Rana Foroohar

What, Me Worry?

Markets have no fear, which is reason enough to be scared

AS THE PRAGMATIC CONSERVATIVE economist Herbert Stein once said, "If something cannot go on forever, it will stop." I've been thinking about that saying a lot in relation to today's bull market and the complacency with which investors seem to view it. The VIX, or fear index—which measures investors' expectations of volatility in the stock market—is at its lowest ebb since 2007, before the financial crisis. Prices for all sorts of assets, even things like junk bonds, are soaring in a way that would seem to indicate blue skies over the global economy.

How is this possible, given that we barely dodged the fiscal cliff, must now navigate the debt-ceiling rapids and are seemingly stuck with sluggish 2% economic growth? Partly it reflects the fact that as bad as things are, they could be worse. We did avoid the cliff's worst damage. Europe isn't quite the disaster it was a year ago. And China is once again showing signs of growth. "After years of risks and bad news, people are getting comfortable with the idea that the worst is over," says Ruchir Sharma, head of emerging markets and global macro at Morgan Stanley.

Other signs support that notion. Many economists expected fiscal-cliff anxiety to tank retail sales and business spending in December, but the data trickling in show that didn't happen. In a report titled *Dude, Where's My Uncertainty Shock?* JPMorgan pointed out that consumer demand was stronger in the fourth quarter of 2012 than it was in the six months prior. People were spending more on everything from cars and clothes to furniture and restaurant meals. So much for worries over higher taxes or the growth-slowing effects of dysfunctional politics.

This should actually come as no surprise, according to Sharma, who has examined the past 100 years of bull-market history. He says we're exactly where we ought to be in the economic cycle. Typically, by the fourth year of a recovery, stocks have more than doubled. In the fifth year, markets tend to rise about 10%, which is what many analysts predict for this year. In this context, the low fear index and bullish sentiment seem perfectly reasonable.

But there's a problem: while markets are reacting just as history tells us they should, the real economy is not. Putting aside a better-than-expected fourth quarter last year, we are still in the middle of the second weakest recovery in a century and the weakest one of the post–World War II era. McKinsey Global Institute estimates that it will take another 25 months for employment to reach prerecession levels.

Just as worrisome is the disconnect between the fortunes of companies and the fortunes of workers, which has never been greater. Stock prices are far from a perfect proxy for the economy; they ultimately reflect the earnings and earnings potential of large corporations. While 60% of the profits of the S&P 500 today come from large multinational manufacturing firms, those companies account for only about 15% of U.S. employment, far less than when outsourcing to nations with cheaper labor costs began on a large scale in the 1980s.

Many of these companies get an in-creasing share of their sales from abroad, some of them as much as half, while wages paid to U.S. workers remain flat. Put these facts together and it's clear that global gains for American multinationals are no guarantee of economic growth and job creation at home.

This is an important—and often overlooked—risk factor in the markets right now. At some point, as Sharma puts it, "you need stronger growth in the real economy for corporate earnings to go up." We may already be at a breaking point. Some big firms, like DuPont, have lowered profits and expectations. Meanwhile, the overseas growth they have come to depend on is either slowing (in the case of Europe) or uneven. Emerging markets used to move upward all together as a class. Now they are diverging from one another. Some, like Brazil, are totally stagnant. Others, like China, are growing—but much more slowly than in the past, with huge bubbles that keep expanding. (If you think the Fed has pumped too much money into the U.S. economy, just look at the Middle Kingdom, where the money supply has tripled from $5 trillion to $15 trillion in four years.)

The bottom line is that it's no time to be lulled into complacency in the U.S. Markets may be telling us that investors' collective expectations of unpleasant surprises are at a record low. But expectations don't necessarily track reality—and fear and risk often have an inverse correlation. ■

ILLUSTRATION BY HARRY CAMPBELL FOR TIME