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How to Spot a Bubble in Advance

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"America needs another bubble. At this point, bubbles are the only thing keeping us afloat." – Bob Taiken

What’s a Bubble?
Why Care?

The Anatomy of Bubbles

Bubbles are infectious … and like Sirens, can lure in everyone

Anatomy of Bubbles and Crashes

The bible on bubbles is *Manias, Panics and Crashes*, by Charles Kindleberger. In the book, Kindleberger outlined the five phases of a bubble.

- Stage 1: Displacement
- Stage 2: Boom
- Stage 3: Euphoria
- Stage 4: Crisis
- Stage 5: Revulsion

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Necessary Ingredients to Bubbles

A human phenomenon catalyzed by unrealistic expectations

1. A bubble can result when money supply and debt grow appreciably faster than savings and GDP growth.
2. Financial markets lose their connection to the course and health of underlying economies.
3. Human penchant for optimism, financial gains, and love for an imaginative story adds to the infectious mix.

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Bubbles Have Harmful Effects

Bubbles destroy real wealth and capital

Keynes touches upon the consequences of speculative bubbles and manias:

> "*Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.*" — John Maynard Keynes

Why Wealth Managers Care

Ultimate results common to all bubbles.

1. Bubbles always lead to asset busts … and usually, also currency and financial crisis.
2. Always, bubbles lead to massive wealth redistributions. How will our clients fare?
3. Much financial capital ends up destroyed due to related economic malformation during bubble periods.

Do you believe in bubbles …
or the tooth fairy?

Bubbles: Legend or fact?

No Bubbles Say Reputed Experts

At best, bubbles can only be seen in retrospect … in rear-view mirror

"Bubbles cannot be seen in advance" … only "after the fact."

Recently admitted that he "Never Saw it Coming." (2006 – 2009)

(Source: Foreign Affairs, Why the Financial Crisis Took Economists by Surprise, Nov/Dec 2013

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No Bubbles Says New QEen

At best, bubbles can only be seen in retrospect … rear-view mirror

- Janet Yellen sees limited evidence of "reach for yield."

- Yellen says "you would not see stock prices in territory that suggest…bubble-like conditions."
- Yellen doesn't see "misalignments" in asset prices.

Source: Recent interviews

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No Bubble Nobel

Markets are rational all the time …or are they?.

Eugene Fama, 2013
Nobel Prize Recipient

"The word 'bubble' drives me nuts."

Fama believes markets are basically rational. At any given moment, he says, prices reflect the collective wisdom of everyone in the market. If it were clear that prices were irrationally inflated, investors would stop buying en masse — and prevent a bubble from getting out of control.

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No Bubbles Say Reputed Experts

At best, bubbles can only be seen in retrospect … rear-view mirror

Many high-profile macroeconomists, monetary policymakers all believe that bubbles are mythical … not dangerous … nothing to see.

Then why have investors sustained such huge volatility … and low returns … in financial markets these past decades?

What are the facts on bubbles?

Keynes' List of Bubblonia Eras

Classical economists were able to diagnose bubbles.

1. Neophyte investors owning an increased proportion of capital investment;
2. Day-to-day price fluctuations having an excessive influence over the market;
3. Violent changes in the mass psychology of ignorant individuals changing asset valuations;
4. Professional investors devoting their skills to "anticipating what average opinion expects the average opinion to be;" and:
5. Confidence, or lack of, in the credit markets.

Source: John Maynard Keynes (Chapter 12 of *The General Theory of Employment, Interest, and Money)*

Our Beliefs of 5 Commonalities

Underlying markers or conditions that spawn financial bubbles

1. A large expansion in debt, either driving an overconsumption or over-investment binge.
2. A heavy reliance on capital gains for income and reported profits.
3. A sharply higher participation level in an asset market (most importantly, marketable items of some kind that can be readily borrowed against, usually securities) either directly or indirectly.
4. Crucially, a misreading of underlying credit and inflation trends.
5. A "great new world" impulse, usually represented by a technological shift of some kind. (The telephone and the automobile were impulses contributing to past booms.)

Seeing Bubbles in Advance

5 “Classical“ Diagnostics that can serve as early warning

Let’s look for the symptoms today:

- Credit & debt growing faster than savings.
- Chronic external deficits – current accounts.
- Enormous shifts on the household’s balance sheet – plunging personal savings
- Widening income and wealth skews.
- Gross distortions in the input/output structure of an economy.

Where is “Great Impulse” for a Bubble?

What Big "Story" Impulses?

What beliefs are abetting a money and asset bubble explosion?

<u>Impulses in the past bubbles:</u>

Technology, Real Estate, Government Bonds, LDC debt, New Era?

<u>Common impulses & delusions this time? </u>"No alternative" … equities only game!

Elevation of central bankers to "Masters of the Universe" and macro-economics to "Science"!

Let's be serious!

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Risks of High Water & Herds

Velocity inflations … and everyone rushing to the same side of boat

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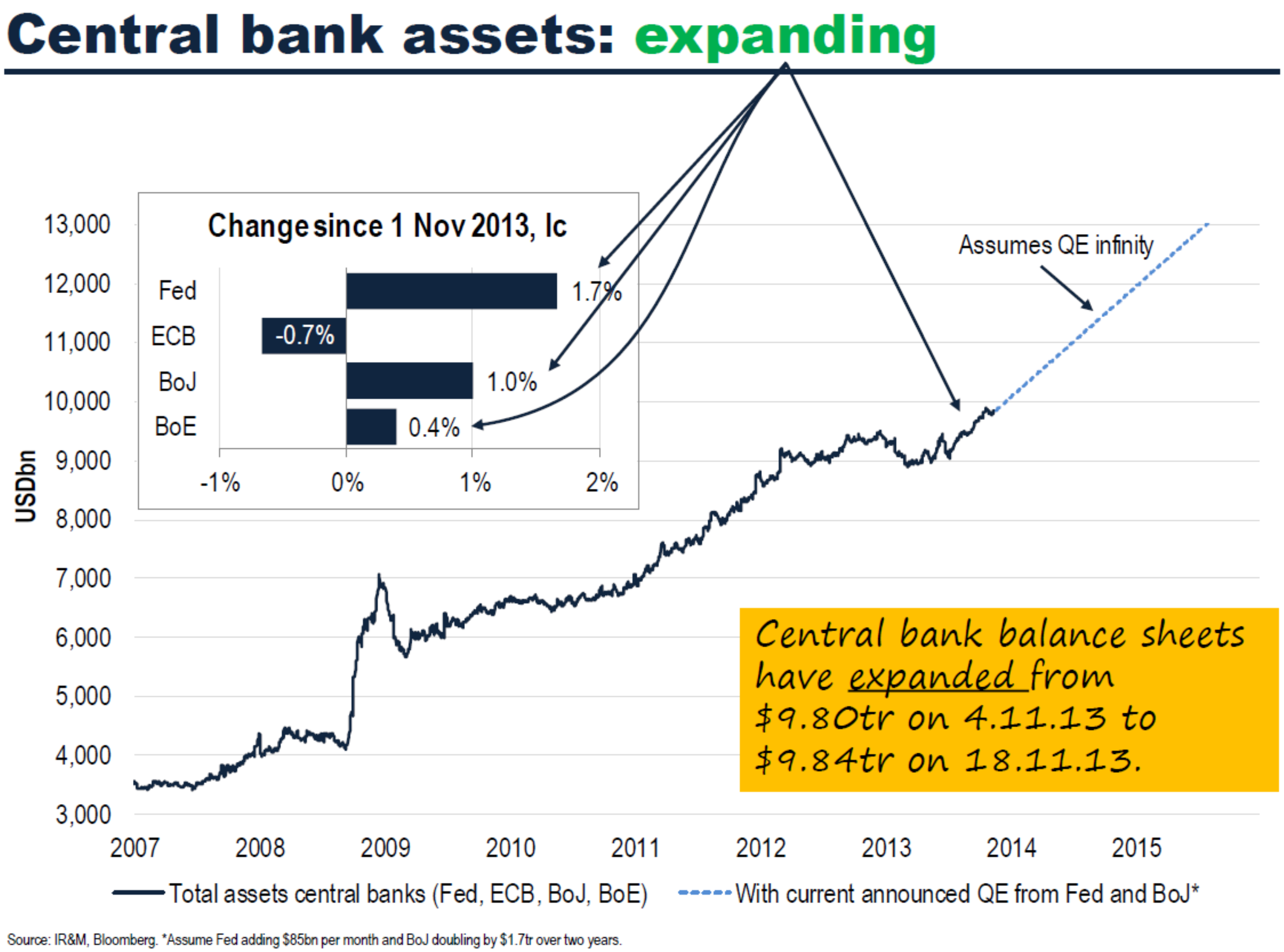
Does a Bubble Exist Now?

The evidence is clear!

Start Here: Money Growth

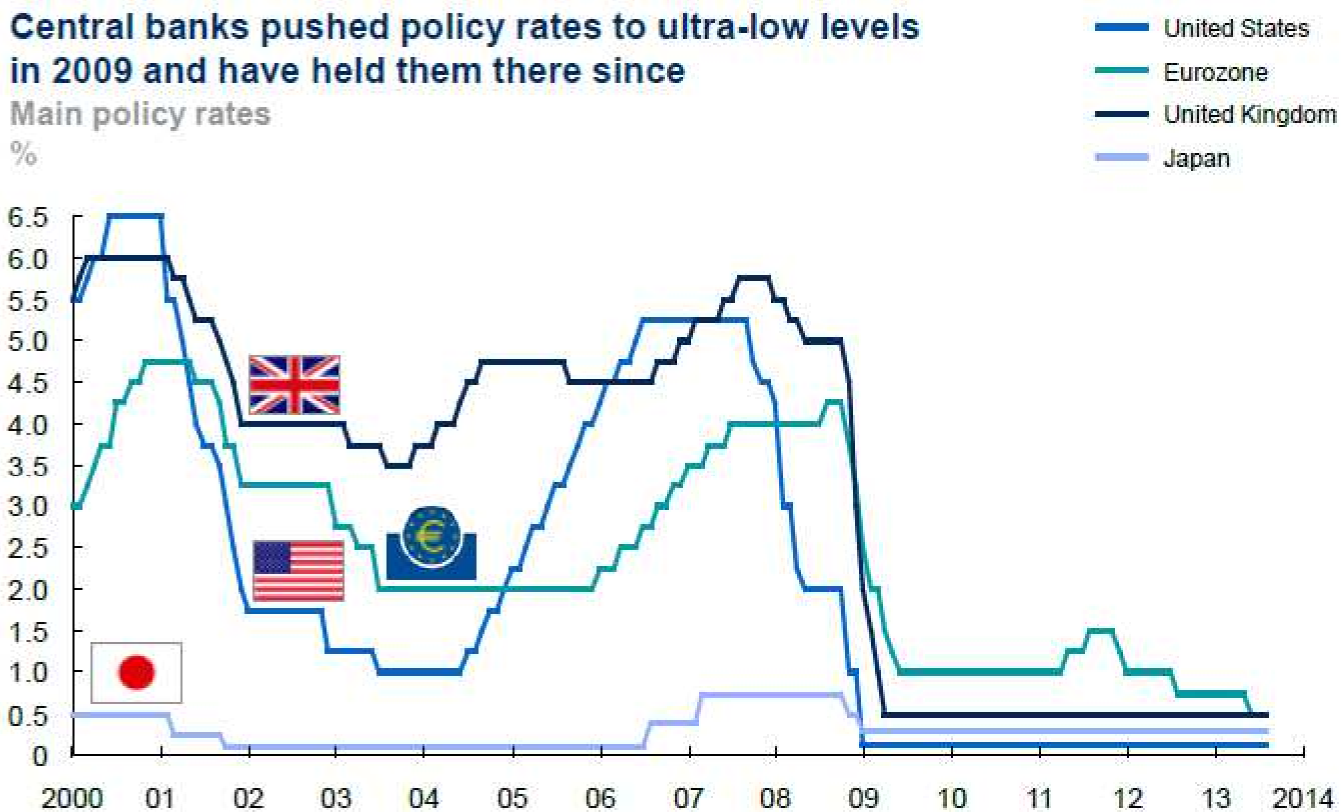
Huge reserve growth is entering financial system.



Source: Ineichen

Manipulated Interest Rates

Major central banks all proclaim low rates … even to 2017



SOURCE: US Federal Reserve; European Central Bank; Bank of England; Bank of Japan; McKinsey Global Institute analysis

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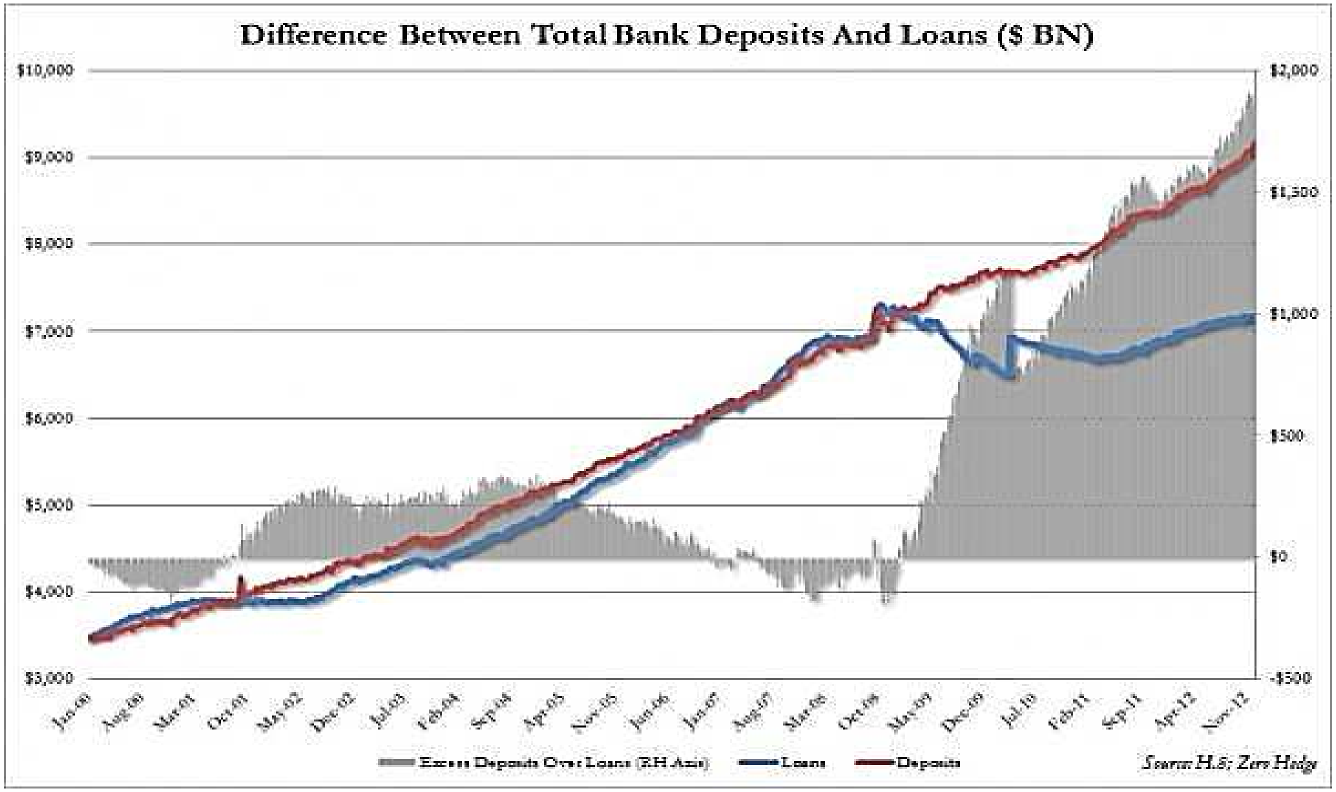
Where is the Money Going?

Every bubble has its unique channels. Banks at the epicentre.

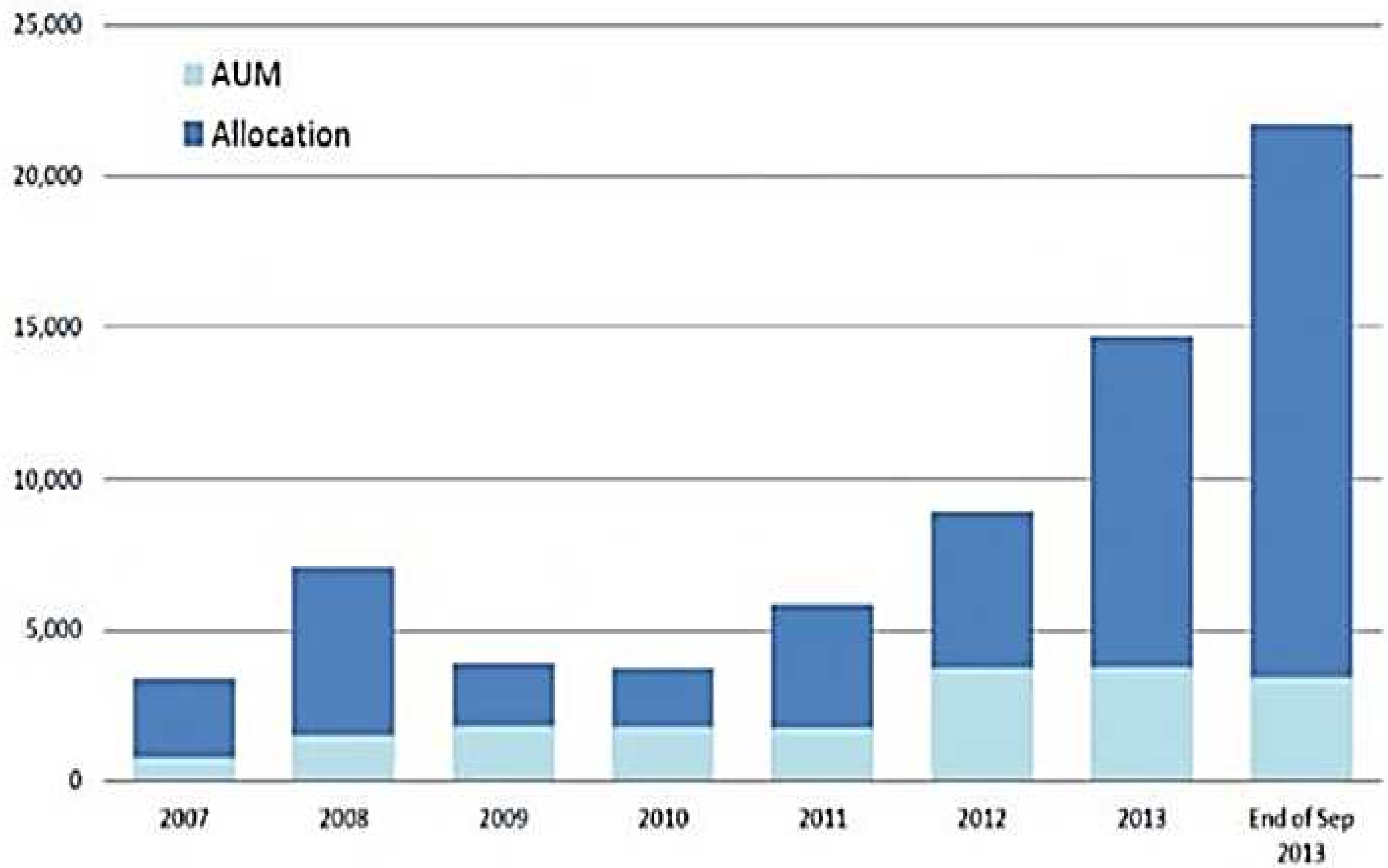
Nearly $2 trillion needs to find returns … somewhere in U.S. banking system.



Source: Zerohedge

Hedge Funds' Huge Leverage

Massive increase in leverage to 5x. Usually ends badly.



Source: Zerohedge

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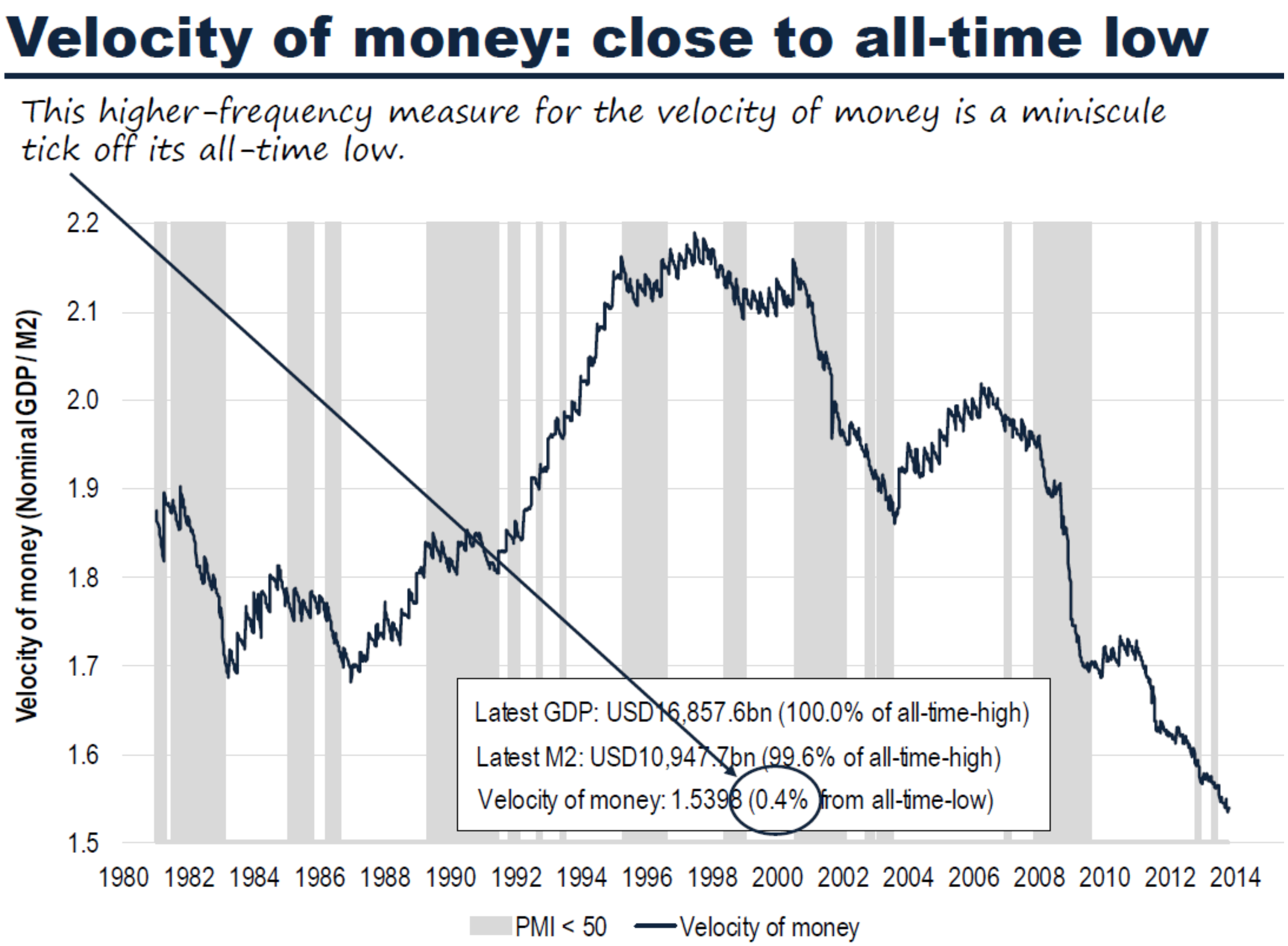
Important Indicator That's Different

Crucially, slumping money velocity changes the analysis

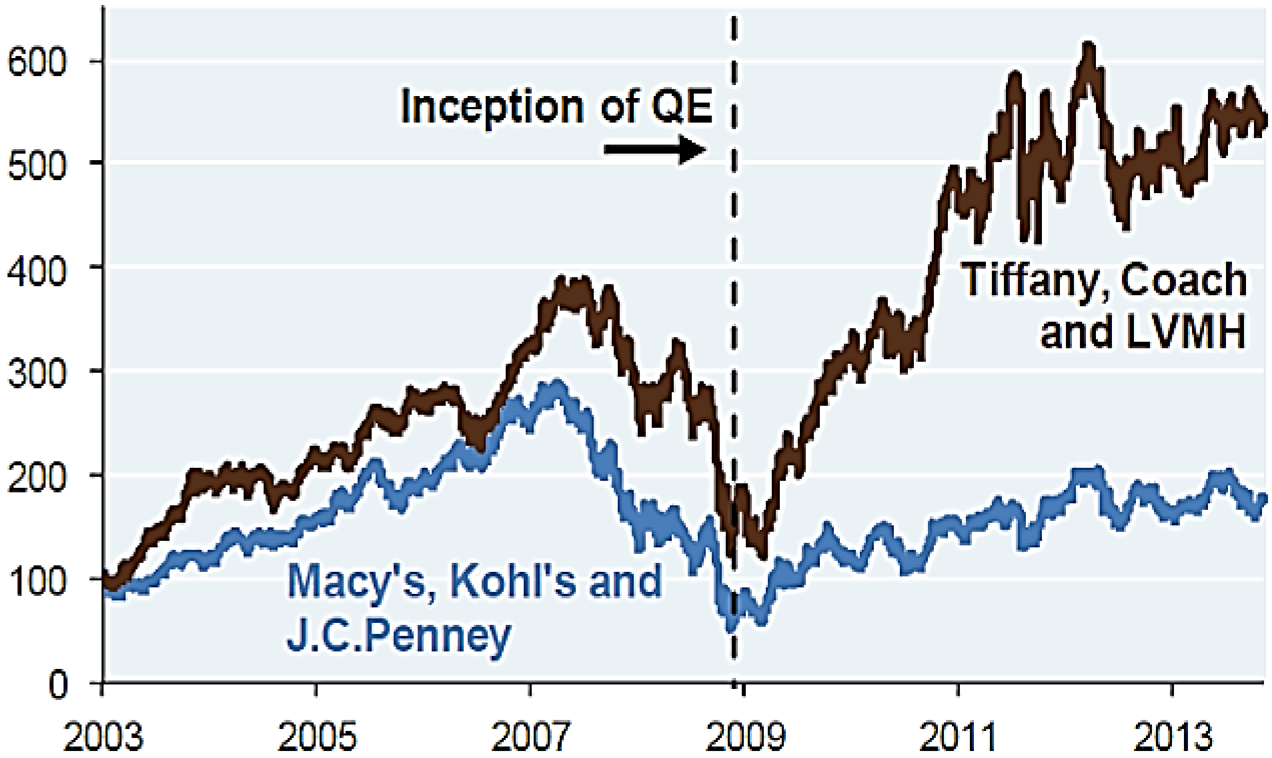


Source: Ineichen

Redistributional Effects Are Here

Booms are followed by busts … big winners and big losers

A stock market reflection of the distributional effects of Quantitative Easing, Equal-weighted index, Jan. 2003 = 100



Source: Bloomberg. November 2013.

The problem with bubbles is that their inflation and inevitable deflation lead to massive redistribution of wealth.

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Unprecedented Character

Current bubble is partly also buoyed by income redistribution

McKinsey estimates that households in the U.S. have lost a cumulative $360 billion. Meanwhile, banks and businesses have done very well.

Bubble Busters: Who ya’ gonna call?

Who Wants to be Bubble Buster?

Like “whistleblowers”, “bubble poppers” are not popular

Observational Fact: Few in the wealth management industry are incentivized to pop the balloon.

> *“Even in such a time of madness as the late 1920s, a great many men in Wall Street remained quite sane. But they also remained very quiet. The sense of responsibility in the financial community for the community as a whole is not small. It is nearly nil.” ― J.K. Galbraith*

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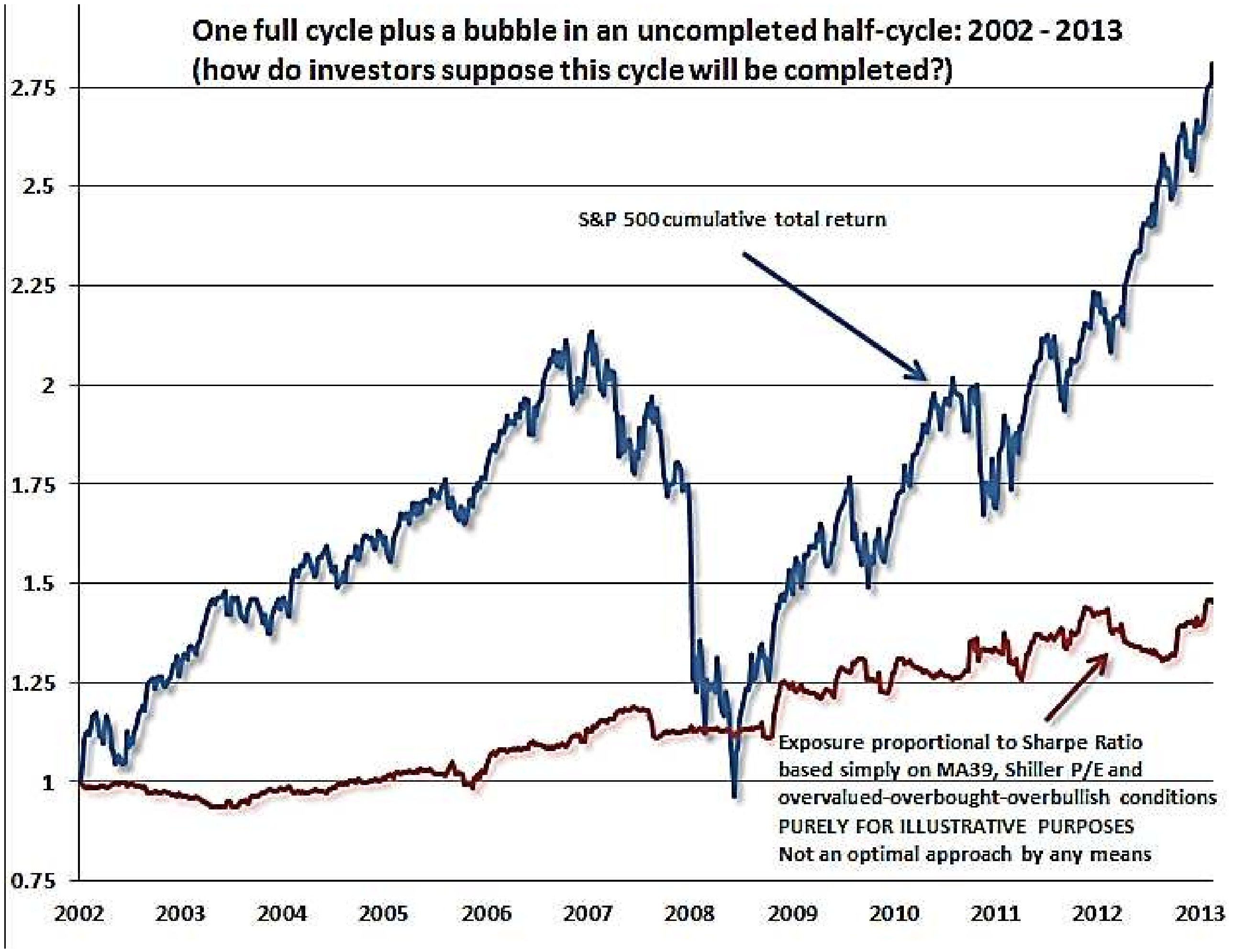
Fiduciary Duty of Manager?

The greater evil … lost opportunity or inopportune losses?

- We must act in the best interests of our clients … and follow our research and disciplines.
- Even when clients want to disagree with us as to lost opportunities.
- Well known investors such as GMO, Buffet … etc. have proven their disciplines by resisting psychological hazard.
- Clients have thanked us after the fact in the past.

Honestly … How Does This End?

S&P 500 modelled on risk-adjusted and long-term measurements.



Source: Hussman

Evolution of Bubble Theory

A huge attitudinal change has taken place regarding their occurrence

- Bubbles, like tornados, were once considered a dangerous aberration … unpredictable … and to be avoided.

- Today, in an zero-sum, low growth world, storm chasing is seen as necessary investment strategy.

How to Insulate Portfolios?

We have successfully done so in the past!

- Understand risk … know when lure of potential gain is too expensive.
- Stick with proven investment process.
- Buy insurance & stay diversified.
- Focus on income.
- Raise cash strategically.
- Be patient … specific catalysts (pins) that pop bubbles cannot be reliably forecasted.

Results for Bubble Watchers?

Firms that identify risks earn better credibility with their clients.

- Lower draw-downs
- Lower risk and volatility
- Proven record of long-term outperformance
- Better client experience over the long term
- Achieve long-term credibility with clients

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The End

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