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November 6, 2007

Downunder Daily

Growth Doesn't Matter (As Much As You May Think)

The 1990s tech bulls at least got one thing right: real demand for technology products has consistently outstripped GDP growth. Of course, buying tech in the late 1990s was still a lousy investment. Conversely, mining sector output has consistently disappointed forecasts over the past few years, with supply estimates repeatedly pushed out. Yet mining equities have been a stellar investment.

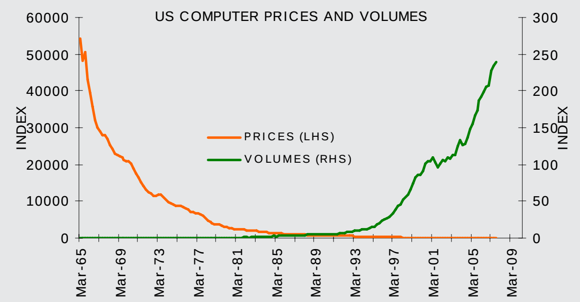
All of which hints that there is no close link between real growth – in both these cases, at a sector level – and investment returns. There are two missing pieces to the puzzle:

First, pricing and margins. While real technology demand remained strong, prices kept falling. Exhibit 1 shows the story for computers in the US. The flipside for miners is that the disappointing supply response contributed to strong and rising prices, and hence profits. We will never know what would have happened if supply had met forecasts, but my hunch is that prices, profits and equity returns would have been significantly lower.

The second missing piece is what is in the asset price. Technology stocks were priced for spectacular profit growth in the late 1990s; mining companies were not. The former surprised on the low side, the latter on the upside.

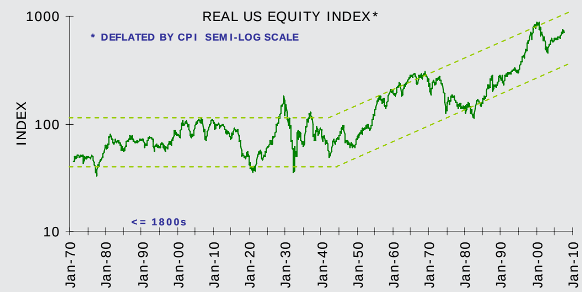
One final example before I get to the bigger-picture point. A century ago, the US was the world's biggest, most successful emerging market. Exhibit 2 shows the real level of US equities. What is remarkable is that, in real terms, equity prices in the 1940s were no higher than in the 1880s. I have drawn the chart in a log scale, so the flat trend masks huge variation within the period, moreover, this is a price-only index – total returns were higher – but the simple point is that 60 years of stupendous GDP growth had not lifted real equity prices on a sustained basis.

Exhibit 1
Growth Was Strong – Shame About Returns



Source: BEA; Morgan Stanley Research

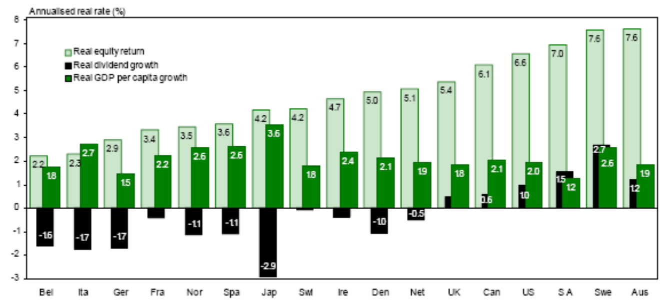
Exhibit 2
Nothing To Show For 60 Years of Growth



Source: BLS, Robert Shiller, Standard & Poor's; Morgan Stanley Research

All of which illustrates a key point: there is surprisingly little correlation between equity returns and real growth, either at the sector level or at an economy-wide level.

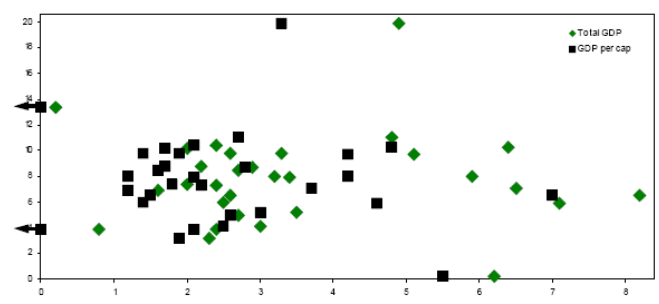
Exhibit 3
Returns, Dividends & GDP, 1900-2004



Source: Elroy Dimson, Paul Marsh, Mike Staunton, Rolf Elgeti, *Global Investment Returns Yearbook, 2005*; Morgan Stanley

The following three charts are all taken from the *Global Investment Returns Yearbook* (2005 edition; by Elroy Dimson, Paul Marsh, Mike Staunton & Rolf Elgeti). They focus on the correlation – or, rather, lack of it – between GDP growth and investment returns for national markets.

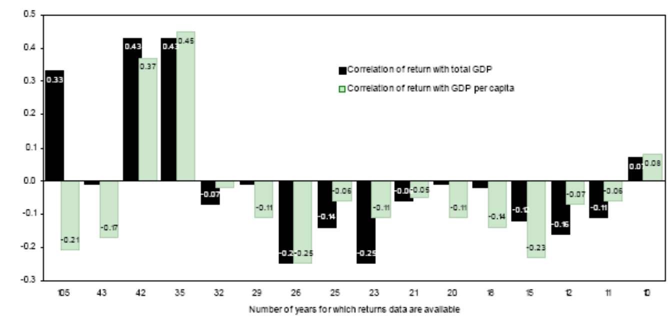
Exhibit 4
Real Equity Returns & GDP Growth Since 1976



Note: Scatter-plot is for 30 economies: Australia, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, South Africa, Spain, Sweden, Switzerland, UK, US, Norway, Finland, Korea, Austria, Hong Kong, Singapore, Malaysia, Argentina, Chile, Greece, India, Mexico, Thailand and Zimbabwe. Covers the period 1976-2004.
Source: Elroy Dimson, Paul Marsh, Mike Staunton, Rolf Elgeti, *Global Investment Returns Yearbook, 2005*; Morgan Stanley Research

Exhibit 3 shows real equity returns (total returns, including dividends), real dividend growth and real per capital GDP growth for 16 economies over the period 1900-2004. The simple message is that there is little correlation between per capita GDP growth and real equity returns, even over this very long time horizon. In fact, statistically, the correlation is negative (-0.21).

Exhibit 5
Correlation Between Returns and Growth



Note: correlations calculated over the period to 2004. Sample size varies over each time period. 16 countries available over full 105 years (that is, 1900-2004).
Source: Elroy Dimson, Paul Marsh, Mike Staunton, Rolf Elgeti, *Global Investment Returns Yearbook, 2005*; Morgan Stanley Research

Exhibit 4 shows a larger sample of countries (30), but over a shorter time horizon (29 years – so the horizon is not short in an absolute sense!). The scatter plot shows market returns versus both real GDP and real GDP per capita. Again the correlation is negative (-0.25 for both GDP and GDP per capita versus real equity returns).

Finally, Exhibit 5 shows the correlation between real equity returns and GDP/GDP per capita over various time periods. The sample size varies, with 53 economies/markets used for the 10-year horizon, and 16 for the 105-year horizon. Again the point is that there is no consistency in the correlation, and more often than not it is perverse (higher GDP growth goes with lower returns).

Note what I am not saying: I am not saying low growth economies are necessarily better investments. (Although, at the stock level, many studies show that value investing consistently beats growth investing.) The point is that growth is not by itself sufficient to produce returns – what is in the price, and the outlook for margins are critical.

The forward-looking point to all this is obvious: there is now a strong global consensus that emerging economies have entered a golden period for growth. As a result, the strong investment consensus is that emerging market equities have likewise embarked on a super-cycle of superior returns. History says that the consensus may be right on the first point, but nonetheless wrong on the second. To put a concrete example on this view: we may not be far from the point where a global equity investor will do much better on a 1-2 year horizon being overweight Japan/underweight China.

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