

## Key Questions

# Has Irrational Exuberance Returned?

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Exuberance is evident, and while not all of it is irrational, some investors may be overly confident of the long-run economic outlook.

In a speech delivered on December 5, 1996, titled “The Challenge of Central Banking in a Democratic Society,” Alan Greenspan, then-Chairman of the Federal Reserve Board, posed a question. This question was, “How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?”

Known for choosing his words carefully to avoid rattling markets, Greenspan’s remarks rapidly reverberated across the globe, beginning in Japan. The stock market there briskly fell and was down 3% by the time its market closed for the day. After the US market opened hours later, it fell by nearly 2.5% in the morning.

Stocks had gained nearly 70% in the two years before Greenspan’s statement, which perhaps prompted him to posit that equities had inflated to the bubble stage.

Greenspan was considered to be so effective in artfully sending subtle messages to market participants. Irrational exuberance was such an uncharacteristically clear term for him; the financial media portrayed it as a signal he was trying to “talk the markets down.”

Regardless of his intentions, stocks recouped most losses by the afternoon of the day after his comments. Moreover, notwithstanding his concerns regarding the level of stock prices, equities doubled over the next three years before plunging in the Dot Com bubble burst.

In his book *Irrational Exuberance* (2000), Nobel Prize laureate and Yale economist Robert Shiller defined the term as:

***“...a situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify the price increases, and bringing in a larger and larger class of investors who, despite doubts about the real value of an investment, are drawn to it partly by envy of others’ successes and partly through a gamblers’ excitement.”***

Twenty years later, the term is back on the scene. Since fundamental factors such as economic expansion and corporate profit growth remain depressed, many investors have questioned whether speculative behavior fueled the stock market’s recovery from its March low. “Stock prices are decoupled from reality,” one well-known investor recently exclaimed.

In our view, exuberance is evident in many areas of the financial markets. While not all of it is entirely irrational, some investors may be overly confident in their long-run economic outlook.

We are not suggesting that we are unduly bearish. We simply believe that a wider-than-usual dispersion of possible outcomes is being created because of an unprecedented number of “known unknowns.” Thus, we are maintaining a relatively cautious stance, preferring to spend our risk budget judiciously and commit capital to areas that are starved for capital versus areas where capital is in abundance. This line of thinking led us to nibble at small cap equities and distressed areas of the fixed income market in April. We continue to believe opportunities exist there and elsewhere, although selectivity is of paramount importance.

Regarding the unknowns, we ask the following: Will there be a second wave of COVID-19 cases? Will there be a vaccine? What will the immunity response be? Since the bar for future shutdowns appears to have risen, is the healthcare system exposed to unbearable stress if a second wave emerges?

US GDP is expected to decline 20-30% in the second quarter and 5-10% for the full year. Projections indicate unemployment to be around 10% at the end of the year. While weakness in the economy could persist longer than initially anticipated, investors, for the time being, are “looking across the valley,” with some forecasting that total economic output will be fully restored by next year. We don’t rule this out, but it’s not our base case given the aforementioned unknowns.

Further, if the return to work is slow or halted, many small businesses might never reopen, and millions of jobs currently classified as temporarily lost might be permanently lost. We also wonder about the future path of defaults and bankruptcies as well as the significant damage done to the finances of state and local governments. More unknowns are out there, to be sure.

The Federal Reserve (Fed) and the US Congress have provided enormous support, which has likely been the most significant catalyst for risk assets in the past three months. Can the Fed continue to provide such support forever while keeping inflation in check? Many market participants appear to be betting that it can.

In closing, the powerful rally since late March has been built on optimism, and some of it has been rational and justified. Yet, in our opinion, it would be imprudent to ignore the risks that remain as well as second-order effects that may materialize, many of which are unknowable.

For more information, [please contact your Key Private Bank Advisor.](#)

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