Popular Economics Weekly

WEEK OF NOVEMBER 7, 2005—MARKET BUBBLES

A recent Nobel Laureate, Daniel Kahneman (Economics), illustrates why so-called asset bubbles occur—whether in stocks or real estate. Professor Kahneman is a psychologist who studies economic behavior. In the words of CBS Marketwatch columnist Paul Farrell, Kahneman discovered that it is our brain that misinterprets markets and their data. It is not the markets that mislead, in other words.

Why? Kahneman found that we invent stories to fit the facts, rather than let facts dictate stories. The brain can be a very bad computer, "irrational, clueless, extremely vulnerable to mistakes," says Farrell per Kahneman. Overconfidence is one such pitfall when playing the markets. If we win something (or sell a property at a high price), for example, the brain tends to become less cautious. So we take bigger risks and his research says we usually wind up losing.

Japan is the best illustration of the consequences of market bubbles, since it is still recovering from its 1990-91 bursting of both real estate and stock market bubbles. You may remember when Tokyo's real estate prices rose to such absurd heights in the 1980s that a single Tokyo skyscraper was once valued for as much as all of New York City (which was in recession, albeit)!

Kahneman maintains that no one can really beat either financial or real estate markets over the long term. It is more due to luck that some make excessive profits. We will do best to invest automatically in broad, market indexes and diversify. "The idea that I can see what no one else sees is an illusion," says Kahneman.

This means each of us sees and understands events according to our predilections and prejudices. The Oct. unemployment rate is one such example. It is perhaps the most closely watched indicator of economic health these days because job growth has been below expectations for more than 3 years, yet we are near full employment. Every other post-war economic expansion after a recession has added an average one million more jobs per year than the current recovery (2002 to the present).

As an illustration, just 56,000 seasonally adjusted payroll jobs were added to the rolls in October and the unemployment rate fell back to 5 percent. This is after September's payrolls had shrunk by 8,000 jobs. "Non farm payroll was little changed in October," summarized Kathleen Utgoff, Commissioner of the Bureau of Labor Statistics. "…job growth in the remainder of the country (outside of hurricane-damaged areas) appeared to be below trend in October."

Yet Barron's Gene Epstein sees the glass half full, since the 5 percent unemployment rate tops the 5.5 percent rate at this time (1995) in the previous expansion. So, which 'illusion' is it? In fact, 76.9 million have chosen not to work (or look for work) in this expansion, says Epstein, or the unemployment rate would be higher. This is because those not working, or looking for work, are not counted in the workforce from which the unemployment rate is calculated!

Such statistics only make a difference to the Federal Reserve, since the unemployment rate is one measure of whether an economy is near or at full capacity.

Their indicator is called the NAIRU, or Non-accelerating Inflation Rate of Unemployment. This means when unemployment drops below the NAIRU rate—it is 5 percent at present—the Fed Governors' believe that inflation will begin to accelerate. The Fed believes that at the NAIRU full employment rate, consumers tend to have so much money in their pockets that they will drive up prices faster than goods can be produced to satisfy said demand. That is the major reason why the Fed has continued to raise interest rates.

CONSUMER CREDIT—Consumer credit was unchanged in September, reported the Federal Reserve, with an increase in revolving credit (i.e., cards) offset by a decrease in non revolving credit (e.g. auto loans). Outstanding consumer debt rose just 3.25 percent in the third quarter, excluding mortgage debt. This statistic is important, since it shows consumers cutting back on spending, in part a result of higher interest rates.

CONSUMER CONFIDENCE—The U. of Michigan survey rebounded somewhat from October's 13-year low. It is hard to take the rebound seriously, though, since only the current conditions index improved due to lower gas prices. Future expectations are still in the dumps due to higher interest rates and still high energy prices.

There is little doubt that we are at the peak of this business cycle. Housing prices are beginning to level off, and for sale inventories of both new and existing home are rising. We are also beginning to see bottlenecks in other business sectors, indicating short supplies so that inflation could take hold in the overall economy.

So how can an investor get a realistic picture of market conditions? Here are some pointers from Farrell/Kahneman:

*__Distrust all data__—This means don't accept everything you hear or see at face value. Look behind the faces reporting that information. They may be trying to sell you something.

*__Don't follow the herd__—Herd behavior, or allowing others to override you own common sense judgment—is a major cause of misjudgment. A hot investment always cools down.

*__Don't obsess over investments__—Behavioral psychologists have discovered that those who check their accounts often are more anxious and so bigger losers, believe it or not.

*__Don't trust investment gurus__—Your own common sense is usually the best indicator of what is best for you. If you don't understand it, don't buy it, in a word. Guru's usually work for someone else.

__*Look at the big picture__—Don't neglect the forest for its trees. Study the overall health of an economic sector, before deciding to invest in that sector. Don't fake it, in other words, or convince yourself that you know something when you don't.

Much of irrational behavior could be a result of an increasingly complex world. There are so many choices to make, and sometimes so little time to make them. Yet our brains have evolved from the Stone Age less than 100,000 years ago. Only the most basic arithmetic addition and subtraction functions were understood by most of us less than one hundred years ago—fractions not at all—according to psychologist Steven Pinker in his best-seller, “The Blank Slate—The Denial of Human Nature and Modern Intellectual Life.”

And so we come to Honest Abe Lincoln’s most famous quote: “ You can fool all the people some of the time, and some of the people all the time, but you cannot fool all the people all the time.” It is still a timeless assessment of human nature.