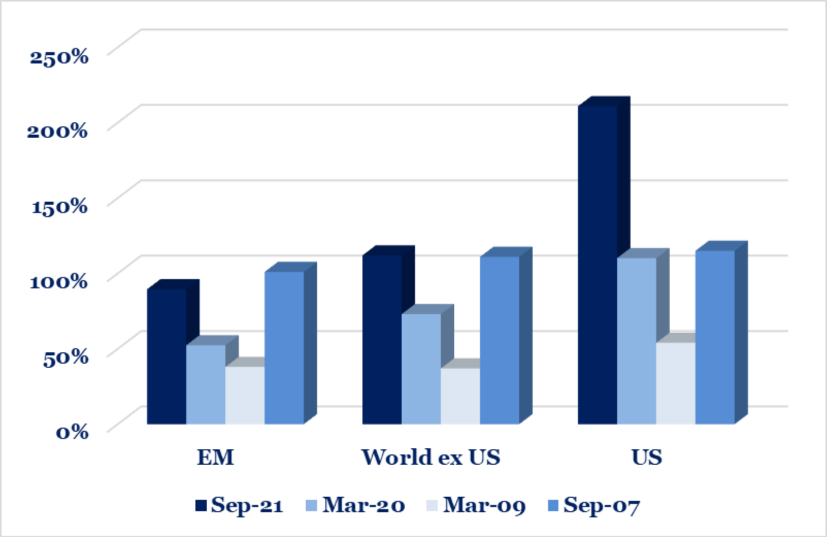
Taking the Pulse of the Buffett Indicator

There are many metrics utilized to value the broader equity markets. In this report, we focus on what is known as the Buffett Indicator -- total market capitalization to gross domestic product ratio -- to evaluate the attractiveness of the global equity markets. In 2001, Warren Buffett commented that "total market capitalization to gross domestic product ratio is probably the best single measure of where valuations stand at any given moment". We take the pulse of the Buffett Indicator in the US, international developed (World excluding the US) and emerging markets. To do so, we use country and regions as defined by MSCI. Based on a historical analysis of the Buffett Indicator, we find that currently, international equity markets are more attractively valued than the US.

In Exhibit 1, we present the Market Capitalization to GDP ratio for the three regions at four distinct points in time when global equity markets peaked and bottomed in recent history. We sum market capitalization of domestic companies to calculate the total market value of a country. The first data point - September 2007 – marks the market peak just before the Global Financial Crisis (GFC). This was also when equity markets were amidst a commodity boom driven by China's insatiable demand for fixed investment growth, which rose above 20% each year for almost a decade starting in 2003. By contrast, March 2009 was close to the bottom of the market following the GFC and Lehman collapse in 2008.

Similarly, global equity markets bottomed in March 2020 driven by restricted global economic activity to contain the spread of the coronavirus. Meanwhile, September 2021 represents the most recent quarter-end.

Exhibit 1. Market Capitalization to GDP Ratio: A Historical Perspective



Sources: Bloomberg, MSCI, IMF

As presented in Exhibit 1, the Buffett indicator hovered around 100% for all three regions in September 2007, indicating that the total market capitalization of publicly traded companies was on par with the domestic output of the countries included in the respective regions. However, after the GFC, international equity markets and emerging markets declined close to 40% of GDP while the US fell to 54%. These values indicate that global equity markets were trading at extremely attractive levels. Subsequently, the global equity markets rose at varying returns over the next decade, until the longest bull run was interrupted by the coronavirus pandemic.

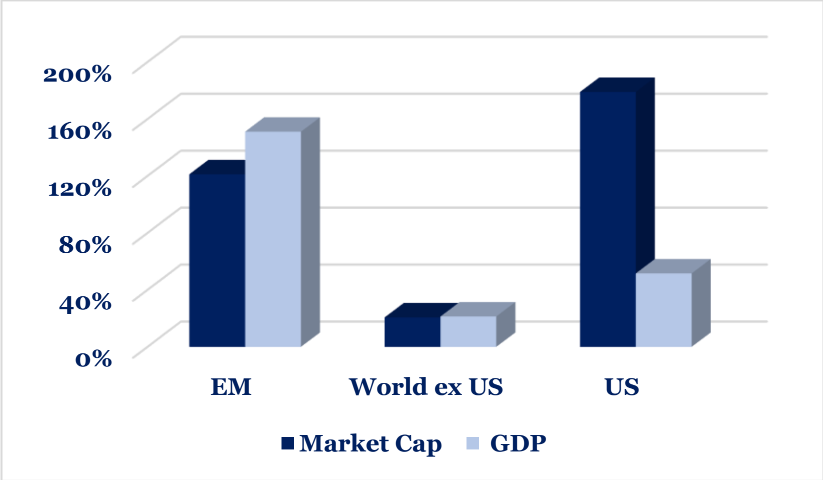
At the beginning of 2020, most countries imposed a stringent lockdown to control the spread of the coronavirus, which in turn had a severe negative impact on the global economy causing one the deepest recessions since the World War II. Consequently, equity markets collapsed until it bottomed in March 2020. At the nadir, the US market was again trading at close to 100% of GDP as presented in Exhibit 1. However, the international equity markets were trading at a discount, with the World ex US and Emerging Markets at 73% and 52%, respectively.

The recession, however, was short-lived due to the massive fiscal and monetary stimulus in many countries. Between March 2020 and September 2021, MSCI US, World ex US and Emerging Markets rose more than 74%, 54% and 53%, respectively, thus pushing the total market capitalization significantly higher. Meanwhile, restricted economic activities dampened growth and global output. Collectively these movements pushed the Buffett indicator higher in all the regions. However, in the US, the Buffett indicator has almost doubled to 211% while World ex US and EM are close to 100%, implying that the US equity market is extended.

However, some argue the merits of the Buffett indicator because the US market has been trading above 100% since 2012, and more recently the trend has been in an upward trajectory jumping from 122% in 2019 to 147% in 2020, and now at 211%. Another criticism is that the Buffett indicator only includes public equities while ignoring other asset classes such as corporate bonds and real estate. Still others contend that higher valuations are justified in a current low interest rate environment.

We take the view that regardless of the shortcomings of the Buffett Indicator, on a historical basis the US equity market is out of sync with economic output. In Exhibit 2, we compare the change in total market value and GDP growth since the market peak in Sept 2007 to Sept 2021.

Exhibit 2. Change in Current Market Value and GDP Relative to 2007



Sources: Bloomberg, MSCI, IMF

As presented in the chart above, World ex US total market value growth since 2009 has tracked GDP growth while it has lagged in Emerging Markets. Similarly, GDP growth in EM excluding China was 70%, which is higher than the 63% rise in equity value. By contrast, there is a significant divergence in the US. The US GDP grew 52% during the same period while the US equity market value climbed a whopping 179%!

Hence, we believe that although the Buffett Indicator has tracked above 100% in the US for some time now, the recent sharp rise in the US presents an attractive opportunity to invest in international developed and emerging equity markets, as we do not believe such a divergence is sustainable over an extended period.