Whither Goeth the Stock Market?

The Dow Jones Industrial average rose back above its September 11^{th} level less than two months after that unprecedented terrorist shock. More recently, it temporarily snuck above 10,000, but eventually retreated. And most recently, the Enron collapse heightened concern about the adequacy of current accounting standards. The financial-market bubble burst, however, well before September 11 and the market still faces a significant climb to restore its all time peak. What path lies ahead for the stock market? Can it reestablish upward momentum? How might monetary and fiscal policy actions affect the stock market's performance?

Stock Market Pricing

Stripped to its basic function, the stock market provides a forecast, albeit imprecise, of the future profitability of the economy. The market sees through lenses that can focus a few months down the road or extend the horizon to several years. Severe unexpected shocks, such as the September 11^{th} terrorist attack or the Enron debacle, can quickly shorten the focal point.

The chair of the Federal Reserve (Fed), Alan Greenspan, popularized a standard finance valuation model, the dividend-earnings model, now referred to as the "Fed model." That model assumes that stock values reflect the discounted value of expected future earnings per share. In theory, the model discounts the value of all future earnings. But as the future unfolds, uncertainty increases the farther into the future that we try to see. In practice, the market only discounts the value of near-term expected future earnings, depending on the focal points of market participants. Thus, higher market valuation requires higher expected future earnings and/or lower interest rates.

The discounted value of the consensus forecast of the Standard & Poors (S&P) 500 earnings over the next twelve months possesses a strong, but not perfect, correlation with the actual S&P 500 market value. Such implicit valuations, however, can be too low or too high. The actual market value merely reports buyers and sellers willingness to pay and get. For example, during the final phases of the recent high-tech, dot-com stock market boom, the market value exceeded the Fed model's valuation by up to 70 percent.

Will the stock market rise in the near term? Here, a bad news-good news story emerges. The bad news: The recent red ink splashed across the business press as corporations reported actual earnings may not have a precedent since the Great Depression. Once the ink dries, the consensus forecast expects a 15 percent drop in after-tax corporate earnings in 2001, much worse than the declines recorded in the last 6 recessions. The good news: The consensus forecast sees earnings rebounding in 2002, although much of the increased earnings will occur in the second half of the year.

The Stock Market Reflects the Macroeconomy -- Eventually

Long-run firm profitability depends on the vitality and growth of the macroeconomy. Whither goeth the macroeconomy? Most analysts currently paint an upbeat picture. That is, majority thinking sees a short, shallow recession with economic activity picking up steam in the current or possibly second quarter. Most recently, Chairman Greenspan surprised market watchers when he apparently reversed himself and identified strong signs of the recession's end. Since Chairman Greenspan chooses his words very carefully, that statement received much attention.

The evidence supporting the recession's end and eminent recovery includes several indicators. Inventories are slashed to the bone. The index of leading indicators has jumped higher. Consumer confidence rebounded from recent lows. The initial claims for unemployment insurance peaked. Finally, and maybe most importantly, Chairman Greenspan almost explicitly said that the recession ended.

But wait, I caution against such optimism. Forecasting economic turning points is a most difficult task, even under normal conditions. But normal conditions do not currently exist. Psychological factors now play a critical role in the future path of the economy. Consumer and business confidence rest on shaky ground. The Enron fiasco dealt a severe blow to the market's solarplexes, only adding to the anxiety unleashed by the events and aftermath of September 11. The Enron affair, it must be said, may affect the macroeconomy more radically than the terrorist attack of September 11. Even absent additional anxiety-provoking events, developing the head of steam necessary to pull the economic train out of recession will require careful policy decisions and mountains of good fortune.

Additional factors also cast dark shadows over the macroeconomic landscape. First, household and business debts accumulated to high levels in recent years, making further spending increases less likely. (The unexpected jump in auto sales at the end of last year due to the zero interest financing deals adds to existing debt burdens. That jump did cause the preliminary fourth quarter GDP estimate to rise by 0.2 percent, which borrows against the future.) Second, a worldwide-synchronized recession looms on the horizon. So, we cannot rely on our friends (or enemies) to provide additional stimulus in the near term.

Does Monetary Policy Lack the Necessary Muscle?

Monetary policy proceeded down the correct track with its 11 cuts in the Federal funds rate. Chairman Greenspan's recent conversion to economic optimism quashed an expected 12th interest rate cut. The Fed, however, may not possess the necessary leverage to jumpstart the economy. Household and business debt burdens may forestall further extensions of borrowing to spur demand. In that regard, we may need some good old-time Keynesian fiscal pump priming.

Can Fiscal Policy Come to the Rescue?

Wither goeth fiscal policy? President Bush shepherded a fiscal (tax) reform package through Congress in 2001. The projections of fiscal surpluses as far as the eye could see gave birth to that plan. After September 11th, Congress committed $55 billion in additional spending, largely for disaster relief and grants and loans for the airline industry.

Congressional debate raged through the late fall and early winter over a fiscal package that ultimately did not pass before the holiday recess. Republicans offered primarily tax cuts. Democrats provided more support for spending increases. President Bush's State-of-the-Union address re-ignites that debate in Congress. One clear fact exists: Tax cuts only stimulate demand, if such cuts promote spending and not saving; government spending clearly increases demand.

The recession also pushes state and local budgets into deficit, since nearly all states require, either by law or by their constitution, a balanced budget. Thus, state governments will provide significantly less stimulus during the current recession. Thus, any federal fiscal stimulus needs first to offset state and local contractions before it can hope to fire up the macroeconomy.

The Fed and the President Face Off

Dawn had hardly broken on the New Year before policy makers seemed to play musical chairs. Chairman Greenspan now argues that we do not now need a fiscal stimulus. That is, while a fiscal stimulus last year may have helped, it is no longer necessary. President Bush, however, used his State-of-the-Union address to promote a large fiscal expansion. The combined image of increased military spending, a large structural tax cut, and implied non-defense-related government spending cuts harkens back to Reaganomics.

The Stock Market's Future

The stock market can resume upward momentum only if the macroeconomy shows evidence of recovery early in 2002. If the recession stretches into 2003, then the stock market cannot generate such momentum. Absent significant fiscal stimulus, the economy does not begin to recover until early 2003 and the stock market languishes through the first half of 2002. President Bush's fiscal expansion can provide the necessary boost to the macroeconomy. Will Congress pass a fiscal expansion? What government programs will benefit from that expansion? Of course, the politics of this latter debate could torpedo the passage of a fiscal expansion package before it leaves the harbor.

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