

Bubbles always burst, eventually

By Vern Gowdie, The Daily Reckoning, 16 March 2017

The Dow Jones is up. The Aussie dollar is stronger. Gold has recovered.

Why?

The Wall Street Journal reports:

‘Consumers should feel pretty good about the Fed raising rates, Ms. Yellen said. “The simple message is, the economy is doing well,” she said. The Fed feels confident about the economy and its ability to withstand shocks.’

With those reassuring words from Federal Reserve chair Janet Yellen, the Fed gave the nod to increase official US interest rates by a 0.25%, taking the cash rate to a range of 0.75–1.0%.

Forgive me if I take Janet’s outlook with a grain of salt. Here’s what she said on 22 January 2017:

‘While the decline in housing activity has been significant and will probably continue for a while longer, I think concerns we used to hear about the possibility of a devastating collapse — one that might be big enough to cause a recession in the U.S. economy — have been largely allayed.’

The Fed is using the same tried and failed formula it’s relied on previously to stimulate the economy...and, this time, it’s miraculously predicting a different outcome.

Yellen probably believes what she says. After all, she lives in a little bubble of Keynesian PhD groupthink that uses flawed models to make their predictions. What could possibly go wrong?

Housing bubble? What housing bubble?

So, what is the truth?

Will the Dow Jones continue rising to 30,000 points and beyond, OR will it come crashing down?

Are interest rates going higher OR lower?

Is the property market — mainly in Sydney and Melbourne — still good long-term value, or does it represent a bubble in search of a pin?

On that last point, Treasurer Scott Morrison, in an interview with Bloomberg on 13 March 2017, was adamant that there's no housing bubble:

'Overall, the household debt position is predominantly, about 80 per cent of it, is around mortgage debt, and in Australia our prices may be high, particularly in Sydney and Melbourne, but they're real. The issue in housing affordability and housing prices in Australia is the mismatch between supply and demand.'

'It's not the function of any sort of investor credit bubble or anything like this. They're real prices, they're real values, and what we're working as a Government to do is put downward pressure on those rising prices by addressing the supply challenges that are out there and working with state governments to achieve that.'

Scott, here's a very quick lesson in how markets function: *They're real prices; they're real values...until they're not.*

In 1637, people bought tulips in the belief that the prices were *real* and that tulips had *real* value.

The same goes for those who bought shares in the Mississippi Company and the South Sea Company in 1720...and stocks in 1929...and Japan's miracle economy...and the dotcom mania...and the lossmaking tech companies in 2017 (sorry, that last one hasn't happened yet).

In every single case, people thought they were *real prices* and *real values*...until the market decided to reprice and revalue the [insert the asset here].

That's how markets work. They inhale and exhale. Real prices and real values are not set in stone. They are a fluid concept...influenced primarily by interest rates and economic activity.

History tends to rhyme

If we woke up tomorrow and interest rates were 10% — and Australians decided to save more, spend less and pay down debts — what do you think would happen? Do you think house prices would rise or fall? Would share prices rise or fall?

My money would be on a downward revaluation and repricing of these assets.

Defining the 'truth' is not easy when there are so many vested interests — like a Treasurer not wanting to spook a market or, even more worryingly, who does not have a clue as to how markets function — and no two situations being an exact replica of the past.

Which is why history tends to rhyme, rather than repeat.

Historically, asset prices are determined by comparisons to 10-year government bond rates.

Interest rates are the benchmark from which all other asset classes are valued. Why else do you think central banks want to have absolute power over interest rates? They know the monopoly on interest-rate pricing gives them control to create the 'wealth effect'.

By suppressing interest rates to historically low levels, central banks have forced yield-hungry investors to place *un-real* prices and *un-real* values on property and stocks.

These prices and values will only stay at these levels on the proviso that there's not a significant increase in interest rates and/or economic activity is maintained.

Any nasty disruption to either component (or both) of this pricing equation, and we'll see how the *real* markets operate.

As Søren Aabye Kierkegaard, a 19th-century Danish philosopher elegantly noted: *'There are two ways to be fooled. One is to believe what isn't true; the other is to refuse to believe what is true.'*

What Morrison said is simply not true. Addressing the supply challenges is nothing but a diversion.

Don't be fooled.

If you want to stop rising property prices in their tracks, increase interest rates.

But no one in authority, or who is profiting from the boom, dares to mention the elephant in the room.

The RBA created this bubble by lowering rates to 'accommodate' growth (which is code for higher levels of borrowing). The government needed the 'debt binge growth' to generate tax revenues. The banks welcomed the lending frenzy with open loan books, boosting earnings and, not inconsequentially, triggering executive share-bonus plans. Developers and real estate agents are definitely not going to sink their pearly whites into the hand that's been feeding them so generously.

If you're looking to the people holding the smoking guns over the bullet-ridden corpse to offer up any truth or admit guilt, take it from me, you're wasting your time.

An admission of failure to see the obvious only ever comes with hindsight.

That's just human nature. Greed, fear and 'it wasn't me'.

In the midst of a bubble, all sorts of reasons are given to validate why 'it's different this time'. It never is.

The Australian property market is only one of the bubbles that's been created by the officially-sanctioned 'wealth-effect' policy.

Ultra-low interest rates and excessive levels of liquidity have driven shares, bonds and property values to levels that are off the historical grid.

In the past, what went up had to come down.

Perhaps the laws of gravity and reversion to the mean have been repealed by central banks' wizardry with interest rates and money creation.

But these laws have stood the test of time for centuries. Whereas central bankers holding sway over market pricing is a recent phenomenon.

How has that worked out in the past?

The dotcom bubble — a mere pimple — ended up busting. The housing bubble — a boil by comparison — went bust with ugly consequences.

Is the current market a bubble OR will that line on the right-hand side keep soaring higher and higher?

In keeping with the unsightly skin condition analogies, my diagnosis is that we have a market tumour on our hands. When this one blows, you do not want to be in close vicinity.

While history may not repeat itself identically, human nature is fairly predictable.

The following chart tracks the New York Stock Exchange margin debt (red line) with the performance of the S&P 500 index, adjusted for inflation. An apples to apples comparison.

As sure as night follows day, when the market is building to a climax, investors take on debt to participate in the booming market — greed. When the market suffers a downturn, debt levels also plummet — fear.

The pattern is a 'rinse and repeat' cycle.

This time, however, in real terms, the market and debt levels are higher than they were during the two previous bubbles. One would think that, based on history, this is an ominous sign.

Perhaps Einstein was wrong; maybe you can do the same thing over and over again and get a different result.

Perhaps *they're real values and real prices* backed by *real* fundamentals and not supported by greedy investors using borrowed dollars.

Perhaps adding US\$60 trillion more debt to the system that nearly collapsed from too much debt in 2008 has made the world a more stable place.

Or perhaps it is not different this time at all and the era of central bankers playing God is coming to an earthshattering end.

The truth I've chosen to believe is backed by history.

Booms always bust.

Credit crises end badly.

Debt accumulation does not continue indefinitely.

Asset values do not expand continuously.

The longer the deception continues, the greater the number of people that will be fooled into believing these false prophets.

In the end, the *real* truth always wins out.

Regards,

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