Bull market blues

By Paul Krugman
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Like most economists, I don't usually have much to say about stocks. Stocks are even more susceptible than other markets to popular delusions and the madness of crowds, and stock prices generally have a lot less to do with the state of the economy or its future prospects than many people believe. As the economist Paul Samuelson put it, "Wall Street indexes predicted nine out of the last five recessions."

Still, we shouldn't completely ignore stock prices. The fact that the major averages have lately been hitting new highs — the Dow has risen 177 percent from its low point in March 2009 — is newsworthy and noteworthy. What are those Wall Street indexes telling us?

The answer, I'd suggest, isn't entirely positive. In fact, in some ways the stock market's gains reflect economic weaknesses, not strengths. And understanding how that works may help us make sense of the troubling state our economy is in.

O.K., let's start with the myth Samuelson was debunking, the claim that stock prices are the measure of the economy as a whole. That myth used to be popular on the political right, with prominent conservative economists publishing articles with titles like "Obama's Radicalism Is Killing the Dow."

Strange to say, however, we began hearing that line a lot less once stock prices turned around and began their huge surge — which started just six weeks after President Obama was inaugurated. (But polling suggests that a majority of self-identified Republicans still haven't noticed that surge, and believe that stocks have gone down in the Obama era.)

The truth, in any case, is that there are three big points of slippage between stock prices and the success of the economy in general. First, stock prices reflect profits, not overall incomes. Second, they also reflect the availability of other investment opportunities — or the lack thereof. Finally, the relationship between stock prices and real investment that expands the economy's capacity has gotten very tenuous.

On the first point: We measure the economy's success by the extent to which it generates rising incomes for the population. But stocks don't reflect incomes in general; they only reflect the part of income that shows up as profits.

This wouldn't matter if the share of profits in overall income were stable; but it isn't. The share of profits in national income fluctuates, but it has been a lot higher in recent years than it was during the great stock surge of the late 1990s — that is, we've had a profits boom without a comparably large economic boom, making the relationship between profits and prosperity weak at best. We are not, in fact, partying like it's 1999.

On the second point: When investors buy stocks, they're buying a share of future profits. What that's worth to them depends on what other options they have for converting money today into income tomorrow. And these days those options are pretty poor, with interest rates on long-term government bonds not only very low by historical standards but zero or negative once you adjust for inflation. So investors are willing to pay a lot for future income, hence high stock prices for any given level of profits.

But why are long-term interest rates so low? As I argued in my last column, the answer is basically weakness in investment spending, despite low short-term interest rates, which suggests that those rates will have to stay low for a long time.

This may seem, however, to present a paradox. If the private sector doesn't see itself as having a lot of good investment opportunities, how can profits be so high? The answer, I'd suggest, is that these days profits often seem to bear little relationship to investment in new capacity. Instead, profits come from some kind of market power — brand position, the advantages of an established network, or good old-fashioned monopoly. And companies making profits from such power can simultaneously have high stock prices and little reason to spend.

Consider the fact that the three most valuable companies in America are Apple, Google and Microsoft. None of the three spends large sums on bricks and mortar. In fact, all three are sitting on huge reserves of cash. When interest rates go down, they don't have much incentive to spend more on expanding their businesses; they just keep raking in earnings, and the public becomes willing to pay more for a piece of those earnings.

In other words, while record stock prices do put the lie to claims that the Obama administration has been anti-business, they're not evidence of a healthy economy. If anything, they're a sign of an economy with too few opportunities for productive investment and too much monopoly power.

So when you read headlines about stock prices, remember: What's good for the Dow isn't necessarily good for America, or vice versa.