

## Happy talk and the stock market: Why our situation is worse than many people think

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Americans seem to view the stock market as the most important indicator of the nation's economic health. Equity trading activity is incessantly reported in almost real time; the Dow Jones Industrial Average (DJIA) shows up on the margins of newspapers and web pages that have little to do with business. In the present crisis, the "recovery" of the stock market is taken to indicate that the nation is on its way back to economic health, and by extension, that the structure of our economy is fundamentally sound, and regulatory reform presumably need only tinker around the edges.

Recent experience, however, does not encourage us to view stock price increases as good evidence of economic strength: the stock market was doing very well as we spiraled into the great recession. More generally, and for many reasons, stock indices are a poor reflection of our economic well-being: they tend toward "happy talk" that masks a more complicated and often disconcerting reality. And yet, the political will for financial market reform appears to fluctuate daily with the movement of the Dow and S&P 500.

In hope of cutting through some of the happy talk to a more honest policy discourse, it's worth exploring some of the ways that these indices are biased toward an unduly sunny view of our situation.

### Time Slicing

By restarting the clock in January of 2009, after the near-panic selling of Fall 2008, we've established a misleading baseline for the DJIA and other indicators. The DJIA is still down almost a third from its peak in 2007, and roughly flat over the last decade (showing a loss if inflation is taken into account). The dramatic effects of time slicing may be easier to see in the context of a single company's stock. Imagine a company whose share price falls from a price of \$100 to \$1 in the final months of a given year. Now just imagine that the share price subsequently recovers to \$10 (maybe the company successfully argues that it is too big to fail, and the government intervenes) in January of the following year. The lucky investor who (somehow foreseeing government intervention) invests at \$1 will reap a return of 1000%. The stock is still down 90%. But we tend to focus on the 1000% return – the happy talk – not the 90% loss.

### "Up" looks bigger than "Down"

Imagine a stock that falls from \$100 a share to \$50 a share, i.e., the stock has lost 50% of its value. Now imagine that the price rises to \$75 a share. The stock has gained 50% of its value "back." Happy talk, even though the stock is actually still way down. Now imagine that the stock returns to 100, i.e., a 100% gain. More happy talk, but that's why 2009 was such a great year for the stock market, and why the administration and Fed clearly did such a "good job" in helping us to navigate the "tsunami."

Both time slicing and the rhetorical distortion of percentages can be illustrated with a significant, if unusually dramatic, example, AIG. On June 18<sup>th</sup>, 2007, AIG closed at

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\$1450/share. On March 9<sup>th</sup>, 2009, the share closed at \$7, a loss of three orders of magnitude, but still less than 100%. With good timing, however, the investor who bought on March 9<sup>th</sup> would see the share price close on January 21, 2010, at \$27.5, a roughly 400% profit in ten months, no doubt because AIG is a well run business.

### **Composition**

The composition of an index changes over time. Companies that weaken sufficiently are no longer counted, but are replaced with other companies. The DJIA would look much different if it still included AIG, Citigroup, and General Motors. Thus, to compare the DJIA of, say, January 19, 2006 (12,566) with the DJIA of January 21, 2010 (10,389) is to compare two rather different sets of companies.

This is somewhat like fantasy football, if one could keep picking players as the season progresses: the DJIA reflects all of the stock price increases, but does not reflect the large decreases, of the companies that compose(d) it. Therefore the DJIA, like other indexes, has an upward skew, which conversely means that indicated losses can be significantly understated.

As the composition of the index changes, our ability to use the index to say how the market in question (and by extension, our society) is doing over time degrades, because it's not the same market. At best, an index indicates fluctuations of aggregate cost of capital to the kind of companies that happen to be on the index, i.e., an index is sort of a barometer of financial fashion. For example, during the internet mania, shares on the tech-heavy NASDAQ soared.

### **A market without friction**

In order to match an index, an actual investor would have to buy and sell the right companies, at the right time, and incur transaction costs in doing so. None of this shows up in the index. More generally, indices do not attempt to represent the real world of investing; the index presents a "frictionless," and hence flattering, version of the market on which it is "reporting."

### **Demand noise**

It is often assumed that demand for a stock indicates belief that the company is performing well. But when demand is high enough, and when alternative investments are not attractive (especially during crises, when asset classes fall in tandem), then "demand" may only indicate that the stock is "good enough for these hard times." Portfolio managers typically are under pressure to do something reasonably safe and profitable with the money under their care, and to do it now. This can be difficult. Leading into the present crisis, the world was awash in liquidity, and there literally were not enough investments to go 'round. At the worst of the crisis, investors bought U.S. government debt at negative yields. Such "investment" did not indicate belief that the US government was doing well; it indicated belief that there was no better place to park money. By the same token, and despite the crisis, today vast quantities of money need to be invested. The United States remains an intensely capitalized country: schools, hospitals, governments and retirement funds, and so forth – the structure of our society is mirrored in pools of capital, and that money has to go somewhere. Much of it goes into the stock market, especially now that interest rates are so low. Such demand for stock does not necessarily indicate that the companies in question are doing very well; it may well indicate reinvestment risk. (This can be observed with my own retirement

funds, such as they are.) Indeed, rather flat earnings, and more generally, sluggish growth (especially once inventory manipulations are factored out), and miserable employment numbers, suggest a very different interpretation of how businesses are doing. But we tell ourselves that the real economy lags the financial economy; hope is required.

### **Government bias**

Much of the “recovery” of the stock market is due to the recovery of share prices in the financial sector. (At one point last summer, almost 40% of volume in the entire NYSE was due to trading in just four financial companies.) And why shouldn't these institutions make money? The government has ensured the operations of institutions deemed too big to fail. Much competition has been eliminated, as the companies picked to survive gobbled up those fated to die. The cost of capital has been lowered in various ways, including guaranteeing credit, purchasing assets outright, and allowing the use of trashy assets as collateral for low interest loans. With cheap money in hand, it is fairly easy to make money in financial markets. Institutional clients, who are in charge of vast amounts of money that must be managed, have certainly appreciated doing business in these difficult times with a company backed by something approaching the full faith and credit of the United States. Business has boomed; profits have risen.

Owning a financial institution that operates without much competition, a guaranteed spread, a gratefully captive customer base, and assurance of unlimited government funds if the going gets rough is a sweet proposition. Share prices have risen accordingly. While no doubt gratifying to those who own such companies, the rising prices of their stock hardly demonstrate that our financial policy has been a success. More generally, stock prices should and do reflect the fact that trillions of tax dollars have been spent upon some firms, including non-financial firms. However, such price increases do not necessarily indicate that our economy is healthy. In fact, the opposite seems more likely. Rather than the health of the economy, the index may well be reflecting the fact that it is a good thing to be paid, or guaranteed, by the government.

So equity indices are skewed upward. Nonetheless, and allowing for a degree of puffery, rising stock prices are a good thing, right? Not necessarily. It is true that rising stock prices can indicate a certain optimism, even momentum. As suggested by the example of massive government intervention with tax dollars, however, stock prices also may rise for reasons that are not good for anybody but shareholders. We should remember at least some of the basics of classical economics: in a competitive market, prices (and profits) tend to be driven down. This is good for consumers; this is the purpose of antitrust laws. In a competitive market, because profit margins are thin, stock prices should also be relatively low. Following this logic, widespread increases in stock price may suggest a correction of irrational downward trading, but may also indicate market power or government subsidy. The bottom line is that the investors' (including management's) interest in rising prices for their stock is completely understandable, but is not synonymous with a sound market, much less with the public interest in any broader sense.

The analytic distinction between the price of equity and the public good is crucial for thinking about government intervention during financial crises. If an investor's interest in the price of his stock is not the same thing as society's interest in a sound market, then we might draw a parallel distinction between the fortunes of the firms that currently dominate a business, and the business itself. For obvious example, we might differentiate between certain large *banks*, a small collection of very big companies, and *banking*, which is a valuable industry with many participants. Investors may be expected to care about the fate of

the particular banks in which they happen to be invested, but citizens, whether or not they are investors, should care about banking, and only incidentally about the fate of particular banks. By the same token, the government, presumably acting on behalf of all citizens, should care about banking, not about this or that bank. Although this distinction between banking and banks may seem clear enough in theory, in practice two administrations have conflated the need to intervene in the financial markets with the need to save particular, well-connected, institutions, and extended trillions of dollars in aid directly to such institutions.

The results of these highly targeted (and profitable) interventions have been disappointing. Credit remains tight, and the broader economy weak. The Federal deficit has soared to record heights, but over two years after the Fed started giving investment banks access to the discount window, efforts at reform have been modest. The financial industries have grown more concentrated, and remain vulnerable. Unemployment remains high, job creation low, foreclosures high . . . The government, in short, has used trillions of dollars to rescue some financial (and a few non-financial) institutions, but has not rescued banking, or financial markets more generally, much less the economy. We comfort ourselves by saying that no other form of intervention was possible, and the alternative was “another Depression.” But the fact remains that we have very little – beyond stock price increases – to show for the expenditure of trillions. (Surely there were better ways to avoid another Depression.)

With little really good news, the stock market numbers have assumed even greater political significance. Improvements in the equity markets have been hailed as “green shoots,” signs of our economy’s revival, that is, the government is on the right course, and as evidence that the system isn’t that broken, and so little government action is required. While one must hope that a rising market expresses some renewed confidence in the real economy, a prudent skepticism is in order. As discussed above, the biases built into indices are overwhelmingly positive. This is not accidental. Our indices are essentially a way of defining and reporting on financial markets: Dow Jones, of Dow Jones Industrial Average fame, is a newspaper company. Treating the *Wall Street Journal* (another of Dow Jones’ products) as revealed truth would hardly be prudent – financial journalism generally encourages increased participation in financial markets, much as the New York Review of Books is enthusiastic about reading. Unsurprisingly, financial journalism accentuates the positive for the financial industries and their investors – indices are merely a technical way of doing so. None of this should be confused with an impartial assessment of the economy’s health.

While enthusiasm for asset prices is hardly new, the use of indexed data for “happy talk” has been particularly inane recently. The liberal media is, by and large, supportive of the administration, and so tries to emphasize the relatively strong performance of the stock market, while downplaying lackluster growth, bad unemployment, and downright shocking poverty numbers. The conservative media cheers for a stock market recovery and hopes to avoid increased regulation. Unfortunately, our financial markets, and our broader economy, have structural problems that those at either end of the political spectrum are unwilling to confront, presumably for fear of giving ground to their adversaries. Under such circumstances, interminable discussion of the stock market stands in for serious engagement with economic issues.

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