Stocks Are Headed for a Fall

The Fed is playing catch up, and as inflation and rates rise, asset prices will revert to previous norms.

By MARTIN FELDSTEIN

Year after year, the stock market has roared ahead, driven by the Federal Reserve’s excessively easy monetary policy. The result is a fragile financial situation—and potentially a steep drop somewhere up ahead.

To deal with the Great Recession, the Fed cut interest rates to a historic low. The short-term federal-funds rate hit 0.15% in January 2009 and stayed there until the end of 2015. In a strategy aimed at reducing long-term rates, the Fed under then-Chairman Ben Bernanke promised to keep short-term rates close to zero until the economy fully recovered. The Fed also began buying long-term bonds and mortgage-backed securities, more than quintupling its balance sheet from nearly $900 billion in 2008 to $4.4 trillion now.

Mr. Bernanke explained that this “unconventional” monetary policy was designed to encourage an asset-substitution effect. Investors would shift out of bonds and into equities and real estate. The resulting rise in household wealth would push up consumer spending and strengthen the economic recovery.

he strategy eventually worked as Mr. Bernanke had predicted. The value of equities owned by households increased 47% between 2011 and 2013, and overall household net worth rose nearly $10 trillion in 2013 alone. The S&P 500 stock index gained more than 200% in the seven years from 2009 to the month before the 2016 election. By now the total increase is more than 300%.

Stock prices rose much faster than profits did. The price/earnings ratio for the S&P 500 is now 26.8, higher than at any time in the 100 years before 1998 and 70% above its historical average. Although some of the market’s recent surge reflects improved expectations since the 2016 election, the P/E ratio just before the election was already 49% higher than its historical average.

The high price of stocks reflects the very low returns available on fixed-income securities. Though the federal-funds rate has been raised since 2015, its real value is still negative. The 2.5% yield on 10-year Treasury bonds approximately equals expected inflation over the next decade, implying a real yield of zero. Historically the real yield on 10-year Treasurys was about 2%.

When interest rates rise back to normal levels, share prices are also likely to revert to previous norms. If the P/E ratio declines to its historical average, the implied fall in the market would reduce the value of household equities held directly and through mutual funds by $10 trillion. If every dollar of decline in household wealth reduces annual consumer spending by 4 cents, as experience suggests, spending would fall by $400 billion, or more than 2% of gross domestic product. The drop in equity prices would also raise the cost of equity capital, reducing business investment and further depressing GDP.

What about interest rates on bonds? I see four different reasons for a coming increase.

First, the Fed is raising the short-term rate and will continue to do so at least until its favored inflation measure, the price of personal consumption expenditures or PCE, moves from its current 1.8% to the stated target of 2%. Higher short rates will cause long rates to rise even if the slope of the yield curve does not increase.

Second, the Fed is cutting its balance sheet by reducing its holdings of Treasury bonds, pushing up the interest rate needed to get the market to absorb the greater supply of securities.

Third, the federal government’s deficit of 3.5% of GDP means Washington will borrow some $700 billion this year. The Congressional Budget Office forecasts that the deficit will grow to more than 5% of GDP over the next decade under current law. That would push America’s debt-to-GDP ratio from 77% now to 97% in 2027. This is probably too optimistic.
on defense and discretionary programs is shrinking as a share of GDP, and the need to reverse this trend means the deficits and debt will be even greater than current law suggests. Buyers of this increased U.S. debt will require a higher interest rate.

Fourth, easy monetary policy has produced an overly tight labor market that is beginning to push up inflation. The consumer price index rose 2.1% over the past 12 months, and there is an increased risk that at some point inflation will shoot upward. The expectation of rapid inflation will cause long-term rates to rise even before that faster inflation occurs.

In short, an excessively easy monetary policy has led to overvalued equities and a precarious financial situation. The Fed should have started raising the fed-funds rate several years ago, reducing the incentive for investors to reach for yield and drive up equity prices. Since it didn’t do so, the Fed now faces the difficult challenge of trying simultaneously to contain inflation and reduce the excess asset prices—without pushing the economy into recession.

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