

## Soros - A Rudimentary Theory Of Bubbles

Of the last few weeks, I have touched on the impact of [valuations and forward returns](#). However, it is not just valuations that are an issue, but also the surge in corporate debt, balance sheet leverage combined with declining profitability which is a result of weak economic growth. All in all, such a combination of factors have historically been associated with "bear markets" in equities.

However, none of these fundamental concerns seem to be a problem currently. Despite one selloff after another leading to increased volatility, the markets are currently hovering near all-time highs as the "chase for yield" continues. [Just recently David Rosenberg](#) made an interesting observation in this regard:

"All this reminds me of what Alan Greenspan said about this type of behavior more than a decade ago:

*Thus, **this vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk.** Such an increase in market value is too often viewed by market participants as structural and permanent. To some extent, those higher values may be reflecting the increased flexibility and resilience of our economy. But what they perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. **This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums.***

*Alan Greenspan, August 25<sup>th</sup>, 2005.*

***A decline in perceived risk is often self-reinforcing in that it encourages presumptions of prolonged stability and thus a willingness to reach over an ever-more extended time period.** But, because people are inherently risk averse, risk premiums cannot decline indefinitely. **Whatever the reason ? for narrowing credit spreads, and they differ from episode to episode, history caution's that extended periods of low concern about credit risk have invariably been followed by reversal, with an attendant fall in the prices of risky assets.** Such developments apparently reflect not only market dynamics but also the all-too-evident alternating and **infectious bouts of human euphoria and distress and the instability they engender.***

*Alan Greenspan, September 27<sup>th</sup>, 2005.*

Well, remember what happened next! The ensuing two years caught up to investors pretty quickly. ? **It goes without saying that we should all heed the message from a zero percent interest rates. We are seeing in some cases negative interest rates right out to the 10-year part of the yield curve or even sub-zero as is the case in Japan and Germany, something we only really saw to this scale in the 1930s."**

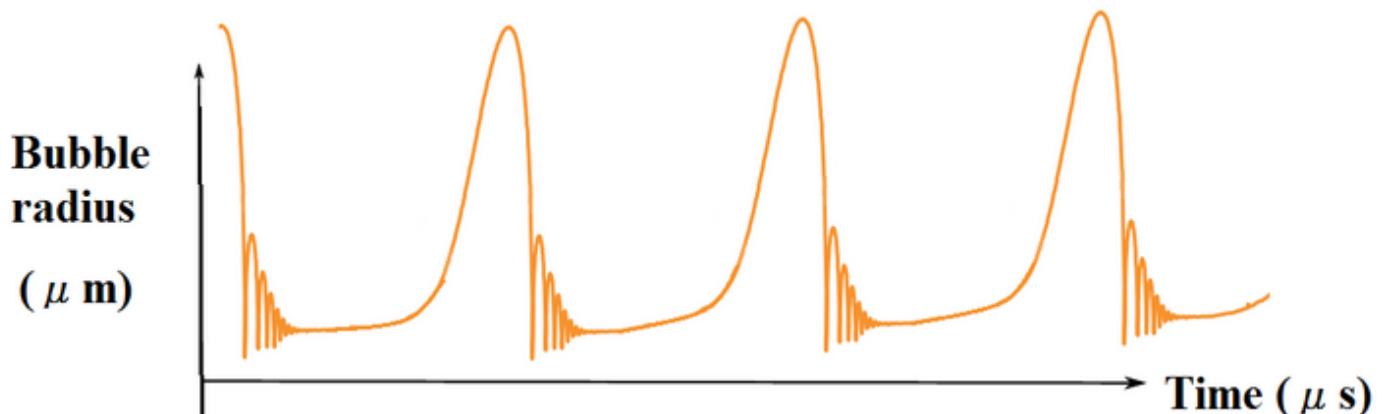
David's comments reminded me of George Soros' take on bubbles.

*"First, financial markets, far from accurately reflecting all the available knowledge, always provide a distorted view of reality. The degree of distortion may vary from time to time. Sometimes it's quite insignificant, at other times, it is quite pronounced. **When there is a significant divergence between market prices and the underlying reality, there is a lack of equilibrium conditions.***

***I have developed a rudimentary theory of bubbles along these lines. Every bubble has two components: an underlying trend that prevails in reality and a misconception relating to that trend. When a positive feedback develops between the trend and the misconception, a boom-bust process is set in motion. The process is liable to be tested by negative feedback along the way, and if it is strong enough to survive these tests, both the trend and the misconception will be reinforced. Eventually, market expectations become so far removed from reality that people are forced to recognize that a misconception is involved. A twilight period ensues during which doubts grow and more and more people lose faith, but the prevailing trend is sustained by inertia. As Chuck Prince, former head of Citigroup, said, 'As long as the music is playing, you've got to get up and dance. We are still dancing.' Eventually, a tipping point is reached when the trend is reversed; it then becomes self-reinforcing in the opposite direction.***

***Typically bubbles have an asymmetric shape. The boom is long and slow to start. It accelerates gradually until it flattens out again during the twilight period. The bust is short and steep because it involves the forced liquidation of unsound positions."***

The chart below is an example of asymmetric bubbles.



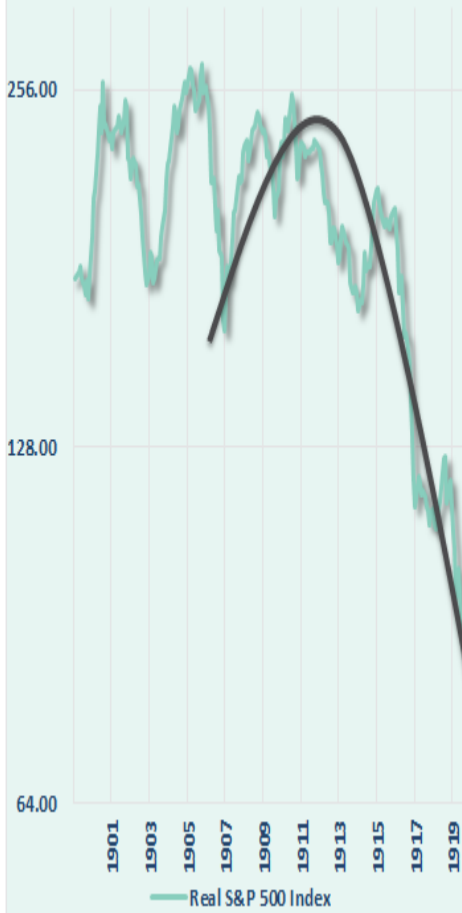
Soros' view on the pattern of bubbles is interesting because it changes the argument from a fundamental view to a technical view. Prices reflect the psychology of the market which can create a feedback loop between the markets and fundamentals. As Soros stated:

***"Financial markets do not play a purely passive role; they can also affect the so-called fundamentals they are supposed to reflect. These two functions, that financial markets perform, work in opposite directions. In the passive or cognitive function, the fundamentals are supposed to determine market prices. In the active or manipulative function market, prices find ways of influencing the fundamentals. When both functions operate at the same time, they interfere with each other. The supposedly independent variable of one function is the dependent variable of the other, so that neither function has a truly independent variable. As a result, neither market prices***

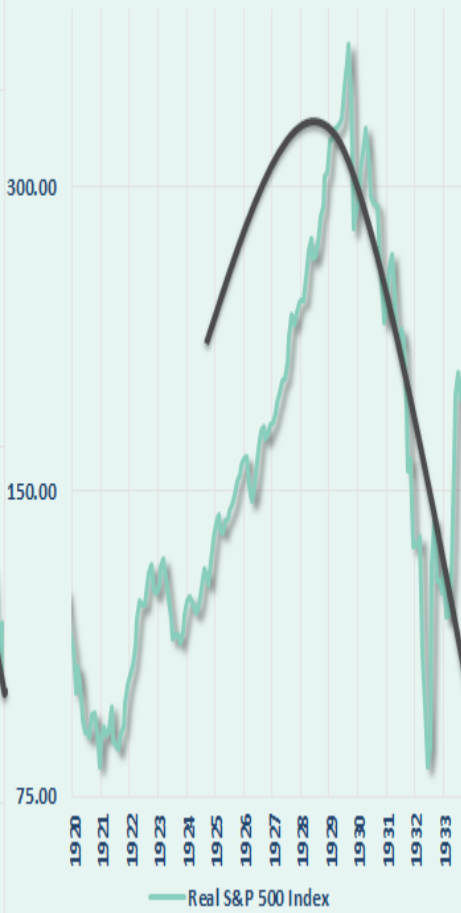
***nor the underlying reality is fully determined. Both suffer from an element of uncertainty that cannot be quantified."***

The chart below utilizes Dr. Robert Shiller's stock market data going back to 1900 on an inflation-adjusted basis. I then took a look at the markets prior to each major market correction and overlaid the asymmetrical bubble shape as discussed by George Soros.

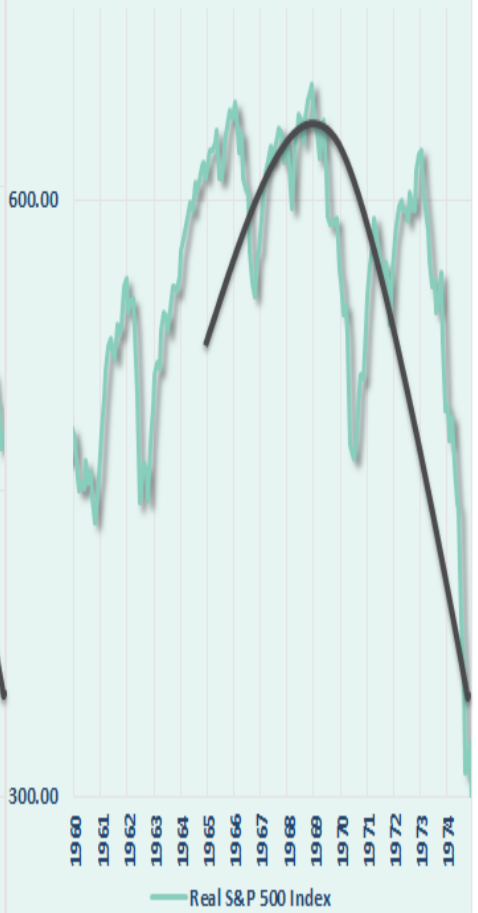
Real S&P 500 Index 1900-1920



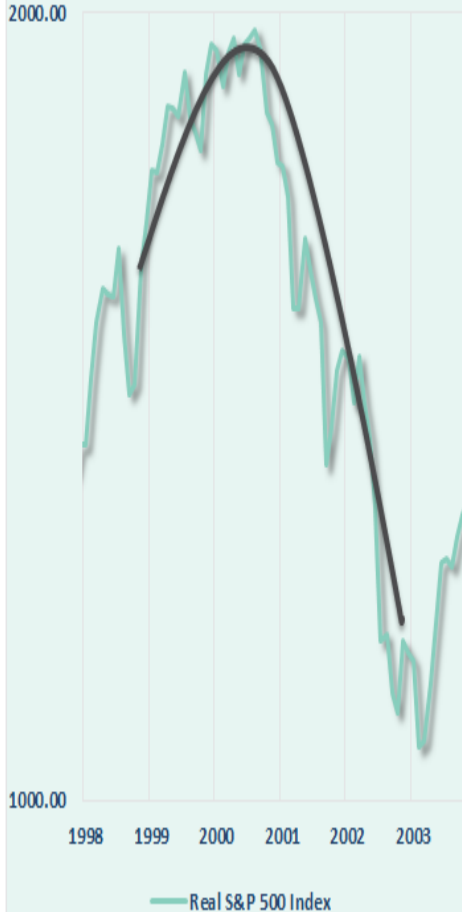
Real S&P 500 Index 1920-1933



Real S&P 500 Index 1960-1974



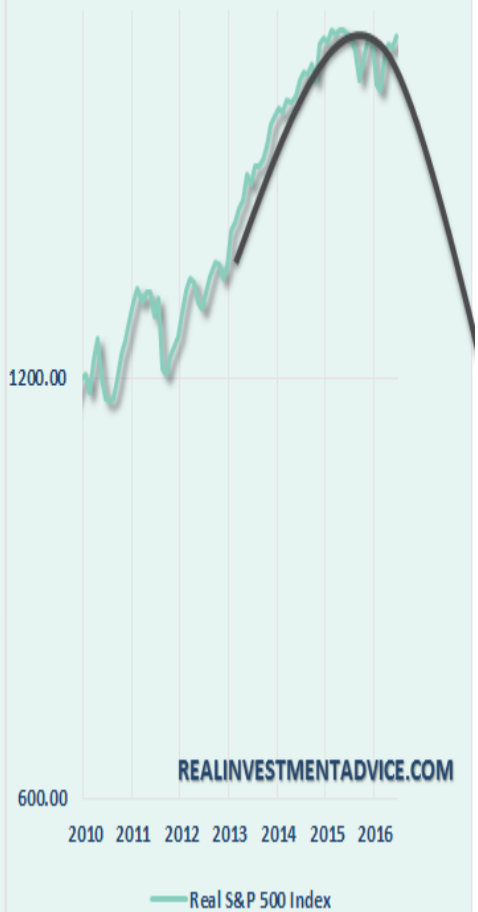
Real S&P 500 Index 1997-2003



Real S&P 500 Index 2006-2009



Real S&P 500 Index 2010-???



There is currently much debate about the health of financial markets. Have we indeed found the "Goldilocks economy"? Can prices remain detached from the fundamental underpinnings long enough for an economy/earnings slowdown to catch back up with investor expectations?

The speculative appetite for "yield," which has been fostered by the Fed's ongoing interventions and suppressed interest rates, remains a powerful force in the short term. **Furthermore, investors have now been successfully "trained" by the markets to "stay invested" for "fear of missing out."**

The increase in speculative risks, combined with excess leverage, leave the markets vulnerable to a sizable correction at some point in the future. **The only missing ingredient for such a correction currently is simply a catalyst to put "fear" into an overly complacent marketplace.??**

In the long term, it will ultimately be the fundamentals that drive the markets. Currently, the deterioration in the growth rate of earnings, and economic strength, are not supportive of the current levels of asset prices or leverage. **The idea of whether, or not, the Federal Reserve, along with virtually every other central bank in the world, are inflating the next asset bubble is of significant importance to investors who can ill afford to, once again, lose a large chunk of their net worth. ?**

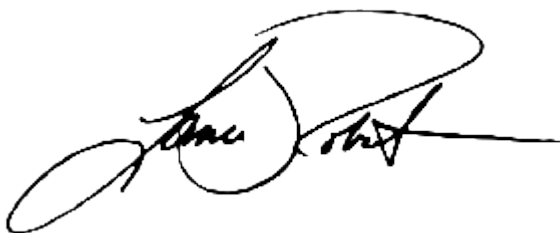
It is all reminiscent of the market peak of 1929 when Dr. Irving Fisher uttered his now famous words: "Stocks have now reached a permanently high plateau." The clamoring of voices proclaiming the bull market still has plenty of room to run is telling much the same story. **History is replete with market crashes that occurred just as the mainstream belief made heretics out of anyone who dared to contradict the bullish bias.**

It is critically important to remain as **theoretically sound as possible. The problem for most investors is their portfolios are based on a foundation of false ideologies.** The problem is when reality collides with widespread fantasy.

Does an asset bubble currently exist? Ask anyone and they will tell you "NO." However, maybe it is exactly that tacit denial which might just be an indication of its existence.

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Lance Roberts

A handwritten signature in black ink, appearing to read 'Lance Roberts', with a large, stylized flourish at the end.

Lance Roberts is a Chief Portfolio Strategist/Economist for Clarity Financial. He is also the host of [The Lance Roberts Show](#) and Chief Editor of the [Real Investment Advice](#) website and author of [Real Investment Daily](#) blog and [Real Investment Report](#). Follow Lance on [Facebook](#), [Twitter](#), and [Linked-In](#)