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BOOM OR BUBBLE?

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With the stock market setting new highs on a nearly daily basis, even as the real economy just slogs along, there seems to be one question on everyone's mind: are we in the middle of yet another market bubble? For a growing chorus of money managers and market analysts, the answer is yes: the market is a house of cards, held up by easy money and investor delusion, and we are rushing all too blithely toward an inevitable crash. Given that we've recently lived through two huge asset bubbles, it's easy to see why they're worried. But in this case the delusion is theirs.

The bubble believers make their case with a blizzard of charts and historical analogies, all illustrating the same point: the future will look much like the past, and that means we're headed for trouble. Smithers & Company, a London market-research firm, says that, according to a number of market indicators, stocks are, by historical standards, forty to fifty per cent overvalued. The bears admit that corporate profits are high, which makes the market's price-to-earnings ratio look quite normal, but they insist that this isn't sustainable. They think that earnings will return to historical norms, and that, when they do, stock prices will be hit hard. Today, after-tax corporate profits are more than ten per cent of G.D.P., while their historical average is closer to six per cent. That's a vast gap, and it's why bears believe that the market is, in the words of the high-profile money manager John Hussman, "overvalued, overbought, overbullish."

It's certainly unusual for corporate profits to soar during a slow recovery. But the argument for a stock-market bubble is flawed: when it comes to the role that corporations play in the U.S. economy, the present looks very different from the past, which means that historical comparisons to the nineteen-fifties, let alone the thirties, tell us little. The four most dangerous words in investing may be "This time, it's different." But this time it *is* different.

Take taxes: one big reason that after-tax corporate profits are much higher than their historical norm is that corporations pay much less in taxes than they used to. In 1951, corporations had to pay almost half of reported profits in taxes. In 1965, they had to pay more than thirty per cent. Today, they pay only around twenty per cent.

Then, there's globalization. Many of the "American" companies in the S. & P. 500 are multinationals: a study of two hundred and sixty-two of them found that, on average, they got forty-six per cent of their earnings from abroad. This is a relatively new phenomenon. As late as 1990, foreign earnings accounted for only a small fraction of corporate profits in the U.S. Today, they account for almost a third of corporate earnings, and they've nearly tripled since 2000. So comparing corporate profits only to American G.D.P. yields a false picture of how companies are doing. The global economy, even with its current woes, is projected to grow more briskly than the U.S. economy over the next decade, so corporations will continue to benefit.

Finally, the decline of unions and the sluggish labor market have enabled corporations to cut payrolls, thus keeping profits high. The result is that labor's share of the economy has fallen steeply. Skilled workers are still in demand, but most workers have little bargaining power. This could change if there is another economic boom—during the tech bubble, in the late nineties, wages did rise briskly—but, even in that case, corporate profits would likely stay high, as increased sales would make up for narrowing profit margins.

The underlying issue is that in recent decades there's been a shift in the U.S. economy: it's become far more congenial to businesses and investors. The fundamental trends that have driven the profit boom are unlikely to be reversed. That doesn't mean that companies are going to be able to keep slashing their way to profit growth. As Doug Ramsey, the chief investment officer for Leuthold Weeden Capital Management, told me, "It's hard to see how companies can get profit margins much higher, unless they want to see massive labor strikes across the country." But keeping profits where they are doesn't look all that difficult, which makes stocks today quite reasonably priced. It's still possible that investor hysteria could eventually inflate stock prices, or that investor panic could send them crashing, but there is no profit bubble and, for now, no stock-market bubble, either.

For investors, that's obviously good news: there's nothing wrong with profits, and the rebound of the stock market has helped restore many Americans' battered finances. Still, it's unsettling that companies and investors are doing so well while the economy as a whole is stuck in the mud. Throughout the postwar era, high corporate profits were coupled with rising wages and strong economic growth. Today, there's a growing divide between the fortunes of corporate America and those of the majority of Americans. You might hope that people could make back as investors some of what they're not getting as workers, but in fact only about half of Americans have any money in the stock market, and most of those who do have only small sums. What's more, the crash of 2008 scared many ordinary investors out of the market, so they haven't benefitted from the recent profit boom at all. "There's a lot of residual shell shock at work, and that's made investors still pretty gun-shy," Ramsey said. The stock-market boom is real, but most Americans have been left on the outside looking in. ♦

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