

# Could uncertainty be the stock market's best friend in the long run?

9 December 2024

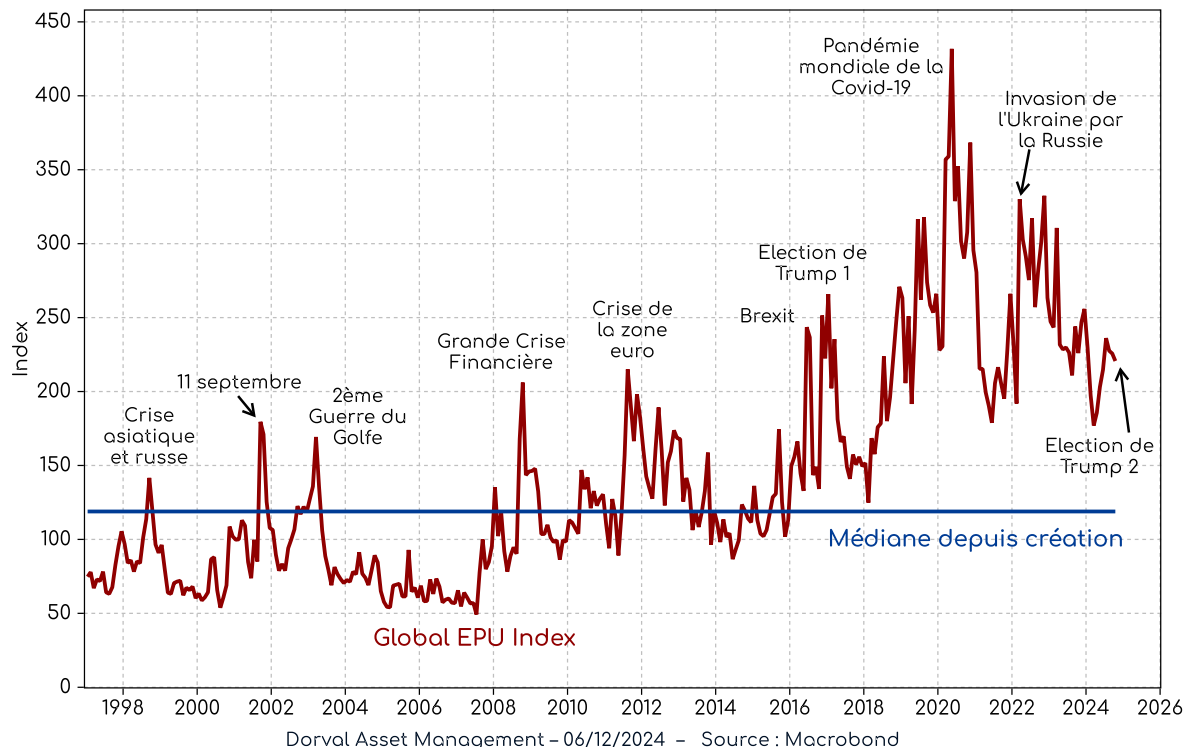
Dear Clients and Partners,

Uncertainty – whether political, geopolitical or financial – has become a catch-all concept. Thanks to big data, uncertainty can now be measured by analysing the contents of national and international newspapers. Indices built on this data have hit historic highs – in particular those pertaining to Europe and international trade. While uncertainty shocks take a toll on growth in the short term, this fallout is usually temporary and quickly absorbed. The paradox is that uncertainty, and the investor consternation that comes with it, is one factor that explains the equity market's sustained outperformance.

The Global Economic Policy Uncertainty Index built by Baker, Bloom and Davis (<https://www.policyuncertainty.com/index.html>) diverged from its median in 2016 and has never returned since (cf. chart 1).

## Global Economic Policy Uncertainty Index

### Indice Global d'incertitude économique



Asian and Russian financial crises/ 9/11 / Second Gulf War / Global financial crisis / European debt crisis / Brexit / Trump's 1<sup>st</sup> election / Global Covid-19 pandemic / Russia's invasion of Ukraine / Trump's 2<sup>nd</sup> election

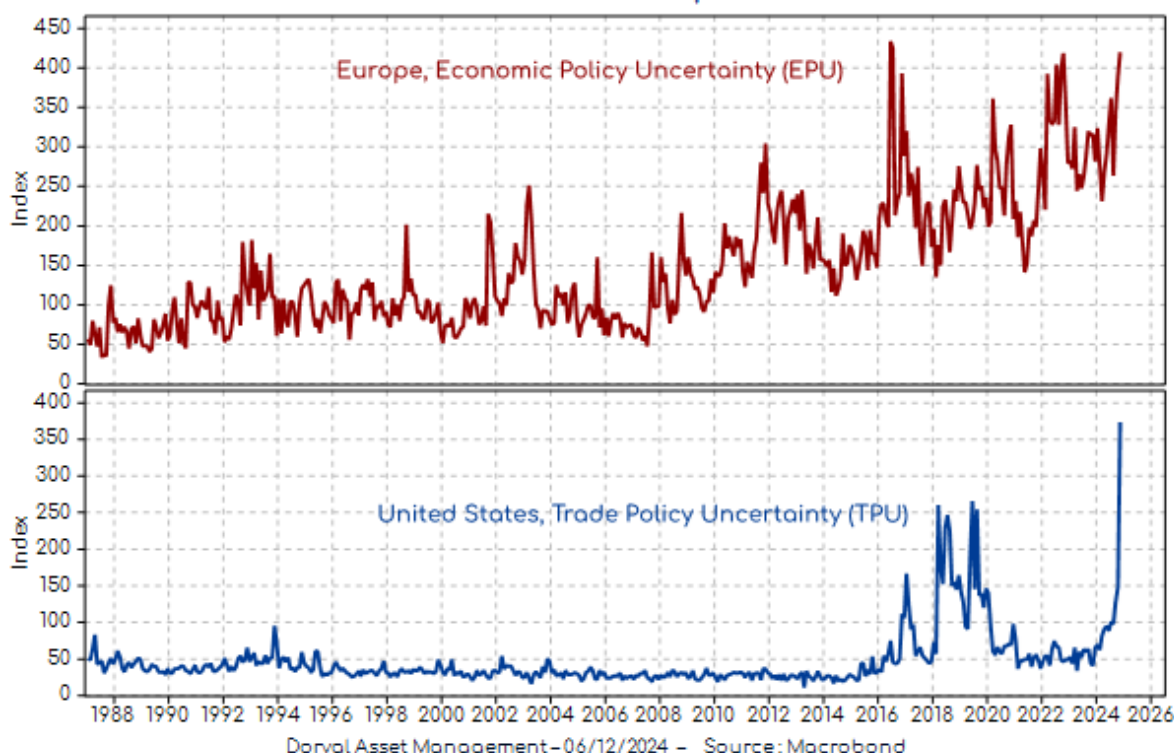
Median since creation / Global EPU Index



In the last 24 months, Europe has suffered back-to-back blows with Russia’s invasion of Ukraine, accompanying interruptions to Russian gas supply and the looming prospect of trade barriers from the United States. This has led to the Uncertainty Index reaching all-time highs (cf. chart 2).

Economic and trade policy uncertainty indices

Indice d'incertitude économique et commercial



Economic literature exploring the impacts of uncertainty shocks on the economy highlights their detrimental effects on investment and hiring decisions. The model underpinning this literature is real options theory: Decisions that are irreversible (or sufficiently costly to reverse) are similar to options on financial markets – the higher the uncertainty, the broader range of possible future outcomes of the security. This tracks with what we can observe empirically: When there is a sudden surge in uncertainty, companies put their investment and hiring plans on hold but generally end up following them through. The effect is therefore temporary – especially since, as with many psychological effects, a certain acclimation to uncertainty wins out in the end.

The effects of uncertainty on financial markets are similarly short-lived and tend to fade fairly rapidly. The anxiety awoken in investors when they find themselves plunged into this uncertain environment is – paradoxically – one potential explanation behind risk-adjusted outperformance by equities compared to other asset classes that are less risky over time. This is the mystery of the equity premium puzzle, which was put forwards by Mehra and Prescott in 1985 and has fuelled an

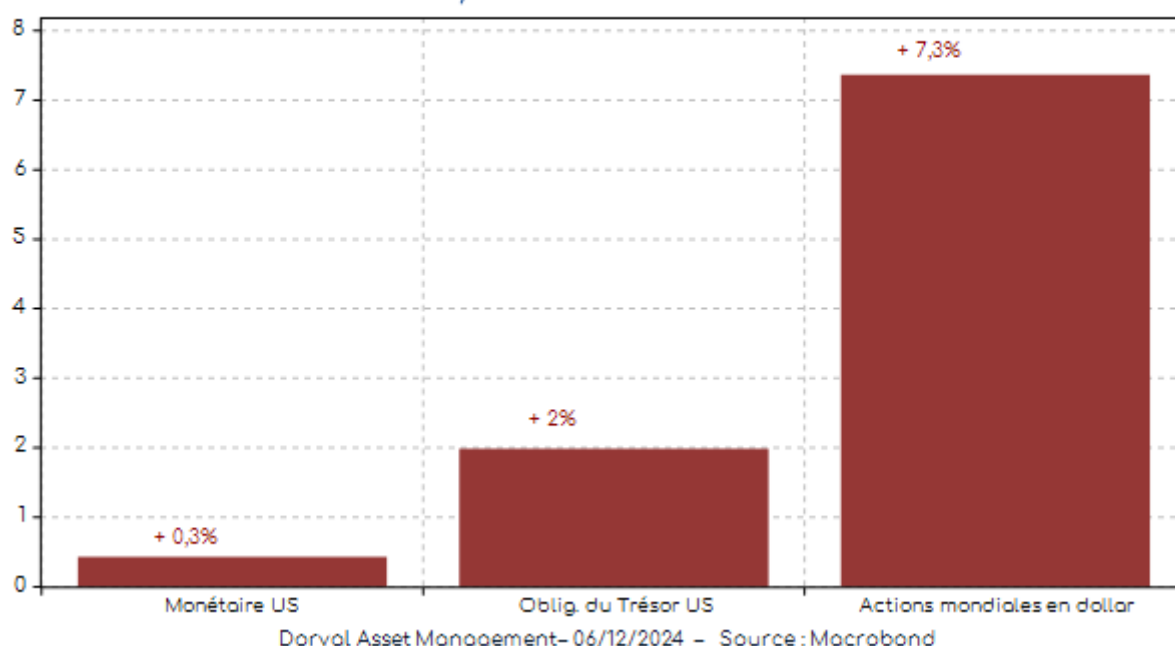


extensive body of financial literature ever since. Between 1971 and 2024, global equities saw a resultant annual real return (i.e. inflation-adjusted) of +7.3%, versus +2% for bonds and money market instruments narrowly making it into the positive (cf. chart 3). To capitalise on this excess return, however, it is necessary to accept the considerable volatility inherent to this asset class.

### Real returns (= above inflation) by asset class

Annual averages 1971-2024

#### Performances réelles (= au-dessus de l'inflation) par classe d'actifs moyennes annuelles 1971-2024



US money market / US Treasury Bonds / Global equities in dollars

Despite the political noise, we are maintaining our exposure to equities and themes in our European and global portfolios.

Our exposure rates are as follows:

- Dorval Convictions: 65% net exposure to equities, comprising 60% Euro STOXX 50 SRI core basket, 6.5% financials basket, 7% small-caps basket. Hedged using Euro STOXX 50 futures.



## Dorval Asset Management

Public limited company with share capital of €493,876

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