A Third Scenario for Stock Markets

By Antonio Fatas , INSEAD Professor of Economics

Are stock prices expensive or cheap? Compared to other asset classes, prices are consistent with historical levels.

The stock market turmoil of recent weeks has sparked a flurry of arguments about whether stocks are overpriced or not. Robert Shiller, the Sterling Professor of Economics at Yale and Nobel Laureate recently weighed in on the **New York Times**, arguing that the stock market is expensive by historical standards, according to the cyclically-adjusted price earnings ratio (CAPE) that he has made popular through his writings since the late 1990s.

There is no doubt that the CAPE ratio for the US stock market is high by historical standards. Using Shiller's estimates it stands at around 26 today, clearly above the historical average of about 17. What a higher CAPE means is that you are paying more for the same earnings. Earnings' growth could, of course, be different in the future. They might be lower because potential GDP growth is slowing down but they might be higher as profits as a share of GDP increases. If we assume the same number just for simplicity, a higher CAPE means that investors should expect a lower return if they buy shares on the stock market today compared to an average year in the past.

What does it mean for the future price of the stock market? Shiller concludes that maybe we will see the stock market returning to historical averages (which implies a massive fall in the current values) or maybe we see what we saw in the late 90s where the market continues going up and reaching a CAPE of over 40 before crashing. As Shiller puts it we "just don't know".

Another scenario

But what about a third option? The market remains at a level around 25, as it is today, and this implies that returns will be lower than historical averages. Is this possible and consistent with investors' expectations? Yes, under two assumptions. One is that returns in all other assets are also lower than historical averages. This is certainly the case today where interest rates on bonds are at very low historical levels and it is difficult to foresee a large increase in the coming years.

The other justification for high CAPE ratios is that investors' risk aversion has gone down relative to previous decades. While talking about low risk perception this week might not sound right, the reality is that the years in which the stock market had CAPE ratios of around 17 were also the years where academics wondered about why risk aversion was so high among investors (what we call the equity risk premium).

How much do we need those numbers to change to justify higher-than-normal CAPE ratios? A quick calculation using current bond interest rates would tell us that the stock market at a 25 CAPE ratio offers a risk premium over bonds that is similar to what the stock market offered when the CAPE ratio was 17 (around 6-7 percent). In that sense, the stock market is not expensive, it is priced in a way that is consistent with historical levels.

If you want to make the stock market cheap you just need to argue that the risk premium should be lower than that. If you want to make the stock market very expensive you need to argue that interest rates on bonds will soon go back to historical levels. In that scenario the US stock market should go down by about 30-40 percent relative to current levels.

Boring, but more plausible?

Predicting which scenario will be realised is not easy, as Shiller argues. But I would have liked him to have considered the third possible scenario where current CAPE levels are fine and investors get used to lower-than-historical returns that are consistent with what is going on in other asset classes. Maybe we put too much emphasis on the bouncing back and crashing scenarios when we talk about stock prices and we forget a much more boring but plausible one that delivers a less volatile stock market.

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