Which Bubbles Will Burst Worst?

By Martin Hutchinson *Fri, Nov 15, 2013*

The universe of assets whose price will collapse in the next downturn is considerably better populated than the collection of assets whose price won't collapse. If you asked me to guess, I'd put the collapse's onset in the fourth quarter of 2014, writes this columnist, who calls himself "Prudent Bear."

This week the hedge fund SAC was fined $1.8 billion, and will revert to running Steve Cohen's family money only—still a big job, since he's worth some $8-9 billion. This raises the question of which forms of investment will be exploded by the next market downturn, just as were subprime mortgages and complex securitizations by the 2008 unpleasantness. Guessing what the next downturn will look like and which forms of wealth will suffer permanent rather than temporary diminution in value is the most important task facing investors as we approach the top of the current bubble.

After the 2000 bubble burst, the value downturn was almost entirely in equities, and a tiny subset of equities at that. While the main share indexes declined less than 50%, and were above their previous peaks within six years, the Nasdaq is still thirteen years later more than 20% below its 2000 peak of 5,048, a loss of more than 40% when inflation is taken into account.

For individual companies, the decline was more comprehensive. Microsoft (Nasdaq:MSFT) and Cisco (Nasdaq:CSCO) are both more than a third below their 2000 highs, even though their assets and profits are much greater than they were in 2000. Some companies have had much steeper falls; the switchgear specialist JDS Uniphase (Nasdaq:JDSU), valued well over $100 billion in 2000, now has a stock price of little more than 1% of its high, even though the company's operations remain solidly profitable and its P/E ratio is still elevated at 45 times earnings. Finally, a few companies that had taken excessive advantage of easy money and easy ethics went outright bankrupt, the most prominent being Enron, WorldCom and Global Crossing.

Other types of asset saw only a modest downturn after 2000. Emerging market stocks had already been beaten down in 1997-98, so the 2000 crash saw only a hiccup in the beginnings of recovery. The hedge fund that had sold all its tech holdings in March 2000 and reinvested in Russia and Indonesia would have truly deserved its management's exorbitant fees. Gold and silver too were close to their bottom in 2000, and would prove an excellent investment over the next decade.

For small investors, here's a tip. It's true most of the time, but it's overpoweringly, Biblically true at the top of a bull market: the best investment going forward is not the best-performing fund among a broad family of mutual funds, based on 1-year, 3-year and 5-year track records, but the worst-performing fund, which is almost certainly close to a cyclical low and will shortly rebound sharply.

The next time around in 2007-08 the casualty list was quite different. There were no significant losses in the tech sector, other than stock market declines that were mostly made up when the market recovered. Again, emerging markets were little affected—the world central banks' policies of ultra-easy money soon reflated their balloons. U.S. house prices declined, by as much as 50% in some over-inflated markets, but real estate in general suffered only modest losses—General Growth, the shopping center operator that went bust in 2009, was soon refloated. General Motors and Chrysler filed for bankruptcy, but those bankruptcies, like the frequent bankruptcies in the airline sector, reflected long-term lack of profits rather than any bursting bubble.

The biggest permanent losses of value were suffered in three areas: housing bonds and the associated securitizations, the financial sector and the PIIGS of southern Europe. All three losses were directly linked to excesses of the preceding bubble. Lending practices in the home mortgage sector had deteriorated to unsustainable levels, largely owing to government encouragement by housing legislation and the Fed, and that bubble had been further encouraged by the practice of securitization and associated derivatives games. The result was a bust that had been inevitable, but was made much worse by government and Wall Street malfeasance.

The financial sector's losses were largely a spin-off of the losses in the housing sector, but strictly reflected a bubble of easy money and unsound derivatives innovation rather than the housing bust directly. Credit default swaps in particular were poorly managed, dominated by rent-seeking trading practices, and should have caused a lot more damage than they were allowed to (if they had caused more damage in 2008, they would not still be around to plague us in 2014-15).

Finally, the losses in peripheral Europe resulted from the unsound self-deluding structures surrounding the establishment of the euro and the admission of Greece to the EU. Greece, in particular, had been allowed to become a subsidy junkie and had driven its living standards up to unsustainable levels. Its GDP per capita needed to halve, and it could do not do so within the euro without intolerable levels of deflation. Interestingly, the Baltic states, also ahead of themselves in living standards in 2007, were able to solve their problems through deflation alone—the living standards excesses were less than Greece's and the internal discipline was much better. The other PIIGS: Ireland, Italy, Spain, Portugal, and now Slovenia, had only a mild version of Greece's problem, so only a bearable deflation and possibly a modest debt write-off should see it solved.

The sectors self-destructing this time round will be those showing most excesses in this bubble, which are not the same as the excesses of the two previous bubbles. Housing is unlikely to cause another major problem directly, at least in the United States, because it hasn't recovered far enough, although the bloated and overblown London housing market, where prices are now above those of 2007, seems certain to crash. Most emerging market countries have managed their finances much more carefully than Western countries, so are unlikely to see more than modest problems, although every year this bubble lasts will increase the numbers of emerging markets that get into difficulties—the temptation to spend the money being thrown at them is too great. Finally, commodity prices have fallen back a long way from their 2011 peaks; unless that bubble reflates rapidly it is unlikely to cause much trouble—the underlying driver of strength, growth in emerging markets relative to developed ones, is a long-term trend that is not going away.

Having listed assets that won't suffer a meltdown when the current bubble bursts, it is a melancholy fact that the list of assets that will melt down is much longer.

First, there are the assets located in the BRIC economies of Brazil, Russia, India and China. Far too much money has poured into these economies, drawn by their likely future wealth, but also by the foolish theory of BRIC domination perpetrated by Jim O'Neill of Goldman Sachs. These economies are already showing their cracks, but there's much more to come. The Batista bankruptcy in Brazil is the first of many; both the consumer debt and government sectors in that ill-run country are hugely overblown and due for a credit crunch similar to that suffered in the 1980s.

In Russia, trouble will accompany an oil price collapse, caused by the plethora of new energy sources currently being developed; with oil at $40-50 a barrel, a perfectly reasonable long-term expectation, Russia's fiscal and economic position is hopeless. In India, the economy is already showing signs of strain; it's most likely that fiscal and economic collapse, accompanied by a major balance of payments crisis, will be Congress's legacy to its successor in spring 2014, a poor recompense for the bright, reformist outlook Congress inherited at its unjustifiable election victory in 2004. Finally, China's bank bad debt problem is now sufficiently large as to swallow even its $3.4 trillion of international reserves. The four BRICs may well have good long-term prospects, but they are due to suffer a grisly and costly decade before re-embarking on the road to prosperity.

The BRICs are only the tip of the cracking iceberg of bubble credit, albeit a very large one. The U.S. junk bond market has prospered in the last few years with credit standards weaker even than in 2006-07 and interest rates at unsustainably low levels. When interest rates rise, holders of junk bonds will suffer gigantic losses, many of which will be unrecoverable as the underlying borrowers collapse in turn.

U.S. Mortgage REITs, which buy long-term mortgage bonds, financing themselves in the repo market, will be a medium-sized casualty, with losses somewhere under $1 trillion, as short-term and long-term interest rates rise, collapsing their capital structures as bond prices decline. Their death will also kill off the repo market, which is rather more serious, as all kinds of entities depend on it for their short-term liquidity excesses and shortages.
To return to where we opened, hedge funds will also collapse, as their investment returns become heavily negative, their funding dries up and the legal vultures close in, as they have on SAC. The hedge fund and private equity sectors have grown far larger than is justified in a non-bubble economy; their return to their proper size will inevitably involve large losses for their investors. It's another bubble; therefore it must burst.

There will also be collapses in the too-big-to-fail bank sector. Here the losses and bailout of 2008 have made them more cautious, although they still employ trading desks that are far too large and aggressive for the genuine businesses of the banks. However in the last few months, governments have discovered the political joy of zapping big banks with penalty after penalty, mostly relating to malfeasances that should by now have passed beyond the five-year statute of limitations. A financial system cannot survive continual looting raids by regulators and trial lawyers, out of proportion to any losses directly caused. At some point, one of the majors will find itself unable to attract either further capital or funding and will fail. That failure will drag the other largest banks with it, since they all have similar legal liabilities and are hopelessly intertwined. Only medium-sized banks may survive, since the politicians and lawyers have not yet targeted them to the same extent.

The tech sector, spared in 2008, will crash again this time. The hopelessly over-optimistic valuations given to the likes of Twitter and Facebook will collapse, as Internet advertising revenues prove finite, while teenage and young adult fashions move on from Facebook membership and tweeting to some other activity. This particular part of the movie we have seen before; it will involve only modest credit losses, but a substantial number of ex-billionaires will be created.

A wholly new credit crash will come in the area of college debt, which recently passed $1 trillion as students hocked themselves to the eyeballs to pay for overpriced college courses. With college courses now available for free or close to it over the Internet, much of the college infrastructure, and college debt infrastructure, is hopelessly overpriced malinvestment and will have to be liquidated. The process will be both painful and to the intelligentsia wholly unexpected.

Finally, government bonds are themselves a bubble, which will inevitably burst. However only Japan's public debt is large enough in terms of the country's GDP to cause a bursting bubble in the next year or two. U.S., British and most EU public debt is still within historical norms in terms of GDP, although the accompanying deficits often aren't. My crystal ball is thus clouded on whether the public debt bubble bursts this time around, or whether reflationary policies cause it to grow further, becoming an unimaginably damaging centerpiece of a collapse around 2020. Either way, when it goes it will take the entire banking system with it, because of the Basel regulatory structure's incredibly foolish zero-weighting of public debt in calculating capital needs.

As you can see from the above discussion, the universe of assets whose price will collapse in the next downturn is considerably better populated than the collection of assets whose price won't collapse. It is only a question of time, and if you asked me to guess, I'd put the collapse's onset in the fourth quarter of 2014.