Toxic Demand and Financial Manias*

Have we learned nothing?

MCS Family Wealth Advisors

Assets Most Affected	Bonds, Stocks, Real Estate, Gold, et al 2014-20XX?	Real Estate 2005-2008	Dot-Com Stocks 1998-2000
Rationales	• World economies are fragile and will fall into deflation and recession without constant central bank stimulus in the form of negative to ultra-low interest rates. • Low interest rates raise the price of all assets. • It's different this time	• They're not making more of it. • Everyone needs a place to live. • Past performance is proof that it's always a good investment. • Since the Great Depression, there's never been a national collapse of housing prices. • Unlike the 1930's, bank deposits are now insured, so what could go wrong? • It's different this time	• Web-based businesses will make bricks and mortar businesses obsolete. • Theoretical but untested efficiencies of e-commerce are extrapolated to show tremendous upside profit potential. • Values of dot-com companies are telling you that profound changes are imminent. • It's different this time
How is **toxic demand** being created?	• Central banks keep interest rates low by buying bonds. • Stricter regulations spur banks to buy the same bonds the central banks are purchasing. • Additional competition comes from pension funds, insurers and index investment products. • Low interest rates used as a foreign exchange tool (e.g. the Swiss created negative interest rates to drive down their currency's value after the Euro faltered). • Economists find examples to support central bank policies (i.e. Japan's economy and theoretical rationales for negative rates). • Increased use of index funds assures a steady demand for assets regardless of price or fundamentals. • Bond managers take refuge in their index benchmark duration, hold their nose and buy regardless of price. • Retail investors aggressively buy long term bond funds and yield oriented stock funds attracted by recent high returns and low current interest rates.	• Loans to "anyone with a pulse" create more home buyers than would otherwise be the case. • Abundant, cheap credit encourages prices to be bid higher and higher. • Dependent on real estate agents and lenders for their business, appraisers play along by confirming that homes are worth whatever someone will pay. • Higher prices create more equity in previously purchased property • Investors "pyramid" their holdings: – Borrow to buy a house – Use home equity loan based on increased home value to purchase a second house – Use home equity loan on the second house to buy a third – Use home equity loan on the third house to buy a fourth… • Banks /mortgage lenders waive their lending standards and commit fraud by putting non-conforming loans into pools • The rating agencies are complicit by failing to do their due diligence for fear of losing business to competitors.	• Analysts hype the prospects of dot-com companies to support their investment banking departments. • Underwriters offer equity stubs, a small percentage of a company's total outstanding stock for public sale, creating a low supply. • The underwriter drums up buyers for the deal based partly on the low supply of available stock. • The order book exceeds the shares for sale many times over • The stock jumps on IPO as demand greatly outstrips supply. Repeat. • Economist cite efficient market theory to defend ridiculous valuations. • Worried about losing their jobs or clients, investment managers hold their nose and buy tech because other stocks they own are going nowhere. Or, they grossly overpay for solid, profit making tech companies because (compared to hyped dot-com stocks) those companies look 'attractive'. `• Retail investors aggressively buy tech stock funds attracted by high returns.

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Reality	• Ultra-low rates become counterproductive, stifling economic growth. – Liquidity trap – Low rates require more savings thus reducing consumption – Decreased lending as spreads between short and long term rates compress • Low rates finance stock buybacks rather than business expansion as intended. • Wealth effect is not working as expected. • A significant percentage of new business or product creation is 'capital light' and therefore does not require lots of borrowed money. • Mortgage lenders are now offering 3% down payments because home prices have once again gone too high, too fast and fewer people can qualify despite record low rates. As a long time mortgage industry executive and client observed, "I've seen this movie before and it doesn't end well."	• Inevitably the pool of qualified and unqualified buyers runs dry. • The movie The Big Short captures this nicely when the stripper tells the portfolio manager she bought five houses using adjustable rate loans with low initial rates, not realizing the interest rate would soon reset to higher payments than she could afford. • Pyramid real estate buying strategies collapse (see above), forcing excess supply on the market. • Too much supply and not enough buyers means lower prices. • Price declines quickly wipe out low down payment home equity. Homeowners are unable to refinance even as rates decline. • The economy sinks as lending halts. The self-reinforcing upward price spiral becomes a self-reinforcing downward price spiral.	• Companies with little or no operating history are unlikely to succeed on a big idea alone. • The few that do succeed are the great exception to the thousands that don't. • Investors often pay absurd prices for blue-sky excitement. • The reality of growing profit year in and year out brings prices back to earth. • It's called the 'bleeding edge' for a reason. • Theoretical value meets actual negative cash flow and losses as highly touted companies lose gobs of money.
Outcome(s)	What do you think?	Real estate prices collapse resulting in worst financial period since the depression. Many investors never recover.	Dot-com / tech stocks collapse resulting in a recession and heavy investor losses. Many investors never recover.

* Demand becomes toxic when unfavorable changes in the demand outlook have a high probability of resulting in a vicious negative feedback loop with widespread financial repercussions. 'Mania' describes crowd psychology characterized by the adoption of beliefs that, while perhaps initially grounded in reality, ultimately devolve into destabilizing memes directing investor behavior.