FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

Issue #38
October 29, 2021

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Boombustology

After decades of experience in grappling with Fed officials in committee meetings and of lunches and private discussions with Fed chairmen, a lifetime of reading serious economic literature, and a profound awareness of the dangers to liberty in our time, I know there is absolutely no hope for the Fed to conduct responsible monetary policy. ~ former Congressman Ron Paul

I just finished reading the book Boombustology: Spotting Financial Bubbles Before They Burst by Vikram Mansharamani, which was published in 2011. It's an excellent book and I highly recommend it.

Vikram begins by recounting the fate of the huge, successful hedge fund Long Term Capital Management (LTCM), which had almost $1 trillion at risk based on a belief in the Efficient Market Hypothesis (EMH). (By the way, that's the same theory upon which index funds--which today probably account for most of the money invested in mutual funds and ETFs--are based.) "...LTCM had never had a monthly loss of greater than 3% prior to 1998....the Asian financial crisis and the Russian debt default, however, were enough to cause not one, but two days of more than $500 million in losses. According to the LTCM... models, the likelihood of having one such day was 1 in 50 million. The likelihood of two such days was incalculably small. Needless to say, the revelation of the flawed framework, as well as the huge monetary losses, were shocking to the LTCM financial wizards…." *EMH, meet the Black Swan.*

"The most ironic element of the story…is that a team of efficiency-committed, Nobel prize-winning 'equilibriumists' effectively undermined their intellectual position by first demonstrating it was possible to generate excess returns (i.e., that markets were not in fact efficient) and then by blowing up due to massive market inefficiency."

Next, Vikram explains the theory of reflexivity developed by hedge fund manager George Soros, who wrote of it, "Reflexivity is…a two-way feedback mechanism in which reality helps shape the participants' thinking and the participants' thinking helps shape reality in an unending process in which thinking and reality may come to approach each other…." Vikram says Soros suggests "that observers actually change…reality…and that this changed reality in turn affects their perception, creating a self-reinforcing cycle that compounds misperceptions."

Next Vikram covers the Financial Instability Hypothesis, which was developed by economist and economics professor Hyman Minsky: "…after long periods of economic stability…destabilizing forces in the economy begin to develop, forces that eventually lead to financial instability….this happens through the progressively…more dangerous use of leverage."

Minsky wrote that there are three types of financing: "*Hedge financing* takes place when one is able to pay back both the interest owed as well as the principal due via normal cash flows….*Speculative financing* is a bit riskier…because interest expenses are paid, but the principal must be refinanced upon maturity….the speculation is that refinancing will be available when needed." Such financing "may be available at materially different prices [interest rates] than originally envisioned." The federal government employed hedge financing for probably over a century, until it reached the speculative phase, which was sometime between The Great Society and The Great Financial Crisis.

"Finally, *Ponzi financing* takes place when one is dependent on the availability of additional debt in order to pay interest on existing debt. Given the inability to pay interest expense out of cash flows, the possibility of principal paydown is nonexistent." We are now at a point where in order to keep the financial system and economy from imploding, we must continually go deeper into debt.

Minsky's hypothesis "is based on a shift in the mix of financing structures." He writes, "Over a protracted period of good times…economies tend to move from a financial structure dominated by hedge finance…to a structure in which there is a large weight… engaged in speculative and Ponzi finance." Vikram continues, "Thus, in a self-fulfilling, reflexive manner, financing…gets more and more aggressive as the lack of failure justifies the tendency. Eventually, however, the weight becomes unbearable and the structure implodes. This procyclical tendency of credit to grow in riskiness during good times is very destabilizing…something I call the Minsky Migration."

The Minsky Moment represents “that moment in time when the credit structure switches from getting more aggressive to less aggressive. After the Minsky Migration crosses the Minsky Moment, bad things happen. Speculative and Ponzi units begin to implode, and hedge units become vulnerable as the entire economy wobbles. Asset prices plunge as those units unable to obtain refinancing are forced to sell assets. This dynamic...causes broad and great pain....”

Next, Vikram examines how the Austrian school of economics (of which I am a longtime adherent) explains booms and busts: “...excessive credit growth (driven by government intervention via interest rate policies, etc.) is the root of speculative booms and busts by generating unsustainable growth....artificially low interest rates result in bad investments and overconsumption, creating excess capacity and motivating businesses and individuals to under-save. Because central banks monopolize money creation...[they] lie at the origin of financial bubbles.”

“Market-clearing interest rates [i.e, rates set by the free market instead of by central planners in central banks]...allow for the optimal allocation of resources between consumption and investment....Central banks...are motivated to keep interest rates below their appropriate level, and the result...is an inappropriate increase in long-run investments,” which results in malinvestment and overcapacity. “Likewise, inappropriately low interest rates cause consumption to be higher” than it should be.

“Eventually, bad investments and/or overconsumption must be addressed and an overly 'consumed' society is found with too much debt (due to the low cost of money) and a need to increase savings. At this point, the bust portion of the cycle begins as savings increase (either via actual savings or via debt repayment), consumption slows....Significant excess capacity from overinvestment results in deflationary forces....Austrians believe that this process must be free to run its course, independent of bailouts and other government intervention, in order to purge the system.”

Vikram explains the difference between puzzles (which can be solved) and mysteries (which cannot). For investors, the future is a mystery, and Vikram recommends that they use five different lenses to examine and gain a better understanding of current events and thus have a better chance of correctly predicting the future: microeconomic, macroeconomic, psychological, political, and biological.

Regarding psychology, Vikram writes, “It is only relatively recently that psychologists have demonstrated that humans may not be 'rational' [as the EMH assumes]....it seems that human beings are motivated by cognitive biases of which they are largely unaware....Through hundreds of empirical studies, psychologists have found that people often make suboptimal decisions for a variety of reasons, including incomplete accounting of costs and benefits, partial risk understanding, and flawed assumptions regarding the probability of various outcomes....we are all plagued by predictable and consistent biases that affect our decision making in a manner that directly conflicts with our supposed rationality....irrationality may be the norm, rather than the exception, making booms and busts more likely than stability....Humans appear to be routinely overconfident and unaware of their own knowledge limitations.”

Humans tend "to rely on a handful of heuristics or 'rules of thumb' to simplify the complexity of a cost/benefit analysis for each decision. In most circumstances, these heuristics are quite useful, but sometimes they lead to severe and systematic errors." Vikram then explains the biases of Representativeness, Inattention to Base Rates, Insensitivity to Sample Size, Misconceptions of Likelihood (the Gambler's Fallacy), Dismissing the Powers of Regression, Conjunction Fallacy, Availability, Ease-of-Recall Bias, and Retrievability-Based Biases. He then covers other cognitive issues: Anchoring and Adjustment, Framing and Preference Reversal, Fairness, Mental Accounting, the Endowment Effect, the Congruence Heuristic, and the Confirmatory Bias. If you're an investor and are unaware of these biases, you will probably end up as roadkill.

Regarding the political lens, Vikram writes, "Political processes...are likely to exacerbate financial extremes. Specifically, politically determined price floors and price ceilings can confuse price discovery processes, and tax policies are prone to either inflate or depress the demand (and supply) for certain goods, sometimes quite dramatically." Echoing Austrians, Vikram writes, "...prices [including interest rates, which are the price of money] contain tremendous information about the appropriate allocation of scarce property."

"...the introduction of property rights where they previously did not exist (think of China's housing reform program of the late 1990s) creates a particularly fertile ground on which bubbles may grow." (See Issue #36: The Great Debt Wall of China.)

When the government sets prices (including interest rates), it invariably results in shortages or surpluses, black markets, unintended consequences, perverse outcomes, and booms and busts. "...politically motivated or mandated price distortions usually exacerbate...the problem they seek to address."

In the chapter about the biological lens, Vikram writes, "Epidemiology is the study of diseases and their transmission across a population. If we think about markets as being composed of individuals who are either affected or not affected by a particular 'disease' (i.e., infatuation with the new thing), the...terminology of epidemics has a striking pertinence to the study of booms and busts."

Economist Robert Shiller emphasizes the need for a transmittable story to fuel a speculative mania (humans love stories, as that was how they recorded and transmitted information for millennia): "Word of mouth may function to amplify public reaction to news events....the likelihood of any event affecting market prices is enhanced if there is a good, vivid, *tellable* story about the event....Word-of-mouth communications, either positive or negative, are an essential part of the propagation of speculative bubbles." Whenever you hear the Dumb Money (novice/amateur investors) talking about some new investment story that's on everyone's lips (e.g., internet companies, IPOs, day trading, BRICs, FAANG, cryptocurrencies, Tesla, SPACs, etc.), watch out.

Throughout the book, Vikram repeatedly uses the model of infection to ask who is left to infect (or who is left to buy). "...a growth in amateur or beginner investors into a particular asset class is very telling. After all, we must assume that expert investors have already been infected, and if amateur investors are now infected, who is left to infect?

Thus, by gauging the prevalence of newcomers to an asset party, one can get an approximate sense of the bust's imminence."

Vikram examines the behavior of locusts, bees, and ants to explain emergent behavior in human swarms. Similar to humans, the behavior of locusts "changes radically when placed into crowded situations." When the density of locusts reaches about seven per square foot, "they begin marching in synch with each other....Normally shy and solitary, the close proximity of other locusts...stimulates them to produce the neuro-modulator serotonin, which not only makes them gregarious, but also stimulates other nearby locusts to generate serotonin as well. The ensuing chain reaction soon has all the locusts in the vicinity seeking each other's company." Sounds like the Wall Street Bets group on Reddit or the audience of CNBC.

"If unsuspecting group members (think ordinary investors) can be led in any direction by a relatively small number of confident (regardless of whether such confidence is merited) members, one can imagine how such confidence might feed upon itself to generate a boom-like scenario. Famous research conducted by Stanley Milgram...demonstrated the power of silent leadership in groups....the research confirms the ability of a few people to guide the behavior of a much larger mass....this experiment actually demonstrated the ability of a few to *mislead* the many, an outcome that has significant pertinence to the study of booms and busts."

"Humans have a tendency to conform to the behavior of the seemingly knowledgeable group member....initial decisions made without meaningful reason might be interpreted by later deciders to have been based on careful analysis and contemplation. By placing greater weight on early decisions made during a chain of decisions, information cascades may develop and create outcomes that seem to defy explanation....such information cascades serve as the basis of herd behavior and have deep evolutionary value....Seemingly irrelevant decisions take on greater meaning than originally anticipated and have the potential to snowball into herdlike behavior of uninformed individuals. If everybody else is making money investing in housing, why shouldn't I? Clearly they've done the analysis and everyone can't be wrong, can they?....The most telling signs of a mature boom that is rapidly approaching the bust phase are a rapid growth in the number and type of participants, as well as the increasingly prevalent participation of unsophisticated or amateur investors."

Vikram explains why so many active fund managers actually run closet index funds: "John Maynard Keynes noted...that 'worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally.'...money manager Jeremy Grantham of GMO has built on this logic to replace the word 'reputation' with 'your career.' Describing the phenomenon as 'career risk,' Grantham notes that herd behavior and consensus investing is the norm not because professional investors do not recognize financial extremes, but rather that the risks to their careers for unconventional decisions are asymmetric. Failing with the crowd is accepted and succeeding with a crowd is expected, but failing on your own is likely to lead to termination....the likelihood of losing your job is small while sticking with the crowd, and significant when deviating from the crowd. Why take such unnecessary career risks?"

As analyst Andrew Smithers wrote in March 2000 at the top of the market, "Most fund managers are aware the market has gone bananas. What they do not and cannot know is when the madness will end. If they are going to stand out for sanity, they must have ***stalwart clients who will back their judgement*** even if the result is poor performance over a number of years. Unfortunately, ***such clients are rare.*** It is, therefore, more reasonable to blame the clients than the fund managers [emphasis added]." After 25 years in the business, I have concluded that most people simply aren't psychologically equipped to have a successful investment experience. I have found that investment advisors get fired at the top (FOMO) and bottom (fight or flight) of the market.

In the next section of the book, Vikram applies his five analytical lenses to five different historic episodes of boom and bust: the tulip bubble in 17^{th} Century Holland, the Great Depression, the Japanese real estate and stock market boom/bust in the late 1980s, the Asian Financial Crisis in 1997-8, and the U.S. housing boom/bust.

One fascinating aspect of the tulip bubble which I had never read about was that "from 1635 to 1637, contemporaneous with the formation of the tulip bubble, the Netherlands was ravaged by the [bubonic] plague….This context of tremendously good times (and corresponding financial innovations) with an ominous overlay of disease, uncertainty, and death proved a potent mixture for speculative desire among the Dutch….Given the end of the war with Spain and the impact of the plague…[the Dutch] were likely in a particularly vulnerable psychological state. The uncertainty of life due to rampant disease generated a short-term orientation and focus on the present and immediate future. Longer-term thinking was considered wasted thought. Alongside these reminders of mortality, however, overconfidence was ubiquitous during this golden age of the Netherlands' economic history. In short, economic optimism combined with the heightened uncertainty of life to generate and strengthen a gambling tendency, thereby magnifying bubble possibilities." Hmm, does that situation sound familiar?

One aspect of the Asian Financial Crisis (which was primarily driven by hot investor money from the U.S. seeking higher returns via emerging markets mutual funds) was that even though the crisis originated in (and really primarily concerned) Thailand, it subsequently resulted in large stock market losses in other emerging Asian countries due to mutual fund rebalancing. After the Thai stock market crashed, fund managers were suddenly overweight in all of the other emerging stock markets in Asia. They knew they were being evaluated based on how they performed relative to the MSCI Emerging Markets Index, and due to career risk (failing unconventionally would probably result in termination), they decided to fail conventionally by selling stocks in other Asian stock markets to make their fund more closely resemble the index.

One of the recurring themes of the book is the reflexivity of confidence: "The primary cause of this reflexivity was the use of borrowed money that was collateralized by assets—assets which had their values inflated by the excess purchasing power generated through borrowed money….The dynamics leading to disequilibrium can be summarized as a self-reinforcing, self-validating reflexive feedback loop that connects…the five Cs—confidence, collateral, credit, conditions, and capital….During the boom phase of the cycle, confidence inspires credit, credit improves collateral values, which generates confidence and better economic conditions via increased activity. The improved conditions drive more confidence and attract capital, which results in greater availability of credit. The greater availability of credit broadens the universe of acceptable collateral, which generates better conditions, and on it goes."

"Unfortunately, the world discovered that these highly interconnected and reinforcing five Cs can also work in reverse. So, during the bust phase of the cycle, reduced confidence led to less credit, credit contraction hurt collateral values, which hurt confidence and conditions. Deteriorating conditions further hurt confidence, which caused capital to flee, while further reducing access to credit. The contraction in credit tightens collateral standards, which further hurts conditions, and so on....If confidence is the root of our signal, then the shock to one's confidence is what tips the balance and turns our virtuous cycle into a vicious one....the highly iterative and self-reinforcing loop is very reflexive and can lead the system to extremes of instability...." A sudden (and unexpected) loss of confidence causes the avalanche.

Another recurring theme is the relationship between credit and collateral. "During the course of the five case studies...the most prominent examples of reflexive dynamics at work involved the self-reinforcing, pro-cyclical dynamic between credit and collateral. This often occurred in times of extreme optimism when lenders modified their lending criteria from income-oriented toward asset-focused approaches. When the primary criteria for extending credit switches from income-based affordability to collateral value, watch out. This is a spectacular early warning sign of a powerful reflexive dynamic being unleashed....If credit is rising rapidly along with asset prices, there is a high probability that reflexive dynamics are under way. These dynamics were prominent in the Florida, Japan, and U.S. housing cases...."

Vikram includes an illuminating chart that shows which factors or conditions were present in each of the five case studies. In order of prevalence, they were (five times): collateral/credit, financial innovation, cheap money, moral hazard, conspicuous consumption, New Era thinking, amateur investors, and silent leadership; (four times): supply/demand manipulation, regulatory shift; (three times): credit criteria, popular media; (twice): hot money.

In the final chapter, Vikram uses the five lenses to analyze whether China may be the next bubble. (He speaks Mandarin and once worked at the U.S. embassy in Beijing.) "Signs of bubbly conditions in Chinese property seem ubiquitous....developers in Tianjin have created a $3 billion 'floating city'...featuring the world's largest indoor ski resort [Sound familiar? See Issue #37.]....a real estate investor noted 'the speed you buy a house here is faster than you buy vegetables.' In one case, more than 800 people lined up...some waiting in a downpour for six hours or more—with the hope of purchasing one of the 220 units in a new development....there are reports of as many as 65 million urban electricity meters that are registering zero consumption over a recent six-month period."

"On the commercial property front, reports vary from the official vacancy rate of around 22% to one...estimate of 50%....hedge fund manager Jim Chanos [perhaps the most famous short seller in the U.S.] believes that there was roughly 30 billion square feet of office real estate under construction in January 2010, [of which he said] 'There is a 5 foot by 5 foot office cubicle being built for every man, woman and child in China.'...the mean reversion tendency and force will be violent and create a bust that has the potential to drag banks and the economy with it."

"A final example of the overinvestment boom [is] the South China Mall....the largest mall in the world with the ability to accommodate ~1,500 businesses. The 7 million square foot complex was described as being 'Disneyland, Las Vegas and Mall of America rolled into one.' There are carnival rides, mini-parks, canals and lakes....Although completed in 2005-6...in late 2009 the mall had 10 or 12 operating tenants. Originally planned to have 70,000 visitors a day, the mall has not come anywhere near achieving this objective." One visitor in 2011 described it as having "shuttered shops, never occupied by a single tenant, dusty escalators that lead to floor upon floor of emptiness." But don't worry, the Chinese have found a solution to the problem: "...a further expansion [of the mall] is in the works, with more than two million square feet to be developed." A retail consultant noted, "When it's easy to get financing without having to convince someone of the project's feasibility, and without having to show preleasing commitment, you can start to get into trouble."

Vikram notes that "by linking their currency to the U.S. dollar, the Chinese have effectively outsourced their monetary policy to the United States....The only problem is that the Chinese patient was not as dangerously ill as the U.S. economy was when the medicine [QE] was administered. The outcome is extraordinarily easy money in China.... Chinese real [interest] rates are remarkably negative. To understand why negative real interest rates are a recipe for an asset boom, one need only think of the fact that negative real rates mean that investors get paid to borrow from a bank and park the money in any asset that grows in nominal terms." As Chanos observed, "Bubbles are identified by credit excesses...and there's no bigger credit excess than in China." Vikram continues, "The sheer volume of lending in China is staggering....in the past two years, China's new credit creation has amounted to $2.7 trillion—an amount equal to 4.4% of global GDP, or as much as the size of the U.S. credit expansion in the mid-2000s....a majority of this lending has taken place since the beginning of 2009...."

"This scenario of massive credit flowing and easy money is precisely the foundation of an Austrian school prototypical unsustainable boom. Excess investment and overconsumption will result in too much capacity and an eventual bust. If money is inappropriately priced, it is likely to be inappropriately allocated."

Next, Vikram covers Goodhart's Law, which states that "economic indicators lose their informational content if used as a target of economic policy....Whereas GDP had historically been a useful indicator...it has now become a policy target subject to manipulation in the quest to achieve the 'number.' Economic activity no longer drives GDP; rather, GDP drives economic activity....government-mandated lending has driven local governments to demolish usable roads and dynamite functioning bridges in a quest to develop projects through which to deploy investment dollars and generate GDP. These actions, while illogical to most observers, actually make a great deal of sense from the perspective of incentives at the local level—not only does the creation of new infrastructure generate economic activity (i.e., GDP), but so too does the act of destruction! Given that local officials are often evaluated on GDP growth in their geography, such infrastructure destruction and re-creation might also accelerate one's climb up the communist party's ladder."

(By the way, what is the infatuation by communists and the Left with destroying things? Everything from broken windows to war to riots and arson to Year Zero to Cash for Clunkers. When will they learn that humans don't make progress by destroying things?)

One professor made this interesting point: "...[corruption] is tougher to pull off in states with a free media, independent judiciary, and rule of law....Small crises are not allowed to emerge to inform the public of accumulating systemic risks, thereby allowing the covert building of large problems." People can't see the snowdrifts building at the top of the mountain.

Finally, Vikram notes the concerning ubiquitous involvement of large, state-owned businesses (the dumbest of the Dumb Money) in the property sector. "...in August 2010 approximately 82% of all land auctions in Beijing have been won by big state-owned companies outbidding private real estate developers....Between 2003 and the first quarter of 2010, Beijing real estate prices rose between 350 and 900%. Defense equipment manufacturers, salt miners, railway groups, oil companies, chemical processors, shipbuilders, and telecom companies are all active in the property development business....a large state-owned shipbuilder recently [2009-10] paid $1.3 billion for land in Beijing upon which to build residential communities." Although the central government ordered "78 companies to dispose of or spin off their real estate divisions....experts believe that more than 90 of the 125 state-owned companies entirely under Beijing's control still have actively operating real estate efforts....Who might be left to purchase more real estate?"

In closing, Vikram mentions the Skyscraper Index (which I've discussed before), and how China dominates the list of the tallest buildings in the world that are currently under construction. I wanted to see if this was still the case a decade after the book was published, so I went to SkyscraperPage.com, which shows that of the 25 tallest skyscrapers currently under construction, 19 of them are in China. As Vikram notes, the construction of these buildings marks the top because the builder has to obtain financing from someone, they are almost certainly not 100% preleased (especially in China, a communist state), and they're a trophy asset and a sign of hubris and excess confidence.

What You Should Be Doing Now

I plan to cover the why and how of these in future issues (if I haven't already), but here are some actions I recommend you take (or at least start thinking about) now:

1. Avoid Chinese real estate and equities and the countries that heavily depend on China (Australia, Brazil, Indonesia, etc.).

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I would love to hear from you! I thrive on feedback from readers. If you have any comments, suggestions, insight/wisdom, or you'd like to share a link to a great article, please email me.

Generally, I don't have time to answer questions about your specific situation, but if you have a general question that I think other readers also have, let me know and I will provide an answer in a future issue.

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Before starting a new diet or exercise regimen, you should consult with a doctor, nutritionist, dietician, or personal trainer.