3.2 WHITE PAPER

Why does strong GDP growth not always correlate with high equity returns?

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Investment in emerging markets is constantly changing. Opportunities have been evolving since the discovery of emerging markets in late 1980, and they had been affected by events such as the Russian and Asian financial crisis in 1990 or the rise of China in the 21th century.

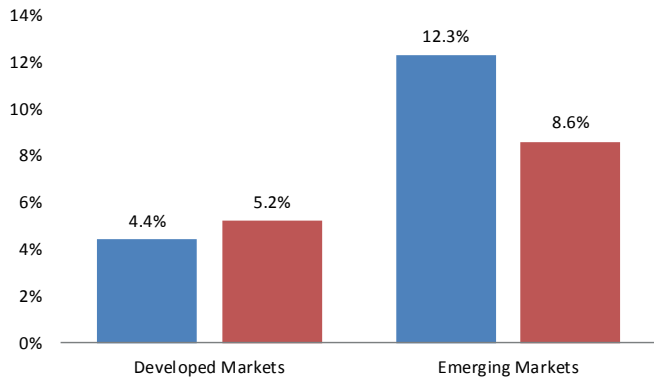
As a consequence, in order to analyse the emerging markets, it is necessary to take into account that its composition has changed substantially in the last 25 years. Furthermore, the "emerging" category includes different countries which have an economic structure very divergent. Finally, liquidity and risk in emerging markets are not the same as in developed market countries.

There are two traditional reasons to invest in financial markets of emerging countries: on the one hand, there is a low correlation with financial markets of developed countries, so it is useful to diversify risks. But this is something that has ceased to make sense. In December 2014, the correlation between the MSCI World Index (which represents the equities of the developed markets) and the MSCI Emerging Markets Index was 0.80[1]. On the other hand, it is generally assumed that the higher rates of growth of the emergent countries will also imply higher investment returns.

In fact, the latter reason to invest in emerging countries might be incorrect. A recent study by the London Business School researchers[2] shows that correlation between economic growth per capita and financial returns since 1900 seems to be slightly negative. Nevertheless, there is a positive correlation between economic aggregated growth and financial returns. In conclusion, increasing population is better than economic growth.

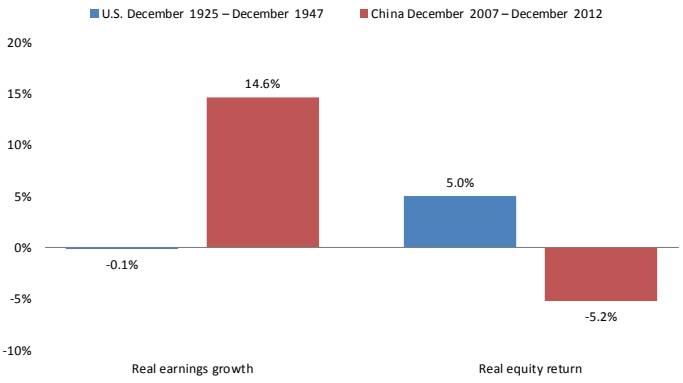
Strikingly, those who would have been invested in those countries since 1972, with the fastest growth in the previous 5 years, would had received a 14.5% annual return. Nevertheless, those who would have invested in those countries with the slowest growth, would had received a 24.6% annual return.

Chart 1: GDP growth vs equity market earnings growth 1999–2012



Source: Vanguard, 2013

Chart 2: Real equity returns vs earnings growth in the U.S. and China



Source: Vanguard, 2013

1. *Why Invest in Emerging Markets Small Cap Stocks?, Parametric, March 2015.*
2. *Global Investment Returns Yearbook 2014, Credit Suisse, February 2014.*

The absence of correlation between economic growth and financial profitability would have an easy explanation: countries with high rates of growth attract attention (and money) from investors, pushing up prices and as a consequence decreasing the profitability in the long term. On the contrary, countries with low growth rates are forced to provide cheaper prices and better profitability in order to raise investment.

As a result, most of the literature and the economic press do not consider fast economic growth of emerging countries as a wise indicator of juicy investments. Furthermore, there are additional reasons that back up this claim:

- The absence of relation between real economic growth and the behavior of financial markets
- Globalisation implies that the earnings of multinationals in emerging countries may depend on the economic environment in developed countries
- Bright economic perspectives in emerging markets are internalized in higher prices

In conclusion, there is enough evidence against the popular claim that high growth rates of emerging countries imply also high returns in financial markets. In any case, there is a higher return as a premium for the higher volatility in emerging markets.

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