The Fall of 13 Years Ago

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Two or three hundred people a day now read this web page. A few are not research economist or journalists. Some of them send me emails asking me what they should make of the stock market.

I am not in that business. But it seems useful to remember what happened thirteen years ago. On October 19 of 1987, the US stock market lost 23% of its value. That was in a day. Approximately 600 million shares were traded; the paper loss was 500 billion dollars.

For the last year, one of the best macroeconomists in England has been trying to persuade me to go in with him to buy Put options on the London market (derivatives that make money when the market crashes). I have told him not to, because the market probably had a bit further to run, but that if he must speculate it seemed best to do so instead by selling Calls, which would make money if the market merely failed to rise too much.

With price-earnings PE ratios now at around twice their long-run historical average in the US market, and because the last public bear has now almost been eradicated, and because in the great financial centres of the world the fund managers know that because they are assessed by comparison with their peers their optimal risk-averse strategy is simply imitation of the others (see the recent paper by Clark and Oswald in the Journal of Public Economics), and because most on-liner traders mistakenly think they know something and can beat the index but have never lived through a big market drop and do not understand the fear they will feel, I believe a crash is now likely. The alternative, the Japan experience in the broadest sense, is that the index will simply not improve much for years and years. That is possible but improbable.

I have decided no longer to buy shares, but simply to hold those that I have, weighted towards oil and one other market, and for the next year or two to keep the dividend flow in cash. Selling rarely works; listen to Buffet whatever his young critics currently think. But ceasing to buy is now what I view as sensible.

The key fact is this: *markets have underestimated how much a temporary fall in real energy prices has been responsible for the prosperity and economic growth that we have seen*.

Investors have mistakenly attributed the new-economy boom to other factors. The near-tripling of oil prices has yet to work its way through our economies. Because of the pervasive role of energy in western society, and for reasons given elsewhere in oil-price papers on this web-site, profits and employment are likely to turn down sharply.

October, if we actually manage to get there without disaster, which is unlikely, will be an interesting month. I am looking forward to the Fall.