The stock-bond disconnect

Kenneth Rogoff | Harvard University | 09 March 2015

How should one understand the disconnect between the new highs reached by global equity indices and the new depths plumbed by real interest rates worldwide? Several competing explanations attempt to reconcile these trends, and getting it right is essential for calibrating monetary and fiscal policy appropriately.

The most popular explanations downplay risk factors in a way that can be dangerously misleading. For example, the secular stagnation theory claims that low interest rates tell the true story. The global economy is suffering from a chronic demand shortfall, which can be remedied through sustained growth in government spending.

According to this view, soaring stock markets merely reflect low discounting of future profits. Moreover, labor's share of profits seems to have fallen markedly in recent decades across the world's eight largest economies, with the possible exception of the UK. Conversely, capital's share of profits has been rising, which of course raises the value of equities (though, stock prices have continued to rise in countries like the US and the UK where labor shares have begun at least a cyclical recovery, and where interest-rate hikes may soon be on the horizon).

Proponents of secular stagnation argue that government spending as a share of GDP, which has more than doubled in most advanced economies since the 1950s, should continue to rise. Although one can readily agree that high-yielding government investments in education and infrastructure are especially justified today, the idea that demand permanently constrains supply in a significant way is dubious. More refined studies of the recent recession suggest that the lasting so-called hysteresis effects on unemployment have been limited, at least in the US.

Another possible explanation of low interest rates is financial repression. The European Central Bank and the Bank of Japan, like the Federal Reserve before them, are gluttonously buying bonds. At the same time, a host of new regulations to promote financial stability are forcing banks, pension funds, and insurance companies to stock up on government securities. Thus, today's low interest rates are more a reflection of distortions in financial markets than of low growth expectations.

Proponents of the financial repression explanation essentially view low interest rates as a hidden tax on bondholders, who receive a lower interest rate than they would otherwise. This is not necessarily a bad thing, given that all taxes are distorting, and that there really is no way to deal with today's outsize debt burdens that does not impinge on growth in some way

But the financial repression tax is not nearly as progressive as a more general wealth tax would be, because lower-income households typically have a smaller share of their assets in equities. In any event, it is unclear how financial repression can be the whole story. The fall in bond yields has extended to a far broader range of debt than just government paper.

Other factors are contributing to today's ultra-low interest-rate environment as well. Adverse demographics and declining labor-supply growth in most advanced economies are undeniably important. The puzzle, though, is that this trend has played out in a very gradual and predictable way, whereas the decline in interest rates has been more rapid and somewhat unexpected (certainly by central banks). And it is difficult to argue that weak demographics is the main driver of strong stock prices, though some have tried.

Curiously, heightened risk and fears of further disruptions - not just another financial crisis, but also geopolitical instability and pandemics - do not seem to carry much weight in current policy discussions, though the idea has been around.

Although bonds are hardly a perfect hedge against such risks, they typically beat stocks (except, perhaps, in cases of global conflagration, when both fare badly). In recent work with Carmen and Vincent Reinhart, we show that even relatively minor shifts in disaster risk - say, a rise from a normal 2% to 3% to 3% to 4% - can lead to a massive decline in global real interest rates, even taking them well into negative territory. This can be the case even if expected growth is strong.

But the policy implications of this are not straightforward. If government has superior information and analysis, and correctly assesses that public fear is not justified, then of course it makes sense to take advantage of the information - by issuing more debt, for example.

If, on the other hand, the public is basically right about heightened disaster risks, the policy issues become much more complex. The problem is that the government likely faces high costs if a disaster strikes, which implies a high option value to preserving fiscal space for when it is most needed.

The idea that hyper-low interest rates are merely symptoms of deficient demand or financial repression is dangerously simplistic. Surely heightened public concern about the risk of future economic catastrophe in the wake of the financial crisis is still playing an important role, reinforced by lingering fragility in the eurozone and rising instability in emerging markets. This makes the public understandably more cautious. But, if the risks that might help explain the price trends for stocks and bonds are real, policymakers, too, should be careful not to throw caution to the wind.

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