

THE “YOU MAY NOT KNOW REPORT”

A PUBLICATION OF RETIREMENT LIFESTYLE ADVOCATES



Bubble Watch and Surviving a Bubble Bust

By Dennis Tubbergen

Price bubbles have existed for much of history.

This month, we'll examine some of these price bubbles to attempt to determine the root cause of the bubble and, more importantly, to identify potential strategies to survive and perhaps even prosper when the bubble bursts.

Let's begin with the fact that bubbles are difficult for most to recognize.

In 1841, in his classic work, "Extraordinary Popular Delusions and the Madness of Crowds", author Charles Mackay discussed bubbles in detail.

He wrote, "Let us not, in the pride of our superior knowledge, turn with contempt from the fol-

lies of our predecessors. The study of errors into which great minds have fallen in the pursuit of truth can never be un instructive."

To attempt to paraphrase Mr. Mackay using more modern language, "We should never be so smug as to think we're a lot smarter than other smart people who have made big mistakes. Instead, we should study the mistakes they made to figure out why they made them."

Interestingly, as a bubble builds, experts emerge that support the existence of the bubble using what seem to be logical arguments. Mackay described this phenomenon in his book 180 years ago.

Mackay advised that questioning experts is a far more productive exercise than following the experts since the experts who rise to prominence as a bubble builds are those who reinforce the crowd's behavior using their 'expert' positioning. In other words, these experts reinforce and encourage the behavior of the crowd.

Crowds are comprised of individuals. Individuals become comfortable with their behavior when it is reinforced by experts and is congruent with the behavior of the rest of the crowd.

Matthew Piepenburg, writing for Matterhorn Capital Management commented on this topic¹ (emphasis added):

*Throughout the cyclical history of delusional market bubbles and their subsequent implosions, **otherwise "logical" and/or intelligent market participants always find themselves in the comforting presence of crowds.***

In Japan, for example, just before the Nikkei died in 1989, the popular expression in Tokyo was: "How can we get hurt if we're all crossing the street at the same time?"

Crowds, of course, love comforting consensus, feedback loops and opportunism, often at the expense of historical lessons, ignored data or even common sense.

Instead, crowds focus on current signals, lofty credentials and the loud logic of price momentum at the expense of risk's more unpleasant whispers.

*In other words, **logical minds will often overlook unpleasant information and cling exclusively to the data which confirms their hopes and biases**, creating a mass perception that is often misperception.*

When studying bubbles and history, one quickly concludes that bubbles can suck in even the

brightest of the bright. Sir Isaac Newton, who wrote "Principia Mathematica" that defined the three laws of motion and laws of gravity sparked the European enlightenment. His second major book, titled "Opticks" detailed his work to determine the properties of light. He was also a student of Biblical history and alchemy and served as president of the Royal Society of London and was the master of England's Royal Mint until his death in 1727².

Despite Sir Newton's unparalleled academic credentials and genius, the South Sea Bubble chewed him up and spit him out, leading to the possible conclusion that it is easier to define the laws of gravity and the properties of light than it is to recognize a bubble when that bubble is validated by crowd behavior and the logical sounding opinion of some experts.

The South Sea bubble ultimately resulted in a monster financial crash in London. Prices of stock on the London stock exchange rose to levels that were unsustainable before finally crashing in the fall of 1720. The bubble got its name due to the fact that the boom in stocks was largely driven by shares in a company called the South Sea Company. The company was formed by Robert Harley to trade with modern day South America. The British Government gave Mr. Harley a monopoly on trade with the region.

Shares in the company were hyped by many experts who expected the South Sea Company to replicate the success of the East India Company which provided England with a robust trading relationship with India.

The government helped fuel the bubble, allowing holders of 9 million pounds of government bonds (government debt) to exchange their bonds for stock in South Sea Company. (Note: the same tactic was used by John Law in France

at about the same time to drive the bubble in the Mississippi Company.)

Sir Isaac Newton bought shares in the South Sea Company and initially sold them for a profit. But then, the allure of easy and quick profits got the best of him and he repurchased shares. The second time he invested, Mr. Newton was not as fortunate. He lost 20,000 pounds, the equivalent of several million dollars today.

While Sir Isaac was still widely respected nationally, his own family taunted him for his investing

foolishness telling him that “he could calculate the movement of heavenly bodies but not the madness of people.”

Seems families haven’t changed much in 300 years either.

If the man who defined the laws of gravity and light can get caught up in a bubble, anyone can.

My goal in this issue of the “You May Not Know Report” is to analyze bubbles and how to recognize them.

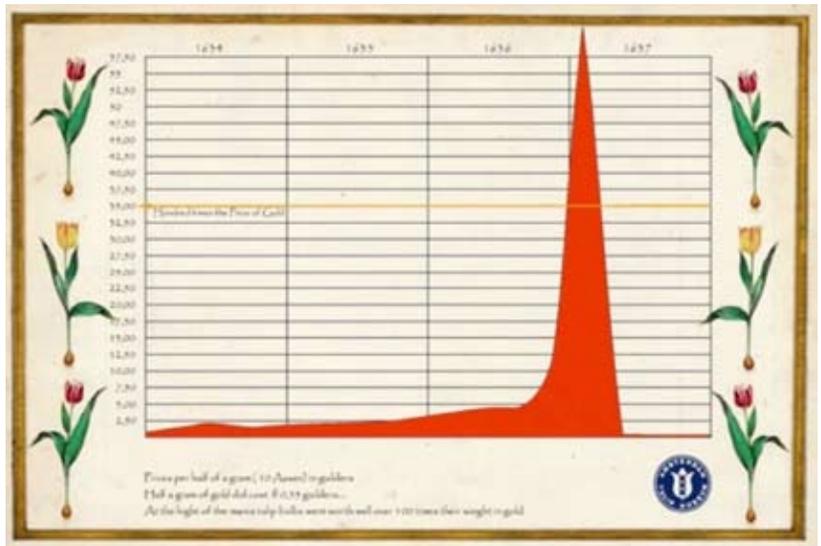


Often, in this publication, we discuss the indisputable fact that those who don’t study history are doomed to repeat it. When examining historical bubbles, this is truth becomes self-evident.

In the 1600’s, in the Netherlands, a bubble built in tulip bulbs.

Notice from the tulip bulb price chart on this page how vertical the price of tulip bulbs was when plotted on a chart.

The price of a tulip bulb from 5 Guilders to about 100 Guilders in the span of months. The crash also occurred quickly.



Examining the price chart, it's easy to see that bubbles tend to be symmetrical taking about as long to build as they take to bust.

There is one other 'bubble factor' that doesn't manifest itself on the price chart; in order for a bubble to build there has to be easy money or easy credit to fuel the bubble. Easy money and easy credit is 'bubble fuel'. A bubble cannot form without it.

The tulip bubble was no exception. In the 1600's the Dutch, newly independent from Spain, grew wealthy on trade. It was this easy money that helped to fuel the tulip bubble³.

Mr. Mackay, in his 1841 book mentioned above, described the tulip bubble:

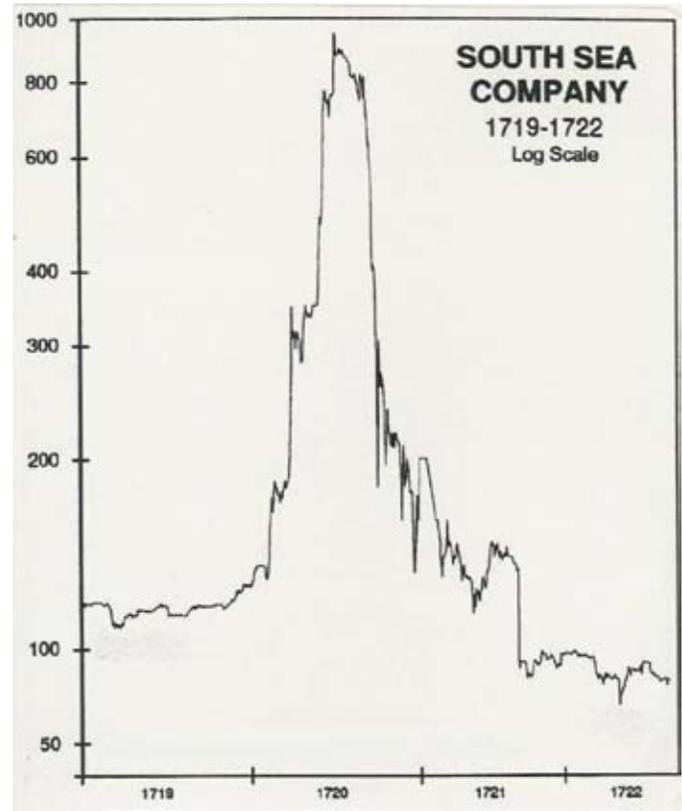
"A golden bait hung temptingly out before the people, and one after the other, they rushed to the tulip-marts, like flies around a honey-pot. Nobles, citizens, farmers, mechanics, sea-men, footmen, maid-servants, even chimney-sweeps and old clothes-women, dabbled in tulips."

"Many who, for a brief season, had emerged from the humbler walks of life, were cast back into their original obscurity. Substantial merchants were reduced almost to beggary, and many a representative of a noble line saw the fortunes of his house ruined beyond redemption."

Then, there was the South Sea Bubble mentioned above in which Sir Isaac Newton lost a fortune.

Notice again from the price chart of the South Sea Company that this price bubble, when charted, was also symmetrical taking about as long to bust as it did to build.

Also observe that the price of the South Sea Company stock rose nearly ten-fold before it reached the peak. Just prior to prices peaking,



the price line goes almost straight up or parabolic.

This bubble was also fueled by easy money or 'bubble fuel'. As noted above the government allowed about 9 million pounds of government debt to be put into South Sea Company stock.

By now, you should be seeing the recognizable bubble pattern. Parabolic or near vertical price movements fueled by 'bubble fuel' or easy money. After the bubble bursts, the price chart is nearly symmetrical with prices returning to their starting point.

I mentioned the Mississippi Bubble above. This bubble occurred in France in the early 1700's when John Law was the central banker of France.

Like every other bubble, the Mississippi bubble was fueled by easy money. Mr. Law, in response to the massive debts of the French Government began to create money out of thin air. Law introduced a system of paper money to the

French citizens. Initially these paper receipts could be redeemed for coins containing precious metals. After a period of time though, as usually happens, this redemption privilege was suspended and the paper money became a fiat currency allowing for more money creation.

It was during this period of significant, unsustainable money creation that the Mississippi Bubble built. As always happens when money is created initially, it seems that prosperity is created. But eventually poverty is the outcome.

When the money printing was initiated in France, the prosperity illusion predictably emerged. Real estate prices soared and luxury items were flying off the shelves. Bubbles formed.

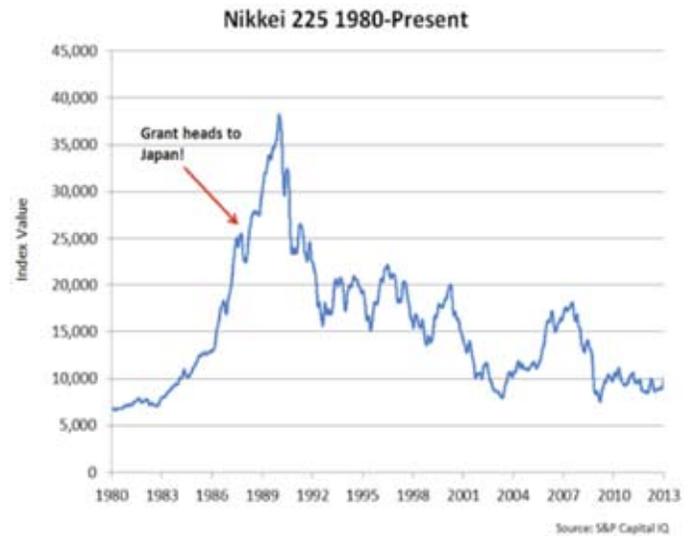
The chart shows the price of the Mississippi company stock. Notice that it too is almost symmetrical.



Another more recent bubble was the Japanese stock market bubble the peaked in the late 1980's. The chart on this page illustrates the Nikkei Stock Index,

Note that as the Nikkei peaked in 1989, the price movement was nearly vertical.

Also note that the chart is nearly perfectly symmetrical from 1986 to 1992. The final stages of the bubble built from 1986 to 1989 and then the bust took place from 1989 to 1992.

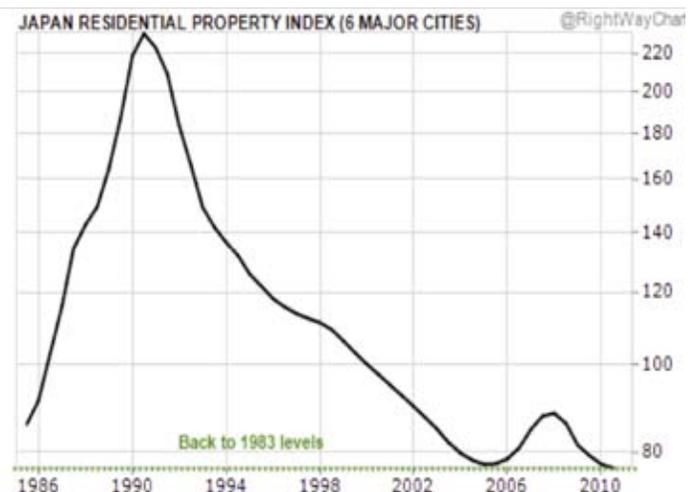


Also worth noting is the fact that the bubble's bust ultimately returned prices to where they began.

It's important to point out that as the stock bubble was building in Japan, a real estate bubble was also developing. The chart shows the Japan Residential Property Index.

The real estate bubble built from 1986 to 1989 and then burst with the stock market, a pattern similar to the housing bubble in the United States about a dozen years ago. At that time, in the US, stocks and real estate both experienced simultaneous bubbles.

When observing the Japan Residential Property Index chart, one can again see the symmetry of the chart pattern and that prices ultimately finished where they began.



The Japanese stock market bubble and real estate bubble was driven by easy money. Remember that key point – bubbles cannot build without easy money or easy credit.

From 1980 until the crash of the stock market and the real estate market, the Japanese Central Bank reduced interest rates as seen on the chart.



In a fractionalized banking system, as interest rates decline, money is created because money is loaned into existence.

For example, if banks in the system are required to maintain a 10% reserve requirement, when a bank accepts a deposit, 10% needs to be reserved or kept on hand and the balance can be loaned out.

To make the point clear, let's assume Mr. Jones deposits \$100,000 into his bank account. That banker needs to reserve 10% or \$10,000 and can loan out the other \$90,000 or 90%. In this example, we'll say Ms. Smith borrows \$90,000 to buy an investment property. The seller of the investment property takes the \$90,000 from Ms. Smith as payment for the property and deposits the \$90,000 in her bank. That banker reserves 10% or \$9,000 and loans out the other \$81,000.

This process continues.

A \$100,000 deposit into a bank can turn into \$1 million with a 10% reserve requirement as long as borrowers keep borrowing. By reduc-

ing interest rates, borrowing becomes more attractive. As borrowing becomes more attractive, more borrowers borrow and more money is created.

As the stock and real estate bubble built in Japan in the 1980's interest rates fell from about 9% to approximately 3%. That's a decline of 67%.

As interest rates fell, borrowers borrowed and money was created providing the 'bubble fuel' that drove stock and real estate prices higher.

Then there was the NASDAQ stock bubble in the United States in the late 1990's. The chart shows the price bubble that built from 1998 to 2000 and then unwound from calendar year 2000 through 2002.



Notice again how symmetrical the bubble was taking about as long to build as it did to burst.

And, like every other bubble, this bubble was fueled by the usual 'bubble fuel', easy money/easy credit.

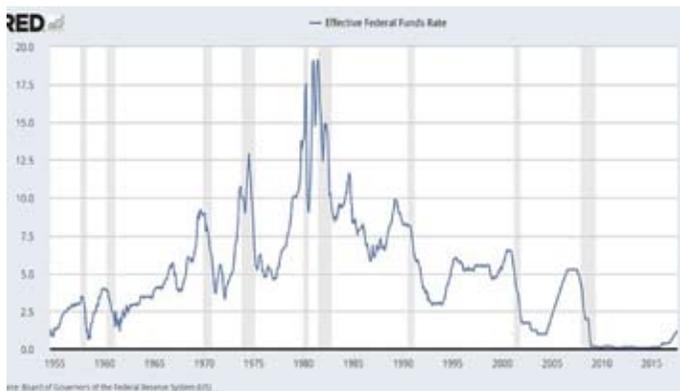
In January 1990, the Fed Funds interest rate was 8.25%. By September 1992, the Fed Funds rate fell to 3.00%. Just like in Japan in the 1980's these low interest rates in the United States in the 1990's created easy money or 'bubble fuel' that found its way into the stock market.

The Federal Reserve responded to the tech stock bubble blowing up by once again reduc-

ing interest rates to create more money.

Notice from the chart that shows the history of the Fed Funds rate that the Fed Funds interest rate fell from about 7% at the time the tech stock bubble began to unwind to 1%.

That reduction in interest rates again spurred borrowers to borrow and created more money. The provided bubble fuel for the housing market bubble and the stock market bubble that built and then burst in the first decade of this century.



Keeping in mind the conditions that must exist for a bubble to occur, let's look at the state of some markets presently.

Bubbles require 'bubble fuel' or easy money/easy credit. Bubble price charts are symmetrical. The shape of the price chart helps to identify a bubble AFTER the bubble has unwound, but to identify a bubble before it bursts, one

Notice from the stock chart of the Dow Jones Industrial Average that the stock bubble from the financial crisis was almost symmetrical, taking about as much time to build as it did to bust.

The same observation can be made when looking at a price chart of housing prices from the same time frame.

In each of these bubbles, there are two general commonalities.

One, prices take about as long to build as they do to unwind.

Two, price bubbles cannot exist without easy money/easy credit.

There is another commonality as well. One that Mr. Mackay warned us about. As each of these price bubbles built, there were experts providing what seemed to be logical reasons for the rapid and extreme price rise. And, in each case these experts were wrong.

needs to see a parabolic or near parabolic price pattern.

At the present time, there is no shortage of easy money/easy credit, also known as bubble fuel.

Ever since the time of the financial crisis in 2008, the central bank of the United States, the Federal Reserve, has been engaging in a program of quantitative easing or money creation.

In 2008, in an effort to revive the floundering US economy and US financial markets the Fed began a program of “quantitative easing” or money creation.

They have continued this program and presently money creation is at record levels. There is plenty of bubble fuel in the financial markets.

With that said, let’s take a look at some markets at the present time beginning with the S&P 500.

This chart is a weekly price chart of the S&P 500.



When looking at the bubbles that burst in 2000 – 2002 and in 2008 and comparing those levels to present levels, there is no comparison.

And, when looking at the most recent price action in stocks, one can recognize the nearly vertical, parabolic chart pattern. While stocks could go higher, it would also not be surprising to see the market correct here.

Just compare the chart patterns of the bubbles we’ve already analyzed with the chart of the S&P 500 above.

But, it’s not just stocks.

Take a look at the Case-Shiller housing index, the most widely used index to track the value of residential real estate.

The chart nicely illustrates the boom and then bust of the last housing price bubble. Presently,

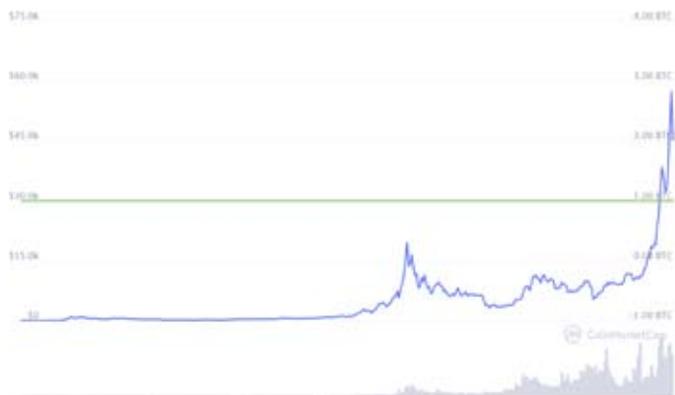


residential real estate is priced higher than at the time of the housing market bust.

While the current slope of the price increase is more gradual and could admittedly go higher, it’s highly likely that we are once again approaching a bubble peak.

Bitcoin and other cryptocurrencies are also looking like that are peaking.

One look at the Bitcoin price chart has one quickly concluding that the price has gone vertical or parabolic from about \$10,000 per Bitcoin to more than \$50,000.



Classic bubble.

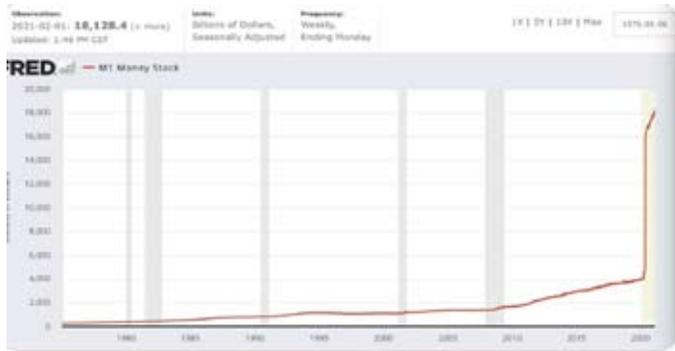
Other cryptocurrencies like Ethereum are behaving similarly.

I have recent stated that we may be in an “Everything Bubble”.

The most disturbing of these vertical or para-

bolic price charts may be that of the money supply.

This chart illustrates the M1 money supply is perhaps the most parabolic of all the charts we have reviewed in this issue.



Keeping in mind that easy money and easy credit are bubble fuel, what happens if the bubble fuel evaporates?

The price bubbles collapse.

And what if the easy money and easy credit continue, the price bubbles could go nominally higher but, in real terms, they will still have to decline.

That is why I have long advocated the two bucket approach to managing assets.

My book “Revenue Sourcing” outlines this strategy in detail.

The premise of the two-bucket approach is that an investor holds assets in one “bucket” that will protect assets from a bubble bursting and prices collapsing. The other bucket holds assets that will perform well in an inflationary environment.

Here is the key point – bubbles always burst. The question moving ahead is will the price bubbles burst before the money bubble bursts? Or, will the money bubble burst before the asset price bubble?

You need to be prepared for both potential

outcomes.

At this point it seems that those in charge of monetary policy will determine if they will continue to create money until the money bubble bursts or if they will slow down enough so that the asset price bubbles burst.

My bet is that given the recent comments by Jerome Powell, Chair of the Federal Reserve, the money bubble may burst first. Remarkably, Mr. Powell recently stated that the rules of money creation and inflation had changed.

Here’s what Jerome Powell, the Federal Reserve Chair, had to say about inflation recently⁴ (emphasis added):

*In response to a questions posed by Congressman Warren Davidson about whether “M2 [money supply] going up by 25% in one year” is going to “diminish the value of the U.S. dollar,” Powell responded, “**there was a time when monetary policy aggregates were important determinants of inflation and that has not been the case for a long time.**”*

*Powell added that “**the correlation between different aggregates [like] M2 and inflation is just very, very low.**”*

Let’s rephrase the Chairman’s statement for clarity:

“There was a time that money creation caused inflation but that’s not the case presently. The amount of money printed and the rate of inflation are not closely correlated.”

So, it used to be that money printing increased the rate of inflation but, according to the Fed Chairman, that is no longer the case?

What has changed?

Have the basic rules of economics changed?

Have the laws of supply and demand changed?

Does an abundance of something (including money) make that something more valuable?

Obviously the basic rules of economics have not changed.

Scarcity creates value and abundance does exactly the opposite.

An abundance of money makes it less potent. An abundance of money does create inflation as we are currently witnessing in many parts of the economy.

The only thing that has changed is the way the inflation rate is calculated.

I have often used the following illustration to make this point.

I like to go fishing in Florida. One of my favorite species of fish to catch requires that it be 12 inches in length in order to keep it. When fishing, it's easy to figure out if the fish is a 'keeper'

or not by taking an ordinary 12-inch ruler and holding it next to the fish.

If I decide to cut my ruler in half and recalibrate the numbers so there are 12 inches on the ruler, I still have a ruler that says it's a 12-inch ruler but it's half as long as the ruler I used on my prior fishing trips.

Now, using the new, shorter ruler, I catch a lot more 'keepers'.

Am I a better fisherman?

No. But I changed the measuring stick so I can now keep more fish. Reality hasn't changed, only the way I measure it.

That's the game the Fed is playing. Reality hasn't changed but the way it's measured has. That's why I expect the money bubble to burst first, but you need to be prepared for both outcomes.



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Sources

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