

## Are we witnessing irrational exuberance?

Alan Greenspan first coined the phrase “irrational exuberance” on December 5, 1996. He used it during a lecture to warn of the dangers of an overvalued market—something he feared in light of the Dow’s rapid rise over the preceding two years.

Since then, the notion has taken hold among investors and analysts. Especially during bull markets, the fear of irrational exuberance looms like the elephant in the room and, for better or worse, often keeps bull enthusiasm in check.

It’s no surprise, then, that analysts today are becoming more serious about looking for signs of irrational exuberance in the market. The Dow is up 40 percent since November 2012. The S&P is up 51 percent. Even a volatile dollar, the end of QE and relative uncertainty regarding future Fed policy has hardly put a dent in what is now one of the biggest stock market rallies ever.

But not every bull market is caused or defined by irrational exuberance. We should expect asset prices to grow over time. Historically, rallies like this haven’t always culminated in bust. And yes, policymakers can do things that actually strengthen markets, resulting in higher asset values and more efficient markets all around.

Here are some reasons for and against irrational exuberance as the defining characteristic of today’s market.

### Reasons to think so

1. **Asset prices are at an all-time high.** Of course, rapidly appreciating asset prices should only be expected following a major sell-off, like the recession of 2008. And we should always expect asset prices to grow, on average, in the long term. But this bull market is different. Over the past two years, the Dow is up 45 percent. The S&P 500 is up 51 percent. These have been the best two years in these indices history that did not immediately follow a cycle’s bottom. While some might credit this to better financial policy, improved fundamentals, or any host of other reasons, there are just as many reasons to think the opposite—plenty of reasons why such growth might not reflect the true state of the economy’s performance. Chief among these is an extremely accommodative monetary policy—the long-term effects of which remain mysterious, but are generally viewed as inflationary.
2. **Despite growing asset prices, economic inequality is worsening.** While inequality isn’t often leveled as something that affects financial markets directly, it certainly has a dampening long-run effect on general economic performance. Theoretically, this should correlate with suppressed growth in asset prices. But this, of course, isn’t happening despite virtual stagnation of incomes in the bottom three quintiles of the economic totem

pole. Asset prices continue to climb even as disposable income among the lowest classes dwindles. A sign of irrational exuberance? It's a question worth considering.

3. **Inflation is low.** Yes, this might seem more like a reason to doubt irrational exuberance than a reason to support it. But the simple fact that the stock market has performed so well despite a lack of sustained inflation should raise eyebrows. If the Fed had been successful in boosting inflation to a sustained rate of two percent, would the market have performed even better than it has? Would the Dow be up another 10 or 20 percent? Would the S&P 500 have doubled altogether? Should we be thankful that inflation has been low, so as to avoid pushing markets to unsustainably high levels? On top of that, the simple fact that the inflation discount on today's asset values is almost nil means that virtually none of this rally's highs can be attributed to apparent monetary inflation. Alan Greenspan noted during the lecture cited above:

Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?

### **Reasons to think not**

1. **U.S. financial markets have a strong comparative advantage right now.** The Eurozone is [stuttering](#). Japan has resorted to [last-ditch stimulus measures](#) to avoid quadruple-dip recession. Chinese economic growth [has slowed](#), as they too [cut interest rates](#) to stave off recessionary fears. All this makes U.S. markets an attractive buy for foreign investors. Even if there's truth to claims that U.S. markets are too dependent on monetary stimulus, it makes no difference if it remains the most attractive market for international investors. Investing is about picking relative winners—not fundamentally-sound companies and markets.
2. **Unemployment is falling fast.** Two years ago, the unemployment rate stood at roughly eight percent. Today it's down to 5.8 percent. We should expect this to reflect in asset values, as [fewer people](#) are on unemployment insurance and more people go back to work, once again paying rent, making 401k contributions and upping aggregate demand for products and services.
3. **Businesses are investing.** Except for Q3 2014, private, non-farm inventories have grown at an increasing rate since Q1 2013. But this growth has not been as rapid as that which immediately preceded the stock market collapse of 2008. By most measures, it looks sustainable—even slowing slightly as businesses perhaps have become concerned about signs of irrational exuberance in asset prices and are therefore adjusting accordingly.