HIGHER GROWTH DOESN'T ALWAYS MEAN HIGHER RETURNS

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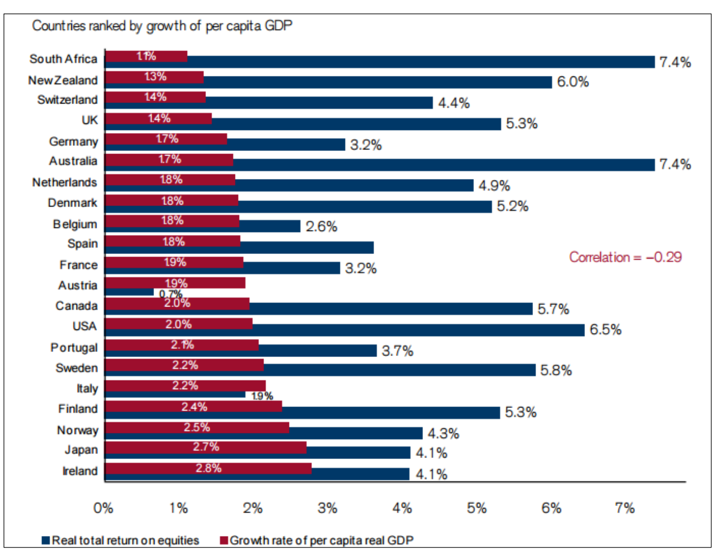
"The only function of economic forecasting is to make astrology look respectable."

John Kenneth Galbraith

Recent fears regarding Brexit and its potentially detrimental impact on economic growth have market prognosticators worried about the resulting side effects on financial markets. In the case that slower global economic growth ensues, equity market returns are not necessarily headed lower. There are many variables that affect future market returns, economic growth being just one. Given the several factors that affect future returns and one's ability to predict each accurately, investors must be careful not to over emphasize recent political or economic events in building their expected return assumptions.

Some are convinced that economies with faster growth result in outperforming equity markets. Looking at over 100 years of data, the overall correlation between equity returns and GDP per capita has actually been negative. A positive growth figure for GDP doesn't always result in a positive return for equities, and on average, the two figures move in the opposite direction. In the 2014 Credit Suisse Global Investment Returns Yearbook, Elroy Dimson, Paul Marsh, and Mike Staunton of the London Business School illustrate the correlation of real per capita GDP and real stock returns for developed and emerging countries from 1900 to 2013. The correlation is -0.29 when measured in local currencies.[1] When returns are adjusted for changes in the exchange rate relative to the U.S. dollar, to reflect what a U.S. investor would receive, correlation stays negative.[2] Emerging markets including Brazil, Russia, India, and China also display a negative correlation between per capita economic growth and equity returns.

Real Equity Returns and Per Capita GDP, 1900 - 2013



Source: Elroy Dimson, Paul Marsh, Mike Staunton, London Business School. Credit Suisse Global Investment Returns Yearbook 2014.

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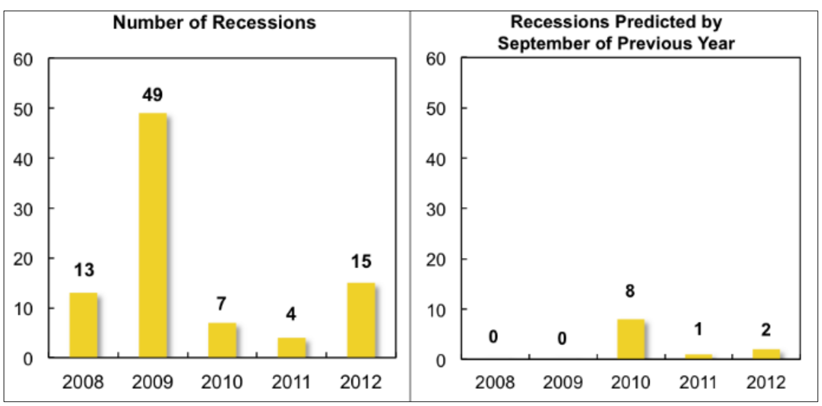
In the countries we've analyzed, shareholders do not reap all the benefits of higher economic growth and its impact on profits. Corporations issue more shares which means existing shareholders are diluted.[2] In turn, dividends grow slower than the overall economy. This is true even in the United States, which was the most successful economy between 1900 and 2013.

Improvements in productivity and increases in capital and labor spending may grow economies, but they do not necessarily benefit owners of capital. In many cases, the additional surplus created by improving economic growth goes to consumers and workers. Japan provides a good example. Dividend per share growth has been negative in real terms for Japan, although it had one of the highest economic growth rates of the countries reviewed.[2] The Japanese government has focused on full employment at the expense of corporate profitability. China is also notable for its high economic growth and poor equity performance historically. Much of the growth in stock market capitalization in China came from an expansion in the number of listed companies, not return on invested capital.

Can investors extrapolate recent economic data into the future to predict which equity markets will perform best? Since 1972, if an investor had put money to work in the economies that had grown the fastest in the previous 5 years, they would have earned 14.5% a year. If they had invested in the economies with the slowest growth, they would have earned 24.6%.[3] Most observers struggle with this counterintuitive result. The data indicates that investors favor countries with good growth records, which in turn pushes up valuations. Countries with poor growth records create cheap valuations, which offsets the impact of slower than expected economic growth.

If investors could consistently provide accurate forecasts of which countries could grow the fastest into the future, it may help improve returns. Unfortunately, the track record of economists' ability to predict economic growth has been dismal. Ned Davis Research has shown that "economists, as a consensus, called exactly none" of the last seven U.S. recessions, dating back to 1970. Lant Pritchett and Larry Summers of Harvard University argued that forecasters tend to overestimate the extent to which the future will look like the recent past (e.g. fast growing countries will continue to grow at that rate, which would positively impact earnings growth). Regression to the mean, where booming countries slow down and slumping ones speed up, is in fact the more robust observation.



Source: Loungani, Prakash. Ahir, Hites, IMF, Jan. 2014.

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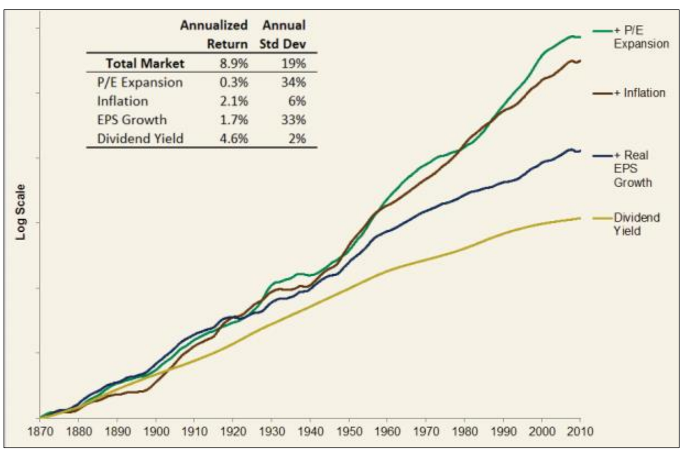
Forecasters' ability to predict economic downturns has shown to be the most challenging, precisely when investors could use an accurate gauge of the economy. The financial crisis of 2008 was a prime example. According to a report by Tim Harford of the Financial Times, of 77 countries surveyed by economists in 2008, not one of the countries was predicted to be in a recession in 2009. The finally tally? 49 of them ended up being in a recession! It is no surprise that one of the most respected economists, John Kenneth Galbraith, had this to say about the matter: "The only function of economic forecasting is to make astrology look respectable."

In developing our forecasts for future returns, we have found other variables to be more consistent drivers of equity returns going forward. We break down these variables into four fundamental building blocks: beginning dividend yield, real earnings per share (REPS), inflation expectations, and valuation. In the below graph, the Price to Earnings multiple ("P/E") is used as a proxy for valuation. One can see how the annualized return is broken down between these four variables over the period from 1870 – 2010.

Building Blocks of U.S. Equity Returns, 1870 - 2010



Source: Research Affiliates, Shiller, Christopher Brightman, Investments & Wealth Monitor. Jan/Feb 2012.

Over this time period, the dividend yield of the U.S. stock market accounted for more than half of the nominal return and 70% of its real return.[4]

The other significant sources of return were EPS growth, inflation, and valuation. The return on capital of invested earnings and the percentage of earnings paid out to shareholders via dividends and net share repurchases are two variables that will drive real EPS growth over the long term. Real earnings per share growth averaged 3.7% annually from 1988 to 2007, much faster than real GDP growth of 2.4%, making GDP an inaccurate predictor of earnings power.[5] Profits as a percentage of GDP rose from 8 to 11% during this relatively stable time period for financial markets.

Conclusion

Unexpected changes in economic growth in the short term may cause stock prices to react, but the longer term impact to stock returns is more complex and potentially counterintuitive. Investors need to focus on the variables that have consistently shown

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to affect stock prices. Dividends, earnings growth per share, valuation, and inflation are the building blocks behind our long term return assumptions. By focusing on these factors and extending one's time horizon, an investor can avoid the short term noise of the economy and increase his or her probability of investment success.

[1] Elroy Dimson, Paul Marsh, Mike Staunton, London Business School, Credit Suisse Global Investment Returns Yearbook, Feb 2014.
[2] Jay R. Ritter, "Is Economic Growth Good for Investors," Journal of Applied Corporate Finance, 8/7/2012.
[3] The Economist, "The growth paradox," 2/5/2014.
[4] Christopher J. Brightman, CFA, "Expected Return," Investments & Wealth Monitor, Jan/Feb 2012.
[5] Antti Ilmanen, "Expected Returns on Major Asset Classes," Research Foundation of CFA Institute, 6/5/2012.