# Economic Growth: A Bull Market or a Bubble?

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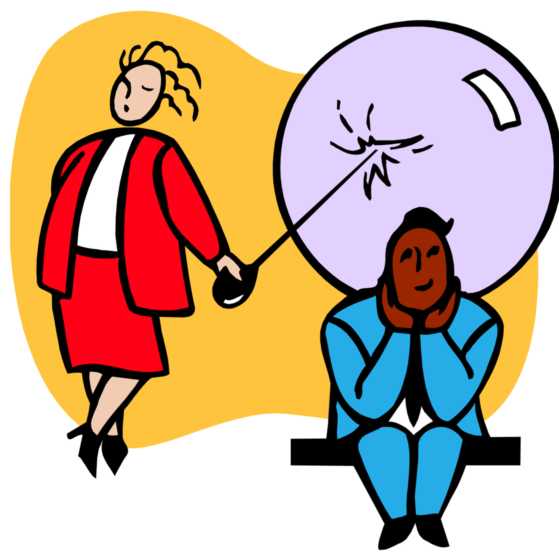
## Abstract

There is ongoing academic debate on the issue of whether the current economic recovery will lead to a disorderly bubble (as in 2008) or an orderly bull market as in the post-World War Two period. The massive destruction of wealth in the 2008 – 2010 period – if repeated – could be catastrophic. Steady growth would allow investors/savers to regain trust in the economy and induce business investment. Are asset bubbles inevitable as investors chase returns – and if so – are they necessarily a negative-sum game for society? This proposed research explores current evidence on each possible outcome and suggests future directions for analysis.

## 1. What are asset bubbles?

No standard definition but there are certain generally-accepted characteristics:

- Excessive enthusiasm
- News media coverage
- Regret by non-participants
- "Irrational exuberance" (Alan Greenspan)
- Credit expansion
  - Federal Reserve's balance sheet now four times 2008 results
- Increase in asset prices
  - Research by GMO Fund Management Group (gmo.com) reports such price increases as bubbles when they exceed 2 standard deviations above the inflation-adjusted trend



## 2. History of bubbles*

330 bubbles between 1720 and 2010 (GMO data)

Most occurred in recent times due to:

- Greater information on international markets
- Global market funds flows as capital seeks returns
  - Inconsistent data quality in world markets
- Increasing evidence that the "efficient market hypothesis" is suspect
  - Do current prices reflect all known information?
  - If that were so, how can bubbles occur?

Uncertainty that bubbles all suddenly pop

- May pop as in global markets in 2008
- May deflate/shrink as in gold market in 2013
- "Agency" problem compounds analysis
  - Professionals manage much of global assets
  - Tend to continue past successes despite possible market turns

*Note: The research proposed by the presenter does not refer to specific asset bubbles (e.g., Twitter) or categories of assets (e.g., social media stocks) but to market (systematic) bubbles

## 3. Potential bubbles by asset type

Real estate particularly susceptible as the lowest proportion of equity (ownership) of any asset (except for commodity futures): often as low as 15%.

- As prices fall, weakest owners are affected and may lose property; lenders withdraw, further pushing prices down; vs.

Stock margin (amount that can be borrowed): 50% (U.S.)

- Accountholder must have some assets to establish a margin account; vs.

Gold: often 100%, particularly in certain countries (i.e., India)

- Tends to be held regardless of short-term price fluctuation; vs.

Corporate/sovereign debt

- In strong hands: institutions including banks, central banks

## 4. Affect of macroeconomic trends

Central banks have pushed interest rates to "zero lower bound"

- Interest rates cannot be reduced below zero in the attempt to stimulate corporate borrowing
- Currently $1/10^{th}$ of 1% (10 basis points [bp])

Pushes investors toward equities and other asset categories

Risk factors:

- Returns from investments could be below investor expectations
- Change in monetary policy may affect asset values

"Secular stagnation" (Alvin Hansen, *Full Recovery or Stagnation,* 1938)

- Reduced investment opportunities due to limited population growth in developed countries
- Hansen's remedy was constant, large-scale government deficit spending financed by progressive income taxes
  - Obviously not occurring in world economies
- Could deflate bubbles as increased taxes on higher incomes would reduce speculative asset purchases

## 5. Bubble or bull market? I

U.S. equity markets trade at adjusted price-earnings (P/E) of 25 (of S&P 500 index)

- > historical average (mean) P/E of 16½ (multpl.com/table) (Robert Schiller, 2013 Yale Nobelist)
- But ≤ P/E peaks of 1895 (25x), 1934 (24x), 1999 (33x) and 2002 (46x)
- Equity mutual funds (individual investors) experienced negative flows in 2008-2012

No evidence of general asset bubble currently although global growth would have to increase for a significant bull market to occur

- Possible sources:
  - Federal government spending on infrastructure – but not likely
  - State/local government spending; but most need funds to meet unfunded pensions
  - Repatriation/ investment of corporate liquidity; see panel #6

## 6. Bubble or bull market? II

Business capital investment

- Companies reluctant to spend on fixed assets
  - Nearly $2 trillion cash/short-term investments in the U.S. by non-financial businesses
  - About $6 trillion held by U.S. companies worldwide (Reuters data)
  - Results in large current account surpluses in certain economies (i.e., China)

Bubbles may appear in specific categories of assets but are not likely as a macroeconomic phenomenon

- Usually self-correcting through price adjustments except where public policy interferes (i.e., housing)
- Bubbles could occur in specific equities (i.e., Bitcoin) or categories of equity (i.e., social media) or in narrow asset classes (i.e., modern art, Manhattan apartments)

## 7. Summary and Further research

I. What will happen to asset prices assuming that a *disorderly* (bubble) global economic recovery occurs? Issues to consider:

- 2005-2007 bubble largely attributable to unrealistic real estate transactions fueled by poor lending practices and public policy decisions
- Unlikely to be repeated given changes in banking regulations, and the collapse of Fannie Mae and Freddie Mac
- A current fear is a collapse in the Chinese real estate market; see, e.g., *The Economist*, Nov. 16, 2013, pp. 75-76.
  - Could such an event affect the country's economy? The Asian economy?

II. What will happen to asset prices assuming that an *orderly* (bull market) global economic recovery occurs? Issues to consider:

- Economic recovery after two World Wars
- During the period 1949-1966 (conversion to peacetime after World War II to Viet-nam), the correlation of real GDP to the S&P 500 index was .972 (explaining about 95% of stock price increases)
  - S&P 500 stock index used as a surrogate for asset prices in general
  - Negligible asset bubbles at that time

III. Orderly expansion of asset values appears to require substantial real GDP

- Current estimates are about 2¾%, some 1% below growth in earlier bull markets
- P/E multiples can expand if higher future growth is expected, but is a low likelihood if GDP growth continues at current pace
- Research question: has 2012-2013 stock market performance been based on GDP expectations (bull market) or on quantitative easing and other Federal Reserve actions (market bubble)?

See *The Economist* reprint for further commentary