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Are bubbles inevitable? They may be the new norm - Part 1

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Part I: There is a growing school of thought that bubbles - real estate, stock or otherwise - are inevitable; i.e. that they are now part of normal business cycles. In fact, some say that the bubble cycle has replaced the business cycle, and we will see more and more extreme peaks and subsequent crashes. Some even say that bubbles are good, because they are often linked to innovation, quick advances in technology, finance or medicine, in other words, game changers.

If a bubble is the new norm, then we need to look closely at the definition. There are many precise economic definitions of bubbles, but mostly it boils down to situations where asset prices go way beyond their intrinsic value. Bubbles are often linked to irrational behavior, i.e. betting that things can only go up. Bubbles are obvious in hindsight, but rarely visible in foresight. In a past Harvard Business School review, authors said "it would be nice if we could predict bubbles; even nicer if we could prevent them. Unfortunately this would violate the laws of nature; asset bubbles occur because the limits of our ability to process information and coordinate activity in a market setting, where no one is in charge, an no one has a complete view of the big picture". Another economist writes that "we are no better today at predicting tomorrow than we were yesterday. Eighty years after the Great Depression we still argue about what caused it and why it ended."

Although we can't see the bubble typically, investors may have some sense of it, but they don't want to get out because they may miss some of the upside. They want to time the collapse of the bubble, and get out just before. This is of course impossible. The vast majority of people get caught in the bubble, because of not wanting to sell early, greed, denial, or misinformation.

Let's explore the causes of bubbles. In real estate bubbles, availability of information is a significant part of the problem. Unlike the stock market, where information is constantly available on a daily basis, known with every trade and every swing of the Dow or NASDAQ, real estate information gets to us usually well after the fact. Sales are typically viewed in arrears. Public information is relatively limited. Developers of real estate plan as quietly as they can, so as not to alert competitors. The permit process is always uncertain, and projects planned for one year may in fact be built several years later, overlapping new ones in an unplanned way. No one fully knows the "big picture", nor are they able to gather and synthesize information well. Late-comers to the market, i.e. conservative investors, smaller participants, are all typically chasing the excitement of the good news typical in a later phase of the real estate cycle. Their lack of information, and reliance on "buzz" will cause them to pay the irrational price.

Technology will and has helped with the information gap. However, on the other hand, there is an irony to improved technology: the same increase in information availability may pump up markets faster, changing them from a sustainable up trend in a cycle to a full blown bubble. Certainly that could be true of positive "news" found on the internet. So while economists will say that "perfect information" helps with market equilibrium, and therefore by definition bubbles should not exist, that information may in fact set fire to a smoldering real estate bubble.

Another problem is that it is harder to see the bubbles, because the world is more complicated and interrelated. Who in Iceland could have foreseen that their collapse would be caused in large part by our residential collapse in the southwest? It had to do with the interrelations of world banking and finance, with no one in charge and few seeing the big picture.

Another concern is that people are encouraged to live beyond their means, thus providing fuel to bubbles. We are encouraged to borrow in order to spend. People purchase asset classes with their irrational exuberance because, while they may not be able to afford it, they are convinced or coerced to make the bet that value will increase.

There is a thin line between economic expansion and the "irrational exuberance" of bubbles. Some will benefit from bubbles, but the majority will suffer painful losses. If bubbles are in fact inevitable, people should be better informed to recognize the difference between them and healthy sustainable growth patterns.

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