Investors are once again optimistic, driven by expectations of interest-rate cuts and AI

The Globe and Mail (Ontario Edition) · 10 Jan 2025 · GEORGE ATHANASSAKOS OPINION Professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, Western University. He is the author of the recent book Value Investing: From Theory to Practice.

Afew years ago, a Blackrock study found that while the average equity mutual fund in the United States over a 40-year period produced an annual rate of return of 8.1 per cent, the average investor in the funds made only 2.1 per cent.

Blackrock researchers attributed this to the fact that many retail investors tend to try to time the market, but without much success. They panic at market bottoms and sell and get exuberant at market peaks and buy. Buying high and selling low is not a strategy that will lead to high long-term returns.

Investors are once again optimistic, driven primarily by (a) an expectation of further interest-rate cuts and (b) the belief that AI will solve the world's productivity problems and lead to better living standards, higher GDP per person and more highly valued companies.

This optimism has propelled the market into uncharted territory. The Buffett indicator – the ratio of total U.S. stock market value divided by GDP – in the U.S. is approaching 200 per cent, well above the level we saw in early 2000 during the dot-com bubble. The S&P 500 trailing price-to-earnings ratio is the fourth highest in the last 124 years; the three previous peaks were in December, 1921, June, 1999, and June, 2021 – just prior to the arrival of bear markets. The CAPE indicator – which uses real earnings per share over a 10-year period to smooth out fluctuations in corporate profits – also flashes red, with U.S. stocks at their most expensive since 2000. Market breadth is weak, with the top five stocks in the S&P 500 accounting for about 27 per cent of market capitalization – a near record – compared with 18 per cent in March, 2000.

And yet, 56.4 per cent of retail investors expect stock prices to rise over the next 12 months, based on a recent survey by the Conference Board.

Is such enthusiasm warranted? Is the expectation of further interest-rate cuts too sanguine? Could falling inflation, which underlies expectations of interest-rate cuts, stop in its tracks or even worse, reverse its decline?

There is precedent. Inflation fell significantly in 1971 from record-high levels in the years before – much like in 2023-24 – only to rise sharply again in 1972-73, leading to higher interest rates.

Deglobalization and/or nearshoring will have a negative effect on inflation as production moves to more expensive countries, with higher costs being passed on to consumers. Possible global tariffs will have a similar effect, as will the fact that

environmental, social and governance regulations have discouraged commodity companies from investing in increased production. This may create major shortages in metals down the road at a time of rising demand because of renewable energy and electric-vehicle manufacturing.

And all this happens while the Western work force is shrinking. Germany, for example, will have five million fewer workers by 2030. Fewer people are entering the work force, which will lead to higher wages. Bloomberg reports that wage growth at the smallest U.S. firms has been accelerating at the highest pace in the last two years. Will wages at larger U.S. companies follow suit soon?

In addition to a potential pickup in inflation threatening retail investor optimism about rate cuts, other forces may lead to higher interest rates.

First: the record U.S. fiscal debt. And it is not just government profligacy. Consumers seem to be spending more than they can afford. Household excess savings are plummeting.

Second, many foreigners are dumping U.S. Treasuries. For example, in the third quarter of 2024, Japanese investors sold a record US$62-billion of U.S. debt securities, while Chinese investors sold US$51.3-billion, the second largest sum on record.

Third, global central banks continue to sell U.S. Treasuries and buy gold.

This is happening while imbalances in demand and supply of investable long-term capital will be pushing the real interest-rate trend higher. This is because the demand for capital, driven by the need for renewable energy, EV and AI investments, will far outweigh the supply of capital as retired baby boomers disinvest rather than supplying more capital to the markets.

Meanwhile, the optimism around AI may be exaggerated. In my opinion, people overestimate the capabilities of AI, which are not even close to where they need to be to become useful. AI may surcharge productivity, but for now this is purely hypothetical. As Harvard Business Review explains: AI suffers from vagueness. Historically, new technologies have not necessarily led to increased productivity. A prime example being that productivity has been trending downward since the 1980s in the U.S. and around the world – despite the emergence of computers and the internet. As Nobel Prize-winning economist Robert Solow once said: "You can see the computer age everywhere but in the productivity statistics."

All this is keeping me up at night.