



They say nobody rings a bell at the top of the market. But whether this is the top or not, two prominent market observers and historians, Robert Shiller and Edward Chancellor, are expressing concern. First, Shiller warns readers not to take big increases in earnings too seriously because earnings are volatile. Everyone knows that stock prices have risen dramatically since 2009. A \$100 investment in the S&P 500 in 2009 has grown to nearly \$400 at the end of August 2018. But Shiller [reminds us](#) that earnings have grown dramatically too. In fact, ?real quarterly S&P 500 reported earnings per share rose 3.8-fold over essentially the same period, from the first quarter of 2009 to the second quarter of 2018,? according to Shiller. Prices, in fact grew a bit more slowly than earnings since the end of the crisis. So should we think stocks are reasonably priced since earnings have grown at the same pace as prices? Not so fast, Shiller says. Earnings, the difference between two other data sets -- revenues and expenses, are volatile, and cyclical. Rapid rises in earning are often followed by a return to long term trends or subpar levels. Such episodes have

occurred more than a dozen times in U.S. stock market history. Earnings can grow dramatically from things like "panicky demand" for U.S. goods from Europeans at the beginning of World War I. This led to political calls for "wealth conscription" or a heavy taxation on war-related profits. At that time stock prices didn't follow profit advances as investors seemed to realize those gains would be short-lived. In the "Roaring '20s," however, emergence from a "war to end all wars" and a spirit of freedom and individual fulfillment spurred stock prices by Shiller's lights. And this, of course, led to a crash at the end of the decade. Another period where price gains outstripped earnings gains was 1982-2000. Real stock prices increased 7.5-fold, while real annual earnings only doubled, according to Shiller. Indeed the S&P 500 Index delivered an eye-watering 17% compounded annual return from 1982 through 2000, mostly on the back of multiple expansion (the increased price investors are willing to pay for underlying earnings). In the next period, from 2003 through 2007, real corporate earnings per share almost tripled, but the real S&P 500 didn't manage a double, because, as Shiller puts it, "investors apparently were unwilling to repeat their mistake in the years leading to 2000, when they overreacted to rapid earnings growth." After the 2008 financial crisis, which decimated earnings and prices, both have increased dramatically in tandem. Shiller can't easily analyze investor psychology to know why, but he thinks it must be rooted in the "public's loss of healthy skepticism about corporate earnings, together with an absence of popular narratives that tie the increase in earnings to transient factors." In other words, nobody thinks earnings will go down dramatically or that their recent increase might be tied to something that can't last. Shiller doesn't know if this is a bubble. He asks the question initially, but doesn't answer it completely. I suspect that's because Shiller thinks bubbles rest more on narratives and human psychology than on things like interest rates, and he can't find a compelling narrative currently. But Edward Chancellor thinks record low interest rates since the financial crisis have produced [bubbles galore and zombies](#), meaning overpriced assets and unproductive companies sustained only by low rates. Chancellor, concentrating less on psychology in his recent article, reminds us of Adam Smith's remark that "the ordinary price of land" depends everywhere upon the ordinary market rate of interest. That's because one discounts future income by the interest rate to arrive at the present value of an asset. The lower the rate, the higher the present value, and *vice versa*. Unfortunately, central bankers refused to accept this Smithian calculation after the collapse of Lehman Brothers. And so, they have kept rates so low for so long that they have created bubbles in industrial commodities, rare earths, U.S. farmland, Chinese garlic bulbs, fine or not-so-fine art, vintage cars, fancy handbags, super-city properties from London to Hong Kong, long-dated government bonds, listed and unlisted technology stocks, and the broader American stock market. Finally, Chancellor wonders whether low rates have encouraged a cryptocurrency bubble. U.S. stocks are very expensive on dependable valuation measures such as total market value relative to GDP and on replacement cost basis (Tobin's Q) compared to historic levels. American companies have also been on a borrowing binge. The problem is the economic rebound has been lackluster, and Chancellor blames easy credit and zombie corporates for this. Usually, a severe recession washes out weak companies, and investors reallocate capital to productive enterprises. "Business failures are essential to the recovery." Low interest rates have allowed companies that would have otherwise gone out of business to stay alive, and this has caused a tepid recovery. Chancellor notes the cumulative default rate on junk bonds during the entire recession was 17%, or "around half the level of the two previous downturns." And while central bankers might view this as a victory, he views it as the cause of economic weakness. The lessons for investors are to remain vigilant about stock valuations and higher yielding bonds. At some point the zombies will not be able to sustain themselves any longer. And that's when having a good financial plan and asset allocation will help.