Abroad

An Interview with Professor Robert Shiller

What's the next bubble?

The man who saw the folly of the Nasdaq written on the wall inspects the markets in search of risks you would never want to see materialized.

There has been much talk about the stock market "mania" of the 1990s, especially in hindsight. But few saw it before the crash. Among this latter group, Robert Shiller not only predicted the inevitable collapse, but also wrote a thoughtful and highly practical study of bubbles, in his famous book "Irrational Exuberance," a book that made Shiller one of the financial prophets of our time. Today, he thinks, "stocks are still expensive, although not in a dramatic way." Commodities have started to show some of the symptoms of a bubble, while home prices are definitely risky in certain areas.

Professor Robert Shiller

Robert Shiller is Professor of Economics at Yale University. He has written on financial markets, behavioural economics, macroeconomics, real estate, statistical methods, as well as on public attitudes and opinions regarding markets. An influential author, Professor Shiller has stressed the importance of developing instruments that allow individuals and market participants to manage risks in housing. The Chicago Mercantile Exchange has just introduced a housing futures index that factors such risks and is based on Shiller's studies.

It is six years since the Nasdaq peaked, which is actually not a very long time in terms of boom-bust cycles in financial markets. In other words, many required a longer time to digest the excesses. Can you offer a conceptual framework for understanding the course of future events as regards US stocks?

"Of course it is hard to predict. I do not have a sharp forecast as I had in 2000 for the Nasdaq. Back then, the stock market was in a dramatic situation."

Would you say Wall Street is cheap, fair-valued, or expensive?

"The market has responded to an important progress in corporate earnings. However, I suspect participants have over-responded, and consequently the price/earnings ratio (p/e, ed.note) is high. Especially if you calculate it the way I do, which divides the price by a long-moving average of earnings. This way the p/e is quite high, although not as much as in 2000. Overall, I still think the market is likely to disappoint as an investment."

I call from Europe and I note that the rebound in US stocks has been almost neutralized by the decline of the dollar versus the euro. Meanwhile, some old leaders such as Microsoft or Dell continue to deflate badly in euros. Any comments?

"Yes, that is why I invest more in Europe and abroad than I do at home. I think the dollar has a good chance to depreciate even further and so I am not particularly bullish on America."

Let's shift to commodities. I have read your observation that "commodities markets resemble the technology stock bubble of the 1990s." Could you elaborate a little bit on this?

"Well, actually, I am not calling it a bubble, but I think a lot of commodities are moving according to a thesis that can lead or that has led to a bubble. The thesis is both magnetic and straightforward: the demand emerging from the opening up of China and India cannot be matched by an appropriate supply. You always need a simple, engaging and agreeable thesis to build up a self-reinforcing trend. The problem presents itself when you push the reasoning to the limit and buy and buy."

But you are not sure that limit has been reached, are you?

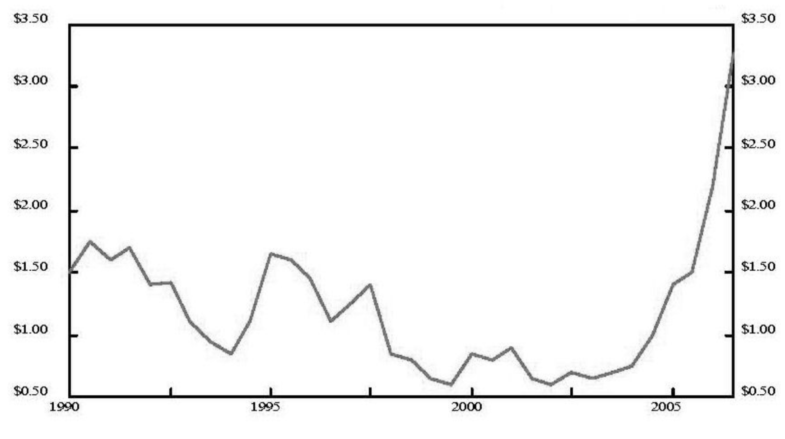
"There is an exaggerated attention to the thesis, I mean the China and India story. Of course, the story is true; the vulnerability arises if people over-react. But yes, you are right. My analysis is tempered by the insight that it is very hard to understand what the price of these commodities should be in the existing context."

Some argue we are back to the '70s. Would you agree with that?

"To some extent, I would agree. The oil boom was then associated with what was called the great population scare. People thought that the world

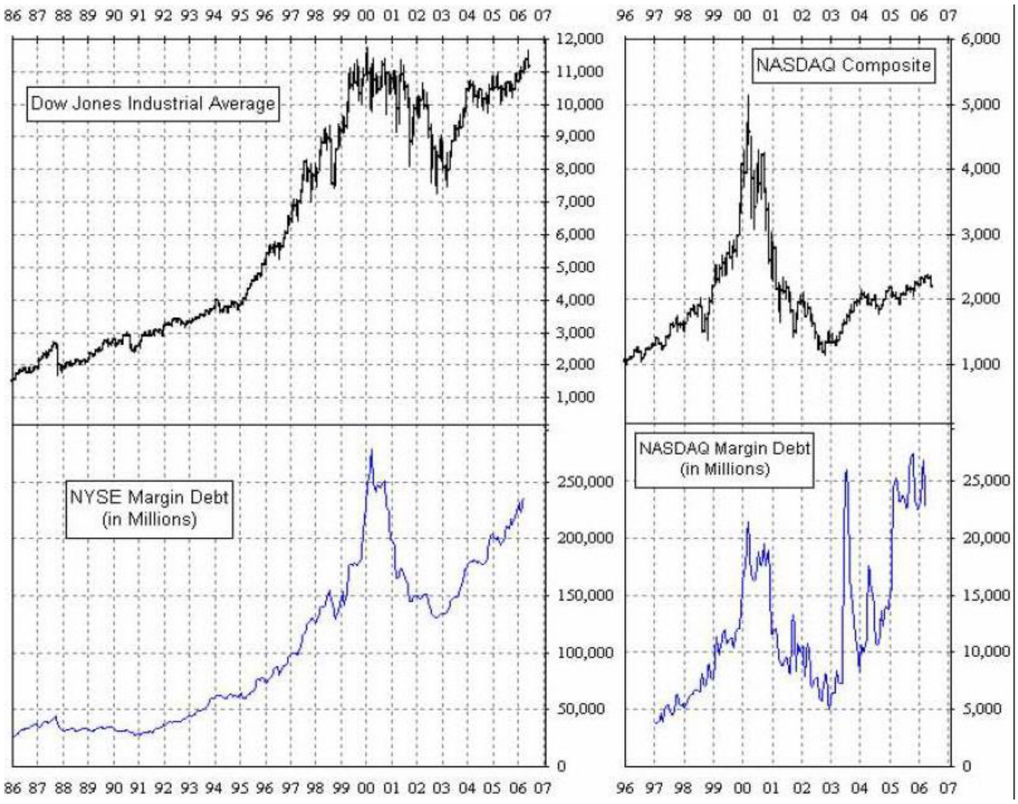
A bubble for natural resources?

Copper Price 1990 to date



Like many other commodities, copper has been skyrocketing

Margin Debt Surpasses 2000 Peak



Louise Yamada called our attention to a slightly alarming scenario as regards margin debt and Wall Street and offered the two charts on the left to support her view. Ms Yamada was head of technical analysis for Smith Barney, before founding her own company in 2005. She argues that the roller coaster ride of stocks over the last few weeks "raises the spectre of the possibility of margin calls," because statistics show a high level of margin debt. "In the case of the NYSE," she explains, "margin debt levels are close to those of 2000; in the case of the Nasdaq, margin levels are even higher than those in place in 2000." She concludes, "it is an overhang that could prove problematic in a rapid decline, as seen in the Indian equity market a couple of days ago."

Source:www.lyadvisors.com

population was getting out of control and the trend would exert a pressure on resources. It was part of the reason why we had two oil crises, in my opinion. This time the story hinges on the development of a large part of the world that had been lagging rather than on population growth, but there are many similarities of course."

Bulls usually express their reasoning in a very cogent way. They say: "we know where the new demand for oil is coming from, but we do not know where the new oil should come from." Do you have an answer?

"No, I do not have an answer. Perhaps the answer will come from the development of nuclear power, oil sands, ethanol, etc. and by economizing our needs. Also a global warming danger is surfacing. We have to operate within environmental constraints. Ultimately, these challenges must be addressed and our response may contain the demand for oil and keep the price in line."

The bulls would reply to your arguments: yes, but everything you mentioned is at best a few years away. And in the meantime, energy prices can keep on rising…

"I know, I know. My contention is that if we establish a clear policy now, the outlook can affect the price of oil today. In fact, the issue is the long-term one about running out of oil; and if we are aware that an alternative does exist, prices are likely to go down sooner than later."

The Chicago Mercantile Exchange launched on Monday, May 22, futures contracts based on indexes of home prices from research started by you and

Professor Karl Case. You expressed concern on the prospects for home prices. Are you still worried?

"Yes, the outlook for housing in the United States and abroad is very uncertain. That is why we have created a market for home prices. In any case, you are right, I have a bearish bias. I lean toward a hard landing scenario for some of the regions where prices have gone up dramatically. As an example in Los Angeles between 1989 and 1997 real prices corrected by 40 per cent and I suspect a comparable rectification could happen again in certain areas."

Can you mention any names?

"Cities where prices have shot up a lot, including San Diego, Phoenix, Las Vegas and Miami. Buyers and sellers are moved by psychology, which is so hard to predict. A good reason to have a market for home prices."

Do you see any signs that the upward trend for real estate may be approaching its top?

"Inventory. Homes for sale have increased a lot in the last 6 months, which could prepare the ground for a reversal."

Some argue that if housing and stocks suffered a setback, the Federal Reserve would cut rates aggressively because consumption is asset-driven. Do you share this view?

"I believe so. Bernanke is trying to follow Greenspan's footsteps (Ben Bernanke is the current Chairman of the Federal Reserve and Alan Greenspan his predecessor, ed. note). His policy consists of cutting rates before it gets too late. Remember that in 2003, when the great deflation scare materialized, he was publicly concerned about the possibility of a liquidity trap."

However, right now the economy looks quite strong.

"I am not going to contest your assertion. But I see a vulnerability in the real estate market. Should it drop, then a vibrant activity could easily turn into a decline. An indicator I am looking at is the consumer sentiment, which is giving ground. It seems to be falling in part on account of high oil prices and in part because housing is cooling."

Wouldn't it be dangerous to cut rates in a commodity bull market?

"Yes, this is the problem. We might even enter a stagflation regime again. If energy continues to develop its own momentum and the economic trend turns down, the Central Bank will be confronted with difficult choices."

Professor Shiller, thank you for your time.

V.S.