US Macroeconomics

April 18, 2024

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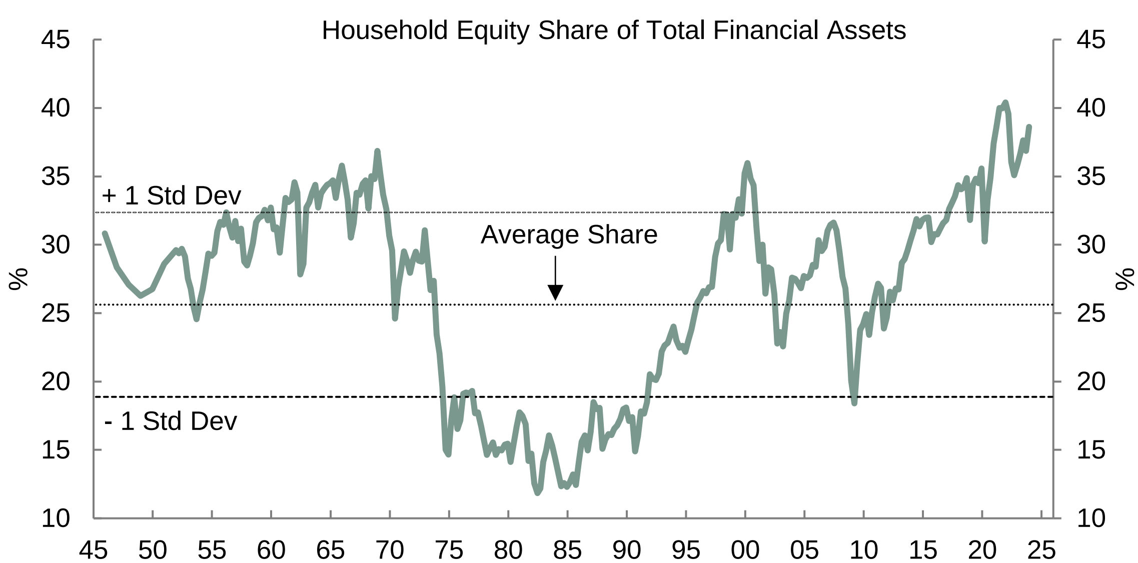
Buyer Beware

Households' equity exposure is down from its all-time high but is still historically elevated and rising again thanks to the substantial and largely uninterrupted rally in stock prices. Higher prices beget more buying which begets even higher prices. Over the past four quarters, we estimate equites have helped to generate upwards of $10 trillion in household net worth, so what the stock market does going forward will have important implications for the larger economy and financial markets. In fact, the surge in stock prices is leading to easier financial conditions which is complicating the Fed's job of slowing aggregate demand.

In Q4 2023, households' share of equities represented 38.6% of their total financial assets. This is up from a recent low of 35% in Q3 2022, but still lower than their record high of 40.4% in Q4 2021. That was just before the stock market had a roughly 25% correction in 2022. The big rally in stocks, which began last October and which has continued into April, should push households' equity exposure even higher when the Q1 data are released this June. This is troubling because even the latest reading is well above previous peaks. Households cannot get enough of a good thing!

What are the implications of elevated equity exposure? **In the past, when households held a high percentage of equities in their investment portfolios, future stock returns meaningfully lagged the historical average returns**. We determined this by measuring future returns when the share of equities was one standard deviation above and one-standard deviation below the long-term average. When household stock holdings are one deviation *above* average, they return just 5.3% annualized over the next seven years (the average business cycle is approximately seven years). When households' equity exposure is low or one standard deviation *below* average, stocks return a large 16.2% annualized over the next seven years. In other words, the best returns come when the market is unloved. In our sample, the average long-run return is 11.4%.

While households may continue to pour money into stocks, it is worth noting that the equity risk premium is negative and previous record peaks in households' equity exposure (Q4 1968, Q1 2000 and Q2 2007) have preceded recessions (Q1 1970, Q2 2001 and Q1 2008). Admittedly, this is a tiny data sample. Nonetheless, given the monetary and psychological importance that the rally in stocks has provided, a sharp and extended correction could have an outsized impact on consumption especially if inflation persists thus disallowing the Fed from pivoting. Time will tell if our caution is misplaced.



Source: S&P, Haver, SMBC Nikko

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