Robert Shiller: U.S. Equities are Still the Place to Invest

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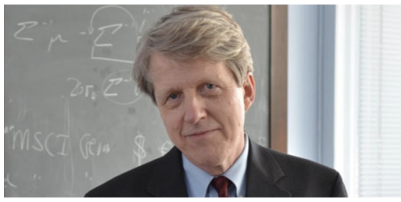

U.S. stocks have the highest CAPE ratio of any global equity market, but they are still the place to invest. But the inventor of that metric, Robert Shiller, says that stocks are indeed risky.

Shiller is a professor of finance at Yale University. He spoke via a conference call hosted by Barclay's Investors for its RIA clients. The title of his talk was, "Finding Value in 2021."

"This is a risky time for investing in the stock market," he said. "But there is a good chance the market will get on the same path as it was before the pandemic."

But it could go the other way, he added, eroding the wealth of equity investors.

The last time I covered a talk by Shiller was in May 2020, when he said that U.S. equities were not "giving much of a sell signal." Since that time, the S&P 500 has returned about 13% on an annualized basis.

The U.S. CAPE ratio is almost 36, which is its second-highest level ever; at the end of 1999, it was 44. But it still has a "long way to go" to set another record, Shiller said.

He has a new paper that discusses how CAPE valuations have been affected by the pandemic. Prices are higher because Fed policy has kept rates at record-low levels. Rates were not this low during the Depression and were not low as far out in the yield curve as they are now, he said. The 10-year TIPS yield is below zero.

He has defined a new measure, which he calls "the excess CAPE yield." It is the reciprocal of the CAPE ratio (1/36 = 2.8%) minus real long-term interest rates (the 10-year TIPS rate is -0.8%). That yield (3.6%) suggests that the stock market will outperform bonds by that much over the next 10 years.

But that forecast is not that reliable and has an r-squared of approximately 0.3.

Let's look at Shiller's comments about the pandemic and the economic outlook.

The post-pandemic economy

Once the economy recovers, we may consume less, according to Shiller. Consumers will realize they do not need two cars, because they spend more time at home. But he said he is not sure how long that effect will last.

As we learn more about our ability to work from home, we will see that there is an unmeasured advantage to society – one that is not captured by the GDP. For example, there is less of a need to move for job reasons, a transition which can be "psychologically horrible" for teens. Society benefits from increased job mobility, but that does not show up in our GDP.

Indeed, he said, the ability to connect virtually is making him happier.

"There is always a problem with GDP as a measure of success," he said.

The epidemic was unusual in its economic impact, he said. During the Spanish Flu pandemic of 1918, there was a short recession; in 1957, there was a polio pandemic that killed 115,000 people, when the population of the U.S. was about half of what it is now. That is equivalent to approximately half the deaths in the U.S. from the coronavirus. There was a short, mild recession and good growth resumed after that pandemic.

But there is a psychological difference now because we were encouraged to stay home, he said.

“We are very upset,” he said, “and this is unprecedented. I am not sure what it will do to business and consumer confidence.”

We will probably have a good recovery, according to Shiller, abetted by vaccines, and we “may get back to a normal life soon.”

He is not sure how long low rates will last. Rates are low because of a lack of investment opportunities, he said. That is the narrative that drives expectations. Even the 10-year Treasury yield was as low as 60 to 70 basis points, he said, although it is rising now. “We are delusional in a way because of the reduced view of inflation,” he said.

He hinted that the Fed might support higher rates. “The narrative of an easy Fed may not be necessary,” he said. We may go back to “normalcy,” just like Warren Harding said after the Spanish Flu pandemic.

Low or negative real interest rates are also driving real estate and home price increases too, he said.

Which sectors are attractive?

At the sector level, he looks at CAPE ratios on a relative basis, by dividing the ratios by their 20-year averages, which normalizes differences across sectors. In the U.S., he said financials, industrials, communication services and consumer staples are historically undervalued.

But he called this approach a “different kind of value investing,” in that it looks for value over a very long-term horizon.

He said the attractiveness of communication services, which includes social-media companies, is due in part to the fact that the U.S. does have a “genius” in this sector and respect for inventors. Those companies were given a boost by COVID-19.

“It is bringing us together,” he said. “It makes sense that this sector is attractive relative to the rest of the world.”

He also commented on the rise in retail investing activity.

Direct retail investing, including investing in options, and the rise of social media have driven a “social change not based in economic fundamentals,” he said. Because we are staying at home, loneliness and extra time have driven social media usage. Gamification is behind this trend and acted as a cure for loneliness. “It is an epidemic in itself,” Shiller said, and could be studied under the guise of “epidemiological economics.”

People are more focused on “going viral” and as are the attitudes toward investing, he said. But it is good for us to invest in small stocks, which he called the “America spirit” rooted in our immigrant history. Early settlers did this by buying land and starting farms.

“It is practical,” Shiller said, “unlike gambling. It’s not a bad thing. It will make us more informed about investing.”

More thoughts on the economy

Shiller was asked whether he fears the growth in the U.S. deficit.

Fiscal stimulus has always been controversial, he said, especially it is when borrowed. The Keynesian argument says you never have to pay it back because the stimulus drives growth. That view is that a stimulus is a good thing. He thinks fiscal stimulus still works and may not need to be paid back. But the sudden increase in the deficit since the start of the pandemic raises the question of whether there will be a “day of reckoning.”

“You can’t create wealth out of nothing,” he said. “There is a limit to how much the stimulus will produce goods and make debt go away.”

“I am still behind it at this point,” Shiller said. “Americans need help for humanitarian reasons.”

Shiller was also asked about the possibility of a universal basic income (UBI), which he said is an “old story that is coming back.” The concept originates from Thomas Paine, the author of *Common Sense*. In another book, Paine wrote about “agrarian justice,” and the fact that a small number of rich people are the ones who own the land. Paine called for a tax on land to be distributed as income to all citizens.

Americans have something akin to UBI with the earned-income tax credit, which is a government subsidy for workers. With rising inequality, Shiller said there are more calls for a UBI. His concern is that it “inspires laziness.” The earned-income tax credit is a better model, he said, and something like it may be necessary as technology improves productivity and makes jobs scarcer.

If there is a more severe recession, he said people will blame advances in artificial intelligence as the cause of job losses. In the Depression there was a similar outcry, he said, and it was called “technological unemployment.” It is more than a narrative, he said; it has logic. People with menial jobs are the most vulnerable.

Income inequality has caused a resentment of the top 1%, he said, and was one of the causes of the Capitol occupation. This is a “serious sociological force,” he said.

Technology and productivity increases have a good side, he said, and “I hope Americans have a good experience with it.”