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Gross Domestic Product: A Poor Predictor of Stock Markets Returns

11988 El Camino Real | Suite 500 | P.O. Box 919048 | San Diego, CA 92191-9048 | 858.755.0239 | 800.237.7119 | Fax 858.755.0916 | info@brandes.com | www.brandes.com

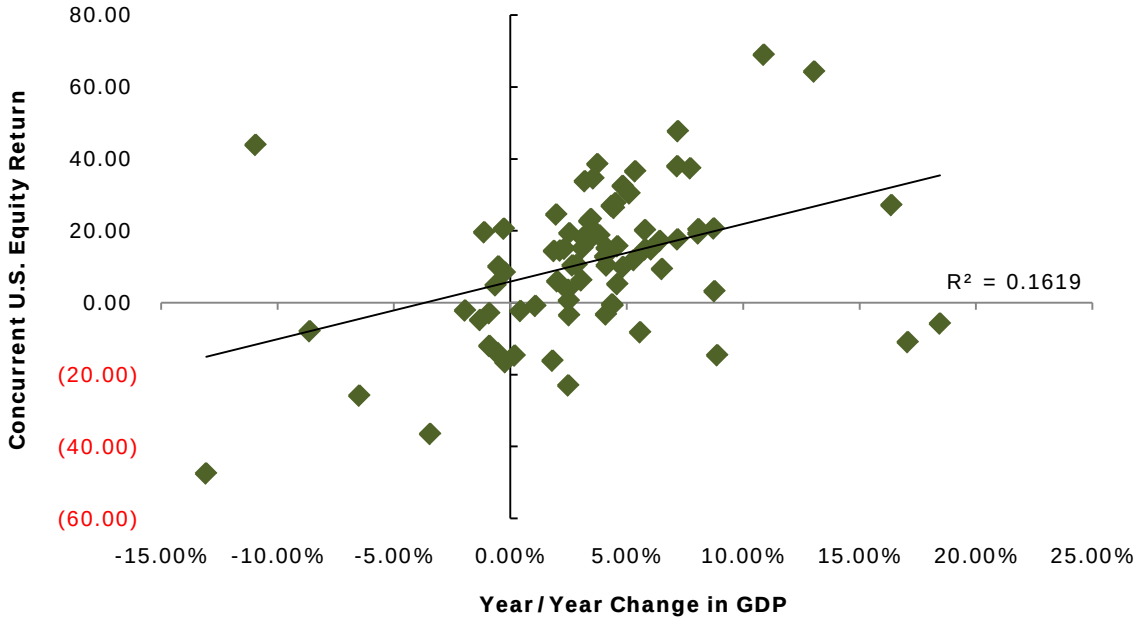
With the economic adversity of the last two years, many market participants and the financial media seem to increasingly focus on economic measures such as gross domestic product ("GDP") in weighing investment timing decisions. Implicit in this interest is an assumption that an increase in GDP might signal when economic conditions are more favorable and more conducive to higher stock market returns.

Investors should be aware that research indicates GDP has historically been a poor predictor of stock market returns, both in the United States and in international markets. Market participants who wait for GDP levels to improve before investing may find themselves on the sidelines, missing out on remarkable opportunities in the stock market.

Examining the Relationship between GDP and Stock Market Performance

Research conducted by the Brandes Institute reveals that annual changes in GDP from 1929-2008 were a poor predictor of both concurrent and subsequent stock market returns (represented by the S&P 500 Index). Exhibit 1 shows the predictive power of changes in GDP (in explaining concurrent equity returns) was not statistically significant. The coefficient of determination, or the portion of stock market performance explained by GDP changes,[1] is only 0.1619, and the regression line (the straight line in Exhibit 1) is a poor fit.

Exhibit 1: Relationship between Real Changes in U.S. Year-on-Year GDP and Concurrent U.S. Equity Returns, Annually, 1929-2008

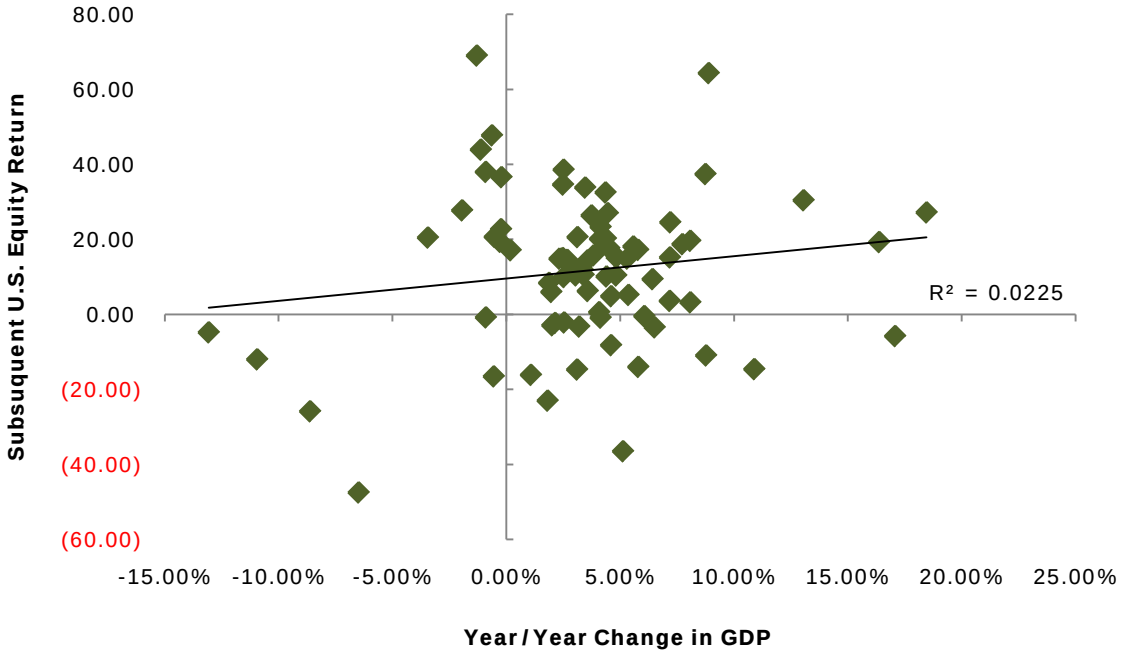


Source: The Brandes Institute, FactSet, as of 12/31/08

[1] The coefficient of determination tests the fit of the relationship or model. The measure is a value between zero and one. The closer the value is to one, the more reliable the independent variable or model is in explaining the dependent variable. A value closer to zero suggests there is little relationship between the variables, or the model offers little explanatory power.

In addition, Exhibit 2 reveals that predictive power for changes in GDP in explaining subsequent equity returns is not statistically significant. The coefficient of determination for this relationship is .0225, and again the fit of the regression line is poor. Note that Exhibits 1 and 2 look at the relationship between GDP and stock returns not over just five or 10 years, but over 80 years.

Exhibit 2: Relationship between Real Changes in U.S. Annual GDP and Subsequent U.S. Equity Returns, 1929-2008



Source: The Brandes Institute, FactSet, as of 12/31/08

The Brandes Institute results are consistent with findings reported by other researchers. For example, Elroy Dimson, Paul Marsh, and Mike Staunton (2002) examined the relationship between GDP and total real return for equities across global markets between 1900-2000, observing "...real returns seem unrelated to GDP growth, and statistically, the correlation is -0.27 for 1900-2000 and -0.03 for 1951-2000." The authors concluded "we find no link between stock market performance and GDP growth."[i]

Conclusion

Amid heightened media coverage, many market participants have been increasingly attuned to economic measures and statistics. However, research finds stock market performance has not been correlated with GDP performance. As Jeremy Siegel noted in *Stocks for the Long Run*, "Almost without exception, the stock market turns down prior to recessions and rises before economic recoveries."[ii]

We believe the results confirm that investors are best served by focusing on the valuation of stocks compared to their long-term profitability and earnings power. Perhaps Warren Buffett said it best: "You pay a very high price in the stock market for a cheery consensus."[iii] Investors who wait for GDP and other economic measures to provide clear signals of economic health may miss robust stock market performance.

The S&P 500 Index is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

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The foregoing reflects the thoughts and opinions of Brandes Investment Partners® exclusively and is subject to change without notice.

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i Dimson, Marsh, and Staunton. (2002). Triumph of the Optimists. Princeton University Press. p. 156.
ii Siegel, Jeremy. (1998). Stocks for the Long Run. McGraw-Hill, p. 172.
iii Buffett, Warren. (1979). "You Pay a Very High Price in the Stock Market for a Consensus," Forbes, August 6, 1979.