

Robert Shiller: I'm Betting the Farm

By Robert Huebscher

May 24, 2011

Yale's Robert Shiller, the economist who foresaw the implosions of the tech bubble in 2000 and the housing market in 2007, is now closely watching a different asset class. This time, however, it is one that is in an early stage of bubble formation, not of collapse.



"This is my only bullish call that I'm making right now: It's farmland," Shiller said last week.

Shiller delivered the keynote presentation at the IMCA 2011 annual conference in Las Vegas.

His prognosis for the economy was that a lack of motivation on the part of consumers to spend will impede recovery. Equity returns will be disappointing over the next decade, he said, and TIPS is the only other asset class he likes right now.

But for those who follow Shiller – he writes a regular column in the Sunday *New York Times* – farmland was the big surprise.

Animal spirits on the wane

Shiller laid out a dour assessment of the economy, based largely on a series of measures that gauge the emotional state of American consumers. His approach, which he wrote about in his recent book, *Animal Spirits*, co-authored with the Nobel Prize-winning economist George Akerlof, traces back to the theory of John Maynard Keynes.

In 1936, in *The General Theory of Employment, Interest and Money*, Keynes wrote:

Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.

Shiller's book is another chapter in the growing field of behavioral economics, and it documents how emotions can lead to irrational economic decisions. In his talk, Shiller said that if people were truly rational, they would be paralyzed by uncertainty. Instead, they exhibit a Keynesian spontaneous urge to action.



Animal spirits, he said, are what makes you want to get out of bed in the morning. “But sometimes you don’t,” he said, “and that is the problem with the economy right now.”

Those without a job for more than 27 weeks now constitute over 40% of unemployed workers. As an example of the role animal spirits have in shaping the direction of the economy, Shiller said this kind of unemployment is damaging to one’s self esteem. “It is psychologically difficult if you don’t have the prospect of a job. It challenges your very sense of identity,” he said.

Shiller cited polling data that documented a lack of desire on the part of consumers to go out and spend. The CBS/New York Times poll, which asks consumers if they think the economy is getting better, worse or about the same, has not shown increase in optimism, according to Shiller.

Another question in that poll asks if consumers feel things are generally going in the right direction. Shiller said the responses are almost as pessimistic as they have ever been.

He also presented data from the Michigan Consumer Center, which asks, for example, whether people expect good times over the next five years or whether there will be widespread unemployment. That data has been on a steady downtrend, he said, reflecting an “erosion of our confidence.”

Real estate and farmland

Shiller spoke about the rise and fall of residential real estate prices over the last two decades, but he did not offer a forecast as to whether he thinks those prices will continue to decline.

He discussed commercial real estate, and he said that its price movements have lagged those of residential real estate.

Shiller then turned to farmland and presented data that goes back over 200 years. He showed that farmland prices don’t correlate closely to residential real estate, and he noted that there was a huge bubble in farmland prices in 1980. He attributed that bubble to a population scare accentuated by the book *The Limits to Growth*, which was published by the Club of Rome. The book created investment demand for farmland, Shiller said, that eventually turned into a bubble.

“But farmland recently has done it again,” he said.

Its price increases have followed closely those of commercial real estate, the only difference being that farmland has not come down very much, whereas commercial real estate has crashed, he said.



The reason, he said, is that “they don’t make more farmland.”

He said there was a psychological error that led to the bubbles in commercial and, in particular, residential real estate. People thought buying a house was the same as buying land. “That was a big mistake,” he said. According to the National Association of Home Builders, land represents about 20% of the value of the average US home. Most buyers still don’t understand this, he said.

Farmland prices, however, are benefitting from food inflation and what he called a “food crisis.” “That’s what is driving our CPI,” Shiller said.

“Watch out,” he said. “These things develop and bubbles form. They overshoot and then they collapse.”

Shiller is not the only one who has commented on the rise in farmland prices. James Grant, in his publication *Grant’s Interest Rate Observer*, has devoted several recent articles to the phenomenon, and has said that farmland buyers are now often speculators rather than farmers.

Projected returns for equities

Shiller has popularized the use of cyclically adjusted price-to-earnings ratios, which smooth out the effect of changes in earnings over the course of the business cycle by averaging them over the trailing 10 years. Graham and Dodd pioneered this method in the 1930s.

When adjusted in that manner, Shiller’s P/E ratios are highly predictive of returns for the stock market over the long term – at least a 10-year horizon.

Right now this P/E ratio is 23, he said, which is “high but not super high.”

“I figure that the expected return for the stock market over the next 10 years is between 2% and 3% a year,” he said, “and that’s including dividends.”

A crash like we had in 2000 is not imminent, Shiller said, and he is more concerned about a “stagnating of market prices over the next decade.”

Nobody can forecast very well, he cautioned. “My best guess is that we would expect disappointing, but not terrible returns.”

Despite yields of less than 1%, Shiller said he likes TIPS, because that 1% yield will be adjusted upward if there is inflation. “It’s really not so bad if you compare it with the outlook for the stock market over the next 10 years,” he said, because TIPS are significantly less risky than stocks.



“Stocks do have a chance of doing really well,” he said. “But we are a little too much on the high side in terms of price-to-earnings ratios to be comfortable.”

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>