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Investment Publications Highlights

Recessions Aren't What They Used to Be

Manoj Pradhan, Patryk Drozdzik, and Pratyancha Pardeshi, *The Global Macro Analyst*, Morgan Stanley Research, January 27, 2016

Consensus global economic growth has been revised downward for 2016, as risks linked to emerging markets have increased the likelihood of a recession in developed markets. In this edition of *The Global Macro Analyst*, the authors suggest that while recessions may occur more frequently in the future, the probability of a near-term recession in developed markets remains low.

The authors believe developed markets economies could be entering a period of low-trend growth, where relatively benign recessions occur frequently. For the past 20 years, Japan's economy has had this type of growth path. But defining a recession as two straight quarters of negative growth may lead to an overestimation of its impact, according to the authors. They advise investors to rely on a broader definition of recession to draw more insightful conclusions about a recession's impact. One such definition, which uses multiple data points like employment, income, production, and sales indicators, suggests US economic weaknesses are confined to the manufacturing sector and that the risk of a recession in the near term is low, but rising.

While disappointing growth in China and emerging markets has negatively impacted manufacturing sectors, the authors do not believe this will be enough to cause a developed markets recession. In fact, weaknesses in the manufacturing sector have pushed yields lower, supporting the interest rate–sensitive service sector. As of December 2015, the US ISM Non-Manufacturing Index (55.3) suggests the services sector is expanding, in contrast to the Manufacturing Index (48.2). Because the services sector makes up nearly 90% of the US economy, a bigger shock to the manufacturing sector is necessary to pull the economy into contraction.

In the event of weak growth, central banks still have a few tools to employ to maintain the economy, despite nearly reaching the limit in asset purchases. These institutions could use negative interest rates, interest rate caps, or promise future payments. But each of these measures has drawbacks. As a result, central banks are likely to be reluctant to implement them, particularly if fundamentals indicate some parts of the economy are performing well, like today's services sector.

In all, the authors estimate the probability of a US recession in 2016 at about 20%. With a lower 2016 growth forecast (1.8%) than consensus expectations (2.6%), they argue the four rate hikes envisioned by the Federal Reserve this year are unlikely. Rate hikes will likely face a high bar due primarily to lower growth expectations and an increasingly strong US dollar weighing on inflation.

What's Growth Got to Do With It? Equity Returns and Economic Growth

Joachim Klement, *The Journal of Investing*, vol. 24, no. 2 (Summer 2015): 74–78

Economic growth is often considered an important driver of equity market returns, in part because corporate earnings growth is thought to reflect economic growth. The author reviews this assumption and argues that, in fact, there is no meaningful correlation. For a better indicator of equity performance, investors should focus on valuation metrics.

The author reviews annual total returns and GDP growth in 22 developed markets and 22 emerging markets between 1997 and 2013 to determine if there is a link between equity performance and economic growth. Although the time period is short, it encompasses two business cycles for each country. The author hypothesizes that small companies may be more dependent on local economic growth versus large companies, but he finds no statistical relationship between growth and performance for large-, mid-, or small-capitalization equities. For the most part, correlations between growth and performance are slightly negative, contrary to widespread beliefs.

Looking beyond just equity returns and nominal economic growth, the author also finds no relationship between real corporate earnings growth and real GDP per capita growth. The author believes this finding could be explained by the relationship between population growth and each variable. When population growth is positive, that may support real corporate earnings growth but limit real GDP per capita growth. Levels of real earnings growth may also be linked to entrepreneurial activities, as newly founded, non-listed companies reduce the future earnings of listed companies, but still contribute to GDP per capita growth.

The author finds that valuation metrics, such as the cyclically adjusted price-earnings ratio, are better indicators of future equity returns than economic growth. This may be because valuation metrics also incorporate expectations of future growth, making them potentially more correlated to future returns. Ultimately, the author believes economic growth is not a useful indicator for equity market returns, instead highlighting valuations as an investor's best hope for insight. ■

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