

When market valuations become too high to fall

By Jan Dehn

It cannot have escaped investors' attention that stock markets are surging and spreads are tightening. Yet, the world has not looked as bad as this in political and economic terms for a very long time. Asset prices seem divorced from fundamental realities. How and why does this happen and what does it mean for investment?

This short note aims to provide a brief perspective on these questions.

After a decade of asset purchases (which are *de facto* subsidies of interest rates and therefore subsidies of capital markets), valuations in US stock markets and most bond markets in developed economies have become so inflated relative to fundamentals that they are – to all intents and purposes – too expensive to be allowed to fall.

If central banks were to allow asset prices to reflect the actual underlying fundamentals – record levels of debt, record low productivity growth, record unemployment, record populism – the resulting crashes in financial markets would be so large that most Western economies would be plunged into deep and lasting depressions.

Since depressions are politically and economically unacceptable, investors are betting that they can count on central banks to continue to prop up markets, regardless of fundamentals. So far, they have been right. Central banks began by supporting only government bond markets, but soon extended their involvement to mortgages, investment grade bonds, and high yield credit. Some central banks in developed economies even buy stocks.

The ever increasing involvement of governments in markets has important implications for the investment environment:

- **There is no real downside to nominal asset prices.**
- **The role of government gets ever greater**, because, in the absence of any effort to address underlying fundamental problems, more and more markets need government life support.
- **Volatility declines.** Since investors generally hate volatility more than they hate expensive valuations, government 'controlled' markets ironically attract more inflows than un-controlled markets.
- **Productivity declines.** This happens for two reasons. One is that the government is less productive than the private sector – and the government grows faster than the private sector. The other is that markets no longer perform the important functions of rejuvenating economies by weeding out poor performers and encouraging risk taking and innovation. Economies therefore gradually stagnate.
- **EM is one of the last remaining free markets**, where investors can express a view without running into massive government manipulation of asset prices. This does not necessarily make EM more attractive in the short term, because while returns will be higher so will volatility. Flows to EM will therefore depend on how investors feel about the trade-off between higher volatility and higher return. If they fear volatility more than they love the potentially higher return then they may even reduce exposure to EM.
- **Currency markets are likely to become far more important going forward.** To see why, suppose that an investor loses faith in US fundamentals. This loss of faith would not show up in lower asset prices, because the government intervenes to prevent prices from falling, but it could show up in a lower Dollar to the extent that the investor gets uncomfortable about holding US assets as economic and political circumstances deteriorate. Until, that is, the Dollar too becomes manipulated. Or not as the case may be.

For a further discussion of these ideas see:

[Macroeconomic control regimes](#)

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The end game is also interesting

Controls gradually morph from markets interventions to economic controls to balance of payments restrictions. As markets are put out of action through ever greater government intervention – *de facto* shifts towards old fashioned state planning – then markets cease to perform one of their most important functions, namely to bring down unsustainable economic systems. Instead, the system is condemned to a slow death from the inside. Planned economies do not collapse due to speculative attacks by foreign investors, because markets are so tightly controlled. Rather, they collapse endogenously due to declining productivity and lack of innovation.

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