






## The rise and the fall

May 5th 2001

From The Economist print edition

**The fall in global equity markets has delivered a salutary shock to investors. But it should not stop the spread of an equity culture around the world, says John Peet**

THE first few months of 2001 have been tragic in a classical sense: the hubris engendered by the long rise in most of the rich world's equity markets has duly been followed by the nemesis of their sharp fall. Now the world is gloomily contemplating the possibility of the first sustained, globally shared, bear market for a quarter of a century. All those who have spent the past five years predicting a crash, even as the markets attained ever giddier heights—including, it should be confessed at once, this newspaper—are feeling belatedly vindicated.

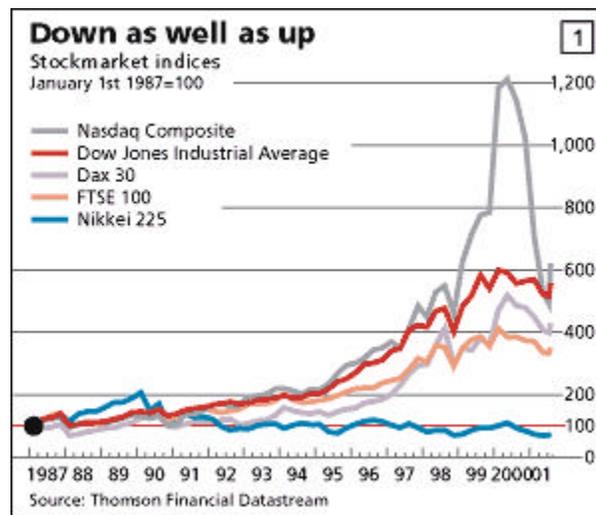
There have been other sharp falls in equity prices, and indeed several genuine bear markets, within living memory: in the 1970s, for example, or, even more painfully, over the past decade in Japan. But most of today's investors have never experienced them. Some may even have begun to assume that, perhaps thanks to the benign influence of America's Federal Reserve, it was normal for share prices to keep going up and up. Yet, historically, what is truly unprecedented is not the arrival of a bear market. It is the extraordinary two decades of rising share prices that ran until late last year.



It is worth putting the figures on record before the bears stamp out the memory altogether. At the start of 1982 the Dow Jones Industrial Average stood at 875; the index for the exuberant and then newish Nasdaq stockmarket was 196. Eighteen years later, at the start of 2000, after the longest and strongest bull market in history, the two indices stood at 11,497 and 4,069, respectively. That meant they had run up average annual real increases over that period of 11.7% and 14.6%, respectively. And this included, among several other dips, the great crash of October 19th 1987, when the Dow fell by 23% in a single day.

Over the past year, the markets have fallen back sharply, with the fall picking up speed as company profit warnings and worries about a recession have spread. Until a recent recovery, the broad S&P 500 index had fallen by well over 20% from its January 2000 peak (a 20% fall is widely, if unofficially, regarded as defining a bear market). The Dow has fallen by less, but it too is well off its peak. As for the technology-heavy Nasdaq stockmarket, despite its recent climb, it is down some 60% from its peak in March 2000. Plenty of blood-curdling figures have been hurled around. Some \$3 trillion has been wiped off the nominal value of America's stockmarkets, equivalent to (though not comparable to: one is a stock, the other a flow) a third of the country's GDP. Around the world the paper loss amounts to as much as \$7 trillion.

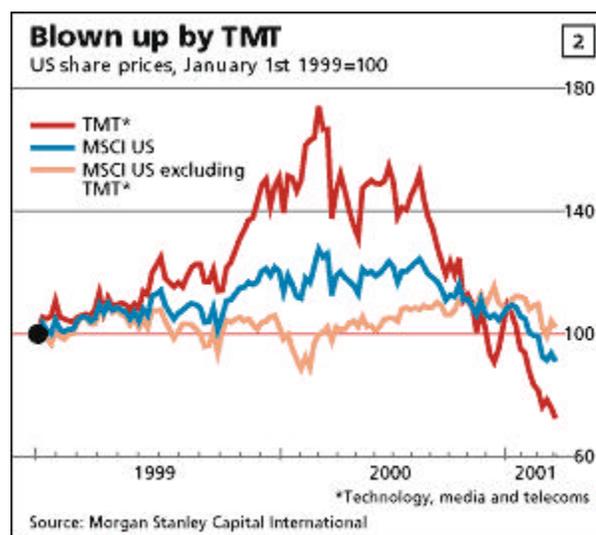
As chart 1 shows, Europe's stockmarkets have mostly followed a similar path to America's, with a slightly less dramatic rise followed by an equally sharp decline. Europe's smaller technology markets have seen an even bigger short-term boom and bust than the Nasdaq. Among rich countries' markets, only Japan's has followed an essentially different path, reaching a peak at the end of 1989 from which it crashed, and has since stagnated as worries about the economic outlook have increased. All in all, it seems safe to conclude that, whether or not the bear market persists, the long bull market is well and truly over.



## Bulls and bears

What caused markets to put in such an unprecedentedly strong performance in the first place? Many things, not least two broadly successful decades of macroeconomic performance, with mostly low inflation and steady growth (except in Japan). Yet equity valuations, as we shall see, are a matter of huge controversy, and markets have a pronounced tendency to get out of line with economic fundamentals, producing froth or even bubbles. The sharpness of the fall into a bear market, at a time when the real economy has done little more than slow down, suggests that this may have been happening in the 1990s.

It is the now notorious technology, media and telecoms (TMT), or “new economy”, bubble that was largely responsible for the heady rise in the markets, and it is its deflation that was responsible for a big part of the subsequent fall. If TMT stocks are taken out of the equation, the rest of the market (sometimes called the “old economy”) was much less buoyant in early 2000; until this spring, it seemed to be partly recovering, confirming its inverse relationship with TMT (see chart 2). Yet bear markets can always be defined away by excluding those sectors that have fallen farthest: that does not make them any less real. Besides, shares have recently declined right across the board.



Alongside the cyclical market rise, and now fall, there has been a structural factor at work in the 1980s and 90s. This factor, which might be called the equitisation of world finance, forms the main theme of this survey, which will seek to answer one of the big questions of the moment: can the new “equity culture” around the world survive a bear market?

Equitisation is only part of a veritable revolution in finance that has taken place over the past 20 years. In most countries, including America, capital markets at the start of the 1980s played a much smaller role than they do today. Banks, once the staid but trusty handmaidens of industry, have been subject as never before to competition and to an erosion of their traditional functions. New financial instruments, from derivatives to high-yield ("junk") bonds, and from swaps to sophisticated options, have been invented and popularised. Securitisation has turned almost any income-producing asset into a tradable instrument. And technology has changed finance perhaps more than any other industry outside computing itself.

## Under the buttonwood tree

It may seem surprising, against such a background of febrile change, that something as old-fashioned as equity should have come so strongly to the fore. Stock exchanges have, after all, been around for centuries. The New York Stock Exchange (NYSE) dates back to 1792, when traders met under a fabled buttonwood tree close to where the Big Board's floor still stands. The London Stock Exchange began trading in its present form in 1801. Amsterdam's bourse is older than either. Yet for most of their history, stock exchanges traded government bonds far more than equities. Until relatively recently interest in shares was limited, confined largely to wealthy individuals and a few institutions. But over the past two decades four related trends have changed that.

The first is rising issuance of equity on the public markets, not least shares in companies that had been either state-owned or privately held. Dick Grasso, the combative chairman of the NYSE, likes to cite his two conservative heroes of the 1980s, Margaret Thatcher and Ronald Reagan, as chief inspirations for both privatisation and the spread of share ownership. Mr Grasso now declares that "equity is the crude oil of the global economy". Ironically, the net supply of new equity in America has actually shrunk recently, thanks mainly to share buybacks by companies.

Elsewhere equity supply has steadily increased. Privatisation, a term coined only in the early 1980s, has given a huge boost to stockmarkets and equity ownership in Europe. The fashion for private or mutually owned firms to list on public stockmarkets, not least to raise capital more cheaply, has spread. The bear market will slow things down: global equity issuance in the first quarter of 2001 fell by 63% compared with a year earlier, to \$48 billion. But it seems sure to pick up again.

Second, there has been a growing appreciation of the huge demographic challenge that faces most countries' pension systems. The old ways of relying on state pensions and pay-as-you-go financing both look increasingly unsatisfactory. Whatever soothing noises governments may make, few prospective beneficiaries now believe that they can depend on these systems in their old age. Instead, the trend is towards greater emphasis on privately funded pensions.

Within the private pension business itself, another significant change has been taking place: a steady shift from "defined benefit" to "defined contribution" schemes. In the first (also known as "final salary"), the employer guarantees the level of the pension and assumes the risk; in the second (often called "money purchase") the risk is shifted to the employee. Individual pension-fund investors, for instance those with 401(k) plans in America, are likely to be especially interested in equity investment. If demographic change is the biggest problem in the provision of pensions, equity has to be the biggest part of the solution.

Third, almost all investors, almost everywhere, have come to understand that, in the long run, only shares hold out the promise of sufficiently large returns to pay for people's pensions. Over the past two decades the notion that there are better returns to be had from equities, with less risk, than from almost any other financial asset has become entrenched in investors' minds—perhaps too much so, as they became used in that period to above-average annual returns in double figures. The result has been a proliferation of equity investing, and especially of equity mutual funds, first in America and Britain, but more recently even in such previously unpromising countries as Germany and France.

Today's bear market, if it endures, will certainly test the enthusiasm for this new-found equity culture. Indeed, one apparently perverse reason for welcoming the arrival of a bear market is that it will remind investors of the main reason why equities have offered better returns: because they are riskier. As the hackneyed phrase from the brochures, usually in small print, has it: "Shares can go down as well as up." If shares only ever went up, the long-run returns from investing in them would inevitably fall to match their lower risk.

It is because of the riskiness of equities that, over time, they outperform other investments, as repeated studies over many decades, including periods of previous bear markets, have confirmed. Table 3, drawn from a long-running annual equity-gilt study undertaken by Barclays Capital, shows comparisons for America of equity, bond and cash returns for as much of the past century as there are reliable records. Equities can underperform significantly in any one year—2000, for example, was one of the worst in living memory, and 2001 could well prove worse still. But over most longer periods (barring such an exceptionally gloomy decade as the 1930s) returns have been substantially higher for equities than for either bonds or cash. Jeremy Siegel, a professor at Wharton Business School and author of “Stocks for the Long Run”, showed similar results going as far back as 1802 when he compared the returns on shares, long-term bonds, short-term bills, gold and cash.

<b>Shares on top</b>			
US real investment returns annual average, %			
	Equities	Bonds	Cash
1931-40	3.6	6.4	1.6
1941-50	7.5	-3.1	-5.1
1951-60	13.8	-0.4	-0.2
1961-70	5.3	-1.5	1.3
1971-80	1.4	-3.6	-1.1
1981-90	7.9	8.8	3.9
1991-2000	14.1	7.1	1.9

Source: Barclays Capital

These three structural trends pushing the process of equitisation have, however, become conflated and confused with the fourth (and perhaps biggest) factor of all, which is the two-decade-long bull market itself. In retrospect even the crash of 1987 now looks like a mere blip. It is thanks largely to the bull market that stockmarket capitalisation as a share of GDP had everywhere risen to record levels by the end of 2000. Against the background of such big share gains over such a long period, it is hardly surprising that so many new investors have been lured into the stockmarkets.

In America, for instance, nearly half of all households now own shares, either directly or through mutual funds, 401(k) plans or directly managed pension plans. In Australia, the level of share ownership is even higher. In Britain, the proportion is a little over one-quarter. Germany and France still lag, with less than a fifth of the population owning shares—but, thanks not least to privatisations, they have made tremendous strides from a far lower base. The number of shareholders in Germany now exceeds that of trade union members. Even in Japan, despite its long bear market, the stock exchange claims that around 30m individuals now own shares directly or indirectly.

The impact of equitisation stretches wider than the number of people investing in the stockmarkets. It reflects the broader triumph of capitalism in the post-cold-war era. There are few better symbols of capitalism's success than the spread of share ownership. It is also part of a shift in favour of what is often tagged as the Anglo-American model of capitalism, in which markets, not banks (and still less governments), become the key allocators of capital.

The rise of equities is also affecting the management of companies. Now that larger numbers of investors pay closer attention to the daily movement of their companies' share prices, bosses' main concern has become the promotion of “shareholder value”—all the more so when their own rewards are linked, as they increasingly are, to share performance. In many companies, employees have got in on the act as well. Stock options for staff and employee share-ownership plans have proliferated everywhere, becoming particularly important in America's technology industry.

In Europe, this has pushed company managers into paying far more attention to short-term profit and share-price performance. In America, it has also led to the fad for share buybacks by firms, which have become so popular as to shrink the net supply of publicly traded equity. Everywhere, people now pay far more attention to what is happening in the stockmarkets. One sign is the mushrooming of personal-finance journalism in many countries.

There are broader economic effects too. The spread of share ownership means that a growing proportion of people's savings is tied to the equity markets. This creates a potentially far bigger direct “wealth effect”, with consumers adjusting their spending with an eye on the rise and fall of the stockmarkets, regardless of whether they realise their own capital gains or losses. Even more important, stockmarkets are having a growing effect on consumer confidence, and therefore on the economy itself. One of the reasons that consumer confidence fell off a cliff in America at the end of 2000 was the poor performance of the equity markets. Now a vicious cycle may be at work: falls in equity markets contribute to a slowing of the economy, which leads to further falls in the markets.

Equitisation has microeconomic effects as well. Avinash Persaud, an economist at State Street Bank, talks about the equitisation of innovation in the 1990s, by which he means that venture (or private equity) capital was freed

provided to innovators, especially in the technology business, in the knowledge that there was an early and profitable exit route through an initial public offering (IPO). Mr Persaud has also shown, on the basis of information in State Street's custodial database, that equity flows across borders account for a growing share of all capital flows, so they are helping to determine the course of exchange rates and the balance of trade.

The effects of equitisation on the world's economies are thus huge. But the biggest question now is how a bear market will influence things. Might it encourage investors to cast around for safer havens, putting an end to the incipient equity culture? And that invites another question: what determines the value of an equity—and a stockmarket?

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