEL Classification: C58, G11, G15, G17

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