What is an Economic Bubble?

This is a risky time to be an investor. Many asset prices are high and investor confidence is growing but the positive underlying economic developments that should be supporting these trends are not present. Are we in a bubble?

The word “bubble” frequently comes up in the financial media. The “tech bubble” of the late 1990s received heavy coverage. Now people are debating whether asset classes like real estate, gold and bonds are in a bubble. The answers and the investment implications depend on how you define the term.

A bubble, in my opinion, is a sustained rise in the trading prices of a certain asset that exceeds its fair or fundamental value by an extremely wide margin. Price gains or even moderate overvaluation are not sufficient to constitute a bubble. Before a bubble develops, a desirable asset will typically experience price gains that are completely justified. For example, the price of technology stocks like Intel and Microsoft delivered large returns in the late 1980s that were completely justified by their growth prospects.

The bubble phase begins when past performance and increasing investor enthusiasm combine to create a herd mentality where investors “can’t lose”. Prices for the asset shoot up in a drastic fashion. Bubble participants justify these abnormal gains by various arguments to the effect that “this time is different” and the asset is now in a “new paradigm” where the “old rules no longer apply”. Bubbles are usually fuelled by leverage – participants are so confident in a positive outcome they borrow to invest. Also, references to the asset gain prominence in popular culture and infiltrate basic social interactions. For example, a character in a sitcom may become a day trader during a stock market bubble.

Bubbles can persist for months or even many years. Finally, at some point, a bubble will typically end with a crash in prices that rapidly destroy the newfound wealth temporarily enjoyed by the bubble participants. Therefore, conservative investors should try to avoid participating altogether in order to minimize risk.

There will always be considerable debate and controversy about whether a given asset class is increasing in price for fundamental reasons, moderately overvalued, or in a bubble. In the sections that follow, I am going to examine a few asset classes that will likely be relevant to you and share my thoughts on whether

they are in a bubble. It is always a challenge to make these judgements in real time (hindsight is 20/20) so I trust you will find this edition interesting and thought-provoking.

North American Government and Corporate Debt

These fixed-income assets are extremely overpriced and appear to be in at least a moderate bubble. Prices are very high and, as a consequence, yields are very low. The secular trend of falling interest rates has persisted since the mid 1980s and has affected all asset classes but especially fixed-income assets in the last 2 years. Retail investors are pouring money into bond funds. Recently, some major corporations have been able to sell debt at absurdly low yields. IBM was able to find buyers for 3 year notes that yield only 1 percent. Johnson & Johnson sold 10 year notes with a tiny 2.95 percent coupon and, incredibly, US railway company Norfolk Southern sold 100 year bonds with a yield of just 5.95 percent.

In the government debt markets, US Government 10 year bonds currently yield only 2.55 percent. Even the Mexican government sold US$1billion in bonds with a maturity in 100 years with a 6.1 percent yield. Clearly investors are not receiving much of a risk premium.

There is no incentive to invest in a bond unless the yield equals the inflation rate plus a premium that represents the real return. Investing in any medium or long-term bond means taking the risk that inflation will accelerate at some point, potentially causing negative real returns and capital losses.

For clients, my response to these market conditions has been to reduce exposure to longer-term bonds in my Fixed-Income Portfolio and move more funds into shorter-term more liquid investments. Clients have realized some good gains on these assets as a result. Unfortunately it is impossible to predict exactly when longer-term bonds will decline enough to make them reasonably priced again, so patience will be required. As mentioned, the trend that brought us to these low yields has persisted for over 20 years, spanning the adult life of a person born in the early 1960s.

North American Stock Markets

Broadly speaking, North American stocks are not in a bubble; however, there are many stocks trading above their fair value, and the underlying economic conditions are not very supportive of sustainable gains in stock prices.

For example, the US economy may begin contracting again. After posting GDP growth of 1.25% in July, the August numbers showed a disappointing 0.6% contraction. This marks the third decline in real economic activity in the past four months. Some stock market participants are ignoring the bad data and instead

betting that central banks can keep interest rates artificially low and print enough new money (quantitative easing) to make stocks attractive relative to holding cash.

US corporate insiders appear to be bearish. The ratio of insider selling to buying in August was very high relative to historical norms. Another potential "red flag" that should shed some light on market sentiment is the number of phone calls and emails I have received from junior stock promoters in the past quarter. The number has been significant by itself (about 4-6 per week), but when you compare it to 2009 (2 per month), it really highlights the average investor's increasing appetite for risk. I feel that caution is always warranted, but especially when the "not so smart money" is looking to gamble.

I have been selling a number of positions in the Total Return Portfolio in recent months. Agrium Inc., Westshore Terminals Income Fund and Northland Power Income Fund were all sold during the quarter with total returns of 56%, 91.9% and 45.8% respectively. These companies may continue to trade higher in the near future but, frankly, the risks outweigh the potential rewards, as they have become somewhat overvalued.

Currently the Total Return Portfolio is very defensively positioned with a 39% cash or cash equivalents weighting. However, year-to-date we are only marginally underperforming the TSX Composite Index (which is 100% invested). I firmly believe that in the coming weeks and months additional investment opportunities will present themselves at valuations that don't require overly-optimistic assumptions or leaps of faith.

Precious Metals

In the early 1980s we saw a gold price briefly over US$800 which did qualify as a bubble. Retail investors were panicking about inflation (which was actually on the cusp of a long-term trend lower) and lining up to convert their paper cash into gold. The bubble burst and gold traded around US$300-$400 for many years (and silver well under US$10) before the current precious metals bull market began. As I write today, gold sits on a lofty perch above US$1,300 and silver is above US$20.

In my opinion, precious metals are not currently in a bubble despite the strong price gains of the last few years. On the other hand, I readily admit that a bubble could develop in this asset class in the next few years. There is also no doubt that precious metals prices are vulnerable to a short term price correction at these levels.

I have defined a bubble as a sustained rise in the trading prices of a certain asset that exceeds its fair or fundamental value by an extremely wide margin. I do not think that precious metals are undervalued today, but I decline to label them a bubble for the following reasons.

The supply of gold has proven difficult to increase in recent years in response to the strong demand. Countries like South Africa are depleting their reserves and the cost of production continues to rise, due to a lack of new high-quality discoveries and an increase in extraction costs. There is also a long time-lag between discovery and production so the supply response to higher prices has been slow.

Gold is a form of money that competes with paper currencies and the fundamentals of those currencies have been deteriorating markedly. Monetary policymakers in the U.S. are printing new dollars to mitigate deflationary forces and that trend shows no signs of stopping with the recent discussions of more quantitative easing. The existence of the Euro in its current form has been questioned due to certain countries' high deficits and an inability to customize monetary policy to their circumstances. China is rapidly expanding its money supply, and other examples are not hard to find. The latest worry is that exporting countries will engage in "competitive devaluation" – deliberately lowering the value of their currency to make their exports more competitive abroad. On the other hand, policies that could potentially end the gold bull market would include a global turn towards policies of deficit cutting along with a normalization of interest rates. Needless to say, taking these steps would appear to be politically difficult in this environment.

Although the general public is starting to awaken to the investment merits of precious metals, there is no herd mentality or euphoria about further price gains at this stage. The early 1980s saw a massive unsustainable bull market in junior miners that accompanied the gold price rise. We have seen nothing of the kind at this stage. Even most high quality growing senior gold companies are not being bid up to overvalued levels.

Although I do not see a bubble in precious metals today, I readily admit that a bubble could develop. Recall that bubbles typically begin after several years of justified strong returns from an asset class with good fundamentals. The bubble begins when investor psychology becomes "irrationally exuberant". The herd mentality can then take over and bubble participants then cite the strong fundamentals as a justification for any valuation for the asset, no matter how lofty.

If we get a bubble in precious metals, I unfortunately do not possess a crystal ball that will allow me to time the peak and reap maximum profits. Bubbles, like irrational people, are by their nature unpredictable.

Greater Vancouver Residential Real Estate

Real estate investing has been the talk of the town in Greater Vancouver since the early part of this decade and people who have owned housing for long periods of time have profited handsomely. That said, it is an axiom of investing that yesterday's price appreciation does not benefit today's investor. While I risk oversimplifying a very complex discussion, I am going to examine the current price of Greater Vancouver residential real estate through the use of some basic valuation metrics. My conclusion is that this asset class is currently trading at valuations that suggest a moderate bubble.

The Real Estate Board of Greater Vancouver recently reported a benchmark detached home price of $790,992 for their area of interest, which includes Vancouver and various suburbs. Real estate valuation is a complex topic, especially since different investors use financing differently, depending on their risk tolerance and return objectives, and there can be tax advantages. Two basic valuation metrics that can be used regardless of what percentage of the property is financed are the gross rent multiplier and the capitalized value of the property.

Gross rent multiplier (GRM) is simply the price of the property divided by the monthly rent. If you assume the benchmark Greater Vancouver home would rent for an estimated $2700 per month, the GRM would equal roughly 293. As a rule of thumb, a GRM over 150 usually results in negative cash flow on a monthly basis without a very large down payment. Even if you believe that a "glamour city" like Greater Vancouver deserves a multiple of 200 (based on the argument that certain premier cities rely more on appreciation than cash flow for returns and are always expensive), the price appears very high.

For another perspective, to calculate the capitalized value of the benchmark property, you divide the property's estimated net operating income (gross rents minus operating and fixed expenses) by your required capitalization rate (the rate of return from the property's net operating income that you want to receive). Here if we deduct property taxes of $1,500, maintenance of $3,000, insurance of $1,000 and generously assume no vacancies or other expenses, we get annual estimated net operating income (NOI) of $26,900. If we also use a low capitalization rate of 6% (which assumes the benchmark is a desirable property in a good neighbourhood and helps increase the capitalized value), we get a Capitalized Value of $448,333. That is a far cry from the $790,992 benchmark price.

To draw an analogy with stock investing, something like a "price to earnings ratio" of the benchmark can be calculated by dividing the price ($790,992) by the NOI ($26,900). The ratio works out to be 29, which is

quite high. Described another way, an all cash purchaser of the benchmark home would only receive a 3.4% yield.

Interestingly, the Economist magazine has just published an estimate that Canadian homes cost on average 23.9 percent more than they are worth. The Economist's analysis is based on comparing the ratio of current house prices to rents with the long term average.

The recent comments of Bank of Canada Governor Mark Carney also suggest caution is warranted in the real estate market: “one of the important downside risks to our [Economic] projection is the possibility that there is a more abrupt correction in the housing market than we’re anticipating,” Mr. Carney told lawmakers at a hearing in Ottawa. “We’re not forecasting an abrupt correction, but it is a possibility, given two factors: the speed with which house prices rose and, secondly, the absolute weight of debt in the economy that is tied to housing.” It is becoming clear that Canadians have been increasing personal debt too quickly during this economic downturn and policymakers in Ottawa are becoming concerned.

When I conclude that Greater Vancouver is experiencing a moderate house price bubble, I am not predicting an imminent downturn or even implying that housing purchases should never be made at these prices, as non-financial factors play a big role in real estate decisions. I am a homeowner myself and I see nothing wrong with buying a home for you and your family to live in that you can afford; however, straining your finances to buy or buying a second home or investment property appears to be ill-advised at the current valuations.

Conclusion

Investors who do not discriminate among investments based on valuation will always risk falling prey to investment bubbles, since the herd mentality can be so strong. Investors must be introspective and honest with themselves about whether they are succumbing to an emotional herd mentality or making investment decisions based on a businesslike approach to valuation. For my clients, I continue to be diligent in the management of their assets.

Thanks for reading this (rather longer than usual) edition of my newsletter! Hopefully it has contributed something to your understanding of investment bubbles.

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager

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