THE AUSTRALIAN,
WEDNESDAY, JANUARY 13, 2021
theaustralian.com.au/businessreview

BUBBLE WILL BURST SOME DAY

13.1.21. THE AUSTRALIAN

The longer the boom, the greater chance of a fall

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It is 92 years since Irving Fisher, the eminent American economist, uttered what turned out to be some of the silliest words in stockmarket history. Share prices, the great Yale professor opined, had "reached what looks like a permanently high plateau". Nine days later Wall Street crashed.

You don't have to see many parallels with October 1929 to be a little unnerved by the unreality of the world's sharemarkets today. Every item of bad news is greeted as good news because it shortens the odds on yet more money-printing and fiscal stimulus, while every item of good news is greeted as, well, good news.

Wall Street ended last week at an all-time high on a day of disappointing news on jobs and only two days after a Trump-supporting mob had invaded the Capitol. The Nikkei hit a 30-year high last week even as a state of emergency was declared for Tokyo. London's FTSE 100 clocked up a 6 per cent boost last week at a time when COVID-19-related deaths and cases went through the roof and all the talk was of further restrictions.

It's the function of efficient markets to peer through the smoke of present-day conflagrations and reflect longer-term prospects. And it's true that vaccines should bring this economic slump to an end very quickly. Even so, it is not surprising that some old market hands are saying things have got too frothy.

Jeremy Grantham, co-founder of GMO, the American fund manager, argued eloquently last week that we are now in "a fully fledged epic bubble". He told his clients: "Featuring extreme overvaluation, explosive price increases, frenzied issuance and hysterically speculative investor behaviour, I believe this (period) will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929 and 2000." He pointed to the flurry of blank-cheque companies, the wave of novice stockmarket investors trying their luck and, of course, the elevated price-to-earnings ratios as evidence of a boom that ineluctably will turn to bust.

Some elements of the argument were more convincing than others. The way in which the investment industry is institutionally biased towards the upside is undeniable. Better to risk failing conventionally, by joining the crowd and continuing to feed cash into risk assets, than to stand by and risk looking a fool if prices go on rising. The last senior professional to refuse to accept the bull case was Tony Dye at UBS Phillips & Drew, who famously was sacked in February 2000, even as the tech bubble was bursting, vindicating him.

Grantham's other red flag is what he calls a rising hostility to bears. That may be true on Wall Street, but it is less evident in the City. Many fund managers are reluctant bulls. They can see perfectly well that there is a "sell" case, but don't know where else to put the money when real interest rates are negative. They are prisoners of the Tina mantra: There Is No Alternative. Or these days, an even more desperate-sounding Katrina: Keep Asset-buying, There Really Is No Alternative.

That partly explains the bitcoin boom. Yes, this is partly driven by inexperienced small traders seduced by the momentum — but

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there are increasing numbers of professional investors backing the cryptocurrency, seeking a haven from a coming inflation threat, so concerned are they by the scale of money-creation by central banks. At least bitcoin, for all its drawbacks, has built-in scarcity, with a maximum possible issuance of 21 million coins, something that emphatically can't be said of dollars or euros or pounds.

The case against the bubble theory is that we are in a completely different financial landscape. Interest rates can and will remain at or close to zero for years, if not decades. Demographics, the plentiful supply of savings and regulation that makes forced buyers of government bonds should all help to keep market interest rates low, never mind the deliberate actions of central banks. It's perfectly logical, it is argued, that the prices of risky assets have risen so far, so fast because we are using a much lower discount rate to value all future returns.

Even if investors suspect that this is a bubble, it's hard to escape it. One of Wall Street's favoured sayings is "don't bet against the Fed"; and certainly don't bet against the Fed plus the US Treasury, which in the Biden era is set to augment the monetary stimulus with a fiscal adrenalin shot. In Britain a similar joint policy mix is likely from the Bank of England and the Treasury.

Even with hindsight, it is difficult to identify the precise pin that bursts a bubble. Grantham argues that this time it may simply be a view that market conditions today are a tiny bit less favourable than they were yesterday. Certainly, the smallest, gentlest, subtlest hint that central banks are starting to think about how to go about tightening policy could be received very badly: the so-called taper tantrums of 2013, when the Fed began signalling the withdrawal of quantitative easing, were enough to send US Treasury yields sharply higher. Treasury yields have been pushing higher in the past week.

Perhaps, Grantham suggests, the peak for sharemarkets will be the day the market agrees that the pandemic has been defeated. "Market participants will breathe a sigh of relief, look around and immediately realise that the economy is still in poor shape, stimulus will shortly be cut back and valuations are absurd."

The longer the present spell of supernormal equity price growth persists, the greater the chance of a sharp and nasty reversal. Fisher's vision of a permanent plateau was bonkers 92 years ago and just as bonkers now. Markets just don't behave like that.

THE TIMES