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Irrational Complacency?

By BURTON G. MALKIEL April 30, 2007

Despite news that the estimated first quarter GDP growth rate fell to 1.3%, the Dow Jones Industrial Average closed last Friday at 13,121, a record high. The broader capitalization-weighted S&P 500 stock index, covering 80% of the market, traded just below its historical high. Only the Nasdaq index is well below its Internet bubble high. Is the stock market correctly pricing strong growth in corporate profits and present economic stability? Or are we being irrationally complacent in the face of substantial risks to the market and the world economy?

Despairing of economists who offered "on the one hand, on the other hand" advice, President Harry S. Truman yearned for a one-handed economist who could offer clear predictions about the future. I fail Truman's test; neither I nor anyone else knows the proper level of securities prices, and we can never be sure if today's stock prices are reasonable measures of uncertain future events. We can, however, evenhandedly assess current valuations in financial markets and the prospects for likely future long-run returns.

The facts are that stock prices are high not only in the U.S. but also in the world's developed and emerging markets. We can estimate long-run annual equity returns by adding today's dividend yield (just under 2%) to the likely future growth rate of earnings and dividends (perhaps 5.5%). This calculation suggests that stocks are priced to produce about 7.5% future returns, well below the 10.5% annual returns achieved from 1926 through 2006. Treasury bond yields (at just under 4.75%) are historically low, as is core inflation, running close to 2%. The prospective equity risk premium (the amount by which stock returns are likely to exceed bond returns) of about two and three-quarter percentage points appears to be well below the five percentage point equity risk premium earned since 1926. We are not being paid as much to take on the risk of holding stocks.

Not only are equity premiums low; so are bond risk premiums. The spread between high-yield bonds (more pejoratively called junk bonds) and safe U.S. Treasuries is just about at an all-time low. Sovereign emerging-market debt yields are not much more than two percentage points over U.S. government debt. The VIX index, measuring expected U.S. stock market volatility, is extraordinarily low. These measures imply that financial markets are very relaxed about risk and that the world is a very stable place. There are reasons to argue that world economic stability has in fact increased. We have not endured a world war in over 60 years. The Cold War ended peacefully, and increased trade has made the world's economies increasingly interdependent. Free market economies have blossomed throughout the world. As money manager Rex Sinquefield reminds us, the only people today who don't believe that markets work are

the Cubans and the North Koreans (and some "active" portfolio managers). Economic activity in the U.S. has become increasingly stable. Depressions have been avoided, recessions have been mild, earnings variability has moderated and inflation has been contained. Moreover, despite the rise in the stock market, and unlike the situation at the 2000 peak, price-earnings multiples in the mid to high teens are not far from their long-run average values.

But could the stock market be underestimating geopolitical risks today? We are all painfully aware of the extraordinarily difficult situation in the Middle East. The conflicts between Sunnis and Shiites as well as the violence of Hezbollah and Hamas threaten to destabilize the entire region. Iran poses a grave threat to Israel and seems determined to become a nuclear power. Unrest in the region has a direct impact on oil prices.

Potential problems in energy-vulnerable Europe seem more remote to most observers. But Europe has a large Muslim population that is experiencing limited social integration, high unemployment and radical Islamist influence. Beyond that, with slow-growing economic activity and rapidly aging populations, European governments will be hard put to fulfill their generous social welfare promises. Could it be, paraphrasing President Franklin D. Roosevelt, that the only thing we have to fear is lack of fear itself? Moreover, economic imbalances in the U.S. could trip us up. According to Yale University economist Robert Shiller, inflation- and quality-adjusted home prices are still more than 50% higher than their averages throughout most of the 20th century. These data suggest that the real-estate correction could have much further to go. Measured savings rates in the U.S. are essentially zero, and the trade deficit is running at 7% of GDP.

The late economist Herbert Stein used to say, If something can't go on forever, it won't. Many observers would also argue that the U.S. income distribution may be unsustainable. The share of after-tax corporate profits (increasingly influenced by the foreign profits of multinational corporations) relative to GDP is almost 9%, compared with an average of about 5% during the 1970s and 1980s. Wages and salaries as a percent of GDP have fallen from 53% to under 46% since 1970.
Corporate profits have shown strong tendencies to revert to the mean in the past and could do so in the future. Inflation-adjusted earnings of the S&P 500 stocks showed zero growth from 1900 through 1947 and again from 1967 through 1987. If we enter such a period in the future, today's moderate price-earnings multiples may look far less attractive.

As a believer in efficient markets, I hesitate to conclude that our markets are being irrationally complacent. I believe that markets are high and risk spreads compressed because of massive increases in world liquidity. A world awash in dollar-based purchasing power has helped to keep our interest rates low and the spreads on risk assets tight. It has encouraged large flows of money into private equity funds that are privatizing (and leveraging) some of the "undervalued" companies in the market, leaving less attractive firms available for public investors. Flows of money have also continued into hedge funds where leverage is high and where "accidents" such as the

Amaranth collapse are always possible. In our highly leveraged, narrow-spread markets, shocks to the system -- be they economic or geopolitical -- can have large destabilizing effects.

So what should investors do as the Dow rises to new highs? Should they "sell in May and go away," as one stock-market bromide suggests? As a student of markets for over 50 years, I am convinced that attempting to time the market is a fool's game. But new highs in the market should induce investors to review their asset allocations. If the rising stock market has pushed your allocation of equities well above the level consistent with your risk tolerances, it makes sense to consider rebalancing. Rebalancing is an excellent strategy to constrain your investment risk in a very uncertain world.

Despite the risks and potential problems I have outlined, I remain a cautious optimist. I don't think anyone will make money in the long run betting against the inherent strength of the U.S. economy. I expect that the economy will adjust eventually to whatever imbalances exist and that the nations of the world will ultimately find peaceful solutions to the seemingly intractable problems that continue to bedevil us.

Having disclosed my optimistic bias, however, I can't help remembering the story of two rabbis at the time of the creation. One rabbi asked the other whether he was optimistic or pessimistic. "I'm optimistic," the second rabbi replied. "Then why are you frowning?" the first rabbi asked. The answer: "Because I'm not sure my optimism is justified."

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