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The Granddaddy of All Bubbles?

By Peter Coy and Roben Farzad on April 13, 2011 | [Twitter](#) [Facebook](#) [LinkedIn](#) [Google+](#) [Comments](#) 0 Comments

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World markets are frothing like shaken Champagne, and doomsayers argue that today's bubbles need to be deflated now before they get dangerously large

It's as if 2008 never happened. Once again the world's investors are pumping up bubbles that will probably explode in their faces. After the popping of a real estate bubble led to the first global recession since the 1930s, world markets are frothing like shaken Champagne. Pundits claim to have spotted price increases that are unsupported by economic fundamentals in assets ranging from U.S. farmland to Israeli biotech to Australian housing to Chinese cemetery sites. Commodities have soared. Global junk-bond issuance hit a record in the first three months of the year. And Yale's Robert Shiller calculates that the Standard & Poor's 500-stock index is trading at 23 times earnings normalized over the past 10 years, compared with a historical average of 16. "I fear this is the granddaddy of them all, an almost-encompassing bubble right at the heart of monetary systems," says Doug Noland, senior portfolio manager of the Federated Prudent Bear Fund.

Cassandras, pointing to the bankruptcies, taxpayer-financed bailouts, and joblessness caused by the last bubble, argue that today's bubbles need to be deflated now before they get dangerously large. Many blame the Federal Reserve for keeping interest rates too low and pumping out a flood of money in search of yield that feeds bubbles around the world. Chinese authorities want the Fed to raise rates to relieve inflation in China. On Apr. 7 the European Central Bank raised its benchmark lending rate a quarter-point, to 1.25 percent. In the U.S., "What we've created is beyond moral hazard," laments Brian Wesbury, chief economist at First Trust Advisors, a Wheaton (Ill.) fund shop. "People are coming to think that the market cannot go higher if the Fed isn't helping it."

Not everyone is in the grip of bubble-phobia, least of all

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Fed Chairman Ben Bernanke. The central bank remains committed to keeping rates ultralow until the economy shows more staying power. In an Apr. 11 speech in New York, Fed Vice-Chair Janet L. Yellen didn't say anything about bubbles. But she rejected the contention that Fed policy is responsible for commodity price inflation, blaming the runup in oil and food prices largely on "rising global demand and disruptions in global supply." She's right: Commodities aren't being hoarded, as they would be if investors were speculating on them. Inventories have fallen since last summer.

Some economists such as Jaume Ventura and Alberto Martin of Barcelona's Universitat Pompeu Fabra go so far as to argue that bubbles are the price we pay for vigorous growth. They say the optimism reflected in sharply rising prices can become a self-fulfilling prophecy: Rising prices induce more hiring and investment. That generates the growth that justifies even higher prices, and so on in a virtuous upward spiral. Of course, eventually the bubble pops and causes a mess. Yet however jarring a boom-bust economy may be, they say, it's better than an overregulated economy stuck in perpetual underperformance. "The bubble has costs. But you prefer the world with the bubble over the one without the bubble," says Ventura.

James W. Paulsen, the bullish chief investment strategist at Wells Capital Management in Minneapolis, happens to think the Fed should raise interest rates a bit now—but, he says, "It's comical that we think we can regulate away future recessions or crises. It's scary to the extent that if we do, we will crush the essence of capitalism, which is basically greed and animal spirits."

Didier Sornette, a physicist who studies finance at the Swiss Federal Institute of Technology Zurich, sketches out six stages of bubbles: 1) the appearance of a new investment opportunity; 2) the expansion of credit; 3) euphoria; 4) distress; 5) revulsion; 6) panic. Ventura and Martin don't even assume euphoria. In their "rational bubbles," investors buy into a bubbly asset because they conclude that the overpricing can last for many years, and the chance they will still be invested when the bubble bursts is small. For all the people who sell before the bust, as well as all those who earn salaries from the sector while it's still bubbling, there's no downside, they note.

One reason it's hard to pick between the bubbles-are-bad and bubbles-are-O.K. camps is that bubbles aren't all alike. The best ones create assets whose value survives the crash. The Apollo program that put people on the moon, only to lose public support in the 1970s, was a "social bubble" in which over-optimism advanced science, Sornette says. Bad bubbles generate worthless assets such as exurban housing subdivisions that are taken over by squatters and mold. Other bubbles don't

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produce any supply response at all. The only impact of China's new mania for old wine—one bottle went for nearly \$233,000 last year—is to transfer wealth to whoever was lucky enough to own the bottles before the Chinese got interested, notes Harvard economist Edward Glaeser.

When the tech sector gets bubbly, consumers are often the biggest beneficiaries, Glaeser says, because investors fund ideas that help the general public, from wireless communications to solid-state data storage to the Internet. So it was in the 19th century with the railroad boom. Today's speculation in tech is concentrated in social networking. The question is whether the new investments will live up to the greatest hits—and productive busts—of Silicon Valley's past.

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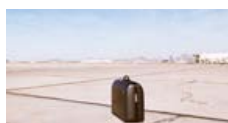
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