Nobel prize winner Richard Thaler's wake up call for bull markets

by **John Kehoe**
Opinion
Oct 12 2017 at 4:36 AM

University of Chicago economist Richard Thaler: the Nobel economics prize winner for his contributions to behavioural economics. AP

Almost every asset class in the world seems expensive at present compared to historical valuations, so the awarding of the Nobel Prize in economics to Richard Thaler is a timely reminder that financial markets can sometimes price things awfully wrong.

Thaler has previously pointed to the US technology stock bubble in the late 1990s and how Americans kept buying houses in the mid-2000s as values soared, just before huge price busts, as two pertinent examples.

According to the Nobel laureate's thesis, markets don't always price assets efficiently because investors are not always rational and can be overcome by emotive human psychology. They also lack perfect information.

The theory has parallels to what former Federal Reserve chairman Alan Greenspan famously dubbed "irrational exuberance".

To underline the point, Thaler even made a cameo appearance at a blackjack table in *The Big Short* movie.

The behavioural economist depicted how the "herd" mentality drove hoards of unwitting investors into synthetic mortgage-backed collateralised debt obligations that blew up the global financial system in 2008.

Today, stocks on Wall Street are perched around a record high and market volatility is abnormally low as investors largely ignore geopolitical risks and burgeoning global public and private debt.

Thaler said this week bullish market conditions are a "mystery" to him.

"That, and the unbelievably low volatility in a time of massive global uncertainty seems mysterious to me," Thaler told Reuters.

Asset risks

Closer to home, Sydney and Melbourne house prices are extremely high and household debt-to-income ratio has hit a record 189 per cent, following a buying binge over the past five years.

The psychology among most local buyers seems to be that property values only ever go up, not down.

Thaler's empirical research shows that such irrational thinking can sometimes turn out to be dreadfully misguided.

Elsewhere, the Japanese stock index touched a two-decade high this week.

The interest rate on corporate junk bonds is just 5.5 per cent, according to the Bank of America Merrill Lynch US High Yield Effective Yield. Non-investment grade companies can borrow at super cheap rates, as yield-starved investors discount the probability of default and drive up bond prices and down yields.

The International Monetary Fund's global financial stability review this week said near-term risks have declined with the strengthening global recovery, but "medium-term vulnerabilities are building as the search for yield intensifies."

"Risks are rotating from banks to financial markets as spreads and volatility compress while private sector indebtedness rise."

The asset price boom across the world has been underpinned by historically low interest rates, and more recently, an improving global economy.

Post the financial crisis, central banks have tried to "nudge" — Thaler's famous term for governments prodding people to take actions in their own interest — people into riskier assets to increase wealth and spending across the economy.

The risk is that central banks have nudged too hard and the world is a powder keg of debt-fuelled asset values.

'Not always right'

Wall Street's US S&P 500 has only ever been higher twice according to Nobel laureate economist Robert Shiller's closely watched 10-year cyclically adjusted price-to-earnings ratio — immediately before the 1929 Black Tuesday crash that brought in the Great Depression and in the late 1990s just before the dotcom bubble popped.

Shiller's index is not a reliable guide in determining the timing of any market correction, but it is considered useful in analysing market valuations.

Yet the revered efficient market hypothesis (EMH) does not always work perfectly in financial markets, due to investors lacking perfect information and people acting irrationally.

For example, investment doyen Benjamin Graham observed as early as the 1930s that the prices of closed-end mutual funds were often different from the value of the shares they own.

The dilemma is, widely traded financial markets remain the best way to price assets.

Thaler himself noted in the *Financial Times* in 2009 soon after the global financial crisis struck that financial markets are still the best way to allocate capital and there are only limited ways to help investors.

"Even so, knowing that prices can be wrong suggests that governments could usefully adopt automatic stabilising activity, such as linking the down-payment for mortgages to a measure of real estate frothiness or ensuring that bank reserve requirements are set dynamically according to market conditions," Thaler wrote.

"After all, the market price is not always right."