Stunted growth: Five principal drivers pushed stock markets higher; all are expected to reverse

Get ready for a change

Wealth accumlation is expected to slow down in the future

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EVENTS SUCH AS BLACK MONDAY in 1987 (the largest one-day price decline in the equity market), the Asian Crisis in 1997, the dot-com crash of 2000 and the Great Recession in 2008 sure put the fear into investors, but both bond and equity markets have generally been extremely rewarding for the past 35 years. Get ready for that to change. The next 20 years will not be like the last, according to *Diminishing Returns: Why Investors May Need to Lower Their Expectations*, a report by McKinsey Global Institute, the global management consulting giant.

If McKinsey is correct, and returns are indeed diminished for an extended period in the future, it appears that the growth of wealth will slow compared to the past three and a half decades. The implications, while not yet dire, could prove to be problematic for Baby Boomers as they begin to retire over the next five years in greater numbers. Individual retirement savings will clearly be affected, but private and public pension funds may also have significant difficulty meeting their obligations as retirees begin to draw on their pensions.

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As a primer for those who aren't economy wonks, there are five principal variables that drive the equity market: corporate profits as a percentage of GDP; the growth rate of corporate profits; the growth rate of earnings per share; the level of interest rates; and the magnitude of stock repurchases by firms. With the exception of interest rates, the higher the value of each factor, the higher the level the equity market will be.

One of the most influential and easiest factors for investors to observe is the current interest rate. In general, the lower that current interest rates are, the higher valuations of stocks should be. Since 1981, we have had a non-stop collapse in interest rates, which contrasts sharply with the rising interest rates seen from 1962 until 1980. Suffice to say, with interest rates declining from almost 18% to near or below zero, the current price/earnings multiple on stocks is likely fairly valued. However, if rates were to rise, then multiples will decline.

The growth of earnings has played a significant role in boosting returns as well. Since the 1980s, the share of national income going to capital (profits) at the expense of labour has increased to nearly 43% from 35%. This trend has been a positive for investors, but given the current slow-growth economic environment, this may not likely continue as the middle-class who feel disenfranchised have been calling for wealth taxes.

Since 2000, corporate profits as a percentage of GDP have been steadily climbing in tandem with earnings. Relative to the past almost seven decades, this level is at an all-time high. Future gains, although possible, are limited, with the likely direction heading down.

Meanwhile, earnings per share of the broad market indicator, the S&P 500, are now approaching US$125. The rise in EPS is an important driver of the stock market since it represents the E in the P/E multiple. One reason for the rise in EPS has been the increase in corporate profits, but another is the effect of large corporate stock repurchases, which have exploded in number during the past couple of decades. Changes to executive compensation in the mid-1990s have encouraged CEOs to focus on share price appreciation over other metrics and net buybacks have played a significant role in pushing EPS higher.

All five fundamental drivers played a positive role in pushing stock-market valuations higher. But going forward, these tailwinds will likely become headwinds. **FPM**

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