Earnings Growth and Performance

If investors contemplate overweighting faster growing stock markets, they should be confident that the markets' earnings will grow faster than other investors expect.

While the allure of associating faster-growing economies with superior stock market performance is strong, empirical evidence challenges this assumption. Over the past 17 years,[1] the correlation between forecast earnings growth and stock market performance over the subsequent 12 months was negligible. Conversely, earnings surprises (changes in earnings expectations over a year) and stock market performance during the same year was positively correlated.

This Viewpoint dispels the notion that faster growth is a reliable predictor of future outperformance. It also cautions investors against chasing growth when making asset allocation decisions.

(650) 328-7283
www.alanbiller.com

Alan Biller and Associates
Investment Consultants

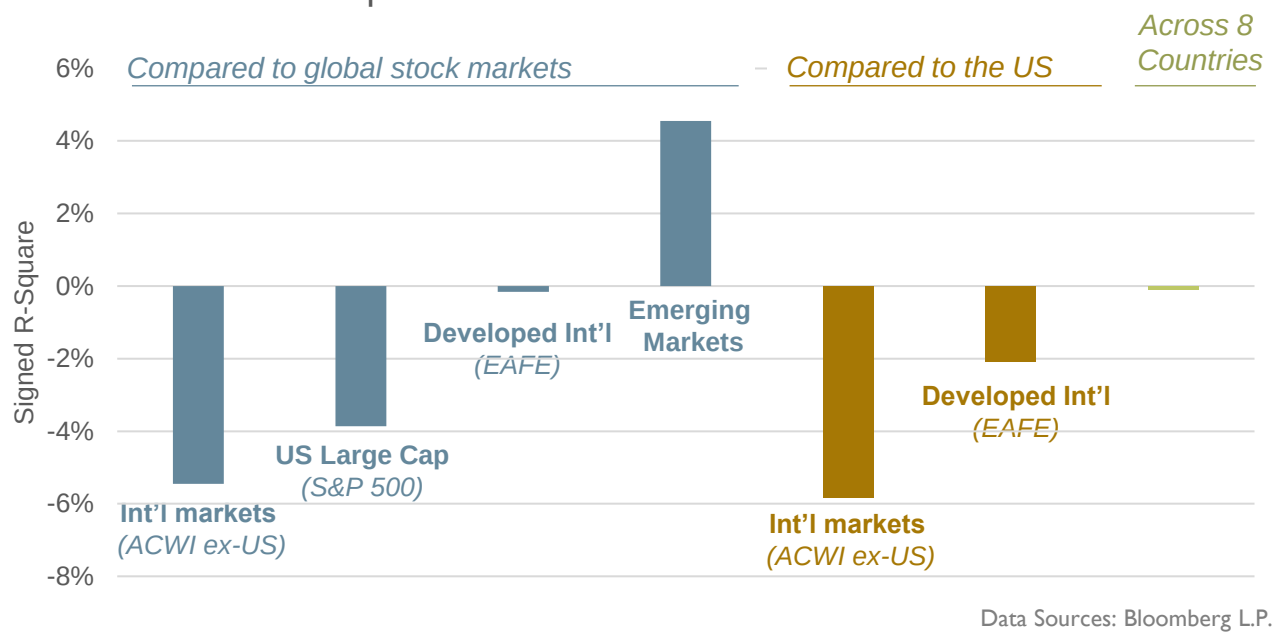
Economic Growth versus Earnings Growth

Often, investors consider economic (GDP) growth when forecasting the attractiveness of a country's stock market. However, what determines stock prices is corporate earnings, and changes in the aggregate earnings of the companies on a stock market are only weakly correlated with changes in the country's GDP. They differ because the composition of the stock market may not resemble the overall economy. For example, banks are often publicly traded, while the agricultural sector is not. Also, imports and exports are likely to affect corporate earnings differently than they do GDP. Locally listed multinational firms complicate the picture as well. According to a November 2023 report,[2] the explanatory power of real GDP to explain earnings has dropped below 30%. As a result, this viewpoint uses corporate earnings as its measure of growth rather than GDP. We are confident that calculations based on GDP growth would tell a similar story.

Expected Earnings Growth versus Subsequent Returns

The seven bars in Chart 1 illustrate pair-wise relationships (using signed r-squares[3]) between expected earnings growth rates[4] and subsequent 12-month returns.[5] They address the question: Did the markets that were projected to have faster earnings growth outperform the others? The first four bars compare regions to the global stock market.[6] The next two compare all international stocks and developed market international stocks to the US stock market. The final bar shows the cross-sectional comparison of eight country stock markets (rather than regions).[7]

Chart 1: Relationship between Relative Expected EPS Growth and Relative Subsequent 12-Month Return



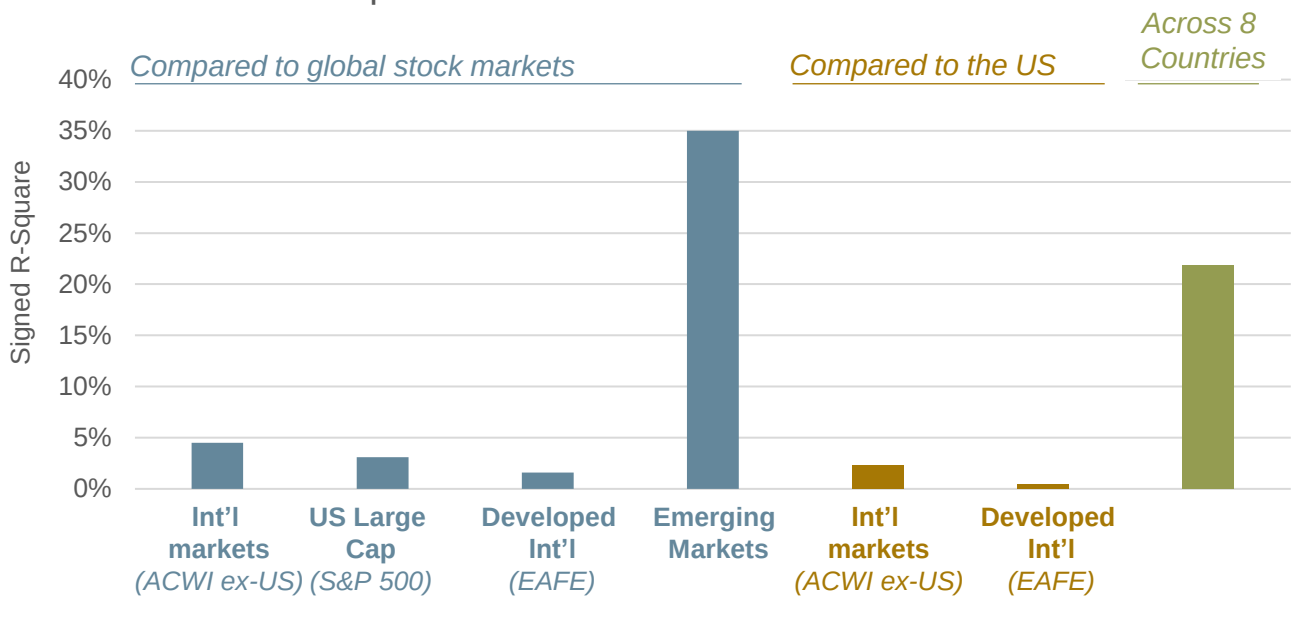
Data Sources: Bloomberg L.P.

Except for Emerging Markets versus the Global Market, all of the values were negative. Also, note that all of the r-squares are close to zero, indicating that during this period relative expected earnings growth had very limited value in predicting subsequent relative stock market performance.[8] The negative value for ACWI ex-US versus ACWI means that when international stocks' earnings were expected to grow faster than the global market, they generally underperformed the global market. The small value indicates that differences in expected earnings growth (at the start of each period) explained only a very small portion of the differences in returns. Emerging markets were the anomaly. They showed a slight tendency to outperform during periods when they were forecast to have faster relative earnings growth. The -0.1% value for the eight-country analysis (the last bar) indicates that, at the cross-country level, there was not a discernible relationship between expected earnings growth and subsequent 12-month returns.

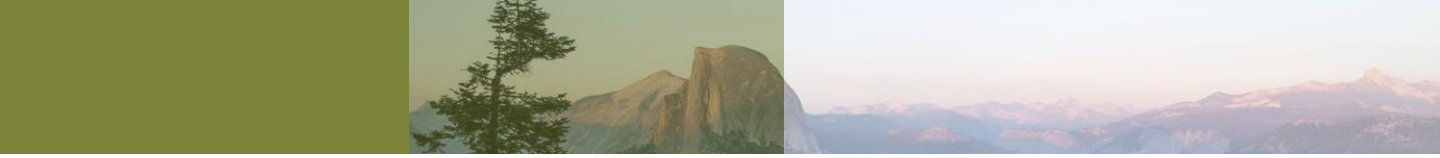
Earnings Surprise versus Returns

Chart 2 shows the relationship between earnings surprises (the change in the earnings forecast) with returns during the identical period. Not surprisingly, the correlations are positive. It is logical that investors would bid up a market in response to the positive news that led them to expect higher earnings. The signed r-squared values range from 0.4% for EAFE versus the S&P 500 to 35% for Emerging Markets versus ACWI. For the eight-country analysis, the average r-square was 22%.

Chart 2: Relationship between Earnings Surprises and Relative Subsequent 12-Month Return



Data Sources: Bloomberg L.P.



The somewhat modest r-squares (less than 5%) for most of the comparisons are expected. Revisions in near-term earnings expectations are only one facet of information influencing investors' decisions. News that affects expectations of longer-term earnings, and non-earnings-related news tends to swamp news about near-term earnings. The higher r-square for the cross-country comparison can be attributed to diversification which mitigates the effects of country-specific news.

Summary

While it is tempting to believe that stocks (and stock markets) that are expected to grow faster than average will have higher returns than their slower-growing counterparts, neither theory nor empirical evidence support that assumption. Theory suggests that investors set prices based on all of the information available to them, including expected earnings growth. The empirical evidence presented here, as well as in others' published research, shows little correlation between countries' expected earnings (or GDP) growth and subsequent stock market performance. If investors contemplate overweighting faster growing markets, they should be confident that their earnings will grow faster than other investors expect.


Appendix

Table 1: Data for 12/31/2017 – 12/31/2018

	Earnings Forecasts as of 12/31/2017			Annual Expected EPS Growth 2020/2018	Forecast CY 2018 EPS as of 12/31/2018	EPS Surprise	Return: 12/2017 - 12/2018
	CY 2017	CY 2018	CY 2019				
ACWI	28.41	31.53	34.27	9.8%	32.25	2.3%	-7.69%
S&P 500	131.22	146.77	158.95	10.1%	160.18	9.1%	-4.38%
ACWI xUS	19.33	21.20	23.07	9.3%	20.32	-4.2%	-12.99%
EAFE	124.83	134.92	145.37	7.9%	131.91	-2.2%	-10.99%
EM	83.26	94.28	104.67	12.1%	84.83	-10.0%	-10.07%
UK	261.72	288.94	310.62	8.9%	306.86	6.2%	-9.47%
Germany	876.46	960.26	1041.11	9.0%	857.75	-10.7%	-18.26%
Japan	112.97	119.04	127.76	6.3%	120.59	1.3%	-15.97%
France	344.56	371.15	405.92	8.5%	378.46	2.0%	-8.88%
Canada	892.44	990.53	1102.03	11.1%	1027.52	3.7%	-8.89%
Australia	351.03	378.75	404.04	7.3%	378.55	-0.1%	-2.84%
Switzerland	524.02	589.87	647.66	11.2%	603.55	2.3%	-8.57%

Data Sources: Bloomberg L.P., Alan Biller and Associates.


Endnotes

1. April 2006 – October 2023. This is the longest period for which Bloomberg had the data we need to perform the calculations.
2. Citigroup, *U.S. Equity Strategy report*, November 2023.
3. Signed r-square = Correlation^2 x (1 if the correlation is positive, -1 if it's negative). From Investopedia: "Whereas correlation explains the strength of the relationship between an independent and a dependent variable, R-squared explains the extent to which the variance of one variable explains the variance of the second variable. So, if the R-squared of a model is 0.50, then approximately half of the observed variation can be explained by the model's inputs."
4. To minimize the impact of short-term economic cycles, we calculate earnings growth as (2-year ahead expected earnings / current year expected earnings). For example, on 12/31/2020 earnings growth would be the expected earnings for 2023 divided by the expected earnings for 2021.
5. We compare the returns for the 12-months ending 12/31/2021 to the expected earnings growth as of 12/31/2020.
6. International stocks: ACWI ex-US; US stocks: S&P 500; developed international stocks: EAFE; emerging market stocks: EM; global stocks: ACWI
7. US, UK, Germany, Japan, France, Canada, Australia, and Switzerland.
8. Note these results are consistent with prior research that showed the correlation between expected growth and stock market performance was zero to negative. See Jay Ritter, *Economic Growth and Equity Returns*, 2005.

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Visit us at www.alanbiller.com

Call us at (650) 328-7283

Email us at info@alanbiller.com

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