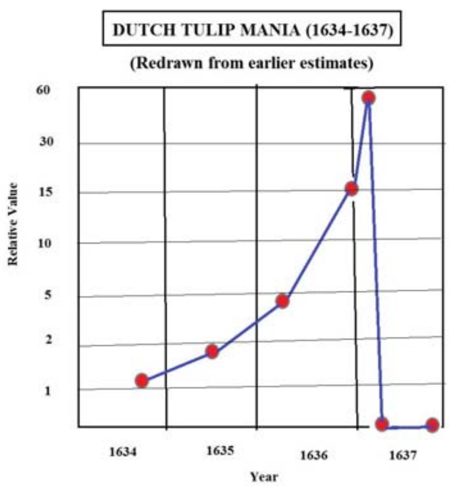
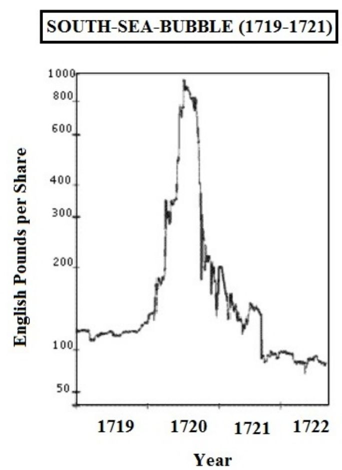
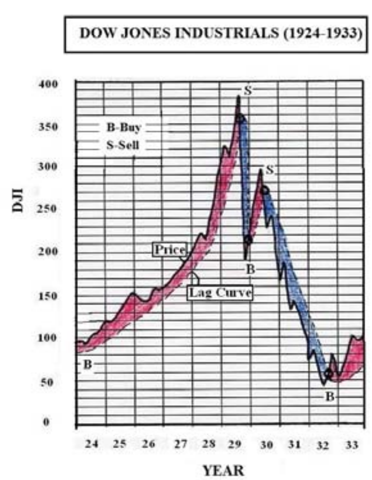
WHAT ARE THE CHARACTERISTICS OF AN ECONOMIC BUBBLE?

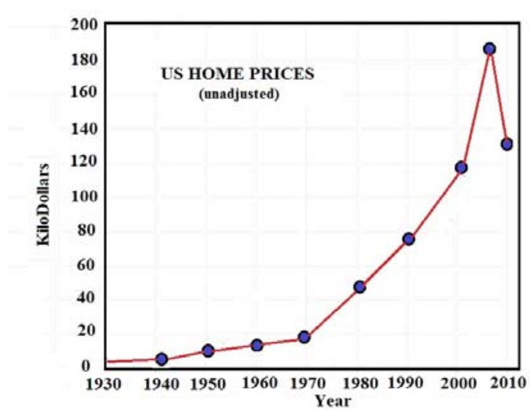
Over the last 400 years or so mankind has been exposed to economic bubbles which are often not recognized when they are occurring and then failing to act until after they have burst. Classic examples of such bubbles (some of these are well discussed in Charles Mackay's 1841 book " Extraordinary Popular Delusions' and the Madness of Crowds "), include the Dutch Tulip Mania of 1637 , the English South Sea Bubble of 1720 and the American Stock Market crash of 1929. Each of these bubbles first produced large gains for early investors, followed by a large public participation raising prices to unsustainable levels, and then followed by a precipitous decline in value leaving many speculators with large financial loses and bankruptcy. It is our purpose here to examine the characteristics such economic bubbles in more detail and especially point out when they are reaching a level where a reversal is likely to occur.

We begin by representing graphic images of some of the better known historical financial bubbles. Here are four of these-









In each of these cases the manic part of the bubble lasts about one to two years where prices are rising at an ever accelerated rate often doubling in value in a single year. The rise is the most rapid just before collapse of the bubble. The caution flag occurs when prices have doubled or more during the last year. Also the evaluation of the particular commodity in question becomes unreasonable near a bubble top such as the equivalence of one tulip bulb equal to three oxen in early 1617 in Amsterdam or the average US home selling in 2006 for three times its value compared to 15 years earlier. Today one should be extremely careful being the owner of stocks such as Amazon selling at 470 times earnings or art including Cezanne's "The Card Players" which recently sold for an unbelievable $273 million, or a 120 sq.meter apartment in Manoco going at the present rate of 53,000 dollars per sq.meter. People's attention will generally gravitate to a commodity with rapidly rising price with the largest participation occurring at the high point of the price. This guarantees that most speculators and investors will be left holding the bag as the price goes into a quick reversal when the bubble finally bursts and heads back to a more realistic level. Was gold really worth $1800/oz in the fall of 2011? Even today at $1200/oz it still seems too high and should reach an equilibrium level at about $900/oz. As with all bubbles the majority buys the commodity (be it stock, houses, art, or metals) at its high price confirming the well known adage that buying high and selling low is a sure way to go to debtors prison. On the other hand, the maximum rate of increase in price of a commodity occurs just before the bubble bursts and is thus the point of highest return provided one can get out before the music stops. House flippers did very well in the period 2003 through 2005 but many got stuck with holding multiple houses and condos on which they could no longer afford the mortgage after 2007. Also those speculating in silver saw an increase in bullion price per troy oz by a factor of ten in a three year period ending in 1981 when the Hunt Brothers gave up trying to corner the silver market.

After a bubble bursts it is best to stay away. I remember as a young and naive investor some fifty years ago having watched the stock of Raytheon go in price from $17/sh in late 1957 to a peak of $72/sh in early 1959. So when it dropped a few months later to $50/sh I bought a few shares thinking it surely would rise again to its old high price and beyond. This was not to be for several decades as I watched the price decline to a low of $21/sh in 1963 and then begin a slow rise. I bought some extra shares near this low point and eventually ended up with a small gain yielding a lousy return over a total seven year holding period. As the above graphs indicate it can be a long long wait (including forever for tulip bulbs) for a commodity price to recover after a speculative bubble has burst. Thus the safest strategy is to stay away from such commodities for years. Its true that Raytheon has been a good stock to own over the long run but in between there have been many periods in which large losses occurred.

Next we come to the question: Are there any potential bubbles extant today (May 2014) ? The answer is yes. I point out to what I consider perhaps the largest bubble threat in all of financial history. It is the Bernanke-Yellen Put which has been produced through excessive money printing by the Federal Reserve over the past few years and is now being imitated by others throughout the world. Here is a graph of the growth of the US monetary base produced mainly by the injection of fiat paper currency into the US financial system by the Federal reserve over the last five years-

THE BERNANKE-YELLEN BUBBLE

The main responsibility for this rise in monetary base rests on the shoulders of Ben Bernanke (who as chairman of the Federal Reserve until his recent replacement by Janet Yellen) is an ardent Keynsian and has the false belief that injecting money into a financial system will cause an economy to recover from a recession. So far all that QE has accomplished is lead to wild speculation on Wall Street , provide free money for banks, and deprive retirees of a descent return on their money on which they depend for a living. The expected inflation has not yet occurred except at the gas pump and at the grocery store. However, once the banks start loaning this excessive extra money instead using it to buy US treasuries, the money velocity will increase dramatically and will result in hurting the average US citizen far more than if Quantitative Easing had never been initiated. Looking at the money base graph, we see that we are in the accelerating phase of a major financial bubble. This will continue as long as accelerated Quantitative Easing stays in effect. The Federal Reserve has recently announced an easing of QE to Infinity but so far I see no signs of any easing. The Yellen announcement of a 50 billion dollar reduction in easing is being counteracted by the purchase of over 100 billion in US treasuries by Belgium using by what is believed to be money supplied by the Federal Reserve. In legal language this represents money laundering and is illegal. Yellen seems to be stuck between a rock and a hard place. If the Federal Reserve stops Quantitative Easing, the economy will collapse (Bubble burst followed by deflation) or if they keep injecting fiat currency at ever increasing rates the dollar will tank and eventually require a large devaluation wiping out people's savings, and the dollar will certainly loose its standing as the world's reserve currency. The loss of reserve status has already begun through the recent oil and gas pact between Russia and China in which the US dollar will no longer be used as the exchange currency. My guess is that we are in the final stages of the Bernanke-Yellen bubble and once it bursts the stock market will tank. In the meanwhile the S&P500 is still making new highs and Titter(TWTR) can be bought at $30.5/sh down from its bubble peak of $73/sh in late 2013 So far it has no earnings and a debt of over two dollars per share. By the rule of no post-bubble purchases, one should at this time stay away from buying TWTR , as well as AMZN and AAPL and most bank stocks such as BAC. My estimate is that Janet Yellen will try to keep the money injection going (although in disguised form) for a bit longer unless the inflation rate exceeds the 18% of the Carter administration or more than 50% of new US treasuries have to be purchased by money printed by the Federal Reserve.

Gainesville, FL
May 2014