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Are bubbles inevitable? They may be the new norm - Part 2

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There are many examples of bubbles throughout history, but they occurred relatively infrequently, maybe just a couple a century. The most well-known textbook bubble is the tulip collapse in 1637, apparently the first bubble. Then, Europeans who were caught up in the frenzy, paid the Dutch irrational prices for tulip bulbs, because they hoped to flip them for a profit. Within a year, someone decided that tulips had very little intrinsic value, and thus the crash. Other bubbles include the rush to invest in railroads in the 19th century; the dot.com bubble in the late 1990s; and most recently the worldwide residential real estate bubble and implosion in Dubai.

My previous article on bubbles indicated that they are here to stay, inevitable as part of the business cycle. What is more troubling, however, is that the frequency of bubbles seems to be increasing. Note that before the dot.com bubble fully deflated, people were already over-investing in residential real estate. While there are many reasons for that, as we all know, a fundamental one is peoples' constant search for wealth. If investors have any funds left after one bubble bursts, they may be all too eager to search for yield somewhere else. A recent example is investors burned and disillusioned with the stock market have retreated to the bond market, causing an unusual increase in bond value, and simultaneous decrease in bond interest -- some say a bubble in the making.

The size of bubbles may also be getting larger, with more disastrous problems on the deflation side. This argument is made by those who believe we are reflating our economy, creating other potential bubbles, in order to stave off paying for our current ones. Another real estate example of this, I heard from a speech the other day, is the high demand and thus high price of multifamily housing. Multifamily seems safe, and currently works better than other real estate, because of low cost, non-recourse funding. When asked a question as to how much demand would drop if funding cost increased, the speaker said the change would be dramatic, potentially a serious problem.

So, to get back to the initial question, are bubbles inevitable? Can we live with them? It seems that, as business cycles are inevitable, so may be bubbles. There appears to be more of them, with greater frequency, and perhaps greater size. Isn't a bubble almost the same as a real estate cycle, just with steeper than normal peaks and troughs. The problem lies in the irrational growth to the peak and the steep fall off the other side. It may be a definitional question, but bubble may be the new norm.

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