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Article

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Markets have been rising for more than a decade and many forecasters think they will continue so. But this may be false optimism, as Anthony Hilton, Financial Editor at the London Evening Standard and veteran market commentator, explains.

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Daniel Kahneman, the psychologist-cum-economist, says nobody can predict what will happen in stock markets. The future is unknowable and we shouldn't pretend otherwise.

But we do. Forecasts are everywhere. Short-term,medium-term, long-term — all trying to predict how different sectors, different industries and different companies will behave.

The Scythians, an ancient Siberian tribe, put their soothsayers into carts, filled them with straw and set them on fire if they were wrong. We don't do that. Instead, we devour forecasts avidly. Indeed, when something untoward happens, business leaders and others rationalise it. The financial crisis, Brexit, surprise election results — these all initially caused consternation, but they eventually moved to the eminently predictable. "It was obvious the world was heading for a crash; it was only the date that was vague," they say. It is known as hindsight bias. And it helps us to think we know what is going on.

This raises the question of what might happen to world markets in the months and years ahead — along with the caveat that we do not know. Most are hitting new highs and most people think they will continue to do so, otherwise prices would fall. The consensus appears to be that markets have another 12 to 18 months of growth. But a select few market watchers are dubious, not least because prices have climbed so high and the bull market has lasted so long.

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There has to be concern about America. It is not just the markets that are high, but valuations too — in fact they are among the highest ever recorded. Bullish analysts say that profits support current prices. Against that, however, there is little sign of capital investment to support future growth, and consumers are growing tired. Markets may start to flag, even if there is no sign of it yet.

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The euro zone is flakier than it was, too, though again this has to be tempered. Yes, this year's growth is below last year's and the political turmoil in Italy could spark a crisis. But that's not the only way to bet. Rather, analysts say the euro zone will probably pull through again. There is always the prospect that it won't, but that is a long shot.

Quantitative easing is another factor to consider. Central banks used their power to create money to help the world get back on its feet, but now they want to back off and disband their unconventional measures. The US Federal Reserve is furthest down this route and it is already cutting back on bond purchases. That could cause rates to move higher, especially as President Trump's tax cuts mean the US budget deficit will become even larger than it is already.

Some economists predict that the US will have to raise interest rates more than expected — and this could cause turmoil in emerging markets, where companies have supped from the well of low dollar rates and would not know how to cope with higher ones. The worry is that many companies could fail, and this is already causing some market anxiety.

A credit crunch is a chilling factor, too. Australian economist Professor Steve Keen says that increased borrowing eventually overwhelms markets. He does not see this as an imminent problem for the US or the UK, suggesting that both of these countries already have their fill of debt and are ready for stagnation. Rather, he describes "the smoking gun of credit and the walking dead of debt" as problems for China, Hong Kong and South Korea. He is certain that there will be a rerun of the crisis in one of these countries sooner rather than later.

And what if the crash does not come through finance, but from technology? Economist Andrew Lo, Professor of Finance at the MIT Sloan School of Management, suggests: "Murphy's Law trumps Moore's Law." Murphy's Law says that anything that can go wrong will. It puts the kibosh on Moore's Law, which says that computers double in capacity every 18 months.

Lo is particularly concerned about flash crashes, where computer trading seems to take on a life of its own, prompting catastrophic stock market falls. There have been several of these in the past 20 years, none of which has been completely understood, despite concerted attempts to unravel them. Inevitably, however, practitioners don't pay much attention to these "glitches" because they have not caused lasting damage — yet. Lo thinks this is playing with fire and that, one day, computers will collapse or go rogue and bring the whole system crashing down.

"'The smoking gun of credit and the walking dead of debt' are problems for China, Hong Kong and South Korea"

Alternatively, there might be a malfunction in the cloud. One company controls 40% of its servers, and four control 75%, but no one apart from a few techies really knows how it works. A problem could be a bug, but it could also be a deliberate cyber-crime. That would give the system a heart attack.

So what is an investor to make of it all, or of any of a myriad other scenarios that may affect markets? Should they run for cover and sell all their holdings or should they think it won't happen on their watch?

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Most people seem to be hanging in there, but this may be because it is impossible to time the market. For more than a century, equities have done much better than bonds over the long term. Investors worry when shares fall before they have had a chance to make a profit. But if they hold their nerve, they normally do quite well.

There is a further problem, however. Today, many investors access the market through passive funds of one sort or another. But Professor Hendrik Bessembinder of Arizona State University has shown that 96% of stocks do worse than Treasury bills in the lifetime of their index exposure. Indeed, 50% of stocks do worse than cash — again over their index lifetime. This underperformance arises because companies tend to leave an index when they are doing poorly, however well they might have performed in earlier times. Over an 80-year period, only 4% of companies managed to avoid this fate.

The phenomenon is good for active managers, who can buy a stock while it is rising and ditch it at will. It is less good for index trackers, because ultimately they sell only when a stock has failed. If a bear market comes along, investors, including holders of exchange-traded funds, will find this to their cost.

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