The Dow’s new high
Rally drivers

There’s froth in the equity markets, but not a bubble
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IT SEEMS like a moment for uncorking, if not a vintage champagne, then a nice bottle of Californian pinot noir. The Dow Jones Industrial Average, America’s most-cited equity benchmark, has finally surpassed the high it reached back in October 2007. Other developed-world stockmarkets have been surging too; Tokyo has managed a double-digit gain this year.

Wall Street’s rally is caused only partly by the performance of the domestic economy, which is forecast to grow by a modest 2.0% this year. Since March 2009 the Dow has more than doubled while the American economy has grown by a cumulative 7% in real terms. Over the same period, the Chinese economy has grown by 41% but the Shanghai stockmarket is less than half its 2007 peak.

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The equity markets have been booming as a result of a deliberate strategy of central banks: by forcing down bond yields, they hope to persuade investors to buy risky assets and thus restore confidence to both businesses and consumers. In much of the developed world, therefore, government bond yields are close to record lows despite the high levels of public debt, while investors get a negative return (after inflation) from holding cash. Equities look like the best bet.

The central banks are pursuing the right policy for a weak world economy, but it has risks. When central banks intervene to boost confidence, they are in danger of encouraging excessive risk-taking—as they did through the long bull market of the 1980s and 1990s. This time round, there are some tentative signs of excessive exuberance in the credit markets, as Jeremy Stein, a Federal Reserve governor, noted in a thoughtful speech last month (see Buttonwood). The kind of high-risk securities that marked the credit bubble are starting to reappear.

And there are reasons to worry that stocks may be overvalued. American companies’ profits
—thanks to their booming overseas subsidiaries—are at a post-1945 high relative to GDP. That suggests it will be difficult for them to rise much further. And indeed, profits growth has been slowing in recent months. For the current quarter, ending March 31st, profits of S&P 500 companies are expected to be only 1.2% higher than the previous year—and only 0.1% if financial companies are excluded from the total. All that leaves American shares looking off-puttingly expensive, with valuations around 40-50% above the long-term average (see article). As yet, however, the excesses are not on the scale of the last two bull markets; indeed, the American public is only just regaining its appetite for equity mutual funds. So central banks can be excused for sitting back and enjoying the bull run, especially as any action they could plausibly take to halt it would damage a still-fragile economy.

A different paradox of thrift  
Nevertheless, equity investors should keep a level head. In particular, American pension funds should be aware that, with bond yields low and equity valuations high, future investment returns are likely to be low. They need to contribute more if pension deficits are to be reduced. Similarly, employees who are responsible for their own pensions via plans such as 401(k)s need to stump up more if they are to retire in comfort. But here is the paradox. To rescue economies from the doldrums, central banks want companies and employees to save less in the short term, not more. Balancing the desire for short-term consumption and the need for long-term thrift is one of the trickiest issues for rich countries as they navigate their way out of the crisis. Perhaps the Dow will resolve that paradox by continuing to soar. More likely, it will not.

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