Which is the next bubble?

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‘As events evolved, we recognized that, despite our suspicions, it was very difficult to definitively identify a bubble until after the fact--that is, when its bursting confirmed its existence.’, admitted Alan Greenspan in 2002, then Chairman of the Federal Reserve. It was not exactly the case with the notorious housing bubble, severely blamed for the present financial crisis of 2007-2010. Pundits warned against the skyrocketing prices of real estate long before the market crashed. But it did happen after all.

So how do you recognise the ‘bubble phenomenon’? Simply called ‘bubble’ by most, it would be more precise to name it ‘asset-price hyperinflation’, loosened at a certain stage of the market development. The herd behavior of market participants causes the majority of them to fall in the trap of unchecked prices and clouds their sober judgement. Only a few are able to escape the bubble`s clutch – they are usually the first to recognise the rising opportunity in the market but are also the first to spot the menace and manage to escape just before the Big Bang sweeps any gains away. Hence, if Alan Greenspan and his advisors wanted to corner a rising bubble with its back to the wall, they should be looking for a surge of investors greedily rushing onto an asset market to reap the profits, thus driving prices to unforeseen heights.

Bubbles, some claim, are neither good nor bad – they are simply a normal market reaction to freely available funding or lack of such. Are they? Money does not vanish into thin air and the leftovers of the housing bubble need to be invested somewhere. So yes, to some extend it does come down to transferring funds from one market to another. Just like the energy in the nature does not disappear free funds find their destined place into the economy. But a bubble is equivalent to volatility – prices are volatile as one cannot predict when the pressure will explode and hence, investing plans become risky, too.

Probably the only encouraging news to alert investors is the intensity with which bubbles arise and subside. If such events were once a rarity and enough time passed before assets in another market started inflating, nowadays we constantly witness an economic frenzy: the old bubble has not deflated yet and a new one starts growing. The most recent example would be the dot-com bubble with its peak in 2000 when market participants ignorantly overlooked signs of market fundamentals and the boosted confidence in companies` stocks. The market crash unleashed funds to be poured into real estate. People ended up trading housing at artificially increased prices. Not that they did not know it, they were completely aware but the prospect for profit blurred their clear judgement. Where are funds heading for now? It is a question that disturbs the sleep of many investors and economic advisors. One thing is sure, though – the next bubble should be large enough to recover the losses from the previous.

Even though in the beginning Alan Greenspan claimed that it is almost impossible to spot a bubble before it bursts out, the imminent question troubles the sleep of his consultants also. Being a private advisor now after he retired from the FED, Mr. Greenspan has filed 4 folders on the desk of one of his advisors, all presenting possible scenarios of how the 'new-bubble-story' would develop.

Before opening any of the folders he rearranges the preconditions for a bubble to emerge in his mind. The first unwritten rule is to look for the signs of financial madness that is going to cause asset-price hyperinflation. Feverishly seeking for a market where to inject their funds, investors should be flocking to the market in question. Next desirable condition is easy access to funds or credits that would allow people to raise enough capital and redirect it to the new market. The advisor knows that the industry where the bubble is about to form must support thousands of firms ensured by securities the Wall Street will create and sell to give credibility to the whole chain of transactions, much as it did after World War II when helping firms to turn wartime inventions (among which refrigeration and radio) into consumer goods. Furthermore, the sector where the bubble will arise must be forming and steadily growing even as the previous (in our case the housing bubble or more strictly speaking, the subprime mortgage crisis resulting from it) deflates. The advisors` economist intuition whispers that investors would more willingly direct to sectors with favourable legislation, offering special tax treatment like tax exemption. Last but not least, an appealing story must be created to attract funds from ordinary people, too. The market where the new bubble would emerge must be well-known, advertised by financiers and politicians, flattered by the media.

The first folder the consultant opens is the bulkiest also: there is a lot of evidence for this 'would-be-bubble' obviously. The heading gazing from the first page of the report is 'BONDS'. If in the late 1990s tech stocks were all the rage, then in mid 2000s it was real estate, now funds are flowing to bond markets. It seems logical, as bonds are more predictable than stocks and less risky, too. In 2009 bonds proved a good investment with some deals amounting to 15 % yields (a staggering height). How did the market end up with enough bonds at hand? The financial crisis forced hedge funds and other financial institutions in late 2008 in need of liquidity to sell bonds in order to raise cash. This caused prices to fall, but as interest rates are inversely related, the latter rose. Bond investors dipped into the pool. The lure of bonds to people lies in their seemingly risk-free nature: so long as the FED keeps rates low, people will become complacent. The less risk-averse could invest in junk bonds that generated abnormally high profits for months. The short-term gains were a bliss and profitchasing enhanced the herd behavior. The bond market expanded, investment in it was openly recommended by experts and ordinary people had the opportunity to direct their funds there. Thanks to bonds fund companies did not fall behind in profitability, as brokers earn a commission in the range of 1-1.5% (more than stocks gain) for each bonds they sell no matter if it makes or loses money.

Up to now the bonds market seems the perfect candidate to house a bubble under its roof: popular even to the public, witnessing herds of investors attracted by invitingly high profits (both for companies and investors), offering low risk levels. Too good to be true, though, as bonds hide some traps. Not as risk free as they seem. People are lured by the thought that Treasury bonds have no risk, as the state can always print more money to pay bond holders. True to some extent as inflation may eat up bond returns, as fixed-income payments are not adjusted to inflation. Moreover, the US economy, showing signs of recovery, will give the FED grounds to raise rates. This may send investors back to the stock market.

Corporate bonds of prospective companies are offering between 7 and 10 % on their 10-year bonds. The corporations in question like PepsiCo and Johnson & Johnson though highly rated by experts, may easily default – a risk that always accompanies corporate bonds. More promising look municipal bonds. The last prominent default dates back to 1994 in Orange County, California. The tax exemptions make them more desired, although all investors should bear in mind that unlike the government, municipal authorities cannot print money to prevent default. The lower state tax revenue often used to finance them presents another worry for holders. Despite the risks the bonds market combines all characteristics of a newly forming bubble.

The next folder on the advisor`s desk says 'GOLD'. The precious metal fulfills most conditions to be the base for the next economic craze. The financial crisis threw people in search of a trustworthy enough investment that is protected against the whims of the global economy. Gold has no valuation issues as it is merely held as store of value – it could be worth whatever people want it to be worth. Experienced investors can sniff the imminent return of inflation as the US economy slowly recovers and gold is a good trump against it. On top of that, advertisements in Britain are persuasively whispering 'bullion, bullion' to add up to gold`s image as the next asset hype.

The availability of credits is arguable as banks tightened lending but simultaneously the loss of trust in the banking system redirected people to other assets (being stock, bonds, precious metals, etc.). The subprime mortgage crisis caused the collapse of the Lehman Brothers giant in 2008, which loosened crowds of ordinary Americans to purchase gold coins. The skyrocketing demand dragged prices up in 2009, expressing people`s preference to it instead of currencies for instance. Gold`s long-term track record in the USA has been inconsistent, as people view it as a last resort against persistent increases in price, and back off as they wane away. Not surprising, of course, since inflation eats up dollar`s purchasing power.

The intensive demand creates problems with the physical existence and delivery of the commodity, though. The Mint barely manages to strike enough coins to answer the market. People sometimes have to wait for weeks to receive the yearned yellow glittery chunk. As bonds turned profitable for brokers and funds, so does gold to wholesalers. The Mint does not raise prices but wholesalers are able to increase the charge to dealers, thus benefiting from the rising demand in combination to the restricted supply elasticity.

Having in mind gold`s ups and downs in its history it probably seems too conservative attraction as compared to bonds. As already proven the latter are riskier but at present yields are offsetting this disadvantage. Additionally, gold may have no valuation issues, which expressed in other words means it brings no yield. It is simply a shield against inflation.

Folder No. 3 presents the insights to a CNBC poll as to 'What will be the next bubble to burst?'. The gold medal goes to Treasury bonds and the runner-up is more real estate. How is this possible someone may ask – the housing bubble to mutate into more real estate? The answer is that bubbles are smart; otherwise it would not be that difficult to spot them. The housing bubble may re-disguise itself into a commercial real estate one. The problem is obviously chronic for the US economy as shopping center mortgages financed on low rates are predicted to fail.

The spotlights at present are directed to bonds and gold as culprits for forming bubbles. The most data in terms of quantity and quality supports their leading positions. A tick can be put next to almost all preconditions necessary to start inflating a bubble. Still, to give credit to some other exotic suggestions, a fourth folder was assembled. The data inside could well be named 'Miscellaneous' as in quest for ideas far beyond the obvious experts suggested bubbles to be forming in the field of…mergers. Yes, KraftFoods jumped on Cadbury, Dell took over Perot Systems but is does not mean something big is going to hit us. Indeed, stories of mergers have always amused both the business world and ordinary people. The availability of funds is the crack in the theory. In the current economic environment mergers are probably one of the few profitable and sane things to do but at the end it all comes down to cutting back on costs – lay off staff, reduce administrative costs, reshape the company and hopefully you would be awarded with the future gains. Before the sign 'Just merged' could be proudly put and before speeding up to make business, an attractive bid should be made. The credit crunch would discourage loan applications but if the initiating company has a favourable balance sheet, it could acquire funds through the old well-known bond markets. Which leads us back to the more credible candidate for the next bubble. A merger boom scored fewer points than bonds and gold because it is not accompanied by the uncontrollable surge in prices typical for assets. KraftFoods` original bid was about \$16.7 billion and the acquiring deal is worth \$19 billion – it is an increase undertaken after careful consideration, hours of counseling and research. The minds of market participants could not be blurred by abnormal profits as the decision for a merger is not equivalent in terms of consequences to the purchase of bonds or bullions for instance.

The next pick from the 'Miscellaneous' folder is alternative energy. The increasing dependency of the USA on foreign energy supplies forces the search for non-oil energy sources. Varying from solar panels to biofuels, anything that promises to take the shackles off the US economy in terms of energy supplies is welcomed. The industry of alternative energy production has long been claimed to have bright future. It is also an industry that requires intensive investment and being exactly in between practical and science-oriented, it carries the burden of scientific insecurity. In other words, as often happens in science, it gulps down a lot of money but the result is not always the expected. Every now and then a major breakthrough makes up for the previous few cases of unsuccessful researches. Still, such cases combined with the worrying environmental issues seem to be credible enough to praise alternative energy into the eyes of society. A further support of this view is the favourable legislation and government support presented to firms engaging in this field. These exemptions are countered by the relative riskiness of the undertaking and the long-term view of reaping any benefits. It has all chances to attract (and it is attracting, in practice) investors, it receives open publicity from the media and pressure groups; has government support but remaining a mainly scientific field, it has kept its sanity still. Lastly, it probably deviates from the standard definition of 'asset bubble', at least to the extent that energy could be viewed as an asset.
(N.B. Indirectly, alternative energy has created environmental market stocks – stock prices of companies 'trading' renewable energy or carbon emissions are cautiously scrutinised.)

Seeing the above side note the advisor shakes head: 'Carbon trading – the next bubble?' sounds like a heading from today`s broadsheet. Leaving these bold predictions behind, one question remains unanswered – the access to funds as a necessary condition for a bubble to form. The credit crisis crunch may have tightened the regulations for lending but it has not wiped out access to funds or the ability to raise them. The simplest proof roots from ordinary people as viewed by the US Conference Board. The Consumer Confidence Index rose from 53.6 in December to 55.9 in January. Meanwhile, the Fed raised discount rates unexpectedly early (a rise was planned not before November 2010), thus scaring a bit investors. Even though this is a straightforward signal for the recovering US economy, interest rates are anticipated to remain low, aiming to build up consumer confidence.

The most serious candidates for the next bubble are bonds and gold, as they match the abovementioned criteria used to recognise them. It is now very much up to the participants` reaction and judgement – whether they will blindly jump onto these assets and again, few will be those who will strike the right time to go out of the market before the bubble pops. The worst course of action advisors and investors could take would be to wait for the bubble to explode to confirm its existence. The devastation from such (non-)actions would mean we have learned nothing from what economy`s rollercoaster have taught us.

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