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Why has M&A activity decoupled from the stock market?

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- Stock prices and M&A activity have historically shown a tight correlation, particularly in the US.
- This is not surprising as increases in both are driven by a similar combination of factors: a strongly performing economy, cheap credit, rising investor confidence, and often a mix of technological or structural change.
- Given the recent stock market volatility and price falls, it is perhaps difficult to recall that global equities enjoyed a stellar 2017, with robust returns and low volatility, set against a backdrop of a strong global economy and still-low interest rates. These conditions usually spell good news for M&A activity. But this wasn't the case in 2016 or 2017, when share valuations continued to rise, while M&A activity declined.
- There are some good reasons for the divergence. Part of it is probably a natural pullback after a record 2015. Policy developments likely also contributed.
- This report examines these issues in detail, using Bureau van Dijk's M&A database.

The tight historical relationship between stocks and M&A has lately begun to break down.

Given the recent stock market volatility and price falls, it is perhaps difficult to recall that global equities enjoyed a stellar 2017, with robust returns and low volatility, set against a backdrop of a strong global economy and still-low interest rates. These conditions usually spell good news for M&A activity – stock prices and M&A volumes tend to move together, as they are driven by a similar combination of factors. But this wasn't the case in 2016 or 2017, when share valuations continued to rise while M&A activity declined. One reason could have been that M&A hit a peak in 2015, and part of the subsequent pullback was simply some of the heat coming out of a frothy acquisition market. But the divergence from the historically close relationship is nonetheless noteworthy. While most participants are understandably focused on the evaporation of 10% of the market's value in a matter of days, the question of why M&A activity was weak at a time when global stock markets were hitting record highs remains worthy of closer analysis.

The divergence is partly explained by policy developments. Even with the signaled end of quantitative easing programs, central banks are still running ultra-loose monetary policies. These artificially boost stock prices but don't necessarily make takeovers more attractive to company management teams, especially in low interest rate environments. The cut in the US corporate tax rate will also help to boost future corporate profits (and, by extension, current stock prices) in the US, at least.

A more speculative conclusion is that the decline in M&A deal volumes since early 2016 portended a fall in the stock market. Indeed, the correction of early February provides some support to this argument. This is probably an over-simplified reading of the data, although the historical correlation remains striking.

One final point is that, despite their historical correlation, stock markets and M&A cycles are really very different animals. Stocks are highly liquid and represent the market's collective view of a company's future profitability. M&A volumes, by contrast, are driven by many discrete choices by many managements, and each transaction is marked by large upfront costs and uncertain returns.

A simple explanation for the recent divergence of equity values and M&A transaction volumes is that, after 10 years of economic expansion and rising market valuations, there may simply not be enough suitable targets to justify taking on this additional risk.

Source

The information used in this analysis was drawn from the Bureau van Dijk M&A database, which tracks global activity (from deal rumor to completion) and houses data stretching back to the late 1990s. Bureau van Dijk's search filters and predefined analyses allow users to slice, dice, track, and export M&A data. This report uses these capabilities to compare M&A activity to the stock market.

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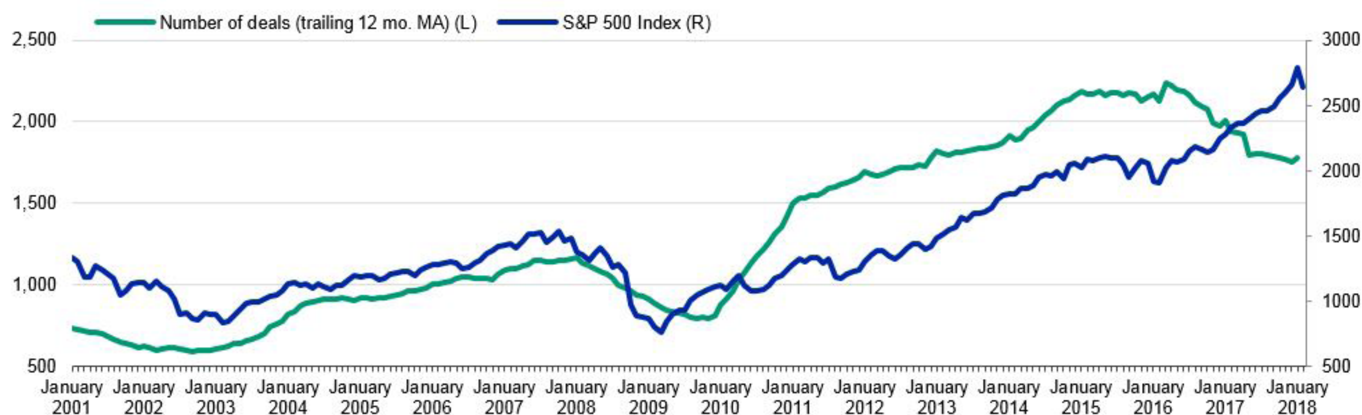
2017 was a great year for stocks, but not so great for M&A

Historically, M&A activity has tended to track stock market performance. This makes sense, as increases in both are driven by similar factors: a strongly performing economy, cheap credit, rising investor confidence, and often a mix of technological or structural change. Higher stock prices also provide firms with greater buying power, which ought to spur M&A. The story is slightly more nuanced than this, as rising valuations of target firms reduce their likelihood of being acquired, at least at the margin[1]. On net, however, and certainly in the aggregate, stock markets and M&A volumes tend to move together.

Yet in recent times the two series have begun to diverge. Stock markets around the world continued to rise in 2017, while M&A activity was flat or lower in most markets. Figure 1 shows the S&P 500 stock index plotted against M&A deal volumes in the US through early-2018.

[1] For a discussion of firm-level M&A drivers, see for example Routledge, B., Sacchetto, S., and Smith, N. (2013). *Predicting Merger Targets and Acquirers from Text*, Working paper, Carnegie Mellon University.

Figure 1. S&P 500 index and USA M&A activity



In the US, the volume of M&A deals follows the broad contours of the stock market, with the peaks and troughs occurring at roughly similar times. M&A activity tends to be more pro-cyclical than stocks and as noted, after tripling between 2010 and 2015, part of the recent pull-back probably just represents some of the heat coming out of the market. Since early 2016, however, the US stock market rose (until February 2018, of course), while M&A activity was falling. After two years' divergence we have enough data points to address the question: Why did M&A begin falling while stocks rose?

Figure 1 confirms that US M&A by deal volume tends to move closely with stock prices, but the story is little changed if we look at M&A by value instead. On a trailing 12 month average basis, the aggregate value of M&A activity in the US peaked in July 2015 at $158 billion, but by December 2017 this had fallen to $129 billion. This simply confirms the story revealed by M&A volumes. In fact, M&A activity in both value and volume terms fell around 19% over this period.

Does the M&A cycle point to an imminent decline in the stock market?

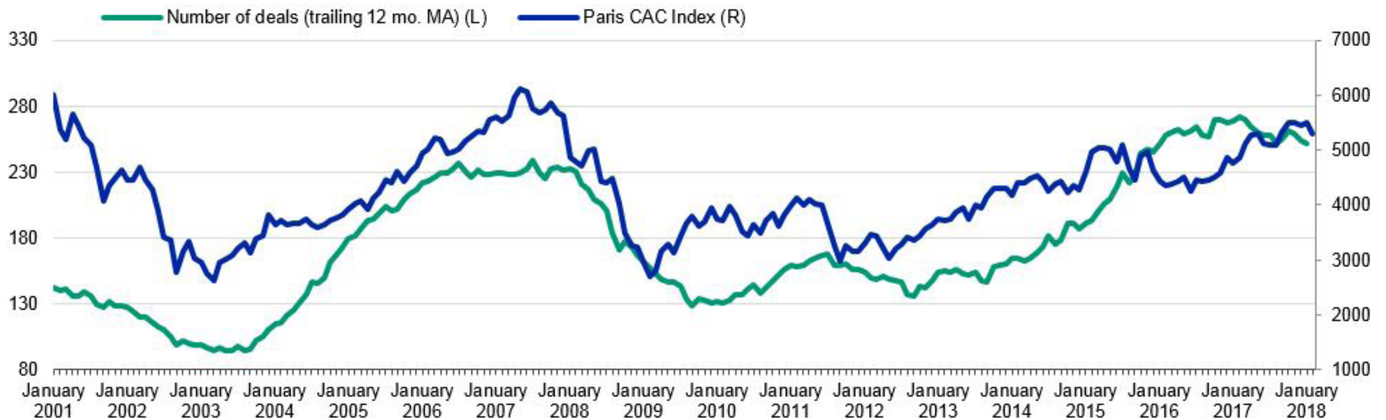
The correlation between the two series in Figure 1 is clear, although the timing varies each time the cycle turns. After the 2001 recession, M&A activity led the upturn in stocks, while at the other two major turning points in the stock market – the late-2007 downturn and the recovery from mid-2009 – stock prices moved before M&A, with a lead time of six months and eight months, respectively. The two series are correlated over time, though it is not clear which way, if any, the causality runs.

Does the recent but sustained fall in M&A portend a continuation of the current decline in US stock prices? It might well do so. We only have three data points (one for each time the stock market has turned during our time series) which isn't a lot, but they all point in the same direction. Other indicators of stock market valuation, such as price-to-earnings and price-to-book ratios, are elevated relative to historical averages and the first two months of 2018 have seen a marked increase in volatility. We shouldn't overstate the predictive power of the M&A cycle, but it adds an interesting factor to the mix.

Evidence from other countries

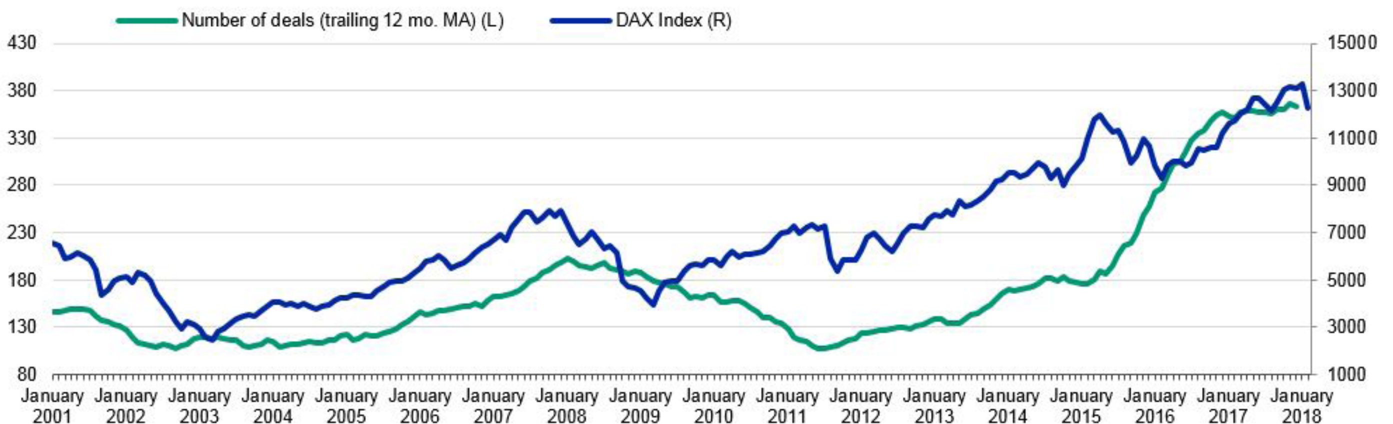
These trends are not necessarily confined to the US. Figures 2 and 3 show the French and German stock indexes plotted against their respective M&A volumes (we exclude the UK from this analysis, as Brexit-related uncertainty may have distorted the results).

Figure 2. Paris CAC index and French M&A activity



The trends are a little different in France and Germany, compared to the US. The French M&A and stock cycles move almost contemporaneously, while in Germany the M&A cycle lags the stock market. More recently, the French stock market hasn't risen as much as the US, while German M&A flattened in 2017 without actually falling. Overall, the French stock market and M&A history shows a fairly similar trend to the US, including the recent divergence in the two series. In Germany, the M&A cycle slowed a little in 2017, though volumes continued to increase, suggesting that Germany has not yet seen the same divergence as either France or the US.

Figure 3. DAX Index and German M&A activity



Which industries are most affected?

Digging deeper into the US data, Figure 4 uses the S&P 500 sector definitions to disaggregate the stock market and M&A data. We compare each sector's stock market performance with M&A deal volumes (12-month trailing average, same as above), starting in January 2016 when the two series began to diverge in the aggregate and ending in December 2017.

The rise in stocks has been fairly broad-based, with stock prices in defensive industries such as Telecommunications and Consumer staples increasing a little slower than average, and pro-cyclical industries such as IT and Financials climbing faster. The trend in M&A, however, is wildly divergent at the sector level and shows little correlation with stock market performance. The IT sector illustrates this point, with M&A falling more than any other sector, but stock prices rising the most. Healthcare was the only sector to register an increase in M&A, yet stocks rose less than average. Conversely, industrials' M&A deal volume was close to flat, making it one of the stronger performers over this period – this is consistent with the sector's strong stock market returns. There are few conclusions that can be drawn at this level. A deeper dive into the Energy sector (which has seen plenty of turbulence recently) may provide additional insight.

Figure 4. Change (%) in Stock Market and M&A activity since January 2016

	M&A volumes	Stock market
Consumer discretionary	-32.0	33.4
Consumer staples	-32.6	15.6
Energy	-26.4	24.0
Financials	-16.3	57.5
Healthcare	0.5	22.6
Industrials	-1.3	45.5
Information technology	-33.8	64.5
Materials	-29.9	51.4
Telecommunication services	-32.6	8.9
Utilities	-39.7	24.6
Total	-16.4	38.8

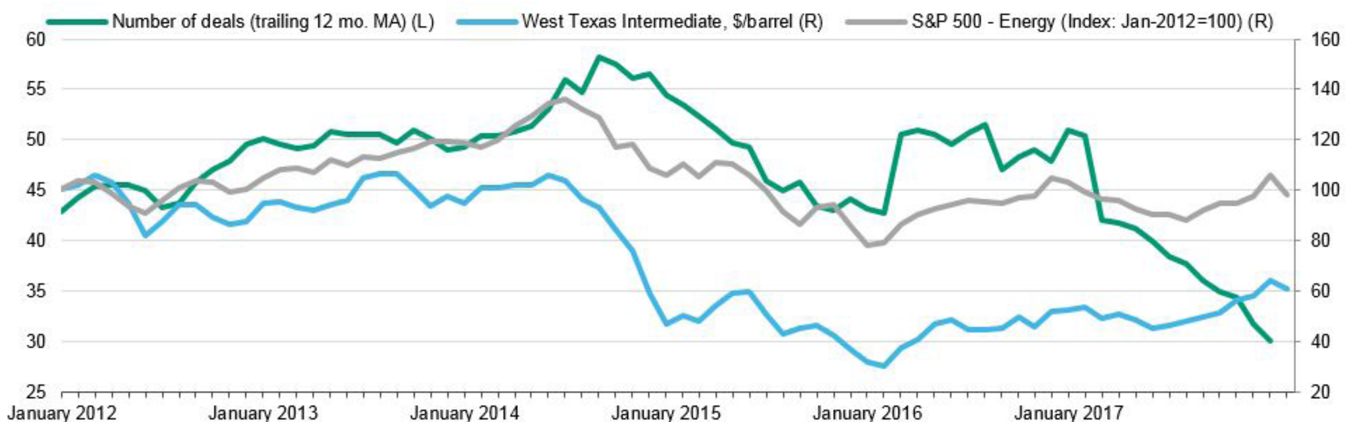
A closer look at the Energy sector

Energy is a fairly homogenous sector whose performance is tightly tied to a single metric – the price of a barrel of oil. Energy prices fell sharply in 2014, causing profitability and stock prices to decline and sparking a wave of corporate defaults[2]. Oil prices dropped from over $100/barrel in July 2014 to an eventual low of $26 in early-2016; prices stabilized near $50 and rose above $60 by the end of 2017. Figure 5 shows oil prices, stock prices (indexed to the $100 oil price at the start of the sample), and M&A activity.

As expected, Energy stocks are tightly linked to the price of oil, with both falling sharply from 2014 and through 2015. M&A is also correlated with stock prices, although the M&A downturn didn't take hold until late 2014, a couple of months after stocks had begun to decline.

We can reach a couple of tentative conclusions about the Energy sector based on this data. The first is that, as oil prices fell and profitability among Energy firms also declined, this drove a fall in M&A through 2015 while M&A in other sectors was still increasing – overall M&A activity rose 10% in 2015. That is, even as valuations in the Energy sector may have initially become cheaper and firms facing financial trouble were looking for a buyer, energy companies found themselves with diminished buying power (and appetite) and, subsequently, declining M&A activity overall. The recovery in M&A through 2016 may indicate that cheaper valuations allowed profitable Energy companies to start acquiring firms or, conversely, it could just be a blip in a downward trend that continued through 2017.

Figure 5. USA M&A activity (Oil and Gas Industry) vs Oil prices



[2] See for example Smith, A. (2016). *Energy Company Market Signals Portend Rising Downgrades and Defaults*. Moody's Analytics Sector In-Depth Report. www.moodys.com/research/Energy-Risk-Report-Energy-Company-Market-Signals-Portend-Rising-Downgrades--PBC_1018180

Conclusion

As noted at the outset of this paper, one reason why M&A deal counts have been falling for two years while stock prices climbed higher (at least until recently), is central banks' ultra loose monetary policies. These included near zero low interest rates and quantitative easing, which have distorted stock market valuations. By definition, low interest rates increase the discounted lifetime earnings of a company, implying a direct lift to stock prices. The Bernanke-led Fed went further than this, buying up large quantities of bonds. This directly lifted bond prices and indirectly lifted stocks, as portfolio managers rebalanced their holdings to take on more (comparatively) cheaper equities.

There is perhaps another reason why the abundance of cheap capital might not necessarily have given managers the confidence to take the plunge on M&A deals, namely the scarring effect on collective memories of the 2008-09 recession. This could well have pushed many to choose the relatively safe path of using capital to buy back shares, rather than acquiring companies or investing in their own operations.

The cut in the US corporate tax rate, which was finalized in December of last year but telegraphed throughout the year, may also have capped M&A in 2017. This is because US firms with large holdings of offshore cash may have decided to "keep their powder dry" until the outline of tax bill was clear. This could now change. With the bill on the books, companies may be more inclined to put their cash to use, while potential buyers – both in the US and abroad – might now find US corporates to be more attractive targets. If so, we can expect a bump in US M&A activity in 2018. Of course, should the sell-off in equities continue, this would represent another break in the historical relationship between share prices and M&A deal volumes.

One final factor worth noting is that M&A cycles operate differently to stock markets. As the business cycle matures, the easy synergies and cheap valuations available at the start of the cycle give way to more marginal deals at richer valuations. Acquiring or merging with another company is a large strategic decision with an uncertain return that, in theory at least, needs to be high enough to justify taking the risk. We are now in the 10th year of the current economic expansion and, as noted, the divergence of M&A volumes from equity prices may reflect the fact that there just aren't enough suitable targets that clear corporate investment hurdles.

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