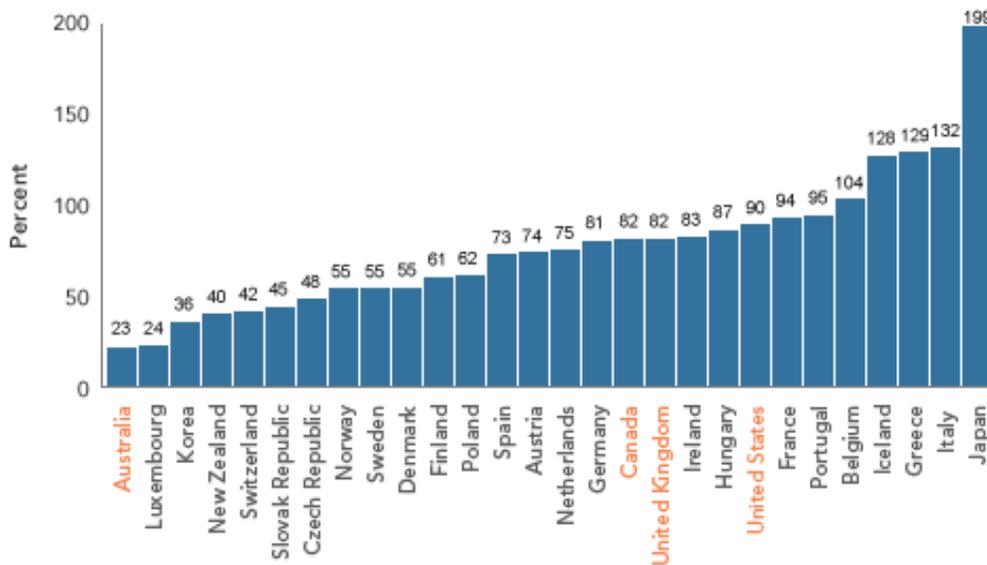


Deficits, Debt, and Markets

As government spending hits record levels around the globe, some politicians, economists, and pundits are warning that rising indebtedness may drag down economies and financial markets. This issue has raised concern among investors who assume that a government’s fiscal policy is closely linked to the country’s economic growth and market returns.

The graph below shows the projected state of indebtedness around the world.¹ Over half the Organization of Economic Co-operation and Development (OECD) member countries expect to have debt-to-GDP levels above 70%—and the US, Canada, and the UK project debt levels exceeding 80% of their economic output.

Government Debt as a Percent of GDP
2010 Projections in OECD Countries



Source: OECD

Government efforts to stimulate these economies out of recession may partly explain this level of borrowing, which is high compared to historical levels. But longer-term trends such as aging populations, expanding public pensions, and rising health care obligations are compounding the fiscal challenges of these countries.

Global investors may be particularly concerned about the economics of government spending in countries around the world. So how does public debt affect economic growth and market

returns? The evidence might surprise you. Although rising levels of government debt create headwinds for economic growth, a country's deficit and debt levels do not seem to adversely impact capital market returns.

Let's explore these issues by addressing a few popular questions about sovereign debt:

Do rising deficits drive up interest rates?

Yes. As borrowing increases, a government must offer higher interest rates on its debt to compete for capital. The public sector consumes savings and investment that may have otherwise fueled private sector growth—a displacement of resources known as the “crowding out effect” in economic theory. Additionally, as debt levels rise, market concerns about higher default and inflation risks put additional upward pressure on interest rates.

Consistent with this theory, our analysis shows that current interest rates reflect expectations of future deficits² but that current government deficits and debt do not predict future interest rates or bond returns.³ So, long-term interest rates rise when the market expects future deficits to increase. However, today's interest rates and bond prices already reflect information about current government spending, and markets quickly incorporate new information.

Do higher deficits hamper economic growth?

It depends on a country's debt level. Using World Bank data from 1991 to 2008, we compared current deficits to future GDP growth in sixty-seven countries and found an increasing interactive effect between deficits, debt, and economic growth. High-debt countries that run deficits are more likely to experience lower economic growth over the next three years. But numerous forces may affect a country's economic direction, and deficits explain only a small fraction of the variation in future GDP growth. The combination of high debt and deficits can create headwinds for economic expansion, but slower growth is not guaranteed.

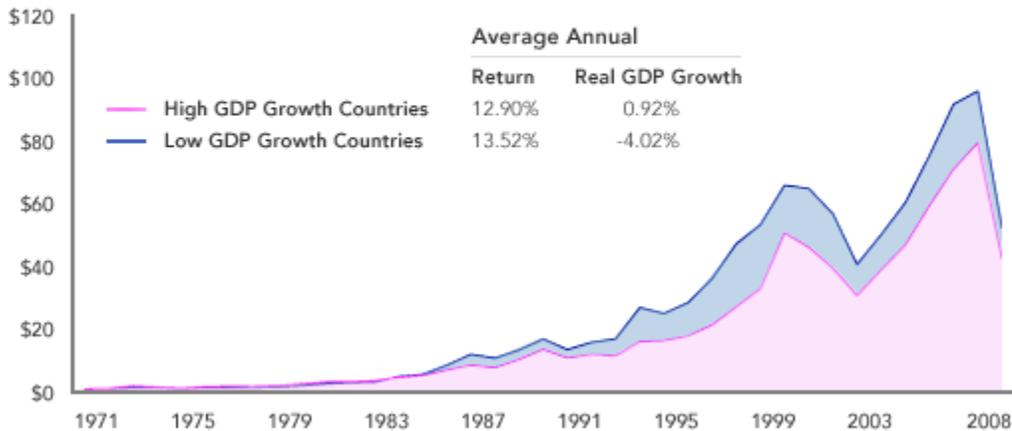
So investors are justified in having some economic concern about higher government spending and borrowing. But the impact on investment returns is less clear. Let's now consider the potential effect on equity markets.

Does low economic growth result in diminished equity returns?

No. This relationship can be tested by comparing a country's GDP growth to its equity market performance in subsequent years. We conducted this analysis using all the developed countries in the MSCI universe, divided each year into high-growth and low-growth “portfolios” based on growth in real GDP. There was no statistical difference between the annual returns of equity markets in high-growth versus low-growth countries. In fact, low-growth countries had slightly higher average returns than high-growth countries.

The graph below illustrates this relationship in terms of a dollar invested in high- versus low-GDP growth portfolios from 1971 to 2008. The low-GDP growth portfolio's higher annual return would have generated slightly more wealth for the period. The chart details the average annual return and real GDP growth for both groups.

Economic Growth Does Not Predict Equity Returns
Growth of \$1 in the Stock Markets of Developed Countries



Source: MSCI

Applying the same methodology to the MSCI emerging market countries shows an even greater return difference, although the data period is much shorter (2001 to 2008). The return of the high-growth country portfolio averaged 19.77% (with 2.5% GDP growth), versus 24.62% for the low-growth portfolio (-4.94% GDP growth).

Other research has confirmed a weak relationship between a country's economic growth and its stock market returns.⁴ Several factors may contribute to this decoupling effect. For one, with globalization, a multinational company's stock price in its home market may not reflect economic conditions in other countries. Also, the fruits of economic growth do not accrue exclusively to public companies, but also to income earners, non-public businesses, and private investments.

Finally, consider that risk, not economic growth, determines a stock's expected return. Research indicates that this principle also applies to a country's stock market.⁵ Similar to value and growth stocks, markets with a low aggregate price (relative to aggregate earnings or book value) have high expected returns, and markets with a higher relative price have lower expected returns. Consequently, while holding a "growth market" may be a rational investment

approach, investors should not expect to earn higher returns by tilting their portfolios toward countries with high expected GDP growth.

Do fiscal deficits lead to currency depreciation?

No. It is commonly believed that large fiscal deficits and high debt cause a currency to depreciate as the government borrows more from foreign sources, and investors who are concerned about inflation and default risk flee the currency. Although recent developments in the US would seem to support this relationship, there is less convincing long-term evidence that deficits affect currency rates. During the 1970s and 1980s, the dollar strengthened while the government increased deficit spending.⁶ This observation is consistent with academic studies concluding that exchange rates appear to move randomly, and there are no models to date that can reliably forecast currency returns.⁷

Conclusions

Some economists claim that developed market countries are moving into an era of high government deficits and lower market returns. While higher deficits and debt may impact a nation's interest rates and economic growth to some extent, the investment implications are not easily discerned. History does not offer strong evidence that current deficits predict future bond or equity returns in a country's financial markets, or anticipate short-term currency movements.

Investors should assume that stock and bond prices reflect all that is currently known and expected about government spending and debt, economic growth, risk, and other issues affecting performance.

Endnotes:

1. The Organization of Economic Co-operation and Development (OECD) is an international economic organization of thirty-three countries founded in 1961 to stimulate economic progress and world trade. It defines itself as a forum of countries committed to democracy and the market economy.
2. Today's interest rates reflect expectations of future deficit levels. The analysis compared five-year US deficit projections (as a percent of GDP) to yield spreads (five-year US Treasuries minus three-month US Treasuries) from 1992 to 2010. The yield spread increased 29 basis points for every one percentage-point increase in projected deficits. Data sources: Baseline projected deficits from the Congressional Budget Office; yields from Federal Reserve Bank of St. Louis.
3. Today's deficits do not predict tomorrow's interest rates or bond returns. Regression results show that current deficits do not reliably predict changes in the five-year US Treasury yield spread (1982 to 2009) or future bond returns (1947 to 2009). Data source: Federal Reserve Bank of St. Louis.
4. MSCI Barra Research Bulletin, "Is There a Link Between GDP Growth and Equity Returns?" May 2010.
5. Clifford S. Assness, John M. Liew, and Ross L. Stevens, "Parallels between the Cross-Sectional Predictability of Stock and Country Returns," *Journal of Business* 79, no. 1 (March 1996): 429–451. Their research uncovered strong

parallels between the explanatory power of aggregate book-to-market and aggregate earnings-to-price ratios for country stock markets.

6. Another common assumption is that current account deficits and currency appreciation are related. (The current account balance is the difference between a country's receipts and payments to the world. This account is composed mostly of the balance of trade, with net income and foreign aid playing a smaller role.) Academic research yields equivocal results on whether this relationship holds.

7. Richard A. Meese and Kenneth Rogoff, "Empirical exchange rate models of the seventies: Do they fit out of sample?" *Journal of International Economics* 14, no. 1 (February 1983): 3–24. Kenneth Rogoff and Vania Stavrakeva, "The Continuing Puzzle of Short Horizon Exchange Rate Forecasting" (National Bureau of Economic Research working paper No. 14071, June 2008).

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