Stock market bubble gets even bigger

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The extent of the divorce between the US stock market and the financial system more broadly from the underlying real economy is revealed in the rise of Wall Street's benchmark S&P 500 index for the past two years.

For the second year in a row, the index rose by more than 20 percent, despite a selloff of 2.5 percent in December.

The market was up by 23.3 percent for 2024 following a 24.2 percent rise the previous year. This is the largest two-year hike this century and brings to four the number of S&P gains exceeding 20 percent in the past six years.

The market has risen by more than 40 percent in the past two years not because of growth in the US economy, running at a fairly modest rate of 3 percent, but on the hype and expectations surrounding high-tech stocks, especially those associated with the development of artificial intelligence (AI).

It has also been boosted by the expectation that the incoming Trump administration will be very favourable for corporate and finance capital both through tax cuts and the scrapping of what remains of regulations in a number of areas.

The rise in the market has also been propelled forward by expectations that the Federal Reserve will cut interest rates further in 2025, although that sentiment appeared to have cooled somewhat after its December meeting. Chair Jerome Powell indicated a more "cautious" approach to further rate cuts and members of the governing body reduced their expectation of the number of interest rate cuts in the coming year from four to two.

There are concerns in the Fed's policymaking bodies that the increases in tariffs foreshadowed by Trump—60 percent on Chinese goods and up to 20 percent on those from other countries—could push up inflation and create less space for interest rate reductions.

As always when the stock market is on a tear, there are those who maintain it is set to go even higher. At the beginning of December, a monthly survey conducted by the Bank of America reported that the long-term exposure of asset managers to the S&P 500 had risen to the highest level in 20 years. This indicated what it called a "super-bullish sentiment." Deutsche Bank reported that retail investor enthusiasms for stock market gains had never been higher.

According to Benjamin Bowler, a strategist at Bank of America whose remarks were cited in a *Financial Times* report, Trump's "laissez-faire economics, tax cuts and deregulation" together with a potential "AI revolution" meant the stock market climb would continue in 2025. While 2024 was a "good year" for stocks, "it may only be the beginning."

Amid the market hype, warnings are being sounded because of the state of the global economy and the impact of Trump's "America First" policies.

According to a survey of economists conducted by the FT and the Booth School of Business at Chicago University, many believe that Trump's policies will boost inflation and lead to a more cautious approach by the Fed on interest rate cuts.

"Trump's policies can bring some growth in the short term, but this will be at the expense of a global slowdown which will then come back and hurt the US later on," ?ebnem Kalemli-Özcan, a professor at Brown University and an advisor to the New York Fed, told the FT.

"His policies are also inflationary, both in the US and the rest of the world, hence we will be moving to a stagflationary world."

There are growing indications that stagnation is taking hold in major components of the global economy. The eurozone is barely growing with its major economy, Germany, confronting its worst downturn in the post-war period as jobs are slashed in

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its major industries, above all auto production.

The chief economist at one German bank told the FT Europe was soon going to resemble the "late Hapsburg empire" falling behind economically and technologically and dominated by "melancholic remembrance of its former greatness."

China is struggling to reach its target of around 5 percent growth for 2024—most observers consider it will make the target but there is considerable scepticism about the accuracy of official data—and the predictions are that growth will trend down in 2025.

Concerns in the Chinese leadership were reflected in the New Year address by president Xi Jinping, in which he directly warned about the state of the economy, rather than simply extolling the accomplishments of the regime over the previous year.

He warned that the economy was facing "some new situations" and there were "challenges from the uncertainty of the external environment" (an oblique reference to Trump's tariff hikes) and pressure from the "transformation of new and old drivers." The term old driver refers to the severe downturn in the property and real estate market, which has been a mainstay of Chinese growth since the global financial crisis of 2008.

As far as financial conditions are concerned, the main issue is the increased role played by private equity markets. The global consultancy firm McKinsey estimates that private markets' assets under management reached $13.1 trillion in mid-2023 and has been increasing at around 20 percent per annum since 2018.

Commenting on these figures, FT columnist John Plender noted that one outcome "is a significant increase in the proportion of the equity market and the economy that is non-transparent to investors, policymakers and the public."

Major financial institutions, including the International Monetary Fund, the Bank for International Settlements and the Fed, have indicated that they have no real idea of the operations of the private equity markets and their interconnections with major banks.

As Plender commented, "private equity credit funds pose a unique set of potential systemic risks to the broader financial system because of their interrelationship with the regulated banking system, the opacity of the terms of their loans, the illiquid nature of their loans and potential mismatches with the needs of limited partners (investors) to withdraw funds."

In other words, major problems could be building up in the financial system, even as the stock market surges ahead, of which regulators would only become aware when they burst over their heads.

There were, he concluded, "no prizes for guessing where the next financial crisis will emerge from."

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