

## **Robert Shiller: A Cautious Outlook for Stocks**

By Dan Richards

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*Few macroeconomic prognosticators have been as correct as publicly at crucial moments as Yale's Robert Shiller, whose first and second editions of the book *Irrational Exuberance* laid bare, with remarkable timing, the speculative bubbles forming first in the Internet-crazed stock market and next in residential real estate. Shiller is a professor of finance at Yale and the co-founder of investment firm MacroMarkets LLC. He recently teamed with Nobel laureate George Akerlof to write *Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism*.*



Robert Shiller

*This interview was conducted on July 9 at his office in New Haven by Dan Richards.*

**I want to first talk about an article that appeared in the *Wall Street Journal* on March 9 featuring you and Jeremy Siegel. I know he's a longtime friend and colleague of yours, and that your views differ somewhat on how the market is valued. At that time you suggested that the market was expensive. Can you talk a little bit about what led you to that conclusion?**

I like to take a long historical perspective. On my website, I plot the price-to-earnings ratio going back to 1881 on the Standard & Poor's index. I calculate the price divided by the ten-year average of earnings, which is a better price-earnings ratio.

**And the reason you do that over 10 years?**

Short-term earnings fluctuate rather rapidly. They are tied up with recessions and are not a good sign of fundamental value. We had a negative quarter of S&P earnings recently. If that ever goes on for a year, we won't be able to even define the price-to-earnings ratio.

**So it normalizes the short-term fluctuations?**

Yes. In my work with John Campbell, we find that, going back to 1881, that ratio seems to predict future ten-year returns. It is not predicting returns for the next day or the next month. It is long-term. When the ratio has been very high, like it was in 1929 or 2000, it did badly afterwards. When it was very low like it was in 1920, 1933, or 1980 and 1982, those were times when the market did very well. It's simple.



### **What is the long-term average price-to-ten-year-earnings ratio?**

It's about 15. It depends on the time period chosen. If you based your sample on the years up to 2000, it would look higher than that. The ratio got up to 46 in 2000. That is when I wrote my book, *Irrational Exuberance*. I thought something was amiss.

I don't like to make forecasts like this all the time. But when it gets so wild and crazy, it is time to write a book with a strong forecast.

### **What is the long-term ratio today?**

It's about 22. So it's high, but it's not super high.

**I was at Wharton yesterday and I talked to Jeremy Siegel. He acknowledges your research analysis. But he makes a couple of points. One of them is that the earnings over the last 10 years have been distorted to the downside by massive write-offs by companies like AIG and some of the other financial firms. To what extent do you think that skews your results?**

Earnings have been exceptionally volatile recently. As I just said, we actually had a quarter of negative earnings. But I think it's a little bit difficult to be systematic in correcting for that, because, going back 100 years, it's happened before. There have been write-offs. They've done funny things. I don't know that anyone can really be authoritative in making judgments like that.

**The second point that Siegel made related to the interest rate environment. His comment was that in periods of high interest rates, the multiples have historically been much lower. In periods of low interest rates such as we have today, the multiples have been significantly higher, and he thinks we should be adjusting for that in terms of what a fair value is. What is your view on that?**

This is a complicated point. One thing is whether we look at nominal or real interest rates. I assume that Jeremy is looking at real rates like TIPS in the US or other inflation-indexed rates, but we don't have a history of that going back before 1997.

If you look at nominal long-term rates and compare them to the price-earnings ratio back to 1881, there were periods when it looked like Jeremy was right, but he hasn't been consistently right. So I think that's a half-truth.

The other thought is that long-term interest rates are very low now, so that would seem to say the stock market is valued very high, and also commodities and everything else should be high. There's some truth to that, but the other question is, how reliably are those long rates going to stay low? The real question that people really want to know is how do we



forecast the market? Nobody has found that long-term rates offer a significant way of forecasting the market.

**You mentioned that the long-term average multiple was 15 times ten-year earnings. Currently it's about 22 which you said is a bit on the high side, but not egregiously high. What kind of returns, based on your experience, could investors expect over a ten-year period in environments where you are starting with the kind of similar multiple of what you have today, in the low 20s?**

Based on our forecast using regressions, it's a tough call whether stocks or bonds will pay more over the next 10 years. It's not an inspired time. Our forecasting regression would suggest positive returns, but not terrific. So what do you do?

**Let's turn to the economic environment and how it might help answer that question. You recently had an opinion piece in the *New York Times*. You argued that investor and consumer sentiment in and of themselves could lead to a double-dip recession. What do you think about that?**

Consumer confidence has always been a difficult topic for economists, because it is really more psychology than economics, and it is hard for us to be systematic about it. Now there are confidence indexes, although they are not usually generated by economists. They are by business groups or psychologists.

We have some evidence now that confidence has taken big swings, and it has gone through long-term swings. In the 1990s, for example, there were periods of rapidly rising confidence as measured by those indices and then sharp drops afterward. In order to forecast the economy it would be nice if we could think about forecasting confidence.

This is where I get worried. I don't need to tell you that right now in the US it looks like the economy is improving, but we still have high unemployment, and it is weighing on people's psyches. It is leading people to wonder whether we are going to have a normal recovery. If they reach negative conclusions it can be a self-fulfilling prophecy.

**Could you define a double-dip recession?**

I have my own definition, which is a recession, which is a pair of recessions between which the economy never fully recovered. If you look at the unemployment rate for the United States going back to 1948, recessions were quite clear and sharp. Between every pair of recessions there was a normal period where the unemployment rate got down to 4% or 5%, or when the long-term unemployment rate got down below 1%. That measures people who have been unemployed for 27 weeks or more.

This time I suspect unemployment won't reach those levels.



### **Have we had a double-dip recession without that intervening recovery?**

The last double-dip recession was 1980 and then 1981-1982. That was a pair of double-dip recessions. Before that, you've got to go back to the 1929-1933 recession and the 1937-1938 recession. Those were four years apart, but I still count them as a double-dip because we never got out of the high unemployment between them.

### **As you look back at those double-dip recessions, to what extent were they fueled by consumers' apprehensions and worries about their jobs or about the economy recovering?**

That is the fuel. In my book, *Animal Spirits*, with George Akerlof, we argue that that is the defining characteristic of economies. Economists don't recognize this, and they should. Recognizing this should lead to a change in economic theory.

It is not just consumers; it is also investors and investor confidence. When you reach a situation when people think that we are going to be in a depression, or that we might be in a depression, everything stops. Consumers don't buy that new car. But it is also the school district that doesn't hire the new teacher. In fact, they lay off.

Businesses decide they are not going to launch a new product now and wait until better times. Or they run down inventory. As an entrepreneur you could say, I have a great idea, but I can't do it now. Even if you thought you wanted to do it now, a lender might conclude, "Great idea, but come back in five years." That's what slows everything down and that is obviously what is happening.

### **Going back to the 1930s, one of the things that President Roosevelt is most known for was reigniting a sense of confidence among Americans, for example through his radio addresses and the famous quote, "We have nothing to fear but fear itself."**

### **To what extent do you see reigniting that sense of confidence going forward as a key role for our political leadership, both the United States and elsewhere?**

It is very important. Offsetting that is that we live in a world economy, and one leader in one country can't cure the world. But I think that we had a boost from President Obama in the United States. He is a charismatic figure despite all the people who dislike him. Maybe they dislike him because he is charismatic. I don't know. But his popularity has suffered. He sounded like a smart guy, in charge, enlightened, and with a plan. He did the stress tests on the banks, and it worked. Those stress tests boosted confidence a lot, because the testers said our banks were basically all right.



**That same stress test process just happened in Europe.**

Those results are about to be announced, and it is a question of whether it will have the same effect. It is actually a powerful technique when it works. But if the testers are really objective, it might not work in some circumstances.

**Let's talk about the housing market and how it affects our economic recovery. Among the things you are known for is the Case-Shiller housing Index, which has hit the headlines in a very prominent fashion in light of some of the recent ups and downs in the US housing market. In April you published an opinion piece in the *New York Times* expressing some doubts as to whether the US housing recovery was sustainable. Could you talk a little bit about that?**

We have had wild swings in home prices in the US. We reached a peak around 2006 and bottomed out in early 2009, and then it seemed to be sharply recovering. But the question is, what happened in early 2009? I mentioned that the Obama administration had come in with the new economic plan, but also very high on the list of that new economic plan's features was what started out as a first-time homebuyer tax credit. It expired initially in November 2009, and then they extended it to April of 2010.

Obviously that got people buying again, because they didn't want to buy after the credit expired. Now the questions are what will happen when the credit is over, and will that boost in home prices be just a temporary thing? Usually, declining home prices go on for years. The big question is, is it going to go back to a period of decline or not? That is something we are about to see.

**There are some measures in the past that predicted housing prices. Can you talk about what those show us?**

I like to use the National Association of Homebuilders Housing Market Index. That index is collected from homebuilders who keep their finger on the pulse of the market.

**Is it a reliable measure of sentiment?**

It's the homebuilders' perceptions of home buyers' sentiment. Their Index peaked in 2005, and it dropped catastrophically until around 2008- 2009. Then it started recovering, but it hasn't recovered very far.

Those initial signs of recovery have been faltering lately. What I am hearing from the homebuilders is they don't see that demand is there. This is confirmed by the fact that new construction is practically at an all-time low now. Housing starts and housing permits are extremely low. It reflects the fact that people are not yet in the mood to go out and buy a house. It reflects this fundamental uncertainty and lack of confidence that still pervades in the economy.



**Some of that is related to the high levels of unemployment and whether we will have a sustained recovery. What it's going to take to get home prices up – more confidence about the economic future?**

That's the problem. Right now, long-term unemployment is at record highs. That's troubling. A lot of people who were mid-career saw their jobs interrupted and don't have any prospect of getting anything back like they had. They talk and they stir up discontent. We have the talk about debt crises in Europe, which reminds people of their own country's debt problems. A number of countries have pushed up their national debt to high levels because of their stimulus needs.

There is a malaise about this, because people think that we don't have a solution and don't have a way out. There is a sense in which economists have failed us. The stimulus package – maybe it worked and maybe it didn't. Maybe we won't get more stimulus, and so people are edgy and still in a wait-and-see attitude.

**I'd like to talk briefly about the book, *Animal Spirits*, you co-authored last year with George Akerlof, the Nobel Prize Laureate professor at Berkeley. Could we start by talking about where the idea for this book came from?**

We traced the term 'animal spirits' back to the British economist John Maynard Keynes. For him, animal spirits was your spirit, what makes you get out of bed in the morning, what makes you start a business, buy things, and make the economy go. Keynes thought that it fluctuates. He wondered about what it is, what underlies it, why is it that sometimes we don't want to start things, and why we don't want to do things. People have been wondering ever since, because it is the driver of the economy.

Akerlof and I think that it has a lot to do with expectations, and a sense of normalcy that things are alright. We have a good government. Our businesses are sound. And I am going to spend?

At other times, you just get shaken from that. People don't necessarily express this, or explain this very well, but their view of the world changes and they become more circumspect and reluctant to spend. That brings the economy down.

**So you end up with a bit of a downward spiral. People stop spending, and if enough of them do that then the economy turns down, and it becomes one of those downward spirals. Is that what you are suggesting?**

This is what Roosevelt meant by the only thing to fear is fear itself. There were other thinkers in the Great Depression who said that we seem to have been down mentality. One psychologist called it a slave mentality. It's like it's hopeless. I'm going to go home



and listen to the radio to cheer up. They had Rudy Vallee to cheer them up, but they were not going to do anything, because they had to wait. Everyone was waiting.

**Is that where you think many people are today?**

I think so, and that is the concern. It's something that is deep-seated and possibly long-lasting. Think about the housing market. People have the sense that they bought this expensive house, and now it is selling for so much less. They are not going to sell it for that. So the sales go down. They stay put. They don't move, because they feel stuck in this house.

**When you are in that kind of a situation that you are suggesting that we may be in today, is there a public policy solution that might help turn that around?**

I've written a book about that, a book called *The Subprime Solution*, in 2008. The package should have included immediate stimulus. To some extent it did. We had the G-20 countries get together and agree on a coordinated stimulus package. That's why we're doing as well as we are. This could have been much worse. But, on top of that, the second part of my book was that governments should take the occasion to make major fundamental transformations of the economy that inspire people to believe that we are moving forward.

**What kinds of transformations are you thinking of?**

One thing that has been happening is infrastructure investment – building new highways, harbors, and bridges, and things like that. People see that, and, if it makes sense to them and they don't see some foolish expenditure of money, they have a sense of progress moving forward. But, on top of that, we should have financial innovation that is advancing our capitalist system, and which convinces people that we have not given up on capitalism, despite this crisis. We should move ahead with it, and make it serve the people better.

I wanted to see new things that bring to mind the 21st century economy.

I'll give you one example from my book: We should come up with a different kind of mortgage. The home mortgages that we have now put 15 million Americans underwater. It put them in a highly leveraged, risky investment, and then all it took was a price decline to wipe out with their life savings.

I want to develop a new kind of mortgage, which I call a continuous workout mortgage, with a workout built in. Already, a Congressional conference committee has agreed on a bill that would have funeral plans for corporations, something analogous to what I am talking about. I want to do something like this for mortgages for individuals. It would not be a funeral plan; it would have a workout built-in – a plan for what it will do when you are in trouble.



**When housing prices decline, or when someone loses their job, there would be an automatic process that takes place.**

Absolutely right. I don't know whether this is left-wing or right-wing. It's for the people. It is a private sector innovation, but it needs government regulatory support. It's hard for private sector innovations of this magnitude to happen. It's analogous to the kind of support that was given in the United States for long-term mortgages in the 1930s – where the government encourages financial innovation, and people see the value and that it leaves them in a more protected state.

We just got health care reform. That was an inspiration. That's part of what may have driven up confidence, but we need more of that kind of thing. It's like putting building blocks in for a stronger economy and for stronger confidence. Every little bit helps. We need a "New Deal" type of government now that will continue to put new structures on our capitalist economy so that it works better.

**That was part of your proposal to reinvent mortgages. Some states have nonrecourse mortgages, where people can walk away if their mortgage is worth more than the value of the house. Do you propose that that feature should be eliminated?**

It's very complicated. The US has 50 different states, and the laws about walking away from mortgages are complex.

We need a mortgage contract that is written with the consumer and homeowner in mind. Our bankruptcy law has built into it a "fresh start" idea. That's an important idea – a safety net.

But the nonrecourse states allow you to walk away from your mortgage debt without declaring bankruptcy. That's not the way I have structured it. I did not focus on recourse versus nonrecourse. I viewed it as let's develop a contract that will protect home buyers.

I tend to think of it in terms of modern finance. Modern finance is all about risk management – about hedging risk. Let's extend that to home buyers. It's not a question about rights. It's a question about having a financial institution that's basically caring about its customers. In the long run it will make for a stronger economy.



**You mentioned one of the things that inspired confidence on the part of not just Americans, but consumers around the world, was the coordinated stimulus spending in late 2008 and early 2009. You suggested that something that we need more of is spending on infrastructure. Should it be a priority going forward for the American government to focus on additional stimulus spending for infrastructure, rather than on debt reduction?**

We obviously have to be concerned about the long-run debt picture. At this point we still need – although it's obviously a judgment call – more stimulus. I wish it could have come sooner before we got into such a negative funk, but I don't think the United States is anywhere near having to worry about its debt levels. The yield on treasury securities are at an extreme low right now, so the world isn't losing faith. They haven't concluded that the US is going to go the way of Greece. For now we need to continue with the stimulus package.

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