A better class of bubble

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We never tire of pointing out that, when it comes to bubbles, no two bubbles are ever the same.

Firstly, bubbles can bid up asset values because of their perceived 'scarcity' (typically, land and real estate, but also tulips, or gold...) or because of their productivity (canals, railroads, telecom lines, energy...). This distinction matters because, in the first case, an economy is left with no more land (or gold, or tulips...) than at the outset. In the second case, productive capital has been put in place which can still be exploited, either by its current owners, or by a new set of owners. Take the late 1990s bubble as an example: when the Technology-Media-Telecommunication hype imploded, consumers were still left with the ability to make cheaper calls and transfer data more cost-efficiently. In turn, this led to much higher levels of productivity (e.g. the birth of Indian and Filipino call centers), higher growth and improved standards of living.

Another key difference between bubbles lies in the way they are financed: a) if a bubble is financed by banks, when the bubble bursts, the banks' capital disappears and the velocity of money collapses; b) if a bubble is financed by capital markets (corporate bonds, junk bonds, and equities...) those owning the overvalued assets take a beating. If they hold those assets on leverage, then the assets get transferred to more financially sound owners. Otherwise, the buck stops with the owners of overpriced assets.

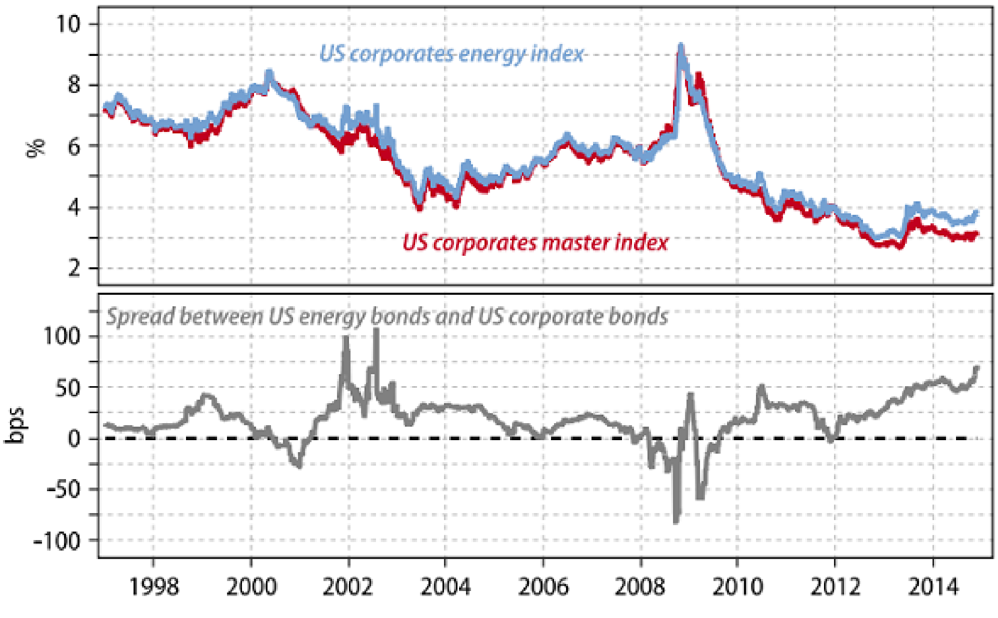
So, from an economic growth point of view, the worst possible kind of bubble is a bubble in unproductive assets (gold, land, tulips...) financed by banks. The best possible kind of bubble (ie, one that does not hurt growth too badly) is a bubble in productive assets, financed by capital markets. The Japanese bubble of the late 1980s and the US real estate bubble of the mid 2000s were 'bad' bubbles. They were mostly in real estate and financed by banks. By contrast, the US TMT bubble of the late 1990s was a 'good' bubble. It was mostly in technology (too much telecom and computing expansion) and was financed by capital markets (junk bonds and equities).

Why are we (yet again) rehashing this distinction?

Because, at this stage, only the most die-hard peak-oil proponents, or other gold-bugs, will fail to acknowledge that the commodity bubble has now burst. As we have said time and again, commodities tend to take the elevator up (as prices shoot up when demand exceeds supply) but then ride the escalator down when supply moves above demand (and prices go down to the production costs of the more efficient producers). At least, that's what happens until supply gets destroyed, at which point a new cycle starts. The end of the commodity bubble thus sparks the following questions:

- Did the bubble take place in productive assets? Our answer: absolutely! In fact, the growing ability to generate cheap, and plentiful, energy has undeniably been one of the more productive developments to occur in recent years.
- Was the bubble financed by banks? Or capital markets? Our answer: probably both. Indeed, looking at the performance of the high yield debt market, as well as the relative performance of bank shares in a number of countries, market participants are clearly becoming more worried that debt restructurings are around the corner. Otherwise, how can we explain the fact that the spread between US energy bonds, and US corporate bonds of similar rankings stands at a high not seen since the 2001-02 recession, when oil was below US$30 a barrel.

Figure 1: Credit markets are sending a clear message on energy
Spread between ML US energy corporate bonds and US corporate bonds



Sources: Gavekal Data / Macrobond

Which brings us to the question of whether the bursting of the commodity bubble is a positive, or negative, for financial markets? Below are some key takeaways:

- With the energy sector having been responsible for roughly a third of S&P 500 capital spending in recent years, it seems likely that capex numbers in the coming months will be disappointing as new projects get mothballed.

- In turn, this may well mean disappointing credit growth numbers over the coming months, even as weaker commodity prices represent terrific news for Western and Asian consumers.
- Weak capital spending combined with weak credit growth and weak CPI readings (on the back of the lower commodity prices) will likely keep central banks somewhere between ultra-dovish and very dovish (ie, we are unlikely to see a repeat of Jean-Claude Trichet's July 2008 interest rate hike!).
- At the same time, we are likely to see more bankruptcies, fund closures, bank-lending reluctance, and other short term market disrupting events as markets absorb the new price realities. To the extent that these trigger wider spreads, the ability of corporates (especially in the US) to financially engineer their way into higher EPS growth will be compromised.

Putting it all together, we reiterate our view that the way to play falling oil prices is to overweight the energy intensive economies of East and South Asia, namely Japan, China, India, Taiwan, the Philippines, Thailand etc. Indeed, in these economies, financial engineering has been kept to a minimum (and thus there is less risk of big earnings disappointments) and most equities are owned by 'strong hands' (as opposed to leveraged hedge funds and retail investors in the West who, having been wrong footed by recent commodity events, could become forced sellers). Moreover, weaker energy prices will have an immediate and visible impact on Asian trade balances and domestic growth.

Most importantly, the fall in commodity prices opens up the door to a genuine fall in short- and long-term interest rates in countries such as India, China and the Philippines (meanwhile, it is hard to imagine interest rates falling that much further in most Western countries). And, of course, lower rates will be highly supportive of Asian asset prices.

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