Let's Give Future Generations a Speculometer

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I RECENTLY participated in a roundtable at the OECD in Paris designed to gauge progress toward restoring confidence in financial markets. As the earnest discussion about technical fixes regarding credit derivatives, rating agencies and the like ground on, it occurred to me that the group was failing to see the elephant in the room: that we all had lived through our first global speculative bubble, and had done nothing to prevent it.

Bubbles creep up on people who have never experienced them before. Seventy years ago the last worldwide stock market bubble and bust led to a raft of important reforms, including federal deposit insurance and limits on borrowing to purchase stock. These vital responses to the Depression, along with many other institutional developments in the intervening years, have ensured that our generation's stock market crash has not been followed by a global economic crisis. These reforms did not, however, prevent the 1990s stock-market bubble and crash from happening in the first place. We studied history, but were still condemned to repeat it.

While many believe that little can be done in the face of financial error, the focus of the OECD discussion was on legislation and regulation, such as the recently enacted Sarbanes-Oxley reforms in the United States. But in fact the financial market crisis this time was not caused by yawning regulatory gaps, with the exception of the mistreatment of options expense – ironically, not dealt with by Sarbanes-Oxley. Rather, the market failure in the 1990s bubble was confusion about the amount of speculation in the stock market. There were plenty of warnings about excesses, such as Yale finance professor Robert Schiller's book "Irrational Exuberance." But this caution was counter-balanced by bullish commentators such as James Glassman, who published the wildly optimistic "Dow 36,000."

This "Tower of Babel" was, and still is, full of skilled academics and practitioners who believe what they are saying. Given the wide range of opinion in the market, it is unsurprising that the overwhelming consensus at the OECD roundtable was that speculative bubbles are impossible to spot. US Federal Reserve chairman Alan Greenspan tried to warn about speculation as early as the mid-1990s, but gave up as stocks soared. He eventually came to the view that market analysts, being so deeply involved in the assessment of corporate data, are the best evaluators of company prospects. I would assume his confidence in company analysts has been as shaken as everyone else's given the events of the last few years. The perpetual optimism of stock-broker forecasts is now well understood and if anything added fuel to the speculative over-shoot.

So what can be done to reach a consensus that speculation is emerging and thus reduce the possibility of a dangerous bubble forming? Unfortunately, no one can ever say definitively that an asset is overvalued or undervalued, because that depends on future events which are by definition unknowable. However, rigorous financial analysis can gauge the assumptions embedded in current prices. Once these assumptions are understood, they can be judged against the range of possible outcomes.

Speculation does not inevitably lead to a crash. This is what makes it so difficult to spot. A speculative asset has a market price justified only by optimistic fundamental assumptions. In the extreme, using the parlance of the 1990s stock market, it is an asset "priced for perfection." If the optimistic forecasts of the 1990s had come true, then we would not have had a crash. But the forecasts were so rosy that the probability of disappoint was high. If you are playing a game that can only be won if everything goes exactly right, it would be nice to at least be given fair warning that the odds are stacked against you.

Rather than rehashing the speculation of the last decade, this analysis can be applied to current market prices. The asset with the most speculative pricing today is probably Japanese government bonds (JGBs). The current yield of a JGB with a ten-year maturity is 0.4%. What assumptions about the next decade are embedded into this price? The first is that the Bank of Japan will keep interest rates at 0% into the foreseeable future. The second is that consumer prices will continue to fall. This by definition is the consensus view, reflected in current market pricing. But what is the range of alternatives to this view? JGB investors drive up prices on economic pessimism, and a more pessimistic set of assumptions in the case of Japan would be difficult to define. If the economy is even worse than the market expects and bonds continue to rally, the absolute downside limit to the ten-year JGB yield is presumably 0%, although many believe it to be closer to 0.25%.

The JGB market is, therefore, close to being priced for perfection from the perspective of a government bond investor, who benefits from recession and deflation. Non-consensus scenarios such as a rebound in Japanese growth prospects will by definition seem far-fetched. To say that there is speculation in JGBs is not a statement about an imminent sell-off in that market, but rather a relatively objective analysis concerning current pricing versus the range of possible scenarios. If there are few scenarios that fundamentally justify a rise in asset prices, the market has become speculative. Investors should be aware that all of the surprise in the market is against them, and only if things go exactly as expected can the exceptionally low yields be justified. The risk is asymmetric: lots of downside risk, almost no potential for upside surprise.

Given the confusing signals the individual investor faces in the financial media, the analysis of the degree of speculation must be done by an independent board of experts sanctioned by governing institutions. In the United States recessions are determined by the business cycle dating committee of the independent and highly regarded National Bureau of Economic Research (NBER). Just as this committee makes the official judgment of recessions, we need a private, non-profit, non-partisan group of experts to gauge the level of speculation in each of the major markets.

How would speculation be measured? I would imagine the development of a speculometer, with a range of 0-100 for each asset class. Japan's bonds might be at 95 today, global stocks somewhere in the middle, US bonds perhaps in the 70s. Housing prices would be judged using inputs such as the affordability index, which is showing more evidence of speculation in the UK than the US at the moment, as well as the ratio of adjustable to fixed-rate mortgages in the market. There is more speculation inherent in adjustable-rate mortgages, particularly when rates are as low as they are in the United States.

There should be few if any regulatory developments associated with the speculometer. Optimistic scenarios can come true, justifying high asset prices. However, when the speculometer is moving up the message to the investing public is straightforward: caveat emptor. My dream is that the mythical "badly served small investor", which, during a bubble, is virtually everyone, flips on the BBC business news and there next to the market data is a small box showing this month's speculometer for the key asset classes. At a minimum this information should increase the amount of fundamental analysis in the media, reducing the airtime for chartists and short-term traders.

Whoever takes this on, the speculometer requires the endorsement of official governing bodies. The last thing we need is 100 private speculometers for each asset class. In effect that's what we have now, no different than the 1920s. If the speculometer works, future generations will thank us for strengthening the system and allowing them to avoid at least the most egregious of our mistakes.