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Don't Panic About the Stock Market

Investors who resist the urge to get out during rough times like this will be glad they did.

By BURTON G. MALKIEL

'The sky is falling! The sky is falling!' Chicken Little's admonition may strike many observers as particularly apt today. I disagree. This is not the market meltdown of 2008 all over again. And panic selling of U.S. common stocks will prove to be a very inappropriate response.

The sharp decline in stock prices last week has renewed fears that the economy is headed for a double-dip recession. Economic growth has been reduced to stall speed, with gross domestic product rising at less than a 1% annual rate during the first half of 2011. Real consumer spending has been negative over the past two quarters. Just as a rider risks falling over when his bicycle slows sharply, so the economy is dangerously close to slipping into recession even before a real recovery has taken hold. And now Standard & Poor's has downgraded the U.S. credit rating, citing inadequate progress in Washington on long-run budgetary problems.

The headwinds restraining the economy are many. Consumers are still over-indebted and household finances are perilously balanced. House prices, after sharp price declines, threaten to fall further. The effect has been a big hit to households' net worth and has prevented any recovery in construction activity, which normally plays a big role in the early stages of any economic expansion. The unemployment rate is stuck above 9%, and even optimistic economic forecasters see little chance of a meaningful decline, even if a tepid economic recovery resumes in the second half.

Making matters worse, Europe has not really fixed its economic problems. Growth prospects there are gloomy. In the United States, government policy is dysfunctional and powerless to help reduce unemployment. While any restraint on spending from the recent budget agreement is back-end loaded, fiscal policy is scheduled to be significantly less stimulative over coming quarters. Monetary policy, which has driven short-term rates to near zero and 10-year Treasury rates to 2.5%, appears to be out of ammunition. And, of course, the sharp decline in stock prices has a negative wealth effect and a pernicious effect on consumer confidence.

Is it time to sell all your stocks, which are still well above their lows of 2009? I think not. No one can predict what the stock market will do in this and coming weeks. Stocks may continue their decline, but I believe it would be a serious mistake for investors to panic and sell out. There are several reasons for optimism that in the long run we will see higher, not lower, market valuations.

First, I believe that stocks today are cheap. Price/earnings multiples are just over 14 and forward P/E multiples, which use forecasted earnings, have shrunk to less than 12. These multiples are low relative to historical precedent and are especially low when considered in comparison to a 10-year Treasury yield of 2.5%. Dividend yields of 2.5% also compare favorably with 10-year Treasuries. Multiples do not look cheap relative to average 10-year earnings (the so-called Shiller P/E multiples), but today's earnings are so much higher than average earnings that a 10-year average is not a good estimate of today's corporate-earning capacity.



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Moreover, the structure of U.S. corporate earnings increasingly reflects economic activity abroad—including the rapidly growing emerging markets—rather than activity in the U.S. This is why corporate earnings have been growing so rapidly even though U.S. economic growth has been so tepid. For large U.S. multinational corporations, the continued growth in emerging markets will be the most important determinant of the future growth of corporate earnings. For many companies, what happens in China, India and Brazil is more important than the inability of Europe to get its house in order and the paralysis in the U.S. and Japan.

There is no doubt that our economy is in a deep hole. The huge amount of deleveraging that is necessary after the housing bubble of the early 2000s can only be accomplished over time. Fortunately, household balance sheets are improving. Debt-to-

income ratios have improved considerably since 2008, though they still have far to go. Household debt-service payments relative to income have fallen sharply to levels existing in the 1980s and '90s. The recent decline in oil prices should also help consumers' financial situations. And corporate balance sheets are unusually healthy today.

Simply working off the excess housing (including the shadow inventory of foreclosure property) will take a long time to accomplish. But if there is a bright spot in the housing picture it is that housing affordability is at an all-time high. With some real improvement in the labor market we could see a substantial uptick in housing sales.

Yes, we have problems, but the current situation bears no resemblance to 2008. And for those who believe that the decline in the stock market reliably predicts a new recession, remember the famous dictum of the late economist Paul Samuelson: "The stock market has predicted nine of the last five recessions."

A strong dose of modesty is clearly in order. We all need to be aware of the limits of our ability to forecast future stock prices. No one can tell you when the stock market will end its decline, but there are some things that we do know. Investors who have sold out their stocks at times when there have been very large declines in the market have invariably been wrong. We have abundant evidence that the average investor tends to put money into the market at or near the top and tends to sell out during periods of extreme decline and volatility. Over long periods of time, the U.S. equity market has provided generous average annual returns. But the average investor has earned substantially less than the market return, in part from bad timing decisions.

My advice for investors is to stay the course. No one has ever become rich by being a long-term bear on the fortunes of the United States, and I doubt that anyone will do so in the future. This is still the most flexible and innovative economy in the world. Indeed, it is in times like this that investors should consider rebalancing their portfolios. If increases in bond prices and declines in equities have produced an asset allocation that is heavier in fixed income than is appropriate, given your time horizon and tolerance for risk, then sell some bonds and buy stocks. Years from now you will be glad you did.

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