

The bull market in everything

# Asset prices are high across the board. Is it time to worry?

*With ultra-loose monetary policy coming to an end, it is best to tread carefully*



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IN HIS classic, “The Intelligent Investor”, first published in 1949, Benjamin Graham, a Wall Street sage, distilled what he called his secret of sound investment into three words: “margin of safety”. The price paid for a stock or a bond should allow for human error, bad luck or, indeed, many things going wrong at once. In a troubled world of trade tiffs and nuclear braggadocio, such advice should be especially worth heeding. Yet rarely have so many asset classes—from stocks to bonds to property to bitcoins—exhibited such a sense of invulnerability.

Dear assets are hardly the product of euphoria. No one would mistake the bloodless run-up in global stockmarkets, credit and property over the past eight years for a

reprise of the “roaring 20s”, or even an echo of the dotcom mania of the late 1990s. Yet only at the peak of those two bubbles has America’s S&P 500 been higher as a multiple of earnings measured over a ten-year cycle. Rarely have creditors demanded so little insurance against default, even on the riskiest “junk” bonds. And rarely have property prices around the world towered so high. American house prices have bounced back since the financial crisis and are above their long-term average relative to rents. Those in Britain are well above it. And in Canada and Australia, they are in the stratosphere. Add to this the craze for exotica, such as cryptocurrencies (see [Free exchange \(http://www.economist.com/news/finance-and-economics/21729995-crypto-coin-mania-illustrates-crazy-and-not-so-crazy-sides-bubbles-manias\)](http://www.economist.com/news/finance-and-economics/21729995-crypto-coin-mania-illustrates-crazy-and-not-so-crazy-sides-bubbles-manias)), and the world is in the throes of a bull market in everything.

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### Where’s the beef?

Asset-price booms are a source of cheer, but also anxiety. There are two immediate reasons to worry. First, markets have been steadily rising against a backdrop of extraordinarily loose monetary policy. Central banks have kept short-term interest rates close to zero since the financial crisis of 2007-08 and have helped depress long-term rates by purchasing \$11trn-worth of government bonds through quantitative easing. Only now are they starting to unwind these policies. The Federal Reserve has raised rates twice this year and will soon start to sell its bondholdings. Other central banks will eventually follow. If today’s asset prices have been propped up by central-bank largesse, its end could prompt a big correction. Second, signs are appearing that fund managers, desperate for higher yields, are becoming increasingly incautious. Consider, for instance, investors’ recent willingness to buy Eurobonds issued by Iraq, Ukraine and Egypt at yields of around 7%.

But look carefully at the broader picture, and there is some logic to the ongoing rise in asset prices. In part it is a response to an improving world economy. In the second quarter of this year global GDP grew at its fastest pace since 2010, as a recovery in emerging markets added impetus to longer-standing upswings in Europe and America. As our special report this week argues, emerging-market economies have come out of testing times in far more resilient shape.

More significant still is the behaviour of long-term interest rates. They have fallen steadily since the 1980s and remain close to historic lows. And that underpins all sorts of other asset prices (see [article](#)

(<http://www.economist.com/news/briefing/21729988-low-interest-rates-have-made-more-or-less-all-investments-expensive-bubble-without-any-fizz>) ). A widespread concern is that the Fed and its peers have grossly distorted bond markets and, by extension, the price of all assets. Warren Buffett, the most famous disciple of Ben Graham, said this week that stocks would look cheap in three years' time if interest rates were one percentage-point higher, but not if they were three percentage points higher. But if interest rates and bond yields were unjustifiably low, inflation would take off—and puzzlingly it hasn't. This suggests that factors beyond the realm of monetary policy have been a bigger cause of low long-term rates. The most important is an increase in the desire to save, as ageing populations set aside a larger share of income for retirement. Just as the supply of saving has risen, demand for it has fallen. Stagnant wages and the lower price of investment goods mean companies are flush with cash. All this suggests that interest rates will stay low by historical standards.

### **Beware of the bull**

Still the most dangerous, anti-Graham motto of investing is “this time is different”. It would be daft to assume that asset prices must remain high come what may. Many hazards could derail the economy and financial markets, from a debt crisis in China to an American-led trade war or an outbreak of fighting on the Korean peninsula. And when the next recession comes, policymakers have less fiscal and monetary ammunition to fight it than they had in previous downturns. Prudence therefore suggests caution.

One option is for central bankers to raise rates more enthusiastically and less predictably, to jolt financial markets and remind investors that the world is volatile. Yet there are obvious perils with this course. The tightening might prove excessive, tipping economies into recession. And with inflation in most big economies below central bankers' target, sharply higher rates are hard to square with their mandate.

Instead, caution calls for gradualism. To minimise disruption, the reversal of quantitative easing should be stretched out. The Federal Reserve has set a good precedent by proposing to reduce its bondholdings at a leisurely pace and flagging the change well in advance. When the time comes, its peers should follow suit. Of these, the European Central Bank faces the trickiest challenge, because it has acted as, in effect, the backstop to euro-zone bond markets, a mechanism that otherwise the currency bloc still lacks.

But the main safety valve lies elsewhere, with banks and investors. Bitter experience has shown that debt-funded assets can magnify losses, causing financial crises. For this reason banks must be able to withstand any reversal of today's high asset prices and low defaults. That means raising bank capital in places where it is too low, especially the euro zone, and not backsliding on strenuous "stress tests" as America's Treasury proposes. In the end, however, there may be no escape for investors from the low future returns and even losses that high asset prices imply. They and regulators should take a leaf out of "The intelligent Investor", and make sure that they have a margin of safety.

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