April 2015 Investment Publications Highlights

Quicksilver Markets

Ted Berg, Office of Financial Research, March 2015

Earlier this year, US equity investors celebrated the current bull market's sixth anniversary and the tripling of prices that accompanied the uptrend. These heady gains have left equity prices high by historical standards. In a recent article, the US Treasury Department's research arm notes that although the market may pose fewer financial stability risks today than a decade ago, four broad vulnerabilities may amplify future corrections.

The author highlights that the market is seemingly reasonably priced according to the frequently referenced price-earnings (P/E) ratio, but this valuation metric has three primary shortcomings: (1) an upward bias in forecasted forward one-year earnings, (2) the misleading sustainability of one-year earnings, and (3) the inability to take into consideration the reversion of profit margins toward a longer-term average. As Nobel Laureate Robert Schiller pointed out, it is a ratio of "tradition and convenience rather than logic."

Other valuation metrics, including the cyclically adjusted P/E (CAPE) ratio, the Q-ratio, and the Buffett Indicator, tell a different story. Each of these valuation tools is approaching a 2 standard deviation threshold, a level reached in many of the previous major US stock market bubbles. For example, the CAPE ratio, defined as the current price of the S&P 500 Index divided by the trailing ten-year average earnings per share, equaled 27 at the end of 2014. This is higher than 94% of historical observations and near the 2 standard deviation threshold of 30.

Although predicting the timing of market corrections is exceptionally difficult, valuation metrics can serve as barometers to estimate potential future returns. Relying again on the CAPE ratio, there is a clear inverse relationship between it and the subsequent ten-year equity return. In fact, ratios above 30 in the past have preceded a median annual real return of -1.1% over the next decade. Of course, valuation metrics are only one of many inputs needed to analyze market conditions.

The author suggests that financial regulators should be mindful of possible systemic risks when valuations approach highs, particularly those risks to credit-supplying firms. Regulators should also regularly review key vulnerabilities that may magnify systemic risks, including leverage, compressed pricing of risk, interconnectedness, and complexity. Although the financial system has been reformed to reduce potential pitfalls, *quicksilver* markets can abruptly change course.

Financial Inclusion—Issues for Central Banks

Aaron Mehrotra and James Yetman, Bank for International Settlements, March 2015

The rapid growth in access to financial services worldwide is challenging policymakers to adapt to the changing macroeconomic environment. In this feature, the Bank for International Settlements argues that while increased financial inclusion in many developing economies is likely to lower household consumption volatility and increase monetary policy effectiveness, it may also heighten risks to financial stability as officials grapple with balancing credit growth and regulation.

The share of adults with access to the formal financial sector (the authors' measure of financial inclusion) varies widely by country and income level. However, developing economies broadly have seen a significant increase in commercial bank branches, ATMs, and deposit accounts in the past decade. Policymakers from Asia to Latin America have supported these advancements by focusing on improving financial literacy, setting numerical inclusion targets, and encouraging a regulatory environment that promotes innovation and reform. Although substantial evidence points to increased financial inclusion globally, the authors note part of the growth may be attributable to cyclical factors.

With increased access to financial services, consumers are changing their behaviors. More households adjust their level of saving and borrowing in response to changes in interest rates, smoothing consumption expenditures. This fact, along with higher percentages of money held in bank deposits, strengthens monetary policy as a tool and helps central banks more effectively guide economies. To be successful, central bankers must be cognizant of the pitfalls of using a benchmark price index that excludes food, which makes up a higher share of income in developing economies. Central bankers must also keep in mind that with an increasingly inclusive economy, the velocity of money may decline, and monetary policy aimed at increasing output may not result in the desired effect.

The authors caution that the shift in the composition of consumers with access to credit will have an uncertain effect on financial stability. Generally, banks will be more diversified and flexible, and evidence from the global financial crisis suggests that more inclusive countries may be less susceptible to bank runs during a crisis. Banks may also be able to reduce the average credit risk of their loan portfolios by extending lines of credit to previously excluded consumers. That said, high-growth policies in developing economies could result in banks compromising lending standards to attract poorer households or in a small number of borrowers amassing large amounts of debt. Improvements in financial access may also be associated with growth in unregulated financial sectors. These scenarios could threaten financial stability in an economy if regulators fail to identify and measure systematic risks. ■

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