ClearBridge Investments

The Economic Growth Myth

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One rich area for behavioral errors is forecasting, where a very limited human ability to accurately forecast is met with an almost insatiable human desire to know the future. Forecasting limits were on full display in 2016 as we were once again surprised by big events, most notably the populist-driven outcomes of Brexit and the U.S. election. Ironically, however, economists that forecast U.S. economic growth have done a fairly decent job since the Great Financial Crisis. The final GDP reading for the 29 most recent quarters has been within the forecasted range 69% of the time, according to a ClearBridge analysis of Bureau of Economic Analysis and Bloomberg data. In particular, during this forecast period there has not been a material miss, such as an unexpected recession, with economists generally getting the slow and steady U.S. growth they have expected.

The actual judgment error that has been made during this period has been in disbelieving the sustainability of U.S. economic growth, with many market participants believing that a deflationary macro crisis was lurking around every corner. These pervasive concerns have resulted in dramatic price action, including 25 market corrections in excess of 5% since 2009 and among the worst-ever S&P 500 returns to begin a year, which occurred in 2016 and priced many U.S. stocks at recession levels.

This dislocation between market price action and economic growth has resulted in what we will call the economic growth myth. As Exhibit 1 shows, the correlation between U.S. real GDP growth and S&P 500 Index returns has actually been negative since late 2013. In many ways, the market has gone up not despite persistent misplaced investor fears, but rather because of them, in classic "climbing the wall of worry" fashion.

Under President Donald Trump, the persistent behavioral dynamics of deflationary fear seem to be changing, with investors starting to get excited about accelerating U.S. growth and reflation. This faster growth narrative does have some potential merit, given the opportunity for comprehensive tax reform, lower taxes, reduced regulatory burdens, and a likely increase in fiscal expansion through the resulting deficit spending. However, we would caution investors to remember that Mr. Trump was elected by Main Street and not Wall Street. Even before considering higher potential costs from trade restrictions, increased wages and the resulting inflationary pressures will likely start to meaningfully dampen corporate profitability and returns, which have been critical but often-ignored fundamental drivers of this elongated bull market cycle. As a result, the negative relationship between U.S. GDP growth and market returns would likely continue.

Exhibit 1: Correlation between U.S. Real GDP Growth and S&P 500 Index Return (Q3 2009 to Q3 2016)

Source: Bureau of Economic Analysis, Bloomberg Finance, L.P., ClearBridge Investments. S&P 500 total return data are rolled forward by one quarter as the final release of GDP data comes roughly three months after a quarter-end.

About the Author

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- 24 years of investment industry experience
- Joined ClearBridge, LLC (f/k/a Legg Mason Capital Management, LLC) in 2005
- MBA from the University of Chicago
- BA in Economics from the College of William & Mary