

Why I fear Wednesday's stock selloff is only a small taste of what's to come



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A few years ago, Blackrock carried out a study in which they found that while the average equity mutual fund in the US over a 40-year period produced an annual rate of return of 8.1%, the average investor in the funds made only 2.1%. Blackrock researchers attributed this to the fact that retail investors tend to try to time the market, but without much success. They tend to 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.

Even with Wednesday's selloff in the wake of the Fed's latest rate decision and outlook, it seems that we are still at the point of maximum optimism driven primarily by the expectation of further interest rate cuts and 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.

US retail investors are more bullish than ever before. Morningstar reports that a survey conducted by investing platform Fundrise found that 60% of respondents were optimistic about their portfolios. Only 15% were pessimistic. According to Fundrise CEO Ben Miller: "You can see everywhere this incredible amount of optimism and confidence in the market."

At the same time, household allocation to stocks as a percentage of their financial assets have reached a record high of 42% in the second quarter of 2024. The previous record was 37% in the second quarter of 2000, according to JPMorgan. And US retail trading as a share of US equity volume stands at the record high level of about 17%, if

we dismiss as unusual the covid-era meme-stock temporary jump of this metric to close to 25%.

Moreover, Federal Reserve data show that 3 out of 5 Americans today are investing in stocks, which represents the highest level on record. Rising optimism combined with technological changes - unlike the past, one can now place trades on brokerage accounts at Robinhood, Interactive Brokers, ETrade or Coinbase after watching TikTok videos – have produced a potent mix of retail investor participation in the stock market.

It seems we have seen this movie before. The dot-com debacle comes to mind.

Could it happen again? I fear Wednesday's selloff could be just a little taste of what's to come.

Here is what makes me nervous, especially as academic studies show that (a) retail investors are the worst market timers and (b) they suffer significant losses when trading against institutional investors.

In recent months, while retail investors are jumping heads first into the stock market, smart money is selling. Insiders are selling. Corporate executive stock sales are at all-time highs as reported by MacNicol & Associates Asset Management Inc. Buffett has been accumulating cash, too. Berkshire Hathaway's cash pile has grown to more than US\$300 billion — a record high. Money market fund assets have also reached a new record.

Is retail investor optimism really warranted, and what can go wrong with its drivers, namely, decelerating inflation and productivity enhancing AI?

What if the expectation of further interest rate cuts is exaggerated? We saw this risk on full display on Wednesday, when the Federal Reserve indicated that it probably would only lower rates twice more in 2025. Money markets are pricing in even less than 50 basis points of further cuts by the Fed now next year.

Could falling inflation that underlies expectations of interest rate cuts stop at its tracks - or even worse, could the decline be reversed? There is precedence. Inflation

fell significantly in 1971 from record high levels in the years before (same as over the last year) to rise sharply again in 1972-73, and so were interest rates.

Deglobalization or nearshoring will have a negative effect on inflation as production moves to higher cost countries, with higher costs being passed on to the consumer via higher product prices. And so will be the effect on prices of the possible imposition of tariffs around the world, as well as the fact that ESG regulations have discouraged commodity companies from investing in production increase, which implies major shortages in metals down the road at a time when demand will be increasing due to renewable energy and electric vehicle production.

And all this happens at a time that the Western world global workforce is shrinking. Germany, for example, will have five million fewer workers by 2030. This is typical of what happens to most Western world countries. As fewer and fewer people are entering the workforce this will lead to higher wages. Already Bloomberg reports that wage growth at the smallest US firms has been accelerating at the highest pace in the last two years. Will wages at larger US companies follow suit soon?

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

First, it is the record US Fiscal debt and its effect on interest rates. A survey conducted by the New York Fed in the fall of 2024 shows that the most cited potential shock to the financial markets over the next 12-18 months could be related the US debt sustainability. And it is not just government profligacy. Consumers seem to be spending more than they can afford. Household excess savings are plummeting. For example, household excess savings as a percentage of GDP have gone from around 10% in 2021 to -2% in the end of 2023. And US consumer credit card delinquencies have reached the highest level since 2011.

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

And third, at the same time, Global Central Banks continue to sell US Treasuries and buy gold.

All the above do not bode well for interest rates going forward.

This all comes at a time when the market looks quite expensive. For example, the Buffett indicator - the ratio of stock market capitalization to GDP in the US - is approaching 200%. This is slightly below the all-time high reached in November 2021 and well above the level we saw in early 2000. This signifies that the stock market is very expensive and may be due for a pull back.

Similarly, the fact that the S&P 500 trailing P/E is the fourth highest in the last 124 years provides further evidence of how expensive the market has become. The three previous peaks were in December 1921, June 1999 and June 2021.

Moreover, the CAPE indicator developed by Noble price winner Bob Shiller also flushes red. Based on this metric, US stocks have been at their most expensive level since 2000.

Another worrying sign that does not bode well for the markets, when viewed against their behavior in previous market peaks, is that the percentage of the top five stocks in the S&P 500 stood at an all-time high of 27.1% as of May 2024, which is higher than the previous peak of August 2020 of 24% and the previous all-time high of 18% in March 2000. And amidst all this, a record 56.4% of retail investors expect stock prices to rise over the next 12 months, based on a recent survey by the Conference Board.

How about AI? Is optimism related to it reasonable or 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 an article in Harvard Business Review explains, AI suffers from vagueness. It asks: exactly how AI will render business processes more effective? Historically, new technologies have been disappointing in terms of increasing productivity. For example, despite technological advances since the 1980s, productivity has been trending downward for decades in the US and around the world as the computer age was everywhere except in productivity stats, according to Noble Prize winner Robert Slow.

These are some worrisome signs which may derail retail investor optimism and are keeping me up at night.

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