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ANIMAL SPIRITS AND EQUITY RETURNS

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Annoyingly, stock markets sometimes suffer from 'commitment issues' towards their respective economies in the short term. However, in the long term they tend to be devoted partners and tag along with the economy, provided certain conditions are met. The data in the table below is ordered on cumulative equity price returns for the last 20 years. Evidently, the Chinese equity market seems divorced from its economy.

The relationship between stock market returns and real economic output has been researched for decades and causality has been hard to establish. In today's globalized and inter-connected world, one cannot hope to study merely the economic output of America to predict the performance of S&P500. There are way too many global variables at play.

But the post-war era (1950s and 60s) was relatively simpler to study and is therefore instructive. During those boom decades, Europe and US were driven by an enduring force of middle-class consumption. Every family wanted a house, a car, a washing machine, a vacuum cleaner etc. The impact on corporate earnings was direct. Animal spirits were rife.

Cumulative Total Index Returns for the last 20 years

S.No.	Country	Average GDP Growth		20-year Total Index Returns (in USD as of 31st May 2023)	Reference Equity Index
		Real GDP 2002-22	Projection 2023-28		
1	India	6.68%	6.08%	1420%	NSE 500
2	Indonesia	5.01%	5.02%	1146%	JSX
3	Australia	2.80%	2.03%	656%	ASX 100
4	Vietnam	6.39%	6.60%	641%	VSE
5	Mexico	1.74%	1.78%	571%	Mexico IPC
6	USA	1.99%	1.80%	543%	S&P 500
7	Saudi Arabia	4.96%	2.27%	451%	Tadawul
8	China	8.42%	4.13%	378%	CSI 300
9	Germany	1.11%	1.18%	375%	DAX 40
10	Brazil	2.25%	1.72%	372%	IBOVESPA
11	France	1.17%	1.45%	312%	CAC 40
12	Chile	3.61%	1.70%	290%	SSE
13	Singapore	1.31%	1.75%	239%	STI
14	United Kingdom	1.47%	1.37%	192%	FTSE 100

Source: World Economic Outlook, IMF April 2023 and Bloomberg

Animal Spirits

> "Our decisions to do something positive, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction."
>
> – John M. Keynes, General Theory (1936).

'Animal spirit' is that powerful force of human optimism that fuels the virtuous cycle of **Hard Work-> Income-> Consumption-> Corporate Profits**. It was embodied in the American Dream and came to symbolize the American middle-class.

Unfortunately, the American middle class has been shrinking since the 1970s and the relationship between the performance of S&P500 and economic growth has broken down. When only the top 7 stocks are performing and the remaining 493 stocks are languishing, equity returns become a matter of luck in having picked the right technology

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stocks. Even in Europe, animal spirits are absent as the aging middle-class cuts back on consumption.

On the other hand, in countries like India and Indonesia, animal spirits are alive and dancing. The causal relationship between expanding middle-class consumption and rising stock market performance is empirically visible.

Consumption

India is one of the few countries enjoying the twin fundamental advantages at scale:

- Growing youthful Middle-Class (**more consumers**)
- Rising per capita income (**with more money to spend**)

Rising consumption is at the heart of earnings-growth for Indian businesses. The outlook for consumption growth in India is materially better than global consumption forecasts – this would be expected given the inflation led growth slowdown globally. The table on the right reflects the bright outlook for consumption orientated Indian companies.

Projected Growth Rates 2023-2028

Consumption Category	Global	India
Baby care	4%	14%
Snack Foods	7%	12%
Beverages	5%	9%
Pharmaceuticals	6%	12%
Pet care	10%	17%
Beauty/Personal Care	3%	6%
Watches	6%	20%
Two-Wheelers	7%	17%
Paints & Coatings	4%	9%

Source: UTI Research and Statista

China Disappointment

The case of China, at first glance seems anomalous but there are three main reasons for the under-performance of the Chinese equity market:

- Top-down state-led investment into industrial capacity has been neither predictable nor profitable.
- Middle-class consumption has lagged and even then, it has been dominated by the real estate sector.
- An ageing, socialist society ruled by fear cannot unleash the Animal Spirits needed for the courageous pursuit of capitalist opportunities

Simply stated, China lacks the core drivers for sustainable and consistent growth of corporate earnings. Thus, its equity performance will remain volatile and unpredictable.

Market Capitalization

As per Goldman Sachs, the total market cap of Emerging markets (China + India + Rest of EM) will aggregate to USD 46 Trillion by 2030, eclipsing that of United States. Presently, India's market cap is the 5th largest in the world and projected to double by the end of this decade.

As long as India keeps adding to its middle-class population, India will remain a reliable engine of consumption. Its animal spirits will continue to fuel the virtuous cycle of growth and the earnings of domestic companies will continue to expand. Inevitably India's weight in global indices will rise attracting greater investment flow.

Market Capitalization (USD Trillions)

Country	Actual for 2022	Projection for 2030	Growth%
USA	39	43	10.3%
Euro Area	8	10	25.0%
Rest of DM	19	27	42.1%
China	10	18	80.0%
Rest of EM	12	22	83.3%
India	3	6	100.0%

Source: Goldman Sachs Report June, 2023

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