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Abstract

Linking GDP Growth and Equity Returns

In the first article of a two-part series we look at the relationship between equity returns and GDP growth. In theory, equity market performance should be linked to economic growth. In practice, however, various studies claim that there has been no correlation between GDP growth and equity returns over longer time spans. We argue that there are significant methodological and conceptual issues with looking at such correlations for a cross-section of countries over time and, more importantly, the concept of forward-looking expectations is entirely ignored.

We find that equity markets are a *lead indicator* of GDP growth and react strongly to *expectations* about the future.

In general, the sensitivity of equity prices to future forecast growth revisions appears higher in the Growth Markets than in the advanced world. Recognizing that equity markets price in future growth, a renewed emphasis is placed on valuation, growth expectations and growth sustainability. Some current and prospective Growth Markets still have the potential for higher and more sustainable growth and upside growth surprises that are not yet reflected in equity valuations.

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Jim O'Neill's **Viewpoints** and **Strategy Series** abstracts are also available on our website.