Is the stock market waiting for its hangman?

World stock markets have lived a charmed life for the past two years, but the end is near, says **Gerard Lyons**

World financial markets heaved a huge sigh of relief last week when the US Federal Reserve decided to leave US interest rates unchanged. This was the right decision. It proved a trigger for another rally in the US bond market and provided another stay of execution for the country's stock market.

The Dow Jones has enjoyed a charmed life in the last couple of years, despite many predictions of an imminent crash. Pessimism has been particularly apparent among UK fund managers, who have taken a cautious view of US equities. This has proved costly, as the stock market has continued to soar.

However, there are some big negatives for US equities. The capitalisation of the market is now at a higher ratio to GDP than at the October 1987 crash or even the Wall Street crash of 1929. This suggests the stock market is over-valued and is already behaving like one of those cartoon characters who has run over the edge of a cliff and is still running, only on thin air. Once it looks down and sees nothing is holding it up, it will plummet.

But is there something holding up the Dow Jones? The US economy has undergone a dramatic transformation in recent years: Firms have used existing capacity and labour far more efficiently in this economic cycle, contributing to low inflation; the share of wages in national income has been squeezed; productivity has proved higher than nearly all economic forecasters expected; new technology has lowered the cost of capital, further encouraging a shake-out of workers. Thus, the rate of return on capital in the business sector has risen sharply, reflected in the improved profitability of the corporate sector.

This is similar to developments in the UK, although there is one big difference. In the US the corporate sector has invested heavily. A similar rise in investment is long overdue in the UK. Higher US investment has not only boosted production capacity, thereby reducing the risk of hitting an inflation bottleneck, but has also propelled the US to the forefront of the technological revolution, well ahead of competitors including Japan.

Despite these positive developments for the US corporate sector, there are concerns. Some of the improvement in profits came through cost cutting – such gains cannot be sustained for ever. Also, there has been an acceleration in US wages and unit labour costs. This is not a threat to the inflation outlook, but it could squeeze profit margins.

The price/earnings ratio of the stock market is not particularly high and does not suggest the equity market is vulnerable. However, the market may have discounted too much good news on US growth. Recent economic data has been mixed and the economy looks set to slow to a steadier pace of growth, with low inflation.

Thus the Federal Reserve was right to leave interest rates unchanged. At their policy meeting in early July, the Fed adopted a "bias towards tightening", suggesting they were prepared to raise rates if necessary. Since then there have been two policy meetings, in August and last week. Despite this and a number of strong economic reports, the decision not to raise rates is significant.

There are policy differences within the Federal Reserve, although chairman Alan Greenspan and vice-chairman Alice Rivlin have convinced the rest of the board that the current stance is appropriate and that more time is needed to see if the economy will slow to a steadier pace of growth, with continued low inflation.

Of course, if a slowdown is not apparent the Fed may decide to raise interest rates when they next meet, in the week after the presidential election. When US interest rates rose in February 1994, there was a dramatic negative impact on world markets as highly-leveraged investors were caught out. But that should not happen this time. Even if there is a rate hike, it is more likely to be fine tuning than the start of an aggressive upward trend.

As strange as it may sound, the biggest threat to the US stock market is if the economy grew too strongly, triggering inflation fears and forcing the Fed to hike rates aggressively. In such a scenario higher rates would trigger a flow away from equities into cash, raising the possibility of a crash.

Liquidity is a crucial factor, as one saw earlier this summer when the market fell on news of reduced flows into mutual funds investing in stocks. As US interest rates fall, investors are happy to put more money into stocks. Fortunately, US inflation is set to remain low. This should allow bond yields to continue to decline and allow the Federal Reserve to leave official interest rates unchanged.

Just as the economy has undergone a dramatic change, so too has the way individuals save. As the US government cuts back on the budget deficit, it forces more individuals to make their own future pension provisions. This points to a steady upward shift in the US savings ratio from its recent low level. The US stock market has been a major beneficiary, but in a low inflation environment, US bonds offer less risk.

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