

FULL CIRCLE

This is my last contribution to EcoWeek before my retirement within a couple of weeks. Looking back at a career in banking and asset management that spans several decades, my main conclusion is that history repeats itself, at least to some degree. When I started in banking in 1987, a hotly debated topic was whether Wall Street had become massively overvalued and my first task was to focus on the sustainability of Belgian public debt. Ironically, today the valuation of Wall Street is again a topic of intense debate and many advanced economies struggle to stabilize their elevated public debt ratio. This reminds us that in the long run, budgetary discipline is of paramount importance. Otherwise, governments will have to confront increasingly difficult choices. Looking at equity markets, valuations should remain highly cyclical but the low frequency of recessions in combination with the belief in a 'Federal Reserve put' imply that investors may be willing to permanently steer close to the cliff and accept elevated valuations.

Over the past several years, I have written more than 300 editorials for EcoWeek. It has been a stimulating, albeit sometimes challenging experience. This is my final contribution before my retirement within a couple of weeks. At a moment like this, one is tempted to look back at key economic events or financial market developments, thereby trying to draw conclusions that may be relevant for the future.

From a career in banking and asset management of almost 40 years, my main conclusion is that history repeats itself, at least to some degree. I'm certainly not the first one to make this point, nor do I expect to be the last one. But still, the conclusion is relevant. Coming from an economist, it is also unsurprising. After all, economists and investors are trained to look for stylised facts -recurring patterns between economic variables and between economic variables and financial markets- when analysing and forecasting business cycles.

But my point goes further than that. After several years of doing research at Ghent University, I joined the economic research department of Generale Bank in Belgium in June 1987. During the summer months and in the early autumn, a hotly debated topic in the team was the rally in US equities and whether Wall Street had become massively overvalued. I remember a colleague defending this view based on the spectacular rise of the ratio between the market capitalization of the Dow Jones index constituents and nominal GDP. My first task in the team was to focus on public finances in Belgium -which were in bad shape at that time- and the so-called snowball effect, whereby rising indebtedness causes ever higher interest charges, higher deficits and more debt.

HIGH STOCK MARKETS VALUATIONS AND PUBLIC DEBT RATIOS AGAIN IN THE SPOTLIGHT

Against this background, it is somewhat ironic to observe that today the media are full of talk about whether there is an AI stocks driven bubble on Wall Street. Moreover, many advanced economies face a major challenge of stabilizing their elevated public debt ratio. It is tempting to say that we have gone full circle or that history repeats itself. A young economist joining our bank today might well be given the same topics as those we were dealing with almost 40 years ago. One could argue that my comparison is too narrowly focused. Equity market valuation and the state of public finances offer a very incomplete picture of the shape an economy is in.

1 There was a limited decline towards the end of the nineties and before the Global Financial Crisis. In 2019 the decline was marginal.

2 Source: Banque nationale de Belgique.

3 Source: Belgian Debt Agency.

CYCLICALLY ADJUSTED PRIMARY BALANCE

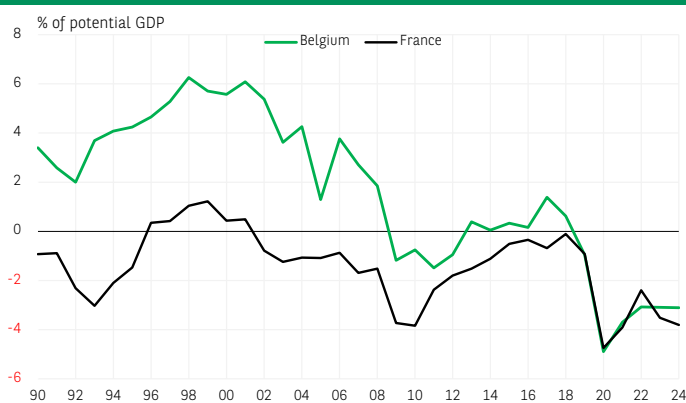


CHART 1

SOURCE: IMF

Broadening the perspective, there is also good news. Just to pick two: in France, where I have been working for the past 11 years, and Belgium, my home country, the unemployment rate is now lower than when I started my career.

In both countries, inflation has been under control most of the time since 1985. However, the French public debt/GDP ratio was very low in the eighties (34.5% in 1987 based on INSEE data) but it has been on a rising trend ever since¹, creating the current policy challenge we're all too familiar with.

In Belgium, public debt as a percentage of GDP doubled between 1976 and 1986, from approximately 60% to 120%, rising further to slightly more than 130% in the first half of the nineties. The ambition to be part of the Economic and Monetary Union from its very start made fiscal consolidation politically acceptable. Budgetary discipline, followed by a favourable cyclical environment led to a drop in the Belgian debt ratio below 90% in 2007². Since then it has again increased, reaching 104.4% in 2024³.



EQUITY MARKET VALUATION AND PUBLIC FINANCES ARE BACK IN FOCUS: A MERE COINCIDENCE?

With respect to the latter, the answer is no. Admittedly, the long-term evolution of public debt is the result of cyclical and structural developments (growth, inflation, real interest rates, etc.) but policy choices -or the absence thereof- also play a crucial role in explaining why some countries have a low indebtedness and others a high one. Economically, these choices are reflected in the cyclically adjusted primary balance as a percentage of potential GDP. As shown in chart 1, in France and Belgium this metric has steadily worsened since the second half of the nineties.

Concerning the US equity market, its cumulative performance over the past four decades has been impressive, but shorter-term fluctuations have been huge as well. Such volatility is normal given the cyclical swings in corporate earnings and the overreaction in markets due to fluctuations in the appetite for risk. What is striking however is that we are (again) in an environment of very elevated equity valuations. This is illustrated in chart 2, which shows a popular and very good indicator⁴, the cyclically adjusted price earnings ratio (CAPE), developed by Nobel laureate Robert Shiller, and in chart 3, which shows the US equity market capitalization as a percentage of GDP, a metric made popular by Warren Buffett⁵.

PUBLIC DEBT SUSTAINABILITY AND EQUITY BUBBLE RISK ARE AGAIN HIGH ON THE AGENDA: LESSONS FOR THE FUTURE

In terms of fiscal policy, in the long run, discipline matters. In the absence thereof, a situation that initially was (rather) healthy can gradually deteriorate and rising borrowing costs due to investor concerns about unsustainable debt dynamics risk creating a doom loop confronting governments with very difficult choices. As an aside, the point of discipline also applies to monetary policy: letting inflation somewhat drift away from its target eventually makes it increasingly difficult to maintain well-anchored inflation expectations.

Looking at equity markets and by extension asset classes that are riskier than high quality sovereign bonds, valuations should remain highly cyclical but the low frequency of recessions in combination with the belief in a 'Federal Reserve put' -i.e. rates will be cut in case of a significant market correction in order to fight its detrimental impact on the economy- imply that investors may be willing to permanently steer close to the cliff and accept elevated valuations.

William De Vijlder

S&P COMPOSITE INDEX: CYCLICALLY ADJUSTED PRICE-EARNING RATIO



CHART 2

SOURCE: ROBERT SHILLER WEBSITE
(ONLINE DATA - ROBERT SHILLER)

UNITED STATES: MARKET CAPITALIZATION OF LISTED DOMESTIC COMPANIES

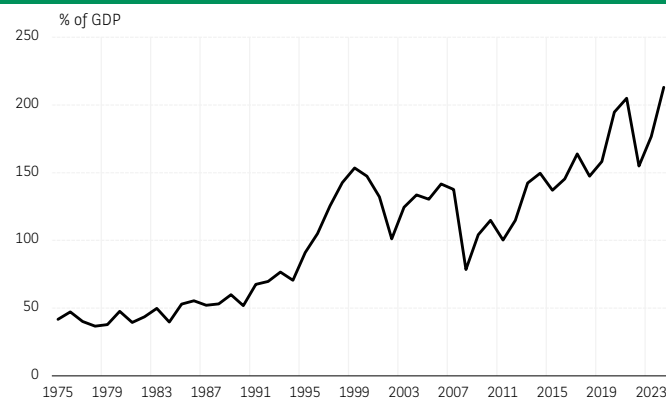


CHART 3

SOURCE: WORLD BANK BASED ON WORLD FEDERATION OF EXCHANGES DATABASE

⁴ 'Very good' refers to its quality as a predictor of future returns. Historically, high CAPE levels have been followed by low average multi-year returns.

⁵ The data are annual so the significant rise in the course of 1987 is not visible. Despite the concern this indicator was causing almost 40 years ago, it's level then was low compared with its current level.

