What Wasn't Making Stocks Boom

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A common view on both Wall Street and Main Street is that stock prices have been rising so dramatically in the past three years because of the large flow of new savings into mutual funds. Some evidence appears to confirm the common view: According to the Investment Company Institute (ICI), the net new cash flow into U.S. equity funds in 1996 was a record $221.6 billion. At the same time, the S&P 500 index of stock prices rose from 620.73 at the start of 1996 to 740.74 at the end, an increase of over 19%. But look a little deeper, and the idea that investment flows drive stock prices makes no sense whatsoever.

The best counter-evidence is what happened to the same numbers in a couple of other years. In 1994, for instance, the net new cash flow into equity funds was $119.3 billion, only a little below the record $129.6 billion in 1993. Yet in 1994 stock prices were essentially flat, with the S&P 500 falling by 1.3%, from 465.44 to 459.27. In 1988 there was a net cash flow of $16.2 billion out of equity funds. Yet the S&P 500 rose by a respectable 8.5%. There is, in fact, little relation between flows to or from equity funds and the prices of stocks.

Nor should there be. The reason is simple. Whenever someone puts money into a mutual fund, and the mutual fund uses the money to buy stock, the stock doesn't come out of thin air. Someone had to sell it. So whatever flow of money went into the market, the exact same amount flowed out. The conviction that money flowing into the market drives prices is akin to the statement--often made by market watchers--that 'prices fell today because there were no buyers.' I guarantee that there were buyers. In fact, the number of stocks bought exactly equaled the number sold. The only time there are no buyers is when markets are closed--and then there are no sellers either.

You can break down the net flow into equity funds into two, and only two, components: (1) an increase in stock ownership through mutual funds, with a corresponding decrease in stock ownership through other vehicles and (2) an increase in the supply of stocks--through new issuances of stock by existing companies or through initial public offerings. There is simply no other way.

Notice that neither of those two factors has anything to do, necessarily, with increased demand for stocks. Interesting, eh?

There is a more sophisticated version of the view that the stock market boom has been due to increased demand for stocks. According to this view, stock prices have risen so rapidly in recent years because baby-boomers and others are saving so much and are willing to pay more for stocks. When the demand for a good rises, and the good is in fixed supply, as stocks are in the short run, the price of the good tends to rise. That looks like Econ 101. But there's a subtle problem with this view. If increased saving alone was the cause of booming stock prices, then how come stocks have so outperformed bonds? The way increased saving leads to higher asset prices is by driving down interest rates. At lower real interest rates, the price of an asset--the present value of its expected flow of future income--rises. These lower rates should have increased the prices of long-term Treasury bonds by about the same percent as stocks.

Yet stock prices in recent years have risen much faster than bond prices. Before the stock markets' late-October gyrations, for example, the Lehman Long T-Bond index had gone up some 9% in 1997; the S&P 500 had increased almost three times as much.

There's only one explanation that really works: higher expected earnings from stocks--whether or not those expectations are well founded. Only if the market expects earnings to rise can we account for the fact that stock prices rose so much more than bond prices. So we're brought back to the simple theory that few of the pundits on Wall Street are happy with but is consistent with virtually all the evidence that financial economists have discovered over the past 30 years: the theory that the price of a stock is the discounted value of the expected future income stream. The boom in stock prices must be due mainly to an increase in the expected stream of future income from stocks. And, as the events of October demonstrated, expected earnings can decrease too.