Looking for bubbles

Dominic McCormick | Select Investment Partners | 03 December 2013

There has been much talk about bubbles in recent months across a variety of asset classes - shares, residential property, and various aspects of debt markets, amongst others. There is certainly a fertile environment for bubbles to develop, courtesy of the great global monetary experiment being conducted by major central banks via large, ongoing buying of bonds with the aim of lowering long-term interest rates and supporting asset prices. This is bloating central bank balance sheets and leaving them with an unpredictable and likely messy "normalisation" in the future.

With so much talk and information flying around making the case for or against bubbles, it is no surprise investors are confused. Bubbles are normally defined in terms of a substantial deviation in the price of an asset over what could be justified using normal valuation metrics. However, given the lack of precision around the latter, bubbles can be a somewhat fuzzy concept - particularly while they are developing. It is often only after they have burst that their existence and trajectory becomes clear. Therefore, it makes sense to weed out as much noise as possible when trying to determine whether various asset classes are in, or vulnerable to becoming, a bubble.

A first step is to identify those people that you should largely ignore when it comes to determining bubbles - not because they are not smart, but because they have inherent biases that may influence their judgements and communications.

Top of this list is central banks, particularly their key spokesmen (or women). Greenspan didn't see the US housing bubble and the fact that Janet Yellen said recently that she doesn't think US equities are in a bubble should provide no particular comfort to investors. Central banks have a poor record of identifying bubbles and an even poorer one of acting pre-emptively to prevent them becoming larger. Reluctant to spook markets, they are unlikely to highlight bubbles even when they see one. Greenspan's "irrational exuberance" speech in 1996 is as far as central bank spokespeople tend to go. Most of their focus is on cleaning up the mess after a bubble bursts, although it could be argued that their preferred policy response - loose money - simply sets the scene for the next bubble.

Mainstream economic forecasters are another group from whom we should expect little warning about bubbles. Too much of mainstream economics is about explaining where we have been rather than where we may be going. Most economists are looking for definitive data to support their descriptions of the current economic environment. This myopic view struggles with the inherent lack of clarity and dynamic nature of bubbles.

Bank CEOs have also been quite prominent lately in talking down the existence or risk of

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bubbles. They may be right sometimes, but it is against their DNA to argue that bubbles exist. They are in the business of providing loans - margin loans, mortgages, business loans, etc - that are usually the required fuel for bubbles to develop. It is bad banking business to talk bubbles. However, keeping an eye on certain types of lending can be useful. For example, margin loans in the US are currently at record levels, which is one worrying sign.

Also to be ignored are investment commentators who point to the existence or non-existence of bubbles by reference to overly simplistic valuations metrics only. An example is the focus on current trailing year or one-year forward Price Earnings ratios (PEs). These can provide a distorted view of value at times such as during recessions (when E is cyclically depressed) or in periods when profit margins are well above normal such as now, especially in the US (thereby overstating likely future E). These should not be ignored by any means, but must be understood in proper context and complemented by a range of other measures.

So, if we ignore central bankers, economists, commercial bankers and overly simplistic investment commentators, what types of people or indicators are likely to give us an idea of whether we are in bubble territory?

Unfortunately, there is no one source you can turn to - but there are plenty of warning signs to keep an eye out for.

As suggested above, looking at a range of valuation indicators rather than just one or two is important. For example, for sharemarkets, cyclically adjusted PEs, price to book, price to sales, total equity value to GDP, etc are all useful additions to current or forward year PEs in assessing just how detached a market may have become from fundamental value.

Ironically, it is often when the most vocal “bears” partly or fully recant their bearish view that bubbles are close to peaking. The business pressure on investment organisations to conform to the crowd can be overwhelming. Thus, an increasing absence of truly bearish and outspoken views - particularly those that manage or influence significant amounts of money - is also a clear warning sign. On this note, it was interesting that well known contrarian Jeremy Grantham was recently quoted as saying the US S&P500 could rise 20% to 30% over the next one to two years - despite the view of his firm, GMO, that the S&P500 is already overvalued by more than 60%. Grantham's statement is not a complete reversal but it is indicative of the sort of capitulation from even the most prominent bears that often signals that we are close to the top of a bubble.

Often, though, the indicators are more subtle. For example, when highly disciplined, value-oriented stockpickers are struggling to find value and are building up considerable cash, this can be a sign that stocks are in a bubble. However, don't expect such views to provide clues to precise timing of a bust.

The element that often signals the end of a bubble is when new, aggressive buyers become overwhelmed by more eager sellers. That imbalance can come from exhaustion of the excessive exuberance of the buyers, or from a significant increase in the supply of eager

sellers.

Therefore, it makes sense to look for signs of excessive exuberance on the demand side, and emerging excess supply.

The increasing number of IPOs and share issues can be (and currently is, in my view) a real warning sign for stockmarkets. Listed fund structures such as listed property trusts (A-REITs) and listed investment companies (LICs) generally trading at a premium to NTA prices is another warning sign (also the case currently), particularly as this typically generates new supply. Large retail flows into equity managed funds (as seen in the US recently) is also a worrying sign. In property, an increasing number of cranes in the sky and new development is usually a warning of increasing supply for commercial property. High levels of housing starts indicate the same for residential property.

Another sign is complacency and talk of how easy it is to make money. Low volatility is often a sign of this. When it seems easy, particularly for buy and hold investors, it's usually about to become hard.

Typically, there is a particular narrative driving the bubble that is widely accepted by the investment community. The benefits may well be overstated - or at least, its underlying profit implications are. In the 1990's technology boom, the narrative was the overwhelming power and future influence of the Internet. Today, we are seeing a reprise of some elements of the tech bubble, although the dominant theme now is the beneficial impact of loose money policies of the central banks (the so-called Bernanke/Yellen put).

One area where bubbles seem more obvious currently is the world of digital currencies. The most prominent of these, Bitcoin, has risen over five times in recent months. Meanwhile, new digital currencies seem to be sprouting up daily (increasing supply). This could turn out to be the Tulip Bubble of our times.

One common view is that if there is a lot of chatter about bubbles, then they can't happen as this implies an inherent level of caution that is the antithesis of bubble behaviour. This is not my experience. Bubbles can occur even when many have identified the risks, partly because there are so many institutional and sentiment pressures to continue to participate in bubbles. I can remember a number of instances where bubbles were identified and widely discussed before they burst. In mid-1987, the Australian equity market had essentially doubled in the previous year. Many knew it wasn't sustainable and were talking about it. However, the key narrative I remember from the period was that the market would keep going in the short/medium term and would probably not peak until 1988 or 1989. That same sentiment was prevalent in the lead up to the technology bubble crashing in 2000. Everyone knew valuations were crazy but it made sense to try and participate while the party was still going. Interestingly, Google Trends shows that searches for "stock bubble" peaked in May 2007 and October 2007 - just before most stockmarkets rolled over before the Global Financial Crisis. Interestingly, we are currently getting close to (but still below) those levels.

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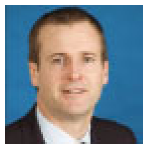
Indeed, when the prime argument being used by many to justify why an overvalued market is not a bubble is because there is too much talk about bubbles, you can bet the fundamentals are likely far from attractive.

Despite the supportive narrative of central bank liquidity and low interest rates, many investors sense that, if not in bubble territory, the recent strength of sharemarkets and some other assets is not sustainable. However, most investors feel they will have plenty of time to reduce or exit before it unwinds. If history is any guide, it will not be that easy. The rush to exit can come at any time. Today's various bubbles may not yet be fully developed and timing the precise end is impossible, but there are enough warning signs to be increasingly cautious, particularly with the US Federal Reserve under pressure to wind back their QE program. 2014 should be an interesting year.



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