



EQUITIES

Bubble Logic: Or, How to Learn to Stop Worrying and Love the Bull

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A bull market, and the incentives of those who make their living from bull markets, can create its own form of logic. That logic, in turn, produces stories that encourage the purchase or retention of stocks or mutual funds. Some stories are honest attempts to explain new phenomenon, others to be unintended falsehoods based on faulty economic reasoning. Some seem less well intended.

The stories, and the analyses behind them, generally originate with Wall Street, sometimes riding academic coattails, and are often readily absorbed by investors engaged in wishful thinking. This has led them to bid up stocks — particularly in the growth/tech sector — so high that even very long-term investors will probably end up disappointed.

Put simply, there are really three possibilities for the broad market (with all three being more extreme for the growth/tech sector):

- 1 Investors understand and are now comfortable with a very low expected return on the stock market going forward.
- 2 We are in for an exceptionally long period of exceptionally high growth in real earnings that justifies today's market prices.
- 3 Most investors are not really thinking about either 1) or 2), but have swallowed the hype and slogans, focused on irrelevant short-term stories, or forced to be in stocks by circumstance (e.g., many mutual fund managers). All this is coming together causing a massive financial bubble. If true, it can only end with a tremendous market crash, or a very long period of stagnation.

The paper argues that 1 and 2 are highly unlikely. Unfortunately, that leaves 3.

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