

## Bubble trouble – the next global asset bubble



### Key points

- Asset bubbles are a fact of life and flow from human nature, which has a strong tendency to jump on to popular fads.
- There is a long history of new bubbles forming from the ashes of the last burst bubble – and this time around it's unlikely to be any different.
- Easy global money – which is getting easier as growth remains sub-par in developed countries and as various emerging countries resist upwards pressure on their currencies – is setting the scene for the next asset bubble.
- Potential candidates are gold and commodity prices, emerging markets and resources shares, however the absence of obvious overvaluation suggests that we are still in the foothills of the next bubble.

### A fact of life

Benjamin Franklin once said: "In this world there is nothing certain except death and taxes." I would add a third certainty, and that is: asset bubbles. Despite numerous attempts to prevent them or regulate them away, usually after one bursts, they are part and parcel of free capital markets. Just as fads are a big part of the worlds of fashion, music, cars and toys (I still have my Russell yoyo from 1970 but the hula hoop broke), the same applies to investing. When combined with human nature to back something that has done well in the recent past, the outcome is an asset bubble. It's also the case that bubbles often form in the ashes of the last bubble. With this in mind it is likely a new asset bubble is forming right now. With another huge round of liquidity about to hit markets on the back of global deflation Mark II, this is virtually inevitable. But where will it be?

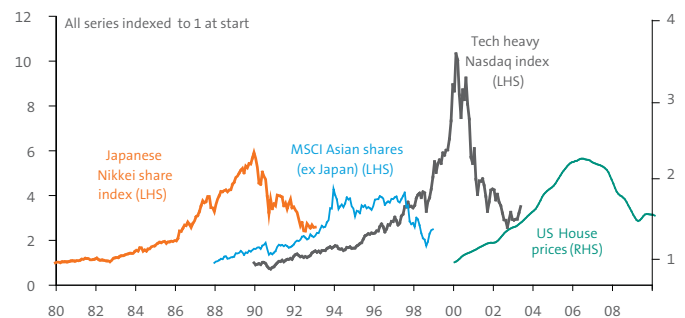
### Recent bubbles

There is a long history of asset bubbles forming from the ashes of the last bubble. Looking at the last two decades:

- the collapse of the Japanese asset bubble in the early 1990s and associated easing in Japanese monetary conditions set the scene for the Asian equity bubble into the mid-1990s;
- the burst of which in 1997-98 led to a bout of easy money in the US and elsewhere and helped inflate the tech bubble of 1999-early 2000;
- which then burst resulting in another round of easy monetary policy setting the scene for the US housing bubble and associated credit boom. Of course, housing bubbles tend to be a bit more constrained compared to those in financial markets (see the chart). Yet as we know, bursting housing bubbles can have much bigger economic and financial consequences.

The phenomenon of bubbles seemingly begetting bubbles likely reflects a combination of monetary easing following a bubble burst. This in turn provides the fuel for the next bubble and investors' desire to jump into something that is seen as safe and offering good return potential far removed from the asset which collapsed in value.

Major global asset bubbles over the last 30 years



Source: Thomson Financial, AMP Capital Investors

### Conditions for another asset bubble are in place

Following this pattern, it would seem reasonable to assume the easy money flowing in response to the bursting of the US housing/credit bubble will have set the scene for the next global asset bubble. Late last year there was much talk of a bubble forming in Asia due to easy monetary policy in the US flowing into Asia, and some were arguing that the US needed to tighten monetary policy to head it off. It was just as well it didn't, otherwise the US economy would be in even worse shape. In fact, with growth in developed countries now slowing below levels necessary to stop unemployment from rising, further monetary easing is now on the way. The US Federal Reserve is talking about another round of quantitative easing, or using printed money to buy government bonds. Japan is already doing the same – using printed money to buy US dollars and Japanese bonds and private securities. The Bank of England is considering more quantitative easing. While Europe is resisting, this is unlikely to continue next year as European growth will likely slow in response to fiscal tightening and a stronger euro.

This additional round of monetary easing will likely see more downwards pressure on the US dollar (US\$), Yen, British pound and ultimately the euro, but will see upwards pressure on the emerging country currencies, gold and commodity prices and commodity currencies such as the Australian dollar (A\$)<sup>1</sup>. Despite the Reserve Bank of Australia's surprise decision to leave rates on hold this month, it has signalled a clear intention to raise rates in the near future unless the economic outlook changes dramatically. As such, more upside in the A\$ seems likely, ultimately taking it through parity against the US\$.

To the extent countries maintain fixed currency pegs to the US (such as Hong Kong) or resist upward pressure in their currencies by buying US dollars or keeping their own interest rates artificially low, they will be importing easy US monetary policy and adding to the increase in global liquidity.

<sup>1</sup> See 'Global Reflation Mark II, gold and the Australian dollar', *Oliver's Insights*, September 2010.

The end result will be very easy global monetary conditions for some time to come. And – unless the US double dips back into recession, which is not our base case – this provides an ideal condition for the inflation of the next asset bubble.

## Bubblexicon

Bubbles are normally thought to exist when a combination of conditions are present. These include easy money, a displacement exciting popular interest in the asset, overvaluation and speculators piling into the asset on the expectation that past price gains will be repeated.

## Prime bubble candidates

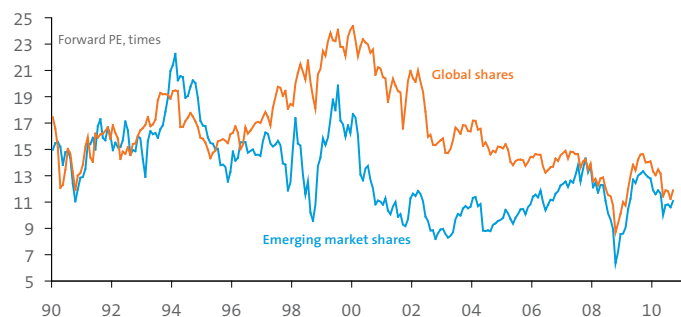
As the US has had a monopoly on asset bubbles over the last decade and, given its debt problems, it's unlikely that it will host the next major asset bubble. Similarly, debt problems in Japan and Europe suggest they won't either. Instead, potential candidates for the next bubble include:

- **Emerging market shares** – emerging countries are increasingly attracting investors' attention, having come through the global financial crisis in reasonably good shape with low debt levels and given the risks hanging over developed market shares. Both of these factors have provided a favourable displacement in terms of investor thinking towards assets in these countries.
- **Gold and commodity prices** – these are another possibility given the commodity-intensive nature of emerging-country-driven global growth and increasing inflows into commodity funds.
- **Resource shares** are also a potential area for bubbles to develop on the back of high commodity prices.

If the next bubble occurs in one or all of these areas, they likely have further to run.

- Emerging market shares are not overvalued and are, in fact, trading on similar price to earnings ratios as developed country shares. Chinese shares are trading on price to earnings ratios well below longer-term averages. In other words, there is little evidence of a bubble yet.

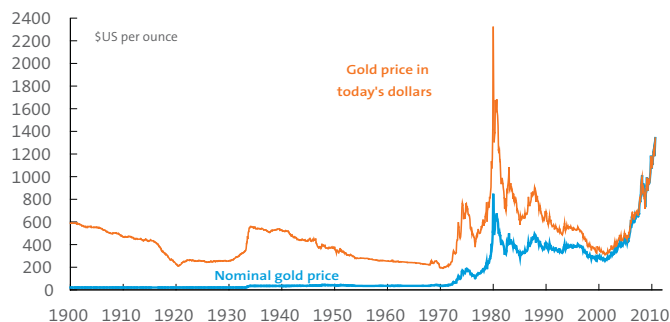
Emerging market shares are still trading at a slight discount to global shares - no bubble here yet!



Source: Thomson Financial, AMP Capital Investors

- **Commodity prices** – while commodity prices have surged over the last 18 months, in most cases they are still below their 2008 highs. Gold is an obvious exception, having gone to a new high in nominal terms, and it may be further advanced into bubble territory. However, even it is still below its 1980 high if measured in today's dollars, which would be US\$2000 an ounce.

More to go - the real gold price is still well below its 1980 peak



Source: Global Financial Data, AMP Capital Investors

- Australian resources shares are also trading at a slight price to earnings multiple discount compared to the rest of the Australian share market.

As an aside, many have claimed that developed market sovereign bonds are a bubble following the collapse in yields over the last six months. Bond yields are well below long-term sustainable levels. However, to the extent that: growth is normally sub-par after financial crises; bond investors are making some allowance for the risk of deflation in the US; and the chance that the Fed might keep the cash rate near zero for several years; they may not be as 'bubbly' as feared. Japanese bond yields around 1% are a case in point. This is not to say bonds offer great returns going forward – on current yields there are much better opportunities elsewhere.

## Conclusion

The surge in global liquidity now underway is likely to provide further fuel to the next major asset bubble, which is likely to already be in the process of forming. Potential candidates are gold and commodity prices, emerging markets and resources shares. But the absence of obvious overvaluation suggests we are still in the foothills of the next bubble, which likely has years to run, providing plenty of opportunities for investors in these assets in the interim.

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