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Fizzy assets

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Bubbles in a market can take years to form and be noticed. After technology and property, will the next assets to inflate be commodities, or even equities? Vanessa Drucker, in New York, explains how bubbles develop and attempts to read the signs.

There is always some plausible underlying narrative that launches and feeds an asset bubble as it swells to unprecedented dimensions. Bubbles may be simple to define, and glaringly obvious with 20/20 hindsight; it is much less straightforward to spot and distinguish them at the time.

Basically, bubbles develop when demand pressures drive prices beyond levels that can be justified by reasonable measures of intrinsic value. The catch is that "intrinsic value is a murky figure that is subject to widely different measures of fair value", warns David Roda of Roda Asset Management in Miami.

One way to look at today's landscape and its proclivity for bubbles is to see it more as the arcade game of Whac-A-Mole than the board game Monopoly. "In the current scenario, investment bankers, derivatives managers, speculators and hedge funds are moving capital around in increasingly short time frames for increasingly diminished returns," explains John Graves, an independent financial adviser and the managing partner of the Renaissance Group in Ventura, California.

In other words, capital demands far outstrip actual demands. Consider that if global GDP amounts to about $45 trillion (£28 trillion), the global derivatives market represents 10 times that sum, eclipsing a few trillion in actual commodity demand. Says Graves: "That capital flows like water in a river, pulled by gravity, in the search for the best risk-adjusted returns."

Let us return to that key narrative, or story, which enables a bubble to expand. The narrative can take various forms, ranging from a scare (the world is on a Malthusian path of peak oil or agricultural products) or a promise of salvation (the dollar and other fiat currencies are doomed, so only hard assets like gold will retain value) to a seductive, new era promise (the internet heralded a paradigm shift of immeasurable technological promise). Often, the hopes and dreams of the latter type of tale are based on an innovation, which cannot exactly promise how useful the new development will prove to be.

A few historical examples illustrate the innovation narrative. During the late 1990s, as the internet industry gained critical mass, it was clear that the technology would lead to vast increases in productivtiy. It was not guaranteed, however, which companies or industries would reap the benefits. Whereas some firms, such as Amazon and Google, have emerged as winners, others, such as certain online retailers or search engines, have been dispatched to the cyber graveyard.

Other cases to highlight the role of innovation are those of the housing and structured finance booms in this past decade. William Dudley, the president of the Federal Reserve Bank of New York, explained the interrelationships in a speech on April 7, 2010, to the Economic Club of New York. Dudley pointed out that, on one front, subprime lending made mortgage credit available to a wider swathe of households, while on another level, innovations in financial engineering, like collateralised debt obligations, reduced the cost of that credit. Several feedback mechanisms then came into play. *(Cover story continues below)*

"The surge in credit availability drove up the demand for housing and pushed up housing prices," Dudley explained. "This increase in demand caused the default experience associated with such lending to be very low, reinforcing the notion that subprime lending was not very risky."

For a more contemporary model, one can look at some of the latest new era narratives and their impact on commodities prices. Accounts of global warming and its disruptive impact on global agricultural prices abound; indeed, one can trace the turmoil in the Middle East to food supply shortages. For those who prefer to focus on the chillier winters produced by "climate change", the weather also points to the spectre of higher fuel prices.

Once a bubble takes shape, even at its early stages, feedback loops and reinforcements tend to bolster the faith that the underpinning storyline justifies such investment enthusiasm. In each of the two examples discussed above, housing and technology, concurrent surges in economic activity added credence to the notion of a paradigm shift. During the 1990s internet heyday, investors came to believe that those companies that came first to market would achieve first-mover advantages, thereby creating impassable barriers to entry for their competitors . As Dudley noted, during the housing boom "the structured finance models appeared to be sound because losses on the underlying subprime mortgage loans were low".

Adding fuel to the fire, Wall Street analysts and media commentators do not hesitate to pile in, helping to drive up prices, promoting groupthink and herd behaviour.

Bob Andres, the chief investment strategist at Merion Wealth Partners in Berwyn, Pennsylvania, gives short shrift to the chorus of financial professionals who kindle the fervour as they embrace the consensus view. "Analysts and economists may know better but are reluctant to say anything actionable, even if they feel negative, since they are protecting their own positions," Andres observes. To make matters worse, they are constantly ready to lower the denominator in terms of what matters, so that when data comes out, markets appear to be beating that denominator. Andres quips: "If we lowered the denominator for the world record in high jumping, you and I could beat that too."

One cannot lay all the blame at the doors of journalists and financial firms. In the end, the worst culprits are investors themselves, entrapped by the universal tendencies that corrupt their judgment.

Hersh Shefrin, a pioneer of behavioural finance from Santa Clara University in California, outlines the three main psychological issues associated with bubbles. First, the "hot hand" fallacy, a term borrowed from basketball, seduces investors into believing that a successful streak is likely to continue.

Second, people suffer a natural aversion to loss, which may take a social form. Shefrin explains: "Suppose you perceive that others whom you regard as peers have invested successfully, and that their social/economic status is rising in consequence. If they have invested in a hot asset and you haven't, they are ahead, and your status is reduced relative to theirs."

The third element is confirmation bias. There is a general tendency to overweight any information that confirms one's personal view of the world and to overlook what contradicts it. It is uncomfortable to hold two conflicting ideas at the same time, so the natural response is to alter one's beliefs in order to allay the cognitive dissonance. Meanwhile, most people are overconfident, regarding themselves as above average and invulnerable. Even if they suspect a bubble exists, they may over-optimistically believe that they will possess the agility to exit in time, before it bursts.

Having reviewed some of the factors that encourage a bubble to grow, it is time to survey some areas where nascent bubbles might be developing today. Note, however, that it is immensely hard to foresee the path of a bubble from its early stage; significant bubbles may persist for many years, so predicting their course may involve looking out far into the future.

"Emerging bubbles are really difficult to identify," says Shefrin, "because pockets of overpriced assets are occurring all the time. They usually self-correct on their own for stochastic reasons, but sometimes they get a push in one direction or other, inducing the efficiency to widen, rather than narrow. So spotting them involves a lot of luck."

In recent months, bubble watchers have been keenly focused on commodities in general, and on precious metals and oil in particular. Roda summarises some of the arguments for the narrative (which may or may not eventually pan out to be true).

Hard assets, especially precious metals, have been flirting with record levels on concerns about future inflation and the eroding quality of American debt, he says. Since many commodities are priced in dollars, any long-term decline in the greenback is destined to push up their prices.

As another angle, population growth and favourable demographic trends in emerging markets are driving demand for agricultural products. As labourers move into cities, forsaking their agricultural roots, import requirements rise; as they earn hard currency wages, they can afford better sustenance, creating demand for meat. "Producing animals for food is very grain intensive, thus taxing supplies further," says Roda, although he adds that he himself does not yet perceive a bubble in agricultural commodities.

Max Dufour, who advises large banks on risk management for Sungard Global Services, points out that many equities investors were burned in 2000 and 2009. They may be turning to commodities instead as an alternative route to making money.

"The problem is, that since [commodities] do not pay dividends, one must constantly buy them at higher prices," says Dufour. "Moreover, since they all serve different purposes, it makes no sense to short them all at once."

In fact, difficulties in shorting any given asset class may help to promote bubbles. For instance, housing is almost impossible to short (assuming that renting is usually too cumbersome a solution), and one of the reasons structured products initially gained undue steam was the challenge of shorting, before standardised instruments were created.

Silver attracted widespread attention as a bubble candidate leading up to its recent correction in May, after its price trebled from September 2010. In Shanghai alone, on the main Chinese metals exchange, silver turnover rose 2,837% from the beginning of the year, with the number of contracts doubling over the period.

What lifted the metal, which backs no currencies, and is easier to find than gold? The move appears in large part to have been propelled by investors' purchases of the exchange-traded fund, which gained popularity both as a "poor man's gold", and as a form of diversification from the yellow metal.

Gold, too, has soared, albeit at a less headlong rate, doubling from about $720 per ounce in November 2008 to about $1,500 per ounce today. The fundamentals do not remotely justify the rise, with industrial and jewellery demand growth creeping at 2% a year versus supply growth. It makes less sense, however, to talk about gold's becoming unmoored from intrinsic value,as gold does not have definable intrinsic value.

According to Roda, gold "is shiny and it is scarce and universally accepted as something of value, but the perceived value is largely politically driven".

Like other commodities, gold has a long history of cyclicality. "Those who bought gold in 1973 paid approximately $106," says Stephen Todd Walker, a managing director at Oppenheimer Investments. He recounts that "by 1979, gold prices were around $459, more than a fourfold increase over six years.

"Just like today, gold was a hot topic and investors wondered whether or not to jump in, wait, or take a pass."

In fact, gold did continue its climb, cresting in 1981 at $594, after which a reversal set in. By 2001 the price of the metal was floundering at $271. "Those who jumped in at the high ground lost more than 50% over this time period," says Walker.

A more telling question is whether equities are at the threshold of bubble territory. The class comprises a much greater share of investors' portfolios than commodities or other alternatives do. "It has been the policy of the Federal Reserve to take risk equities above intrinsic value, which Ben Bernanke [the Fed chairman] has stated quite openly", says Andres, referring to an apparent policy and ploy to manipulate the wealth effect.

On August 27, 2010, Bernanke's speech in Jackson Hole paved the way for further quantitative easing (QE2), after which global markets roared out of the gate. An often quoted phrase was expressed, not by Bernanke, but by Brian Sack, the manager of the System Open Market Account for the New York Fed, at a chartered financial analysts' fixed income conference on October 4: " Balance sheet policy can still lower longer-term borrowing costs for many households and businesses and it adds to household wealth by keeping asset prices higher than they otherwise would be."

Yet a powerful initial shove predated the launch of QE2. On March 9, 2006, when the S&P index touched 666, President Obama used the bully pulpit and it worked like a charm. "Obama, who knows nothing about markets, said, 'I think everyone should invest in equities'," says Graves of Renaissance Group. "Groups like Goldman Sachs were the first to jump in, which helped attract others."

Whether equity markets have become overpriced is controversial. Some argue that they have not, like Professor Robert Shiller of Yale University, who attributes the rebound more to an expression of relief as exaggerated fears of depression have receded.

Others are fearful that stocks have become extremely expensive. Mike Martin, the president of Financial Advantage, an advisory firm in Columbia, Maryland, points to several key indicators to suggest equities are expensive. He referers to Shiller's own cyclically-adjusted price/ earnings ratio (CAPE) formula, which uses the normal price-to-earnings numerator but smoothes out the denominator earnings over a 10-year average to adjust for the volatility of the business cycle. The Shiller CAPE is running at about 23 times, which is 44% over its 100-year mean of 16 times. Martin notes: " The only two periods during the last 130 years that this valuation was higher were just prior to the 1929 crash and during the era of the dotcom boom."

For further ammunition, Martin highlights the S&P dividend yield, which has historically accounted for over half of total returns for stocks and stands at just 1.8%. The only time it has ever been lower was at the peak of the dotcom bubble. "In other words, expectations for growth have never been higher," Martin explains. In addition, the "Q Ratio", which measures price to replacement cost for corporate assets, is 60% above its long-term mean ratio; it is therefore higher than at any time in the past 130 years, except during the 1998-2000 dotcom bubble.

Smaller bubbles can simmer merrily too. Commercial real estate, especially properties with high-credit tenants in some larger cities, may be heading for the heights - again. The culprits come from two directions: banks and investors. Troubled banks are being forced to "extend and pretend" their commercial real estate portfolios because the losses they would occur upon divestiture are larger than the total capitalisation of the banks.

"Thus, without extend and pretend, these small troubled banks are insolvent," says Marc Mattox of Southwest Strata Investment Group in Dallas, Texas. After the collapse of the real estate finance market in 2007, private equity funds began raising opportunistic capital for distressed assets, with a limited time horizon to invest. In their race to deploy that capital fast enough, they are driving prices towards the peak levels of 2006. "It's not uncommon to have over 40 bidders for trophy properties," reports Mattox.

Even some more obscure alternative assets may be ripe for speculation. Shiller has marked farmland as the next prospective bubble, in America and Britain. It fits neatly into the finite scarcity category, like gold, and also ties into the popular narratives for global warming and food shortages.

If bubbles are difficult to identify early, and dangerous to ride as they grow, investors must take protective steps. Warning signs that may point to a deflating bubble include high volatility or a steep daily percentage drop. "A sudden drop of 5% to 10% represents a medium signal, and over 10% is a red signal to sell right away," Dufour advises. Even while such warning signs are flashing, investors often hold positions and double down, convinced the price will climb back up.

Various strategies can add protection. It is prudent to safeguard positions by using stop loss or tracking orders; to consider going flat, entirely into cash; or to take profits along the way to rebalance portfolios regularly.

Where to set stops is an art form, to avoid getting whipsawed with volatility. Dufour routinely places them 7% below his entry point when he purchases an asset, and then tracks its price carefully. Stephen Solaka, the managing partner of Los Angeles-based Belmont Capital Group, adds a recommendation for option collar strategies. By purchasing a put option, one can simultaneously use the proceeds from the premium to sell a call option on the same position, for effectively no cost. The strike prices can be set at any given distance, whether 2%, 5%, 10% or even 20% wide. "Since many bubbles persist, it's a good way for the leery to retain exposure," says Solaka.

Bubbles may endure for months or years, but in the end, they do go pop. Once they start to deflate, the plunge can be dramatic, tumbling deep into undervalued territory, with fallout effects across the economy. Investors should beware of following the momentum, especially with leverage. However euphoric the ride up, however compelling the narrative - from a Chinese housing boom to hungry mouths in emerging markets, to new meteorological eras or dynamic innovations like credit default swaps or social networking models - the journey back down to reality can be brutal.