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Top Economist: Get Ready for a Stock Market Drop

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If you are a stock investor, buckle in.

Investors have enjoyed an amazing run. Stock prices are up by nearly a third over the past 18 months and seem to be hitting new record highs daily. And the run-up has been almost a straight line, with stock price volatility—the ups and downs in prices—the lowest it has ever been.

But if you are an investor, soak all of this in, because it will soon be nothing but a memory. The stock market is due for a significant correction—defined as a greater than 10% decline in stock prices—and stock returns in the next several years will be very pedestrian if they increase at all.

It's not that the stock market is a bubble ready to burst. Bubbles are created by speculation, when investors buy a stock simply because its price has risen strongly in the recent past, and therefore conclude it will rise strongly in the foreseeable future. This clearly characterized the tech bubble that inflated around Y2K. Investors piled into the stocks of dot-com companies, many without even understanding what the Internet was. Most of the companies weren't making any money, and few had business models that seemed likely to ever generate profits. That bubble was also fueled by margin debt, as investors borrowed aggressively against their stock holdings to purchase even more stocks.

To be sure, there are speculators in today's market, as is clear from surging prices for the FANG companies—Facebook, Amazon, Netflix, and Google. The difference is that these are real companies that share a compelling business model—build out a massive global network of users that rely on their quickly evolving products and services. Today's investors are also being discerning by shunning the stocks of companies that don't have a clear story—think Twitter or Snap. And investors remain cautious users of margin debt, which is no higher today than it was in the heyday of the tech bubble.

My skepticism around stocks is also not rooted in some fear that the broader economy is ready to tank, thus undermining corporate earnings and the stock market. Every recession is presaged by a downturn in the stock market, but there are many cases historically where stocks decline and the economy keeps ticking along. This will be one of those times.

The economy and corporate America are in good shape. Corporate profits, the fundamental support for stock prices, are being powered by solid revenue gains, particularly now that the global economy is back on track and the U.S. dollar is no longer rising in value. Margins are also wide despite businesses' difficulty raising prices more quickly, because they've done a great job managing costs.

So why am I pessimistic? The stock market is overvalued. That is, stock prices are much too high despite the good outlook for corporate earnings. The only other time in the past half century that stock prices have been so highly priced was during the tech bubble. Yes, they're even more overpriced now than prior to the 1987 market crash.

Corporate earnings are good, but they are set to grow more slowly, since businesses will have to give their employees bigger pay increases to hold onto them, let alone hire new workers. With unemployment falling toward 4%, wages will slowly, but steadily accelerate. Businesses will respond by raising prices more quickly, but they won't be able to pass through all of their higher costs to customers. Margins will come under pressure.

Intensifying wage and price pressures means that the Federal Reserve will need to raise short-term interest rates more consistently, and begin to wind down its balance sheet, which will cause long-term rates to rise. It is hard to see investors being as enthusiastic about stocks when interest rates are rising. Higher rates will also make it more expensive for businesses to borrow money to buy back their stock, a common practice in the current bull market.

Then there is Washington. So far, the dysfunction there hasn't been a problem; it has only meant that lawmakers have done nothing. That is fine for a growing economy. But doing nothing won't be a winning strategy for much longer. Lawmakers must soon agree on a budget or risk shutting the government down, and they must raise the Treasury debt limit or risk shutting down the global financial system. Tax reform would be nice, but odds are that if there is reform it will fall short of what investors desire.

Mark Zandi is chief economist at Moody's Analytics. He has investments of all of the companies mentioned in this article.