The Inherent Risk of High-Priced Assets

By Martin Feldstein *Thu, Oct 27, 2016*

'Within the US, the greatest risk is a sharp decline in asset prices, which would lead to a collapse of aggregate demand… Conditions are becoming more dangerous as asset prices rise further and further from historic norms,' the Harvard economist writes.

Although the United States economy is in good shape—with essentially full employment and an inflation rate close to 2%—a world of uncertainty makes it worthwhile to consider what could go wrong in the year ahead. After all, if the US economy runs into serious trouble, there will be adverse consequences for Europe, Japan, and many other countries.

Economic problems could of course originate from international political events. Russia has been acting dangerously in Eastern and Central Europe. China's pursuit of territorial claims in the East and South China Seas, and its policies in East Asia more generally, is fueling regional uncertainty. Events in Italy could precipitate a crisis in the eurozone.

But within the US, the greatest risk is a sharp decline in asset prices, which would squeeze households and firms, leading to a collapse of aggregate demand. I am not predicting that this will happen. But conditions are becoming more dangerous as asset prices rise further and further from historic norms.

Equity prices, as measured by the price-earnings ratio of the S&P 500 stocks, are now nearly 60% above their historical average. The price of the 30-year Treasury bond is so high that it implies a yield of about 2.3%; given current inflation expectations, the yield should be about twice as high. Commercial real-estate prices have been rising at a 10% annual pace for the past five years.

These inflated asset prices reflect the exceptionally easy monetary policy that has prevailed for almost a decade. In that ultra-low-interest environment, investors have been reaching for yield by bidding up the prices of equities and other investment assets. The resulting increase in household wealth helped to bring about economic recovery; but overpriced assets are fostering an increasingly risky environment.

To grasp how risky, consider this: US households now own $21 trillion of equities, so a 35% decline in equity prices to their historic average would involve a loss of more than $7.5 trillion. Pension funds and other equity investors would incur further losses. A return of real long-term bond yields to their historic level would involve a loss of about 30% for investors in 30-year bonds and proportionately smaller losses for investors in shorter-duration bonds. Because commercial real-estate investments are generally highly leveraged, even relatively small declines in prices could cause large losses for investors.

The fall in household wealth would reduce spending and cause a decline in GDP. A rough rule of thumb implies that every $100 decline in wealth leads to a $4 decline in household spending. The return of asset prices to historic levels could therefore imply a decline of $400 billion in consumer spending, equal to about 2.5% of GDP, which would start a process of mutually reinforcing declines in incomes and spending leading to an even greater cumulative impact on GDP.

Because institutional investors respond to international differences in asset prices and asset yields, the large declines in US asset prices would be mirrored by similar declines in asset prices in other developed countries. Those price declines would reduce incomes and spending in other countries, with the impact spread globally through reduced imports and exports.

I must emphasize that this process of asset-price declines and the resulting contraction of economic activity is a risk, not a prediction. It is possible that asset prices will come down gradually, implying a slowdown rather than a collapse of spending and economic activity.

But the fear of triggering a rapid decline in asset prices is one of the key reasons why the US Federal Reserve is reluctant to raise short-term interest rates more rapidly. The Fed increased the overnight rate by just 0.25% in December 2015 and is likely to add just another 25 basis points in December 2016. But that will still leave the federal funds rate at less than 1%. With the inflation rate close to 2%, the real federal funds rate would still be negative.

Market participants are watching the Fed to judge if and when the process of interest-rate normalization will begin. Historical experience implies that normalization would raise long-term interest rates by about two percentage points, precipitating substantial corrections in the prices of bonds, stocks, and commercial real estate. The Fed is therefore trying to tamp down expectations concerning future interest-rate levels, by suggesting that changes in demography and productivity trends imply lower real rates in the future.

If the Fed succeeds, the decline in asset prices may be diminished. But the danger of sharp asset-price declines that precipitate an economic downturn should not be ignored.