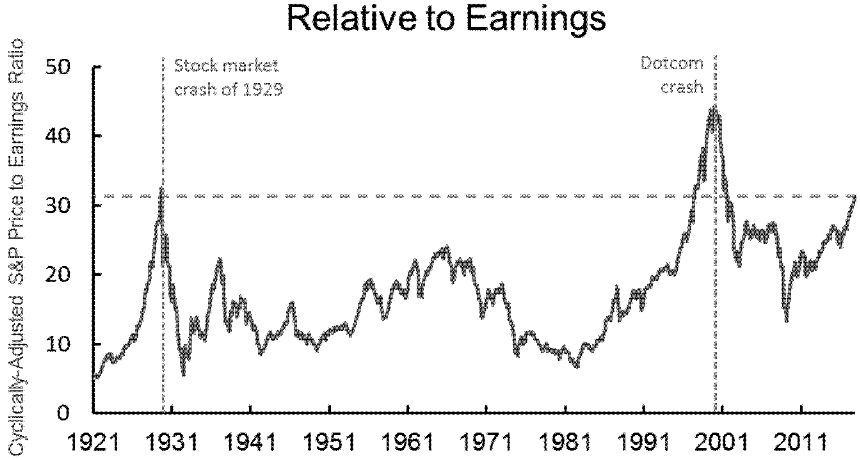
Republican Agenda Threatens Market Stability, Puts Main Street at Risk

With equity market valuations at highs only seen right before the stock market crash of 1929 and the Dotcom crash of 2000, now is the time that policymakers should be focused on maintaining stability, protecting consumers, and promoting sustainable growth. Instead Republicans are pursuing an agenda that will feed bubbles, leave consumers and small investors vulnerable to fraud and abuse, and undermine financial stability.

Market Valuations are at Extreme Highs

Asset prices across the board have been soaring in recent years. One common measure of stock market prices is the Shiller Cyclically-Adjusted S&P Price to Earnings Ratio (CAPE), which looks at stock prices in relation to earnings over the previous ten years. The measure is currently at levels only previously surpassed in the run-up to the 1929 stock market crash and the Dotcom bubble (see Figure below). Other measures of stock market prices are also high by historical standards.[1]

The S&P 500 is Priced Near Historic Highs, Relative to Earnings



Source: Haver Analytics, based on work of Robert Shiller
Note: Red dashed line represents current valuation

High asset prices create risk

Accurately forecasting where markets will go from here is difficult—the current bull market could end next week or keep going for years to come. Indeed, some analysts are predicting a large market correction in 2018 while others are predicting that stocks will continue to climb.[2]

What is less in doubt is that high valuations create risk. Investors are aware that prices are high, making them wary of anything that could disrupt markets.[3] A shock could cause investors to panic and start selling investments, which could trigger a larger market downturn, as seen in the two previous points where stock markets had higher valuations.

A shock could come from a variety of sources. A major bank failure, a war, an energy market disruption, or even a political scandal could be the spark that worries investors. Once a critical mass of investors became bearish, markets would slide, further feeding into a selling frenzy. The market downturns in 1929 and 2000 each triggered more widespread economic crises—a depression and recession, respectively.

Policy Should Maintain Stability, Protect Consumers, and Foster Growth

Especially in this environment where asset valuations are high, policymakers should focus on three priorities: maintaining stability, protecting Main Street consumers and investors, and promoting long-term sustainable growth.

Maintaining stability

Policymakers cannot foresee or prevent every future shock that might harm the economy and create a larger crisis. But they can work to minimize the impact of possible initiating events, such as bank failures. Dodd-Frank legislation gave regulators new tools to do this, including requiring large banks to conduct stress tests and draft living wills, and creating new regulatory entities that monitor and address systemic risks.[4] Given the risk associated with high valuations, this is a time when these new tools are most valuable—policymakers should be appointing regulators capable of and willing to use them and giving these regulators the support they need to do so effectively.

> *"Preventing Main Street consumers and investors from becoming victims of fraud and abuse should be a priority at all times..."*

Protecting Main Street Americans

Periods of high valuations are times at which consumers and Main Street investors are particularly vulnerable. During the housing and derivatives bubble before the most recent recession, for example, fraud and abuse were rampant.

Consumers were talked into buying homes they could not afford and lenders frequently – and, at times, knowingly – lied on paperwork to clear lending requirements. Less-savvy investors often ended up trading in unregulated markets where bigger and more-sophisticated investors (like hedge funds) had a clear leg up, with better information and knowledge on flaws in investments and markets. When the market crashed, these consumers and investors were some of the most-hard hit. Preventing Main Street consumers and investors from becoming victims of fraud and abuse should be a priority at all times, but it becomes increasingly important in times of high valuation.[5]

Fostering sustainable and inclusive economic growth

Ultimately, booms and busts are likely to continue to occur in the future. Ensuring that there is an underlying foundation of sustainable and inclusive growth in the economy helps families and businesses recover from these events, and ensures that in the long-run, the living standards of Americans continue to improve. This means combating income inequality, which the International Monetary Fund has identified as having a negative effect on sustainable growth.[6] It also includes making investments that improve productivity, such as supporting initiatives that spur innovation, improving the nation's physical and technological infrastructure, and increasing access to quality education—areas in which Federal Reserve Chair Janet Yellen suggested should be a focus for Congress in recent testimony before the Joint Economic Committee.[7] Given today's slower population growth and an aging workforce, growing the labor force is important in this as well—which can be done through immigration reform, policies that help women succeed in the workforce, and efforts to reintegrate formerly-incarcerated persons.[8]

The Republican Agenda Does the Opposite

Congressional Republicans and the Trump administration are pursuing an agenda that could destabilize markets and ultimately help bring about the next market downturn.

Constraining regulatory agencies

The regulatory framework that governs financial markets is intended to correct failures that have harmed markets, investors, and consumers in the past. Many of these laws were passed to fix the problems that led to and exacerbated the housing and derivatives bubbles of the 2000s. The Trump administration, however, is abdicating its responsibility to enforce these laws that enhance stability and protect consumers.

Few examples are as apt as appointing OMB Director Mick Mulvaney to be the interim director of the Consumer Financial Protection Bureau (CFPB). The CFPB was created in the aftermath of the 2008 financial crisis to give consumers an advocate that looks out for them and acts on their behalf. Now that markets are soaring is the time when this agency is most important, yet the appointment of Mulvaney is intended to hamstring the agency and prevent it from achieving its mission. Already, he has withdrawn a CFPB brief pushing for restitution for 100,000 customers that had been misled by a mortgage lender.[9]

The administration has also weakened the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR). FSOC is a council of the top financial regulators in the country, and is tasked with monitoring and addressing emerging risks to financial stability. OFR was created to provide critical insight on market risks to both Congress and regulators, with the goal of identifying risks early on so that they can be addressed before turning into systemic crises. The most recent FSOC budget, presided over by Treasury Secretary Steven Mnuchin, will slash funding by 15 percent and staffing by 50 percent. OFR's budget will be cut by 25 percent, and staffing reduced by 38 percent.[10]

Fostering a climate of uncertainty

Stock prices are largely a function of predicted future earnings and market conditions. The more uncertainty in future conditions, the more potential volatility in prices. Unfortunately, the Trump administration has created an atmosphere that encourages uncertainty. The unpredictability of the President's Twitter feed is a highly worrisome example. In July, the President tweeted out an early-morning reversal in policy on transgender soldiers in the military, taking even his own generals by surprise and leading to months of uncertainty, court cases, and an eventual reversal of the reversal.[11] If the President makes a similar drastic pronouncement on policy that relates directly to markets, regulations, or other economic policies, investors may be uncertain on how to react and could trigger panic.

The repeated threats of a government shutdown also create uncertainty. The President himself has talked about a government shutdown as being good for him politically.[12] This ignores the real implications of a government shutdown, such as more than $6.5 billion in lost economic activity for every week the shutdown lasts.[13] It is also unclear how markets will react to a shutdown in a unified government. Previous shutdowns have occurred as negotiations stalled between a Congress led by one party and a White House led by the other. A shutdown where both branches are controlled by a single party, as is the case today, could leave markets worried about how well our government will function in the near term.

Undermining sustainable growth and enhancing inequality

Economic growth has stagnated in recent years, and inequality is near historic highs.[14] Yet Republicans have failed to offer credible plans to address these problems. Despite promising to do so on the campaign trail, President Trump has yet to pursue a real plan to address the nation's infrastructure problems. It is likely that a lack of sufficient infrastructure investment is already impacting economic growth, and its effects will only be magnified if the problem is not addressed.[15] The administration has also proposed substantially cutting the levels of immigration, and has put the status of Deferred Action for Childhood Arrivals (DACA) recipients at risk. Immigrants are an important part of the economy, and limiting their participation in the economy would exacerbate the projected decline in labor force growth, hurting overall economic growth.

Republicans have claimed that their tax proposals would unleash economic growth that will trickle down to most American workers, but both their growth and trickle down claims have been widely panned. What their tax plans would do, however, is grow our already high levels of income and wealth inequality.[16] Economists increasingly see high levels of inequality as having a negative effect on growth, and high periods of inequality have been associated with market instability in the past.[17]

Conclusion

Market valuations are extremely high right now, which creates risk that a large correction could trigger a widespread economic downturn. Rather than mitigating this risk and working towards sustainable growth, Republicans are pursuing an agenda that risks financial instability and increases the likelihood of crises and recessions. The GOP should focus instead on ensuring that financial risks are being monitored and addressed, enforcing the regulations that protect Main Street Americans, and growing the economy in a sustainable and inclusive manner.

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