Why Are Stocks So High?

By Kerry Pechter *Thu, Aug 1, 2019*

Because corporations have been returning more of their profits over to shareholders and less to workers, especially over the past 30 years, according to authoritative recent research. The implication is that investors' gains have come at the expense of workers, who own little stock.

The stock market notoriously climbs a “wall of worry.” But a new academic paper, “**How the Wealth Was Won**,” suggests that we probably should be worried about a rising stock market that, for decades, has grown much faster than economic growth can explain and where the “equity premium” has sunk to low levels.

The paper’s authors, Martin Lettau of Berkeley, Sydney Ludvigson of NYU and Dan Greenwald of MIT, divide the past 67 years into two eras. From 1952 to 1988—from roughly the birth of the H-bomb to the Savings and Loan Crisis—fundamental economic growth accounted for 92% of the increase in stock prices, they found.

But from 1989 to 2017 (from the end of Communism through the tech boom, two Gulf Wars, the digital boom, the Iraq War, and the Great Financial Crisis) only 24% of the $23 trillion in real equity wealth created by the non-financial sector can be attributed to economic growth, the authors found.

Greenwald

“It was largely luck that stock returns were as high as they have been since 1989,” MIT’s

Greenwald told *RIJ* this week. "Our model predicts that the rate of returns on equities, including dividends and buybacks, should have been 5.3% a year. But they've averaged a 10.6% return." That's about twice the rate that the traditional "equity risk premium"—the reward to investors for taking the extra risk associated with equities vs. bonds—would normally suggest.

Something else must have been going on, and the authors believe it was changes in what they call "factors shares." By this they mean the division of the U.S. economy's fruits between investors and workers. "Factors shares have been more relevant than economic growth as a measure of fundamental value in the stock market," the paper said.

For decades, the profits have largely accrued to investors (in the form of dividends, stock buybacks and capital gains) and not to workers (in the form of wages). "What's unusual, over this entire period, the share of output going to profits has grown, relative to the share going to wages," Greenwald said, adding that "workers still typically get more than two thirds of output."

He and his co-authors attributed 54% of the $23 trillion in real equity wealth created by the nonfinancial sector from 1989 to the end of 2017 to "reallocation of rents to shareholders in a decelerating economy… Economic growth accounts for just 24%, followed by lower interest rates (11%) and a lower risk premium (11%)."

"This large divergence is attributable to the good luck equities have enjoyed over the post-war period, driven primarily… by a string of favorable factors share shocks that redistributed rents to shareholders," the paper said. In economic terms, "rents" means unearned income, passive income or, technically, "any payment to an owner or factor of production in excess of the costs needed to bring that factor into production."

At the same time, the "equity premium" is low. That is, investors have shown a willingness to pay a lot for stocks. "We know that asset prices and stock valuations vary by too much to be driven by cash flows," he said. "When the stock market goes up by two percent in one day, it doesn't mean that investors think that profits will go up by two percent. You can attribute that to market demand. Effectively, investors are saying that they are willing to hold risk at a lower price."

There are many possible causes and effects associated with the sharp change in factors shares since 1989—the loss of labor's bargaining power, the export of manufacturing jobs, automation, globalization, monopoly pricing power, the retirement savings boom, or massive deficit spending—but this paper wasn't meant to pursue them, Greenwald said.

Whatever the reasons for the shift, workers have been the losers. Even though millions of Americans have been investing in mutual funds through workplace retirement plans for 30 years, and some of them have accumulated significant nest eggs, there's apparently still not much overlap between workers and investors.

"Only about half of households report owning stocks either directly or indirectly in 2016," the paper said. "Even among those households that own equity, most own very little: the top 5% of the stock wealth distribution [equity owners] owns 76% of the stock market value and earns a relatively small fraction of income as labor compensation."

Depending on your point of view, you might conclude from this paper either that the stock market is dangerously overvalued, or that the shift in factor shares and a shrinking risk premium justifies current stock values, or that the height of the stock market is a symptom of advanced inequality in the U.S., rather than the sign of a healthy economy.