Project Syndicate

Navigating Today’s Frothy Financial Markets

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LONDON – The signs of bubbles emerging in financial markets are clear to see. The Dow Jones index recently surpassed 40,000 for the first time, and the UK FTSE 100 and French CAC 40 also have reached new highs. Forward price-to-earnings ratios in the United States are trading at a multiple of around 25 – well above the historical average of 16 – and these high valuations have persisted despite interest rates above 5%.
Such trends certainly justify worries about new stock-market bubbles. But not all bubbles are equal, and only some are problematic for the wider economy. What matters – as we saw after 2007 – is whether a burst bubble will trigger a chain reaction that undercuts growth for years thereafter.

From an investment perspective, two factors can provide an early warning of where and when a bubble might burst, and whether it will be followed by a market correction or broader economic crisis. The first is the underlying or intrinsic value of an asset (whether it is productive or unproductive); and the second concerns how that asset is financed (be it through equity, cash, or a substantial degree of leverage).

With this two-factor framework, we can evaluate four types of bubbles. The first – and least dangerous for the wider economy – involves a productive asset primarily financed by equity or investor cash. Think of an equity investment in a telecommunications or broadband cable company. If the bubble bursts, the lost capital will be largely contained or ring-fenced among the direct investors (those holding the stock), without many spillovers to the wider economy. Moreover, telecoms/cable companies hold tangible assets with intrinsic value, which both limits the downside risk and represents upside potential for when the economy recovers.

The second category is a bubble of productive assets funded by debt, as when corporations take on debt to finance their operations or remain a going concern. In this case, a bubble bursting can have systemic implications, because large losses will reverberate through the banking system or capital markets, ultimately slowing the economic recovery as financial institutions work through their losses and reduce lending. However, the losses to the economy will be limited, because this scenario still involves productive assets.

In the third scenario, unproductive assets are funded by equity or cash, as in the case of much cryptocurrency investing. Here, the underlying asset is unproductive in the sense that it will not yield a future cashflow stream. If it falls in value, there is no fundamental basis – business or financial, such as hard assets – from which it can recover. But like the first category, the equity/cash financing implies that the spillovers will be contained.

That brings us to unproductive assets financed by debt. The prime example is the subprime mortgage crisis that erupted in 2008-09. An excess of housing meant that the underlying asset was unproductive – uninhabited homes will not yield future cashflow streams – and the manner of financing through mortgage and debt markets meant that the collapse in house prices would trigger a chain reaction.

In today's financial markets, one can find pockets of highly levered, arguably unproductive assets. Even more worrying, many of these lie outside the purview of regulatory oversight. For example, roughly 70% of leveraged loans and mortgages in the US are now held in the shadow banking sector, where institutions take on debt and provide financing without being subject to traditional banking regulations, and without recourse to emergency federal bailout facilities should they become illiquid or insolvent.

These investments obviously carry risk by dint of their debt exposure, and it remains unclear whether they are supported by productive or unproductive assets. Because they are in the shadow banking sector, there is far less visibility regarding the capital structure (the nature and sources of capital used to finance the investments). Specifically, we don't know whether investments are being financed with leverage or through savings that have been accumulated over time. Moreover, if a company has taken on debt, it is hard for outsiders, including regulators, to discern how much the asset is leveraged.

While a loss taken by someone who used accumulated savings will have only a limited effect on the wider economy, losses taken on "borrowed" money, especially with high leverage, could prove contagious.

A system with low visibility regarding the sources and forms of capital underlying many investments is a risky one. Greater scrutiny of unproductive, leveraged assets is crucial to avoiding a financial crisis.

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