

'Pop!' Bubbles are great for America!

Recessions too! Even that \$8 trillion market loss in 2000-2002!

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ARROYO GRANDE, Calif. (MarketWatch) -- Yes, that's the message of Dan Gross' new book, "Pop! Why Bubbles are Great for the Economy." Bubbles are miracle workers. So let 'em pop, Pop, POP! Gross is in love with what happens after a bubble pops, an idea first heard in uber-economist Joseph Schumpeter's 1942 law of "creative destruction."

Destruction is a small price to pay: Business failures, bankruptcies, lost jobs, recessions are all part of natural law eliminating the dead wood from a prior bubble, clearing the way for a new round of creative innovations, prosperity and another roaring bull. So don't get all teary-eyed and maudlin. Suck-it-up, folks. "Pops" are like Irish wakes, lotsa drinking, laughing, singing "Auld Lang Syne," having a good time saying goodbye to a bubble. Well, at least for Wall Street.

But don't tell that to the rest of America's 95 million Main Street investors, the folks who have to suffer through the hellish aftermath of a "pop!" The bear market, the recession, deflation, retirement nest egg wipe-outs ... like those painful memories from the last bust, that horrendous \$8 trillion 2000 to 2002 market wipe-out you're blocking.

Blocking? Yes, because every "pop!" has a "pop before the pop!"

A "pop before the pop?" Yes, before the economic/market bubble pops there's an inner psychological bubble in our brains that pops. Pushed to the limits, overstressed, overwhelmed, our mental wiring short-circuits and pops first. We go numb, into denial, zone out. That inner pop disconnects us from reality, unleashing a renewed blast of irrational exuberance that over-inflates the bubble, like the late-stage manic excesses of the nineties' "new economy."

That first pop has already happened. Americans are tuning-out. Little makes sense in America and the world today. So we go within to protect ourselves. As individuals, we retreat into our private world. As a nation we feel threatened, paranoid and deny the gathering storm, overreacting like arrogant schoolyard bullies.

Revolutionary new market for un-registered stocks

Main Street is a victim of post-traumatic stress disorder, numb. But Wall Street handles stress differently. Greed is a great aphrodisiac. Wall Street has invented an incredible new stress reliever to process the outrageous largess generated by their recent private equity deals, which are on track to top \$1 trillion this year. We know that barely a third of registered securities are traded publicly by individuals, the rest by institutions.

Now Wall Street has invented a revolutionary new market strategy exclusively for the trillions of unregistered securities they're selfishly creating. For example, Goldman Sachs' new GS TruE (for Tradable Unregistered Equity). Unfortunately, this further disconnects Main Street from Wall Street as the inequality gap widens, further inflating the bubble as frustrated Americans shift from investing to spending.

History is repeating itself. Remember Robert Shiller's classic, "Irrational Exuberance"? Its release was perfectly timed, a warning, hitting the market at the last peak in March 2000. Today several new publications from industry leaders are flashing similar neon signs, "Big Pop Coming!" Here are four:

1. Derivatives bubble

"A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation." Risk manager and derivatives guru Richard Bookstaber played a role in the 1987 crash and the 1998 LTCM collapse. In his new book he says the "financial markets that we have constructed have become so complex. And the speed of transactions so fast that apparently isolated actions and even minor events can have catastrophic consequences ... the odds are pretty high we'll see other dislocations that match the type of turmoil we saw with the crash in 1987."

2. Greed bubble

"Capital Ideas Evolving" is Peter Bernstein's follow-up to his pre-dotcom 1992 classic, "Capital Ideas," and his 1998 "Against the Gods: The Remarkable Story of Risk." Bernstein is a Wall Street legend. He examines the path taken by behavioral finance, modern portfolio and the efficient market hypothesis from academia to the frantic hi-speed, hi-tech everyday world of Wall Street.

But Business Week says Bernstein worries that derivatives are playing too big and dangerous a role because "there are a lot of inexperienced players using them." He hears the few winners, like Barclays, Goldman and Yale, "who say how difficult it is to beat the market and that it's getting more difficult." Meanwhile, the irrational exuberance of all the inexperienced masses continues blowing the bubble while "playing" with \$370 trillion in derivatives worldwide.

3. Global bubble

GMO, the global investment management firm, manages \$145 billion. Chairman Jeremy Grantham writes of his six-week trip around the world in GMO's latest Quarterly Letter: "The first truly global bubble: From Indian antiquities to modern Chinese art; from land in Panama to Mayfair; from forestry, infrastructure, and the junkiest bonds to mundane blue chips; it's bubble time!"

He warns of a global mega-pop coming: "Everyone, everywhere is reinforcing one another. Wherever you travel you will hear it confirmed that 'they don't make any more land,' and that 'with these growth rates and low interest rates, equity markets must keep rising,' and 'private equity will continue to drive the markets.' To say the least, there has never ever been anything like the uniformity of this reinforcement."

4. Speculative bubbles

"One Down, Many Yet to Fall" headlines the midyear report in economist Gary Shilling's Insight Newsletter. America's headed into a perfect storm: "An unusual confluence of five forces in recent years created a virtual world of financial speculation that departed spectacularly from the real economic world, the 'grand disconnect' we've called it." The five forces of "runaway speculation" are:

- Global liquidity, fueled by the housing bubble, trade deficits and excessive corporate cash, all being recycled.
- Investors' sense of entitlement to "20% annual returns each and every year," fueled by a long bull market.
- Recent lack of volatility coupled with belief the Fed will "bail them out" has "desensitized many investors."
- Investor risk appetite: "Aggressively taking huge risks in a wide variety of speculation."

- And the "the insatiable American consumer" on a 25-year spending binge, borrowing long-term to spend today, driven by instant gratification while savings dropped from 12% to zero.

Shilling still sees subprimes triggering the meltdown. But like Bernstein, Bookstaber and Grantham, he also feels the speculative excesses of the private equity deals may beat subprimes to the punch: "Just as the U.S. housing bubble is bursting, speculation elsewhere will come to a violent end, if history is any guide. Some astute pioneers, including Richard Bookstaber, who designed various derivative-laden strategies over the years, now fear that financial derivatives and hedge funds - focal points of today's huge leverage - will trigger financial meltdown."

The bottom line

If you're a bullish optimist, stick to Gross's quixotic upbeat vision in "Pop!" Look years into the future; past the widespread devastation of another extended bear market and recession into the promises of a "New Age" of innovations, prosperity, a roaring bull.

But if you're more of a realistic, conservative bear, heed Grantham's warning: "The bursting of the bubble will be across all countries and all assets, with the probable exception of high-grade bonds. Risk premiums in particular will widen. Since no similar global event has occurred before, the stresses to the system are likely to be unexpected. All of this is likely to depress confidence and lower economic activity."

GMO has \$145 billion at stake; they're planning ahead. Are you? ■