



Are All Bubbles Bad?

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In this note, Strategas Chief Economist Don Rissmiller addresses fears of an AI asset bubble. While some metrics do currently look a bit extreme, Don argues that we may be too focused on stopping bubbles altogether when we could be spending time distinguishing between the different types of bubble.

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EVALUATING THE CURRENT LANDSCAPE

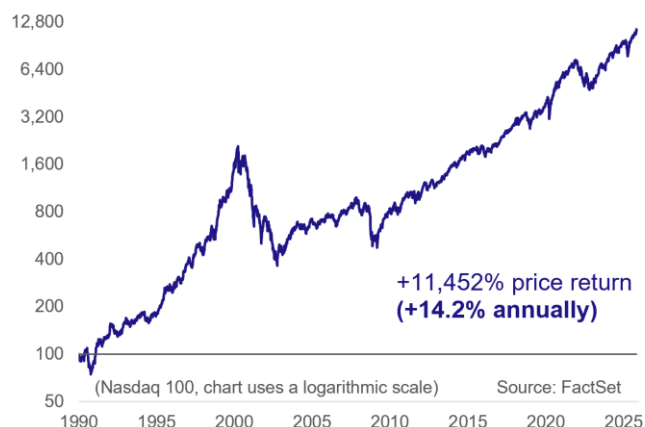
The word “bubble” has been popping up all over. Fears of asset bubbles popping have been drilled into students of economics since the Dutch “Tulip Mania” of the 1630s. And over the ensuing 400 years, as detailed in Charles Kindleberger’s classic book “Manias, Panics, and Crashes,” booms have consistently and regularly led to busts.

In recent weeks, many investors have had their bubble antennae up. The New York Times raised a red flag with an editorial titled “Warning: Our Stock Market Is Looking Like a Bubble.” Not to be outdone, MarketWatch followed up with, “A friend calls it the everything bubble: Why do so many economists fear a 1929-style crash?” But are all frenzies bad? Bubbles destroy wealth, but they also create it. Perhaps a more nuanced approach is needed.

When we invent nice things, bubbles happen. Many modern technologies were accompanied by overenthusiastic investment, and yet were net positives for the global economy (railroads, cars, airlines, computers). So, in attempting to analyze both the costs and benefits of bubbles, the key lies in what the boom produces and how it is financed. The strategists at Gavekal described these differences succinctly when they wrote the following:

“[T]he worst possible kind of bubble is a bubble in unproductive assets (gold, land, tulips) financed by banks. The best possible kind of bubble (i.e., one that does not hurt growth too badly) is a bubble in productive assets, financed by capital markets. The Japanese bubble of the late 1980s and the US real estate bubble of the mid 2000s were ‘bad’ bubbles ... By contrast, the US TMT (Technology, Media, and Telecommunications) bubble of the late 1990s was a ‘good’ bubble.”

Although the 1990s tech bubble burst, it was followed by a productive future



A bubble in a productive asset that is financed by equity can work out without too much trouble (equity, typically holding the lowest priority position on the capital structure, is known to be a “risky” asset). There’s a short-term cost, but a long-term benefit (in the case of AI, a new technology). In contrast, a bubble in an unproductive asset financed by debt (and the banking system) is troublesome because it jeopardizes “safe” assets like deposits.

Once a bubble is underway, it’s very difficult for policymakers to intervene. If there is a well-defined financial vulnerability, “macroprudential” policy—such as regulation aimed at prevent systemic risks to the financial system—could help to avoid a frenzy. But it is difficult to regulate new technologies since it takes time for regulators to catch up with the often-rapid pace of innovation and usage. Monetary policy can act quickly in such a case, but once a bubble is already

underway, an intervention is asking a lot of policymakers. A 2015 San Francisco Fed study noted that the U.S. housing bubble in 2006 could have been stopped, but only by raising the fed funds rate an astronomical amount, and very early:

“Since a 1 percentage point increase translates into about a 4.4% decline in house prices, keeping house prices on trend would have required about an 8 percentage point increase in the federal funds rate in 2002 according to our calculations...preemptive interest rate policy would have been extraordinarily tight in 2002...such a large increase in interest rates would have depressed output more than the Great Recession did, roughly speaking.”
(Jorda, Schularick, and Taylor, 2015).

Preventing the eventual housing bubble would have caused a deep recession, and a central bank with a dual mandate that includes maximizing employment will have trouble doing such a thing, especially 1) in a committee vote; and 2) with incomplete information in real time.

Without bubbles, we would have other problems. Strategas (a Baird company) Head of Fixed Income Research Tom Tzitzouris reminds us that any effort to achieve the trifecta of 1) asset market stability (no bubbles that end up popping); 2) price stability (low inflation); and 3) social stability (no populist revolutions) simultaneously is likely futile. Perceived stability in prices and politics invites risk elsewhere. Tom recently posed the question of what would happen if central banks became so successful in their fight against inflation that markets begin to view stable prices for goods and services as permanent. He answers his question like this:

“When that happens, we find that anything that sheds positive cash flows can be leveraged. And if low inflation and low inflation volatility persist forever, then infinite leverage can be added to obtain any level of return desired, provided default risk is not a factor. That sounds like the foundation of financial instability. But then, what if we mandate financial market stability, or at least use monetary policy to nudge markets to a more stable zone? We find that capital is hoarded, firms aren’t allowed to fail as often as they should, and social instability grows as wealth inequality further separates the haves from the have nots.”

The argument that “anything that sheds positive cash flows can be leveraged,” may be even more extreme for new tech companies. If the business plan calls for double (if not triple) digit growth, does it really matter if interest rates are 2% or 5%? It’s not shocking that entrepreneurs and their backers dance until the music stops. Right now, with many policymakers in Washington D.C. inclined to go for growth and U.S. inflation moderate, the music is still playing.

This bubble could turn out to be good or bad; in the meantime, we watch for productivity gains. Back in 2008, in the middle of a substantial crisis, joke newspaper The Onion found it amusing enough to run an article titled “Recession-Plagued Nation Demands New Bubble To Invest In.” Underneath the veneer of satire, there’s probably some truth there. After all, isn’t it possible that a “boom-and-bust” cycle leads to more overall growth versus “slow and steady” by encouraging risk-taking and the creation of new industries?

That said, recognizing and popping an asset bubble early is very difficult. In the current environment, policymakers look set to run the U.S. economy hot—or at least try to. If this technology boom leads to productivity gains such as AI aiding business processes, then growth will be more sustainable. In the end, this could be deemed a “good bubble” even if some investments wind up overdone.

On the other hand, if the boom is a stimulus sugar-high with no lasting impact on U.S. productivity, it is almost certainly a “bad bubble.” Therefore, the biggest risk right now is probably that AI fails to deliver on its promises of efficiency. To that end, it makes more sense to try to answer the productivity question (for instance, looking at company earnings transcripts for hints of successful uses of AI in non-tech sectors) rather than speculating as to what inning of the bubble we are in.

Headlines may get attention when they stoke fear about a bubble, but we think a more nuanced look at the current environment is warranted.

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