The Daily Dish

Policymakers and the Dow

DOUGLAS HOLTZ-EAKIN | FEBRUARY 6, 2018

Eakinomics: Policymakers and the Dow

"The stock market has forecast nine of the last five recessions," famously said American Nobel Prize winning economist Paul Samuelson. In light of the recent movements in the Dow (or S&P or Wilshire or any market index), this is a good lesson for policymakers. Specifically, there is very little day-to-day connection between market valuations and the economic reality on the ground. Economic policies should be targeted to making a more prosperous economic reality, but there is no guarantee that this will be reflected in market valuations on any specific timetable, and there is the real risk that sharp declines are present even when beneficial policies are being put in place. Politicians should avoid commenting on stock market movements in any direction.

How can the stock market become so disconnected? Arithmetically, owning a share of stock permits one to receive a stream of dividend payments in the future, plus the sales value of the stock. Thus, an investor will bid or value a stock on the basis of expectations of those future dividends and sales prices, which in turn may be rooted in expectations of future economic conditions on the ground. In addition, one has to use a discount rate — interest rate — to make present and future dividends equivalent. Future dividends are a lot less valuable as interest rates rise and it becomes easier to raise the equivalent cash in a bond investment. The upshot is that valuation of shares — and the market as a whole — is built on investors' expectations that cannot be directly observed. There could be shifts in interest rate expectations, earnings potential, and a million other variables that feed into these.

This makes it essentially impossible to say why a particular market move happened, and certainly risky to tie it to any particular policy development. It is much more realistic to recognize that over longer periods the stock (and other) asset markets will track the overall economy. Policymakers should track and monitor the main street economy — not the stock market — and focus on using policy to support better conditions on the ground.