

MARKET MONITOR SEA CHANGES, INFLATION AND BUBBLE BIAS

BRETT HAMMOND
MARTHA PEYTON

As the economy and the markets begin to recover from the Great Recession, the critical question is what sort of economic pathway will map the way ahead: continuous modest economic improvement, relapse into recession, inflation, or even stagflation. The case for or against any one of these pathways depends, in large part, on the effects of the monetary and fiscal policies the government put into place to combat the Great Recession and on how consumers and businesses around the world react.

But there are other fundamental forces at work, in particular a continuing bias toward asset bubbles. While bubbles have occurred in the marketplace for centuries, the tendency toward bubbles is exacerbated today by structural changes in investment markets and the economy that include accelerating globalization of capital, labor, and production as well as an excess of global savings looking for places to invest. These forces could temper the potential for inflation, while creating continuing susceptibility to asset bubbles.

- What is an asset bubble and how does it affect investors?
- What conditions, if any, are present that would tend toward continuing bubbles as opposed to inflation?
- What can investors do to mitigate against the effects of bubbles?

ASSET BUBBLES

Unlike inflation, which is a general rise in the price of most goods and services, an asset bubble is a rapid rise in the price of an asset that surpasses traditional measures of that asset's fundamental value. Asset bubbles have been with us at least since the 17th century, when investors bid up the price of tulip bulbs far beyond their intrinsic value.



Three things make bubbles difficult—if not dangerous—for investors. First, in a growing global economy, rising asset prices based on increased earnings and profits are to be expected. In other words, in a healthy market with healthy companies, security prices rise for good fundamental reasons. But, when asset prices rise beyond any reasonable expectation of future earnings, there is no agreed-upon metric for determining when an asset's price has crossed the line into bubble territory based on its price relative to earnings, book value, revenues, rents, historical prices or other measures. Second, someone is nearly always available to provide an explanation of why “this time is different” when it comes to being able to sustain the current asset price rise. And third, when an asset bubble bursts because investors finally begin to refuse to pay increased prices, the effects can cascade through the economy, as they did in the aftermath of the recent housing bubble. In retrospect, we can often see the effects of an asset bubble, but it is hard to spot one in advance or to act when in the middle of one.

Examples of asset bubbles include:

- Residential housing 2005-2008;
- Broad equities 2005-2007
- Dot-com stocks 1996-2000;
- “Asian tiger” stocks and bonds 1996-1998;
- Commercial real estate 1985-1989.

What sets the more recent bubbles apart, among other things, is how extreme they were. Their rise and fall, and the resulting fallout, were arguably greater than any other market gyrations that have occurred since the Great Depression.

WHY NOT INFLATION?

Many investors today are less worried about asset bubbles than they are about incipient inflation. The current preoccupation with inflation appears to be based on:

1. The ballooning size of the Fed's balance sheet reflecting loans, the purchase of securities such as mortgage-backed securities and the intensity of monetary easing;
2. An essentially zero Fed funds rate (the interest rate U.S. commercial banks charge one another for overnight loans);
3. The unconventional tools that the Fed and the Treasury have used to bring about monetary easing;
4. Skyrocketing federal budget deficits; and
5. The challenges the Fed has historically faced in knowing when and how much to tighten monetary policy.

Fortunately, the Fed has, since the early 1980s, kept inflation largely in check. Moreover, since the last severe inflationary period starting in the 1970s, the global economic system has evolved in ways that mitigate inflation:

- **Global economy.** Goods and services production is increasingly located and relocated globally. In many sectors, competition can come from anywhere, so that effective capacity is deeper and more flexible than ever. Firms capable of operating in many locations can take advantage of these opportunities (and just-in-time manufacturing practices) to reduce supply-chain adjustment time and lower prices. Think clothing, food, autos, steel, computers and financial services.

- **Capital flows.** The rise of global megabanks—along with vastly increased international trade, foreign direct investment, investment in foreign securities and related changes—means that the supply and demand for capital is now more global. For example, the U.S. residential and commercial real estate markets are deeply connected to global capital markets through: (1) short-term debt used by banks to purchase mortgages; and (2) mortgage securitization and sales to buyers around the globe.
- **Flexible labor and limited income growth.** Global labor flexibility has increased, too (though it is much more geographically constrained than capital). Vietnamese workers are effectively competing against counterparts in China, Latin America, and even Africa. Income increases in the U.S. were much higher from 1946-1973 than after 1973. Since 2000, despite rising labor productivity, most U.S. workers' real incomes have fallen or barely budged.¹ Even at the high end of the labor market, an expansion of advanced degree programs in the United States and other countries has been shown to hold down compensation for scientists and engineers over the last several decades.

POTENTIAL FUTURE BUBBLES?

Some of the same structural conditions that are serving to keep general price inflation in check paradoxically are those that laid the groundwork for recent asset bubbles. To these structural changes, we can add the following:

- **Global savings glut.** Over the last several decades, as U.S. consumers virtually ceased to save, the average Chinese household came to save about 40% of its annual income (most other countries enjoy savings rates somewhere between the

U.S. and China). Using a variety of transmission mechanisms, a rapid increase in global savings beginning in the 1990s sought investment opportunities around the globe. These flows are implicated in the dot-com bubble of the late 1990s, the stock market bubbles of this decade and the recent housing and asset-backed security bubbles.

- **New financial products.** An explosion of new securities has appeared (e.g., asset-backed securities, credit default swaps, and many variations) that promised to deal with risk in new ways. These products can also mask or appear to reduce risk by slicing it up and dispersing it, making it seem to have gone away even when it hasn't. These instruments have figured prominently in key crises of the last couple of decades.

We can by no means predict the next bubble, but the potential for new bubbles is visible in the continuing conditions that produced recent bubbles and that are essentially still in place, fueled by extremely expansive monetary policies and low interest rates. Those policies remain in place, in an effort to restore sustained economic growth.

- Monetary authorities cannot raise interest rates until growth is healthier, even though ongoing low interest rates feed bubbles.
- Globalization of capital, labor and production has changed the nature of inflation, allowing asset bubbles to occur in the absence of inflation.
- The role of monetary authorities and national governments in driving recovery and exerting effective regulatory oversight is evolving but only very slowly.

¹ Significant exceptions, at least through 2008, were: (1) workers with a law degree or MBA; and (2) those already at the top of the income scale (there is significant overlap between 1 and 2). These represent a small proportion of the total U.S. workforce.

MITIGATING BUBBLES

Public policies to address bubble tendency may be under consideration, including assignment of authority for a “systemic risk regulator,” discussions of limitations on the size of global financial institutions, open exchange trading of the new financial derivatives and other instruments, and greater cooperation among central banks and financial regulators. Such measures are being discussed, not just in the United States, but also among members of the G20 industrial nations around the globe. Depending on the outcome of such discussions and any legislation embodying them, these steps could potentially affect the size and severity of future asset bubbles.

INVESTOR RESPONSE

With the possibility of continuing asset bubbles, how can investors respond? It goes without saying that investing in a growing bubble can provide outsized returns, until the bubble bursts. In fact, it might be argued that investing into an incipient asset bubble is really a market timing bet, one that requires the investor to gauge when to sell.

What matters most to the majority of investors is that a diversified portfolio, one that contains an appropriate mix of relatively uncorrelated asset

classes, can be undermined by an asset bubble that disproportionately pushes up the value of one or two of those assets and thus the proportion of the portfolio allocated to those assets. If no action is taken to rebalance the resulting unintended mix, the investor is then caught in what might be called inadvertent market timing, where more and more is riding on those one or two rising assets in an increasingly concentrated portfolio.

In such circumstances, the usual admonition to examine one’s portfolio from time to time takes on more urgency. When markets are shifting rapidly, a more vigilant approach to portfolio rebalancing can go a long way toward protecting against the inevitable downturn, even if it means missing some of the bubble’s upside. Investors who more rigorously rebalanced through the stock market run-up and those who managed to avoid increasing their home ownership debt are probably better off today than if they had not taken those steps.

Where will the next bubble come from? It is hard to know. But we do know that some of the structural conditions conducive to future bubbles are present today, and we do know that one of the best methods to mitigate their effects is strict adherence to asset allocation, diversification and, above all, more regular rebalancing than we might have done in the past.

Market Monitor is prepared by TIAA -CREF Asset Management and represents the views of TIAA-CREF’s Investment Strategy and Client Solutions Group as of January 25, 2010. These views may change in response to changing economic and market conditions. Past performance is not indicative of future results. The material is for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which this information may relate.

TIAA-CREF is a national financial services organization and the leading provider of retirement services in the academic, research, medical and cultural fields with over \$414 billion in combined assets under management (as of December 31, 2009). Further information can be found at tiaa-cref.org.

TIAA-CREF personnel in its investment management area provide investment advice and portfolio management services through the following entities: Teachers Advisors, Inc., TIAA-CREF Investment Management, LLC, and Teachers Insurance and Annuity Association. Annuity products issued by TIAA, New York, NY. TIAA-CREF Individual & Institutional Services, LLC, member FINRA, distributes securities. TIAA, TIAA-CREF, Teachers Insurance and Annuity Association, TIAA-CREF Asset Management and FINANCIAL SERVICES FOR THE GREATER GOOD are registered trademarks of Teachers Insurance and Annuity Association.

Brett Hammond is available to comment on economic data. If you wish to speak with him, please contact Chad Peterson, Media Relations, 212 916-4808 or e-mail cpeterson@tiaa-cref.org

C46933(16568)