# The Illusions Driving Up US Asset Prices

By Robert Shiller *Mon, Jan 23, 2017*

*'The Dow is up only 19% in real (inflation-adjusted) terms since 2000. A 19% increase in 17 years is underwhelming, and the national home price index that Karl Case and I created is still 16% below its 2006 peak in real terms,' writes Nobel winner Robert Shiller in this guest column.*

Speculative markets have always been vulnerable to illusion. But seeing the folly in markets provides no clear advantage in forecasting outcomes, because changes in the force of the illusion are difficult to predict.

In the United States, two illusions have been important recently in financial markets. One is the carefully nurtured perception that President-elect Donald Trump is a business genius who can apply his deal-making skills to make America great again. The other is a naturally occurring illusion: the proximity of Dow 20,000. The Dow Jones Industrial Average has been above 19,000 since November, and countless news stories have focused on its flirtation with the 20,000 barrier – which might be crossed by the time this commentary is published. Whatever happens, Dow 20,000 will still have a psychological impact on markets.

Trump has never been clear and consistent about what he will do as president. Tax cuts are clearly on his agenda, and the stimulus could lead to higher asset prices. Lower corporate taxes are naturally supposed to lead to higher share prices, while cuts in personal income tax might lead to higher home prices (though possibly offset by other changes in the tax system).

But it is not just Trump's proposed tax changes that plausibly affect market psychology. The US has never had a president like him. Not only is he an actor, like Ronald Reagan; he is also a motivational writer and speaker, a brand name in real estate, and a tough deal maker. If he ever reveals his financial information, or if his family is able to use his influence as president to improve its bottom line, he might even prove to be successful in business.

The closest we can come to Trump among former US presidents might be Calvin Coolidge, an extremely pro-business tax cutter. "The chief business of the American people is business," Coolidge famously declared, while his treasury secretary, Andrew Mellon – one of America's wealthiest men – advocated tax cuts for the rich, which would "trickle down" in benefits to the less fortunate.

The US economy during the Coolidge administration was very successful, but the boom ended badly in 1929, just after Coolidge stepped down, with the stock-market crash and the beginning of the Great Depression. During the 1930s, the 1920s were looked upon wistfully, but also as a time of fakery and cheating.

Of course, history is never destiny, and Coolidge is only one observation – hardly a solid basis for a forecast. Moreover, unlike Trump, both Coolidge and Mellon were levelheaded and temperate in their manner.

But add to the Trump effect all the attention paid to Dow 20,000, and we have the makings of a powerful illusion. On November 10, 2016, two days after Donald J. Trump was elected, the Dow Jones average hit a new record high – and has since set 16 more daily records, all trumpeted by news media.

That sounds like important news for Trump. In fact, the Dow had already hit nine record highs before the election, when Hillary Clinton was projected to win. In nominal terms, the Dow is up 70% from its peak in January 2000. On November 29, 2016, it was announced that the S&P/CoreLogic/Case-Shiller National Home Price Index (which I co-founded with my esteemed former colleague Karl E. Case, who died last July) reached a record high the previous September. The previous record was set more than ten years earlier, in July 2006.

But these numbers are illusory. The US has a national policy of overall inflation. The US Federal Reserve has set an inflation "objective" of 2% in terms of the personal consumption expenditure deflator. This means that all prices should tend to go up by about 2% per year, or 22% per decade.

The Dow is up only 19% in real (inflation-adjusted) terms since 2000. A 19% increase in 17 years is underwhelming, and the national home price index that Case and I created is still 16% below its 2006 peak in real terms. But hardly anyone focuses on these inflation-corrected numbers.

The Fed, like the world's other central banks, is steadily debasing the currency, in order to create inflation. A Google Ngrams search of books shows that use of the term "inflation-targeting" began growing exponentially in the early 1990s, when the target was typically far below actual inflation. The idea that we actually want moderate positive inflation – "price stability,” not zero inflation – appears to have started to take shape in policy circles around the time of the 1990-1991 recession. Lawrence Summers argued that the public has an “irrational” resistance to the declining nominal wages that some would have to suffer in a zero-inflation regime.

Many people appear not to understand that inflation is a change in the units of measurement. Unfortunately, although the 2% inflation target is largely a feel-good policy, people tend to draw too much inspiration from it. Irving Fisher called this fixation on nominal price growth the “money illusion” in an eponymous 1928 book.

That doesn’t mean that we set new speculative-market records every day. Stock-price movements tend to approximate what economists call “random walks,” with prices reflecting small daily shocks that are about equally likely to be positive or negative. And random walks tend to go through long periods when they are well below their previous peak; the chance of setting a record soon is negligible, given how far prices would have to rise. But once they do reach a new record high, prices are far more likely to set additional records – probably not on consecutive days, but within a short interval.

In the US, the combination of Trump and a succession of new asset-price records – call it Trump-squared – has been sustaining the illusion underpinning current market optimism. For those who are not too stressed from having taken extreme positions in the markets, it will be interesting (if not profitable) to observe how the illusion morphs into a new perception – one that implies very different levels for speculative markets.