MV Capital Management E-Update

The Bubble Decade

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It's still too early to start writing the historical perspective on this decade – the 00s or the 'Oughts or the Decade of Nought? It's a fairly educated guess, though, that when the talking heads of the future turn their attention back to our present the word "bubble" will percolate into the conversation. What an interesting time we've had of it so far – interesting, that is, in the sense of that old Chinese adage "may you live in interesting times". Indeed. At the dawn of the decade we had Internet pet food stocks selling over ten times sales with no profits as far as the eye could see. That party ended in an inglorious heap on the (virtual) floor, but no sooner could you say "1% Fed Funds rate" than a more pernicious bubble took shape – more serious because it affected the single most important asset on the household balance sheet, the home itself. Home prices soared, incomes stayed flat, and hucksters from subprime lending boiler rooms sprouted like mushrooms to entice aspiring homebuyers and condo-flippers with offers that sounded too good to be true – and proved to be just that.

So here we are in 2008, still very much in the thick of the soup that boiled over from the housing bubble, and already the notion is in the air that we are getting sucked into the vortex of yet a third '00s bubble. Seemingly in the blink of an eye the price of crude oil has more than doubled, surmounting successive barriers with increasing ease: $100, then $120, now closing in on $150. Of course the number that registers in our minds more than the price for a barrel of crude oil is the price for a gallon of gasoline, now sitting comfortably over $4 and becoming an ever-larger component of household budgets.

There is no question that $4 gas is painful – but does it mean that we are in the middle of a commodities bubble? On this question there is virtually no agreement – not among economic experts with their detailed breakdown of supply and demand variables, not among populist Congressional leaders ranting about the evils of unconstrained commodities hedge fund speculators. From equally plausible arguments we hear that the "natural" price of oil based on fundamental factors should be $60 per barrel, while from others we are told that the day of $200 oil is around the corner – get ready to shell out $7 or more for each gallon at the pump and dump that SUV while you still can.

What is a bubble, and how do we know if we are in one? One thing that practically all bubbles have in common is that they start from something real, something that makes sense. The Internet, which emerged in a commercial sense in the early 1990s, really did revolutionize the way people did so many things in their lives, contributed to a tremendous burst of productivity in the economy and breathed new life into the technology sector. It made sense that tech stock prices would go up. So when did the fundamental value of stocks in the New Economy of the mid-late 1990s turn into the dot-com bubble that blew up in 2000?

It is never really possible to pinpoint the location where price starts to decouple from value – which is essentially what a bubble is. When the price at which an asset trades in the market moves on a sustained trajectory away from any valid measure of its underlying value, and when this happens to a whole bunch of similar assets at the same time, then we are in a bubble, whether that asset is Dutch tulips or online grocery retailers or Miami condos.

The problem with pinpointing this – with saying: Aha! We are now entering bubble country! – is that the science of asset valuation is imprecise and subjective. Looking through the rear-view mirror it's easy to argue that the price of an Internet stock whose stock value was 10 times the value of its sales was decoupled from reality. At the time, though, all manner of intelligent-sounding equity analysts came up with new ways to measure value – New Economy buzzwords like "eyeballs" and "clicks" and "virtuous spirals." If we could just believe these metrics made some plausible sense then we could convince ourselves that prices could go higher still. The emotion of greed took over as ever-higher prices begat ever more frenzy. And of course there is no warning when the peak occurs – no red light that flashes to say "the end is at hand".

So the debate over commodities prices continues. Prices have soared in a very short time – and the time intervals between successive high points seem to be shortening. It took longer for oil to go from $90 to $100 late last year than it did to careen from $130 to $140, which seemed to happen almost overnight. That's one sign of a bubble gathering steam. Another sign is that flurry of junk email and one-page faxes that show up at your place of work. You know the ones – the large fonts, appalling grammar and seemingly endless number of exclamation points tacked onto every sentence, promising untold riches from commodity futures or drilling partnerships or some other enticing proposition. Photos of gas pumps appear on the covers of *Time* and *Newsweek*. You hear the phrase "it's different this time" a lot on the news shows.

Except that it never is different. Not with revolutionary technologies, not with real estate, not even with the hydrocarbon-based substance that powers the world's economies. No economic asset ever goes up and up in price without ever reverting to its long-term fundamental value. At MVCM we know that from time to time our portfolios will be exposed to assets that get caught up in bubble mania. Although we may make tactical moves that reflect shorter-term cyclical opportunities our focus is always on long-term value – and as long as we are convinced of the long-term rationale – for example holding commodities in our portfolios because of their attractive diversification properties – we feel confident in withstanding the whiplash effects of shorter-term manias. The manias will come and go. Truly, it never is different.

With warm regards,

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