The Economist

Asset prices

Not fully inflated

Many investments are becoming expensive. But there is little sign of the mania that accompanies most bubbles

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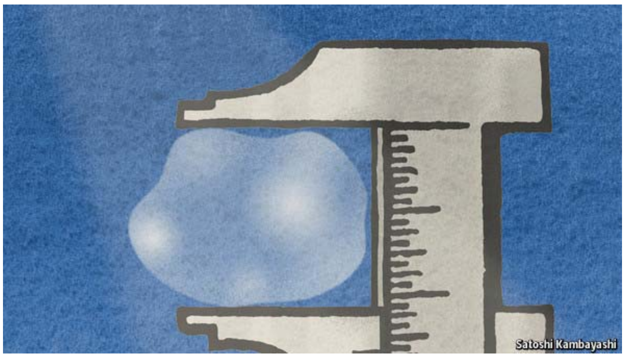
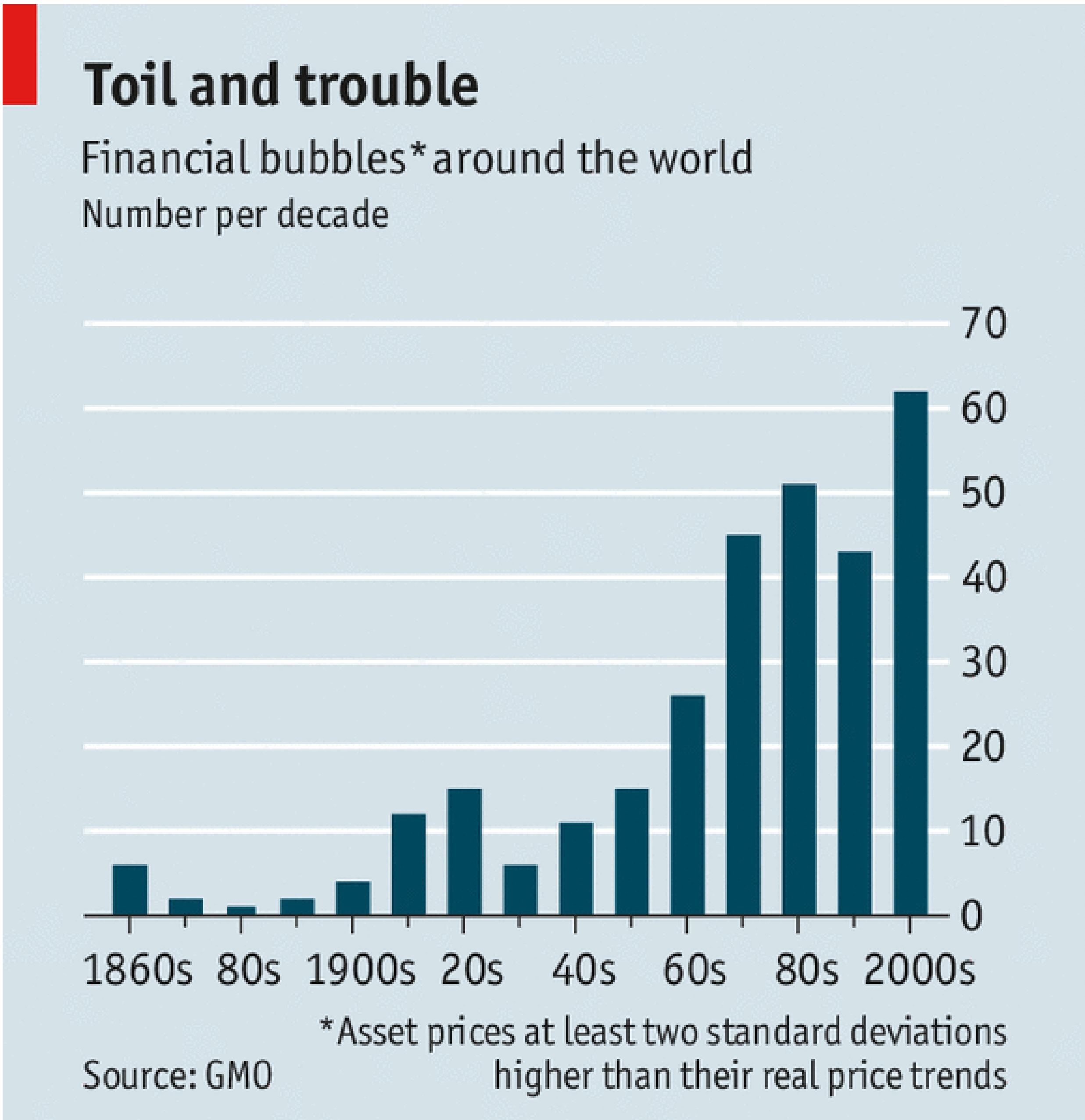


TALK of bubbles is in the air again. The Dow Jones Industrial Average has hit an all-time high. A loss-making technology firm (Twitter) has floated its shares on a flood of investor demand. Private-equity groups are buying companies using amounts of debt not seen since 2008. A record price (more than \$50m) has just been set for a penthouse in Manhattan. A triptych by Francis Bacon became the most expensive piece of art sold at an auction when Christie's flogged it for \$142.4m last month. Robert Shiller of Yale University, who correctly identified bubbles in tech stocks in the late 1990s and in property in the 2000s, has expressed unease about giddy American share valuations.

All this suggests that wealthy investors have become increasingly confident. The question is whether they are right to be. Under certain circumstances, fast-rising asset prices are justified. New industries can emerge and create corporate giants (Microsoft, Apple and Google, for example); countries can change their economic policy and grow rapidly (Japan in the 1960s, China in the 1990s). How, then, do you tell a bull market from a bubble?

Mr Shiller describes a bubble as "a psycho-economic phenomenon. It's like a mental illness. It is marked by excessive enthusiasm, participation of the news media and feelings of regret among people who weren't in the bubble." They are often enlarged by an expansion of credit. But establishing an objective definition is hard. For GMO, a fund-management group, a bubble is an increase in the price of an asset of more than two standard deviations above the trend, taking inflation into account.

Using that standard, GMO has identified 330 bubbles between 1720 and 2010. They have become much more frequent in recent decades (see chart). That is partly due to there being more markets to analyse these days. But it is probably also a reflection of the explosion in global capital flows that followed the collapse of the Bretton Woods system of fixed exchange



rates in the early 1970s. It is hardly surprising to find that more bubbles have been inflated as investors have rushed round the globe in search of the next big thing.

Many economists have struggled to accept that bubbles exist, as that is difficult to square with the idea of efficient markets. If assets are obviously overpriced, why don't smart investors take advantage and sell? Edward Chancellor of GMO argues that investors can find it hard to arbitrage away a bubble. Manias can last much longer than investors think, as many contrarians discovered to their cost during the dotcom boom of the late 1990s. Nor do investors know whether a bubble will be resolved through a sharp fall in prices or a long period of stasis, in which inflation erodes prices in real terms (something that happened to British houses in the 1970s).

Dimitri Vayanos and Paul Woolley of the London School of Economics have suggested that problems of agency contribute to bubbles. Investors do not buy shares directly but hire fund managers to do it on their behalf. They tend to select managers who have performed well in prior years. As the managers receive cash from new clients, they buy their favourite stocks which, by definition, will have performed well—witness the enormous sums flowing into tech funds in the late 1990s. The favoured stocks get driven even higher.

Property bubbles also have a self-reinforcing element. Most properties are bought with money borrowed from banks. When prices are rising, banks are more confident about lending money; the greater availability of credit means that borrowers can afford higher prices, and so on. Conversely, of course, when banks become unwilling to lend more money, prices can collapse.

Many commentators believe current monetary policy may be encouraging bubbles to form (see Free exchange). Nominal interest rates in much of the developed world are close to zero, and central banks have been buying bonds through the policy of quantitative easing. The intention is to reduce yields on the safest assets and so encourage investors to buy riskier ones, reducing financing costs for companies and boosting economic confidence through the wealth effect.

Low interest rates may also persuade some investors that risky assets are worth more. If one lowers the rate at which future cashflows are discounted, then the present value of an asset rises. But that is only if other things stay equal. Central banks have adopted their current monetary policy because they worry that the outlook for economic growth has deteriorated; if they are right, then investors should be reducing their estimates for the cashflows they will receive from dividends, rents, etc.

That may leave markets exposed to two risks: that the income from assets does not rise as quickly as investors hope and that capital values decline sharply if monetary policy changes. In its latest report on financial stability, the Bank of England acknowledges that monetary policy has had spillover effects. “Large capital flows into emerging economies have enabled credit levels in these countries to rise sharply,” it states. Emerging markets wobbled this summer when the Federal Reserve spoke of scaling back its monetary stimulus.

Looking back over five years, it is worth reflecting that markets have rebounded from some huge falls in 2008 and early 2009. Investors’ returns over the last 15 years have not been great. But there are a number of markets that look overvalued on an historical basis. American equities are trading at a cyclically-adjusted price-earnings ratio of 25, according to Mr Shiller. This is much higher than the historic average of 16.5 but below the levels reached in the great peaks of 1929 and 2000. Corporate profits are also at their highest level relative to GDP since the second world war, suggesting further growth is unlikely.

Mr Shiller is not yet ready to declare a bubble in American equities, however. There is nothing like the same excitement about shares that was seen in the late 1990s; net flows into mutual funds only just turned positive this year. Another measure of public indifference is that CNBC, a television station that tracks the financial markets, suffered its lowest ratings since 2005 in the third quarter.

Some would put government bonds into the bubble category: last year, yields in some markets reached the lowest levels on record. Buying bonds when yields are less than 2% has in the past led to heavy losses. Again, however, debt markets do not look too frothy by other measures. There is little talk at dinner parties of the massive profits to be earned on sovereign bonds. The biggest buyers have been central banks; there may be a problem when they try to unwind their purchases, but that moment does not look imminent.

The Economist's house-price indicators suggest that property in New Zealand, Canada and Australia is substantially overvalued (and GMO sees clear signs of bubbles in British and Swedish house prices). But Hong Kong is the only overvalued market where prices are still surging ahead—by almost 20% over the past year.

The Japanese stockmarket is up 51% so far this year (in yen terms), but that constitutes little more than a recovery after nearly a quarter-century of disappointment. Venezuelan equities are up more than fivefold this year (and 273% in dollar terms) but that is not a market many international investors are excited about.

When it comes to collectables like art and fine wine, high prices may simply reflect inequality in the developed world. Throughout history, the rich have liked to demonstrate their status by displaying luxury goods that their inferiors are unable to afford. An Old Master can add real va-va-voom to your Manhattan penthouse.

The asset with a price trajectory most like a satellite launch—until a slump on December 5th — is Bitcoin, an electronic currency. The news media had excitedly chronicled its ascent. Those buying faddish financial instruments without intrinsic value may do well to remember the adage "Up like a rocket, down like a stick."

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