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Today’s Rational Exuberance

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LONDON – With share prices around the world setting new records almost daily, it is tempting to ask whether markets have entered a period of “irrational exuberance” and are heading for a fall. The answer is probably no.
What many analysts still see as a temporary bubble, pumped up by artificial and unsustainable monetary stimulus, is maturing into a structural expansion of economic activity, profits, and employment that probably has many more years to run. There are at least four reasons for such optimism.

First and foremost, the world economy is firing on all cylinders, with the United States, Europe, and China simultaneously experiencing robust economic growth for the first time since 2008. Eventually, these simultaneous expansions will face the challenge of inflation and higher interest rates. But, given high unemployment in Europe and spare capacity in China, plus the persistent deflationary pressures from technology and global competition, the dangers of overheating are years away.

Without hard evidence of rapid inflation, central bankers will prefer to risk over-stimulating their economies rather than prematurely tightening money. There is thus almost no chance of a quick return to what used to be considered “normal” monetary conditions – for example, of US short-term interest rates rising to their pre-crisis average of inflation plus roughly 2%.

Instead, very low interest rates will likely persist at least until the end of the decade. And that means that current stock-market valuations, which imply prospective returns of 4% or 5% above inflation, are still attractive.

A second reason for confidence is that the financial impact of zero interest rates and the vast expansion of central bank money known as “quantitative easing” (QE) are now much better understood than they were when introduced following the 2008 crisis. In the first few years of these unprecedented monetary-policy experiments, investors reasonably feared that they would fail or cause even greater financial instability. Monetary stimulus was often compared to an illegal performance drug,

which would produce a brief rebound in economic activity and asset prices, inevitably followed by a slump once the artificial stimulus was withdrawn or even just reduced.
Many investors still believe the post-crisis recovery is doomed, because it was triggered by unsustainable monetary policies. But this is no longer a reasonable view. The fact is that experimental monetary policy has produced positive results. The US Federal Reserve, which pioneered the post-crisis experiments with zero interest rates and QE, began to reduce its purchases of long-term securities at the beginning of 2014, stopped QE completely later that year, and started raising interest rates in 2015 – all without producing the "cold turkey" effects predicted by skeptics.

Instead of falling back into recession or secular stagnation, the US economy continued growing and creating jobs as the stimulus was reduced and then stopped. And asset prices, far from collapsing, hit new highs and accelerated upward from early 2013 onwards – exactly when the Fed started talking about "tapering" QE.

The Fed's policy experimentation points to a third reason for optimism. By demonstrating the success of monetary stimulus, the US has provided a roadmap that other countries have followed, but with long and variable lags. Japan started full-scale monetary stimulus in 2013, five years after the Fed. Europe lagged by seven years, starting QE in March 2015. And in many emerging economies, monetary stimulus and economic recovery only began this year. As a result, business cycles and monetary policy are less synchronized than in any previous global expansion.

That is good news for investors. While the Fed is raising interest rates, Europe and Japan are planning to keep theirs near zero at least until the end of the decade, which will moderate the negative effects of US monetary tightening on asset markets around the world, while European unemployment and Asian overcapacity will delay the upward pressure on prices normally created by a coordinated global expansion.

This suggests the fourth reason why the global bull market will continue. While US corporate profits, which have been rising for seven years, have probably hit a ceiling, the cyclical upswing in profits outside the US has only recently started and will create new investment opportunities. So, even if US investment conditions become less favorable, Europe, Japan, and many emerging markets are now entering the sweet spot of their investment cycles: profits are rising strongly, but interest rates remain very low.

All of these cyclical reasons for optimism are, of course, challenged by long-term structural anxieties. Can low interest rates really compensate for rising debt burdens? Is productivity really falling, as implied by most economic statics, or accelerating, as technological breakthroughs suggest? Are nationalism and protectionism poised to overwhelm globalization and competition? Will inequality be narrowed by job creation or widen further, causing political upheaval?

The list could go on and on. But these structural questions all have something in common: We will not know the true answers for many years. One thing we can say with confidence, however, is that market expectations about what may happen in the long term are strongly influenced by short-term cyclical conditions that are visible today.

During recessions, investor opinion is dominated by long-term anxieties about debt burdens, aging, and weak productivity growth, as has been true in the period since 2008. In economic upswings, psychology shifts toward the benefits of low interest rates, leverage, and technological progress.

When this optimistic shift goes too far, asset valuations rise exponentially and the bull market reaches a dangerous climax. Some speculative assets, such as cyber currencies, have already reached this point, and shares in even the best public companies are bound to experience temporary setbacks if they run up too fast. But for stock markets generally, valuations are not yet excessive, and investors are far from euphoric. So long as such cautiousness continues, asset prices are more likely to rise than fall.

ANATOLE KALETSKY

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Anatole Kaletsky is Chief Economist and Co-Chairman of Gavekal Dragonomics. A former columnist at the *Times of London*, the *International New York Times* and the *Financial Times*, he is the author of *Capitalism 4.0, The Birth of a New Economy*, which anticipated many of the post-crisis transformations of the global economy. His 1985 book, *Costs of Default*, became an influential primer for Latin American and Asian governments negotiating debt defaults and restructurings with banks and the IMF.

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