Do Bubbles Predict Or Project?

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What next for the now-stalled equity rally?

With the second quarter data season now in full swing, the rebound in equity prices that followed the Covid-19 panic seems to have stalled. This was always to be expected (see **Time To Run With The Herd?**). Predictably pessimistic corporate guidance and dire economic data are forcing investors to reassess hopes of a V-shaped recovery based on projecting into the future the rebound in high frequency indicators that was inevitable after the lifting of Covid lockdowns. So, what happens now? Will markets balk at the hurdle of terrible earnings and grim data? Or will bulls charge through these obstacles, pushing momentum-driven equities to ever more vertiginous highs?

Following the herd has a certain evolutionary logic

A month ago, I wrote an article about herd instinct (see **Five Features Of Market Madness**) which started with the famous aphorism credited to Keynes: "The market can remain irrational much longer than you can remain solvent." However, I went on to note that herd behavior is not necessarily irrational. Herd instinct is an instinct because millions of years of evolution have made it a formidable mechanism for survival. If you are a wildebeest running away from lions, running with all the other wildebeest is a much better survival strategy than expressing your individuality by taking a contrarian course.

For those of us struggling for survival in financial markets, a learning experience equivalent to the ruminant stampede in the Serengeti was the dot-com bubble of 1998-99. In the month since I wrote those comments, the Nasdaq Composite has hit new all-time records almost daily, Tesla shares have exploded by 50% and companies such as Netflix and Nvidia have risen by 15% or more. On the other hand, most non-tech equities have merely drifted, with the spectacular exception of shares in China, where the MSCI index shot up by 15% this month before correcting by -5%.

Intellectually, I am convinced that soaring share prices bear no relation to the financial prospects of Tesla, Netflix, Peleton, Nvidia and many other cyclical consumer companies that are currently identified as economically invulnerable tech stocks. Most of these Nasdaq supernovas are loss-making or modestly profitable businesses that operate in very competitive markets characterized by low profit margins, with no hope of the natural monopolies or network advantages enjoyed by Facebook, Google or Amazon.

Momentum investing is perfectly reasonable, as long as we can recognize bubbles and get out before they burst

Does this mean that investors are necessarily irrational when they buy these stocks? Maybe not. Momentum is a powerful force in financial markets, and being a momentum investor is a perfectly reasonable strategy, as long as we recognize a bubble when it is forming and prepare to get out before it bursts.

So, if stock markets today are in the early stages of a speculative bubble, how can we try to judge whether the risks of this speculation outweigh the potential rewards? Louis offered three possible reasons why economic reality and stock market behavior may be diverging in a series of brilliant

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Louis proposed three explanations why economic reality and equity markets seem to have diverged...

(and entertaining) articles this month (see **The Consequences Of 'Worthless Cash'**): markets may be sensing a faster return to economic normality than the gloomy conventional wisdom among policymakers and economists. Alternatively, investors could be hedging against future inflation, as central banks and governments throw caution to the wind and abandon all monetary and fiscal rules. Finally, investors could simply be succumbing to mindless herd instinct.

...I propose a fourth

In my view, there is another, potentially more positive, way of thinking about Louis' last two explanations, which will become increasingly relevant if equities resume their upward trajectory in the weeks ahead. Instead of treating herd behavior as irrational and the signs of an economic regime change as reasons for caution, perhaps we should ask whether one or both of these phenomena will become the new bull market's sustainable driving force.

The useful taxonomy of bubbles proposed by Louis was based on the twin contrast between scarcity bubbles versus efficiency bubbles and between bubbles financed by commercial banking systems versus bubbles financed by governments and central banks. I would suggest that another dichotomy could be even more important: the difference between bubbles that predict the future and bubbles that simply extrapolate the past.

Which brings me to another way of looking at the three possible bubbles now developing in the financial markets: in Nasdaq, in Chinese equities and, most egregiously, in government bonds. To explain what I mean, let us return to the observation that seemingly crazy herd behavior can turn out to be perfectly rational at a deeper level.

Almost all big financial speculations have been either forward-looking or backward-looking

Almost all big financial speculations, however apparently deluded, turn out to reflect some kind of deep transformation in economic or political reality—and these structural changes are usually much more important, in hindsight, than the financial gains or losses they incidentally create. Crucially, however, the revolutions that inspire speculators are not always in the future. Quite often, financial speculators who think they are predicting the future are over-confidently extrapolating a revolution that has already happened and may actually be in its death throes by the time the market bubble forms.

In my professional experience, which started in the late 1970s, there have been spectacular cases of both forward-looking predictive bubbles and the backward-looking extrapolative type. The 1998 to 2000 dot-com bubble was clearly a forward-looking speculation that anticipated the enormous technological and social changes from unlimited connectivity and computing power. Another predictive bubble was the surge in equity prices that preceded the 1987 Wall Street crash. This stock market boom anticipated a defeat of inflation and reversal of interest rates that turned out to be far more decisive and enduring than anyone at the time imagined possible. Of course, predictive bubbles often get their predictions wrong, for example the cryptocurrency craze of 2017.

By contrast, the mania for Japanese assets in the late 1980s had nothing to do with the future. This bubble was all about extrapolating the trends of the previous decade, in which Japanese business methods appeared to conquer

the world. Similarly, the speculation in bank stocks and mortgages that triggered the 2008 global financial crisis projected into an imagined future some unsustainable long-established trends. The same was true of the oil booms of 1980 and 2014.

History is rife with examples of speculations that anticipated the future, or projected the past

Looking back through history, the famous speculations of the early capitalist era can be schematically divided between those that anticipated the future and those that projected the past. Tulipomania was perhaps the weirdest financial bubble ever, yet the mad prices paid for tulip bulbs in 1637 reflected, albeit in a bizarrely distorting fairground mirror, the astonishing upsurge of wealth in Holland based on enormous shifts in global economics and politics that were only just beginning as the center of gravity of global commerce moved to the North Sea from the Mediterranean and Protestant competitive individualism prevailed over Catholic hierarchical centralization.

The City of London's South Sea Bubble of 1720 can also be seen in retrospect as a forward-looking speculation, foreshadowing the British control over the trans-Atlantic commerce previously dominated by Spain. The Mississippi Bubble that simultaneously gripped Paris, by contrast, was as a backward-looking speculation which wrongly projected the previous century's French ascendancy in Europe into a dominance of trans-Atlantic trade routes that France failed to sustain. While the cleansing of British finance after the South Sea bubble confirmed the Bank of England as the world's most reliable financial institution, the collapse of the French Mississippi Company precipitated a collapse of government finances that sowed the seeds of the French Revolution in 1789.

Perhaps we should consider what we see today as three different markets: the Nasdaq, Chinese equities and G7 government bonds

What has this simplified and stylized history got to do with investment conditions today? Maybe that we should not focus on a generalized asset-price bubble in the wake of the Covid crisis, but instead consider the three distinct speculations that have developed in three different markets—Nasdaq, China and G7 government bonds—and ask this question about each case: are investors anticipating some profound new change that is about to transform the world economy? Or is this a speculation that extrapolates trends that are already well established and maybe about to reverse?

If what is happening today is an extrapolative bubble, then the medium-term investment implications are dangerous. If, on the other hand, investors are anticipating some kind of genuine regime change, then "no price is too high" could be a reasonable investment view about some of the businesses that stand to benefit from the new regime, even if many such companies eventually fall by the wayside, as the dot-com stocks did after their 1998-2000 boom.

So, are the assets that seem to be in bubbles today extrapolating the past or trying to predict the future? If we ask this question about each of the three asset classes now arguably in bubble conditions, we get very different answers.

G7 government bonds are obviously in a backward-looking bubble

Starting with the clearest case, G7 government bonds are obviously in a backward-looking extrapolative bubble. Long-term interest rates would be nowhere near their present levels if it were not for central bank intervention and financial repression through regulations that force financial institutions to hold vast amounts of "risk-free" assets guaranteed to produce negative real rates of return. The belief that conditions like this will continue for decades

into the future is obviously just a straight-line projection of past events. This naive extrapolation, even more than the Japanese speculation of the 1980s, will end up inflicting enormous losses on investors, not just for years but for decades to come. This is a view that all of us at Gavekal agree on, even if my reasoning (see **Another View Of The Bond Bubble**) is somewhat different from that of Louis, Charles, Will and Kai Xian (see for example **The Bond Blow-Off Top** and **Excess Money And Where To Find Value**).

Chinese equities have not reached bubble-type valuations yet, but even if they do...

Chinese equities present the opposite picture. Chinese equity valuations, unlike those of G7 bonds, have not yet reached speculative extremes. And if the Chinese stock market does turn into a bubble, the speculation will obviously be about predicting the future, rather than extrapolating the past. Predictions about China's future could, of course, turn out to be wrong. Nobody can be sure whether China will become the world's biggest economy. It is equally plausible that the US will succeed in what has now clearly become its national mission to stop China ever becoming a rival economic and technological superpower.

But if China does manage to overcome American resistance, perhaps by creating an Asia-centric economic and technological ecosystem distinct from the US-dominated structures of 20th century globalization, this will certainly be the biggest upheaval in global conditions for a century, and arguably since the rise of Europe and the decline of China from around 1500 onwards.

...this will definitely be a forward-looking bubble that—rightly or wrongly—anticipates the future

Even if China succeeds in the coming geopolitical struggle, many investments predicted to benefit from the rise of China will probably fail and many more will turn out to be over-hyped, just like many investments predicted to benefit from the internet. But whatever the fate of particular companies, the winning bets on China will probably more than compensate for the losers, just as the winners of Nasdaq, such as Microsoft, Amazon and Apple, eventually compensated for the failed dot-coms. In short, if Chinese valuations continue rising to the point where they create a bubble, this will definitely be a forward-looking bubble that rightly or wrongly anticipates the future, rather than a Japanese-style backward-looking bubble of the kind that has already reached monstrous proportions in bonds.

Nasdaq investors have projected onto many tech companies the kind of world domination that will only be achieved by a few

Finally, what about the near-record level of US equities at a time when the global economy is still nowhere near recovery from its deepest ever collapse? Investors in Nasdaq have projected onto many US technology companies the apparent immunity from macroeconomic conditions enjoyed by a handful of giant tech monopolies. This is clearly a delusion. No business in transport, logistics, entertainment, or consumer electronics can hope for the world domination achieved by Facebook, Google or Microsoft. And even the technology giants with genuine monopoly power cannot rely on keeping their monopoly profits, once politics, public opinion and regulation turn against them.

Many US tech stocks can therefore be classed as extrapolative, rather than predictive investments. If their valuations reach bubble levels (clearly true of the second-generation giants such as Tesla and Netflix, but not yet of the first-

generation monopolies such as Microsoft and Apple) these will be backward-looking extrapolative speculations that cause permanent losses to investors, like the Japanese banks in the 1990s and the oil companies in the last decade.

Maybe investors are sensing a regime change towards stronger real economic growth

It may be, on the other hand, that looking beyond the short-term devastation caused by Covid lockdowns, equity investors are starting to sense a regime change not towards more inflation, as Louis suggested earlier this week (see **The Consequences Of 'Worthless Cash'**), but instead to stronger real economic growth—or perhaps to both stronger growth and more inflation. This would be even more conducive to the huge flight of capital out of bonds and cash into equities and other real-value assets, including gold, that Louis and I are both expecting.

Why would growth and inflation simultaneously accelerate, potentially raising the rate of growth of nominal GDP from 3-4% to 5-6% and maybe even higher in the US and Europe? My reasons for taking this concept seriously are probably tainted with confirmation bias and wishful thinking, but they could still be worth considering as an alternative to the consensus view that nominal GDP growth will be stuck forever in the sub-4% range and that stock market investors are mad if they assume that revenues and profits might compound at higher rates.

The fiscal responses to the Covid-19 crisis would have seemed like a deluded Keynesian pipe dream a few months ago

Higher rates of nominal GDP growth now seem very likely because the Covid-19 crisis may mark a regime change in global economic management. The overwhelming fiscal stimulus that I suggested back in March as the right policy response to the crisis, seemed like a deluded Keynesian pipe dream even to me at the time (see **A Modest Proposal To Avert Economic Catastrophe**). But three months later, astonishing experiments in open-ended deficit spending have been launched in every major economy. Even the zealously anti-Keynesian German finance ministry and European Commission have amazed their critics (myself included, see **A Modest Proposal For Europe**) with their sudden enthusiasm for unbridled fiscal expansion.

Central bankers all over the world have shifted attention from managing inflation to maximizing employment and minimizing the financing cost of government debts. And at the same time, a revival of government activism, combined with heightened public awareness of the challenges posed by nature, have created conditions for global investment in energy transformation, transport and environmental infrastructures, on a scale never seen before.

If this transformation in the political economy persists, the Covid crisis may be followed surprisingly quickly by stronger growth

If this transformation in political economy persists, which I think it will, the economic weakness resulting from Covid-19 could be followed surprisingly quickly by stronger growth, just as the mass unemployment resulting from post-World War II demobilization was not followed by a second Great Depression, as most economists at the time expected. Instead, the worldwide determination to avoid another depression resulted in a golden age of post-war reconstruction and full employment in the 1950s and early 1960s, followed by accelerating inflation from the mid-1960s onwards.

Something similar could happen in the next decade. Back in 2009, I wrote a book called *Capitalism 4.0*, which suggested that the global financial crisis could cause a shift in economic and political ideology towards a new model of capitalism. (A brief synopsis of my argument was published here by the OECD)

We could see a new version of capitalism, closer to the mixed-economy Keynesianism of the 1950s and 1960s

I expected this new version of capitalism to be closer to the mixed-economy Keynesianism of the 1950s and 1960s, than the monetarism and market fundamentalism introduced by Ronald Reagan and Margaret Thatcher in the 1980s, and then legally embedded into the structure of the European Union by the Maastricht Treaty and the creation of the euro. I also pointed out, however, that after the previous systemic revolutions in global capitalism—after the crises of the 1970s, the 1930s and the mid-19th century, it typically took 10 to 15 years of political upheavals before a new version of capitalism evolved to supplant the failed model. Now that 12 years have passed since the Global Financial Crisis, perhaps the Covid lockdowns will mark the emergence of something like the new, more constructive relationships between the public and private sectors that I was anticipating back in 2009. Could this be the ultra-optimistic possibility the markets are starting to scope out?

Keynesian demand management and low rates, plus smart supply-side policies could boost profits, income and productivity

In sum, a combination of Keynesian demand management and low interest rates, with intelligent supply-side policies on competition and innovation supporting massive investment in the energy transition, could quite possibly produce simultaneous improvements in profits, personal incomes and productivity growth across most of the global economy.

I am not ready yet to bet on the optimistic outcome, but if the bulls keep charging, it may soon be time to join them

If something like this happens, then the apparent bubble in equity prices will be a predictive speculation that anticipated a new era of Keynesian prosperity arising out of the wreckage of Covid—and the bullish investors I ridiculed a month ago will turn out to have been right. I am not quite ready yet to bet on this optimistic outcome. But if the bulls keep charging onwards and can sweep away all the obstacles created by the worst quarterly results season on record, we should remember the evolutionary value of herd instinct. It may soon be time to take a leap of faith and join the bulls.