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23.4 is the number of points that State Street Global Markets' global INVESTOR CONFIDENCE index has fallen over the past year.

THE WAY WE LIVE NOW

Taking Stock

Is Wall Street in for a long funk?

By Roger Lowenstein

It has been three decades since Business Week proclaimed "The Death of Equities" on its cover. That 1979 obituary for the stock market, published when the Dow Jones industrial average languished at a mere 875, became a symbol of an age of doubt. So shattered were ordinary Americans by gas lines, recessions and double-digit inflation that they resorted to pulling cash out of equity mutual funds — for eight straight years.

Investors in the '70s were stunned by an alarming rise in volatility. The comfortable, ordered system of international exchange, in place since the Bretton Woods accord at the end of World War II, had come apart, leading to violent fluctuations in currency values. Grain shortages sent food prices soaring, and memorably, OPEC put the squeeze on oil. The cumulative effect was a loss of faith in money itself. (Doomsayers urged redeploying assets into metals, oils — anything other than paper.) Inflation, a virulent form of instability, terrified investors, who duly stayed on the sidelines.

It may seem strange to be drawing parallels to the '70s now — prices are so stable that the fear is of deflation. Yet there is no mistaking the '70s-ish gloom that has overtaken Wall Street. The trauma of the financial crisis has yet to be dispelled. It is not just Lehman Brothers and Bear Stearns that have disappeared but an ethos of confidence in long-term investing.

Though stocks remain well above 2009 lows, investors are withdrawing money from U.S. equity funds for the third straight year. Dispiritingly, investors are shunning attractively priced stocks in favor of bonds (both government and corporate) on which the returns are anemic.

The current crisis was inspired by financial shocks rather than commodity disruptions. But the result is a familiar malaise. The international monetary system, hobbled by imbalances and deficits, seems broken. Another echo is the sense that the sheer number of economic problems precludes a solution to any one of them. In 1979, an investment analyst was heard to despair, "The future is clouded by many ugly questions." Today analysts despair over high unemployment, failing mortgages, government deficits, impotent political responses, a weakening economy and a similar litany abroad. In another echo, Chicken Little has staged a comeback. In the early '80s, an energy consultant forecast — in this magazine — a "high probability" of an oil shock in which "the basic legitimacy of our political system might be called into question." Today's version is hyping the possibility of a stock-market crash. Albert Edwards, an investment strategist for the French bank Société Générale, has said he expects a "bloody, deep recession" that produces a stock-market collapse of at least 60 percent. He recently drew a crowd of 600.

Of course, any such forecast could prove right. But it is generally more lucrative to sell prophecies of doom than to act on them. What the herd tends to overlook is that stocks are not — except perhaps in the very short term — a bet on the odds of an apocalypse, nor are investors in securities rewarded for their prowess as macroeconomists. The real challenge of investing is so prosaic it is often forgot. Stocks are simply a claim on future corporate earnings: if you can buy those claims at a discount, you should do well.

Wise men will disagree on the meaning of "at a discount." But American business is profitable even today. And the Standard & Poor's 500 stock index is trading at only 12 times the expected earnings of the underlying stocks over the next year. Inverting that ratio, stocks have an earnings yield of 8.5 percent. (Each $100 of stocks is backed by $8.50 of expected earnings.)

Compare that with Treasury bonds, on which the yield is a dismal 2.58 percent. Short-term bond rates are well under 1 percent. The gap between 8.5 percent and 2.58 percent represents a striking reversal. For most of the past generation, bonds yielded more, sometimes much more, than stocks. The theory was that since earnings would grow over time, investors in stocks would accept a lesser return at the outset. They would pay for growth.

Now investors are flocking to bond funds; they are paying to avoid uncertainty — to avoid the prospect of financial Armageddon. Americans whose attitudes toward investing were shaped by bibles like "Stocks for the Long Run" seem to have undergone a fundamental rewiring. Perhaps when you are out of a job, the long run doesn't matter. "People would rather overpay for bonds than underpay for stocks," says David Kelly, a strategist for J. P. Morgan

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Funds. "It's a function of years of very miserable stock returns. And just a general fog of gloom over the country right now."

In markets, of course, gloom is no more permanent than boundless optimism. For the previous generation, the turn arrived in 1982 — three years after "The Death of Equities." It was fueled by corporate raiders, who could not resist seeming bargains on Wall Street and whose takeover bids sent share prices soaring.

There is no telling how long the present funk will last, but there are signs it could end in similar fashion. Corporations in droves have been exploiting low interest rates by borrowing. I.B.M. raised $1.5 billion at a record-low interest rate of 1 percent. It used a chunk of its haul to acquire a software vendor. Borrow cheap and buy low.

So far, ordinary consumers remain too in hock or too frightened to do either. What money they have is going into bond funds. "The individual investor is saying *no más* to equities," notes Robert Barbera, the chief economist for Mount Lucas, a private investment firm. It is hardly a stretch to say that the recovery of companies like I.B.M. is being fueled by the willingness of small investors to lend to them on the cheap.

Most of the people buying bond funds do not use a calculator in making investment decisions. They are captives, understandably, of their experience. But gloom and doom also has its price. It would be a sad twist if people were to mirror their recent excessive risk-taking with excessive caution now. ◆

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