During the 1990s, and especially in the past few years, a declining proportion of Americans has thought the stock market is too risky a place to put its money. More than three-quarters of the married men surveyed thought the stock market was too risky for most families through most of the 1980s, but that proportion fell to 70 percent by 1993. The survey question was changed in 1994, but the number of married men responding that the stock market is too risky for them has continued to fall. Responses for women show a similar pattern.
ARTICLE

The Stock Market: What Goes Up...

Movements in the stock market are unpredictable in the short run. But longer-term movements appear to be somewhat more predictable.

First, the good news. Although the stock market stands at very high levels, it is impossible to say whether it will rise further or fall in the short term. Any predictable short-term movement would provide investors with an opportunity to make virtually unlimited amounts of money by betting on that movement. With investors constantly on the lookout for any sure-fire way to make money, even small amounts of short-run predictability tend to be eliminated by immediate investor reactions. Fortunately, the principle of short-term unpredictability offers a good reason not to expect an "anniversary effect" this October based on the 1987 crash.

Now, the bad. The same argument for short-run unpredictability might logically seem to apply to the long run as well. Nevertheless, certain indicators have some ability to predict changes in stock prices over periods longer than a few years. A particularly useful indicator is the ratio of the average price of stocks to average earnings (profits). For annual U.S. stock market data since 1872, years in which the price/earnings ratio has been high have typically been followed by poor average price performance over the subsequent 10 years (see chart). Today's price/earnings ratio is "off the chart"—by far the largest of any year for which we have data—and implies a decline in stock prices over the next decade of about 10 percent per year (if typical historical patterns repeat themselves).

Say it ain't so. These data are public, so why are investors not selling? One reason is that the P/E ratio in the calculation is based on past earnings, and current Wall Street forecasts of future earnings are very bullish. Indeed, the current projections of stock market analysts imply that aggregate real (inflation-adjusted) earnings are expected to grow about 9 percent per year over the next 5 years—more than three times the projected rate of overall economic growth. If such earnings growth were realized, capital's share of national output would exceed its previous postwar record high, with a corresponding decline in the labor share.

Some analysts have argued that bearish forecasts based on historical relationships are not valid today because the economy has entered a "New Era" of greater productivity growth and efficiency gains, perhaps attributable to the computer revolution. Such claims are not new; in previous eras of high stock market valuation, similar prophets made similar claims. In the 1880s and 1890s, for example, railroads were to be the...
engine of unlimited prosperity; in the late 1920s, the prospect of electrification was said to justify astronomical stock prices; in the late 1960s, the advent of “scientific management” techniques, the supposed end of the business cycle, and the virtues of the interstate highway system were touted. In each case, the anticipated earnings bonanza failed to materialize, and a long bear market ensued.

Risk and reward. But maybe it is a new era in terms of people’s willingness to bear risk (see the Chart of the Week). A longstanding puzzle in economics is that, in the past, people appear to have been far more reluctant to bear the risks of stock ownership than seems rationally justifiable. If they were suddenly to become much more tolerant of these risks, the effect would be to bid up stock prices.

Investors do appear to be acting on their changed perceptions of risk. For example, TIAA-CREF, the largest private retirement saving plan in the United States, keeps track of participants’ choices about where new contributions are invested. Between 1986 and 1996, the fraction of participants directing all of their new retirement contributions to the stock market increased from 3 percent to over 20 percent, while the fraction of participants investing at least half of new contributions in stocks increased from under 15 percent to nearly half (see chart). But increased tolerance for risk is insufficient to explain the current high stock market; those levels appear to be justifiable only in the unlikely event that investors now strongly prefer risky assets to safe assets with the same expected return.

The trend is not your friend. The S&P 500 has yielded an average annual real rate of return of almost 15 percent since 1981. Perhaps the best explanation for the market’s current giddy heights is that investors, observing the market’s remarkable performance since the early 1980s, have concluded that the market can yield such high rates of return forever. A large portion of these returns, however, has reflected a rebound in corporate profitability from historically low levels in the late 1970s—a trend that cannot be sustained indefinitely.

Conclusion. An immediate stock market crash is not inevitable. But over the next decade, the stock market is very unlikely to yield returns comparable to those seen during the past 15 years.