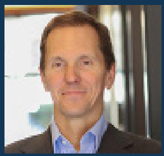

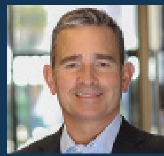

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One of the relationships in finance that catches investors by surprise is the lack of correlation between what is happening in the economy and the performance of the stock market. The last few weeks have produced many examples of a stark contrast between stock market and economic indicators. For example, there were several days in May in which the economic news was terrible—such as reports of the worst unemployment rates since the Great Depression—and yet the stock market rallied. Why the apparent disconnect?

In Buckingham's recent video interview with Apollo Lupescu, he addressed this question. In short, economic events are happening now, in real-time, and economic statistics, although they are reporting data as it is released, reflect statistics from the previous week, month or quarter.

In contrast, the stock market attempts to place a value on a company whose revenues and earnings are not just happening today but also stretch far out into the future. Today's stockholders will get the returns on the activities of companies for years and decades down the line. Therefore, stock prices today are forward-looking and reflect market participants' aggregate expectations of the future. Those expectations include whatever future economic developments are anticipated and their potential impact on cash flows and dividends, which are the keys to a stock's value.

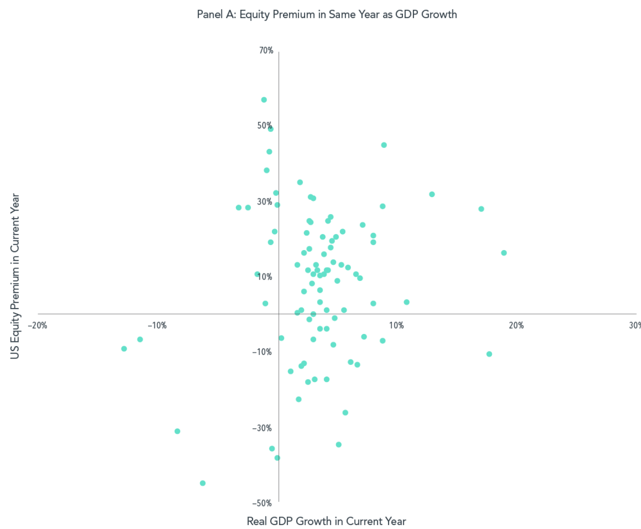
For example, if the market expects the economic environment to weaken company cash flows, the stock market may react well in advance of when we observe the impact on cash flows, as expectations are embedded in prices. And the eventual direction of the market will depend on how the economic outcome compares to expectations. If things aren't as bad as expected, poor economic news can be greeted positively by markets.

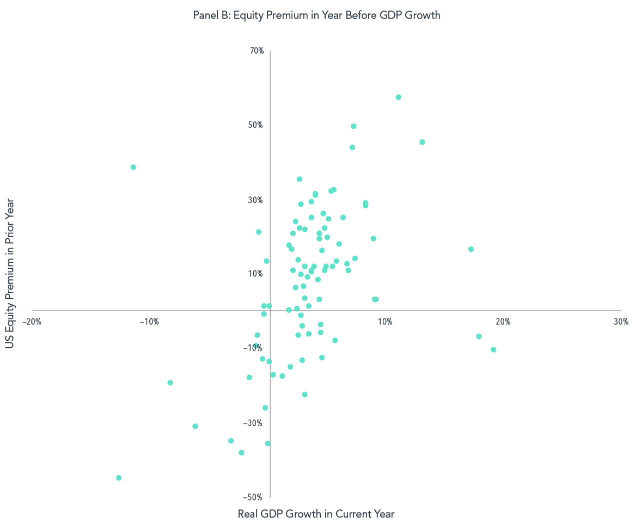
We can see this anticipatory nature of markets in action by looking at the relationship between U.S. gross domestic product (GDP) growth and equity premiums (the stock market's return in excess of risk-free, one-month U.S. Treasury bills). When annual U.S. equity premiums are plotted against GDP growth for the same year (top panel of Exhibit 1), there is no clear correlation between the two. Changes in GDP were not strongly related to concurrent stock market returns.

It is important to note that this result does not imply financial markets ignore macroeconomic data. We can see a relationship between economic growth and stock prices if we plot GDP growth against the previous year's equity premium (bottom panel of Exhibit 1 on the next page). The positive trend in the data suggests market prices have in fact reacted to changes in GDP, but have done so in advance of these economic developments coming to fruition. This result is consistent with markets pricing in their expectation of future economic growth.

Of course, markets do not always get it right, but we believe they are the best assessment of fair value as prices implicitly reflect the aggregate

Exhibit 1
Plot Development
US equity premium vs. GDP growth, 1930—2019





knowledge of millions of informed participants, all of whom have real money on the line. Accordingly, investors would be wise to accept these prices as fair without second-guessing or trying to outsmart the market.

That brings us to the latest news headline worrying some investors: the potential for an eventual fallout from increasingly large government expenditures to ease the economic burden of the COVID-19 pandemic. Will these efforts ultimately create a financial burden for the U.S. economy that will lower future stock returns?

Historical data suggest that we should not be worried about this. In Exhibit 2, we sort countries each year based on their debt-to-GDP for the prior year (top panel). We can see that average annual equity premiums have been slightly higher for high-debt countries than for low-debt countries, however, the return differences have small t-statistics suggesting that these averages are not statistically significant.

The top panel uses prior year debt-to-GDP data to sort countries into the high/low groups. But investors may be more focused on where they expect the debt to end up, rather than on where it's been. In the bottom panel of Exhibit 2, we rank countries on debt-to-GDP at the end of the current year, assuming perfect foresight of end-of-year debt levels. Again, average equity premiums have been similar for high- and low-debt countries. Like the results for GDP growth, these results imply that markets have generally priced in expectations for future government debt.

In summary, we should feel confident that markets are adept at aggregating and processing vast sets of macroeconomic indicators and expectations for the future. By incorporating this information into market prices, we believe capital markets effectively become the best available—although not perfect—leading macroeconomic indicator.

We hope that you and your family are healthy and staying safe. As always, thank you for you continued trust and confidence.

Warm regards,

Daniel C. Goldie

Dirk G. Gilliard

Exhibit 2
Debt Defying
Average equity premiums for countries sorted on debt

	Developed Markets (1975–2018)	Emerging Markets (1995–2018)
Prior Year Debt/GDP		
High-Debt Countries	8.14%	10.42%
Low-Debt Countries	6.57%	8.68%
Difference	1.57%	1.74%
t-statistic	0.63	0.49
Same Year Debt/GDP		
High-Debt Countries	7.94%	8.28%
Low-Debt Countries	7.06%	9.22%
Difference	0.88%	−0.94%
t-statistic	0.41	−0.25

Past performance is not a guarantee of future results.

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All returns in USD. Countries are sorted at the beginning of each year. High-Debt and Low-Debt refer to countries above and below the median debt, respectively. Debt is general government debt and central government debt. Source: The International Monetary Fund. Equity market returns represented by MSCI country indices. Dimensional calculations from Bloomberg and MSCI data. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

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