Funding the Future

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Six months on, this video is as relevant as when we first made it, except a crash is probably nearer now. Every time stock markets drop, headlines say that billions have been lost. But where does that money actually go? If you want to understand crashes, confidence, and the baked bean market (trust me), this one’s for you.

And apologies for the repeat: I really could not face doing a longer recording yesterday.

https://www.youtube.com/watch?v=QZntEyjROcg?si=-V700WeM_7rn7Yjm

This is the audio version:

https://www.podbean.com/player-v2/?i=83zx6-19e6d76-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a

This is the transcript:

I am expecting a stock market crash. I don't know when it's going to happen. I do think it will happen.

Why do I think it will happen? Because the peace that has been brokered in the Middle East is not going to last, and the euphoria that is still sweeping markets is going to end, and as a consequence, I think markets will fall.

Every time that happens, a newsreader in a studio in the UK reads out a headline that says something like "A hundred billion pounds was wiped off the value of the stock market today", and the question that I'm always asked as a result is, where did that money go? And the answer is *nowhere. Let me explain.*

Imagine that there aren't shares for sale, but instead, there are tins of baked beans for sale in the stock market, and the stock market looks remarkably like Sainsbury's, or Tesco, or Lidl, or Asda, or wherever else you go. Let's give the Co-op an honourable mention.

Those tins of baked beans are sitting there at a price of £1 each. And suppose that there are one million tins of baked beans available for sale today in the UK, which is a number which I suspect is not far from the truth.

Now, what is the total value of the baked bean market today? If the beans are sold for one pound each, it's £1 million. That's the value of the baked bean market.

Now, let's suppose that one of those supermarkets decides that it's going to drop its price of baked beans from £1 to 80p, and all the others will copy because this is one of those benchmark items on which they price match. So the consequence is, everybody will cut the price of baked beans to 80p, and there are still 1 million tins available, so what is the value of the baked bean market today? It's £800,000.

£200,000 has disappeared, apparently, except it never existed.

The £1 price tag that was attached to the baked beans was simply a hope value. It was a measure of what the supermarket hoped that you would buy baked beans for, but until you paid it, there was actually no proof that the price was right.

And now the hoped-for price of baked beans has fallen from £1 to 80p. The market has revalued baked beans. Hopes have changed, but no real money changed hands as a consequence.

The same thing happens in stock markets. If £100 billion is lost because the price of shares has fallen, people are no longer willing to pay the higher price. A share that was valued at £1 is now valued at 80p, in exactly the same way that a tin of baked beans that was valued at £1 can now be valued at 80p.

No money's disappeared. All it means is that the expectation of the sale price that the share in question might realise if somebody came along to buy it has changed.

There's been a repricing of hope in the stock market, and stock market values in this sense have nothing to do with money in the bank. They're a measure of the hope of the amount of money that might end up in the bank if every single share that was available for sale in the market was sold at the price somebody might pay today.

In other words, that value is just a guess. It's nothing more than that. There has been no sale to prove it's right in most cases. There has been no money made across the *market as a whole at the price in question.*

So, when, and if, markets are revalued, the people who hold the shares that have now fallen in value will have made a loss, but only on the shares they're holding for sale. If they didn't expect to sell them, they've lost nothing at all. They've still got the share, and that's exactly the same with the supermarket. They will, as a consequence of repricing baked beans from £1 to 80p have lost 20p on each tin of beans that they sell, but suppose that in the couple of days time everybody is flooding into the shops and buying lots of bake beans, they can put the price back up to £1 again, and their hope value will have been restored. The loss would've been small. So might it be when there's a hundred billion pounds written off the value of stock markets.

The point is this. Markets are not built on certain prices. They're built on confidence, and confidence comes and goes. When confidence is high, prices go up. When confidence is low, prices fall. But that doesn't mean that money has gone anywhere, because all that the price of a share represents is that ticket, which is on the stock market shelf, which says you can buy this if you are willing to part with this much now, and the price of a share can move quicker than the price of any tin of baked beans because that's just the way that stock markets are designed. But to suggest that the value was certain in the first place is wrong. It was wrong, in fact, to price the product - the share - at £1 - because, in fact, it turns out it was only worth 80p.

So the point is, has there been a profit? Has there been a loss? Well, in principle, those who own the shares that they could put up for sale have made a loss, but if they sit things out, as I just explained with regard to baked beans, the price might go up again very soon, and they've lost nothing at all.

If somebody's got to sell today because the share is sitting on the shelf and has to go by tonight, like some perishable food item rather than a tin of baked beans, then yes, sure, they've made a short-term loss.

But there's only really a big loss if everybody starts to sell in a panic, and all of those people who then force their shares into the market create massive cash losses, and that's what, for example, happened in 1929, and to some extent it happened in 1987, and it happened again in 2008. It's only panic that really creates big, real losses in financial markets, when there are usually just small movements day by day, and the market goes up by a few billion or down by a few billion. Then there's not really any cash loss at all. This is just a simple repricing exercise. So crashes shift hopes, but unless everybody sells at the new lower price and nobody is normally forced to do so, they don't shift bank balances.

So, did money go anywhere as a result of that £100 billion being wiped off the markets?

No, the money didn't disappear because it was never there in the first place. The only thing that was there were shares that were made available for sale at the wrong price, *and as a result of things changing, expectations changing, there's been a revaluation of the market, but there's been no destruction of cash.*

The simple point is, value is a guess; we get our guesses wrong, stock markets reprice our expectations, and then share trading carries on. Market crashes are about emotion, not the physical exchange of goods or services, or even money. They are just about people having hopes for the future, which they sometimes get wrong, and when they do, the value of stock markets falls, but don't let that sort of panic define your truth. A stock market crash does not need to mean an economic downturn.