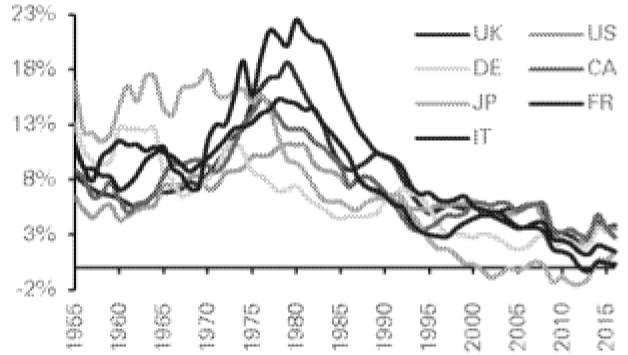
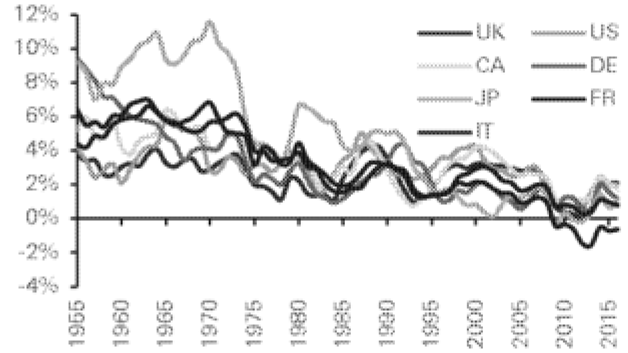
Figure 60: Nominal GDP (left) and Real GDP (right) growth rates (Last 5Yr average YoY growth)





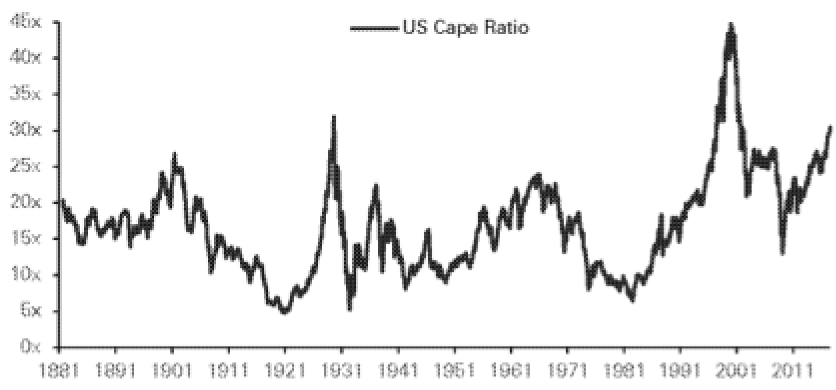
Source: Deutsche Bank, Haver, Global Financial Data

Nominal and real GDP growth rates have been trending down and unless equity returns slow relative to the past, then valuations on our measure will go up. Obviously if profits take up a bigger share of GDP for a period of time our method will look more stretched than traditional P/E ratios. However over the longer-term, this should be mean reverting as profits can't permanently outstrip nominal growth – especially at a global level. Currently there is some evidence that the US is one area where actual earnings have outstripped nominal growth in recent years for various reasons that include their large global players gaining excess overseas earnings (must be a zero sum game globally), a more shareholder friendly and focused culture and perhaps higher inequality and therefore more spoils to capital over labour.

However we'd repeat that history suggests all this is mean reverting over the medium to long term. If we look at more detail on the US which has the most developed history of equity data, including the longest series of earnings data through history we can see the longer term issues with equity market valuations.

Indeed the US CAPE ratio (Figure 61) has only been higher before the 2000 equity bubble bursting and was only slightly higher ahead of 1929 crash. CAPE analysis cyclically adjusts earnings by using the average of the last 10 years so you would have to believe the higher earnings of the last decade represent a new paradigm to not be concerned by this graph.

Figure 61: US CAPE (cyclically adjusted Price/Earnings) ratio



Source: Deutsche Bank, Global Financial Data