What drives Q and investment fluctuations?

Abstract

A dynamic present-value relation implies that variations in the ratio of the marginal profitability of capital to marginal Q are driven by shocks to the expected growth of the marginal profitability of capital or discount rate shocks, or both. We find that this ratio predicts future marginal profitability of capital growth at horizons of up to 20 years, but not investment returns. Thus, in contrast to stock prices, the primary source of fluctuations in marginal Q as well as of aggregate investment is expected profit growth shocks, whereas the role of discount rate shocks is negligible. The results indicate that managers' real investment decisions are strongly related to economic fundamentals.